

Memorandum

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To: The Chairman and Members
Commerce Commission

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by email

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CAVALIER WOOL HOLDINGS AND NEW ZEALAND WOOL SERVICES INTERNATIONAL – GODFREY HIRST POST CONFERENCE SUBMISSION

Introduction

- 1 On behalf of Godfrey Hirst (NZ) Limited (**Godfrey Hirst**) in this post conference submission we address issues relating to:
 - 1.1 The Commission's valuations for the surplus land and buildings at Whakatu, Clive and Kaputone scour sites;
 - 1.2 The Commission's advice regarding avoided capital expenditure, as well as new claims made by the Applicant in relation to such expenditure and reduced redundancy costs.
 - 1.3 The Commission's query as to the increase in scouring prices over current levels that Godfrey Hirst could sustain before it would become uncompetitive such that its New Zealand manufacturing operation would become unviable, and related issues around allocative efficiency losses.
- 2 In addition to the submissions that we make on these individual points, it is important to step back and consider the overall impact of the revised information that has come to hand. Over the course of the last two months – indeed, with one exception, over the course of the last two weeks (and nearly eight months since the Application was filed) – information has been provided as follows:
 - 2.1 The Commission's independent valuer has confirmed that the Applicant's estimate of value was overstated by \$[];
 - 2.2 The Commission's independent expert has confirmed that [

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2.3 The Applicant has suggested that it understated foregone capital expenditure [] by \$[]; and

2.4 The Applicant has suggested that it overstated its redundancy costs by \$[].

3 While these figures do net off to a certain degree, and there are timing considerations, it is the gross sum – at least \$[] in total corrections – that should alarm the Commission. First, they need to be read against the declaration as to accuracy and completeness of relevant information, that forms part of the Application.

4 Second, they relate to an application that the Commission preliminarily indicated it would likely grant authorisation by a narrow \$2.5 million margin, and yet, just a few days out from the scheduled final determination date, there is serious debate over errors and corrections that total more than [] that narrow margin.

5 This is an unfair and unsatisfactory position for the Commission, Godfrey Hirst and other interested parties to be placed in. It begs the question of whether, were consideration of this Application to go on for another few weeks, the Applicant would endeavour to claim other significant errors in its own application, seeking to decrease detriments and/or increase benefits.

6 But, more significantly, it takes us back to the cautionary words of the High Court judgment in *Godfrey Hirst NZ Limited v Commerce Commission* [at 115] as to the need for the Commission to assess the quality of the evidence being proffered to support claimed benefits:

... 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.

7 This ruling echoes the Commission's own *Authorisation Guidelines*, which are specific about an applicant's obligation to identify how claimed benefits arise and to provide robust supporting evidence for those claims. The Guidelines state:

44. We place less weight on the benefits and detriments that are less likely to occur. This may include those that occur further into the future or are more distantly related to the goods and services being purchased and consumed. This is because the more distant a benefit, the less direct the causal link is likely to be. Applicants should explain precisely how the benefit arises from the transaction and provide robust evidence about each step in the causal chain.

45. *We also consider the reliability of the evidence and analysis when determining what weight to attach to each benefit and detriment.*

- 8 Surely, in light of the Applicant's recent revisions and findings of the Commission's own experts, the Commission must now have real doubts about the reliability of the information that the Applicant has provided and is continuing to provide to it?
- 9 Indeed, the Commission ought to have real concerns about the integrity of the process it is now being asked to undertake, with the Applicant seeking to present it with information in support of claimed benefits *after* the conference that it has held to test those benefits. The number of revisions, the dollar amounts involved, and their potential impact upon the ultimate decision put this well outside any acceptable fine-tuning of the Application or in proper response to matters raised at the conference. We note that, as a practical consequence of the Applicant's provision of further information in support of claimed benefits, we received only yesterday (being 24 hours from the Commission's deadline for this submission) from the Commission a total of 28 further documents.
- 10 But putting that procedural objection to one side, even were the Commission to take the Applicant's revised information into account, these substantial revisions must, at the very least, surely lead the Commission to allow wide ranges in its assessment of likely outcomes in each category, to provide for this additional uncertainty. We expand upon this point further below.
- 11 Included with and forming part of this post conference submission are:
- 11.1 A further report from Professor Graeme Guthrie (Allocative Efficiency Losses and a response to Direct Capital); and
- 11.2 A further report from C W Nyberg of Darroch (Commentary on Commission's Valuations).

The Commission's valuations

- 12 Godfrey Hirst accepts and endorses the valuations provided to the Commission by Knight Frank and Turley & Co. They set the initial benchmark by which the benefit of freeing up this property can be assessed. But for the reasons noted above and discussed more fully below, it is appropriate to discount these valuations to allow for uncertainty, as the Commission did in the draft determination (i.e. by allowing a 10% reduction).
- 13 Dealing first with our endorsement of the valuations themselves, we sought further assistance from an experienced valuer, C W Nyberg of Darroch, in relation to the Commission's valuations. In brief, Mr Nyberg says:
- 13.1 Valuations can vary between valuers and still be in best practice, and the valuations carried out by Knight Frank and Turley are both examples of best practice valuations.

13.2 The approaches taken in the Commission’s valuations are utilised correctly in order to ascertain the most probable competitive price prediction to give accurate market valuations.

14 Turning, then, to the reasons why the Commission should nevertheless discount the valuations it has received, we make four submissions. First, as Mr Nyberg points out, there are still

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[] The Commission’s email of 25 May 2015 to Knight Frank refers specifically to “seismic and environmental factors”. While the Commission asks that the Commission’s valuations include expert views on whether and how those factors might affect the valuation for each property, the Commission makes it clear that it does not request [] report be obtained by the valuer.

16 As a result, in each of the Commission’s valuations the valuer has, correctly,

[

[] (Because the valuer has assumed the factors are not present, if subsequent work were done to establish that the risk did not exist, this would not increase the valuations.)

17 [

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¹ [

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- 18 In short, therefore, the Commission’s valuations represent the top point of a range of values properly attributable to those properties to allow for contingency. Certainly, there is nothing in the Commission’s valuations to indicate that it would be acceptable for the Commission to take any point above those valuations and there is good support for the idea that it should provide a range somewhat lower than this figure.
- 19 The second point is that it is unlikely that any (and certainly not *all*) of these sites would be sold immediately, or even within a short period of time. The valuations provide for a fair market price if sold today; they do not provide that there is a market for these properties today.
- 20 While at the conference there was some evidence that when scours have been decommissioned in the past they were sold relatively quickly, those sales occurred under quite different circumstances. Specifically, in those cases the company had control over the timing: it was able to set the decommission date to match the sale date (rather than the other way around), thereby ensuring that there was a close match in dates. Here, however, there is no such luxury – the decommission date is much more a function of the Commission’s decision-making process and timing, rather than a sale date for the property.
- 21 Further, to the extent that the Applicant does retain a degree of control over timing, the Commission has no assurance that there is in fact an immediate market for the sale of these properties. The Commission currently acknowledges in its draft determination that there is the possibility that sale of the scour sites would not occur within five years.
- 22 Third, there is the further crucial factor outlined by Professor Guthrie in his original Economist’s Report, and elaborated upon at the conference, that the flow of benefits that is relevant to the Commission’s calculation begins only at the time the land starts to be used for its new, non-scouring purpose and not at the time the merger is approved. The land will produce only minimal benefits from being used for other activities between the time that the merger is approved and time that the land’s conversion to some other use is completed. Professor Guthrie states that a discount of two years should be applied to the valuations of the properties to account for the period before the land is used for new economic activity. Another way of addressing this is to allow for a discounting factor.
- 23 Finally, it will be appreciated that the Commission’s valuations are an exercise in professional judgment based on experience, expertise, and subject to instructions. It is always the case that the actual market price is likely to vary somewhat from the valuation. That does not call into question the skill or integrity of the valuers or the valuations themselves, it simply reflects the ordinary course of commercial affairs.
- 24 Mr Nyberg’s report confirms his previous observations that
[
] It is, therefore, appropriate for the Commission to make an allowance for such uncertainty. We suggest that a downwards adjustment of 10% (as the Commission used in the draft determination) is appropriate.

Avoided capital expenditure

- 25 Paragraphs 337 to 344 of the draft determination conclude that total avoided capital expenditure on plant (over five years) amounts to \$[]. To arrive at that figure, the Commission offsets against the \$[] rationalisation costs, savings from capital expenditure that will be avoided as a result of the acquisition and consequent rationalisation. The largest single item of capital expenditure (i.e., accepted by the Commission as likely to occur in the absence of the proposed transaction) is capital expenditure of at least \$[]
- 26 No doubt because of the size of this claim, and its potential impact on the outcome, the Commission retained [] to provide an independent assessment of the capital expenditure. We discuss [] findings below.
- 27 In addition, in its submission on the draft determination NZWSI advised that, since the Application was notified and its initial letter to the Commission, it had identified additional expenditure to be incurred in 2017 and 2018 that it claimed would also be avoided.
[] We were provided with additional documentation relating to this claim yesterday. We discuss that further below.
- 28 But the potential effects of these revised figures should not be underestimated. In their report of 21 April 2015, NERA says that, using that additional expected [] expenditure, it has “updated” table 4 from its 22 October 2014 report. The “updated” table now appears as table 7 of its 21 April 2015 report.
- 29 As we understand it, NERA’s initial table 4 analysis adopted Cavalier’s historical capex of \$[] per year and estimates an average capex of \$[] per year for NZWSI. By contrast, the table 7 analysis retains capex of \$[] per year for Cavalier, but applies all the figures claimed in the [] for NZWSI.
- 30 For ease of comparison, we set out below the two NERA tables to show the effect of the change. Clearly, the additional expenditure on the [] would inflate [] the proposed spend []. NERA claims that the effect of the revised future capex on plant would be to increase the benefit from avoided capex to \$[], compared to the \$[] benefit found by the Commission.

NERA’S TABLES – EXPECTED FUTURE CAPEX ON PLANT

Year	Table 4 – 22 October 2014	Table 7 – 21 April 2015
1	[]	[]
2	[]	[]
3	[]	[]
4	[]	[]
5	[]	[]
Total	[]	[]
PV	[]	[]

31 Similarly, since the Commission conference, the Applicant has advised that it has recalculated its redundancy figures, resulting in a substantially reduced figure. We discuss that further below.

32 Overall, however, we submit that it is apparent that both the need for those late discovered expenditure items, and their quanta, must be very closely scrutinised by the Commission.

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33 Paragraphs 342 and 343 of the draft determination state that Lempriere would expect to incur capital expenditure of at least \$[] The Commission's preliminary position is to accept that avoided capital expenditure; but to disregard the claimed ongoing capital expenditure savings. Nevertheless, to confirm the position the Commission engaged [] to provide an independent assessment as to whether the capex and opex estimates provided by NZWSI in relation to the [] are reasonable, too high or too low.

The [] nature of the expenditure
34 As the [] report makes clear, NZWSI [] For that reason,
[]
[] NZWSI's submission of 16 April 2015 acknowledges that:
[]

35 It is difficult to pin down the likely cost of the []. The spread sheet attached to NZWSI's submission of 16 April 2015 indicates a total of \$[] However, the telephone interview on 4 June 2015 between NZWSI and [] confirms that the [] It is, therefore, also [].)

36 That said, the just released correspondence between [] Indeed, NZWSI's email of 2 July states that []

37 It is far from clear that the figures provided for in the spreadsheet []

38 Whatever the case, what is clear is that [] very much represents an
[
] Wisely,
[
]

39 The Commission must follow NZWSI's caution. The Commission cannot assume that
[]. It would be wrong in
principle to make an allowance – or, at least, a full allowance –
[].
[

] We submit that the Commission's calculations should allow for
this as at least a likely outcome.

40 Even assuming that [] were proceeded with, it is clear that
[
] Specifically, those are:

40.1 [];

40.2 [].

41 To the extent that the Commission determines to make an allowance for
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[]
42 The file note of discussions between the Lempriere executives and [] personnel
confirms that []

43 []
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44 []
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45 []

46 Thus, if the Commission determines to
[]

Only net expenditure should be considered

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[] The onus is on the applicant not just to show the gross costs it will avoid, but the net effect. Otherwise the Commission is left with only half the story.

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59 But, both Decision 725 and the present Application stress that the perennial problem with the wool scouring industry is over-capacity. Commercial common sense would dictate against substantial expenditure to expand effective capacity of a wool scour in those circumstances. That is especially so given that Lempriere had only just acquired NZWSI

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60 The report of the Overseas Investment Office on Lempriere's application indicates that the consideration paid for 100% of NZWSI was less than \$20 million. What prompted the NZWSI's inquiry into [] 16 months later; and its claimed readiness to commit to a \$[] spend on a [] which [] did not exist?

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64 []

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65.1 []

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65.4 [].

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(i) [];

(ii) [].

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83.1 [];

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83.3 [].

84 [

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85 []

85.1 [];

85.2 [].

86 [

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Ramifications of capital expenditure claims for dynamic efficiency losses

87 Putting our submissions as to the likely size of the proposed expenditure on [] to one side, the fact that NZWSI apparently plans such expenditure in the counterfactual demonstrates why the Commission should reconsider its initial conclusion that dynamic efficiency losses will be small.

88 To the extent that in a competitive environment with reducing demand for wool scouring services, a participant would invest in [

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89 When coupled with Mr Hales’s evidence at the conference of the innovative nature of the industry under the current competitive conditions, this establishes that the Commission should reconsider its initial conclusion that a low point estimate is appropriate and, instead, apply a broader range, encompassing the genuine prospect that the losses could be greater than it previously thought.

Redundancies

90 This is the perhaps the most egregious example of the slipshod process that the Applicant is asking the Commission to undertake. Less than two weeks out from the final determination – but over five months since it obtained the information and two months since submissions were filed on the draft determination – the Applicant is claiming that the true redundancy figure from the merger is actually \$[] less than it had previously provided to the Commission. This claim is first alluded to at the end of a telephone discussion between Bell Gully and the Commission on 15 June 2015.

91 The basis for this claim, portrayed in Bell Gully’s letter dated 15 June 2015 as one of the “follow up matters” to the conference, is a report dated 8 January 2015
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92 []

93 Importantly, however,
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94 Both of these factors lead to uncertainty around the net benefits calculation from a rationalisation of staff. That demonstrates the need for the Commission to provide for a wide range in its net benefit calculation.

95 The only rational explanation for the lateness of the redundancy claim is that the Applicant has relied on its general claim that “the substance provided in the previous application process [i.e., in relation to Decision 725] remains largely unchanged” for its estimate of redundancy costs and consequent reduced salaries and wages, as it has with most other matters throughout the current process; and is now hoist with its own petard. There is simply too much uncertainty around how many staff will be made redundant; how many will be redeployed to different operating sites; how many staff numbers in fact will be reduced; and what will be the actual cost of those resulting redundancies. And certainly, there is similar uncertainty as to the gross reduction in salary and wage costs that can be attributed to the merger.

- 96 Indeed, the claims in paragraph 25.20 of the Application
[
]; and at paragraph 25.21 of the Application that
[] indicate
that nothing yet has been decided.
- 97 The various NERA reports do nothing to allay that uncertainty.
- 98 The only proper course is for the Commission to disregard the Applicant’s last-minute endeavours to correct its own figures, in the absence of actual numbers and identities of staff to be released or relocated.
- 99 But, even if full details of staff to be released or relocated were available, the Commission would need to reopen the whole issue surrounding staff no longer required, including the numbers of staff likely to be employed by CWH, especially at its North Island scours, in the counterfactual. Since the date of the Application, Cavalier has continued to announce reducing profit, reducing cash flow and increasing debt. On 20 May 2015 Cavalier announced to the NZ Stock Exchange that further write-downs of certain assets would be required and that the company had prepared an updated strategy and business plan which had been laid before its bank. Details of that plan have not been released; but it is fair to assume that Cavalier will be looking at increased returns from its 50% shareholding in CWH.
- 100 While Cavalier may not satisfy the Commission’s criteria of a failing firm, it is certainly a firm that needs urgently to reassess its operations. The essential rationale for the Application is the reduction in volumes of wool being scoured and resulting over capacity. Indeed, Table 1 of the draft determination shows that reduction as being especially acute in the North Island, with a further 14% reduction there since Decision 725.
- 101 The question must be asked: in the absence of the current proposal, is it likely that CWH – given Cavalier’s current predicament – would continue to operate both Clive and Awatoto scours in the North Island. Or is there a reasonable prospect that CWH would downsize unilaterally.
- 102 A down-sized CWH counterfactual would of course result in substantial reduction in staff costs, too, without the acquisition.
- 103 Put simply, it is far too late for the Applicant to attempt to re-open one aspect only of this complex question.
- Increase in scouring prices**
- 104 The ability of CWH to increase scouring prices post-merger was the subject of considerable discussion at the conference. Professor Guthrie played a significant role in that discussion. In the paper entitled “Allocative Efficiency Losses” Professor Guthrie reviews the threat from China and NERA’s claims that CWH’s scouring prices have [] in real terms since 2006. Professor Guthrie also reflects upon the limit on pricing increases posed by threat of entry by a rival scouring firm.

105 His conclusion after reviewing the draft determination and arguments raised at the conference is that price increases of up to 25% are possible if the merged entity goes ahead. He is also still of the view that it is appropriate for the Commission to use a 20% hurdle rate for its entry analysis.

106 Professor Guthrie’s conclusion is consistent with the Commission’s preliminary view that entry is unlikely to occur without at least a 10% increase in wool scouring prices. His view is also not inconsistent with the Commission’s preliminary view of a potential increase in prices from 10% to 20%, although he is of the view that it is possible for price increases of up to 25% if the merger goes ahead.

107 The issue of potential consequences of increases in scouring prices above current levels also arises in the context of the Commission’s follow-up question to Godfrey Hirst. The Commission asks specifically:

Assuming the price of wool and all other inputs were to remain constant at current levels, what increase in scouring prices over current levels could be sustained before Godfrey Hirst would become uncompetitive such that its New Zealand manufacturing option would become unviable.

108 The short answer is that
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110.1 [

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112 [

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113 [

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Views expressed as to the price point at which merchants would enter

114 At the conference, John Dawson of NZWSI initially opined that merchants would not enter the scouring market. Following discussions with counsel, he has resiled from that position, now indicating that in his view merchants would enter if there was a price increase of more than 15%.

115 He does not, however, provide any support for how he formed this view. And, of course, Mr Dawson is just one merchant – and plainly could not purport to speak for them all – others may have different views.²

116 In addition, we have been provided (yesterday) with a paper from Direct Capital endeavouring to explain why merchants might enter the market at a lower rate of return than other investors. Direct Capital attack Professor Guthrie’s opinions in part on the basis that they are theoretical and not grounded in reality, whereas they lay claim to being more practically focused. But the idea they posit of merchants bandying together to enter this market, following merger of the two remaining players, is just that – it is an idea – and one that is wholly divorced from reality. As set out in the attached paper by Professor Guthrie, any potential new entrant will see the difficulties that Lempriere has encountered and be very conservative before electing to enter – that is, if it can obtain funding to do so in the first place.

² In any event, the Commission would have to be cognisant that Mr Dawson has at least the perception of a conflict, given that he was a major shareholder of NZWSI, and is now an employee.

117 Moreover, even if or when the price rises to the level that some merchants were prepared to contemplate entry, the issue is not the price at which they might consider entering – at least in the medium to long term it is the price at which someone could successfully and sustainably enter.

Views expressed by Mr Dawson as to a USD \$0.10-0.15 differential between scoured and greasy wool exported to China and the reasons for that

118 A similar point arises with respect to Mr Dawson’s statement that there is a USD \$0.10-\$0.15 differential in price between greasy wool and scoured wool for export to China. Mr Dawson’s estimates based on his experiences should be cross-checked with the opinions of other merchants or, better yet, by actual pricing data, before the Commission places too much weight on them.

119 To be clear, by actual pricing data, we mean something more than one example that Mr Dawson has provided of a single transaction (which may not even have taken place).

120 But even assuming that this price differential is indeed the case, as set out in the attached note from Professor Guthrie, that means that competing New Zealand merchants receive benefits from scouring wool in New Zealand that are not available from scouring wool in China. In his paper Professor Guthrie discusses what those benefits might be and how they could impact the analysis – if they can be quantified. Because, as Professor Guthrie points out, without such analysis we cannot know how far the price of scouring in NZ could rise without inducing merchants to give up these benefits and export greasy wool instead.

Conclusion

121 The Commission’s draft determination was that the net benefit of this proposed acquisition was such as to justify authorisation, but only by a narrowest of margins.

122 Since then, the Applicant’s figures that underpinned that conclusion have been demonstrated to be grossly unreliable:

122.1 Independent experts have established that the values attributed to redundant scouring sites were [] overstated;

122.2 Independent experts have established that the proposed expenditure on the [] – [] – [];

122.3 NZWSI has advised that it omitted to advise of \$[] of proposed expenditure – but has failed to establish why spending that much in the current circumstances is a commercially reasonable decision; and

122.4 The Applicant itself has not only confessed that it got its redundancy figures wildly wrong, but has just disclosed its “error” despite having had the updated information since early January.

- 123 Whatever the Commission ultimately makes of the reasons for these various issues, and whatever figures the Commission ultimately attributes to these various categories, t the Commission must now be looking at this Application with a critical eye, and be considering how it can have any real confidence in the numbers that the Applicant has provided to it. At the very least, the Commission must apply substantial discounts to the Applicant's figures, in order to allow for the extent of the uncertainty.
- 124 But even if the Commission does that, Godfrey Hirst submits that the basis for the figures the Applicant has provided is so speculative that the Commission ought not to have sufficient confidence in its calculations or its assessment that it can be satisfied that the acquisition will result, or will be likely to result, in such a benefit to the public that it should be permitted.

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**ATTACHMENT 1: ALLOCATIVE EFFICIENCY LOSSES, PROFESSOR GRAEME
GUTHRIE**

**ATTACHMENT 2: COMMENTARY ON COMMISSION'S VALUATIONS, C W NYBERG
OF DARROCH**