

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.

Cavalier Wool Holdings Limited and New Zealand Wool Services International Limited

The Commission: Dr Mark Berry
Sue Begg
Dr Stephen Gale
Anna Rawlings

Summary of application: Cavalier Wool Holdings Limited (Cavalier) seeks authorisation for Cavalier (or an interconnected body corporate) to acquire control over New Zealand Wool Services International Limited’s (NZWSI) wool scouring business and assets (whether by way of acquiring shares in the wool scouring subsidiaries, or assets, or both).

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. 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. Therefore, the Commerce Commission’s preliminary view is that it would be likely to grant authorisation for the acquisition pursuant to section 67(3)(b) of the Commerce Act 1986.

**Date of Draft
Determination:** 26 March 2015

Confidential material in this report has been removed. Its location in the document is denoted by [].

CONTENTS

THE APPLICATION	5
PRELIMINARY VIEW	5
NOMENCLATURE	5
CONSIDERATION FOR THE ACQUISITION	5
WHAT WE HAVE BEEN ASKED TO AUTHORISE	5
RATIONALISATION OF WOOL SCOURING PLANTS	6
HOW THE ACQUISITION MIGHT AFFECT COMPETITION	7
STATUTORY FRAMEWORK	7
ANALYSING THE COMPETITION EFFECTS OF A MERGER.....	8
<i>When a lessening of competition is substantial</i>	9
<i>When a SLC is likely</i>	9
ANALYSING THE BENEFITS AND DETRIMENTS OF A MERGER.....	9
COMMISSION PROCEDURES	9
PARTIES	10
THE ACQUIRER – CAVALIER.....	10
THE TARGET – NZWSI (WOOL SCOURING BUSINESSES)	11
OTHER RELEVANT PARTIES	11
GODFREY HIRST	11
WOOL MERCHANTS.....	11
BEEF + LAMB NEW ZEALAND.....	12
INDUSTRY BACKGROUND	12
REDUCTION IN THE TOTAL WOOL CLIP AND VOLUMES OF SCURED WOOL	13
<i>Decrease in the total wool clip since Decision 725</i>	13
<i>Decrease in the volumes of wool scoured since Decision 725</i>	14
PREVIOUS DECISIONS, THE HIGH COURT JUDGMENT, AND NZWSI’S SUBSEQUENT SALE	14
DOES CAVALIER BREMWORTH HAVE A SUBSTANTIAL DEGREE OF INFLUENCE OVER CAVALIER? ..	15
MARKET DEFINITION	16
WOOL SCOURING	17
WOOL GREASE.....	17
WOOL AND SYNTHETIC CARPETS	19
THE RELEVANT MARKETS	20
WITH THE ACQUISITION	20
WITHOUT THE ACQUISITION	21
COMPETITION ANALYSIS	21
NORTH AND SOUTH ISLAND WOOL SCOURING MARKETS	21
<i>Existing competition - constraint from NZWSI</i>	22
WOULD EXPORTS OF GREASY WOOL TO CHINA CONSTRAIN NEW ZEALAND WOOL SCOURING PRICES?	23
THE AUSTRALIAN EXPERIENCE	26
POTENTIAL ENTRY	27
<i>Production site with necessary consents</i>	28
<i>Scouring equipment</i>	29
<i>Access to sufficient quantities of wool</i>	29
THE LET TEST	30
<i>Likelihood</i>	30
<i>Extent</i>	31
<i>Timely</i>	32
<i>Conclusion on the LET Test</i>	32
CONCLUSION ON NORTH AND SOUTH ISLAND WOOL SCOURING MARKETS.....	32
EFFECTS OF THE ACQUISITION IN THE WOOL GREASE MARKETS.....	33
<i>Large wool grease customers</i>	33
<i>Conclusion on large customer wool grease market</i>	34
<i>Small customer wool grease market</i>	34

<i>Conclusion on small customer wool grease market</i>	35
EFFECTS OF THE ACQUISITION ON THE DOWNSTREAM CARPET MARKET	35
PUBLIC BENEFITS AND DETRIMENTS	36
QUANTIFICATION	37
DETRIMENTS.....	39
LOSS OF ALLOCATIVE EFFICIENCY	39
<i>Potential scouring price increase</i>	40
<i>Price discrimination</i>	41
<i>Consideration of loss of allocative efficiency</i>	42
<i>Possible responses to price increases</i>	44
<i>Estimating the potential loss of allocative efficiency</i>	45
LOSS OF PRODUCTIVE EFFICIENCIES	45
<i>Increased supply risk</i>	46
LOSS OF DYNAMIC EFFICIENCY	47
<i>Others views</i>	48
<i>Commission’s preliminary assessment</i>	48
<i>Quantification of loss of dynamic efficiency</i>	49
BENEFITS	49
PRODUCTION EFFICIENCIES.....	49
NON-CAPITAL COSTS SAVINGS – ECONOMIES OF SCALE BENEFITS.....	49
<i>Rationalisation of plant</i>	49
<i>Total non-capital savings attributable to the transaction</i>	50
<i>Reduction in salaried and wage staff costs</i>	50
<i>Reduction in administration expenses</i>	51
<i>Reduction in repairs and maintenance costs</i>	51
<i>Reduction in variable electricity costs and electricity lines charges</i>	52
<i>Reduction in coal and gas costs</i>	52
<i>Reduction in effluent system costs</i>	53
<i>Total non-capital cost savings</i>	53
SALE OF SURPLUS LAND	53
SALE OF SURPLUS PLANT.....	54
CAPITAL COSTS OF RATIONALISATION AND ONGOING CAPEX SAVINGS.....	54
<i>Capital expenditure on buildings</i>	54
CAPITAL EXPENDITURE ON PLANT	54
<i>One-off rationalisation costs</i>	55
WEALTH TRANSFERS TO AND FROM NON-NEW ZEALANDERS.....	55
<i>Residency status of relevant groups</i>	57
<i>Economic incidence of price increases</i>	58
<i>Magnitude of wealth transfers</i>	60
BALANCING OF BENEFITS AND DETRIMENTS.....	62
THE COMMISSION MUST BE SATISFIED	64
THE COMMISSION’S ANALYTICAL METHOD.....	64
APPLYING THIS ANALYTICAL METHOD	65
DRAFT DETERMINATION	67

The application

1. On 23 October 2014, the Commission registered an application from Cavalier Wool Holdings Limited (Cavalier) seeking authorisation for Cavalier (or an interconnected body corporate) to acquire control over New Zealand Wool Services International Limited's (NZWSI) wool scouring and wool grease by-product business and assets (whether by way of acquiring shares in the wool scouring subsidiaries, or assets, or both) (the acquisition).
2. The application relates to the same wool scouring assets that were the subject of an authorisation the Commission granted to Cavalier in 2011.¹ The acquisition that was authorised did not proceed.

Preliminary view

3. The Commerce Commission's preliminary view is that it would be likely to grant authorisation for the proposed acquisition pursuant to section 67(3)(b) of the Commerce Act 1986.

Nomenclature

4. Throughout this document we refer to Cavalier Wool Holdings Limited as Cavalier and the merged wool scouring and wool grease entity as CWH.
5. In the wool industry various terms are used to describe wool merchants including wool brokers, wool traders and wool exporters. In this document we refer to them as wool merchants.

Consideration for the acquisition

6. In consideration for Cavalier's acquisition of the shares in NZWSI's Kaputone Wool Scour (1994) Limited and Whakatu Wool Scour Limited, the merged entity will issue shares to NZWSI. The shares in NZWSI will then immediately transfer to a wholly-owned subsidiary of Lempriere (Australia) Pty Limited (Lempriere). As a result, CWH would be held:
 - 6.1 45% by Lempriere;
 - 6.2 27.5% by Cavalier Bremworth Limited (Cavalier Bremworth);
 - 6.3 13.75% by Accident Compensation Corporation (ACC); and
 - 6.4 13.75% by Direct Capital Limited (Direct Capital).
7. See **Attachment 1** for a diagram of the post-transaction structure.

What we have been asked to authorise

8. In this determination, we are considering Cavalier's acquisition of the wool scouring business of NZWSI. As set out in the application² and noted above, in consequence of

¹ Cavalier Wool Holdings Ltd and New Zealand Wool Services International Ltd (Commerce Commission Decision 725, 9 June 2011) (Decision 725).

² At [4.3] and Executive Summary of the Application.

that acquisition, and in consideration for the sale of the shares in the wool scouring business, NZWSI (ultimately Lempriere) will acquire 45% of the shares in CWH (the Lempriere aspect).

9. While the acquisitions are interdependent and are contained in the same transaction document, the acquisition by Cavalier of the shares in NZWSI's wool scouring business is the only acquisition for which authorisation has been applied for under section 67 of the Commerce Act 1986 (the Act). No application for clearance or authorisation has been received in respect of NZWSI's acquisition of a 45% shareholding in CWH and so the section 47 competition effects of this Lempriere aspect are not considered in this Draft Determination.
10. Nonetheless, given that the Lempriere aspect appears to be an indivisible part of the commercial transaction, (provided that Lempriere's acquisition of shares does not breach the Act), as we do when considering the effects of any potential merger, the Commission has had regard to any relevant implications following from the Lempriere aspect as part of the facts and circumstances it must consider in this Draft Determination.

Rationalisation of wool scouring plants

11. Following the acquisition, CWH intends to rationalise NZWSI's scouring assets. Cavalier currently has three scour lines in the North Island (two 2.4 metre scour lines at Awatoto and one 2.0 metre line at Clive (in Hawke's Bay)) and two scour lines at Timaru South (one 3.0 metre scour line and one 2.4 metre scour line). NZWSI has a 3.0 metre scour located at each of Whakatu in Hawke's Bay in the North Island and Kaputone near Christchurch in the South Island.
12. The rationalisation will see CWH:
 - 12.1 closing NZWSI's scours at Kaputone and Whakatu;
 - 12.2 relocating NZWSI's scour lines at Kaputone and Whakatu to Cavalier's existing scouring plants at Timaru and Awatoto; and
 - 12.3 decommissioning the scour line at Clive and the 2.4 metre line at Timaru.
13. As part of the transaction, Lempriere will be obliged to impose covenants on the Whakatu site in the hands of a new owner, to exclude future wool scouring or related activities at the site for a period of 50 years.
14. The Clive site will be closed and the plant, land and buildings will be sold. CWH will similarly be required to impose covenants³ on the Clive site to exclude future wool scouring activity there.
15. The merged entity will also sell Lempriere's Kaputone site with the same 50 year covenants that ensure the use of the site excludes wool scouring or related activities.

³ For a period of 50 years.

How the acquisition might affect competition

16. By reducing the number of scouring firms from two to one, the acquisition would create a single provider of scouring services in both the North Island and South Island markets. Contingent on the level of competitive constraint provided by offshore scourers and/or the ability of wool merchants to export greasy wool, the merged entity could use any market power that it had to raise scouring prices and/or lower its service quality including scouring standards or timeliness.
17. The acquisition would also bring together the only two producers of wool grease in New Zealand. Although most wool grease is exported, there is a small amount that is sold domestically, chiefly to one New Zealand buyer. Post-acquisition this buyer would have no ability to source wool grease from competing domestic suppliers. The ability of the merged firm to increase the price of wool grease to domestic customers would depend on the degree of constraint provided by wool grease imports.
18. The proposed acquisition could also give rise to foreclosure in the downstream carpet manufacturing market. Because of Cavalier's stake in the monopoly scouring company, it may have both the incentive and ability to effectively provide its 27.5% shareholder carpet manufacturing firm, Cavalier Bremworth, with preferential scouring rates. This would provide Cavalier Bremworth with a cost advantage over its primary rival in the domestic market, Godfrey Hirst.
19. Such a cost disadvantage for Godfrey Hirst could render it a less effective competitor and either reduce its market share or drive it from the market completely. Whether such a result would allow Cavalier Bremworth to gain market power in the carpet market (and so have an incentive to raise costs in this way in the first place), would depend on the extent to which imported wool carpets and/or synthetic carpets (whether manufactured here or overseas) provide a sufficient competitive constraint on the domestic carpet manufacturing market.

Statutory framework

20. Any person who proposes to acquire assets of a business or shares and considers that the acquisition may breach section 47 of the Act can make an application for an authorisation under section 67 of the Act.
21. 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.⁴ If the Commission is not so satisfied, clearance must be declined, although it may still grant an authorisation under section 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."
22. 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, or the Commission

⁴ The Commission's approach to assessing whether a merger is likely to give rise to a substantial lessening of competition is set out at paragraphs 25 to 34 below.

is in doubt⁵ as to whether there is a real chance that the acquisition will create public benefit, it must decline an authorisation under s 67(3)(c).

23. 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.⁶
24. 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. An extension of time is currently being negotiated with the Applicant and will be posted on the Commission's website.

Analysing the competition effects of a merger

25. Our approach to analysing the competition effects of the proposed acquisition is based on the principles set out in our Mergers and Acquisitions Guidelines.⁷
26. As required by the Act, we assess acquisitions using the substantial lessening of competition (SLC) test.
27. We determine whether an acquisition is likely to substantially lessen competition in a market by comparing the likely state of competition if the acquisition proceeds (the scenario with the acquisition, often referred to as the factual), with the likely state of competition if the acquisition does not proceed (the scenario without the acquisition, often referred to as the counterfactual).⁸
28. We make a pragmatic and commercial assessment of what is likely to occur in the future with and without the acquisition based on the information we obtain through our investigation and taking into account factors including market growth and technological changes.
29. A lessening of competition is generally the same as an increase in market power. Market power is the ability to raise price above the price that would exist in a competitive market (the 'competitive price'),⁹ or reduce non-price factors such as quality or service below competitive levels.
30. Determining the scope of the relevant market or markets can be an important tool in determining whether a SLC is likely.
31. We define markets in the way that we consider best isolates the key competition issues that arise from the acquisition. In many cases this may not require us to precisely define the boundaries of a market. A relevant market is ultimately

⁵ *Commerce Commission v Woolworths Limited* (2008) 12 TCLR 194 (CA) at [98] and [107]. In *Woolworths* the Court said that the existence of a "doubt" corresponded to a failure to exclude a real chance of a substantial lessening of competition. It went on to note that the Commission and thus the Court should approach the giving of a clearance by direct reference to the statutory test, that is by granting a clearance only if satisfied that a substantial lessening of competition is not likely.

⁶ *Commerce Commission v Southern Cross Medical Care Society* (2001) 10 TCLR 269 (CA) at [7].

⁷ Commerce Commission, *Mergers and Acquisitions Guidelines*, July 2013.

⁸ *Woolworths* (CA) above n 5 at [63].

⁹ Or below competitive levels in a merger between buyers.

determined, in the words of the Act, as a matter of fact and commercial common sense.¹⁰

When a lessening of competition is substantial

32. Only a lessening of competition that is substantial is prohibited. A lessening of competition will be substantial if it is real, of substance, or more than nominal.¹¹ Some courts have used the word ‘material’ to describe a lessening of competition that is substantial.¹²
33. Consequently, there is no bright line that separates a lessening of competition that is substantial from one that is not. What is substantial is a matter of judgement and depends on the facts of each case. Ultimately, we assess whether competition will be substantially lessened by asking whether consumers in the relevant market(s) are likely to be adversely affected in a material way.

When a SLC is likely

34. A SLC is ‘likely’ if there is a real and substantial risk, or a real chance, that it will occur. This requires that a SLC is more than a possibility, but does not mean that the effect needs to be more likely than not to occur.¹³

Analysing the benefits and detriments of a merger

35. The Commission’s approach to assessing the benefits and detriments arising from a merger is set out in the benefits and detriments section which begins on page 37.

Commission procedures

36. This Draft Determination has been prepared to assist the Commission in considering the application. In preparing this Draft Determination, the Commission has obtained information from a wide range of sources. In the course of this process, the Commission has amongst other actions:
- 36.1 reviewed the information and analysis in the application, including the economic report submitted by the applicant’s economic experts;
 - 36.2 posted a public version of the application on the Commission website;
 - 36.3 sought further information and clarification from Cavalier on a range of subjects;
 - 36.4 interviewed Cavalier and other interested parties; and
 - 36.5 considered submissions from Cavalier and Godfrey Hirst including economic evidence.
37. Having completed this initial research and investigation, we now seek written submissions on the Draft Determination on or before 5pm Tuesday 21 April 2015.

¹⁰ Section 3(1A). See also *Brambles v Commerce Commission* (2003) 10 TCLR 868 at [81].

¹¹ *Woolworths & Ors v Commerce Commission* (2008) 8 NZBLC 102,128 (HC) at [127].

¹² *Ibid* at [129].

¹³ *Ibid* at [111].

38. Section 69B of the Act provides that the Commission may determine to hold a conference prior to making a final determination. We have not currently scheduled a conference in respect of this matter. However, we may revisit this decision following receipt of submissions on this Draft Determination.
39. Aside from Godfrey Hirst, only two other parties have expressed concern in respect of the proposed acquisition. A submission from wool grower expressed concern that the likely effect of the merger would be “higher costs for growers as a consequence of increased scouring charges to competing wool exporters”.¹⁴ In addition, the Central Region of the Alpaca Association of New Zealand (AANZ) expressed concern about the availability of scouring services for niche and small volume animal fibres should the scouring capacity in New Zealand be reduced.¹⁵
40. Pursuant to an Official Information Act request, where possible we have provided Godfrey Hirst, and/or its counsel and economic experts with relevant submissions for their consideration. We have also taken Godfrey Hirst, Mr Plowman, and the AANZ’s views into account when conducting our analysis.

Parties

The acquirer – Cavalier

41. Cavalier is 50%-owned by Cavalier Bremworth, which is itself a wholly-owned subsidiary of NZX-listed Cavalier Corporation Limited (together, the Cavalier Group). See the ownership and subsidiaries of CWH at **Attachment 2**.
42. The Cavalier Group is involved in the manufacture of woollen and wool blend carpets in New Zealand (through its subsidiaries Cavalier Bremworth and Norman Ellison Carpets Limited (Norman Ellison)).
43. The Cavalier Group also ultimately owns Elco Direct Limited (Elco Direct), a wool procurement business, which is a service provider to both the wool industry and the Cavalier Group’s carpet businesses. Elco Direct has wool buyers covering all major wool growing regions in the Central North Island.
44. The remaining 50% of Cavalier is owned in equal parts by the ACC and Direct Capital. The interests of both parties are represented by one director on the CWH Board.
45. Cavalier, through its wholly owned trading subsidiary Cavalier Woolscourers Limited (which trades as Hawke’s Bay Woolscourers and Canterbury Woolscourers), owns and operates wool scours in Awatoto, Clive and Timaru. Utilising these scours, Cavalier cleans and processes greasy wool for domestic and export markets on behalf of New Zealand wool buyers and carpet manufacturers. Hawke’s Bay Woolscourers also scours all of the Cavalier Group’s carpet wool requirements.
46. Cavalier also refines and supplies wool grease. Most of its wool grease is exported. While it has a few domestic customers, it only supplies one domestic customer on a regular basis.

¹⁴ Wool grower submission, 28 November 2014.

¹⁵ Central Region of the Alpaca Association of New Zealand submission, 25 February 2015.

The target – NZWSI (wool scouring businesses)

47. Lempriere, the owner of NZWSI, is an Australian based global business which is involved in the wool industry. In Australia it is a merchant supplier of mainly fine wools. It also has businesses in the United States of America, Argentina and South Africa, and is one of the world's major suppliers of fine wool to European, Japanese and American fashion houses.
48. In March 2013, Lempriere acquired NZWSI which as discussed, operates scouring businesses at Whakatu in the North Island and Kaputone in the South Island. NZWSI is also the largest wool merchant in New Zealand, supplying wool primarily for export to a number of overseas countries, including India and China.
49. Lempriere recently acquired J S Brooksbank & Co (A'asia) Ltd (J S Brooksbank), a New Zealand wool merchant and J S Brooksbank is now a wholly owned subsidiary of NZWSI. In addition, NZWSI has a 50% shareholding in Rural Wool-Link Limited (RWL) which buys wool from wool growers and supplies wool merchants.¹⁶ NZWSI's wool merchant businesses including J S Brooksbank and NZWSI's shareholding in RWL will remain with NZWSI post-acquisition.
50. NZWSI also refines and supplies wool grease. Currently NZWSI exports its wool grease, although it has recently received a forward order from a domestic customer.
51. The ownership and subsidiaries of NZWSI are set out in **Attachment 3**.

Other relevant parties

Godfrey Hirst

52. Godfrey Hirst is an Australian owned manufacturer of woollen and synthetic carpets in New Zealand and is a purchaser of scoured wool. The company previously owned and operated wool scouring plants at Clive and Clifton (near Invercargill), but these were purchased by interests associated with Cavalier in March 2009.
53. Godfrey Hirst's purchases of scoured wool have [] since Decision 725. At that time in June 2011, Godfrey Hirst's demand for scoured wool was around [] per annum. In the 2013/2014 year, Godfrey Hirst purchased around [] of scoured wool, [].

Wool merchants

54. There are a number of merchants that are involved in the purchase of wool by auction, direct from growers, and/or in the case of slipe wool,¹⁷ from meat processors for sale to local and overseas customers. These merchants include Segard Masurel (NZ) Ltd (Segard Masurel), J S Brooksbank, H Dawson Sons & Co Wool NZ Ltd (H Dawson), Bloch & Behrens Wool (NZ) Limited (Bloch & Behrens), and Fuhrmann NZ (1983) Ltd (Fuhrmann). Wool merchants are the major customers of wool scourers, but also engage in the sale of greasy (ie, unscoured) wool, particularly to China.

¹⁶ Rural Wool-Link Limited is a wool buyer in the North Island that on-sells wool to NZWSI.

¹⁷ 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.

55. As stated above, NZWSI owns J S Brooksbank, one of the larger wool merchants in New Zealand.

Beef + Lamb New Zealand

56. Beef + Lamb New Zealand Ltd (Beef + Lamb New Zealand) is a promotor of beef and lamb within New Zealand. It is jointly funded by farmers, New Zealand retailers, and New Zealand processors.
57. As part of its operations, Beef + Lamb New Zealand provide statistical data and reports via its Economic Services Branch.¹⁸

Industry background

58. Wool produced by farmers is sold mainly by auction, with the remainder sold directly to buyers by private treaty/contract. Wool merchants comprise the major purchasers of the wool produced by farmers. Additionally, wool merchants purchase slipe wool.
59. As outlined in Cavalier's application, wool produced in New Zealand is either:
- 59.1 scoured and used in New Zealand for the manufacture of carpet, yarn or apparel (8% of the wool clip – was 17% in 2011);
 - 59.2 scoured and exported as clean wool (65% of the wool clip – was 61% in 2011);
or
 - 59.3 exported as un-scoured greasy wool (27% of the wool clip – was 22% in 2011).
60. **Attachment 4** shows the different functional levels in the movement of wool.
61. Wool scouring essentially involves the:
- 61.1 blending of various types of wool to meet an end quality specification – quality means fibre strength, length and diameter, colour, brightness and cleanliness;
 - 61.2 opening of the fibres by a flail process to allow full contact between fibres and washing liquid;
 - 61.3 washing (and sometimes bleaching) the wool in hot water and detergent;
 - 61.4 drying;
 - 61.5 extraction of wool grease;
 - 61.6 testing for correct specification; and
 - 61.7 high pressure packing into bales.

¹⁸ Interview with Cros Spooner, COO of Beef + Lamb New Zealand, 24 November 2014.

62. Wool scouring services are typically provided on a commission basis. Ownership of the wool is retained by the wool merchant, who pays a fee for the wool to be scoured and in some cases delivered to the next destination. In the case of NZWSI, which is a vertically integrated merchant scourer, the ownership of the wool is retained by its merchant division throughout the scouring process
63. 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.

Reduction in the total wool clip and volumes of scoured wool

64. The size of the wool scouring industry is 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 29.8 million¹⁹ at present has been accompanied by a significant reduction in the wool clip. 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 and consequently volumes of wool scoured.
65. **Attachment 5** outlines the 2014 estimated volumes of wool flows in New Zealand.

Decrease in the total wool clip since Decision 725

66. The Commission last considered wool scouring in Decision 725. Table 1 shows the decrease in the total wool clip since then.

Table 1: Total wool clip at the time of Decision 725 compared with 2014

	Total wool clip (tonnes)		Total wool clip (%)		Percentage change
	Year ended 30/6/10*	Year ended 30/6/14	Year ended 30/6/10*	Year ended 30/6/14	
North Island	91,300	78,580	49%	48%	-14%
South Island	94,500	85,522	51%	52%	-9.5%
Total New Zealand	185,800	164,102	100%	100%	-12%

Source: Beef + Lamb New Zealand

*The indicative figures used in Decision 725

67. During our investigation, there was general consensus from industry parties that the decrease has been brought about by two major factors, the global decline in demand for wool and the conversion of sheep farms to dairy farms.

¹⁹ Beef + Lamb New Zealand, New Season Outlook 2014-15

68. Beef + Lamb New Zealand said that its estimation is that the total flock number will further drop to around 26-28 million sheep over a five year period (total decline of between 6% to 13% over the period).²⁰

Decrease in the volumes of wool scoured since Decision 725

69. As a consequence of the decreasing wool clip, volumes of wool scoured have also decreased. Table 2 shows the decrease in scoured wool volumes since Decision 725.

Table 2: Total volume of scoured wool at the time of Decision 725 compared with 2014

	Total volume scoured (tonnes)		Percentage change
	Year ended 30/6/10*	Year ended 30/6/14	
North Island	[]	[]	[]
South Island	[]	[]	[]
Total New Zealand	[]	[]	[]

Source: Customer volumes provided by Cavalier and NZWSI.

*The indicative figures used in Decision 725

Previous Decisions, the High Court judgment, and NZWSI's subsequent sale

70. The Commission has previously considered wool scouring in the following decisions.
- 70.1 Godfrey Hirst NZ Limited and Feltex Carpets Limited (Commerce Commission Decision 587, 31 August 2006). This acquisition gave rise to horizontal aggregation in the market for the supply of wool scouring services in the North Island.
- 70.2 David Ferrier and/or New Zealand Woolscourers Limited and Cavalier Wool Holdings Ltd and Godfrey Hirst NZ Limited (Commerce Commission Decision 666, 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.
- 70.3 In Decision 725 the Commission granted Cavalier authorisation to acquire all of NZWSI's wool scouring assets (being the wool scouring assets and stock located at Whakatu and Kaputone and 50% of the shares in Lanolin Trading Company Limited)²¹ and/or any interconnected body corporate of NZWSI that holds any of those wool scouring assets. The acquisition, which as noted at paragraph 2 did not proceed, would have resulted in the aggregation of market share in the markets for the supply of wool scouring services in the North and South Islands.

²⁰ Interview with Beef + Lamb New Zealand, 24 November 2014.

²¹ The Lanolin Trading Company joint venture was subsequently dissolved and CWH and NZWSI now supply wool grease independent of each other.

71. Decision 725 was appealed in the High Court by Godfrey Hirst. However, while the Court found that the margin between the benefits and detriments was much closer than the Commission determined, the likely detriments were still outweighed by the public benefits and consequently there was “such a benefit to the public” that the acquisition should be authorised.²² The appeal was dismissed by the High Court in November 2011.
72. Subsequent to those events, Cavalier and the NZWSI Board did not reach an agreement for the sale and acquisition of the scouring assets and in early 2013, Lempriere acquired 100% of the shares in NZWSI.

Does Cavalier Bremworth have a substantial degree of influence over Cavalier?

73. As discussed, one of the ways in which the proposed acquisition could harm competition is that post-acquisition, Cavalier may have both the incentive and ability to effectively provide its current 50% shareholder carpet manufacturing firm, Cavalier Bremworth, with preferential scouring rates. This would provide Cavalier Bremworth with a cost advantage over its primary rival in the domestic market, Godfrey Hirst.
74. In order for that to be the case, Cavalier Bremworth would have to have a substantial degree of influence over Cavalier.
75. Section 47(1) of the Act refers to an acquisition by a person. Person is defined as including two or more persons that are interconnected or associated under section 47(2) of the Act.
76. Sections 47(3) and (4) of the Act set out when two or more persons are associated. Two corporate entities are associated if one, either directly or indirectly, is able to exert a “substantial degree of influence” over the activities of the other. The Commission is of the view that, in this context, a substantial degree of influence means being able to bring real pressure to bear on the decision making process of the other, even if that pressure falls short of control.²³
77. In determining whether parties are associated, each case must be considered in light of its particular facts. Typically, the Commission takes into account the:
- 77.1 nature and extent of ownership links between the companies;
 - 77.2 presence of overlapping directorships;
 - 77.3 rights of one company to appoint directors of another; and
 - 77.4 nature of other shareholder agreements and links between the companies concerned.

²² *Godfrey Hirst NZ Ltd v Commerce Commission* (2011) 9 NZBLC 103,396 at [327].

²³ *Air New Zealand Ltd and Ansett Holdings Ltd and Bodas Pty Ltd*, (Commerce Commission Decision 278, 3 April 1996).

78. Cavalier is 50% owned by Cavalier Bremworth, which in turn is a wholly-owned subsidiary of Cavalier Corporation Limited. The current Shareholders' Agreement in relation to Cavalier sets out that Cavalier Bremworth's 50% shareholding in Cavalier entitles it to appoint two directors to Cavalier Wool's board. In total, there are four directors on Cavalier's board, with the other two shareholders, ACC and Direct Capital being entitled to appoint one director each.
79. In addition, clause 4.2 provides that the Board will delegate management of Cavalier's day to day operations to Cavalier Bremworth.
80. In light of these facts, the Commission considers it likely that Cavalier Bremworth can exert a substantial degree of influence over the activities of Cavalier at both the board and management levels. Accordingly, for the purposes of the present analysis, the Commission will proceed on the basis that Cavalier Bremworth and Cavalier are associated and should be considered as one head in the relevant market(s).

Market definition

81. As previously discussed, the proposed acquisition could give rise to competition concerns in respect of wool scouring services, the supply of wool grease and the supply of carpet.
82. Market definition is a tool that helps identify and assess the close competitive constraints the merged entity would face. Determining the relevant market requires us to judge whether, for example, two products are sufficiently close substitutes as a matter of fact and commercial common sense to fall within the same market.
83. We define markets in the way that best isolates the key competition issues that arise from a proposed acquisition.²⁴ In many cases this may not require us to precisely define the boundaries of a market. What matters is that we consider all relevant competitive constraints, and the extent of those constraints. For that reason, we also consider products which fall outside the market but which still impose some degree of competitive constraint on the merged entity.
84. The standard means to define the market is to use the "hypothetical monopolist test" (HMT).²⁵ The HMT asks whether a hypothetical sole supplier of a group of products could profitably raise prices by a small, yet significant, non-transitory (SSNIP) amount. If it could impose the SSNIP, the HMT is satisfied and a market is defined. If it could not, then the market is widened to include the next best substitute and the process repeated. The process continues until a group of products that satisfies the HMT is found.
85. Whether a SSNIP could be profitably imposed depends on the degree of demand and supply-side substitution that would occur. Demand-side substitution is where customers switch to other products outside the candidate market in response to a price increase. Supply-side substitution is where rival firms offering products outside the candidate market could easily, profitably and quickly switch their production processes to supply those products in the candidate market. What matters is

²⁴ Commerce Commission, *Mergers and Acquisitions Guidelines*, above n 7 at [3.10] - [3.12].

²⁵ *Ibid* at [3.17] - [3.22].

whether demand and supply-side substitution together is sufficient to defeat the SSNIP.

86. Where relevant, we also examine the ability of suppliers to discriminate between customers because their competitive alternatives vary.
87. In Decision 725, the Commission concluded that for the purposes of assessing the application, the relevant markets in respect of wool scouring services were:
 - 87.1 the North Island market for the supply of wool scouring services (the North Island scouring market);
 - 87.2 the South Island market for the supply of wool scouring services (the South Island scouring market);
 - 87.3 the national market for the purchase and supply of wool grease (the national wool grease market); and
 - 87.4 the national market for the manufacture, import and wholesale supply of wool and synthetic carpets.
88. Cavalier submitted in its application that these market definitions remain relevant for the consideration of the current application.
89. To assess whether this is the case, the Commission has consulted the wool industry to see whether there have been any developments or changes in the industry since we last looked at it in 2011.

Wool scouring

90. We consider that in the intervening period, little has changed in respect of the supply of wool scouring services (apart from the volumes of wool scoured having reduced). To this extent, for the purposes of this analysis, we intend to adopt the same scouring markets that we used in Decision 725:
 - 90.1 the North Island market for the supply of wool scouring services (the North Island scouring market); and
 - 90.2 the South Island market for the supply of wool scouring services (the South Island scouring market).
91. As we did in Decision 725, given that the competition concerns are generic to both of the North and South Island wool scouring markets, for the purpose of our current competition analysis, we will consider them together.

Wool grease

92. In Decision 725, we defined the relevant wool grease market as the national market for the purchase and supply of wool grease. At the time of that Decision, Cavalier and NZWSI were involved in a joint venture, The Lanolin Trading Company (LTC) that acquired lanolin from each of Cavalier and NZWSI and then supplied it to a few domestic customers and to international customers. So, there was only one supplier of wool grease at that time.

93. In December 2013, the parties reverted to supplying wool grease independent of one another.
94. The majority of New Zealand wool grease is exported and there is only one domestic customer of any significant size, The Shamrock Group Limited (Shamrock).²⁶ Shamrock typically purchases in the order of [] annually at a cost of around [].²⁷
95. [].²⁸
96. []. John Quigley, Managing Director, Shamrock advised that [].²⁹
97. Mr Quigley advised that he could []. Despite this, Mr Quigley said that if faced by a price increase post-acquisition, he would have some options for alternative supply. []³⁰
98. [] Prolan NZ (Prolan), a manufacturer of industrial lubricants that uses wool grease in its production. Murray Shaw of Prolan advised us that Prolan buys around [] of wool grease a year from [].³¹ []
99. []
100. There are small customers of wool grease that buy on more of an ad hoc basis and are therefore generally price takers. []³² Coating

²⁶ Shamrock is a chemical manufacturing company specialising in specialty chemicals for textiles and leather industries. Wool grease is a component for a specific product that Shamrock exports. There are around three or four other small domestic buyers of wool grease who each purchase a limited amount, ie, two or three tonnes per year.

²⁷ []

²⁸ []

²⁹ Interview with Shamrock, 5 February 2015.

³⁰ []

³¹ Telephone interview with Murray Shaw, Director Prolan, 5 March 2015.

³² Telephone call with Cavalier, 26 February 2015.

Technologies Ltd (Cotec) advised us that Cotec, a paint and coatings manufacturer, is a small wool grease customer, using around [] of wool grease a year.³³

101. At present, Cotec buys its wool grease from []. Cotec considers []. It told the Commission that it thought that []
102. CRC NZ, also a manufacturer of industrial lubricants, also buys around [] of wool grease from Cavalier each year and pays a price around [] than [].
103. Because of the ability of Cavalier to price discriminate against smaller wool grease customers and because of their inability to provide any meaningful competitive constraint by importing their wool grease requirements, for the purposes of this analysis we consider that purchasers of small volumes of wool grease are likely to be in a market discrete from Shamrock.
104. In Decision 725, we considered the wool grease market to be national in geographic scope. We consider that still to be the case.
105. Therefore, for the purposes of analysing the current application, in respect of wool grease we intend to adopt the following market definitions:
- 105.1 the national market for the refinement and supply of wool grease to large customers; and
- 105.2 the national market for the refinement and supply of wool grease to small customers.

Wool and synthetic carpets

106. Both Cavalier Bremworth and Godfrey Hirst manufacture and supply wool carpet.
107. New Zealand has historically had a strong affinity with wool carpets. At the time of the Norman Ellison Decision in 2007,³⁴ the Commission was advised by carpet retailers that around 75% of carpets sold in New Zealand were woollen, with the balance being synthetic. Since then, we have been advised that there has been a trend towards synthetic carpets such that only about 20 - 25% of the carpet currently sold in New Zealand is woollen.³⁵
108. Carpet retailers³⁶ advised us that the switch away from wool carpets is due to technological advances which have led to improved synthetic fibres. The improved fibres are softer than previously and have characteristics superior to wool such as stain and crush resistance.

³³ Telephone interview with Cotec, 18 February 2015.

³⁴ Cavalier Corporation Limited and Norman Ellison Holdings Limited (Commerce Commission Decision 628, 14 November 2007).

³⁵ Interview with Flooring Brands, 11 February 2015.

³⁶ Interview with Flooring Brands, 11 February 2015 and Carpet Mill, 12 February 2015.

109. They further advised that it is commonplace for a customer to enter their store with a firm view to purchasing a pure wool carpet and leaving having acquired a synthetic carpet. Steve Ferris, Head of Product at Flooring Brands Limited advised us that synthetic and wool carpets are priced comparably at all price points.³⁷
110. In the Norman Ellison Decision, the Commission acknowledged that while there was a degree of demand-side substitutability between non-carpet floor coverings and carpet, ultimately the imposition of a SSNIP meant that they fell outside the product market. We consider that this still holds.
111. We are of the view that the market remains national in geographic scope.
112. To this extent, we consider that the relevant carpet market continues to be the national market for the manufacture, import and wholesale supply of wool and synthetic carpets.

The relevant markets

113. For the purposes of analysing this application we consider the relevant markets are:
- 113.1 the North Island market for the supply of wool scouring services (the North Island scouring market);
 - 113.2 the South Island market for the supply of wool scouring services (the South Island scouring market);
 - 113.3 the national market for the refinement and supply of wool grease to large customers (the large customer wool grease market);
 - 113.4 the national market for the refinement and supply of wool grease to small customers (the small customer wool grease market); and
 - 113.5 the national market for the manufacture, import and wholesale supply of wool and synthetic carpets (the carpet market).

With the acquisition

114. As noted above, CWH proposes to:
- 114.1 close NZWSI's scours at Kaputone and Whakatu and sell the land and buildings at both sites;
 - 114.2 relocate NZWSI's scour lines at Kaputone and Whakatu to Cavalier's existing scouring sites at Timaru and Awatoto respectively;
 - 114.3 decommission the scour line at Cavalier's Clive plant and sell the land and buildings.

³⁷ Interview with Flooring Brands, 11 February 2015.

Without the acquisition

115. Cavalier has presented its competition analysis and net benefit analysis on the basis that in the absence of the acquisition, each of Cavalier and Lempriere would run their wool scouring businesses independent of one another as a separate scouring entity. Their respective wool grease operations would also be independent of one another.
116. Having confirmed this with Cavalier and Lempriere, we agree that this is the likely without the acquisition scenario.

Competition analysis

117. This section assesses whether the proposed acquisition is likely to result in a substantial lessening of competition. The paragraphs that follow discuss:
 - 117.1 the degree of competitive constraint currently provided by NZWSI in respect of wool scouring;
 - 117.2 the ability of wool merchants to constrain CWH in its ability to increase wool scouring prices (or reduce quality of those services by exporting greasy wool for scouring in China);
 - 117.3 the prospect of entry into wool scouring in New Zealand; and
 - 117.4 the likely impact of the acquisition on the wool grease and carpet markets.

North and South Island wool scouring markets

118. Post-acquisition, NZWSI would be removed as an independent supplier of wool scouring services in both of the affected wool scouring markets leaving CWH as the only provider.
119. As discussed above, depending on the level of competitive constraint provided by offshore scourers and/or the ability of wool merchants to export greasy wool, the merged entity could use any market power that it had to raise scouring prices and/or lower its service quality including scouring standards or timeliness.
120. Any price rises or degradations in quality could be applied across all customers, or could potentially be targeted at those wool merchants who face fewer or more costly alternative sources for scouring services. For example, for those exporting wool to Europe or supplying it to domestic users, the scouring services in Asia may not be a suitable alternative.
121. This is because of the logistical problems and extra costs associated with re-exporting wool from Asia to Europe or back to New Zealand. The extra costs and difficulty associated with ensuring scouring services in Asia are of sufficient quality could also be a barrier to using wool scours in Asia as an alternative.

Existing competition - constraint from NZWSI

122. In Decision 725, the Commission considered that despite NZWSI's limited commission scouring (the majority of its scouring being for its own wool merchant business), NZWSI placed an indirect but real constraint on Cavalier.
123. At the time of Decision 725, NZWSI's commission scouring work accounted for 13.3% of its North Island scouring and 25% of its South island scouring volumes. This amounted to approximately 6.3% and 12.8% shares of North and South Island commission scouring respectively.
124. In the year ending 30 June 2014 NZWSI's commission scouring work accounted for [] of its North Island scouring and [] of its South island scouring. This amounts to approximately [] and [] shares of North and South Island commission scouring respectively.
125. This would suggest that since 2011, NZWSI has [].
126. When it sold its wool scours to interests associated with Cavalier in 2009,³⁸ Godfrey Hirst negotiated a scouring agreement with Cavalier which included [] that Cavalier scours for merchants on behalf of Godfrey Hirst (Godfrey Hirst does not itself purchase greasy wool for scouring). The agreement sets out that Godfrey Hirst [³⁹]
127. Godfrey Hirst advised us⁴⁰ that []
128. Godfrey Hirst said that []
129. Fuhrmann advised us that when negotiating with Cavalier the existence of NZWSI acts as a constraint. Fuhrmann noted that it has previously scoured with NZWSI and Cavalier knows that there is a possibility it could shift back.⁴²
130. NZWSI advised that its Whakatu wool scour []⁴³ [].

³⁸ David Ferrier and/or New Zealand Woolscourers Limited and Cavalier Wool Holdings Ltd and Godfrey Hirst NZ Limited (Decision 666).

³⁹ []

⁴⁰ Interview with Godfrey Hirst, 3 December 2014.

⁴¹ Interview with Godfrey Hirst, 3 December 2014.

⁴² Interview with Fuhrmann, 20 November 2014.

131. In the South Island,
[

]

132. The Commission remains of the view expressed in Decision 725 that NZWSI's commission scouring business places a real, constraint on Cavalier in respect of wool scouring and that with the merger that constraint would be lost.

Would exports of greasy wool to China constrain New Zealand wool scouring prices?

133. Cavalier submitted that should the merged entity increase its scouring price, then merchants would export more greasy wool either to customers with their own scours or for commission scouring in China and Malaysia, and that this would render such a price increase unprofitable.

134. Cavalier argued that the risk of exporters diverting a proportion of their present scouring volumes to China as greasy wool would act as a constraint on Cavalier's pricing post-merger. Any such diversion of volumes would cost Cavalier's currently profitable scouring business. In support of this argument, Cavalier submitted that, [

].⁴⁴

135. In its application, Cavalier asserts that there is more than sufficient capacity in China to process increased greasy wool imports. It also points to a large new wool scour in Malaysia, Compass Wool Processors (CWP), that it considers could also be utilised for scouring New Zealand wool.

136. In Decision 725, we concluded that the ability of exporters to divert more greasy wool to China for scouring was unlikely in itself to sufficiently constrain the merged entity to avoid a substantial lessening of competition in the relevant wool scouring markets.

137. Our view was that while exports to China would place constraint on prices to wool merchants who already export scoured wool to China, they would not provide a sufficient constraint on prices to most wool merchants exporting scoured wool to other countries or selling to domestic customers.

138. However, we noted that price increases would be capped by the possibility of entry and the ability of wool merchants to switch at least some of their sales from other markets to greasy wool exports to China.

139. China is currently the largest export market for New Zealand wool. In the year ending June 2014, about 50% of New Zealand's wool clip was exported to China. About 48% of those exports were in greasy form which suggests that 27% of New Zealand's wool clip is scoured in China at present. China is the destination for over 80% of the greasy wool exported from New Zealand. Table 3 sets out the changes in these figures between 2010 and the present.

⁴³ Interview with Lempriere and NZWSI, 19 November 2014.

⁴⁴ At [15.34] of the Application.

Table 3: Comparison of the proportion of the total wool clip exported to all countries in greasy form in 2010 and in 2014

	Greasy/slipe wool exports (tonnes)		Greasy/slipe wool exports (% of total clip)	
	Year ended 30/6/10*	Year ended 30/6/14	Year ended 30/6/10	Year ended 30/6/14
North Island	16,500	16,500	9%	10%
South Island	26,515	27,976	14%	17%
Total New Zealand	43,015	44,476	23%	27%

Source: Beef + Lamb New Zealand

*The indicative figures used in Decision 725

140. As can be seen in Table 3, while the volume of greasy wool exports has remained at around the same level as in 2010, given the decrease in the total wool clip, the overall proportion exported has increased slightly.
141. During our investigation of this application, we heard from a number of industry parties that China's demand for wool is increasing. However, as was the case in Decision 725, we have received mixed feedback from merchants as to the likelihood of them switching to greasy exports in the face of an increase in domestic wool scouring prices.
142. New Zealand's third largest wool merchant, Fuhrmann told the Commission that it previously exported [] of its wool in scoured form, and it is now exporting approximately [] in scoured form. []. Approximately [] of Fuhrmann's current business is with China.⁴⁵
143. Other industry participants mirrored Fuhrmann's view that China has increased its demand for greasy wool.⁴⁶ The increase in greasy exports to China since 2010 is 7.4%.⁴⁷
144. However, we were also advised that there is significant demand for scoured New Zealand wool in other countries. This is particularly the case where the quality of the scoured wool is as important as the price paid.
145. Post-acquisition, CWH could offer the wool merchants that export scoured wool to China lower rates, [], in order to curb further exports of greasy wool and the loss of volumes through its scours. Where New Zealand scoured wool is exported to countries other than China and where there is no possibility of commission scouring greasy wool in that country as a substitute, it may be possible for CWH to charge higher prices to the wool merchants exporting those volumes.

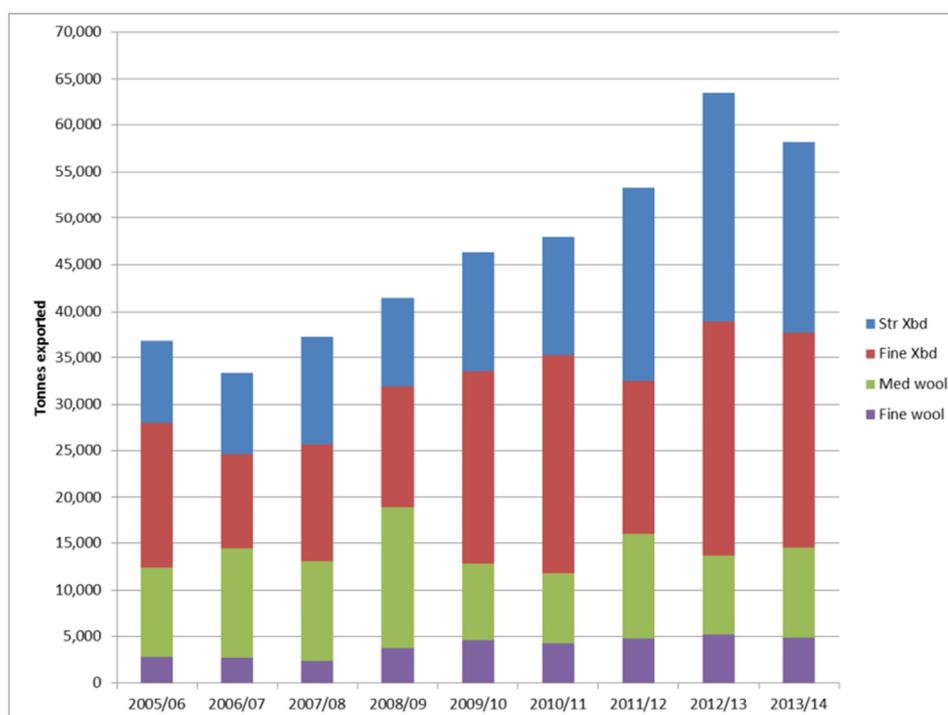
⁴⁵ Interview with Fuhrmann, 20 November 2014.

⁴⁶ Interview with H. Dawson, 19 November 2014 and Rokelay Wool, 12 November 2014.

⁴⁷ Beef + Lamb New Zealand Economic Service. 2010 total greasy exports 36,142 tonnes; 2014 total greasy exports 38,801 tonnes.

146. Such price discrimination may also be the case where the wool merchant is selling to domestic purchasers of scoured wool. The scope for price discrimination based on the destination of scoured wool is discussed in more detail below at paragraphs 261 to 267. Overall, the Commission considers that there would be some scope for price discrimination, but this scope would be limited.
147. Godfrey Hirst submitted that exports of greasy wool were unlikely to increase because there is insufficient scouring capacity in China. However, James Irvine⁴⁸ told us that there is presently excess wool scouring capacity in China.
148. No other party submitted that there is insufficient scouring capacity but some did consider that China scours largely fine wools and therefore could not cope with New Zealand's coarse wools.
149. Cavalier provided the following chart which shows that a significant amount of New Zealand wool exported to China is coarse (strong) wool.

Figure 1: Types of wool exported from New Zealand to China⁴⁹



150. CWP's new wool scour in Malaysia could also be utilised for scouring New Zealand wool. We have received mixed responses from wool merchants as to whether this mill is a feasible alternative to New Zealand and/or Chinese scours with some advising that the CWP mill is set up largely to scour fine wools rather than coarse wools which is the majority of New Zealand wool exports.

⁴⁸ Interview with James Irvine, 17 December 2014. James Irvine is the former owner and managing director of ANDAR Limited (Andar), and was with Andar for over 20 years. Andar is an engineering company in the South Canterbury region. It is the primary supplier of wool scouring equipment in New Zealand. Since 2012 Mr Irvine has been designing, building, and installing wool scouring machinery in China and Malaysia under his own name.

⁴⁹ From Beef + Lamb New Zealand Economic Service statistics.

151. Godfrey Hirst also told us that it considers that CWP scours fine wools only.
152. However, in our interview with James Irvine, he advised us that he is presently working at CWP and that the CWP scour can switch from processing fine to coarse wool simply by changing a computer setting. In respect of the Chinese scours, he said that they too can process coarse wool by “changing a few speeds”.
153. In respect of scouring wool in China for re-export, the parties that we spoke with unanimously dismissed the idea of commission scouring of New Zealand wool in China for re-export to other markets (including New Zealand), most importantly due to a loss of control over the wool and the wool scouring process, the cost of freight and time delays.⁵⁰
154. Mr Peter Whiteman, Managing Director of Segard Masurel, advised [].
155. Godfrey Hirst said that [].
156. Even though we have heard mixed views on the capacity available for scouring in China and/or Malaysia, and the ability for Chinese and/or Malaysian scours to scour New Zealand coarse wool, the parties we have spoken to that have had personal experience with the Chinese and Malaysian scours generally believe the capacity and ability is present in both China and Malaysia. Based on this evidence, we consider there is likely to be the available capacity and the ability to scour New Zealand coarse wool in China and Malaysia.
157. However, given the control, cost, and time concerns discussed above, the Commission’s view is that the ability of merchants to divert more greasy wool to China or Malaysia for scouring is unlikely in itself to sufficiently constrain the merged entity to avoid the effect of a substantial lessening of competition in the relevant wool scouring markets.
158. Nevertheless, the Commission recognises that the Chinese scouring industry poses a significant long term competitive threat to the domestic industry in New Zealand. Consequently, the Commission acknowledges that the threat of losing scouring revenues to increased greasy exports would provide some constraint on the ability of CWH to increase prices in the factual, albeit at a level higher than 5% to 10%. In this regard the recent experience of the Australian scouring sector is informative.

The Australian experience

159. The size of the Australian wool scouring industry has been severely reduced by competition from Chinese wool scours:⁵¹

⁵⁰ Interview with John Marshall & Co, 20 November 2014 / NZ Yarns, 26 January 2014 / Godfrey Hirst, 3 December 2014

⁵¹ Statement by Mr Lindsey Mitchell, Managing Director, Jandakot Wool Washing Pty Limited, January 2009.

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).

160. The suddenness of the decline in the Australian industry mentioned by Jandakot is illustrated below:
- 160.1 In 1995 there were 25 wool scouring sites in Australia scouring about 600,000 greasy tonnes per annum. This constituted 82% of the total Australian wool production of 730,000 tonnes per annum.
- 160.2 In 2009 there were only three remaining commercial wool scouring sites in Australia processing about 54,000 greasy tonnes per annum (14% of total Australian wool production of about 400,000 tonnes per annum). This constituted a 91% reduction in Australian scouring.
161. Cavalier has 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, but the threat of low cost Chinese scouring services remains.
162. Although the Australian experience may be differentiated to some extent based on the higher proportion of fine wool in the wool clip compared to New Zealand,⁵² the Commission considers that the developments in Australia are illustrative of the competitive constraint provided by scouring in Asia in general, and China in particular.

Potential entry

163. In assessing whether a merger (whether between competitors or otherwise) would be likely to have the effect of substantially lessening competition, we assess whether, if prices increase existing competitors would expand their sales, or new competitors would enter and effectively compete with the merged firm.
164. We assess whether entry by new competitors or expansion by existing competitors is likely to be sufficient in extent in a timely fashion to constrain the merged firm and prevent a substantial lessening of competition. This is referred to as the 'LET test'.
165. The LET test is satisfied when entry or expansion in response to a price increase or other exercise of market power is Likely, sufficient in Extent and Timely enough to constrain the merged firm.
166. The obstacles to entry and expansion that firms face (entry and expansion conditions) are relevant to the LET test.
167. In Decision 725, the Commission considered a new entrant into wool scouring would need to secure:

⁵² This makes more of Australia's wool clip suitable for textiles, of which China is major manufacturer.

- 167.1 an appropriate site for a scouring plant proximate to a port;
- 167.2 the relevant resource consents;
- 167.3 a scouring plant; and
- 167.4 access to sufficient quantities of wool.

Production site with necessary consents

168. A key requirement for entry is an appropriate site for a new scouring plant. It would necessarily need to be located at the centre of wool production in each island and be proximate to an export port (most likely Hawke’s Bay in the North Island and Canterbury in the South Island). An appropriate site requires the necessary resource consents, including water supply and effluent discharge.
169. CWH submits that the sites identified in Decision 725 remain available. Further, it says there are now additional sites available in Timaru due to the council rezoning some industrial land. It estimates that suitable land could be acquired for around [].⁵³
170. We note that as part of the transaction restrictive covenants will be placed on the Whakatu, Kaputone and Clive sites which will prevent them from being used for wool scouring for 50 years.
171. When we asked Cavalier why it had included the restrictive covenants in the agreement for sale and purchase, Cavalier responded:⁵⁴
- The placing of covenants on the CWH / NZWSI sites is not intended to prevent new entrants in the wool scouring market (nor will it have this effect), but rather reflects the parties’ desire not to give such a new entrant an advantage.”
- The parties have each invested significant time, effort and money in each of the sites to set them up in a manner that reflects the party’s belief is best for scouring. While the plant will be removed (and sold or used overseas), the parties do not want to give a new entrant the advantage of being able to start off with buildings that are the product of CWH and NZWSI’s efforts to optimise for wool scouring. As Godfrey Hirst have previously threatened to enter the wool scouring market it is not unnatural that CWH would not want to give it, or indeed any other new entrant, a step up.
172. We asked each of Hawke’s Bay Regional Council (HBRC) and Environment Canterbury Regional Council (ECRC) whether in their view sites are available that would be consented for a Greenfield wool scouring operation.
173. The HBRC advised that the HBRC has a Regional Resource Management Plan that sets out the activities that can be carried out on land in its catchment.⁵⁵

⁵³ At [19.6] and [19.7] of the Application.

⁵⁴ Cavalier submission, 19 December 2014.

⁵⁵ Interview with Hawke’s Bay Regional Council, 11 December 2014.

174. HBRC told us that in her view there is land available in HBRC's catchment that would likely gain the consents required for a wool scouring operation. These consents include water, waste discharge and air discharge consents.
175. In addition, Peter Whiteman of Segard Masurel advised us that he "didn't blame Cavalier for putting covenants on the sites" and that he did not think they would deter any entry that might occur. Mr Whiteman told us that he is aware of former meat processing plants (particularly in Napier) that would be suitable for a scouring operation.⁵⁶
176. Similarly, ECRC advised us that in his view, because they are proximate to ports, the best locations in the ECRC catchment for a greenfield wool scouring operation are Lyttleton and Timaru.⁵⁷
177. ECRC advised that in his view there are a number of suitable sites available, particularly in Timaru that would likely gain the requisite resource consents.

Scouring equipment

178. Entry into the wool scouring industry would require amongst other things, the availability of specialised plant and equipment. This equipment can be purchased new from Timaru based engineering company, ANDAR Holdings Limited (Andar) and Chinese manufacturers, or potentially second-hand from overseas (the Clive plant will either be sold []).
179. In the present application, Cavalier submits that total plant costs could be around NZ [] using new equipment.
180. James Irvine considers that he could commission a new wool scouring operation including land, buildings and plant in around six months at a cost of around NZ\$10 million.⁵⁸

Access to sufficient quantities of wool

181. A potential obstacle for a new entrant would be securing sufficient quantities of wool to ensure the necessary capacity utilisation for an economic wool scouring operation.
182. We previously noted that the size of the wool clip in New Zealand is continuing to decline as sheep numbers reduce. However, it is conceivable that a new entrant could be a wool exporter, or group of exporters, perhaps combined with a downstream user such as Godfrey Hirst, such that the entrant could secure enough wool for an economic scouring operation through its own wool trading and/or wool purchasing arms.
183. As discussed below in the likelihood section, an industry expert considers a new entrant would need to scour 15,000 to 16,000 tonnes of wool annually per scour to be profitable. Of a total wool clip of around 164,000 tonnes, and total domestic scouring of [] tonnes, Segard Masurel accounts for approximately [] tonnes

⁵⁶ Interview with Segard Masurel, 24 November 2014.

⁵⁷ Interview with Environmental Canterbury Regional Council, 26 January 2015.

⁵⁸ Interview with James Irvine, 17 December 2014.

(ie [] of total scouring purchases). The next three [] independent merchants, Bloch & Behrens, Dawson and Fuhrmann's, all scour approximately [] tonnes to [] tonnes each.

The LET test

184. As set above, 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, sufficient in extent and timely.

Likelihood

185. Entry or expansion must be likely before it could constrain the merged firm and prevent a substantial lessening of competition. The mere possibility of entry or expansion is insufficient.
186. The likelihood of entry or expansion depends on whether firms can profitably enter or expand the market in light of any entry and expansion conditions.
187. There is now a long history of exit and rationalisation in the wool scouring industry. In addition, sheep numbers have declined substantially in recent years.
188. In Decision 725, we considered that Segard Masurel was a credible and likely entrant.
189. In our interviews with Segard Masurel,⁵⁹ Peter Whiteman, Managing Director advised us that if scouring prices were increased to sufficiently high levels Segard Masurel would "have to" enter wool scouring "at some point".
190. Segard Masurel's parent company (which has global operations in the wool industry) operates a wool scour in South Africa and therefore has wool scouring expertise.
191. However, Mr Whiteman stated that Segard Masurel would not consider entry unless prices increased by at least 10%, and depending on the circumstances it may not consider entry even if prices increased by double this amount. He said that it would not be its wish to enter but would consider it out of necessity if need be. The operation it would commission would be a "boutique type scour" for its own volumes and perhaps for another merchant.
192. We note that Segard Masurel is the second largest wool merchant in New Zealand and is Cavalier's []. In 2013 it sold around [] of scoured wool nationwide and also sold around [] tonnes of greasy wool. Its total wool exports (including greasy wool) accounted for around [] of all New Zealand wool exports.⁶⁰ Mr Whiteman considered that it may be necessary to [].⁶¹ [] This would increase the difficulty of entry.

⁵⁹ Interviews with Segard Masurel, 24 November 2014 and 11 March 2015.

⁶⁰ Interview with Segard Masurel, 24 November 2014.

⁶¹ Interview with Segard Masurel, 11 March 2015

193. James Irvine advised us that in his view, entry is unlikely at price increases of less than \$0.05 per kg of greasy wool. This would constitute a 15% increase at current prices. However, his modelling suggests that a price increase of around 20% above current prices would allow for profitable entry. He told us that that he has developed a number of “payback models” that he has designed to aid with selling wool scours. According to Mr Irvine, to enter on a commercially viable scale, a new entrant would need to scour around 15,000 – 16,000 tonnes of wool per annum to break even.⁶²
194. Other wool merchants that we interviewed did not generally express a desire to enter or re-enter wool scouring markets. The reasons given were the high capital costs, and the fact that wool scouring is not a core business for wool merchants. A number of merchants told us that they thought that Segard Masurel and Godfrey Hirst would be the most likely to enter wool scouring in the event that CWH exercised any market power that it had gained.
195. In Decision 725, we considered Godfrey Hirst was a potential entrant. When we interviewed Godfrey Hirst in the course of this investigation, Godfrey Hirst advised us [].⁶³ As outlined in paragraph 53 Godfrey Hirst’s own volumes of wool are [] than in 2011. [] Godfrey Hirst told us that post acquisition its only option would be to enter; however, it also mentioned that it may be more inclined to shift its entire carpet manufacturing operations offshore.^{64 65}
196. The Commission has also reviewed the entry modelling provided by NERA on behalf of Cavalier. This modelling indicates that entry would be unlikely to be profitable even with a price increase of 5% if initial capital expenditure costs (including plant, land, buildings and working capital) were [] or greater, the entrant required after-tax rate of return of 15% and the average wool grease price did not exceed [] per kg.⁶⁶

Extent

197. Entry or expansion must also be of a sufficient extent to constrain the merged firm and prevent a substantial lessening of competition. Small scale entry is unlikely to pose a sufficient competitive constraint on the merged firm. However, entry or expansion may be of sufficient extent even if that entrant or existing competitor remains smaller than either of the merging firms pre-merger.
198. In Decision 725 we considered that a likely minimum commercial scale of entry would be one 2.4 metre wide scour line to cause the incumbent to react in terms of reducing or capping its prices so other parties do not have the incentive to enter. Illustrative of such a potential effect were Cavalier’s two Hawke’s Bay 2.4 metre wide

⁶² Interview with James Irvine, 17 December 2014 and 11 March 2015.

⁶³ Interview with Godfrey Hirst, 3 December 2014.

⁶⁴ Interview with Godfrey Hirst, 3 December 2014.

⁶⁵ Godfrey Hirst submission, 11 November 2011.

⁶⁶ NERA Economic Consulting, CWH/WSI merger – cost benefit analysis for second authorisation. This modelling also assumed the plant would achieve a volume of 20,000 tonnes within two years with no decrease in scouring volumes over a 20 year time period. It also assumes an exchange rate of NZ\$1:US\$0.73, implying a wool grease price of US\$3.50 per kg.

scour lines each of which was processing at that time approximately [] tonnes of greasy wool per annum, or about [] of the North Island clip.

199. James Irvine considered that a new entrant in New Zealand would be more likely to install a 3.0m line as more wool is available.⁶⁷ However, we consider that the size of the scour would be dependent on the volumes of wool available to a new entrant.

Timely

200. Entry or expansion must also be likely to occur within a reasonably short time period following a price increase or other exercise of market power in order for it to constrain the merged firm and prevent a substantial lessening of competition.
201. As discussed above, James Irvine advised the Commission that he considers he could have a new wool scour fully operational in around six months. This would be after the decision had been made to enter, financing arranged, consents obtained and so on.

Conclusion on the LET Test

202. Despite the fact that entry could occur to a sufficient extent and in a timely manner, the Commission considers that entry fails the LET test as entry is unlikely to occur without at least a 10%⁶⁸ increase in wool scouring prices. We note that in Decision 725, based on the evidence before us at that time, we considered a price increase of more than 5-10% would be required before entry occurred. This change in the price increase is discussed further at paragraphs 250 to 260.
203. However, as discussed in the section on benefits and detriments below, the threat of entry would provide a cap on the levels of detriment that would arise if the acquisition proceeds.

Conclusion on North and South Island wool scouring markets

204. In summary:
- 204.1 the proposed acquisition would remove Cavalier's nearest existing competitor – NZWSI;
 - 204.2 the ability for exporters to switch to greasy exports to China would provide only a moderate constraint on CWH; and
 - 204.3 the potential for new entry into the scouring market would provide only a moderate constraint on Cavalier in that entry would not be likely to occur with a price increase of less than 10%.
205. Therefore, the Commission 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.

⁶⁷ Interview with James Irvine, 17 December 2014.

⁶⁸ Interview with Segard Masurel, 24 November 2014.

Effects of the acquisition in the wool grease markets

206. As discussed in the section on market definition, the proposed acquisition would involve a return to the horizontal aggregation of the parties' wool grease interests as was the case under with the LTC. We are of the view that there are two groups of customers on whom this would impact, large customers and small customers.

Large wool grease customers

207. NZWSI does not currently supply any wool grease to domestic customers; [].

208. Shamrock advised us [].

209. While not currently supplying domestically, domestic customers advised us that they do seek quotes from NZWSI from time to time.

210. To this extent, Cavalier is currently the only domestic supplier ([]).

211. Shamrock previously purchased its domestically-sourced wool grease from the LTC, but since the closure of the LTC now purchases predominantly from Cavalier. []. In 2014, Shamrock [], which accounted for around [] of its total wool grease purchases. In recent years [] has varied substantially in line with its overall purchases of wool grease, which in turn have varied in line with fluctuations in wool grease prices. []

212. The Commission understands that wool grease prices, both in New Zealand and internationally, whilst being set directly between buyers and sellers, tend to follow global prices.

213. As discussed in the market definition section, [].⁶⁹

214. When negotiating a price for its supply contract with Cavalier, the Commission understands that [].⁷⁰

⁶⁹ Interview with Cavalier, 26 February 2015.

⁷⁰ Interview with Cavalier, 26 February 2015.

215. As a result of the proposed acquisition, Shamrock would no longer have a second potential source of domestic supply. Whilst Shamrock indicated that this would reduce its domestic purchasing options, they would continue to be able to import wool grease from elsewhere.⁷¹ Syd Mansfield, Shamrock, stated that there was little difference in quality between domestic and offshore sources of wool grease, although there would be additional logistical complexities if a greater percentage of its purchases were from offshore suppliers.
216. Though Shamrock prefers to use New Zealand certified wool grease,⁷² it could potentially switch to non-New Zealand certified wool grease. This would only require additional scrutiny of the non-certified wool grease to ensure the specifications like water content were suitable.
[]
217. John Quigley, Managing Director of Shamrock, stated that he did not think the acquisition would affect the price of wool grease domestically as wool grease price is mostly affected by the world price. This view was supported by Cavalier.
218. Mr Quigley also did not believe that there would be any reason for the new monopoly supplier to increase the price or reduce the supply of wool grease to Shamrock as logistically it would be easier for CWH to sell domestically to Shamrock than to export.
[]
219. []. In fact data from 2011 and 2012 when the LTC was the sole source of domestic supply show that the cost (including freight) of domestic wool grease was closer to the cost of imported wool grease than in 2014 when both Cavalier and NZWSI were rival domestic suppliers.⁷³

Conclusion on large customer wool grease market

220. The Commission considers that the acquisition is likely to lead to a lessening of competition in the large customer wool grease market; however, this lessening is unlikely to be substantial. Shamrock's ability to increase its imports of wool grease (both New Zealand certified and non-certified) would likely provide a constraint on the merged entity's ability to raise prices.

Small customer wool grease market

221. As discussed in the market definition section, there are a small number of customers against whom Cavalier is likely able to price discriminate, in particular, Prolan, Cotec

⁷¹ Interview with John Quigley, Managing Director, the Shamrock Group Limited, 5 February 2015 and Syd Mansfield, Shamrock 18 February 2015.

⁷² New Zealand certified wool grease is wool grease extracted from New Zealand wool; this includes wool grease extracted from international scours.

⁷³ In 2011 the average cost of imported wool grease was \$[] per kilogram compared to [] for domestic wool grease from the LTC. In 2012 the figures were []. In 2014 after the closure of the LTC the average cost of imported wool grease was [] whereas wool grease from Cavalier was []. Note some proportion of the difference between sources may arise because of different contract dates.

and CRC. In the event that CWH raised the price of wool grease to these customers, they would have no alternative supplier, given their inability to import wool grease because it would not be economic for them.

222. As wool grease is a by-product of wool scouring, unless there is entry into wool scouring, post-acquisition there would remain a single domestic supplier of wool grease. In our competition analysis of the wool scouring market, we determined that entry into that market was unlikely to occur in response to a price increase lower than 10%.

Conclusion on small customer wool grease market

223. To this extent, the Commission is not satisfied that the proposed acquisition would not give rise to a substantial lessening of competition in this market. The detriments arising in this market will be assessed in the detriments section.

Effects of the acquisition on the downstream carpet market

224. Cavalier Bremworth, 50% owner of Cavalier, is a wool spinner and wool and synthetic carpet maker and is associated with Cavalier and would be associated with CWH post-merger.⁷⁴ Cavalier Bremworth competes with Godfrey Hirst and other carpet makers in wholesale carpet markets in New Zealand and offshore.
225. Because of its stake in the only scouring company in New Zealand, post-acquisition, CWH may have both the incentive and ability to provide Godfrey Hirst with higher scouring rates than its downstream carpet manufacturing firm, Cavalier Bremworth. This would provide Cavalier Bremworth with a cost advantage over its primary rival in the domestic carpet market.
226. Such a cost disadvantage for Godfrey Hirst could render it a less effective competitor and either reduce its market share or drive it from the market completely. Whether such a result would allow Cavalier Bremworth to gain market power in the carpet market (and so have an incentive to raise prices in this way in the first place), depends on the degree of competition that exists, including whether Cavalier Bremworth and Godfrey Hirst face significant competition from domestic and international carpet suppliers.
227. Competition in the downstream market for the supply of carpet in New Zealand with or without the proposed acquisition is likely to be the same due to the competitiveness of this market. Along with Godfrey Hirst, a major competitor, there are a number of other market participants. Imports now make up a significant proportion of the carpet market.
228. In our recent interviews, both Godfrey Hirst and Cavalier advised us that the use of wool in carpets is declining because of the increasing use of synthetic fibres in carpets, as well as the use of other flooring materials. Flooring retailers that we spoke to confirmed this to be the case.⁷⁵ This would suggest that Godfrey Hirst faces increasing competition from imported carpets and other flooring materials.

⁷⁴ See above analysis in paragraphs 73 to 800.

⁷⁵ Interviews with Flooring Brands, 11 February 2015 and Carpet Mill, 12 February 2015.

229. As noted above, when Godfrey Hirst sold its wool scours in 2009, it negotiated a scouring agreement with Cavalier which included [] of greasy wool that Cavalier scours for merchants on behalf of Godfrey Hirst (Godfrey Hirst does not itself purchase greasy wool for scouring). The agreement sets out that Godfrey Hirst []].
230. []. This agreement was one of the factors we noted in respect of foreclosure in the carpet market being unlikely in Decision 725.
231. []].
232. As the price of scouring is a relatively small component of the cost of producing carpet (around 0.2% of the final carpet price), non-price effects could be of greater competitive impact than those of any conceivable scouring price increases.
233. We are of the view that while CWH would have the ability to engage in non-price discrimination, it is unlikely to have the incentive to do so. This is because although such behaviour would have a detrimental effect on Godfrey Hirst, it is not profit maximising for CWH. This is because it could result in a reduction in Godfrey Hirst's demand for wool scouring services which would lead to reduced profit for CWH.
234. It is unlikely that Cavalier Bremworth could recoup those lost profits in the downstream carpet market because that market is competitive and it therefore could not guarantee it would capture any of Godfrey Hirst's lost sales. In any event, Cavalier Bremworth would have only a 27.5% interest in CWH, whereas the remaining 72.5% of CWH shareholders would have no direct commercial interest in the carpet manufacturing market.
235. The Commission is satisfied that the acquisition will not have, or would not be likely to have, the effect of substantially lessening competition in the downstream carpet market.

Public benefits and detriments

236. As we have identified a substantial lessening of competition in the wool scouring market in terms of section 67(3)(a) of the Act, we must now consider whether we 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 section 67(3)(b) of the Act.
237. The Commission is tasked with assessing whether the public benefits stemming largely from rationalisation within a sector that is facing a declining demand,

outweigh the detriments to competition arising from having only one domestic scourer.

238. In this case the detriments from a reduction in competition may flow from:
- 238.1 higher scouring prices and/or lower quality scouring services (ie, allocative efficiency losses);
 - 238.2 increased costs of production because of a lower level of competitive pressure on CWH (ie, productive efficiency losses); and
 - 238.3 lower levels of innovation and/or sub-optimal investment patterns over the longer term (ie, dynamic efficiency losses).
239. Offsetting these detrimental impacts to some degree are reductions in the costs of production (ie, productive efficiency gains) brought about by rationalisation. This freeing up of resources (whether labour, capital or land) generates a public benefit. This is because these resources can be put to productive use elsewhere in the economy.⁷⁶
240. In contrast to these efficiency impacts, changes in the distribution of income, where one group gains from higher prices while another simultaneously loses, are generally not incorporated into this assessment. This is because these transfers do not typically result in a net change to the overall wellbeing of the wider public, which includes both buyers and sellers. An exception to this approach can arise if one of the groups affected are non-New Zealanders. This is because it is only gains or losses to the public of New Zealand that are relevant to the Commission's assessment. As this transaction involves parties with a significant degree of foreign ownership, the Commission has assessed any potential wealth transfers to and from non-New Zealanders.
241. The Commission must also consider any non-market impacts that the transaction may generate, for instance any social or environmental impacts. While it is possible there may be some such impacts,⁷⁷ it is the Commission's preliminary view they are unlikely to be material in magnitude.

Quantification

242. As set out by Richardson J in *Telecom Corporation of New Zealand Ltd v Commerce Commission (Telecom AMPS-A)*,⁷⁸ the Commission has a 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. Impacts of an intangible nature, which are not readily measured in monetary terms, must also be assessed.

⁷⁶ Acknowledging that efficiency considerations are not the only relevant public benefits. See *Godfrey Hirst NZ Ltd v Commerce Commission* (2011) 9 NZBLC 103,396 at [51].

⁷⁷ For example,

⁷⁸ []
Telecom Corporation of New Zealand Ltd v Commerce Commission [1992] 3 NZLR 429.

243. The Commission is cognisant of the fact, however, that quantification is simply a tool that enhances the Commission's final qualitative judgement. The estimates provided below are by their very nature only approximations of the implied public detriments and benefits. The Commission does not rely on a rigid balancing of the quantified detriments and benefits without applying a wider qualitative analysis. As the High Court said in *Godfrey Hirst* when referring to how the Commission has previously quantified benefits and detriments:⁷⁹

Consistent with economic theory, detriments (welfare losses) are quantified (as far as practicable) under three categories of efficiency losses: allocative, productive and dynamic. Efficiency benefits (welfare gains), recognised pursuant to s 3A, are also quantified. Other benefits claimed by a party seeking an authorisation are quantified if possible. The Commission then forms its view on the range, magnitude and likelihood of all the claimed benefits (those quantified and any that are not quantifiable).

244. The Court also noted that:⁸⁰

...a purely quantitative assessment is not sufficient. A judgment (also referred to as a qualitative assessment) is required as to whether the Commission is satisfied on the evidence before it that the public benefits do outweigh the detriments such that an authorisation should be granted. That judgment will include an assessment of the quality of the information on which the quantitative analysis was carried out.

245. Cavalier's application used a five year time period and a 10% discount rate to estimate the net present value (NPV) detriments and benefits. This approach is broadly consistent with approaches previously taken by the Commission, including in Decision 725.

246. The use of the five year time period and the 10% discount rate recognises the fact that most detriments and benefits become increasingly less certain over time. Beyond five years it is difficult to forecast the effects of the proposed acquisition. While the Commission considers this framework to be the most pragmatic and appropriate in this case, there are two specific issues in respect of quantification that this approach may not address:

- 246.1 Detriments and benefits beyond five years: As noted, the Commission considers that prediction of merger effects beyond five years is particularly troublesome. However, the uncertainty is unlikely to be so stark that detriments and benefits reduce to zero after five years. Of course, if merger effects do continue beyond five years, the proportion of detriments to benefits is likely to stay roughly the same. Therefore, the five year timeframe can be seen as a representative snapshot of the lifetime merger effects. However, this representation may be skewed if: (a) some benefits take place upfront, rather than over an extended period, and thus get excessive weighting in a five year period; or (b) some benefits do not take place for a number of years and thus get insufficient weighting in a five year period. To address this, the Commission has also undertaken sensitivity testing with a 10 timeframe.

⁷⁹ *Godfrey Hirst NZ Ltd v Commerce Commission* (2011) 9 NZBLC 103,396 at [53]. See also [101] and [102] of the judgment.

⁸⁰ *Godfrey Hirst NZ Ltd v Commerce Commission* (2011) 9 NZBLC 103,396 at [115].

246.2 Possible inconsistencies in the time periods used: In the Commission's analysis below, the estimated values of the sales of the Kaputone and Whakatu scour sites and some of the scouring assets are included as benefits even though there is a possibility that they would not occur within the five year period. This contrasts with other benefits and detriments where the Commission has explicitly only looked at five years. This is because Cavalier would gain the economic value from these assets becoming available for alternative uses even if this value is not realised immediately in a sale. For instance, the sites may be used to derive rental income and the surplus scouring assets may be used in a joint venture rather than be sold.⁸¹ CWH would therefore obtain a benefit equal to the present value of these future income streams. We have not considered alternative value of using scouring assets in a joint venture rather than being sold. This is based on the assumption that the merged entity would only enter into such an arrangement if it expected to receive a greater return from a joint venture than from the immediate sale of these assets. Because of this we have only considered the benefits from sale even though these may be smaller than the returns from a joint venture.

Detriments

247. As in the previous authorisation, Cavalier has stated that, given the constraints imposed by the continued growth of the Chinese wool scouring industry, it considers that the proposed acquisition would result in little if any detriment.⁸² However, the Commission assessed the level of detriment which could arise if the loss of NZWSI as a competitive constraint were to be significant.
248. In undertaking this assessment the Commission has used the following categories – loss of allocative efficiency, loss of productive efficiency, and loss of dynamic efficiency.

Loss of allocative efficiency

249. In general, when the price of a product increases because of a loss of competition (for example, as a result of a merger), demand for that product will fall as some consumers switch to alternative products. These alternatives may meet consumers' requirements in a less satisfactory way and/or are more costly to produce than the product they replace. Alternatively, consumers may simply make fewer purchases, losing the benefit that they otherwise would have obtained from a product. In effect the net result is that the country's resources are allocated less efficiently. The size of the allocative efficiency loss depends primarily on the ability and incentive of the merged firm to increase prices post-acquisition. That ability and incentive depends on the extent that demand for the product declines with an increase in price (the elasticity of demand).

⁸¹ []

⁸² At [26.1] of the Application.

Potential scouring price increase

250. The Commission considers that the constraints on price increases arising from the threat of entry are similar, but not as strong as in the previous decision. Consequently, in comparison to Decision 725 the Commission has estimated allocative efficiency losses based on a higher range of potential price increases of 10% to 20%.
251. The use of a higher range of potential price increases is based on several factors. As previously noted, many of the parties interviewed, including the most likely entrant Segard Masurel, considered that entry is unlikely at a price increase below 10%. Many merchants expressed a view that continued rationalisation in the sector is inevitable, and would follow a well-established long-term trend of fewer scours because of a declining wool clip and declining level of domestic scouring.
252. As described in sections above, the total wool clip has decreased by 12% since 2010. Similarly, the total volume of wool scoured in New Zealand has decreased by [] over the same period. Consequently, the Commission considers that entry would be more difficult than previously because any potential entrant would be seeking to acquire market share in smaller markets.
253. Furthermore, the global shift of the manufacture of wool products to Asia, and China in particular, appears to have continued. At the same time the quantity and quality of the available scouring capacity in that region has increased. Over time this could further reduce the demand for clean wool from New Zealand and could lead to increases in greasy exports. Similarly, the growing substitution of wool products for synthetics, particularly by domestic carpet manufacturers, would also be a greater deterrent to entry.
254. Our preliminary view is that CWH would likely be able to increase prices by at least 10%, however, the threat of increased greasy exports or entry into wool scouring are likely to provide a constraint on CWH increasing prices by more than 20%.
255. For instance, modelling provided by NERA on behalf of Cavalier and adjusted by the Commission suggests that entry would be profitable with a price increase of 20% if initial capital expenditure costs (including plant, land, buildings and working capital) were [], the entrant required after-tax rate of return of 15%, the average wool grease price did not exceed [] per kg, and the entrant's volumes decreased by 1% per annum.⁸³
256. Similarly, as outlined in paragraph 193, James Irvine has suggested that a 20% price increase would be sufficient to make entry profitable by a comfortable margin within a relatively short time frame provided the entrant was able to guarantee volumes around 20,000 tonnes per annum.
257. Provided CWH is not able to undertake substantial price discrimination between wool destined for locations where local scouring is a feasible option versus wool destined for locations where local scouring is not an option (discussed in more detail

⁸³ This modelling also assumed the plant would achieve a volume of 20,000 tonnes within two years. This model also assumed an exchange rate of NZ\$1:US\$0.8, implying a wool grease price of US\$3 per kg.

below), the Commission also considers that a price increase of more than 20% is unlikely because at this price level merchants could switch to exporting more greasy wool.

258. The Commission understands that the additional transport costs of exporting greasy wool are relatively insignificant and would not present a substantial barrier to increased greasy exports.⁸⁴ Greasy wool is pressed into bales in the same manner as clean wool, with the result being that a container of greasy wool bales will provide around 80% to 85% of the amount of clean wool as a container of clean wool bales. This results in an additional freight cost of greasy wool in the order of only \$0.01 per kg.
259. Using estimates of marginal costs provided by NERA, combined with data regarding average revenue (ie, prices) in both geographic markets, the Commission has also estimated the profit maximising prices for the various demand elasticities ranging from -0.05 to -1. This has been undertaken to provide a 'sense check' of the Commission's presumed 10% to 20% price increase under the factual. The Commission's analysis suggests that if demand elasticity is either -0.05 and -0.5 the profit maximising price increase in each island would be well in excess of 20%. If demand elasticity is -1, the Commission estimated that the profit maximising price increase would be approximately 18% and 19% in the North and South Islands respectively.
260. As in Decision 725, the Commission posits that in practice domestic scouring services would face a stepped demand curve which would affect the composition of allocative efficiency losses. For example, some volumes of scoured wool to China could switch to greasy exports in the face of a relatively small price increase because of China's scouring industry, but scouring prices for wool destined for other export markets could increase significantly without greatly affecting the volumes sold. This is because there is no local scouring industry in these other markets and re-exporting wool from China is costly and problematic. Despite this, without more specific detail regarding these differences in demand the Commission has not modelled these aspects with any precision. Therefore, the Commission has taken a more simplified approach and assumed a linear demand curve.

Price discrimination

261. In assessing the potential allocative efficiency losses, it is necessary to consider the potential for CWH to undertake 'destination-based' price discrimination to any substantive degree as this could affect the magnitude of any potential losses.
262. For instance, if a high degree of price discrimination is possible between scouring provided for wool of different destinations CWH may be able to raise the effective price of scouring services for 'captive' wool by considerably more than 20% whilst leaving the scouring price for wool to be exported to China for example, relatively unchanged. This could materially impact the magnitude of allocative efficiency losses.⁸⁵

⁸⁴ Interview with Segard Masurel, 11 March 2015.

⁸⁵ The ability to price discriminate could also have an impact on potential wealth transfers.

263. Given that prices for scouring are established in advance of providing scouring services, and that scourers are often unsure of the final destination of wool when it is received, such price discrimination could conceivably be enacted by providing retrospective rebates.
[
].
264. Therefore, the Commission considers that CWH would be able to price discriminate to some degree. However, the Commission's preliminary view is that the extent of this discrimination would be somewhat limited.
265. Cavalier has submitted that its lack of knowledge, and oversight, of the ultimate destination of much of the wool it scours severely restricts its ability to raise prices.⁸⁶ Moreover, Segard Masurel has stated that if it were to face substantially different pricing based on the ultimate destination of the wool, it would be able to take measures to hide this destination.⁸⁷ These measures could include withholding shipping information and/or having scoured wool returned to its premises before being shipped.
266. The Commission also notes that over one third of clean wool exports are currently sent to China (28,890 tonnes).⁸⁸ This amount is up from 20% of clean exports in 2010 (18,288 tonnes). This is a sizeable proportion of total scoured volumes and an amount that could substantially affect the profitability of scours should it be lost to greasy exports. By way of comparison a similar amount is also exported to the European Union (28,713 tonnes).
267. Because of these factors, the Commission has taken the preliminary view that, for the purposes of estimating allocative efficiency losses, CWH would not be able to undertake substantial price discrimination.

Consideration of loss of allocative efficiency

268. To determine the most appropriate estimate for the potential loss of allocative efficiency in the factual, the Commission must make assumptions about the elasticity of demand for wool scouring in New Zealand. However, as is often the case, there appear to be no studies which show the extent to which the demand for scouring services in New Zealand rises or falls as scouring charges increase or decrease.
269. The Commission first considered whether a post-acquisition increase in scouring prices would be absorbed by merchants or passed on to their customers. In either case, this would mean that there would be limited allocative efficiency loss as volumes scoured in New Zealand would not decrease significantly (that is, demand would be inelastic).
270. However, it is the Commission's view that higher post-acquisition scouring prices would not be simply absorbed or passed on to downstream markets. The reasons are as follows.

⁸⁶ Cavalier submission, 8 December 2014.

⁸⁷ Interview with Segard Masurel, 24 November 2014.

⁸⁸ Beef + Lamb New Zealand Economic Service.

- 270.1 Scoured New Zealand wool competes in international markets against wool from other countries and, in many cases, against other fibres, including synthetic fibres. If scouring prices were to rise in New Zealand post-acquisition, it is unlikely that merchants would be able to pass these price increases onto international customers to any significant degree, because of the competitive nature of wool export markets.
- 270.2 Bloch & Behrens advised the Commission that while for some customers New Zealand wool would not be that easy to substitute, if New Zealand prices became too high those customers would switch to using other wools.⁸⁹ This is consistent with information provided by merchants in 2011 where Segard Masurel advised the Commission that while some customers must have New Zealand wool as part of their wool blends, if New Zealand prices became too high those customers would remove the product from their ranges, or move to equivalent synthetic-based products.⁹⁰ And Andrew Campbell of J S Brooksbank similarly advised that wool is sold in a global market and that New Zealand cannot dictate the price.⁹¹
- 270.3 It also appears unlikely that, if scouring prices were to rise in New Zealand by a significant amount post-acquisition, a substantial proportion of these price rises could be absorbed by merchants. In its previous investigation the Commission understood that merchants work in an extremely competitive environment and within tight margins. Comments from merchants to date suggest that this situation has not changed since Decision 725.
271. Rather than being passed on to downstream markets or absorbed, the Commission considers it likely that over time a large proportion of any wool scouring price increase to wool merchants would be passed back upstream to wool growers.
272. The Commission notes that to the extent that a substantial proportion of any scouring price increases were passed back to farmers, this could decrease the likelihood of entry into wool scouring by one or more merchants. This is because merchants would not bear the burden of the price increase. This could further weaken any constraint on CWH enacting significant price increases.
273. To the extent that a large proportion of any price increase was to be passed back up to farmers, the Commission does not consider that this would result in a large supply response. This is because 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 by sheep meat prices and the prices of production obtainable from alternative use of farm land such as beef, dairying or forestry. In Decision 725 the Commission noted that wool provides about 18% of farmers' sheep alone revenue.⁹² This remains consistent with Beef + Lamb New Zealand's Sheep and Beef Farm Revenue and Expenditure

⁸⁹ Interview with Palle Peterson, Managing Director of Bloch and Behrens, 19 November 2014.

⁹⁰ Interview with Segard Masurel, 21 February 2011.

⁹¹ Interview with Andrew Campbell, 22 February 2011.

⁹² Ministry of Agriculture and Forestry, Farm Monitoring Report 2010.

calculations.⁹³ This suggests that farmers make their sheep stocking decisions on parameters other than just their returns from wool sales.

274. Further, it is unlikely that farmers' sheep stocking decisions would be materially affected by an increase in wool scouring prices of 10% to 20%. Wool scouring services account for only about 8% of the current value of wool. It is, therefore, unlikely that a 10% to 20% change in the price of wool scouring services by itself would have a significant influence on the total amount of wool available for sale, either in scoured or greasy form.
275. The ability of merchants to pass additional scouring costs either up or down the supply chain suggests the possibility that merchant demand is relatively, although not necessarily completely, inelastic. However, this implication must be balanced against wool merchants nonetheless likely seeking to cost-minimise and the likelihood that at least some portion of the wool scoured in New Zealand could be exported greasy and scoured in China, in particular. This is discussed in greater detail in paragraphs 277 to 278, and the impact of elasticity in regard to wealth transfers is discussed in paragraphs 347 to 386.
276. In assessing potential allocative efficiency losses, the Commission must consider the likely demand elasticity facing the merged entity for scouring in New Zealand. To determine the appropriate demand elasticity, or range of elasticities, the Commission must make assumptions about how merchants and farmers would respond to different price changes and how that would depend on alternatives available to them.

Possible responses to price increases

277. The Commission's preliminary view is that CWH would face constraints on its pricing that are likely to limit its ability to raise prices above 20%. These include the ability of merchants to export a greater amount of wool in greasy form and the possibility of new entry. For prices up to this level, the Commission has considered the possible responsiveness in the demand for scouring services.
278. In Decision 725 the Commission used a range of potential elasticities of -0.05 to -1. In this analysis the Commission proposes to use a narrower range of elasticities to estimate the potential allocative efficiency loss; that is, -0.5 to -1. This is to reflect that an increased proportion (over a third) of the wool currently scoured in New Zealand is destined for China.⁹⁴ While not all of the clean wool that is destined for China could necessarily be quickly, easily and profitably switched to being scoured in China instead, it is likely that a substantial portion of this wool is 'at risk' of being scoured in China if New Zealand scouring prices increased. Cavalier claims that the limiting factor to any scouring price increase is the ability to scour overseas.⁹⁵ Moreover, as noted at paragraph 259, an elasticity of -1 is consistent with profit-maximising price increases in the order of 18-19%, which is within the bounds of the upper end of our range of price increases of 10-20%.

⁹³ Beef + Lamb New Zealand, New Season Outlook 2014/15.

⁹⁴ Beef + Lamb New Zealand, Wool export data July 2013 to June 2014

⁹⁵ At [15.31] of the Application.

Estimating the potential loss of allocative efficiency

279. Based on the Commission’s modelling approach in Decision 725, Cavalier has estimated allocative inefficiency losses for a range of demand elasticities. The Commission has amended this to account for a higher range of potential price increases. This is equivalent to considering different amounts of scouring volume loss before the price increase reaches the 10% to 20% level that the Commission considers would prompt entry and/or lead to substantial loss of wool volumes to greasy exports.
280. The Commission received the estimates of the loss of allocative efficiencies that could arise from the analysis submitted by NERA on behalf of Cavalier. These figures incorporate estimates of price-cost margins at current prices to account for the exploitation of any existing market power.⁹⁶ The Commission has adjusted these figures to account for the Commission’s revised view of the potential increase in prices from 10% to 20%.

Table 4: Estimated allocative efficiency losses for scouring (NPV over 5 years)

Price increase	Price elasticity	
	-0.5	-1
10%	\$4,584,024	\$9,168,049
15%	\$7,179,804	\$14,359,608
20%	\$9,978,095	\$19,956,189

281. In addition to allocative efficiency losses for scouring price increases, Cavalier provided an estimate of the potential allocative efficiency losses for small wool grease customers should they face a price increase post-acquisition.⁹⁷ This estimate is [] per year with a corresponding 5-year net present value of [].
282. Consequently, the overall range of total potential allocative efficiency losses is \$4.58 million to \$20.0 million depending on the size of the price increase and the elasticity of demand.

Loss of productive efficiencies

283. One outcome that can be associated with a loss of competition is that a firm gaining market power has less incentive to minimise costs and to avoid waste. Organisational slack may creep into its operations, and costs may increase, because a satisfactory level of profit is assured even when the firm is less than fully efficient.
284. However, determining whether a firm may be susceptible to losses of productive efficiency is difficult. A firm seeking to maximise its profits will have an incentive to

⁹⁶ Estimated pre-merger price-cost margins are approximately 130% in the North Island and approximately 80% in the South Island, based on estimated variable costs as a proxy for marginal costs. High margins are typically a sign of relatively inelastic demand and can indicate the exploitation of existing market power. However, to the extent that market power has already been exploited it may be that any further price increases may face relatively elastic demand. Consequently these estimates use a range of elasticities.

⁹⁷ Cavalier submission, 9 March 2015.

minimise its costs, irrespective of the level of competition in the market. For this reason the Commission does not necessarily assume that reductions in competition will necessarily lead to productive inefficiency.⁹⁸

285. While the Commission considers competition to be an important driver of productive efficiency, it also 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 external pressure placed on Cavalier and NZWSI by the declining wool clip and the possibility of increased greasy export to China. This external pressure is likely to continue.
286. CWH would only have four shareholders. These are Cavalier Bremworth, a subsidiary and major customer of Cavalier, Lempriere, ACC and Direct Capital. The latter two are experienced investors without significant interests elsewhere in the wool sector who are wishing to maximise their investment income and capital growth. This small number of overall shareholders is likely to have the ability and incentive to continue to drive productive efficiencies in the factual. The Commission considers any future shareholders would similarly have the incentive to continue to drive productive efficiencies.
287. Additionally, a substantial proportion of Cavalier's current staff have incentive-based remuneration schemes.⁹⁹ The Commission understands that similar remuneration schemes would be extended to many of the additional staff that CWH would employ. This reduces the likelihood that the transaction would result in a loss of productive efficiency.
288. Nevertheless, there is the possibility that a firm's management, without the day-to-day pressures from a close competitor and the competitive benchmark against which the firm's management can be measured, may become less productively efficient. Therefore, in its submission on behalf of Cavalier, NERA included an estimate of the potential productive efficiency detriments based on the approach used by the Commission in Decision 725. This approach involves applying a percentage factor of up to 5% to the dollar value of pre-merger variable costs. Therefore, the potential productivity loss using this approach is estimated to range from between a total of [] to [] over a five year period.
289. However, the Commission's preliminary view, for the reasons stated above, is that the likely productive efficiency loss would be relatively low and so uses a point estimate of [].

Increased supply risk

290. The rationalisation of scouring services would decrease the number of plants to one in both geographic markets and therefore increase the risk of a plant outage causing significant losses.
291. This risk may be mitigated by the fact that:

⁹⁸ Commerce Commission, *Authorisation Guidelines*, July 2013 at [68] to [71].

⁹⁹ Interview with Cavalier, 13 November 2014.

- 291.1 post-acquisition, CWH's scouring plants will not be operating at full capacity and CWH has comprehensive insurance to cover freight between islands in the case of a plant shutdown. Based on production forecasts, even with the rationalisation of scours, Cavalier has estimated that CWH would retain around [] spare capacity in the North Island and [] spare capacity in the South Island; and
- 291.2 comprehensive risk management infrastructure and processes are in place at both plants.
292. Nevertheless, the Commission considers that some higher risks and so costs associated with a plant closure post-acquisition should potentially be taken into account in the detriment analysis. 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's Awatoto plant was shut down for a short period due to a small fire in a control cubicle. Cavalier has previously submitted that any electrical failure at a time of high demand on one of their scouring plants would be repaired within 48 hours.
293. There is thus a relatively low level of risk based on historical industry experience. The ability to store greasy wool until the plant problem is resolved also limits the potential cost to the industry of an outage. 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. Because of the limited nature of the risk and the precautions already taken by Cavalier, the Commission view is that any likely detriment is likely to be de minimis.

Loss of dynamic efficiency

294. The Commission stated in the reasons for its decision on the *Air NZ/Qantas* matter:¹⁰⁰

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.

¹⁰⁰ Air New Zealand Limited and Qantas Airways Limited (Commerce Commission Decision 511, 23 October 2003).

295. 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. Similarly, even if firms possess market power they still have an incentive to innovate if doing so would lead to increased demand for their products and maximise profits. Consequently, a qualitative element is always a significant part of this assessment.
296. NERA on behalf of Cavalier has provided an estimate of potential dynamic efficiency losses based on the approach used in Decision 725 by the Commission. This approach assesses a loss of innovation by multiplying total sales by factors of 0.5% to 1.5% (this contrasts with the 0.5% to 1% range used by the Commission in the *Air NZ/Qantas* case).¹⁰¹ 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 [] to [].

Others views

297. Godfrey Hirst has suggested that the approach undertaken by NERA to estimate dynamic efficiency losses has too narrow a focus. Godfrey Hirst submitted that the method of estimating such losses does not take sufficient account of the effect of close competition on more general decisions regarding investment and divestment decisions, such as plant location and scale, and that these decisions may be more important sources of dynamic efficiency. As a result, Godfrey Hirst consider the dynamic efficiency loss estimates appear implausibly low and suggests that, in the extreme, poor decision making from CWH could lead to the failure of the domestic wool scouring industry. They also state that it is inappropriate to assume that the interests of the shareholders in CWH to minimise costs would be sufficient to eliminate this risk.¹⁰²

Commission's preliminary assessment

298. As discussed above, the Commission recognises that it is difficult to calculate precise dynamic efficiency losses with any strong confidence. In Decision 725, the Commission considered a number of industry characteristics that may affect its qualitative assessment.
299. In summary, the Commission found that there are a number of reasons why dynamic efficiency losses may be limited. First, the shareholders of CWH would have a strong profit maximising incentive to optimise dynamic efficiencies. Second, many innovations are the result of work by equipment manufacturers both in New Zealand and abroad. While the Commission accepts that the industry does innovate in respect of process and product, these innovations are of the kind whereby the equipment provided by the manufacturer is improved by the scourer, to suit local conditions and requirements. Moreover, most of the innovation tends to be in respect of improved processes, rather than new products. Given the relatively mature state of the technologies involved in wool scouring, any such innovations are likely to be incremental in nature.

¹⁰¹ Air New Zealand Limited and Qantas Airways Limited (Commerce Commission Decision 511, 23 October 2003).

¹⁰² Submission of Professor Neil Quigley, 3 December 2014.

300. Third, regarding dynamic efficiency effects from factors other than product or process innovations, the Commission's preliminary view is that the long-term competitive threat of the scouring industry in Asia is likely to reduce the risks of substantial dynamic efficiency losses. CWH would be acutely aware of the experience of the scouring sector in Australia, which has all but disappeared because of greasy exports to China. Furthermore, while there is risk that poor decision making from CWH could lead the company to fail, this does not preclude other owners from taking over the assets and altering key business strategies if this provides an opportunity for profitable activity.
301. Therefore, the Commission considers that while some innovation in the scouring industry has occurred as a result of competitive pressures within the domestic scouring market, major innovations have occurred outside the competitive environment. This is as a result of improvements by equipment manufacturers, who no doubt wish to remain competitive in their manufacturing markets.
302. As noted above, post-acquisition, CWH will continue to have the incentive to utilise new ideas where they contribute to profit and help ensure competitiveness with overseas scouring options. Therefore, the Commission's preliminary view is that the acquisition is likely to give rise to dynamic efficiency losses that are relatively minor and uses a point estimate of - 0.5%.

Quantification of loss of dynamic efficiency

303. Using a point estimate of a 0.5% loss in dynamic efficiencies, the estimated potential dynamic efficiency losses is [] over five years.

Benefits

Production efficiencies

304. The quantified benefits identified by Cavalier constitute benefits accepted by the Commission in Decision 725 as public benefits arising from the transaction. The assessment of these benefits has been updated using the approaches endorsed by the Commission in that decision and the High Court on appeal.
305. The primary benefits arise from the consolidation of Cavalier's and NZWSI's scouring lines from five sites to two sites generating cost savings and improved economies of scale and enabling the Whakatu, Kaputone and Clive sites to be released for other uses.

Non-capital costs savings – economies of scale benefits

Rationalisation of plant

306. Rationalising the five plants currently operated by Cavalier and NZWSI to two would enable CWH to reduce both the operating and overhead costs associated with operating the scours. This reduction in operating costs per unit would enable CWH to more effectively compete to provide scouring services for the reducing New Zealand wool clip.
307. Following the acquisition Cavalier would:

- 307.1 relocate the NZWSI 3.0 metre scour line currently located at Whakatu to its Awatoto plant;
- 307.2 relocate the NZWSI 3.0 metre scour line at Kaputone to its Timaru plant;
- 307.3 close Cavalier's scour line at Clive in the Hawke's Bay – this is currently used to cover emergencies and peaks in demand and would no longer be needed post acquisition (and as discussed above would either be sold []); and
- 307.4 close and sell Cavalier's 2.4 metre scour line at Timaru. CWH would also move the boiler from Kaputone to Timaru.

Total non-capital savings attributable to the transaction

- 308. CWH would obtain cost savings as a result of the transaction because of a reduction in non-capital costs, such as salaried and wage staff costs, administration expenses, repairs and maintenance costs, reductions in variable electricity, electricity lines charges and coal and gas costs, and a reduction in effluent system costs. Key areas of cost savings are described in further detail below.
- 309. CWH has estimated the cost savings that arise as being [] per year or [] over five years. As outlined below, the Commission has made a few amendments to these figures and our preliminary estimate is that cost savings non-capital cost savings would be worth [] million over five years. This equates to around [] per kilogram of greasy wool processed. These savings were previously considered by the Commission to be [] per year or [] over five years in Decision 725.
- 310. As with the estimates accepted by the Commission in the previous Decision, Cavalier's estimates are based on the level of production remaining largely unchanged as between the factual and the counterfactual. If the reduction in costs expected to result from the merger allows CWH to compete more strongly against scouring in China, volumes could potentially be higher in the factual than the counterfactual (thus leading to greater benefits than forecast).
- 311. The types of cost savings claimed are those accepted by the Commission in Decision 725 and updated to accord with present circumstances.
- 312. The cost savings accepted by the Commission were supported in the High Court as public benefits as they are reduced inputs to achieve the same outputs, regardless of whether CWH passes on the cost savings in the factual. Further, the High Court noted the Commission was cautious in analysing the level of savings and considered no further downward adjustment was required.¹⁰³ The main areas where savings are expected are as follows.

Reduction in salaried and wage staff costs

- 313. Rationalisation of scour lines post-transaction would allow cost savings from the avoided salaries and wages of workers that would no longer be required.

¹⁰³ *Godfrey Hirst NZ Ltd v Commerce Commission* (2011) 9 NZBLC 103,396 at [260].

314. []
].

315. []¹⁰⁴ []
].

316. []
]. The Commission's preliminary position is to accept this estimate.

317. The Commission previously accepted the reduction in staff costs of \$[] as a public benefit likely to occur and this was supported in the High Court which noted:¹⁰⁵

...the same amount of wool can be scoured in the factual as in the counterfactual, but with fewer employees. Those employees no longer required will be available to produce other goods and services for New Zealand consumers. It follows that New Zealand's labour use is more efficient in the factual. In the absence of any evidence or submission otherwise, the Commission was not wrong to value that available resource at the price an employer is willing to pay for it (here, as evidenced by Cavalier's saved salaries and wages), allowing for the social cost of redundancy.

318. The social cost of redundancy mentioned in that paragraph is included in the one-off rationalisation costs calculation below.

Reduction in administration expenses

319. Cavalier expects a reduction in administration expenses as a result of the transaction, including cost savings from: ACC levies; fire protection; information systems; insurance; general office expenses; repairs and maintenance of buildings and grounds; and security. The Commission previously accepted these as "claims of the kind that would result from a reduction in staff numbers and a reduction in the number of operating sites."

320. Cavalier has updated this figure, and expects cost savings of []. This is in comparison to the administrative cost savings in Decision 725 which were expected to be []. The Commission's preliminary view is to accept Cavalier's estimate, with the overall increase arising from increased costs, in particular higher insurance costs.

Reduction in repairs and maintenance costs

321. The reduction of scour lines in the factual compared to the counterfactual would result in savings in repair and maintenance costs. In addition to the reduction in

¹⁰⁴ This differs from the previous application where full crews for the 2.4 metre lines and the 3.0 metre line were expected.

¹⁰⁵ *Godfrey Hirst NZ Ltd v Commerce Commission* (2011) 9 NZBLC 103,396 at [264].

scour lines, the 3.0 scour line metre currently at Whakatu would be run for fewer hours and savings would be made from roller lap and separator service reductions. In addition, [].

322. Cavalier has submitted that it expects [] savings in repair and maintenance costs. The Commission previously considered the reduction in scour lines to result in a savings in repair and maintenance costs of [].
[]
[].

323. []
[].

Reduction in variable electricity costs and electricity lines charges

324. Electricity savings are expected to arise as a result of the transaction because of the rationalisation of lines and savings arising from the modification of the 3.0 metre Kaputone line. Cavalier has allowed for efficiency savings of []%, resulting in a cost saving for lines and variable electricity costs of []. With the closure of Kaputone, Whakatu and Clive, the electricity lines, transformers and switchgear resources used at these sites would be able to be used elsewhere. Against this, additional charges would apply to Cavalier's existing plants in the factual as result of the increased production (and hence increased kilowatt requirement) from Awatoto and Timaru. The Commission's preliminary position is to accept this estimate.
325. In contrast, savings in variable electricity costs and lines charges were considered separately by the Commission in the previous Decision. Efficiency gains were expected to result in variable electricity cost savings of \$[]. The Commission also previously accepted a reduction in lines charges as a result of ceasing wool scouring at Whakatu and Kaputone of \$[] giving an overall electricity cost saving of \$[].

Reduction in coal and gas costs

326. Cavalier expects gas cost savings as a result of the transaction because of a decrease in consumption from the closure of Clive and modifications made. The Commission's preliminary position is to accept Cavalier's estimate of energy savings of [] in the factual compared to the counterfactual.
327. The Commission previously considered energy savings as a result of decreased gas consumption of \$[] arising from the previously proposed transaction.

Reduction in effluent system costs

328. In addition, Cavalier expects significant cost savings as a result of the closure of the effluent system at Kaputone. This effluent system is required at Kaputone given it is in a residential area. It would not be required at CWH's Timaru site which is located in an industrial area and shares effluent disposal into an industrial plant.
329. Cavalier has estimated a benefit of [] from the sale of the system based on the value of the system as parts.
[]^{106 107} The Commission's preliminary position is to accept these estimates.

Total non-capital cost savings

330. Total non-capital cost synergies amount to [] in year one and [] per year for all subsequent years.

Sale of surplus land

331. Following the restructuring described above, the NZWSI sites at Whakatu and Kaputone, and Cavalier's Clive site would be surplus to scouring requirements and would be available for other uses. At the time of the previous application Cavalier had not determined whether it would sell the Clive site, but Cavalier now considers this site to also be surplus to requirements given the continued decline in the wool clip.
332. Freeing up surplus land and buildings is a public benefit, as these resources can be redeployed to other productive uses. This was accepted in the Commission's consideration of the application resulting in Decision 725 and agreed by the High Court.¹⁰⁸
333. The Commission previously considered a total benefit from sales ranging from \$6 million to \$10 million for both the Whakatu and Kaputone sites. This was based on likely sales prices of \$2.5 million for Whakatu and \$5.5 million for Kaputone. Cavalier submits that Kaputone is likely to have risen in value due to the area being marked for rebuild and the land being re-zoned residential.
334. Recent third party valuations of Whakatu and Kaputone provided by Cavalier indicate that sales of these sites would contribute a benefit of [] and [] respectively. Similarly, the benefit of the sale of the Clive land and buildings is expected to be [] based on a recent valuation. This gives a total benefit as a result of the sale of land and buildings of []. In Cavalier's view, these valuations provide the likely benefits to be achieved. Based on the available valuations the Commission's preliminary position is to accept these estimates, with an adjustment of plus and minus 10% to account for variability in actual sale values. The result is that this benefit is estimated at being between [] to [].

¹⁰⁶ Lempriere/NZWSI submission, 28 October 2014

¹⁰⁷ Cavalier expects some increased effluent charges at Awatoto reflecting the use of the Napier City Council effluent plant. These have been incorporated into non-capital cost savings.

¹⁰⁸ *Godfrey Hirst NZ Ltd v Commerce Commission* (2011) 9 NZBLC 103,396 at [281].

Sale of surplus plant

335. Cavalier also anticipates sales of plant and equipment worth []. This consists of the Clive 2.0 metre scour line, the Timaru 2.4 metre scour line and the effluent equipment at Kaputone.
336. This benefit was not included in the previous Decision. This is because these scour lines were not intended to be sold at the time of the previous application, but were to be mothballed. Therefore, the Commission has sought an alternative view on the potential re-sale value of this plant. According to an alternative industry source, the re-sale value of each scour would be between \$500,000 to \$650,000.¹⁰⁹ The Commission's preliminary position is to take a conservative approach and use the lower of these estimates. Consequently, we have estimated a benefit from the sale of plant of \$1 million.

Capital costs of rationalisation and ongoing capex savings

Capital expenditure on buildings

337. To accommodate NZWSI's scours from Whakatu and Kaputone CWH would undertake capital works on the Awatoto and Timaru sites. It would also expand the capacity for wool storage at Awatoto given the closure of the Clive site. Cavalier estimates that the total capital outlay on these alterations would be approximately []. This compares to the [] estimated in the previous Decision when more extensive works were required. As in Decision 725, the Commission has netted this amount off the benefits arising from the rationalisation, outlined below.

Capital expenditure on plant

338. Cavalier estimates that the additional (non-building) expenditure required to relocate the NZWSI scour lines at Whakatu and Kaputone to Awatoto and Timaru, relocate the Kaputone boiler to Timaru, reinstate the buildings at Whakatu, Kaputone and Clive that they can be sold and carry out necessary modifications to the remaining scour lines is []. In contrast the estimate in the previous Decision was [].
339. Cavalier spends approximately [] annually on capital projects for enhancements and improvements in productivity. We are not aware of any reason why this would change in the counterfactual. Given NZWSI's smaller operation, it currently spends approximately [] across both sites on capital projects yearly.
340. This capital expenditure would be avoided in the first year after the transaction (year 1) as it is encompassed by the expenditure on rationalisation described in the preceding paragraph. Cavalier also claims that there would also be on-going savings from this figure.
341. Cavalier considers that the maintenance programme it currently employs at its existing plants has sufficient capacity to encompass maintenance for the NZWSI scour lines (particularly given the same number of lines will result in Timaru).

¹⁰⁹ James Irvine email correspondence, 2 and 4 February 2015. These values rely on the age of the scours, the prevalence of potential purchasers and the expense of installing and obtaining permits for old scours, and the cost of new scours.

Accordingly, it believes its maintenance costs would not increase post acquisition and it would avoid expenditure currently incurred by NZWSI on winter maintenance and improvements in productivity. Further, economies of scale in capital expenditure would also result in savings. As a result, Cavalier claims this would result in a cost saving of [] per year.

342. [

110

343.

]

344. To determine the net capital expenditure savings, the savings outlined above are offset against the [] rationalisation cost. Total avoided capital expenditure on plant over five years therefore amounts to []. The Commission found in Decision 725 that there would have been a benefit of avoided capital expenditure of [].

One-off rationalisation costs

345. Cavalier has estimated that the proposed rationalisation would result in redundancy costs of []. This contrasts with [] in the previous Decision. Cavalier has also incorporated contingency rationalisation costs of [] in the first year of the factual as in the previous Decision. In addition, Cavalier has allowed for [] in cartage costs during the rationalisation period. [

]

346. The Commission's preliminary view is to accept these estimates which result in a NPV of one off rationalisation costs of [].

Wealth transfers to and from non-New Zealanders

347. If the proposed transaction allows CWH to exercise market power by raising prices in the factual it would, in addition to the associated allocative efficiency loss, result in a transfer of wealth from its customers to CWH. Where one group gains at the expense of another in this manner, the transfer of wealth is not generally included in the Commission's analysis of benefits and detriments. This is because there is typically no net impact to New Zealand from such a transfer.¹¹¹

348. However, an exception to this approach is if one or more groups are non-New Zealanders. The Authorisation Guidelines state:¹¹²

¹¹⁰ []

¹¹¹ This is distinct from allocative efficiency impacts described above, which relate to the lost consumer and producer surpluses arising from lower quantities of output bought and sold in the market.

¹¹² *Authorisation Guidelines* above n 98 at [54] and [55].

Wealth transfers may become relevant where the transfer is between New Zealanders and non-New Zealanders. This is because the public benefit test focuses on benefits to New Zealanders. As a result, transfers of wealth from non-New Zealanders to New Zealanders may be a public benefit. Similarly, transfers of wealth in the opposite direction may be a public detriment.

However, in addition to considering the direct effects of wealth transfers, we also consider any effects on non-New Zealanders that may ultimately feedback to impact New Zealanders. For example, if a transaction would lead to a New Zealand firm charging higher prices to tourists, that would result in a transfer of wealth from those tourists to the New Zealand firm resulting in a public benefit. However, equally, those higher prices could lead to fewer tourists coming to New Zealand, which in the longer term could negatively affect New Zealanders.

349. As made clear by the *Air New Zealand/Qantas*¹¹³ decision, not only does the nationality of those who receive the wealth transfer as a result of their exercise of market power matter but so might the nationality of those who incur the price increase (in the case of *Air New Zealand/Qantas*, the foreign tourists). The implications of this in the case of wool scouring is that the nationality of both of the owners of CWH and of those purchasing wool scouring services (wool merchants) and/or those in related upstream or downstream markets (carpet manufacturers and wool growers) may be considered when determining how the wealth transfer is to be treated in the benefits and detriments analysis.
350. A further consideration is whether any transfers comprise of “functionless monopoly rents”.¹¹⁴ Functionless monopoly rents are those returns which are over and above those needed to incentivise efficient investment. They may arise from the exploitation of market power. These can be distinguished from “functional” returns to capital that are necessary to incentivise efficient investment. Therefore returns that non-New Zealanders receive from investments in New Zealand should not necessarily be considered detrimental transfers of wealth to foreigners as New Zealand benefits to a large degree from the inflow of foreign capital.
351. The Commission’s preliminary view is that any exploitation of market power by CWH to increase scouring prices above current levels, arising from a lessening of competition because of the transaction, would generate functionless monopoly rents. These functionless monopoly rents would consist only of that portion of CWH’s returns that flow from an increase in prices.
352. Therefore, any incremental transfer of wealth from New Zealanders (eg, New Zealand wool merchants, carpet manufacturers and wool growers) to the non-New Zealand shareholders of CWH that arises from an increase in scouring prices is likely to constitute a detriment of the transaction. Conversely, any incremental transfer to the New Zealand shareholders of CWH from non-New Zealanders (that is, foreign-owned wool merchants, carpet manufacturers and wool growers) is likely to constitute a benefit to New Zealand.
353. To determine the nature (benefit or detriment) of any wealth transfers, it is first necessary to determine the residency status of those who would receive the transfers, ie, CWH shareholders, as well as those who may incur the burden of any price increase. The next step is to assess the economic incidence of a price increase,

¹¹³ *Air New Zealand and Qantas Airways Limited v Commerce Commission* (2004) 11 TCLR 347.

¹¹⁴ This is outlined in *Telecom Corp. of New Zealand Ltd v Commerce Commission* (1991) 4 TCLR 473, 531; 3 NZBLC 102,340, 102,386.

ie, determine who bears the ultimate financial burden of a price increase. A key element of this assessment is determining whether the immediate buyers of scouring services (merchants) would incur the full cost of a price increase, or whether, and to what extent, these merchants are able to pass this cost on to other parties. If such pass through is possible, the residency of those parties must then be considered (in this case, the residency of the owners of sheep farms).

354. The final step is to consider the likely magnitude of any wealth transfers to or from non-New Zealanders as a result of a price rise.

Residency status of relevant groups

355. In determining benefits and detriments to the public of New Zealand, New Zealanders are considered to be those who are domiciled in New Zealand.¹¹⁵
356. As noted above in paragraph 10, given that the Lempriere aspect appears to be an indivisible part of the commercial transaction, providing that transaction does not breach the Act, the Commission has had regard to any potential relevant implications following from the Lempriere aspect as part of the facts and circumstances it must consider in this Draft Determination.
357. On this basis, post-acquisition 55% of the shareholding of CWH would be held by Cavalier Bremworth, ACC and Direct Capital. The Commission understands that these are New Zealand resident companies with New Zealand resident shareholders and therefore has treated any increase in returns to these parties as a transfer to New Zealanders. And as discussed above, as a consequence of the acquisition, 45% of CWH would be transferred to Lempriere, which is an Australian company which itself has some degree of ultimate ownership located in China.
358. The Commission understands that around 80% of scouring purchases are made by merchants who themselves are foreign-owned.¹¹⁶ As well as NZWSI, which is owned by Lempriere, these merchants include Segard Masurel, Bloch & Behrens, J S Brooksbank, H Dawson, Fuhrmann, Curtis Wool Direct, Standard Wool, and others.
359. Although the Commission has not obtained detailed ownership statistics for sheep farms, it understands that around 1 to 2 % of farms in New Zealand are foreign owned.¹¹⁷
360. The Commission has assumed that all offshore buyers of New Zealand's wool exports are non-New Zealanders. In addition, there are three main domestic buyers of clean wool, consisting of carpet manufacturers Cavalier Bremworth and Godfrey Hirst, and yarn spinner New Zealand Yarns. The Commission understands that both Cavalier Bremworth and New Zealand yarns are New Zealand-owned while Godfrey Hirst is Australian-owned.

¹¹⁵ *Authorisation Guidelines*, above n 98 at footnote 44.

¹¹⁶ Cavalier submission, 22 December 2014.

¹¹⁷ Telephone call with Overseas Investment Office (OIO), 24 March 2015. The OIA notes that due to various factors exact figures for foreign land ownership are difficult to pin point.

Economic incidence of price increases

361. Any price increase by CWH would in the first instance be incurred by the buyers of scouring services, ie, merchants. However, the Commission considers that a substantial proportion of a price increase is likely to effectively be passed back upstream to wool growers in the form of lower farm-gate prices. The rationale for this position was outlined in the previous Decision as described above.
362. In practice it is likely that at least some portion of scouring price increases would be borne by at least some merchants in the form of lower profits and/or passed onto some downstream buyers, particularly those buyers in New Zealand for whom alternative international sources of clean wool are not viable. This presumption was supported by [].¹¹⁸
363. However, the Commission considers it likely that a large share of a scouring price increase would ultimately be borne by wool growers. This is for two reasons: first, purchases of wool by merchants that is scoured domestically account for [] of all farm gate wool purchases. This means that should these merchants have a lower willingness to pay for wool at the farm gate because of higher scouring costs, farmers would face limited alternatives to whom to sell their wool to discipline that decrease in price. Second, because wool is a by-product of sheep farming, the supply of wool is relatively inelastic, as described above. This means farmers are unlikely to supply less wool in response to a small change in price.
364. A 20% increase in scouring prices would be relatively small in comparison to farm-gate prices for greasy wool.¹¹⁹ Such an increase, if passed-through, would represent a \$0.07 per kilogram reduction in farm-gate prices. In comparison farm-gate prices for greasy wool typically range from around \$3 per kilogram for strong wool and up to \$10 per kilogram for fine wool.¹²⁰ Therefore a \$0.07 change in scouring prices could affect prices for strong wool at the farm-gate by less than 2% and is unlikely to elicit a substantial supply response.
365. To put this in perspective farm-gate prices, determined largely under an auction system, are often prone to relatively large fluctuations, whether because of changes in global demand and supply conditions or changes in exchange rates. For example average annual auction prices for strong wool fell by almost 25% from \$4.21/kg at June 2012 to \$3.17/kg at June 2013.¹²¹ These prices are estimated to then have increased by over 20% to \$3.84/kg over the following 12 months to June 2014.
366. There is little evidence that there is likely to be a substantial supply response from growers in relation to a \$0.07/kg price reduction. Some growers may reduce the level of shearing they undertake if farm-gate prices fall too low to compensate them for shearing costs, but at prices above this level shearing activity is likely to be unaffected. A change of this magnitude therefore is unlikely to be the determining factor in whether a significant proportion of growers reduce their shearing activity.

¹¹⁸ [].

¹¹⁹ The Commission has not considered the impact of price increases larger than 20% because at this level the threat of entry into the scouring market as well as the possibility of greater greasy exports is likely to limit pricing.

¹²⁰ Beef + Lamb New Zealand Economic Service, Mid-Season Update 2013-14.

¹²¹ Beef + Lamb New Zealand Economic Service, Mid-Season Update 2013-14.

367. Additionally, while some sheep farms are able to convert to other forms of farming such as dairy, many are not suitable for conversion because of the hilly terrain upon which many sheep farms are located. More sheep farms may be able to be converted to forestry, but given the long-term pay-off periods required for forestry investments, the Commission considers that a change in farm-gate prices of \$0.07 per kilogram is unlikely to be a deciding factor in such decisions.
368. The Commission also considers that an increase in scouring prices of less than 10% would not necessarily result in a large shift to greasy exports. While around a quarter of the total wool clip is currently exported in greasy form, the amount of greasy exports appears to have remained relatively stable over recent years. Exports of greasy wool in 2014 (44,476 tonnes) are very similar to greasy exports in 2010 (43,015 tonnes).
369. This suggests that if faced with a relatively small reduction in the amount that merchants are willing to pay for wool sought for clean exports, growers may not be insulated by this reduction in demand by switching to selling large amounts of wool to merchants seeking to export wool in greasy form.
370. This raises the question of whether an increase in scouring costs would necessarily reduce merchants' willingness-to-pay for greasy wool at auction or whether merchants would absorb these cost increases. The Commission's preliminary view is that the likelihood of merchants absorbing a substantial proportion of a scouring price increase of this magnitude is low.
371. Given that merchants largely sell at world prices into competitive export markets there is little scope for them to raise their prices to derive extra margins to cover any New Zealand-specific increase in scouring costs. The Commission is unaware of any evidence that suggests that merchants are currently deriving 'excess' returns above competitive levels that would enable them to absorb a cost increase.¹²²
372. The Commission also understands that, as is common across many agricultural commodity markets, farm-gate wool prices closely follow clean wool prices in downstream export markets.¹²³ This means that changes in prices in export market markets are typically passed back up the supply chain by merchants to wool growers.
373. The one exception to this is sales of clean wool by merchants to domestic buyers. These buyers are unlikely to be able to switch to an alternative international source of clean wool without incurring significant transport costs. This would provide some scope for merchants to pass on scouring cost increases. However, these sales account for only 8% of the total wool clip. The proportion of a price increase that could be passed onto these downstream buyers is corresponding small.
374. The result of the relatively inelastic supply of wool over the likely range of price increases combined with the reduction in the amount merchants would be willing to bid for a large share of greasy wool at the farm-gate means that the Commission considers that the majority of a scouring price increase would be passed through to

¹²² In Decision 725 at [233] the Commission found that merchants operate in "an extremely competitive environment and within tight margins".

¹²³ Interview with Segard Masurel, 11 March 2015.

growers. The Commission's preliminary view is that sheep farmers are unlikely to further pass on any losses they make to other parties, eg, suppliers of farming inputs, to any significant extent.

375. Given the uncertainty regarding the precise degree of pass-through, the Commission's preliminary view is that a conservative approach towards estimating benefits and detriments is appropriate. Consequently, our judgement is that it is appropriate to estimate the wealth transfers on the basis of a 90% pass-through of scouring price increases to wool growers.

Magnitude of wealth transfers

376. The potential size of the total transfer to CWH from higher prices to buyers (merchants) under different price increases (10% to 20%) has been estimated for different price elasticities as with allocative efficiency loss estimates (-0.5 to -1).¹²⁴ The estimated total transfer ranges from \$3.5 million to \$7.0 million per year. The present value of these transfers over a five year period ranges from \$14.6 million to \$29.2 million.
377. Because these transfer estimates are gross pre-tax figures, the Commission has scaled down these figures by an assumed effective marginal tax rate on foreign shareholders of 28%.¹²⁵ This accounts for the fact that it is only the after-tax portion of these amounts that may be transferred to or from non-New Zealanders.
378. This net wealth transfer from growers to CWH can then be divided up into eight components, as indicated in Figures 2 and 3 below.
379. Segments A, B, C and D together represent the total transfer from merchants to CWH and E, F, G and H represent the total transfer from farmers to CWH.
380. In particular, segment A represents the transfer in relation to the approximately 20% of purchases that are made by merchants that are New Zealand owned to the New Zealand shareholders of CWH (Cavalier Bremworth, ACC and Direct Capital). This does not have impact on the net public benefit to New Zealand because it is a 'neutral' transfer between New Zealanders. Segment B reflects the transfer from these same New Zealand merchants to the foreign shareholders of CWH, ie Lempriere. This is a detrimental wealth transfer from New Zealanders to foreigners.
381. Conversely, segment C represents a transfer to New Zealand shareholders of CWH from foreign-owned merchants and therefore comprises a beneficial wealth transfer to New Zealand. Segment D represents a transfer from foreign-owned merchants to foreign shareholders of CWH and so does not impact on public benefits to New Zealanders.
382. Segment E represent the transfer from the approximately 2% of farms that are foreign owned to the New Zealand shareholders of CWH. This constitutes a public benefit. Segment F represents the transfer from foreign-owned farms to Lempriere and therefore does not impact on public benefits to New Zealanders.

¹²⁴ These estimates are based on a given level of pre-existing market power.

¹²⁵ This is based on the corporate tax rate.

383. Segment G represents transfers from New Zealand farmers to the New Zealand shareholders. This does not have impact on the net public benefit to New Zealand because it is a 'neutral' transfer between New Zealanders. Segment H is a transfer from New Zealand farmers to Lempriere, which constitutes a detriment.

Figure 2

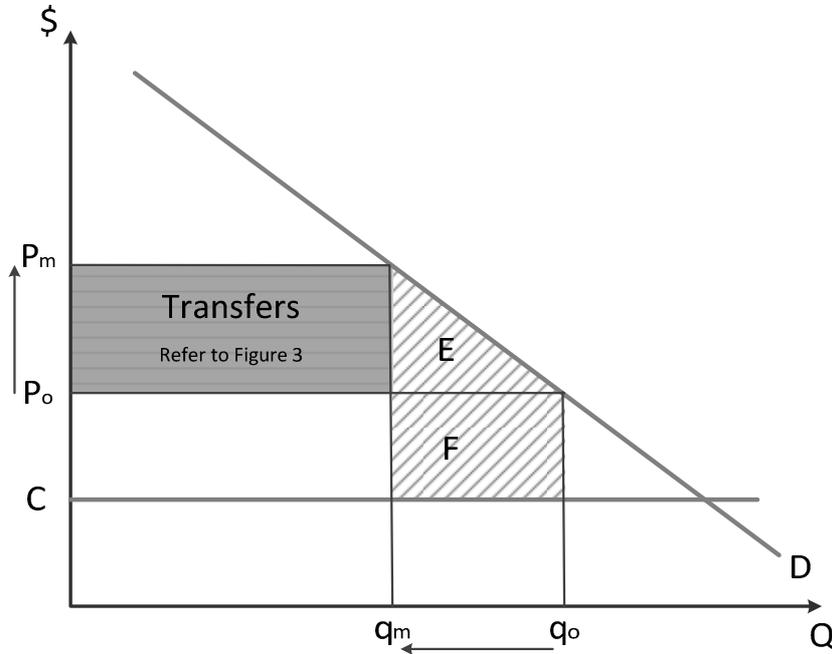
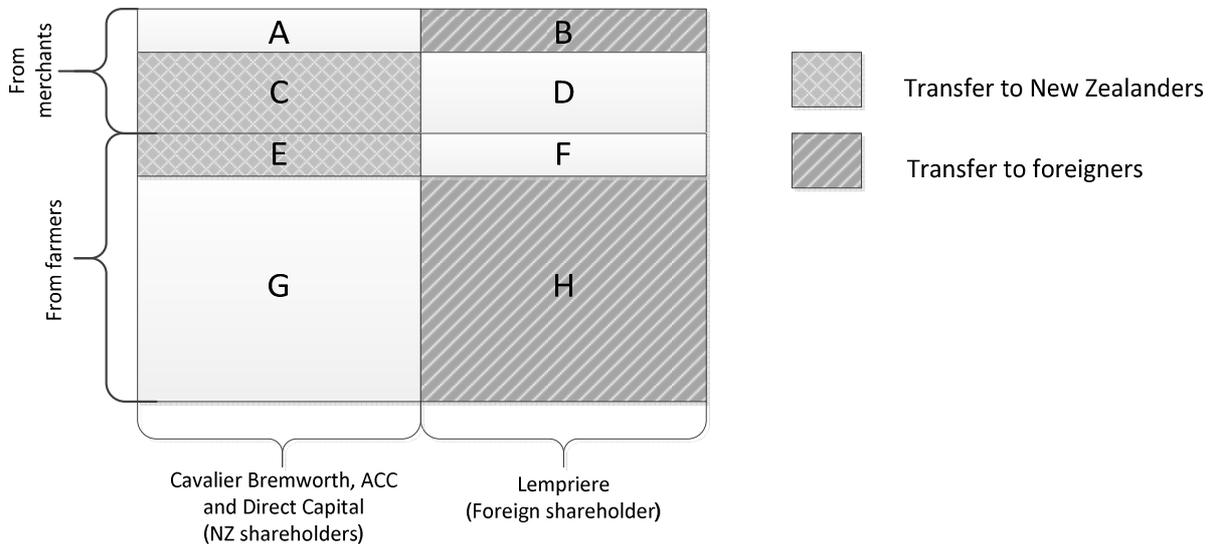


Figure 3



384. Based on these ownership splits, the rate of pass-through from merchants to farmers outlined above, and the range of elasticities considered likely, the Commission calculates that the maximum net wealth transfer to non-New Zealanders ranges from \$0.9 million to \$1.8 million per year. The corresponding present value of the estimated detriment over a five year period ranges from \$3.7 million to \$7.4 million, as outlined in Table 5.

Table 5: Estimated net wealth transfers (NPV over 5 years)

Price increase	Price elasticity	
	-0.5	-1
10%	\$3,900,661	\$3,695,363
15%	\$5,697,019	\$5,235,098
20%	\$7,390,727	\$6,569,535

385. The Commission has not considered any possible “feedback” effect, by which transfers to New Zealanders from non-New Zealanders may result in non-New Zealanders either making fewer purchases or undertaking less investment in New Zealand.¹²⁶ This may be relevant particularly when considering wool merchants. Since, as noted at paragraph 371, wool merchants are said to be operating on thin margins, should some portion of an increase in wool scouring costs be borne by merchants this would make doing business in New Zealand less attractive, potentially impacting their investment decisions. A reduction in inward investment could be detrimental to New Zealand. This consideration is largely mitigated here since the Commission’s preliminary view is that scouring price increases would likely be substantially passed through to farmers, leaving wool merchants not much worse off.
386. Additionally, the Commission has not reduced potential productive efficiency losses or dynamic efficiency losses despite foreign ownership. This is because it is not clear that these losses would only impact on functionless monopoly rents. That is, these efficiency losses could reduce socially valuable returns to capital that incentivise efficient investment. Consequently these detriments are harms to New Zealand despite their effect on non-New Zealanders.

Balancing of benefits and detriments

387. This application involves a balancing of the public benefits and detriments which will, or will be likely to result, from the acquisition. Only when there is such a benefit can the Commission be satisfied that the acquisition should be permitted, and that it should grant an authorisation for the acquisition.
388. Tables 6 and 7 summarise the Commission’s quantitative assessment of the detriments and benefits arising from the acquisition.

¹²⁶ An example of this is given in the *Authorisation Guidelines*, above 98 at [55]. A transaction that led to higher prices to tourists may generate beneficial wealth transfers to New Zealanders. However, higher prices may also lead to fewer tourists visiting New Zealand, which could be detrimental.

Table 6: Summary of detriments

Category	Evaluation	5-year NPV
Allocative efficiency	\$1.1 million to \$4.79 million per year	\$4.58 - \$20.03 million
Productive efficiency	[]	[]
Dynamic efficiency	[]	[]
Net wealth transfers	\$0.89 million to \$1.77 million per year	\$3.70 million to \$7.39 million
Total of quantified detriments		\$10.57-28.69 million

Note: A 10% discount rate was used in these calculations. The maximum estimated allocative efficiency detriment arises from an elasticity of -1.0 whereas the maximum wealth transfer detriment arises from an elasticity of -0.5. The opposite is true for minimum estimates. Therefore maximum and minimum total quantified detriments sums to different values than the maximum and minimum of individual detriment ranges.

Table 7: Summary of benefits

Category	Evaluation	5-year NPV
Reduction in Production and Administration Costs	[]	[]
Sale of land and plant	One-off benefit	[]
Capital expenditure buildings	One-off cost	[]
Capital expenditure on plant	[]	[]
One-off Rationalisation Costs	One-off cost	[]
Cartage to North Island	[]	[]
Total of quantified benefits		\$31.19 – 33.45 million

Note: A 10% discount rate was used in these calculations. Figures have been rounded to one decimal place after the calculations have been made and therefore all columns may not sum.

389. Under the various scenarios, including the 'worst case' scenario based on the most conservative likely assumptions (ie, taking into account the greatest efficiency detriments) the estimated net impact of the transaction is positive.
390. The Commission has also considered the likely magnitude of the benefits and detriments over a longer timeframe to gauge the sensitivity of the findings to the period considered. The results of this are included in Table 8 below.

Table 8: Estimated net impact (NPV)

Time frame	Overall net impact	
	High detriment / low benefit	Low detriment / high benefit
5 years	\$2.51 million	\$22.88 million
10 years	\$0.32 million	\$31.94 million

391. As the High Court noted in *Godfrey Hirst*:¹²⁷

The Commission is not bound to value detriments at the middle point of an identified range. It may be legitimate to reach a judgment that a value falls at a particular point within a range. That judgment may depend in part on an assessment (if it is able to be made on the facts) of the distribution of probabilities.

392. The High Court went on to say:¹²⁸

...unless the Commission has good reasons for excluding other values within the (likely) range that it has determined, it is the range rather than any point within the range that should form the basis for the balancing exercise.

393. The Commission acknowledges that quantification is only one tool to be used in its judgements in such a case. The necessary balancing of benefits and detriments is also informed by the Commission's qualitative judgements of the likely magnitude of benefits and detriments. In this case we have not identified any inherently unquantifiable benefits or detriments that must be considered as part of the analysis.

394. The result of this qualitative assessment of the likely magnitudes of the various benefits and detriments leads the Commission to the preliminary view that this transaction would generate a net overall benefit. The Commission does however acknowledge that under the 'worst case' scenarios involving high detriment assumptions, the overall net benefit would be relatively small.

The Commission must be satisfied

395. As set out above, the Commission may authorise the application under section 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.

The Commission's analytical method

396. To assist with determining whether the Commission can be satisfied that this test is met, since the *Telecom AMPS-A* decision,¹²⁹ it has been clear that the Commission

¹²⁷ *Godfrey Hirst NZ Ltd v Commerce Commission* (2011) 9 NZBLC 103,396 at [102].

¹²⁸ *Ibid* at [105].

¹²⁹ *Telecom Corporation of New Zealand Ltd v Commerce Commission* [1992] 3 NZLR 429 (CA) at 447 per Richardson J.

must so far as possible quantify benefits and detriments rather than rely on purely intuitive judgement. In *Ravensdown* the High Court confirmed that assessing benefits and detriments within an analytical framework helps the Commission to guard against missing elements that require consideration, or from double-counting elements.¹³⁰

397. In *Ravensdown* the court also noted that quantification was not the end of the analysis:¹³¹

Where evidence was available to arrive at a quantitative assessment, that was done, but equally in the absence of sufficient evidence no evidence to quantify in dollar terms was attempted. It is also significant that the analysis included both a separate examination of the benefit and detriment elements, followed by a more holistic exercise. In other words, the Commission stood back and looked at benefits and detriments in the round. We are not persuaded that the methods employed were inadequate or wrong.

398. As noted earlier, this view was approved by the same court in *Godfrey Hirst*. Justice Mallon stated:¹³²

....a purely quantitative assessment is not sufficient. A judgment (also referred to as a qualitative assessment) is required as to whether the Commission is satisfied on the evidence before it that the public benefits do outweigh the detriments such that an authorisation should be granted. That judgment will include an assessment of the quality of the information on which the quantitative analysis was carried out. If the quantitative analysis, allowing for uncertainties, shows that efficiency gains outweigh efficiency losses and if unquantifiable factors are not sufficient to “tip the balance”, we consider it would be wrong then to stand back and ask what is so “good” about this merger that it should be permitted.

Applying this analytical method

399. In this case, as can be seen from Table 8 above, the benefits outweigh the detriments in the five year timeframe by between \$2.51 million (using high detriment assumptions) and \$22.88 million (using low detriment assumptions) in an industry with annual turnover in the vicinity of \$60 million to \$80 million.
400. In weighing the benefits and detriments, we have considered the quality of the evidence and tested the assumptions that underpin the quantitative analysis.
401. We have allowed for uncertainties in the quantification exercise, such as by including the upper points in the likely ranges for allocative inefficiencies and net wealth transfers. We have also allowed for concerns over the quality of the evidence before the Commission, such as by including a plus or minus 10% range to the estimated land resale value provided by Cavalier.¹³³

¹³⁰ *Ravensdown Corporation Ltd v Commerce Commission* HC Wellington, AP 168/96, 9 December 1996 at 47 and 48.

¹³¹ *Ibid* at 48.

¹³² *Godfrey Hirst NZ Ltd v Commerce Commission* (2011) 9 NZBLC 103,396 at [115].

¹³³ *Godfrey Hirst NZ Ltd v Commerce Commission* (2011) 9 NZBLC 103,396 at [327].

402. As Justice Mallon noted in *Godfrey Hirst* the size of the margin between the net public benefits and the detriments may not matter, providing allowance has been made for uncertainties in the analysis.¹³⁴

The size of the margin between the net public benefits and the detriments may not matter, providing allowance has been made for uncertainties in the analysis. For example, the uncertainties may have led the Commission to take an upper point in a range for an efficiency loss and to have carried that point through to the balancing of benefits and detriments. If so, it would be wrong to then effectively double count this uncertainty in the balancing exercise. Or, as a further example, the quality of the information relied on may be such that the Commission is satisfied with the robustness of the analysis. Where, however, the net public benefits and detriments are finely balanced it will be particularly important for the Commission to set out its reasons for being satisfied that these are “such” benefits to the public that the proposed acquisition should be permitted.

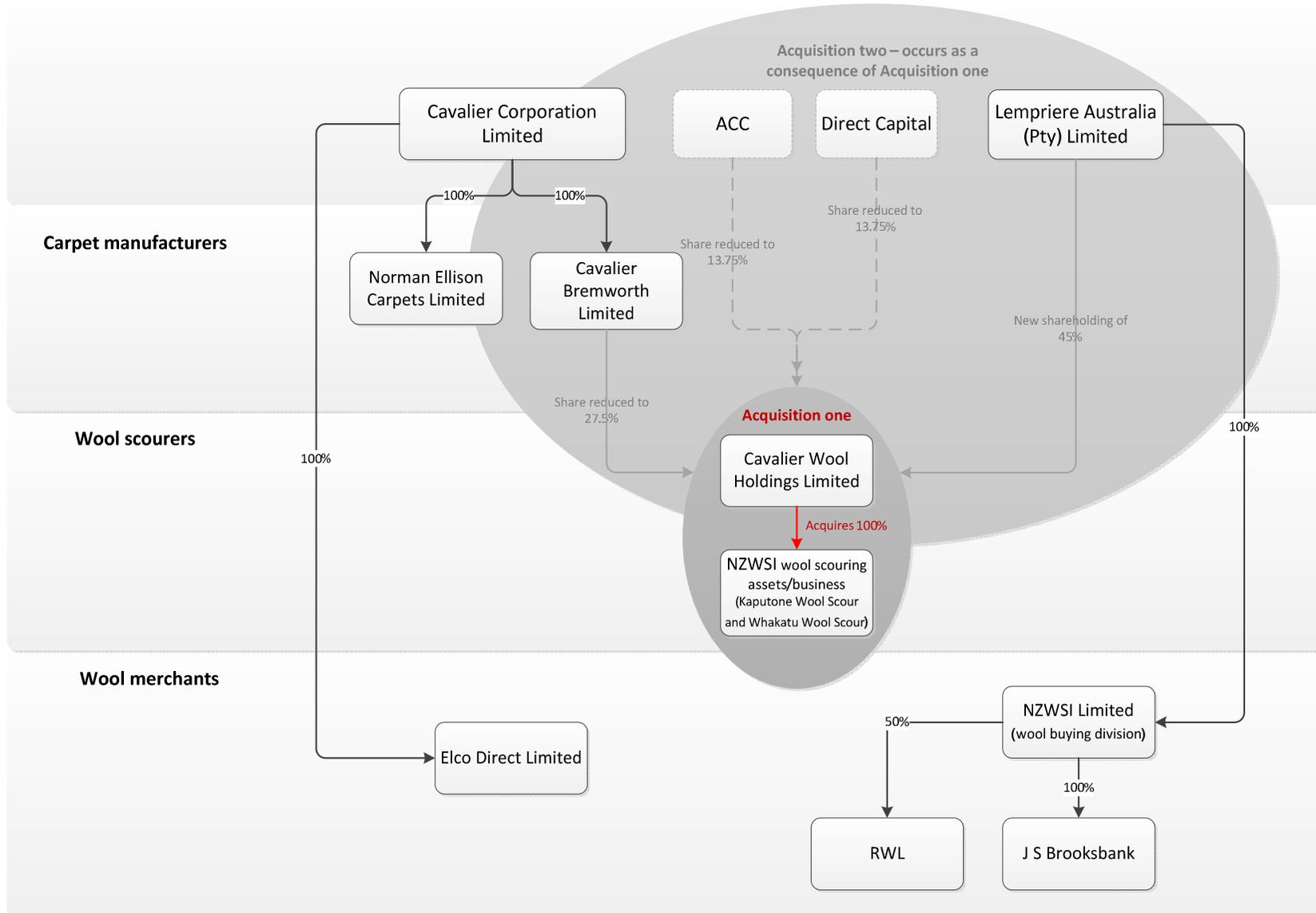
403. In *Godfrey Hirst* the court was satisfied that “such a benefit” was present where the benefits outweighed the detriments by \$3.6 million.
404. At this preliminary stage, we consider that using high detriment assumptions the public benefits are likely to outweigh the detriments and we are therefore satisfied that our analysis establishes that there is such a benefit to the public that the proposed acquisition should be authorised.

¹³⁴ Ibid at [116].

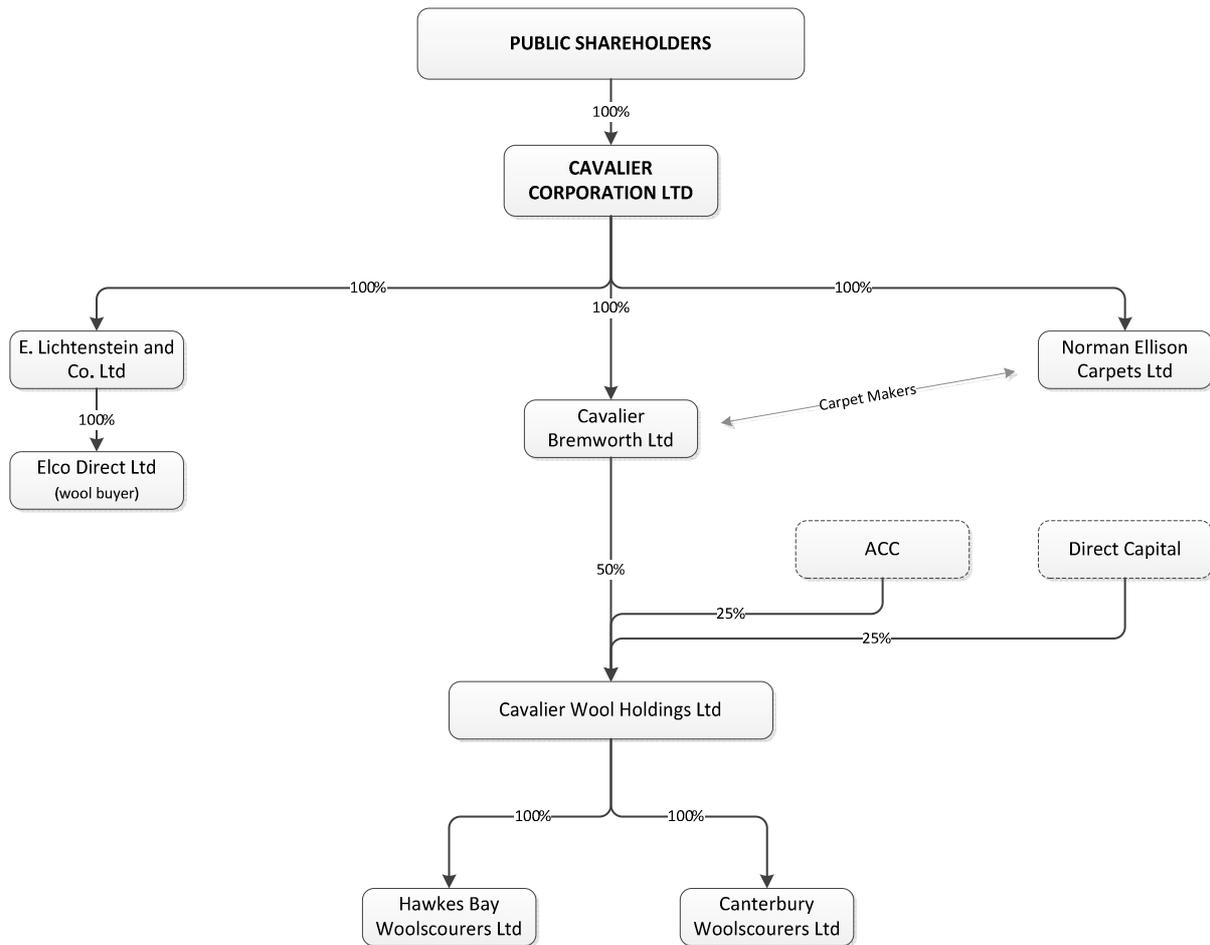
Draft determination

406. 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, or the small domestic customer wool grease market.
407. The Commission's preliminary view is 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.
408. Following the Commission's consideration of submissions on this Draft Determination, if its preliminary views are confirmed, the Commission would grant an authorisation of the acquisition under section 67(3)(b) of the Act.

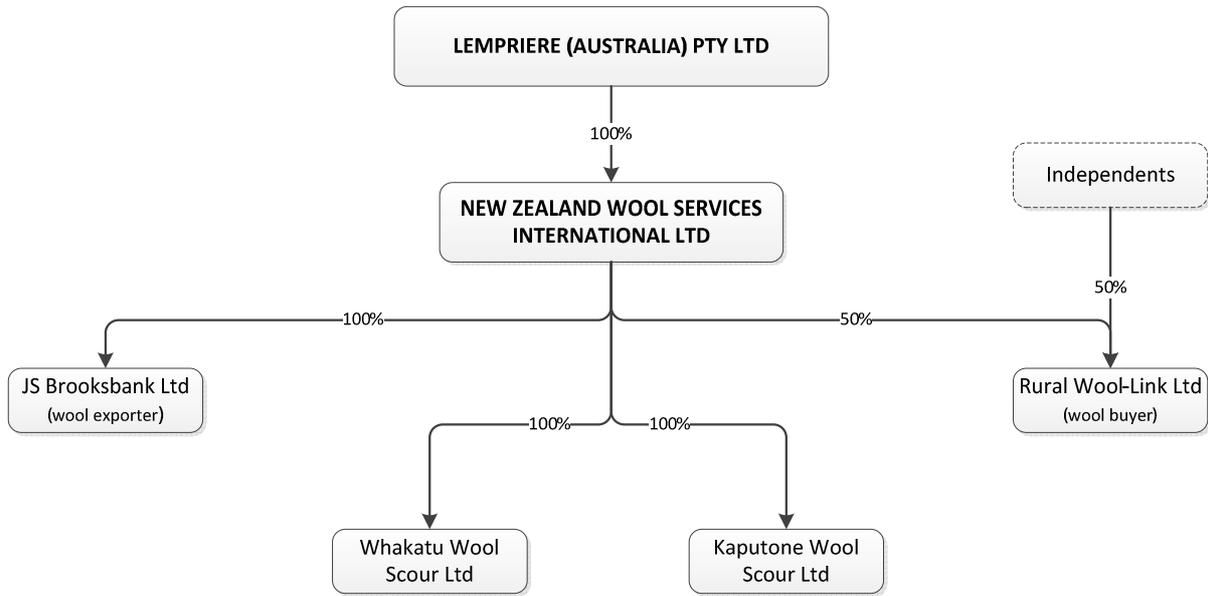
Attachment 1 – Post transaction structure

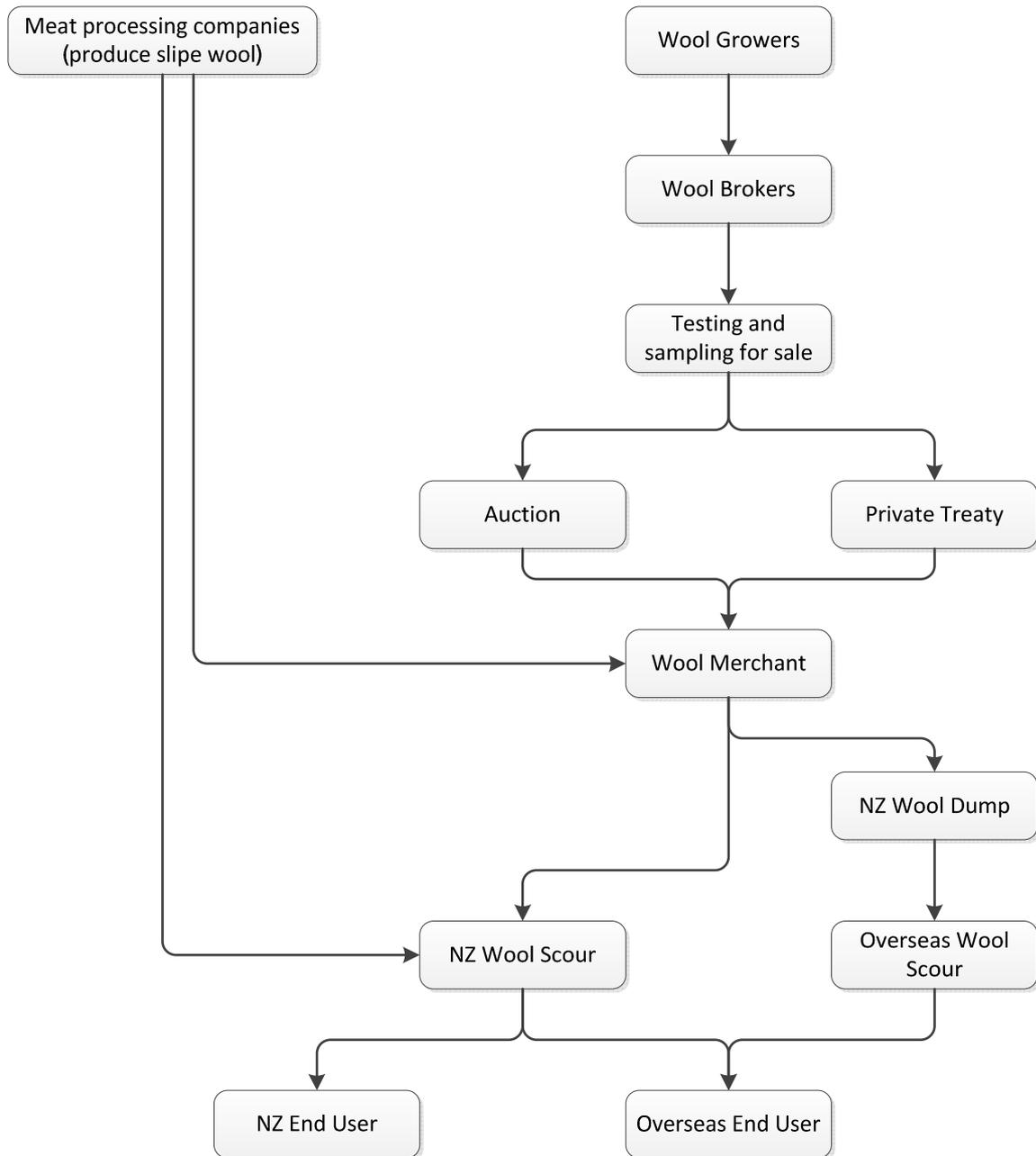


Attachment 2 – Ownership and subsidiaries of CWH

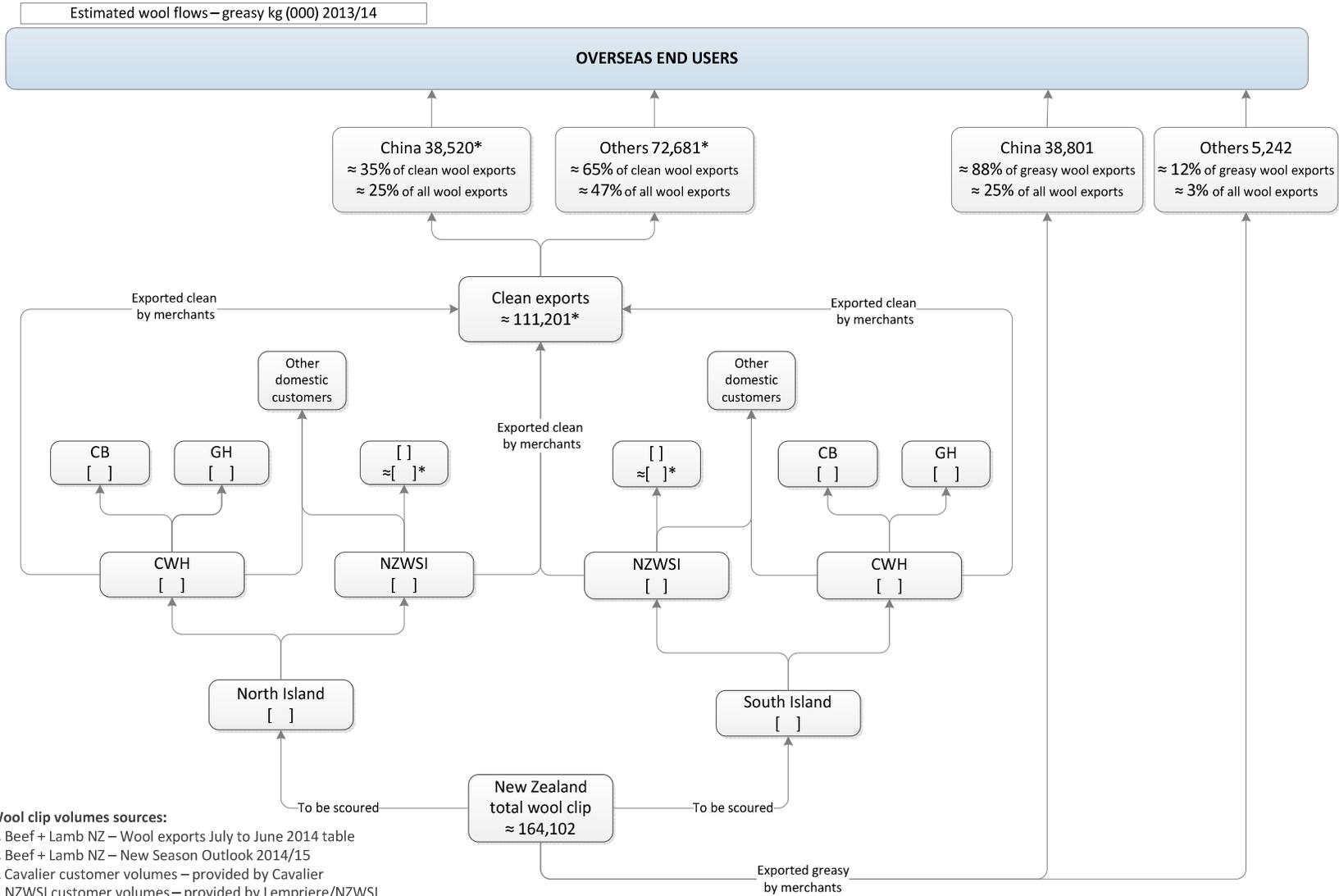


Attachment 3 – Ownership and subsidiaries of NZWSI



Attachment 4 – Functional levels in the movement of wool

Attachment 5 – Estimated wool flows 2014



Wool clip volumes sources:

1. Beef + Lamb NZ – Wool exports July to June 2014 table
 2. Beef + Lamb NZ – New Season Outlook 2014/15
 3. Cavalier customer volumes – provided by Cavalier
 4. NZWSI customer volumes – provided by Lempriere/NZWSI
- *Clean scoured kg have been converted into greasy kg (000) by using a 0.75 conversion rate.