PUBLIC VERSION

IN THE HIGH COURT OF NEW ZEALAND
WELLINGTON REGISTRY

CIV 2011-485-1257

BETWEEN	GODFREY HIRST NZ LIMITED Appellant
AND	THE COMMERCE COMMISSION First Respondent
AND	CAVALIER WOOL HOLDINGS LIMITED Second Respondent
AND	NEW ZEALAND WOOL SERVICES INTERNATIONAL LIMITED Third Respondent
AND	WOOL EQUITIES LIMITED Fourth Respondent

Hearing: 22-26 August 2011

Court: Mallon J
K M Vautier CMG (lay member)

Counsel: P R Jagose and J J Brown for the Appellant
M N Dunning and J B Hamlin for the First Respondent
B R Latimour, D J Cooper and D A K Blacktop for the Second Respondent
D A Laurenson for the Third Respondent
T C Weston QC for the Fourth Respondent

Judgment: 23 November 2011

JUDGMENT OF THE COURT

Contents

Introduction .... **[1]**
Wool scouring .... **[12]**
The process .... [12]
Rationalisation .... [14]
Export Markets .... [17]
Market structure .... [28]
Market shares .... [34]
Prices .... [39]
Reason for acquisition .... [40]
The statutory provisions .... **[45]**
The Commission's approach .... **[54]**
Appeal grounds relating to the statutory test .... **[62]**
Detriments in any market? .... [62]
Summary of issues Godfrey Hirst raises about the Commission's approach to the statutory test. [76]
Is the test different from s 27 authorisations? .... [80]
The role of the quantitative assessment in the statutory test and how it is to be undertaken .... [91]
Is there a second step? And is the merger to monopoly relevant to any such second step? .... [107]
Merger-specific efficiencies .... [118]
Allocative efficiency losses .... **[126]**
Introduction .... [126]
The Commission's assessment .... [127]
The alleged errors .... [130]
Incorrect starting point and calculation of mid-point? .... [132]
Was the Commission's price increase analysis inconsistent? .... [138]
Error in taking an intermediate value of detriment? .... [149]
a) Effect of removing the constraint provided by NZ Wool Services .... [150]
b) Price discretion .... [155]
c) A new entrant will be competing against Cavalier's economies of scale .... [158]
d) Capacity utilisation .... [162]
e) The constraint from China's scouring industry .... [165]
f) Volumes lost to China need not be permanent .... [170]
g) Price discrimination .... [171]
h) Effect on wool production .... [174]
i) Long-term contracts .... [183]
Conclusion on allocative efficiency losses .... [186]
Productive efficiency losses .... **[191]**
Introduction .... [191]
The Commission's decision .... [192]
Issues on appeal .... [196]
Impact of loss of NZ Wool Services .... [197]
The mid-point .... [199]
Dynamic efficiency losses .... **[202]**
Introduction .... [202]
The Commission's decision .... [204]
Issues raised on appeal .... [208]
Approach .... [209]
Should the range start at zero? .... [215]
Was it appropriate to take the mid-point? .... [223]
Conclusion .... [229]
Other detriments? .... **[230]**
Effect on growers' returns and wool production .... [230]
Disruption to wool prices .... [232]
Vertical impacts .... [236]
Production efficiency benefit .... **[243]**
Introduction .... [243]
The Commission's decision .... [245]
Functionless monopoly rents .... [248]
Merger-specific production efficiencies .... [251]

Tendency to over-state? [258]
Salaries and wages [261]
Conclusion [271]
Sale of surplus land and buildings [272]
Introduction [272]
The Commission's decision [273]
Is there a public benefit at all? [277]
Valuation [283]
a) Colliers' valuation for Kaputone [283]
b) Unchallenged evidence re Kaputone [288]
c) Was the Commission in error in taking the mid-point? [290]
d) Was it relevant that no undertaking was given? [295]
Conclusion [296]
Wool superstore benefits [297]
Introduction [297]
The Commission's decision [300]
Likely in the factual? [302]
Unlikely in the counterfactual? [307]
Conclusion [313]
Quality improvements (brighter wool) [314]
Balancing of detriments against public benefits [322]
Result [328]

Introduction

[1] Cavalier (the second respondent) has been authorised by the Commerce Commission (the first respondent) to acquire the wool scouring assets of its sole New Zealand competitor, NZ Wool Services (the third respondent). Godfrey Hirst (the appellant), a carpet manufacturer and customer of Cavalier, appeals against the Commission's authorisation determination. Wool Equities (the fourth respondent), whose shareholders are wool growers,[1] and which has expressed an interest in purchasing the shares of NZ Wool Services, supports Godfrey Hirst's appeal. The appeal is a rehearing which proceeds on the record.[2]

[2] Under the Commerce Act 1986, the purchase of assets of a business (or shares in a company owning a business) is prohibited if the acquisition would have, or would be likely to have, the effect of substantially lessening competition in a market.[3] That prohibition does not apply if an authorisation of the purchase is granted by the Commerce Commission.[4] An authorisation can only be granted 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".[5]

[3] In 2001 amendments were made to the Commerce Act. These changed the threshold at which acquisitions were prohibited in the absence of an authorisation, from the earlier "dominance or strengthening of dominance" threshold to the present "substantially lessening competition" threshold.[6] The authorisation test was left unchanged.[7] This is the first time since the 2001 amendments that the Commission

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1 Growers of "strong (coarse) wool".

2 And to which the approach set out in *Austin, Nichols & Co Inc v Stichting Lodestar* [2007] NZSC 103, [2008] 2 NZLR 141 at [16] applies*; Commerce Commission v Woolworths New Zealand Ltd* CA 55/2008, 1 August 2008 at [59].

3 Section 47 of the Commerce Act 1986.

4 Section 69 of the Commerce Act 1986.

5 Section 67(3)(b) of the Commerce Act 1986.

6 As was said in *Air New Zealand v Commerce Commission (No 6)* (2004) 11 TCLR 347 (HC) at [42], the new statutory test "focuses on a possible change along the spectrum of market power rather than on whether or not a particular position on that spectrum, i.e. dominance has been attained".

7 The test for a clearance was changed to correspond with the new "substantially lessening competition" threshold.

has granted an authorisation; and it has done so where the proposed acquisition will leave only one supplier in the relevant markets.

[4] In this case the Commission was not satisfied that the proposed acquisition would 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. However the Commission was satisfied that the benefits to the public resulting from the acquisition were likely to significantly outweigh the public detriments from the loss of competition arising in those markets; and that as a result the acquisition would result, or would be likely to result, in such a benefit to the public that it should be permitted.

[5] In reaching this conclusion, the Commission considered that the removal of NZ Wool Services as a competitor to Cavalier would remove a "significant competitive constraint". It considered that potential entry represented only a moderate constraint, as Cavalier would be able to impose scouring price increases on its wool scouring customers of at least 5 to 10% before new entry was likely. It considered that the potential for more wool to be scoured in China also provided only a "moderate" constraint. The public benefits likely to result from the acquisition were in the form of production and administration cost savings from the consolidation and rationalisation of scour lines on to two sites; the sale of surplus land and buildings; and the establishment of a cost-saving superstore (for the storage of wool).

[6] Godfrey Hirst purchases wool scoured by Cavalier. It competes with a Cavalier associated company (Cavalier Bremworth Limited) in the market for the manufacture and supply of carpet in New Zealand. It is potentially detrimentally affected if Cavalier is able to increase scouring prices or exercise market power in other ways. Godfrey Hirst views the proposed acquisition as creating a monopoly, which will cause the price of wool scouring to increase and output to fall, but with no quality improvement. It submits that it is surprising that the Commission would authorise a proposed acquisition which creates a monopoly, where previously there was effective competition, principally on the basis that the merged wool scouring business would save Cavalier administration and operating costs.

[7] Godfrey Hirst submits that, in reaching its conclusion, the Commission erred in its approach to the statutory test of "such a benefit to the public that it should be permitted". It submits that this occurred because the Commission adopted a purely quantitative assessment of detriments and benefits and failed to stand back and ask itself whether the benefits were "such" that the acquisition should be permitted. Related to this, Godfrey Hirst submits that the Commission failed to have sufficient regard to anti-competitive factors, informed by theoretical concerns, arising from a merger that leaves the market with a monopoly supplier (referred to as a "merger to monopoly"). Godfrey Hirst also submits that the Commission erred in its quantitative assessment of detriments and benefits, and in its view that the establishment of a wool superstore was likely to occur if the proposed acquisition were to proceed but not otherwise.

[8] Wool Equities' shareholders, as suppliers of wool, are also potentially detrimentally affected if Cavalier is able to increase scouring prices or otherwise exercise market power. Wool Equities supports the submissions made by Godfrey Hirst but has two additional concerns. The first relates to the Commission's finding that if Cavalier increased wool scouring prices, that would most likely translate into lower margins for sheep farmers. Wool Equities submits that, despite making this finding, the Commission failed to take this detrimental impact into account in authorising the proposed acquisition. Secondly, Wool Equities submits that the Commission erred in not viewing the closing of NZ Wool Services' wool trading division (which would occur if the proposed acquisition were to proceed) as a detriment.

[9] Cavalier submits that the proposed acquisition will provide it with greater economies of scale, which will enable it to become a more efficient wool scourer (that is, it will be able to scour more wool using fewer resources) while also improving quality. It submits that the proposed acquisition is a further step in the rationalisation of the wool scouring industry, which has occurred as New Zealand's wool clip has declined and processing industries have migrated offshore, particularly to China. Cavalier says that, even though it will be the sole remaining wool scourer in New Zealand, its market behaviour will remain significantly constrained by the

continued threat of losing scouring business to China and the threat of new entry into the New Zealand markets.

[10] Cavalier and the Commission[8] submit that the Commission's approach to the authorisation determination was orthodox and correct. Cavalier submits that, in finding that the public benefits significantly outweighed the detriments arising from the loss of competition in the North and South Island wool scouring markets, the Commission was correct to find that the public benefits were such that authorisation should be granted. Cavalier also submits that, if anything, the Commission over-stated the detriments and under-stated the public benefits, such that the public benefits even more significantly outweighed the detriments than the Commission's analysis concluded.

[11] NZ Wool Services adopts a neutral position in the appeal.[9]

Wool scouring

The process

[12] Wool scouring is the process by which wool clipped from sheep is cleaned ready for use in other processes. The wool is washed, and sometimes bleached, in hot water and detergent to remove the non-wool contaminants. It is then dried, packed into bales and tested for the correct wool specification. Wool is scoured on scour line equipment and packed with high density presses. At present scouring in New Zealand is done on either 2, 2.4 or 3 metre scour lines. Wool which has not been scoured is called "greasy wool". Not all the wool which is grown in New Zealand is scoured in New Zealand. Wool which is not scoured in New Zealand is exported as greasy wool.

[13] Wool scouring is a high fixed cost/low variable cost business. Profitability is driven by volume and capacity utilisation. This was accepted in 2009 when the

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8 The Commission's submissions were directed to matters of general principle and approach.

9 NZ Wool Services was initially considering the Cavalier proposal at a time when its controlling shareholders had run into liquidity problems. At the time of the Commission conference it was opposed to the acquisition.

Commission was considering Cavalier's acquisition of Godfrey Hirst's wool scouring assets.[10] When applying to the Commission in respect of the proposed acquisition of NZ Wool Services' assets, Cavalier illustrated this with a "critical loss analysis" which it submitted to the Commission. That analysis showed that a 5% price increase sustained over a year would be unprofitable if Cavalier lost more than [ ] tonnes of greasy wool, being just over [ ]% of its volume.

Rationalisation

[14] In 1982/3 wool scouring was carried out at 20 sites in New Zealand.[11] By 2006 the number of sites had reduced dramatically,[12] and the four existing wool scouring operators (Feltex Carpets Limited, Godfrey Hirst, NZ Wool Services and Cavalier) reduced to three when Godfrey Hirst bought the wool scouring assets of Feltex Carpets Limited.[13] In 2009 the three operators (Godfrey Hirst, NZ Wool Services and Cavalier) each had two sites (one in each Island).[14] That year Cavalier acquired Godfrey Hirst's wool scouring assets, leaving Cavalier and NZ Wool Services as the two remaining operators.[15] The present position is that Cavalier has 3 wool scouring plants (two in the North Island[16] and one in the South Island) and NZ Wool Services has 2 plants (one in each Island).

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[10] In Decision No 666 (*New Zealand Woolscourers Ltd* [2009] NZComCom 5) the fixed costs were described by the applicant as making up a "large proportion" of wool scouring costs. The applicant considered that removing excess capacity would achieve industry efficiencies, because higher levels of capacity would "significantly reduce" average costs of scouring wool. Industry participants "unanimously confirmed the importance of economies of scale" for wool scouring (see [106]). The Commission accepted that the presence of excess capacity and economies of scale were among the factors which taken together would likely provide a sufficient constraint on Cavalier post its acquisition of Godfrey Hirst's wool scouring assets (see [207]).

[11] The Commission's decision (*Cavalier Wool Holdings Ltd* [2011] NZ ComCom 12: Decision No 725) says that in 1982-3 "there were about 20 separate wool scouring operations" (at [44]). This appears to relate to sites rather than competitors and it is unclear how many competitors there were.

[12] We do not have complete details about this but Decision No 587 (*Godfrey Hirst NZ Ltd* [2006] NZComCom 17) at [83] refers to four scouring plants in the North Island.

[13] This purchase was the subject of a clearance from the Commerce Commission (Decision No 587). The Commission considered that the level of existing competition and the level of excess capacity meant that the acquisition was unlikely to result in a substantial lessening of competition in the North Island wool scouring market (being the market in which aggregation would occur).

[14] Decision No 666 at [40].

[15] This acquisition by Cavalier occurred through a company called New Zealand Woolscourers Limited. It was the subject of a clearance by the Commission (Decision No 666). The acquisition included an underwriting agreement by which Cavalier underwrote a minimum increase in New Zealand Wool Services' commission scouring volumes, subject to certain terms and conditions being met.

[16] The site at Clive operates only for a few weeks a year at the peak of the shearing season.

[15] The acquisitions in 2006 and 2009 were the subject of Commerce Commission applications. In each instance the Commission accepted that there was excess wool scouring capacity.[17] In clearing Cavalier's acquisition of Godfrey Hirst's wool scouring assets the Commission considered that there would continue to be excess capacity.[18] At present, the wool scouring capacity in the North Island is a total of [ ] tonnes (including the intermittently used Clive plant) and in the South Island is a total of [ ] tonnes. There continues to be excess capacity now but this appears to be concentrated in Cavalier's plants.[19] Cavalier estimates that its "average year" capacity utilisation is [ ]%.[20] Despite this industry over-capacity, both Cavalier and NZ Wool Services were said to be profitable.

[16] Part of the reason for the excess capacity is the significant decline in the New Zealand wool clip. Between 1983 and the present, New Zealand's sheep flock has declined by 53% (ie from its peak of 70 million to 33 million sheep). Cavalier sees this as driven by the removal of subsidy protection for wool and a decrease in relative returns for sheep farming compared with dairy farming. The Commission's decision also refers to "the development of higher capacity modern scouring plants and presses" as contributing to the reduction in number and total capacity of wool scourers in New Zealand.[21]

Export Markets

[17] At present 78% of New Zealand's wool clip (147,030 tonnes) is exported to a range of markets for use by offshore processors. Of these exports, approximately 41,470 tonnes are exported as greasy wool (ie 22% of total wool clip of 188,500).

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17 Decision No 587 at [3]; Decision No 666 at [41].

18 Decision No 666 at [79] and [157].

19 We were not referred to any detail on the extent to which, on current market shares, the excess capacity resides with Cavalier as opposed to NZ Wool Services. However, there was information that in the peak season NZ Wool Services runs at full capacity. And, based on the information provided as to North and South Island demand, and Cavalier's share of that, it seems that NZ Wool Services has a throughput of [ ] tonnes relative to its present capacity of [ ] tonnes.

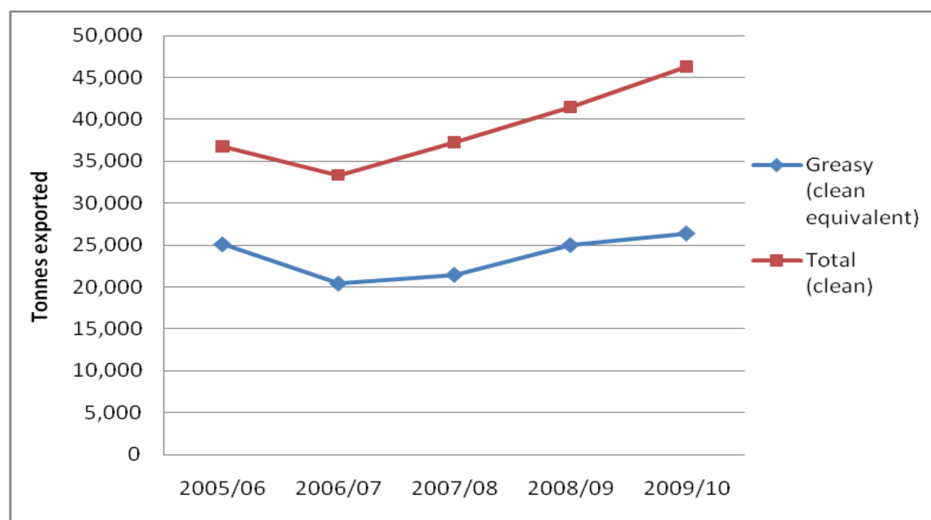
20 The information about total existing tonnage capacity comes from a table which Cavalier produced at the hearing and which was later clarified in response to a minute we issued subsequent to the hearing.

21 At [44] of Decision No 725.

[18] New Zealand's largest export market is China. As an export market, China has been growing in relative importance as well. In the year ended June 2010 it accounted for 32% of all New Zealand wool exports and 25% of New Zealand's total wool clip.[22] Of those exports, 57% (26,819 tonnes) was exported in greasy form (ie 14% of the total wool clip); and 43% (20,231 tonnes) was scoured in New Zealand and exported to China (ie 11% of the total wool clip).

[19] The Commission estimated that 18% of New Zealand's wool clip (ie 33,930 tonnes) is scoured in China at present and 14% of the wool clip is scoured in New Zealand and exported to China (ie 26,390 tonnes).[23] These figures are in error as they are based on the incorrect statement that "about 32% of New Zealand's wool clip was exported to China", as distinct from "around 32% of New Zealand wool exports in 2009/10" [24] was exported to China. These are material errors in that the actual volume of the wool clip exported to China in both greasy and scoured form was 22% less than the Commission's estimates.

[20] The following table, which was reproduced in the Commission's decision, reflects the correct position and also shows the volumes of scoured and greasy wool exports to China in the preceding four years.[25]



[22] This latter figure comes from Cavalier's submissions.
[23] At [113] of Decision No 725.
[24] At [39] of Decision No 725.
[25] From Beef and Lamb Economic statistics and included as Figure 4 in the Commission's decision. The figures use clean wool weights exported. One kilogram of greasy wool is equivalent to about 0.75 kilograms of clean wool.

[21] Broadly consistent with the above table, NZ Wool Services' figures of New Zealand wool exports to China as submitted to the Commission (with the figures in brackets being NZ Wool Service's exports), but also calculating the percentage of scoured wool as against total wool exports to China, were as follows:

	NZ Wool Exports to China			
June years	Greasy/Slipe **(Tonnes)**	Scoured **(Tonnes)**	Total **(Tonnes)**	Scoured as % of Total
2007/8	23,658 (1,280)	13,587 (6,493) 42.8%	37,245 (7,773) 20.9%	36.5
2008/9	27,000 (2,287)	14,483 (7,341) 50.7%	41,483 (9,628) 23.2%	34.9
2009/10	27,994[26] (1,589)	18,288 (8,423) 46.0%	46,282[27] (10,012) 21.6%	39.5
2010 1/7/2010 to 31/12/2010	11,316 (589)	8,994 (4,952) 55.0%	20,310 (5,541) 27.3%	44.3

[22] China is a growing and important market globally. It is the second largest grower of wool in the world (behind Australia) but also imports 49% of the wool exported by all other wool growing countries. It uses nearly one third of the world's raw wool and is the largest manufacturer of textiles and clothing in the world. It does not export any unprocessed wool.

[23] The view expressed by Godfrey Hirst to the Commission was that as processing industries have moved to China, the opportunity for wool to be scoured there has arisen.[28] Similarly, Cavalier's view was that, as wool processing has developed in and migrated to China, its wool scouring infrastructure has developed. It estimates that China's top 18 scour lines have a combined capacity of nearly twice New Zealand's scouring capacity. Consistent with this, the above tables[29] appear to show an increase in New Zealand exports to China in recent years in both greasy and scoured wool (noting that the figures for 2010/2011 are for 6 months only).

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26 This is 4% higher than the corrected Commerce Commission figure but that may be because of the inclusion of slipe.

27 This is within 2% of the figure of 47,050 tonnes (being NZ exports to China in 2009/10 in prior chart).

28 Comment made at the Commission conference in respect of the demise of wool scouring in Australia.

29 Refer [20] and [21].

[24] Rationalisation in the wool scouring industry has not been confined to New Zealand. In 1995, Australia, which is the largest wool grower in the world, was scouring about 83% of its (predominantly fine merino) wool clip at 25 sites. By 2009 this had dropped to 13.5% of the wool clip at three sites. So far as there is information before us about the reasons for this, it seems that the growing market dominance of China together with the decline in wool production have been the significant factors.[30] The Commission accepted that the Australian wool scouring industry had been severely reduced by competition from Chinese wool scourers.[31]

[25] Australia is predominantly a grower of merino (fine) wool.[32] We were told that Cavalier predominantly scours coarse (ie not merino) wool and NZ Wool Services does not scour merino wool. According to information NZ Wool Services provided to the Commission, merino scouring is more labour intensive, takes longer and produces higher grease. NZ Wool Services suggested in submissions to us that these factors, together with the use of merino to make cloths and clothes, made scouring merino in China more attractive for merchants than was the case with coarse wool. NZ Wool Services suggested that this was a potential difference between the decline in the wool scouring industry in Australia and the position here.

[26] However, the information before us about New Zealand does not seem to bear this out. The following table of New Zealand's exports to China for the year 2008/09 (supplied by NZ Wool Services to the Commission) shows that, although merino[33] is predominantly exported in greasy form, a significant proportion of coarse wool[34] is also exported in greasy form:[35]

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[30] Cavalier refers to comments made by the managing director of Jandakot Wool Washing Pty Limited in January 2009 when announcing the cessation of its Western Australian wool scouring operations. Godfrey Hirst also commented at the conference that the sudden demise in the wool scouring industry in Australia was a result of the removal of further processing industries in Australia to China.

[31] At [29] of Decision No 725.

[32] NZ Wool Services provided figures to the Commission showing that 86% of Australian production is merino, 10% is mid-micron with the balance being fine Xbred and coarse Xbred.

[33] This is also the case for mid-micron halfbred which is not a coarse wool type either and which is closer to merino in terms of labour and speed of scouring and levels of grease produced.

[34] Strong Xbred and Fine Xbred require similar levels of labour and speed to scour and produce similar volumes of grease.

[35] Figures are from New Zealand Beef and Lamb statistics.

	Wool Type	Micron	Total Production (greasy tons) (exports to China)	Scoured %
Strong Xbred	35-40	12,052	9642	80%
Fine Xbred	32-34	16,918	6767	40%
Mid Micron Halfbred	25-31	21,167	2117	10%
Fine Merino	12-24	5,280	528	10%
Totals		55,417	19,054	

[27] The Commission recognised that the Chinese scouring industry poses a significant long term competitive threat to the scouring industry in New Zealand,[36] even though New Zealand is predominantly a coarse wool producer. The submissions advanced by NZ Wool Services do not provide a sufficient basis for us to view the Australian experience as irrelevant to the rationalisation that has occurred in New Zealand and which is contemplated by the proposed acquisition.[37]

Market structure

[28] Wool is sold by sheep farmers (growers) to merchants, via brokers, either by private treaty or auction. Merchants sell wool to international and domestic customers in either greasy or scoured form. Of the 78% of New Zealand wool that is exported by merchants, 72% is exported as clean wool (ie having been scoured in New Zealand before export) and 28% is exported as unscoured greasy wool.

[29] The two largest domestic customers of scoured wool are Cavalier Corporation Limited (through its wholly owned subsidiaries Cavalier Bremworth Limited[38] and Norman Ellison Carpets Limited) and Godfrey Hirst. Together they account for nearly [ ]% of wool volumes used in domestic processing. Following the sale of Godfrey Hirst's scouring assets to Cavalier, the two parties entered a

[36] At [128] of Decision No 725.

[37] Cavalier also drew comparisons with the position in the United Kingdom, which has acted as a hub for scouring of coarse and fine wools, and where there are now two commission wool scourers. One of those is operating at limited capacity. We have not been directed to any information in the record as to how that compares with the size of the United Kingdom wool scouring industry in the past. However, it does not seem to be contested that the present size of the industry represents a significant decline.

[38] A 50% shareholder of Cavalier.

contract which sets out the terms which Cavalier must offer for scouring Godfrey Hirst's wool. This contract sets the price for Godfrey Hirst and provides [ ]. It runs until [ ].

[30] The merchant business model depends on obtaining a margin between the price at which the merchant buys greasy wool and the price at which it sells the wool. In its 2009 decision[39] the Commission said that merchants operated on "very low margins" between their costs and their revenue. One of the more profitable merchants was said to have a margin of 7 cents per kilogram of wool and the margins of most other merchants were believed to be less than that. The Commission said that a scouring price increase of 5% to 10% would equate to an increase of about 3-6 cents per kilogram in scouring charges.[40]

[31] In the decision under appeal the Commission referred to merchants working on margins of 15-20 cents per kg of greasy wool sold. We do not know whether this refers to the margin before other costs (including scouring) are deducted and so do not know how margins compare with the position in 2009. In any case, a price increase of 5% to 10% would represent a significant erosion of the merchants' margins. Merchants therefore have a strong incentive to exercise any countervailing power they might have.[41]

[32] Cavalier carries out wool scouring on a commission basis. Cavalier has in place over-arching agreements with merchants setting the terms for the scouring, with prices negotiated about once a year. Merchants supply Cavalier with batches of greasy wool that are of a suitable mix of wool types to meet the quality specifications of their customers.[42] Ownership of the wool is retained by merchants who pay for the wool to be scoured. They then send the scoured wool to its next destination, which is not known to Cavalier.

[33] NZ Wool Services is involved in both wool scouring and the wool merchant business. Between 85% and 90% of its wool scouring is for wool that it purchases

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39 Decision No 666.
40 At [188] and [189] of Decision No 666.
41 As the Commission recognised in Decision No 666 at [189].
42 At [42] of Decision No 725.

itself as a wool merchant. The balance is commission scouring. It has capacity to increase its commission scouring business. NZ Wool Services provided the Commission with figures for 2009, 2010 and part of 2011 which showed that commission scouring as a percentage of all its scouring increased from 9% to 17% in the North Island and from 1.14% to 10.3% in the South Island.[43] NZ Wool Services also informed the Commission that although it runs at capacity at times in the peak season, it can accept further commission scouring (it is able to alter its business programme to accommodate additional commission scouring).

Market shares

[34] The rationalisation process, as reflected in previous Commission decisions, has seen a marked change in market shares. Following the 4 to 3 market participant merger in 2006, Godfrey Hirst's market share rose from [ ]% to [ ]%. Following the 3 to 2 market participant merger in 2009, Cavalier's share rose from [ ]% to [ ]% in the North Island market and [ ]% to [ ]% in the South Island market.[44] At present, in relation to commission scouring (rather than total volumes of scouring in New Zealand) Cavalier has a share of about [ ]% in the North Island and about [ ]% in the South Island (ie about [ ]% in New Zealand). NZ Wool Services has the balance. Although NZ Wool Services' share of commission scouring is relatively small, its market share of all scouring (commission and non-commission) is more substantial.

[35] Cavalier's Board minutes show that Cavalier monitors its market share in relation to NZ Wool Services. A decline in Cavalier's North Island market share of all scouring between 2007-08 and December 2010, due to volumes lost to NZ Wool Services, is shown in the following table from Cavalier's February 2011 Board minutes:

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43 There were higher percentage increases for 2011 but these were not year end figures and so we do not know whether this would alter if the full year's figures were included.

44 At [45] of Decision No 725.

[

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[36] Cavalier's Board minutes state that the decline in market share relative to NZ Wool Services is not necessarily attributed to NZ Wool Services increasing its commission scouring share of the market. The view expressed in the minutes is that NZ Wool Services may be scouring its own stocks and that it had been active in the market at a time when other wool exporters were holding back waiting for the wool price to increase.

[37] Moreover, Cavalier's view is that, to the extent NZ Wool Services has increased its commission scouring business, it has not done so to the extent envisaged at the time Cavalier acquired Godfrey Hirst in 2009. As part of that transaction, NZ Wool Services acquired additional plant. Cavalier understands that this plant was for modifications to enable NZ Wool Services to better engage in commission scouring, but that NZ Wool Services has not implemented the modifications. NZ Wool Services also entered into an underwriting agreement with Cavalier. Under that agreement NZ Wool Services was guaranteed [ ] greasy tonnes of new commission scouring work in the first year following the acquisition. NZ Wool Services' claim under the agreement implies that it gained about [ ] greasy tonnes or about [ ]% of scoured wool.

[38] A difficulty for NZ Wool Services in obtaining increased commission scouring is that it competes with merchants in the wool export market. The major merchants told the Commission that they did not like to use NZ Wool Services because of this. The largest merchant expressed this view even though acknowledging that [ ] in the short term.

Prices

[39] Cavalier's real wool scouring prices have declined since 2006/07. In 2010 Cavalier initiated discussions with some customers (we presume this refers to merchants) about a 4-5% increase. It says that it faced such resistance to this that it did not proceed.[45]

Reason for acquisition

[40] Cavalier says that the proposed acquisition of NZ Wool Services is a response to the challenges presented by the smaller volume of wool clip and, significantly, the growing threat of greasy wool volume being lost to China. It says that the acquisition will enable it to gain increased economies of scale and thereby enable it to compete more effectively with offshore scourers to supply scouring services in New Zealand.

[41] In the North Island, Cavalier presently has three scour lines at two sites (two 2.4 metre scours at Awatoto and one 2.0 metre scour at Clive). NZ Wool Services has one scour line in the North Island (a 3 metre scour at Whakatu). Cavalier proposes to sell NZ Wool Services' land (and buildings) at Whakatu, to move the 3 metre scour at that site to Awatoto, and to reconfigure the existing two 2.4 metre scours at Awatoto (which are currently in a "dog leg" configuration). It proposes to "mothball" its Clive site pending a decision on whether to retain it for business continuity (if, for example, damage is sustained to its Awatoto plant).

[42] In the South Island, Cavalier has two scour lines at one site (one 3 metre scour and one 2.4 metre scour at Timaru). NZ Wool Services has one scour line in

[45] At [249] of Decision No 725.

the South Island (a 3 metre scour at Kaputone). Cavalier proposes to sell NZ Wool Services' land (and buildings) at Kaputone and to move the 3 metre scour at that site to Timaru. It intends to run the two 3 metre scours at Timaru and to run the 2.4 metre scour only if and when it is needed.

[43] Cavalier's rationalisation proposals do not eliminate industry over-capacity. Total capacity in the North Island will reduce by the mothballing of the 2m scour at Clive. At the same time, modifications are intended to be made to improve performance and throughput from the remaining scours. The combined effect of mothballing Clive and makings these modifications is that total North Island capacity will reduce from [ ] tonnes to [ ] tonnes. In the South Island, capacity will actually increase from [ ] tonnes to [ ] tonnes. This is because the 2.4 metre scour will still be available to be deployed and because modifications will improve performance and increase throughput. Post-rationalisation, Cavalier estimates that it will have [ ]% spare capacity in the North Island and [ ]% spare capacity in the South Island. Its modelling of the rationalisation benefits does not depend on winning back volumes from China, though it believes that rationalisation will assist in attempts to do so.

[44] Cavalier's claimed production efficiencies are expected to come principally from savings in administrative and operating costs from running increased capacity from its existing sites, while dispensing with NZ Wool Services' sites and mothballing Cavalier's smallest scour. Other benefits are expected to come from increased volumes (which will enable capital expenditure); investment in a wool superstore; and improvements to the brightness of all the wool scoured (which will allow greater returns from the sale of the wool clip).

The statutory provisions

[45] The purpose of the Commerce Act, as stated in s 1A, is "to promote competition in markets for the long-term benefit of consumers within New Zealand". It is premised on the basis that "society's resources are best allocated in a

competitive market where rivalry between firms ensures maximum efficiency in the use of resources".[46]

[46] Because competition is not an end in itself, the Commerce Act recognises that efficiency in the use of resources for the long-term benefit of New Zealand consumers may be achieved in other ways. The Commerce Act therefore permits exceptions to the premise on which it is based, in the form of authorisations granted by the Commerce Commission. Authorisations can be granted in respect of restrictive trade practices and business acquisitions which would otherwise be prohibited because of their likely or presumed effect on competition.

[47] For present purposes the relevant prohibition is s 47(1). It provides that "[a] person must not acquire assets of a business or shares if the acquisition would have, or would be likely to have, the effect of substantially lessening competition in a market". A party wishing to acquire shares or assets, who is prohibited by this section from doing so, can apply to the Commission for an authorisation.

[48] An application for such an authorisation is determined under s 67(3) which provides:

> Within 60 working days after the date of registration of the notice, or such longer period as the Commission and the person who gave the notice agree, the Commission shall—
>
> (a) if it is satisfied that the acquisition will not have, or would not be likely to have, the effect of substantially lessening competition in a market, by notice in writing to the person by or on whose behalf the notice was given, give a clearance for the acquisition; or
>
> (b) if 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, by notice in writing to the person by or on whose behalf the notice was given, grant an authorisation for the acquisition; or
>
> (c) if it is not satisfied as to the matters referred to in paragraph (a) or paragraph (b), by notice in writing to the person by or on whose behalf the notice was given, decline to give a clearance or grant an authorisation for the acquisition.

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46 *Tru Tone Ltd v Festival Records Retail Marketing Ltd* [1988] 2 NZLR 352 (CA) at 358: and see *Goodman Fielder Ltd* (1987) 1 NZBLC 104 (Com) at [258] which is to similar effect.

[49] Accordingly, in considering an authorisation application, the first step for the Commission is to determine whether 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. If it is so satisfied, the acquisition is given a clearance. If it is not so satisfied then the Commission considers whether the acquisition will result in "such a benefit to the public" that it should be permitted. If it is satisfied that this statutory requirement is met, then the Commission grants an authorisation.

[50] The only section which gives any specific indication of what constitutes a benefit to the public is s 3A, which provides:[47]

> 3A **Commission to consider efficiency**
>
> Where the Commission is required under this Act to determine whether or not, or the extent to which, conduct will result, or will be likely to result, in a benefit to the public, the Commission shall have regard to any efficiencies that the Commission considers will result, or will be likely to result, from that conduct.

[51] As the case law has made clear, however, efficiency considerations are not the only relevant public benefits.[48]

[52] Since the Act's inception the Commission and the Courts have discussed how the "such a benefit to the public" test should be approached. The leading case is *Telecom Corporation of New Zealand Ltd v Commerce Commission*.[49] It is the first (and only) time the Court of Appeal has considered the s 67(3)(b) test. In that case the Court of Appeal accepted that the test involved a "balancing" of likely public benefits from the acquisition and likely public detriments from (what would now be

[47] Godfrey Hirst's written submissions noted that s 3A referred to "conduct" and was therefore focussed on a person's actions, particularly those restrictive trade practices to which ss 27 and 28 may apply. However, in oral submissions counsel for Godfrey Hirst clarified that it accepted that s 3A also applied to the assessment of public benefits under s 67 (relating to acquisitions prohibited by s 47).

[48] *Telecom Corporation of New Zealand Ltd v Commerce Commission* (1991) 4 TCLR 473 (HC) at 528 "[e]fficiency considerations...are relevant...but clearly do not exhaust society's interest in the business conduct the subject of the Commerce Act"; *Air New Zealand v Commerce Commission (No 6)* at [319] "[b]enefits include efficiency gains (s 3A of the Act) and anything of value to the community generally".

[49] *Telecom Corporation of New Zealand Ltd v Commerce Commission* [1992] 3 NZLR 429 (CA).

read as)[50] the lessening of competition in a market as a result of the acquisition.[51] It was accepted that the relevant benefits and detriments were almost entirely efficiency gains and losses. Richardson J commented that the Commission had a "responsibility" to "attempt so far as possible to quantify detriments and benefits rather than rely on a purely intuitive judgment to justify a conclusion that detriments in fact exceed quantified benefits".[52]

[53] Since then it has been the standard practice of the Commission to do just that. 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).

The Commission's approach

[54] In this case, in accordance with s 67(3)(a), the Commission first considered whether the proposed acquisition would be likely to substantially lessen competition in any market. The Commission defined the relevant markets as being the North and South Island markets for the supply of wool scouring services.[53] There is no challenge on this appeal to the Commission's definition of these two markets.[54]

[55] In those two markets, the Commission followed its usual method, comparing the state of competition if the acquisition were to proceed (known as "the factual") against the state of competition if it did not (known as "the counterfactual"). The

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[50] At the time, s 47 prohibited acquisitions which were likely to result in a dominant position in a market or the strengthening of a dominant position in a market. The Court of Appeal therefore referred to the likely public detriment from the strengthening of Telecom's dominant position.

[51] Refer Cooke P at 435; Richardson at 447; McKay at 449.

[52] At 447.

[53] The Commission also considered the national market for the purchase and supply of wool grease and the national market for the manufacture, import and wholesale supply of wool and synthetic carpets. The proposed acquisition was not considered likely to substantially lessen competition in these markets and so they were not considered further. There is no challenge to this on this appeal.

[54] While not disputing the relevance of these markets, Wool Equities submits that the Commission failed to consider adequately impacts on growers.

counterfactual was accepted as being the status quo – that is, if the acquisition did not proceed there would continue to be two unassociated competitors in the two wool scouring markets, even if the shareholders in NZ Wool Services were to change. There is no challenge to the counterfactual, as accepted by the Commission, on this appeal.

[56] The Commission considered the potential constraints on Cavalier's conduct in the factual.[55] Its conclusions on these were:[56]

> As noted above:
>
> - the proposed Acquisition would remove Cavalier Wool's nearest existing competitor – [NZ Wool Services];
> - the ability for exporters to switch to greasy exports to China provides only a moderate constraint on Cavalier Wool in the factual; and
> - the potential for new entry into the scouring market provides only a moderate constraint on Cavalier Wool in the factual in that entry would only be likely to occur with a price increase of at least 5-10%.
>
> Therefore, the Commission's conclusion 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.

[57] This conclusion meant that, in accordance with s 67(3)(b), the Commission needed to determine whether the acquisition was likely to result in such a benefit to the public that it should be permitted.[57] The Commission said that this required it to determine "whether the detriments flowing from the lessening of competition are outweighed by the public benefits that result, or would be likely to result from the acquisition".[58]

[58] The Commission assessed detriments to allocative, productive and dynamic efficiency. It also considered concerns raised on behalf of NZ Wool Services about

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55 The Commission made no express mention of any change in the factual in the countervailing power of merchants which was seen as a significant constraint in Decision 666, partly because of the presence of NZ Wool Services.
56 At [187]-[188] of Decision No 725.
57 At [51] of Decision No 725.
58 At [51] of Decision No 725.

disruption to production during the rationalisation period, and to wool prices as a result of the sale or discontinuance of NZ Wool Services' wool trading division, if the proposed acquisition proceeded.

[59] The Commission set out principles for the public benefits assessment as follows:[59]

> Any assessment of detriment and benefit will be fact specific but a number of principles have emerged from the Courts' decisions. The High Court in *Air New Zealand v Commerce Commission (No 6)*[60] noted the following:
>
> - Benefits include efficiency gains (s 3A of the Act) and anything of value to the community generally: *Telecom v Commerce Commission* (1991) 4 TCLR 473,530.
> - Only net benefits are included. Any costs incurred in achieving efficiencies must be taken into account. Transfers of wealth which achieve no benefit to society as a whole should be disregarded.
> - The benefits must result from the acquisition. Benefits which would or would be likely to accrue whether or not the acquisition proceeds should be disregarded.
> - Benefits should be quantified where possible but benefits, which by their nature, are incapable of quantification, should still be taken into account. The Court acknowledged that quantification of dynamic efficiencies and dynamic gains is particularly difficult.

[60] The Commission assessed each of the benefits Cavalier claimed would arise from the proposed acquisition: being production efficiencies, the sale of surplus land and buildings, capital expenditure, the removal of "a weak seller" in international markets, a wool superstore, and improvements to the quality of scoured wool. The Commission was not satisfied as to the "weak seller" or the quality benefits claimed by Cavalier. It accepted that the other benefits (net of capital expenditure and one-off rationalisation costs) were likely to arise from the proposed acquisition.

[61] The Commission then compared detriments with benefits as follows:[61]

> This Application involves a balancing of the public benefits and detriments which would, or would be likely to, result from the Acquisition. Only when

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59 At [58] of Decision No 725.

60 Above n 48 at [319].

61 At [501]-[505] of Decision No 725.

there is a net positive public benefit can the Commission be satisfied that the Acquisition should be permitted, and that it should grant an authorisation for the Acquisition.

Table 5 and 6 summarise the Commission's quantitative assessment of the likely detriments and benefits arising from the acquisition.

Table 5: Summary of Detriments

Category	Evaluation	5-year NPV
Allocative efficiency	$0.2 million to $3.8 million per year	$0.7 - $22.7 million
Productive efficiency	$[ ] million to $[ ] million per year	$[ ] - $[ ] million
Dynamic efficiency	$[ ] to $[ ] million per year	$[ ] - $[ ] million
Total of quantified detriments		**$1.4 - $28.8 million**

Table 6: Summary of Benefits

Category	Evaluation	5-year NPV
Reduction in Production and Administration Costs	$[ ] million per year	$[ ] million
Sale of land	One-off benefit	$6.0 - $10.0 million
Capital expenditure on land and buildings	One-off cost	[($[ ] million)]
Capital expenditure on plant	[ ]	$0.9 million
One-off Rationalisation Costs	One-off cost	[($[ ] million)]
Superstore	Savings of $4.1 million per year in years four and five	$7.2 million
Total of quantified benefits		**$29.6 - $33.6 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.

The Commission is required to assess likely benefits and likely detriments. The above represents the Commission's quantitative assessment of these benefit and detriment ranges. The Commission notes that the high estimates

> for the detriments and the lowest number for the quantified benefits are relatively close.
>
> As previously noted, the Commission considers 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 most likely benefits and detriments within any ranges. As already noted, the quantitative assessments informs upon the ultimate qualitative assessment of both benefits and detriments.
>
> Using the midpoint estimates, as identified throughout this document, gives an estimate of the likely net present value of detriments over five years of $18.1 million and benefits of $31.6 million. Accordingly, the benefits in total and in various combinations, are sufficient to outweigh the detriments. For example, the Acquisition would be authorised even without the Commission's acceptance of the superstore benefits. The Commission is therefore of the view that the public benefits are likely to significantly outweigh the public detriments. The proposed Acquisition has the potential to generate real gains for the public of New Zealand.

Appeal grounds relating to the statutory test

Detriments in any market?

[62] Wool Equities submits that all detriments must be taken into account and not merely detriments that arise in the North and South Island wool scouring markets. It submits that there were potential detriments to farmers through decreased returns on wool and/or a reduction in wool production in New Zealand. As to these potential effects the Commission said:[62]

> However, it is the Commission's view that higher post-acquisition scouring prices would not be simply absorbed or passed on as described. Instead, increased prices would be likely to translate into lower margins for growers. The reasons are as follows:
>
> - Scoured New Zealand wool competes in international markets against wool from other countries and against other close substitutes such as cotton and nylon. 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, due to the competitive nature of wool export markets.
>
> - Peter Whiteman, Managing Director of Segard Masurel (NZ) advised the Commission that while some customers must have New Zealand wool as part of their wool blends, if New Zealand

[62] At [233]-[235] of Decision No 725.

> prices became too high those customers would remove the product from their ranges, or move to equivalent synthetic-based products. Andrew Campbell of J S Brooksbank similarly advised that wool is sold in a global market and that New Zealand cannot dictate the price.
>
> - It also appears unlikely that, if scouring prices were to rise in New Zealand post-acquisition, price rises could be absorbed by merchants. The Commission understands that merchants currently work in an extremely competitive environment and within tight margins of, on average, NZ$0.15 – 0.20 per kg of greasy wool sold.
>
> The Commission notes that 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. Wool revenue as a proportion of total on-farm revenue for sheep and beef farmers has averaged about 11% over the past five years. Further, wool provides only about 18% of farmers' sheep alone revenue. This would suggest that farmers make their sheep stocking decisions on parameters other than just their returns from wool sales and these decisions would be unlikely to be affected by an increase in wool scouring prices.
>
> Further, wool scouring services account for only about 8% of the current value of wool. It is, therefore, very unlikely that a change in the price of wool scouring services by itself would have a significant influence on the amount of wool available for export, either in scoured or greasy form.
>
> (footnotes excluded)

[63] Wool Equities submits that the Commission acknowledged the need to balance the public benefits against all detriments in any market but then did not proceed to do this. The acknowledgement is said to have been made in the following passage from the Commission's decision (Wool Equities relies on the words in italics as the acknowledgement):[63]

> The authorisation procedures require the Commission to identify and weigh the detriments likely to flow from the Acquisition and to balance those against the identified public benefits likely to flow from the acquisition as a whole. The Commission considers that within the relevant markets, a public benefit is any gain, and *a detriment is any loss*, to the public of New Zealand, with an emphasis on gains and losses being measured in terms of economic efficiency. In contrast, changes in the distribution of income, where one group gains while another simultaneously loses, are generally not included because a change in efficiency is not involved. (emphasis added)

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[63] At [212] of Decision No 725.

[64] We consider that Wool Equities' submission overlooks that "a detriment is any loss" is qualified by the introductory words of the sentence: "within the relevant markets". However, those introductory words appear intended to qualify both "a public benefit is any gain" and "a detriment is any loss". On their face, those words might suggest a change of approach, in that the Commission has linked both detriments and public benefits to "the relevant markets" (which here are the North and South Island wool scouring markets). The Commission's previous approach has been to consider detriments from the lessening of competition in the market(s) in which competition is likely to be lessened (ie the relevant markets), whereas any benefits likely to accrue to the New Zealand public are considered irrespective of the relevant market(s) in which competition is likely to be lessened.

[65] The Commission submits however that there had been no change in its analytical method. It submits that we should not read too much into the construct of the passage relied on by Wool Equities, especially since earlier in its decision,[64] and in its published Guidelines,[65] the Commission expressly linked the assessment of detriments to the relevant markets, while referring to any public benefits arising from the acquisition. In its decision the Commission cited, in support of this approach, Wilson J in the Court of Appeal in *NZ Bus Limited v Commerce Commission*,[66] where His Honour said:

> As the Commission correctly held in *Re Goodman Fielder Ltd – Wattie Industries Ltd* (1987) 1 NZBLC (Com) 104,108 at p 104,147 and in *Re Air New Zealand Ltd and Qantas Airways* Ltd (Commerce Commission, Decision 511, 23 October 2003, P R Rebstock, Chair) at para [897], all benefits must be taken into account, whereas only detriments in a market where competition is lessened will be relevant.

[66] Wool Equities says this was *obiter* and incorrect because all detriments are to be considered regardless of whether they occur in the relevant markets. It submits that this Court is therefore not bound by this statement and should not apply this approach. We agree that it was *obiter*. We turn to consider whether it was incorrect.

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64 At [199] of Decision No 725

65 "Guidelines to the Analysis of Public Benefits and Detriments" (Commerce Commission, Wellington, October 1994, revised December 1997).

66 *New Zealand Bus Ltd v Commerce Commission* [2008] 3 NZLR 433 (CA) at [271]. The Commission also cites in support of this approach the two decisions of its own which Wilson J referred to in this passage.

[67] This issue appears first to have been considered by the Commission in *Re Goodman Fielder Ltd.*[67] There the Commission was considering an authorisation application shortly after the Commerce Act had come into force. At this early stage in the Commerce Act's life, a financial threshold determined what acquisitions needed to be the subject of clearances or authorisations. A clearance was to be granted if the acquisition would not result in a dominant position being created or strengthened in a market.[68] An authorisation was to be granted if the proposed acquisition was likely to result "in a benefit to the public which would outweigh any detriment to the public which ... would be likely to result from any person ... acquiring a dominant position in the market or strengthening a dominant position in the market".[69]

[68] The Commission considered that the wording of the relevant section meant that it was only to consider the detriments in markets in which dominance was acquired or strengthened and that these detriments were to be weighed against "all public benefit resulting from the whole of the proposal and not merely those created by dominance".[70] The Commission asked itself "[i]f the benefit from the whole of the proposal is taken into account then why not the detriment arising therefrom?"[71] The Commission's decision was appealed but the High Court[72] and Court of Appeal[73] made no comment on this topic.

[69] Wool Equities does not contend that the Commission was wrong in *Re Goodman Fielder Ltd*, and in subsequent decisions, to consider only detriments in the markets in which dominance was acquired. It says that this followed from what was the then wording of the authorisation test. It says that, with the amendment to s 47 in 2001 (to prohibit acquisitions that substantially lessen competition in a market), the Commission/courts are no longer bound by this approach. Wool Equities' submissions did not elaborate on why that amendment should change the

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67 *Re Goodman Fielder Ltd* (1987) 1 NZBLC 104 (Com).
68 What was then s 67(4) of the Commerce Act 1986.
69 What was then s 67(5) of the Commerce Act 1986.
70 *Re Goodman Fielder Ltd* at [260]. A later example is *Ruapehu Alpine Lifts Ltd* Commerce Commission Decision No 410, 14 November 2000 at [234]: "...the detriments may only be found in the market or markets where dominance is acquired or strengthened, whereas benefits may arise both in those and in any other markets."
71 *Re Goodman Fielder Ltd* at [261].
72 *Goodman Fielder Ltd v Commerce Commission* (1987) 1 NZBLC 102,701 (HC).
73 *Goodman Fielder Ltd v Commerce Commission* [1987] 2 NZLR 10 (CA).

Commission's approach to the assessment of detriments from a lessening of competition in defined markets, against public benefits from the proposed acquisition as a whole.

[70] We cannot see why the change to the s 47 competition threshold (from acquiring/strengthening dominance to substantially lessening competition) would alter the detriments assessment in the way that Wool Equities contends. The new threshold still requires an assessment of any change in the level of market power in relevant markets. The Commission/courts only proceed to consider whether there is "such a benefit to the public" from proposed acquisitions if they have first found that market power has increased to the extent that competition is substantially lessened in one or more markets. Just as acquiring or strengthening dominance in a market would have given rise to detriments from the increase in market power, so too will acquiring a position which has the effect of substantially lessening competition in a market. The focus of the s 47 test remains on those markets where the threshold is met.

[71] Moreover, earlier amendments, made in 1990, do not support Wool Equities' submission either. At this time the authorisation test was amended so as to require the Commission to be satisfied that the acquisition was likely to result "in such a benefit to the public that it should be permitted". Section 47 was introduced so as to prohibit acquisitions likely to result in dominance or a strengthening of dominance in a market.[74] That 1990 wording of the authorisation test was not altered when s 47 was later amended in 2001 to change the competition threshold from dominance to substantially lessening competition.

[72] The consistent approach of the Commission throughout the legislative changes has been to assess competitive detriments in the relevant markets (that is those markets in which dominance was likely to be strengthened/acquired or competition substantially lessened) and compare those detriments (or welfare losses) with the public benefits claimed to flow from the acquisition. That approach was

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[74] Prior to these amendments this prohibition was incorporated only as part of the authorisation test and not in a stand-alone section. The authorisation test required that public benefits outweigh "any detriment to the public which would result or would be likely to result, from any person … acquiring [or strengthening] a dominant position in a market".

sanctioned by the High Court and Court of Appeal in *Telecom*[75] when s 47 was in its previous form but the authorisation test was in its present form.

[73] An acquisition may however result in detriments (other than competition detriments)[76] beyond those markets in which an increase in market power has been found. As to such detriments, the High Court in *Telecom* said this:[77]

> Moreover, we would caution that the detriments attributable to the strengthening of dominance are not the only detriments that could conceivably be relevant. *The very concept of benefit to the public allows for some netting out, in an appropriate case, of any detriments to the public from the acquisition itself* — albeit, again, it is a question of what difference is made to the shape of the future with and without the acquisition. (emphasis added)

[74] It is well accepted that, in assessing public benefits, a "net" approach is taken whereby the costs in realising the efficiencies are deducted.[78] This point was expressly noted by the Commission in this case.[79] The above passage refers to a wider concept of "net benefit" to the public than that. We are not aware of any New Zealand decision, after these comments by the High Court in *Telecom*, which has viewed "net benefit" in this wider way. That is, where there are "other detriments" that fall outside the defined markets, these can be considered as "disbenefits" or "negative benefits" and then offset (along with the costs of realizing efficiencies) against the (positive) public benefits claimed. The assessed detriments from the loss of competition in the defined markets would then be weighed against the net public benefit (ie deducting negative benefits as well as realisation costs) from the proposed acquisition to give the overall result.

[75] Although counsel for Wool Equities did not accept that this was the analytical approach by which detriments outside the defined markets could be taken into

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75 *Telecom Corporation of New Zealand v Commerce Commission* [1992] 4 TCLR 473 (HC) at 533 and *Telecom Corporation of New Zealand v Commerce Commission* [1992] 3 NZLR 429 (CA) at 435 and 449.

76 If there are likely to be competition detriments in other defined markets which are real or of substance then the Commission will find that a substantial lessening of competition is likely in those other markets and the detriments will then be assessed and weighed against the claimed public benefits.

77 At 528.

78 "Guidelines to the Analysis of Public Benefits and Detriments" *in the Context of the Commerce Act* (Commerce Commission, Wellington, October 1994) at 6; Revised Guidelines (December 1997) at 12.

79 Refer [59] above.

account, it would meet the point he was making. If that approach were to be taken it would be important to avoid double-counting negative benefits, for example by adding first and second-round price effects.[80] In this case, for example, it would not be appropriate to treat an increase in the price of wool scouring services to merchants (the first round price effect) as a detriment in terms of allocative inefficiency while at the same time calculating a disbenefit (in terms say of lower wool production) if it is assumed that merchants pass on the price increase (the second round price effect) to farmers rather than to final consumers. We discuss this issue further in relation to the Commission's assessment of allocative inefficiency in this case.[81]

Summary of issues Godfrey Hirst raises about the Commission's approach to the statutory test.

[76] Godfrey Hirst submits that:

(a) the Commission erred in the way it reached its conclusion that there was such a public benefit that the acquisition should be authorised. It says the Commission focussed solely on a quantitative assessment of detriments and benefits and granted the authorisation based on its quantitative assessment that detriments outweighed benefits. In so doing, it submits that the Commission failed to "stand back" and make the overall qualitative assessment that the statutory test requires;

(b) the Commission erred in its quantitative assessment by "expressly plump[ing] for...mid-points" as a substitute for exercising the judgment that the statutory test requires the Commission to make. The Commission's adoption of mid-points was "not informed by the competition-relevant aspects of the [particular] market conditions";

(c) in assessing the competition-relevant aspects of the particular market conditions the Commission failed to consider that it was authorising a "merger to monopoly"; and

80 Whether it is merchants, final customers or farmers who ultimately bear any price increase by the merged entity is, in and of itself, not a different detriment.

81 Refer [174] to [182] below.

(d) the Commission failed to consider whether the claimed efficiencies were "merger-specific efficiencies".

[77] Godfrey Hirst did not advance these submissions in quite the same way before the Commission. Godfrey Hirst did make a submission to the Commission that benefits and detriments be calculated on an "expected value approach". The Commission said that such an approach would involve calculating both the probability of the gain or loss occurring and the impact if it did. It considered that this approach was not in accordance with the "more likely than not" standard of the statutory test. The Commission noted the requirement that it needed to attempt to quantify benefits and detriments, but that it still needed to consider gains or losses of an intangible nature, and that quantification was simply a tool to enhance its final qualitative judgment.[82]

[78] Godfrey Hirst also submitted to the Commission that there was an "extra component" when it was considering whether to grant an authorisation. Godfrey Hirst submitted that the statutory authorisation test was a "high" one, not satisfied by a bare positive margin in favour of benefits; and that "the Commission must be more cautious and where there is uncertainty surrounding the purported public benefit, the application must be declined…"[83] The Commission rejected this saying:[84]

> First, it is clear that the standard is the balance of probabilities and the Commission does not agree with [NZ Wool Services'] submissions insofar as it appears to suggest a standard of "beyond reasonable doubt". The Commission agrees with Godfrey Hirst's comments about the difference in wording and that it must apply the test as laid down in s 67(3)(b), but notes that:
>
> - It is difficult to see what process could be used other than using the best evidence possible, assessing detriments and benefits and making a comparison between the results to determine where the likely outcome lies.
> - The test has been applied by the Commission using that process, and sanctioned by the Courts, on a number of occasions.
> - It is not clear on what basis the Commission could justify declining an authorisation if there was a positive margin in

82 At [215] of Decision No 725.
83 At [53] of Decision No 725.
84 At [56]-[57] of Decision No 725.

favour of benefits (that is, there were net public benefits). The Applicant would likely have legitimate grounds of complaint in that case, and it would potentially make the outcomes of authorisation applications variable insofar as they would be dependent on the unspecified subjective views of different Commissioners from time to time.

Secondly, to the extent that the Commission must be satisfied on the balance of probabilities on the basis of evidence put before it, it agrees that such evidence should be as "clear and convincing" as the circumstances allow.

[79] Regardless of whether the submissions now being advanced are partly new submissions, we accept that if the Commission has erred in its approach to the statutory test then that is a matter which can be corrected on this appeal. (To the extent that any error in approach meant that necessary factual enquiries were not made, that would be relevant to the nature of any orders we may make.)[85] We therefore proceed to consider the detail of the submissions advanced.

Is the test different from s 27 authorisations?

[80] There are variations in the wording of the statutory provisions under which authorisations are granted for arrangements and acquisitions that would otherwise be prohibited. With reference to these variations, Godfrey Hirst submits that a different test applies to the authorisation of a business acquisition than to the authorisation of arrangements prohibited by ss 27 and 28.

[81] The statutory wording for authorisations is as follows (emphasis added):

(a) **Authorisation of ss 27 and 28 arrangements**:

61(6) The Commission shall not make a determination granting an authorisation pursuant to an application under section 58(1) to (4) of this Act unless it is satisfied that—

(a) the entering into of the contract or arrangement or the arriving at the understanding; or

(b) the giving effect to the provision of the contract, arrangement or understanding; or

[85] We note the Supreme Court's comments in *Commerce Commission v Telecom* [2010] NZSC 111 at [48] about the difficulty for a respondent where new arguments are raised by an appellant on an appeal.

(c) the giving or the requiring of the giving of the covenant; or

(d) the carrying out or enforcing of the terms of the covenant—

as the case may be, to which the application relates, *will in all the circumstances result, or be likely to result, in a benefit to the public which would outweigh the lessening in competition* that would result, or would be likely to result or is deemed to result therefrom.

(6A) For the purposes of subsection (6) of this section, a lessening in competition includes a lessening in competition that is not substantial.

(b) **Authorisation of s 29 arrangements**:

61(7) The Commission shall not make a determination granting an authorisation pursuant to an application under section 58(5)or (6)of this Act unless it is satisfied that—

(a) the entering into of the contract or arrangement or the arriving at the understanding; or

(b) the giving effect to the exclusionary provision of the contract, or arrangement or understanding—

as the case may be, to which the application relates, *will in all the circumstances result, or be likely to result, in such a benefit to the public that*—

(c) the contract or arrangement or understanding *should be permitted* to be entered into or arrived at; or

(d) the exclusionary provision *should be permitted* to be given effect to.

(c) **Authorisation of ss 37 and 38 arrangements**:

(8) The Commission shall not make a determination granting an authorisation pursuant to an application under section 58(7) or (8) of this Act unless it is satisfied that—

(a) the engaging in the practice of resale price maintenance to which the application relates; or

(b) the act or conduct to which the application relates—

as the case may be, *will in all the circumstances result, or be likely to result, in such a benefit to the public* that—

(c) the engaging in the practice *should be permitted*; or

(d) the act or conduct *should be permitted*.

(d) **Authorisation of business acquisitions**:

[Refer [48] above].

[82] As we understand it, the point Godfrey Hirst is making is that the ss 27/28 authorisation test is limited to an evaluation of detriments against an evaluation of public benefits. If, in all the circumstances, the estimated total value of detriments is likely to be lower than the estimated total value of benefits then the authorisation will be given. The Commission need not be concerned about the size of the gap between the detriments and benefits nor the nature of them.

[83] In contrast, the authorisation of a business acquisition requires the Commission, having done a quantitative assessment of detriments and benefits, to carry out a second step: one that involves "standing back" and exercising a "value" judgment to determine whether or not there is "such a benefit" to the public that the acquisition should be permitted. In effect, Godfrey Hirst is submitting that a higher authorisation hurdle applies to mergers (and to ss 29, 37 and 38 conduct) than to ss 27/28 conduct, ie a "positive margin in favour of benefits" may not be sufficient to justify an authorisation. The reasons (as put forward by Godfrey Hirst)[86] that underlie that higher hurdle must form part of the value judgment the Commission is required to make.

[84] Godfrey Hirst does not view this submission as inconsistent with *Air New Zealand v Commerce Commission* where the High Court said:[87]

> The tests under ss 61 and 67 are substantially the same. Both require a consideration of whether there is or is likely to be a lessening of competition and an assessment of public benefit. The way in which public benefit is required to be weighed is subtly different, but the practice of the Commission, sanctioned by the Courts, is that there is no material difference between the tests mandated by the two sections.

[85] In our view, Godfrey Hirst's submission is inconsistent with that view. The High Court expressly stated that there is no "material difference" between the two tests. Nonetheless, we proceed to consider the argument presented for why there is a difference.

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[86] And discussed below at [86].

[87] *Air New Zealand v Commerce Commission (No 6)* at [33].

[86] Godfrey Hirst submits that the difference in the test arises because ss 27 and 28 arrangements "are the ordinary stuff of commercial dealings", in contrast to the other restrictive trade practices prohibited by ss 29, 37 and 38 which should be "exceptional" commercial dealings. If they are to be authorised, Godfrey Hirst submits that there should be "something about the particular benefit to the public they confer". It says that it is no coincidence that s 67(3)(b) (the authorisation test for business acquisitions) adopts the same test as for authorisations of ss 29, 37 and 38, because business acquisitions are more permanent in effect and therefore potentially more harmful to the public (in terms of their anti-competitive effect).[88]

[87] However, if that view has any validity, it is only as a general proposition, since when particular examples are considered the validity of the proposition falls away. To take one example, long term contracts may have a more permanent effect on competition in a market than some business acquisitions.[89] To take another example, price fixing can be authorised and is assessed under the same statutory wording as that which applies to ss 27 and 28 arrangements,[90] even though competition literature is full of references to price fixing as "hard core cartel" activity (ie the antithesis of the competitive process).

[88] It is not clear why the legislature would have chosen a higher hurdle for authorisations of resale price maintenance (ss 37 and 38) or exclusionary arrangements (s 29) than for ss 27/28 arrangements. There is no particular reason to assume (and no persuasive reason was advanced) that such arrangements would be any more permanent or detrimental to competition than an arrangement caught by s 27 (or s 28).

[89] We therefore do not agree with Godfrey Hirst's reasons for why a higher threshold should apply to applications for authorisation of business acquisitions compared with ss 27 and 28 arrangements. Although the statutory wording varies,

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[88] While Godfrey Hirst's written submissions also submitted that the test for business acquisitions is further confined by the omission of "in all the circumstances", in oral submissions it accepted that it was difficult to see any substantive difference arising from the omission of these words in the s 67(3)(b) test).

[89] Depending on the market dynamics and the nature and terms of the contract.

[90] Section 30 deems price fixing to have the purpose or effect or likely effect of substantially lessening competition in a market under section 27. An application for authorisation of s 30 arrangements is therefore assessed under the authorisation test that applies to s 27 applications.

what is common to all the authorisation provisions is that the Commission is directed to grant an authorisation only on public benefit grounds. What is explicit in respect of ss 27 and 28 authorisations, ie that public benefits must outweigh the lessening of competition (which need not be substantial), is implicit in the other provisions. The "such a benefit" test could only be satisfied if there is: first, an assessment of the detriments to the competitive process that flow from the arrangement or acquisition for which authorisation is sought; and, secondly, a comparison and evaluation of those detriments as against the (net) benefit to the public.

[90] Beyond that, we consider that it is not necessary to rationalise why the legislature has used slightly different wording in the authorisation provisions, noting that all counsel accepted that there was no complete and obvious rationale. It is the authorisation test in s 67(3) that the Commission was required to apply. We turn now to consider what the "such" a public benefit requirement entails.

The role of the quantitative assessment in the statutory test and how it is to be undertaken

[91] Godfrey Hirst's submissions raise an issue as to the role of the quantitative assessment when the Commission is considering the statutory test for granting an authorisation, viz "such a benefit to the public" that it should be permitted. In accordance with *Telecom*, that test involves a balancing of the detriments and benefits found. It was recognised in *Telecom* that this exercise is more difficult where the detriments and benefits are not all efficiency losses and gains. But where there are efficiency losses and gains, the Commission is required "where possible" to quantify them "rather than rely on a purely intuitive judgment to justify a conclusion that detriments in fact exceed quantified benefits".[91]

[92] In directing that detriments which are efficiency losses should be quantified where possible, the Court of Appeal was concerned that the claimed detriments arising from the proposed acquisition in *Telecom* were "theoretical and speculative", whereas there was a solid basis for finding that Telecom would achieve economies and that the public would benefit from a more efficient Telecom service. It said that

[91] *Telecom* above n 49 Richardson J at 447.

the direction to have regard to efficiencies in s 3A should not be "circumvented by assuming inefficiencies on grounds of economic doctrine".[92] Avoiding speculation was also considered to be necessary when considering whether the dominance threshold was met. That test involves a "value judgment" which should be "as informed by practical evidence as possible".[93] "Pure speculation...and simple intuition" were viewed by the Court of Appeal in *Telecom* as "no substitute for hard data drawn from empirical studies and evidence from participants in the industry".[94]

[93] How the quantitative assessment is to be carried out was considered by the High Court in *Ravensdown Corporation Ltd v Commerce Commission.*[95] In that case Ravensdown was appealing the Commission's decision declining to clear or authorise a proposed acquisition. It submitted on appeal that the Commission had not been specific enough when undertaking its quantitative assessment because it had exercised its judgment on the basis of ranges. It submitted that:[96]

(a) it was not open to the Commission to conclude that detriments may be of a "significant to major order of magnitude and towards the upper bounds of the ranges";

(b) such an approach failed to assess detriments and benefits on the basis of likelihood;

(c) the mean (average) position within the range may be likely, but an upper bounds position was not.

[94] The Court rejected these submissions. It considered that if the Commission were bound to take a mid-point in a range that would "pre-suppose a symmetric distribution within the range", which would not necessarily be the case. The Court considered that, in undertaking the quantitative assessment, it may be legitimate to

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92 Cooke P at 439 – 440. In making these comments, Cooke P also referred to the absence of substantial evidence to show that Telecom was anything other than an efficient and determined competitor. McKay J at 449 similarly referred to some benefits having been "demonstrated" while the claimed detriments were "nebulous and speculative".

93 Richardson J at 446.

94 Richardson J at 446.

95 *Ravensdown Corporation Ltd v Commerce Commission* HC Wellington AP 168/96, 16 December 1996.

96 *Ravensdown* at 49-50.

make a judgment that the losses or gains could fall anywhere within a range. Moreover, the appellant's submissions assumed that the statutory test required the Commission to determine a particular "likely" value of a loss or gain, whereas the question of whether an acquisition was "likely" to result in "such benefit to the public that it should be permitted" was the end decision based on the facts-based assessment of benefits and detriments.

[95] It was also submitted by the appellant in *Ravensdown* that the balancing exercise in that case was "a close-run" thing. This was because the mid-point of the total detriment range and the mid-point of the total benefit range were about the same. But the Court determined that the Commission was not bound to value the benefits and detriments at the mid-points. It concluded that the Commission had formed the view that it could not be satisfied that the public benefits outweighed the detriments. It went on to say that it was "legitimate for the Commissioners *to then stand back and notice* that Ravensdown would be largely free from competitive restraint in the South Island markets and bring that consideration to account as part of the balancing exercise"[97] (emphasis added).

[96] The need for a "facts-based assessment" was referred to again by the High Court in *Rugby Union Players' Association v Commerce Commission.*[98] In that case the Court was considering an appeal from the Commission's decision, which had granted an authorisation for an arrangement (a player transfer system) that breached ss 27, 29 and 30 of the Commerce Act. The Players' Association appealed partly on the ground that the Commission had an insufficient evidential basis for its finding that public benefits would "comfortably" outweigh the detriments of the arrangement. The Court rejected this saying that it was open to the Commission to reach the conclusion it had.[99] Having considered the Commission's facts-based assessment the Court asked itself whether, "at the end of that process", the Commission could not or should not have been satisfied that the benefits from the arrangement were likely to outweigh the detriments. This is perhaps consistent with *Ravensdown*'s "stand back and notice" point.

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[97] *Ravensdown* at 61.

[98] *Rugby Union Players' Association Inc v Commerce Commission (No 2)* [1997] 2 NZLR 301 (HC) at 320.

[99] *Rugby Union Players' Association* at 326.

[97] *Telecom, Ravensdown* and *Rugby Union Players' Association* were all referred to in *Air New Zealand.* In that case the High Court was considering an appeal from the Commission's decision declining to grant an authorisation for a share acquisition and a strategic alliance agreement between Air New Zealand and Qantas. In considering whether the acquisition and agreement breached ss 47 and 27 respectively the High Court, guided by what was said in *Telecom,* was concerned not to act on speculation and intuition. The Court referred to the need to "draw on a careful examination of the available evidence" rather than to speculate and rely on intuition.[100] It also described the assessment as involving a "value judgment" typically involving "the application of economic theory, practical experience (in the market or other markets having shared characteristics) and known facts about the structure of the market and the behaviour of competitors and potential competitors".[101]

[98] Similarly, when considering whether the arrangement/acquisition should be authorised, the Court noted, with reference to *Ravensdown* and *Rugby Union Players' Association,* the need for a facts-based assessment.[102] With reference to *Telecom,* the Court referred to the need to attempt to quantify detriments and benefits where possible and said that assumptions of inefficiency were not to be made on the grounds of economic doctrine alone.[103] It made the point that detriments and benefits which could not be expressed in monetary terms still needed to be included in the balancing exercise.[104] In declining the authorisation the Commission had carried out a quantitative exercise of detriments and benefits. This included setting out a likely range for all detriments and some categories of benefits and a "most likely" figure for each item. Although the Court did not express a view on this approach, it commented on the quantification and balancing exercise as follows:[105]

> At the same time, it may be necessary to reduce the weight to be given to some categories of quantified detriments and benefits if there are doubts about the reliability of the calculation or when the quantification process is necessarily abstract in nature. The balancing process is not to be seen as a purely arithmetical exercise. It should be leavened with a healthy regard for

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[100] *Air New Zealand v Commerce Commission (No 6)* at [51].
[101] At [117].
[102] At [33].
[103] At [235].
[104] At [415].
[105] At [416].

> any shortcomings in the way in which detriments and benefits have been quantified.

[99] The Court's view was that the quantified public benefits were "significantly less" than the quantified detriments, even allowing for reservations it had about some of the detriments. It asked itself whether the unquantified benefits were "sufficient to tip the balance to such an extent" that the Commission ought to have authorised the arrangement/acquisition.[106] The Court considered those benefits to be "material" but in its "judgment" failed "by a significant margin" to tip the balance to the necessary extent.[107]

[100] Godfrey Hirst placed emphasis on comments by the Court of Appeal in *Commerce Commission v Woolworths Ltd* that the Commission in that case "was right to give weight to the theoretical concerns raised by a 3:2 merger in markets such as these"[108] and that "the empirical evidence is insufficient to outweigh its concerns about a duopoly in markets having the characteristics of those at issue".[109] That case was concerned with whether a proposed acquisition (of a new entrant) should be granted a clearance.[110] It was not concerned with whether an authorisation should be granted. Nor did it discuss *Telecom* and cannot be taken to have intended to overrule the direction given by the Court of Appeal in that case as to how the authorisation test was to be applied.[111] That is not to say that economic theory is irrelevant. It can inform the judgment to be made in carrying out the quantitative assessment of efficiency gains and losses and the weight to be given to any particular quantified gain or loss in light of any uncertainty in its quantification.

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[106] At [429].

[107] At [430].

[108] *Commerce Commission v Woolworths Ltd* (2008) 12 TCLR 194 (CA) at [200].

[109] At [206].

[110] The Court of Appeal was there considering a new entrant to the market which had been performing below expectations. The two existing competitors, who were both seeking clearances, were able to point to empirical evidence about the competitive impacts when the market had gone from three to two competitors as well as the impact to date of the new entrant in support of their applications. The Court of Appeal was not satisfied that this evidence meant that the proposed acquisition by one of the two competitors was not likely to substantially lessen competition in a market.

[111] Compare with the view discussed in Justice J G Fogarty "Running the mischief rule over appellate decisions trans-Tasman" (2011) 18:3 *Competition and Consumer Law Journal* 224 and commented on in Kerrin M Vautier "Theory vs evidence? Or designer vs economic law?" (2011) 18:3 *Competition and Consumer Law Journal* 236.

[101] We consider that the authorities show that the role of the quantitative assessment is to underpin and facilitate the balancing exercise that the statutory test requires. It informs the judgment that must be made as to whether the acquisition is "likely" to result in "such a benefit to the public" that it "should be permitted". In so doing it seeks to avoid the speculation and intuition that might otherwise come into play in that judgment without the discipline and rigour of the facts-based quantitative assessment. Like the value judgment that must be made as to whether an arrangement or acquisition is likely to substantially lessen competition in a market, the quantitative assessment for authorisation purposes relies as far as practicable on available evidence rather than economic doctrine.

[102] That is not to say that the quantitative analysis then becomes the only reference point in the balancing exercise. Most obviously, and as the High Court in *Air New Zealand* said, there may be benefits which are not quantifiable that are still to be given weight. In such a case a judgment will need to be made about the nature and significance of those benefits relative to the likely detriments. When all the claimed detriments and benefits are efficiency losses and gains, judgment must be exercised in quantifying them. 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.

[103] Godfrey Hirst submits that in the present case the Commission did not exercise the necessary judgment "informed by the competition-relevant aspects of the [particular] market conditions". It says that, instead, the Commission adopted "mid-points" in the ranges, and so did what the Court rejected as inappropriate in *Ravensdown*. If the Commission's adoption of mid-points was not an exercise of judgment as to the likely detriment or benefit we agree that this would be an error.

[104] We also consider it would be wrong for the Commission, in the quantitative assessment, to attribute greater certainty to its estimates of detriments or benefits than is warranted on the facts. The quantitative analysis is a tool to assist the Commission, but it rests on assumptions, often contested, and on assigning dollar

values that can at best only approximate the detriment or benefit being considered. It is legitimate therefore for the Commission to be left with a value range for a particular detriment or benefit where the level of uncertainty indicates that any further precision would be unwarranted.[112]

[105] We consider that the Commission is not obliged to determine (on a balance of probability basis) a single figure for a particular detriment or benefit. This is because it may be difficult to make such a precise quantitative assessment; and it may well be that the uncertainties surrounding an assessment mean that the best the Commission can do is to say that (on the balance of probabilities) a particular gain or loss falls within a likely range. We consider that 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. That is not to say that the Commission cannot find that a single figure is the likely detriment or benefit. As was said in *Ravensdown,* the statutory test of "likelihood" is applied at the end of the process after the factual assessment of detriments and benefits has been made.[113] However in assessing the overall "likelihood" that benefits outweighs detriments the Commission will need to form its view on the likely detriments and benefits (whether ranges or single figures) that make up its overall assessment.

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[112] In *NZ Bus Ltd v Commerce Commission* above n 66 at [104] (per Hammond J) commented that "more systematic ways to inform that judgment are merely techniques, or hand tools ... this Court should not allow a kind of false scientism to overtake what is in the end a fundamental judgment which is required by the Act itself". See also *Re Qantas Airways Ltd* [2004] A CompT 9 (12 October 2004) at [651] which says "... the determination of a single dollar figure could be open to numerous challenges".

[113] We are not aware of any New Zealand decision which has discussed the meaning of "likely" in the statutory authorisation test. In the context of ss 27 and 47 (where the test is whether a contract or an acquisition is "likely" to have the prohibited effect) it has been held that this means "a real" rather than a remote "chance" or "prospect": *Commerce Commission v Port Nelson Ltd* (1995) 6 TCLR 406 at 432; *Woolworths Ltd v Commerce Commission* (2008) 8 NZBLC 102,128 (HC) at [122]-[126]. In Australia, that same view of "likely" has been taken in relation to the equivalent authorisation provisions: see *Re Queensland Co-operative Milling Association Ltd* (1976) 25 FLR 169 at 183 referring to "commercial or economic likelihoods that may not be subject to formal proof"; *Re Qantas Airways Ltd* [2004] A CompT 9 (12 October 2004) at [152]-[156] commenting that "likely" should be given the same meaning in the authorisation provisions as the restrictive trade practices, thus "for a benefit or detriment to be taken into account, we must be satisfied that there is a real chance, and not a mere possibility, of the benefit or detriment eventuating ... There must be a commercial likelihood that the applicants will... bring about the public benefit or ... [give] rise to the public detriment"; *Re VFF Chicken Meat Growers* [2006] 1 CompT 2 (21 April 2006) at [366] referring to a "real chance" that a benefit will occur; S G Corones *Competition Law in Australia* (5th ed, Thomson Reuters, Sydney, 2010) at [3.135].

[106] Having reached those conclusions on the role of and approach to the quantitative assessment, we will come later to whether the Commission erred in this respect when we consider each of the detriments and benefits where mid-points were taken. In considering these the following questions will arise:

(a) In taking "mid-points" did the Commission consider that a symmetrical probability curve applied in respect of each of the relevant detriments and benefits?

(b) Did the Commission have a sufficient basis to conclude that these mid-point estimates gave the "likely net present value" of detriments and benefits over five years?

(c) On what basis did the Commission exclude all other points in the likely ranges, thereby implying that none of these were likely?

Is there a second step? And is the merger to monopoly relevant to any such second step?

[107] Godfrey Hirst contends that the Commission, having completed its quantitative analysis in the manner directed and sanctioned by the Courts, should then embark upon a second step. That second step would require the Commission to ask itself why this acquisition, which is a prohibited acquisition, should nevertheless be permitted. Godfrey Hirst submits that this is the "stand back and notice" requirement as per *Ravensdown*. It says that here the Commission needed to stand back and notice that Cavalier would be acquiring its last remaining domestic competitor, thereby permitting a merger to monopoly and the loss of a "significant competitive constraint". In this second step the Commission would be asking: what is "so good" about the proposal that implementation should be permitted, even though the presumption underpinning the Act is that, generally, efficiency (allocative, productive and dynamic) is best achieved through the competitive process?

[108] Godfrey Hirst submits that by lowering the s 47 competition threshold to one of substantially lessening competition, "the Act may be taken implicitly to require a more careful scrutiny of acquisitions of dominance (or, after the 2001 amendments, a substantial degree of market power)". [114] We do not accept that submission. The threshold change may well result in an increased number of both clearance and authorisation applications over time, but the statutory test for authorisations did not change with that threshold change. A merger to monopoly is likely to have been caught by the former s 47 threshold, but this could have been authorised if it met the authorisation test. Those acquisitions which would not have been prohibited under the former test, but which fail the current competition threshold, will also need to meet the authorisation test if they are to proceed. But this says nothing about the level of scrutiny required where authorisation is sought for a merger to monopoly.

[109] Godfrey Hirst says that when the Commission undertakes the proposed "second step", where authorisation is sought for "a monopoly", its decision should be informed by economic theory about the way a monopolist will behave. So, for example, the Commission would need to consider that the monopolist might act in inefficient ways because "slackness" would creep in. Godfrey Hirst submits that the Commission needs to ask whether there is something about the public benefits here that warrants the opportunity for a monopolist (Cavalier) to behave inefficiently.

[110] Godfrey Hirst refers to a number of statements in the New Zealand authorities as to the anti-competitive consequences of a "monopoly". For example, it has been said that "the essence of market power is discretionary power, the discretion to adopt production and selling policies different from those that a competitive market would constrain".[115] Godfrey Hirst goes on to refer to statements made in cases in the United States. These statements are less helpful because of the different test that applies there.[116] A more general point made by Areeda, which is cited in Godfrey Hirst's submissions and has potential relevance here, is that "[n]o

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[114] In 2001, as well as the amendments made to s 47, s 36 was amended from being a prohibition on use of a dominant position in a market to a prohibition on taking advantage of market power.

[115] *Telecom Corporation of New Zealand Ltd v Commerce Commission* (1991) 4 TCLR 473 (HC) at 508.

[116] The different approaches to the role of efficiencies in merger analysis in the United States, the European Union and Australian competition law are discussed in Griffin and Sharp "Efficiency Issues in Competition Analysis in Australia, the European Union, and the United States" (1996) 64 Antitrust Law Journal 649.

merger threatens to injure competition more than one that immediately changes a market from competitive to monopolized”.[117]

[111] Areeda goes on to acknowledge that it would be a rare situation for a market to change from being “perfectly competitive” before a merger to “absolutely monopolized” post-merger. However, even where a merger involved two competitors that shared the entire market (as here) Areeda says that a “concern with such a merger would be warranted”. Areeda says that although duopoly markets “typically perform quite poorly ... competition is possible and may sometimes be quite robust”. In respect of new entry, Areeda says that with a monopoly rather than a duopoly, the incumbent firm may indefinitely preserve its dominant or monopoly status if it is permitted to acquire any new entrant in future.[118]

[112] We consider that these observations, including the statement relied on by Godfrey Hirst, do no more than affirm the importance of the market power assessment that the Commission is required to undertake on a case by case basis. This facts-based assessment must analyse, on the balance of probabilities, the likely state of competition in both the factual and the counterfactual (which may not be the same as “before a merger”). In so doing, the Commission will compare the constraints that would be likely to impact on firms’ behaviours in each of these alternative futures.

[113] It is unhelpful therefore, either ahead of or after that assessment, to characterise a particular proposal as somehow less worthy of approval, especially in authorisation cases where it is open to the applicant to establish that there is such a public benefit that the otherwise prohibited merger should be authorised. We therefore agree with Cavalier’s submission that the word “monopoly” adds nothing to the factual assessment which the Commission has to make. Any concern that the sole remaining competitor will have a high level of discretionary market power, leading to potential detriments in the market, is something which should be accounted for in the factual/counterfactual comparison and in the related quantitative analysis.

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[117] Areeda & Hovenkamp *Antitrust Law: An Analysis of Antitrust Principles and Their Application* (3rd ed, Wolters Kluwer, Boston, 2009) at [911a].

[118] Areeda at [911a].

[114] We also consider that the Commission is not required to overlay some kind of social policy judgment (enabling it to decline an authorisation even if the merger specific efficiencies accepted by the Commission outweigh the efficiencies likely to be lost through the substantial lessening of competition or conversely to grant an authorisation where losses exceed gains). At times, Godfrey Hirst's submissions seemed to suggest that such judgment was required as part of the "second step".[119] Such an approach would invite the kind of speculation and intuition (and corresponding unpredictability) which *Telecom* directed against.[120] It could also be contrary to the total welfare approach (which does not require judgments about wealth transfers) which has been accepted as appropriate to the assessment of detriments and benefits.[121]

[115] That said, 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. An applicant for an authorisation does not have to produce any other reason for why the acquisition should be permitted. It would also be wrong at that juncture to introduce speculation as to what a monopolist might do. That would be contrary to what was said in

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119 At the hearing we raised whether an example of a social policy overlay might be where the Government had given a s 26 notice. No such direction was received in this case so it is unnecessary for us to take this further. Godfrey Hirst did not identify anything other than the theory of monopoly behaviour and merger-specific efficiencies.

120 As long ago as 1968, Oliver E Williamson, in an article which introduced the "efficiency defence to antitrust merger analysis" ("Economics as an Antitrust Defense: The Welfare Tradeoffs" (1968) 58:1 American Economic Review 18) asked "can economies be dismissed on the grounds that market power effects invariably dominate? If they cannot, then a rational treatment of the merger question requires that an effort be made to establish the allocative implications of the scale economy and market power effects associated with the merger" (at 18-19). He referred to refinements in the tools for assessing these effects which "will permit both the courts and enforcement agencies to make more precise evaluations" (at 34). More recently this analysis is discussed in relation to monopsonies: Roger D. Blair, *Merger to Monopsony: An Efficiencies Defence* (2010) 50:3 The Antitrust Bulletin 689. In New Zealand, the Court of Appeal in *Telecom* has said that this kind of evaluation is required.

121 *Air New Zealand v Commerce Commission (No 6)* at [241].

Telecom and would cut across the facts-based assessment that the High Court cases have required in accordance with *Telecom*.

[116] 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.

[117] We see no difficulty with "standing back" to perform an overall check on the balancing exercise – whether or not detriments and net public benefits are finely balanced – especially in circumstances where a significant constraint will be removed in the factual by the acquisition of the only remaining competitor. This 'check' could be directed at the robustness of the market power and constraints analysis, the material assumptions underlying that analysis, and the quantification (and likelihood) of the material detriments and benefits identified. However, this "check" may already have occurred as part of the Commission's assessment of each detriment or claimed public benefit. While a "check" at the end of the process may still be useful, it is not to be elevated to a necessary second step in which other subjective preferences come into play.

Merger-specific efficiencies

[118] Godfrey Hirst submits that, in assessing claimed efficiency benefits from the proposed acquisition, the Commission must consider only "merger-specific efficiencies". Its submission relies on commentary from Areeda, in the context of a dominant firm acquiring a new entrant, that for the dominant firm to defend its acquisition "it would have to show provable efficiencies that could not be brought

about by means other than a merger (ie "merger-specific" efficiencies) and that do not result from the creation of a monopoly".[122] Godfrey Hirst also refers to commentary by Professor Maureen Brunt that for there to be efficiencies from a merger there must be "prospective economies that run with the size and scope of the enterprise, not with the size and scope of plants, establishments, corporations forming the merged group".[123]

[119] It is well understood that any claimed public benefits must be causally connected to the proposed acquisition. That is to say, an applicant claiming public benefits (usually efficiencies) must show that they are public benefits that are likely to arise from the proposed acquisition (the factual) and that they would not be likely to occur if the acquisition does not proceed (the counterfactual). Godfrey Hirst's submission is a different one: the point being made by Areeda and Brunt is that the Commission should not just count up the economies of scale and scope benefits and treat them as public benefits that are determinative. Rather, it is necessary "to direct one's attention to merger-specific efficiencies, things that don't arise from the creation of a monopoly and [which] could not be brought about otherwise than by means of the merger".

[120] The passage from Areeda which best captures the point is the following:[124]

> While efficiencies are a good thing and should be pursued diligently, a merger case raising the efficiency defence requires the making of an administratively difficult trade-off between likely anticompetitive effects that have already been established and off-setting efficiency gains. Society would be better off if the same or equivalent efficiency gains could be realised without the anticompetitive merger. An efficiency is said to be "merger specific" if it is a unique consequence of the merger – that is, if it could not readily be attained by other means or if the social cost of attaining it by other means is at least as high as the social cost of the merger. As a general proposition, the efficiency defense requires a showing that claimed efficiencies are "merger specific". If they are not, then anti-trust policy would prefer that the efficiencies be attained by the less costly alternative route. For example, in *Evanston* the Federal Trade Commission rejected a claimed efficiencies defense after observing that the parties had begun to implement several of the claimed efficiencies even before the merger occurred. In that case the efficiencies could not be said to be a specific consequence of the merger.

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[122] Areeda at [912c].

[123] Maureen Brunt *Economic Essays on Australian and New Zealand Competition Law* (Kluwer Law International, The Hague, 2003) at 288.

[124] At [973a].

> The two most obvious alternative routes to efficiencies are (1) internal expansion achieving equivalent gains ... and (2) joint ventures or licensing arrangements permitting efficient joint development of needed inputs. In assessing the internal expansion alternative, one must consider whether internal expansion is socially desirable and whether it is likely to occur....
>
> [Emphasis added and footnotes excluded.]

[121] Areeda goes on to discuss the "likelihood of internal expansion" and "joint venture/licensing" alternatives to achieving the efficiencies. For present purposes it is the former that is most relevant (as Godfrey Hirst does not advance any submissions on the latter except in respect of the superstore concept which we discuss later).[125] Areeda says that if greater efficiency requires a certain minimum size, then that efficient size could come about through a merger, or internal expansion of inefficient-sized firms, or through their displacement by efficient-sized new entry.[126] Taking the internal expansion example, Areeda says that the question then becomes whether "(1) the internal expansion route is better or worse for society than the merger route, and, if better, (2) whether it is likely to occur if the merger route is prohibited by law".[127]

[122] While Areeda says that the answer to both these questions is uncertain, Areeda also says "it seems clear that internal expansion is least likely to occur and least likely to be substantially preferable when (1) scale economies are substantial and (2) market demand is declining, stable, or perhaps expanding slowly".[128] Areeda goes on to say that the facts in particular cases "often point simultaneously in opposite directions and thus frequently will not be persuasive enough to overcome whatever general presumptions seem wise".[129]

[123] We agree that there is a need to consider only merger-specific efficiencies. A proper assessment of the factual as against the counterfactual should be doing just that. Such an assessment does not simply compare, for example, the present costs of the two competitors and the lower costs of the merged entity as indicated by the present value of calculated savings in administration and operation. That would be

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[125] At [310].
[126] At [973b].
[127] At [973b].
[128] At [973b].
[129] At [973b].

to adopt too static an approach to the benefits of an acquisition. First and foremost, it would fail to recognise the possibility that the claimed benefits may be achieved through competition if the acquisition were not allowed to proceed. Secondly, the claimed savings may not be achieved in the factual (for a number of reasons, including the potential for gains to be dissipated through "slackness").

[124] We consider that the proper comparison is between the likely durable lower costs (average costs per unit of throughput in an acquisition as proposed here) of the merged entity in the factual and the likely combined costs (average costs per unit of throughput) of the two competing entities in the counterfactual. We consider that this assessment is directed to Areeda's question as to whether the greater efficiency "is likely to occur if the merger route is prohibited by law". The quantitative assessment directed by *Telecom* serves to assist with the assessment that Areeda invites: that is, as to whether the merger is "better or worse for society" than internal expansion, having regard *inter alia* to the capacity for and cost and timing of such expansion if there were no merger.

[125] To this extent there is nothing in the "merger-specific efficiencies" point that is new or controversial. We agree with Godfrey Hirst that the Commission should not just count up the economies of scale and scope benefits and treat them as public benefits that are determinative. They must be merger-specific in that they are likely to occur in the factual and not in the counterfactual. However, we do not accept the further point made by Areeda, and Godfrey Hirst (in referring to Areeda), that provable efficiencies can only be counted if they "do not result from the creation of a monopoly". The Commission is not required to apply this second criterion as the creation of a monopoly is not prohibited by the Commerce Act.

Allocative efficiency losses

Introduction

[126] Allocative efficiency losses are concerned with the detriment to society from price increases that are not justified by economic cost and that lead to a less efficient allocation of resources through distortions of consumer choice. They are a function

of both a firm's ability to raise prices and the elasticity of demand in response to price rises.[130] The loss of allocative efficiency was the most important detriment found by the Commission as likely to arise from the proposed acquisition. Godfrey Hirst contends that errors were made by the Commission in its quantification of this loss, leading it to under-state the detriment.

The Commission's assessment

[127] The Commission started with a range of annual allocative efficiency losses. This was based on a range of demand elasticities (-0.05, -0.5 and -1.0) and a range of price increase assumptions (5%, 10% and 15%). The range of demand elasticities reflected the Commission's assessment of the extent to which greasy wool exports to China were a close substitute for wool scouring in New Zealand. The price increase assumptions reflected the Commission's assessment of the range within which new entry was likely to be prompted.

[128] Having determined a range of allocative efficiency losses, the Commission made "a qualitative judgment", to conclude that an intermediate value of detriment (corresponding to a 10% price increase and a demand elasticity of -1.0) was the "most likely" allocative efficiency loss;[131] it also described this as "the likely" allocative efficiency loss.[132] This intermediate value (or, as Godfrey Hirst describes it, "mid-point" estimate) was a net present value (NPV) of $14.7 million over a five year period. This was a critical finding because the value at the top of the Commission's range, an NPV loss of $22.7 million over five years (corresponding to a 15% price increase and a demand elasticity of -1.0) exceeded the estimated value (NPV $[ ] million over five years) accepted by the Commission for the [ ] claimed benefit, ie gains in [ ].

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130 The extent to which a firm can increase prices and 'get away with it' depends (in the absence of other constraints) on the availability of substitute products or services and the ability of consumers to switch between them in response to a change in relative prices (the cross-elasticity of demand). A firm that is not constrained by the presence of competitors selling substitute products or services, and which therefore faces a relatively inelastic demand, can (in the absence of other constraints) raise its prices and profits without risk of losing demand. While inelastic demand may allow prices to rise further than otherwise, allocative efficiency losses will be less due to the inability of consumers to switch to a substitute and cause resources to be reallocated as a result.

131 At [257] of Decision No 725.

132 At [258] of Decision No 725.

[129] In reading its conclusion the Commission said this:[133]

> The Commission considers that the demand elasticity would likely be relatively low for small to moderate price increases, but would increase significantly for larger price increases to a point where such price increases would not be profitable because either, diversion of greasy wool exports to China would increase, or domestic entry, would occur.
>
> As shown in Table 2, the Commission has modelled allocative inefficiency losses for a range of demand elasticities. This is equivalent to considering different amounts of scouring volume loss before the price increase reaches the 15% level that would prompt entry. The Commission has calculated above that it considers domestic entry is likely to occur following a 5-15% post-acquisition price increase. To be conservative, the Commission has modelled a maximum price increase of 15%. As shown in Table 2, the Commission has modelled allocative inefficiency for the following demand elasticities:
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> - The demand elasticity of -0.05 represents a scenario where switching to greasy wool exports to China is not a close substitute, and where the Applicant would be able to increase prices up to a point where it provoked new entry (10% to 15% price increases). For a demand elasticity as low as -0.5, the Commission considers a price increase of only 5% appears unlikely.
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> - The demand elasticity of -0.5 represents a scenario where greasy wool exports to China are a closer substitute, and where the Applicant would face volume losses as prices increase. The threat of new entry still imposes the ultimate cap on price increase in this scenario.
>
> - The demand elasticity of -1.0 represents a scenario where greasy wool exports to China are a much closer substitute, and where the Applicant would face significant volume losses as prices increase.

Table 2: Estimated national allocative inefficiency detriments (NPV over 5 years)[134]

	Price increase		
Demand elasticity	5%	10%	15%
-0.05	n/a	$0.7 million	$1.1 million
-0.5	$4.2 million*	$7.3 million	$11.4 million
-1.0	$7.1 million	$14.7 million	$22.7 million

[133] At [254]-[258] of Decision No 725. (Prices refer to Cavalier's prices for wool scouring services in the factual.)

[134] "Note: These estimates exclude quantities of wool currently going to Cavalier Bremworth and Godfrey Hirst. The Applicant argues these quantities should not be included as they would not be subject to any price increase due to a 50% ownership of Cavalier Wool by Cavalier Bremworth and the [ ] supply contract that Godfrey Hirst possesses."

> [*Note: We were advised from the bar that the figure of $4.2 million in the second column ought to have been $3.541 million, i.e. half of $7.1 million.]
>
> The Commission has quantified the range for allocative efficiency detriments as $0.7 to $22.7 million for a five year NPV.
>
> The Commission therefore needs to make a qualitative judgement as to what is the most likely level of detriment. For the reasons set out below the Commission considers that an immediate value of detriment corresponding to a 10% price increase is the most likely:
>
> - Entry could occur at price levels well below a 15% price increase and as such Cavalier Wool will be careful not to increase prices too far.
> - It will not be possible for Cavalier Wool to know in advance exactly what quantities of wool will switch to greasy exports to China as prices increase.
> - Volumes of wool losses to China are likely to be permanent and could undermine the economies of scale benefits from the proposed acquisition.
> - The possibility for some price discrimination would lower allocative losses.
> - The presence of any long term contracts will limit the immediate scope for price increases.
>
> The Commission is therefore of the view that the likely allocative efficiency loss is a NPV of $14.7 million over a five year period.

The alleged errors

[130] Godfrey Hirst submits that:

(a) the Commission erred in stating that the table gave a range of $0.7 million to $22.7 million, because the range begins at $7.1 million (at a 5% price increase) and ends at $35.2 million (at a 15% price increase);

(b) even if allocative efficiency losses should be calculated on a 10% price increase, the Commission did not take a mid-point for that price increase, because the mid-point would be $18.7 million;

(c) the Commission erred in calculating the allocative inefficiency loss on the basis of a 10% price increase in light of other statements it had made about the price increases necessary to prompt new entry;

(d) the Commission erred in taking an intermediate value of detriment (ie taking a 10% price increase and a demand elasticity of -1.0 in calculating the allocative inefficiency loss) because Cavalier's incentive is to price towards the upper end of the range found by the Commission, if not beyond that.

[131] Wool Equities' submission that the Commission failed to take into account price impacts on farmers is also relevant to whether the Commission erred in concluding that an intermediate level of allocative efficiency was likely.

Incorrect starting point and calculation of mid-point?

[132] The first two of Godfrey Hirst's submissions proceed on the assumption that the Commission has applied "a stepped approach" to changes in demand (ie a stepped demand curve), based on the different demand elasticities shown. That is to say, it assumes the Commission was calculating a cumulative loss in allocative efficiency, which commences with the most elastic demand. The total allocative efficiency loss is then the sum of the values at each of the three demand elasticities.

[133] Godfrey Hirst submits that on the Commission's calculations, the first allocative efficiency loss occurs at a 5% price increase and a demand elasticity of -1.0 (ie $7.1 million); and the greatest loss of allocative efficiency occurs with a 15% price increase and the sum total of all three demand elasticities at that price increase (ie $22.7 million + $11.4 million + $1.1 million = $35.2 million). On this basis it submits that the range of allocative efficiency losses is $7.1 million to $35.2 million (not $0.7 million to $22.7 million as the Commission said), and so a mid-point figure would be $21 million. It submits that if the Commission were to proceed on the basis of a price increase of only 10%, then a "mid-point" for the allocative efficiency loss was $18.7 million (based on a range from $14.7 million for the most elastic demand to the cumulative total of $22.7 million).

[134] However the Commission did not take a stepped demand curve approach, although this is not necessarily obvious from a reading of the paragraphs from the Commission's decision quoted above. Godfrey Hirst understood that a stepped demand curve had been used at least partly because of the error in the figure for a 5% increase and demand elasticity of -0.5. That is because, if $7.1 million was the total cumulative loss at a price increase of 5%, then one would expect the loss at a demand elasticity of -0.5 to be smaller than the $4.2 million stated in the Commission's table. However, as noted above, the Commission advised us that the $4.2 million was an error.

[135] Godfrey Hirst also referred to the Commission's statement in its decision that it "posited a stepped demand curve".[135] Also, in the Draft Determination[136] the Commission said that it "posited" a stepped demand curve. In the Draft Determination this statement came after the Commission had estimated allocative losses based on constant demand elasticity. Those estimates correspond with the Commission's figures in the table above (except that in the Draft Determination the Commission used a 20% price increase rather than a 15% price increase in calculating the upper range of the loss). In the Draft Determination, the Commission went on to say that a stepped demand curve would alter the composition of allocative efficiency losses and that it did not have sufficient information on the demand characteristics for New Zealand wool to narrow the range of estimates.

[136] In the decision under appeal the Commission posited the stepped demand curve after setting out a table summarising the allocative efficiency loss estimates it had received from the parties. The Commission goes on to say that a stepped demand curve would alter the composition of allocative efficiency losses. It does not say that it had received further information after the Draft Determination to enable a stepped demand curve approach to be adopted, nor that it had decided to take a stepped demand curve approach.

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135 At [224] of Decision No 725.

136 The Draft Determination is prepared as the basis upon which interested parties have the opportunity to provide information and make submissions prior to the Commission making its decision on the authorisation application.

[137] The Commission's submissions explained why, if the table in the Commission's decision was applying a stepped demand curve, it would not be correct to cumulate the losses in each column. It is not necessary to go through the detail of this because we accept the Commission's advice to us that it did not use a stepped demand curve. We understand Godfrey Hirst to have accepted this also because it made no reply submissions on this topic.

Was the Commission's price increase analysis inconsistent?

[138] The Commission discussed price increases in the factual both when considering whether the proposed acquisition was likely to substantially lessen competition (under s 67(3)(a)) and when assessing detriments from the lessening of competition found (under s 67(3)(b)). As to the former, the Commission limited its pricing analysis to those price increases likely to be necessary for new entry to occur (and before constraints from potential competition could be recognized). The extent of price discretion (or use of market power in other ways) was left to the assessment of detriments.

[139] The Commission made the following statements about the level of price increase likely to be necessary for new entry to occur:

(a) Taking the range of entry costs for a 2.4m scour ($9.9 million to $16.5 million) submitted by Godfrey Hirst and NZ Wool Services,[137] "*...if an entrant achieved the requisite wool volumes* an initial conclusion … would be that entry could be profitable with a price increase of between 2% and 15%"[138] (emphasis added).

(b) Although NZ Wool Services' profitability suggested a new entrant could be profitable at current market prices, new entry would be unlikely without any increase in price. The model used by the Commission, being the model put forward by Cavalier, indicated

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[137] Godfrey Hirst's estimate was $9.9 million. NZ Wool Services' estimate was $16.5 million. The Commission considered that Godfrey Hirst's estimate, which was above Cavalier's estimate (of $6 million), was "the most robust".

[138] At [177] of Decision No 725.

"...an entry-supporting price increase would likely be between 2% and 15%". But the Commission was "not satisfied that, within this range, entry would[139] occur before prices increased by *at least 5%*"[140] (emphasis added).

(c) The Commission considered that entry fails the LET test as "the Commission is not satisfied that entry would occur without *at least a 5-10% increase* in scouring prices"[141] (emphasis added).

(d) When reaching its conclusion that it was not satisfied that a substantial lessening of competition was unlikely, the Commission said that new entry would only provide a moderate constraint because entry "*would only be likely to occur* with a price increase of *at least 5-10%*" (emphasis added).[142]

(e) When considering the effect of the proposed acquisition in the downstream carpet markets, the Commission said "[a]s outlined in the allocative efficiency section, the Commission considers that the *maximum likely* cost increase that Cavalier Wool could impose on Godfrey Hirst without triggering entry would be *about 15%*" (emphasis added).[143]

(f) When considering possible responses to price rises (in the context of considering the loss of allocative efficiency) the Commission said that "entry with a 2.4 metre wide scour *could be prompted* with a price increase of 15%" (emphasis added), but also noted NZ Wool Services' profitability with a 3.0 metre scour in each market which suggested that a new entrant "could be profitable if it had sufficient wool

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139 This quote removes 'not' which is included in the decision, but which the Commission corrected in the Court as being a typographical error.
140 At [179] of Decision No 725.
141 At [185] of Decision No 725.
142 At [187] of Decision No 725.
143 At [206] of Decision No 725.

volumes, similar cost structures to [NZ Wool Services], and could achieve the current market price". [144]

(g) With reference to Table 2[145] the Commission said that this "is equivalent to considering different amounts of scouring volume loss before the price increase reaches the 15% level that would prompt entry".[146]

(h) In its Executive Summary, the Commission said that "entry could occur at price levels below a 15% price increase".[147]

[140] These statements on the face of them are not altogether consistent:

(a) The first and second statements indicate that entry could potentially occur as low as 2%, though new entry is unlikely below 5%, and the entry-inducing price might be as high as 15% (but noting the important caveat in the first statement).

(b) The third statement indicates that new entry may not occur unless prices increase by 10%, whereas the fourth statement is firmer in that new entry "would only be likely to occur" with a price increase of *at least* 5-10%. Since 5-10% is a range, the "at least" description appears to relate to the range of 5-10%, in which case the Commission seemed to be contemplating a higher range, up to 15%.

(c) Taking these four statements together, the Commission was saying that new entry may not occur unless there is a price increase of at least 10%, although this increase is not likely to exceed 15%.

(d) The next three statements of the Commission focused on 15% price increases and read as though the Commission's view was that new entry could or would be prompted at that level.

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144 At [242] of Decision No 725.
145 Refer [129] above.
146 At [255] of Decision No 725.
147 At [E14] of Decision No 725.

(e) Finally, the statement in the Commission's Executive Summary suggests that entry could occur at any price increase "below" 15%. (The caveat as to securing volumes is not repeated.)

[141] The Commission's conclusion that new entry would not occur without at least a 5-10% increase, meant that it was not satisfied that the threat of new entry, on its own, would serve as a sufficient constraint on Cavalier in the factual, such as to ensure that a substantial increase in market power (over price) was unlikely. It follows that the Commission was also saying that, unless there were other constraints operating in the factual, Cavalier might be able to raise prices by at least 10%, and up to 15% before inducing new entry. The other constraints, if any, then became relevant when the Commission quantified the allocative efficiency loss.

[142] The other constraint considered by the Commission was the ability of New Zealand wool exporters to divert more greasy wool to China for scouring there. This was also found to be "only a moderate constraint",[148] not in itself sufficient to constrain an increase in Cavalier's market power in the factual.[149] The Commission did not say at what point greasy wool exports would cap prices. It did however say that:

(a) Greasy wool exports to China "would not be a significant constraint on moderate price increases".[150] However, "with larger price increases, China would become a stronger constraint".

(b) Together, the threat of new entry and the risk of Cavalier being by-passed by merchants who increase greasy wool exports to China, would serve to cap Cavalier's ability to increase prices.[151]

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148 At [187] of Decision No 725.
149 At [127] of Decision No 725.
150 At [240] of Decision No 725.
151 At [127] of Decision No 725.

(c) However it was domestic entry that provided the ultimate cap on price increases.[152] And this cap meant that "very large increases in the factual appear improbable".[153]

[143] The Commission's conclusion that it was new entry that was the ultimate cap on price increases followed through into its analysis of the allocative efficiency losses. As the basis for its calculations in Table 2,[154] the Commission referred to its finding that "domestic entry is likely to occur following a 5-15% post-acquisition price increase".[155] The Commission went on to say: "To be conservative, the Commission has modelled a maximum price increase of 15%."[156] It then proceeded to model price increases of 5%, 10% and 15% together with a range of low to high demand elasticities.

[144] The China constraint was reflected in the demand elasticity used in Table 2. In describing its scenario where the elasticity of demand was assumed to be as low as -0.05, the Commission said greasy wool exports to China would not be a close substitute; prices could therefore increase 10-15% before new entry was provoked, as a price increase of only 5% appeared unlikely.[157] At the high end of the elasticity range, that is at -1.0, greasy wool exports to China would be "a much closer substitute", leading to significant volume losses for Cavalier should it increase its prices in the factual.

[145] As explained earlier, the Commission opted for "an intermediate value" as "the most likely value of detriment", which corresponded to a 10% price increase (ie the mid-point of the Commission's price range). It did not expressly note that it was assuming a demand elasticity of -1.0 (ie a relatively high level of demand reduction in response to any price increases). However that was apparent from its conclusion that the likely allocative efficiency loss was NPV $14.7 million over a five year period.

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152 At [241] of Decision No 725.
153 At [241] of Decision No 725.
154 Refer [129] above.
155 At [255] of Decision No 725.
156 At [255] of Decision No 725.
157 At [255] of Decision No 725. Consistent with this, Table 2 does not does not include a calculation of allocative efficiency losses for a demand elasticity of -0.05 and a price increase of 5%.

[146] This intermediate value was said to be the Commission's "qualitative judgment" of the "most likely level of detriment". The Commission set out its reasons for this judgment. Insofar as those reasons relate specifically to the decision to take a 10% price increase, the Commission reasoned that entry could occur at price levels "well below a 15% price increase". On its own that statement might be viewed as inconsistent with:

(a) The Commission's statement that entry would only be likely to occur with at least a 5-10% increase (see (d) at [139] above).

(b) The inclusion in Table 2 of a 15% price increase as a "maximum likely cost increase" (for users of scoured wool), which leaves the impression that a price increase in the 5-15% range (and at least 5-10%) would be required to induce new entry.

(c) The absence, in the context of new entry, of anything to suggest that a 10% price increase was the most likely figure in the range.

(d) The Commission's view that because domestic entry would provide an ultimate cap on price increases, large price increases in the factual appeared to be improbable. (In the context of the Commission's other statements, "large" here seems to refer to larger than 15%.)

[147] However, the possibility that entry "could occur" (profitably) at a price increase of well below 15% (which was consistent with Cavalier's view), but not lower than 5%, was contemplated in the Commission's various statements on price ranges. While the "ultimate cap" was viewed as being 15%, the Commission envisaged that it could kick-in well below that level. The Commission said that, as such, Cavalier would be careful not to increase its prices too far.

[148] Having regard to the Commission's analysis and all of its statements about the price at which new entry could or would be prompted, we reject the submission that the Commission was inconsistent in taking a price increase of 10% for capping the calculation of allocative efficiency losses. The decision to take that percentage

increase was based on a number of reasons, not simply that this was the Commission's view of the price at which new entry was likely to be prompted. We consider these further reasons below.[158]

Error in taking an intermediate value of detriment?

[149] Godfrey Hirst submits that the Commission failed to take into account factors which meant that Cavalier would be able to increase prices at closer to the upper end of the Commission's range. It says that it "is more likely that demand elasticity must exceed -1.0 to enable price increases that would represent a realistic incentive for new entry". It says that the Commission ought to have concluded that a price increase of 20% was likely to be necessary to prompt new entry.

a) Effect of removing the constraint provided by NZ Wool Services

[150] In support of this submission, Godfrey Hirst submits that the Commission has made insufficient allowance for the removal of the significant competitive constraint that NZ Wool Services provides. Godfrey Hirst compares the Commission's conclusion that an entry supporting price increase was at least 5-10% with the Commission's view in 2009 when considering the 3:2 merger (Decision No 666).[159] Godfrey Hirst submits that the competitive significance of new entry is much higher when it seeks to disrupt a monopoly and yet the Commission's approach is "equally indifferent to new entry irrespective of the severity of the lessening of the competition."

[151] It is not entirely clear to us what Godfrey Hirst means by this. In Decision No 666 the Commission concluded that a number of factors "when taken together" provided a sufficient constraint on the merged entity such that the proposed merger was not likely to have the effect of substantially lessening competition. Those factors included the constraint from NZ Wool Services and the constraint from potential competition (ie new entry). However, although removing the constraint

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158 At [149] to [173].

159 There the Commission said that "entry is likely in the event of a 5% to 10% price increase". Godfrey Hirst reply submissions say that Decision No 666 referred to "at least 5%" but this is not correct.

provided by NZ Wool Services may increase Cavalier's market power in the factual, that does not necessarily increase the price at which new entry is likely to be triggered. What is important is the price level at which the remaining constraints will kick in.

[152] In the decision under appeal the Commission did not expressly consider the constraint from the countervailing power of merchants. As to that constraint, in Decision No 666, the Commission viewed the countervailing power of merchants as likely to be "significant". This was not only because of the presence of NZ Wool Services (which will not be present in the factual in this case), but also because of the possibility of increased greasy wool exports to China and the threat of new entry, all of which meant that merchants could "credibly threaten to switch" from Cavalier. In the present case, it is apparent that the countervailing power of merchants must diminish in the factual with the removal of NZ Wool Services and in view of the Commission's finding that potential entry failed the "LET" test.

[153] In saying this we acknowledge Cavalier's submission, based on the merchants' statements to the Commission, that merchants would not use NZ Wool Services and had no concerns about the proposed acquisition. Merchants were of the same view in respect of the 3:2 merger considered in Decision No 666.[160] Despite this view, the Commission considered that, if faced with actual increases in Cavalier's wool scouring prices in the counterfactual, merchants would be likely to respond by placing some volumes with NZ Wool Services.[161]

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160 In Decision No 666 the Commission noted that "virtually all the wool merchants spoken with expressed a reluctance to use [NZ Wool Services], even in the event of a price increase by the combined entity [Cavalier], unless [NZ Wool Services] ceased its wool trading operations". This was because these wool merchants competed directly with NZ Wool Services and had concerns that information about their quantities, wool blends and customer details would be disclosed via any scouring contracts. They were also concerned that NZ Wool Services could use wool scouring profits to undercut them in the sale of scoured wool to customers and to increase the price NZ Wool Services offered farmers for the purchase of wool.

161 At [128] to [132] of Decision No 725. While the Commission did not consider what level of price rise might be necessary to provoke a switch of volumes between these two competitors, it did note merchants' low overall operating margins as a relevant factor. The Commission also considered that some of Cavalier's customers would move to NZ Wool Services under the proposed underwriting agreement and that Cavalier "would not want this trickle to turn into a torrent as a result of any price increases that [Cavalier] would impose" (at [141] of Decision No 725).

[154] However, that does not necessarily increase the price at which new entry is likely to be triggered. Removing NZ Wool Services in the factual leaves merchants with the option of new entry and/or of exporting more greasy wool to China if they want to switch volumes from Cavalier.[162] The question is what price discretion that gives Cavalier. That was specifically addressed by the Commission. Its view was that Cavalier's pricing discretion was capped at 15% by the threat of new entry. While that was the cap, it calculated allocative efficiency losses on the basis of a "most likely" cap of 10%.

b) Price discretion

[155] Godfrey Hirst submits that "by reason of Cavalier's reduced variable costs [in the factual] ... Cavalier has an additional buffer before lost volumes will reduce its present profitability". It submits that Cavalier can "press right up to the boundary of entry provocation, without putting itself in a worse revenue position than it would be in the counterfactual". Although Cavalier may not know in advance the price at which entry will in fact be provoked (a factor relied on by the Commission), Godfrey Hirst submits that the evidence before the Commission was that new entry would take at least 18 months to establish. It submits that this is more than sufficient time for Cavalier to refine its prices in a way that undermines entry.

[156] We agree that a profit maximising Cavalier would seek to increase the price as far as it can without reducing profitability through lost volumes. However, as the Commission said, Cavalier does not have certainty about what level of price increase will prompt new entry or cause it to lose volumes to China. Nor does it know (generally)[163] where wool is destined so as to enable it to seek to increase prices for those customers with relatively low demand elasticity. The Commission considered that demand elasticity would increase significantly for larger price increases (ie of 10-15%), resulting in a diversion of greasy wool either to China or to new entrants which would render such price increases unprofitable.[164]

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[162] Re-importing scoured wool for domestic customers was unanimously dismissed by the wool industry as an option.
[163] In some cases it has long term contracts with end customers.
[164] At [254] of Decision No 725.

[157] It is the threat of both new entry and of increased greasy volumes to China that would enable merchants to exercise some countervailing power in response to price rises in the factual. If Cavalier is able to keep its prices just below the level at which new entry or diversion of volumes to China would be likely to occur, then that serves to demonstrate that, taken together, new entry and China are constraining influences. For Cavalier to observe this price constraint is not a reason why the Commission erred in its assessment of the price increase which would be likely to prompt new entry.

c) A new entrant will be competing against Cavalier's economies of scale

[158] Godfrey Hirst submits that the Commission's modelling of new entry is founded on a new entrant having sufficient wool volumes, and similar cost structures to NZ Wool Services, while being able to charge the current market price and yet competing against the incumbent's economies of scale. It says that "in other words the constraint [of new entry is the]...creation of the very market environment the Commission has authorised Cavalier to destroy, to reduce its own costs". We understand Godfrey Hirst to be submitting that Cavalier's economies of scale in the factual would serve as a barrier to new entry, thereby raising the price level at which new entry would be prompted.

[159] This was a matter the Commission specifically had regard to when considering the likelihood of new entry. The Commission said that, post-acquisition of NZ Wool Services, Cavalier's costs were likely to be significantly lower than the present industry cost structure and that a new entrant initially would face a significant cost disadvantage (we infer the Commission is referring to per unit scoured), even if that entrant were able to enter on the same scale as a current industry competitor.[165]

[160] The Commission reviewed the capital costs of entering the market with a single scouring line (as it had also done in Decision No 666). When it came to assess allocative efficiency losses, the potential for relatively small scale entry (and related costings) was the basis for the Commission's price assumptions in Table 2. It

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[165] At [159] of Decision No 725.

is common ground that profitability in the wool scouring industry (through reducing average costs) is driven by volume and plant capacity utilisation. The Commission's view was that, despite Cavalier's economies in the factual, the potential for relatively small scale entry (ie a single scouring line) would provide a moderate constraint on its conduct - providing a new entrant achieved a relatively high level of utilisation of that line.

[161] The efficient utilisation of a scour line would be dependent on attracting volumes away from Cavalier (assuming wool production does not grow). However, as the most likely new entrant was a merchant/customer seeking to scour its own wool, there would be some certainty about the volumes the new entrant would have. Godfrey Hirst itself consumes over [ ] greasy tonnes per annum; and another [ ] of Cavalier's customers each scour more than [ ] tonnes of greasy wool with Cavalier. The Commission considered that Godfrey Hirst's demand could be sufficient for a 2.4 metre wide scour line to operate at a capacity utilisation of up to 70%.[166] There was no suggestion by either the Commission or the parties that the scale economies to be achieved by the proposed acquisition would create a (higher) minimum efficient scale of entry into the wool scouring markets.

d) Capacity utilisation

[162] As a result of the proposed acquisition Cavalier expects to have [ ]% spare capacity in the North Island in the factual and [ ]% spare capacity in the South Island.[167] We take from this that, in addition to handling New Zealand's total wool scouring demand, Cavalier would have enough capacity to process an additional approximately [ ] tonnes in the North Island and an additional approximately [ ] tonnes in the South Island, ie equivalent to almost [ ] of NZ Wool Services' present throughput. This is a significant level of spare capacity, especially if demand remains stable rather than grows. As discussed above,[168] Cavalier's purpose in gaining increased volume and throughput is to reduce costs per unit of output. Losing volume through new entry or through increased greasy exports to China

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166 At [155] of Decision No 725.
167 See [43] above.
168 Refer [40] above.

would undermine the benefits Cavalier hopes to obtain from the acquisition. Cavalier provided the Commission with analysis showing the sensitivity of unit cost to volume losses.[169]

[163] Cavalier's submission that it will be sensitive to volume losses is not inconsistent with the view that the threat of new entry and the constraint from China are not such that a clearance could be granted for the proposed acquisition.[170] These constraints are relevant both to s 67(3)(a) (the clearance test) and to part of the s 67(3)(b) test (when quantifying the detriment). Market power (and hence the ability to increase prices) is likely to be greater without NZ Wool Services and this led the Commission to conclude that there is a "real chance" that competition will be lessened to a degree that is "real or of substance". But when quantifying the likely detriment from the loss of allocative efficiency, the Commission also needs to take account of other constraints on that market power.

[164] In Decision No 666 the Commission said that "even the threat of entry may be sufficient to constrain" Cavalier given the importance to the firm of maintaining high capacity utilisation. That must also be the case when the benefits to Cavalier in the proposed acquisition flow from obtaining increased volume. Even one further scour line with a capacity of around, say, 20,000 tonnes would represent a significant increase in industry capacity in either the North or South Islands, at a time when Cavalier itself has spare capacity. Similarly, the Commission said in relation to volumes of wool lost to China that this "could undermine the economies of scale benefits from the proposed acquisition". The extent of such erosion depends on the degree of constraint provided by the Chinese scouring industry.

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[169] Refer n 176 below.

[170] Godfrey Hirst submits that Cavalier effectively says that the Commission was wrong to find that a substantial lessening of competition was likely to occur if the proposed acquisition proceeded, when there has been no cross appeal from that part of the decision. Cavalier responds that by declining a clearance the Commission has not been satisfied that there is not a real chance of a substantial lessening of competition. Cavalier submits that it is not inconsistent with that conclusion to say that the most likely outcome in the factual is that Cavalier will not increase its prices by as much as 10% as the Commission's calculation has assumed.

e) The constraint from China's scouring industry

[165] Cavalier submitted that China was the most important constraint on its future conduct. We have found that the Commission was in error in calculating that 18% (rather than 14%) of the New Zealand wool clip is presently exported to China in greasy form,[171] thereby over-stating China's impact on the New Zealand scouring industry to date. Nonetheless, even at 14% of the total wool clip, total greasy wool exports to China are significant. Scouring in China, however, will not be commercially advantageous for all customers and at the same level of price increase, a point made by Godfrey Hirst. In Decision No 666 Cavalier accepted that the option of scouring in China would generally only apply to wool that was scoured in New Zealand which was destined to be processed into manufactured goods in China.[172]

[166] Based on the figures given in the decision under appeal,[173] 11% of wool production in New Zealand that is exported to China as scoured wool would be available for export to China in greasy form. The Commission's quantification of allocative efficiency losses took a demand elasticity of -1.0 and a price increase of 10%, with volumes falling by 10%. Based on the present level of scoured wool exports to China,[174] ie just over 20,000 tonnes, that would represent a volume loss to Cavalier of about 2,000 tonnes, or about 1%[175] of its post-acquisition scouring volumes.[176]

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171 See [19] above.

172 At [179] of Decision No 666. It was estimated that only about 8% of New Zealand's wool production that was currently scoured in New Zealand (at [180] of Decision No 666) would be available for export to China in greasy form (Footnote 16 of Decision No 666). The Commission was in error in stating here that the 8% was the proportion of "wool currently scoured in New Zealand" that would be available for export to China in greasy form. That proportion would have been higher.

173 At [10] of Decision No 725.

174 Refer [18] above.

175 ie 2000 as % of 147,030 (being 78% of the total wool clip that is scoured in New Zealand).

176 Cavalier's expert carried out analysis intended to demonstrate Cavalier's sensitivities to lost volumes. For example, this analysis showed that a 10% price increase would not be profitable if Cavalier lost sale volumes of more than [ ] tonnes in the North Island or [ ] tonnes in the South Island. It also showed that a 5% price increase would be unprofitable if it lost more than [ ] tonnes. However, this analysis is concerned with a price increase across all volumes (excluding those committed under-long term contracts). The Commission's approach here is concerned only with sensitivity to price changes of scoured exports to China, in order to assess the degree of constraint from the China scouring industry.

[167] In selecting the top of its demand elasticity range for calculating the "likely" loss in allocative efficiency, the Commission has assumed that China will be relatively responsive to the larger price increases it modelled. In capping the loss at a 10% price increase the Commission reasoned that Cavalier would not know in advance exactly what quantities of wool would switch to greasy exports to China in response to price increases.[177] That is not a particularly powerful point because no-one who puts up prices can know in advance exactly what the demand response will be.

[168] It seems that, although the parties calculated various ranges for the allocative efficiency assessment, there was not much specific information about the price at which customers would be likely to switch to greasy exports to China. The advice from exporters to the Commission in Decision No 666 was that offshore scouring would not be a commercially advantageous alternative to scouring in New Zealand, even in the event of a 10% increase in New Zealand scouring prices (although the Commission took the view that it must be advantageous for some exporters).[178] This suggests that a lower elasticity than -1.0 may have been appropriate. However, if China was viewed as being a less close substitute (ie a demand elasticity of say -0.5) the allocative efficiency loss would be less than the Commission calculated as the most likely level of detriment.

[169] The estimate of greasy wool exports as a percentage of New Zealand's total wool exports to China fell from 65% in Decision No 666 to 57% in Decision No 725.[179] While that suggests that at present scouring in China may be less commercially advantageous than it was at the time of Decision No 666, that does not necessarily mean that the constraint from China has weakened. We note that the volume of greasy wool exports to China has increased by around 30% in recent years[180] at the same time as Cavalier's nominal and real prices have been falling.[181] While that does not reveal China's degree of responsiveness to nominal price increases for New Zealand's scoured wool, it suggests that the Commission was

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[177] At [257] of Decision No 725.

[178] At [186] of Decision No 666.

[179] Footnote 16 of Decision No 666 and at [39] in Decision No 725. The Commission did not refer to this.

[180] Estimated from Figure 4.

[181] Shown in Figures 6 and 7.

appropriately cautious in treating China as "a much closer substitute" and using the demand elasticity that it did. If China is not in reality such a close substitute then the Commission has, if anything, erred on the side of over-stating the allocative efficiency losses rather than under-stating them.

f) Volumes lost to China need not be permanent

[170] Godfrey Hirst submits that there was no basis for the Commission's view that volumes lost to China "are likely to be permanent". However volumes lost to China will only occur when prices are increased to a level where it becomes commercially advantageous for merchants to sell greasy wool to China. For so long as it is advantageous the volumes will continue to be lost. If Cavalier responds to lost volumes by decreasing prices then the constraint from China is reducing the potential allocative efficiency losses.

g) Price discrimination

[171] A further reason for the Commission's intermediate value of detriment was the possibility of some price discrimination. The Commission does not expand on this, but seems to be referring to its earlier comments where it said:[182]

> As stated, any ability of the Applicant to price discriminate in the factual could ameliorate allocative efficiency losses. If the Applicant were able to price discriminate it could increase prices for wool destined to markets other than China, while maintaining (or lowering) scouring prices for wool destined to China. This would mean that increased prices could be achieved without resulting in lower scouring volumes. The Commission notes, however, that the Applicant has submitted that its lack of knowledge, and oversight of, the scoured wool's destination may restrict its ability to price discriminate over the long-term. Moreover, the ability and incentive for merchants to arbitrage is likely to limit Cavalier Wool's ability to price discriminate. The Commission has treated as a worst case assumption that no significant price discrimination will take place in the factual, but notes that if it were possible, price discrimination would limit the impact of allocative efficiency losses.

[172] The Commission is therefore saying that it has made a conservative assessment of the ability of Cavalier to price discriminate and that if it can in fact

[182] At [253] of Decision No 725.

discriminate to any significant extent then allocative efficiency losses would be lower. We agree with that statement in so far as it goes. However there is nothing to suggest that Cavalier can price discriminate in respect of wool destined for export markets.

[173] More importantly, the Commission was considering allocative efficiency losses in the wool scouring markets, on the assumption that merchants and their customers, as well as potential entrants, would respond to material increases in wool scouring prices in the factual. Allocative efficiency losses in the wool scouring markets would be lower to the extent that merchants/exporters are able to pass on price increases to offshore customers, including by price discriminating in favour of those with relatively elastic demand (rather than risking a switch to greasy exports). If the Commission was referring to the ability of merchants (rather than Cavalier) to price discriminate then this also cannot have carried much weight. That is because the Commission said that they may be able to pass price increases on to some customers in the short term but "it was unlikely that merchants would be able to pass these price increases on to international customers to any significant degree".[183] This was broadly consistent with its view in Decision No 666 that merchants had no ability to pass on price increases.[184]

h) Effect on wool production

[174] Allocative efficiency losses in the wool scouring markets would also be lower to the extent that price increases are passed on to farmers without there being a consequent decrease in wool production. The Commission's view was that increased prices "would most likely translate into lower margins for growers".[185] In respect of such pass-back of wool scouring price increases to farmers, the Commission said that it was "very unlikely that a change in the price of wool scouring services by itself would have a significant influence on the amount of wool available for export, either in scoured or greasy form".[186]

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[183] At [120] of Decision No 725.
[184] At [189] of Decision No 666.
[185] At [120] of Decision No 725.
[186] At [235] of Decision No 725.

[175] However, the Commission (whether by conscious decision or not) did not model its allocative efficiency losses on the basis of an assumed pass-back of price increases to farmers. Rather its modelling assumed that price increases would cause allocative inefficiency through the responses of merchants and customers, particularly China. That seems to us to be inconsistent. If the Commission is correct that scouring price increases are most likely to be passed on to farmers, but that it is unlikely that the wool clip would be significantly influenced by an increase in the price of wool scouring services alone, then allocative efficiency losses would be much lower than suggested by Table 2.

[176] Wool Equities criticises the assumption that scouring price increases passed on to farmers will not significantly impact on wool production. It considers that the Commission made inadequate enquiries about this, devoted only two paragraphs in its decision to it[187] and hinged its conclusion on what that limited information "suggested". If Wool Equities' criticisms are valid, and there was likely to be an impact on wool production if scouring price increases were passed on to farmers, that would be relevant to the assessment of allocative efficiency loss in the defined markets, ie to the extent that the volume of wool available for scouring declined. Wool Equities submits that, in the absence of a proper investigation by the Commission, we should take the upper limit of the allocative efficiency range calculated by the Commission.

[177] However, while the information the Commission had before it on this topic may have been limited, that was not through any failure of the Commission to make the relevant enquiries. As is its usual practice, as part of its consideration of the authorisation application, the Commission sent out an agenda and invited interested parties to submit a statement of issues that they thought ought to be addressed. Wool Equities did not propose that a relevant issue was whether wool production would decrease if scouring price increases were passed on to farmers. Nor did it suggest that the Commission's modelling approach should be different.

[178] Prior to the Commission's Draft Determination, Wool Equities submitted a letter which emphasised the importance to growers of wool being scoured in New

[187] Refer to [234] and [235] of Decision No 725.

Zealand. It did not make any submission to the Commission that price increases passed on to farmers would significantly impact on wool production. Its view was that sheep numbers were likely to increase because the worldwide demand for wool exceeded supply. Its view was that the maximum value for New Zealand wool was obtained through quality scouring in New Zealand. It also saw risks if scouring occurred in limited locations (citing the Christchurch earthquake as an example of the need to ensure an appropriate geographic spread).

[179] Also, prior to the Draft Determination, the Commission met with two representatives of Federated Farmers, one of whom was the Chair of the Meat and Fibre section of that organisation. They expressed the view that they would prefer to have two choices rather than one but that they needed "to look at bigger picture and [could] see the possible cost advantages". They said their concern "lay more around extracting greater value from the market, and if restructuring can help to achieve this then it is a good thing". Like Wool Equities they expressed a concern about wool scouring going offshore. Unlike Wool Equities they considered that production was unlikely to go up, as wool prices were so low that a doubling of prices was "not that great". They considered that there would need to be wool prices of "$6-7" for a number of years before there would be increases in sheep numbers. They said that lamb prices were a bigger driver of sheep numbers and that wool returns currently accounted for 8-12% of on-farm returns.

[180] The Commission's Draft Determination reflected these views accurately. The Draft Determination contained essentially the same statements as appear at [234] and [235] of the Commission's decision.[188] The difference was that the Draft Determination did not include the concluding sentence of [234], namely that:

> This would suggest that farmers make their sheep stocking decisions on parameters other than just their returns from wool sales and these decisions would be unlikely to be affected by an increase in wool scouring prices.

[181] However this additional sentence was a conclusion that followed from the information the Commission had received as set out in the Draft Determination. It seems that nothing material arose at the Conference to alter the Commission's view.

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[188] Refer [62] above.

(If it did, we were not referred to it). The Commission's conclusion about the impact on growers was therefore based on the information it had. Its conclusion had been foreshadowed in the Draft Determination. Parties had an opportunity to respond if they disagreed with it. Wool Equities put in a submission commenting on the Draft Determination. Neither in that submission nor at the Conference did Wool Equities suggest that the Commission was wrong that wool scouring price increases borne by farmers would not have a significant influence on the available wool clip. It is irrelevant that Wool Equities did not instruct lawyers to represent them either before or at the conference (a point Wool Equities relied on).

[182] We therefore consider Wool Equities' criticisms are not valid. The Commission's conclusion that scouring price increases were likely to be passed on to growers, but that this would not have a significant impact on wool production and hence the volume of greasy wool available for scouring, suggests to us that the Commission's modelling was inherently cautious. We see this as an important reason why the Commission, in adopting its intermediate value, is unlikely to have under-stated allocative efficiency losses. It was not, however, a reason the Commission relied on.

i) Long-term contracts

[183] Cavalier has long-term contracts with [ ] and others. The Commission's last reason for adopting an intermediate value of detriment was that the presence of these long-term contracts would limit the immediate scope for price increases. Earlier in its decision the Commission had also commented that, while "such long term contracts would be a barrier to Godfrey Hirst's [and, presumably, another's] potential entry, the contracts could lessen any allocative inefficiency arising from the Acquisition if [Cavalier] was required to offer lower prices in order to induce long-term commitments from merchants".[189]

[184] To the extent that Cavalier entered into further long-term contracts in the factual, which had the effect of preventing or inhibiting customers switching their demand to a potential new entrant, that new entrant would face a higher hurdle for

[189] At [157] of Decision No 725.

achieving the wool volumes required for a profitable operation. However, long-term contracts are present in the factual and counterfactual and, if these and other contractual terms are 'competitive', then only less efficient potential entrants would be deterred from entry.

[185] We agree with the Commission that the presence of these contracts protects customers from price increases (both while they are in effect and to the extent that Cavalier has to offer lower prices than otherwise to induce renewed long term contracts). However, the Commission's Table 2 had already excluded the quantities of wool currently going to Cavalier Bremworth and Godfrey Hirst, thereby reducing the potential detriment. We do not therefore accept that the long-term contracts (present in the factual and counterfactual) provide an additional reason for taking an intermediate value from Table 2.

Conclusion on allocative efficiency losses

[186] We consider that the Commission did not err in its allocative efficiency loss assessment by, as Godfrey Hirst submits, failing to consider the loss of NZ Wool Services as a constraint. The removal of NZ Wool Services as a constraint might give Cavalier increased pricing discretion and reduce the countervailing power of merchants. But other constraints would remain in the factual. These included the potential for merchants to switch to greasy wool exports to China and the prospect of new entry. The latter was viewed as capping the pricing discretion and therefore was the basis on which the allocative efficiency loss was quantified. New entry was assessed on the basis of a single scour line and on the assumption that the new entrant could obtain sufficient volumes. While demand was stable or declining, a new entrant was most likely to be a merchant/customer who would scour its own wool and therefore enter with some certainty as to volume.

[187] Given the significant spare scouring capacity in the counterfactual and the fact that the benefits for Cavalier from the proposed acquisition arise from obtaining increased volumes, the Commission has not been shown to be wrong in eliminating a greater than 10% price increase as the cap on allocative efficiency losses. [That is because Cavalier would be careful not to set prices at a level where new entry would

be prompted and volumes then lost.] Further, in combining a 10% price increase and an elasticity of -1.0, the Commission's assessment assumes that China was a closer substitute than the information from exporters necessarily suggested. In so doing, the Commission does not appear to have under-estimated the likely allocative efficiency loss.

[188] We consider that the Commission's additional reasons (namely, the possibility of some price discrimination and the presence of long-term contracts) did not provide much support for taking an intermediate level of detriment. However, there was an important factor which seems not to have been taken into account, namely, that prices would be passed on to farmers without affecting wool production; and this outcome would support a lower allocative efficiency loss in the wool scouring markets. In assuming that merchants would be sensitive to price increases and respond by exporting more greasy wool to China, the Commission has, if anything, over-stated the allocative efficiency losses. For this additional reason we also consider that Godfrey Hirst and Wool Equities have not shown that the Commission was wrong to find that an intermediate level of detriment of NPV $14.5 million was the likely detriment.

[189] The Commission settled on this level of detriment because it viewed it as the "most likely". Having reached that view it then said that this was the "likely" detriment. Two criticisms can be made about this. First, the use of both "most likely" and "likely" is confusing (particularly when the Commission has also said that its Table 2 set out the "likely" range of allocative efficiency losses), when the ultimate test is what is "likely". Secondly, it can be said that, in quantifying the loss as a single figure, this gave the appearance of more certainty of the likely loss than the reality, given the assumptions that were a necessary part of the quantification analysis and the impossibility of predicting precisely future market influences and responses. However, this does not matter if the single figure was set at the upper bounds of what was likely, so that any higher figure is not "likely".

[190] For the reasons we have set out, we consider that the Commission was not wrong to regard any higher level of detriment as unlikely. The Commission was cautious and allowed for the uncertainties. We therefore conclude that Godfrey Hirst

and Wool Equities have not shown that the Commission was in error in taking a single figure rather than a range when balancing the allocative inefficiency detriments against public benefits.

Productive efficiency losses

Introduction

[191] Productive efficiency losses arise from reduced incentives to minimise costs and to avoid waste following a loss of competitive pressure. As the Commission said, in the absence of competitive pressures, "[o]rganisational slack may creep into [a firm's] operations, and costs may increase, because a satisfactory level of profit is assured even when the firm is less than fully efficient".[190] It determined that the "most likely" loss of productive efficiency in this case was a NPV over five years of $[ ] million. Godfrey Hirst and Wool Equities say that this under-stated the likely detriment.

The Commission's decision

[192] Cavalier, Godfrey Hirst and NZ Wool Services all put forward to the Commission calculations of this detriment based on a percentage applied to the pre-merger variable costs of Cavalier and NZ Wool Services. Cavalier submitted that a percentage of 1% to 2.5% was appropriate. Godfrey Hirst submitted that it should be higher than this because of the increased supply risk (from interruption caused by a natural disaster, strike or equipment breakdown) arising from scouring at fewer sites. NZ Wool Services submitted that the percentage should be 5% to 10% because that had been used in a previous case where the proposed acquisition would leave a single supplier.

[193] The Commission considered that any likely detriment from an increased supply risk would be *de minimis*. This was because of the low level of historical risk, and the potential to use the mothballed plant, or to transport wool to a plant in

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[190] At [259] of Decision No 725.

the other Island, or to store wool. The Commission rejected NZ Wool Services' comparison with the other case. This was because the Commission had not reached a final view on the appropriate percentage in that case, and there were differences between the two cases as to the size of operation, management skill and shareholder influence.

[194] The Commission said that the weight to be given to competition as a driver of productive efficiency was "quite speculative"[191] in the present case. The Commission's view was that an important driver to operate efficiently in recent years had come from the declining sheep numbers and (consequently) reducing wool clip. It considered that this external pressure was "likely to continue notwithstanding some improvements in wool prices and a recent stabilisation in sheep numbers".[192] It considered that "future shareholders will have the incentive to continue to drive productive efficiencies",[193] and was "confident that the on-going competitive threat from the Chinese scouring industry ... will ensure that any productive efficiency losses are unlikely to be large".[194]

[195] The Commission concluded:[195]

> While it recognises the uncertainty of any assumed productive efficiency losses, the Commission considers the upper range for loss of productive efficiency is between 1% and 5% of pre-merger variable costs. This equates to approximately $[ ] million to $[ ] million per annum.[196] The Commission's qualitative judgement as to what it considers to be the most likely loss of productive efficiency is the midpoint of this range, namely 3% of pre-merger variable costs. This amounts to a five year NPV of $[ ] million.

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191 At [268] of Decision No 725.
192 At [268] of Decision No 725.
193 At [269] of Decision No 725.
194 At [270] of Decision No 725.
195 At [271] of Decision No 725.
196 The Commission has used Cavalier Wool's pre-merger variable cost figures for the industry of about [ ] cents per kg to calculate the estimated productive efficiency losses. Futures, on behalf of NZ Wool Services, advised that its estimate of pre-merger variable costs is [ ] cents per kg, which is somewhat higher than Cavalier Wool's estimates.

Issues on appeal

[196] Godfrey Hirst submits that:

(a) the Commission wrongly discounted the competitive pressure of NZ Wool Services; and

(b) Adopted a "mid-point" detriment without reasons.

Impact of loss of NZ Wool Services

[197] Godfrey Hirst submits that the Commission was wrong to discount the utility of competition from NZ Wool Services as quite speculative. It says that the Commission was wrong to prefer non-competition pressures (ie sheep numbers), especially as it acknowledged that sheep numbers were stabilising. It says that the Commission provided "no real assessment of the impact of Cavalier's monopoly".

[198] We do not agree with Godfrey Hirst's submission. We consider that in quantifying this detriment the Commission was carrying out the assessment that Godfrey Hirst says it was not, ie it was assessing the negative impact on productive efficiency of Cavalier becoming the sole New Zealand supplier. The Commission considered that there were likely to be losses but these would be small because of other factors which would continue to operate in the factual. We see no error in the Commission's approach. Further, the reasons Godfrey Hirst and NZ Wool Services submitted for higher productive efficiency losses than those Cavalier calculated were considered by the Commission and rejected for the reasons it gave. These parties have not submitted that there is any error in the reasoning on these points.

The mid-point

[199] The Commission gave reasons for its view that the productive efficiency losses were unlikely to be large. It viewed the "upper range" as being between 1% and 5% of pre-merger variable costs, but settled on a "mid-point" of 3% as "the most likely" loss. The Commission does not give reasons for adopting the mid-point other

than that it represents its "qualitative judgment". That a figure is the mid-point is not in itself a reason for adopting it. Unless there were reasons why any other figure in the range was unlikely, any other figure within the range may be just as "likely" as the mid-point.

[200] The Commission may well have had reasons for adopting the mid-point, but it did not articulate them. What is clear is that it has decided upon a "most likely" figure that was 0.5 percentage points above that put forward by Cavalier, although it was not persuaded by the matters raised by Godfrey Hirst and NZ Wool Services in support of a higher figure. It appears therefore to have intended to proceed cautiously because of the uncertainties in the quantitative assessment.

[201] The Commission seems to have considered it necessary to settle upon a "most likely" figure rather than either a "likely" figure or a range (but it did not give reasons). Given the difficulty involved in quantifying a detriment of this kind, and that the Commission gave no indication that it had discounted any part of its upper range as unlikely, it was appropriate for it to include its likely "upper range" for this detriment when balancing detriments against public benefits.

Dynamic efficiency losses

Introduction

[202] Dynamic efficiency losses arise from reduced incentives for companies to innovate following a loss of competitive pressure. The potential detriment lies in consumers being deprived of the benefits of product, service, process or technology innovations. Competition tends to encourage innovation in order for competitors to match or keep ahead of rivals. However, in highly competitive markets firms may lack the resources to invest in research and development. Monopolists may have these resources but lack the competitive pressure to invest and innovate.[197]

[203] Although this is the accepted economic theory, as the Commission said in its decision, dynamic efficiency losses are difficult to calculate with any strong

[197] *Air New Zealand v Commerce Commission (No 6)* at [298] to [299].

confidence in the precision of the calculation;[198] and there is no theoretically robust methodology for estimating dynamic efficiency losses.[199] Industry characteristics are, however, relevant to determining the size of likely losses.[200] In this case, the Commission determined that the "most likely" level of loss in the factual was a NPV over five years of $[ ] million. Godfrey Hirst and NZ Wool Equities say that this under-stated the likely detriment.

The Commission's decision

[204] The Commission set out the submissions it had received on how dynamic efficiency losses should be quantified:

(a) Cavalier's expert had proposed that revenue be multiplied by a factor of 0.5% to 1.5% which would give a range of NPV $[ ] million to $[ ] million over five years as a conservative estimate of the detriment;

(b) Godfrey Hirst's expert submitted that the detriment would be at the upper end of this range;

(c) NZ Wool Services' expert submitted that this range was materially smaller than the plausible estimates of allocative and productive inefficiencies combined, when the widely held view of economists was that dynamic efficiency losses were more material than allocative or productive efficiency losses. He proposed that the Commission apply a factor of 100 – 150% of the combined allocative and productive detriments which would give a range of NPV $[ ] million to $[ ] million over five years. Alternatively, he proposed that the Commission take the same approach as *Air New Zealand* but use a factor of twice that used in that case, which would give a range of NPV of $[ ] million to $[ ] million over five years.

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198 At [286] of Decision No 725.
199 Futures, quoted at [282] of Decision No 725.
200 At [305] of Decision No 725.

[205] The Commission considered that there were a number of factors which suggested that "any losses in dynamic efficiencies may be very limited". The Commission referred to the long-term competitive threat of China's scouring industry. It said that this threat was real and would be a major spur for ongoing innovation to avoid volume losses and thereby lose the gains from the proposed acquisition. It said that major innovations had occurred outside the market by equipment manufacturers who would wish to remain competitive in their markets. It said that Cavalier would have the incentive to utilise new ideas where these contributed to profit and helped ensure competitiveness with overseas scouring options. It said that Cavalier's financial performance was likely to be closely monitored by its shareholders. It noted that any concern about losing some of the benefit of any innovation because it can be quickly copied by a competitor would be ameliorated under the proposed monopoly structure.

[206] Under the heading "[d]iffering constraint offered by [NZ Wool Services]", the Commission referred to the competing submissions about the constraint provided by NZ Wool Services. It referred to the merchants' advice that they would not use NZ Wool Services because it was a competitor. It also referred to the small volume of commission scouring carried out by NZ Wool Services. It referred to Godfrey Hirst's submission that the loss of NZ Wool Services, because of its different business model, would lead to greater dynamic efficiency losses. It referred to its earlier conclusion that NZ Wool Services provided a real constraint on Cavalier. It concluded that "any loss of dynamic efficiency would not be affected, positively or negatively, by [NZ Wool Services'] vertically integrated scouring model".[201]

[207] The Commission considered the approaches to quantifying dynamic efficiency losses put forward by the parties as well as another approach which it had used in *Ruapehu Alpine*. It decided on the approach used in *Air New Zealand* of multiplying total revenue by a factor. It concluded:[202]

> To apply the approach used in Air NZ/Qantas, the Commission had to estimate a factor to apply. From the above qualitative analysis, the Commission is of the view that any loss of dynamic efficiency in this instance is likely to be small. The Commission has estimated a likely range

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[201] At [302] of Decision No 725.

[202] At [310]-[311] of Decision No 725.

> of dynamic efficiency losses of zero to one percent of total industry revenue. This equates to a range of $0 to $[ ] million per annum.
>
> The Commission's qualitative judgement as to what it considers to be the most likely loss of [dynamic] efficiency is the midpoint of this range, namely 0.5% of total industry revenue. This amounts to a five year NPV of $[ ] million.

Issues raised on appeal

[208] Three issues were raised on this appeal:

(a) Wool Equities submits that the Commission was in error in applying the approach it did;

(b) Wool Equities and Godfrey Hirst submit that there was no basis for starting the range of detriments at zero; and

(c) Wool Equities and Godfrey Hirst submit that there was no basis for the Commission taking a mid-point of the range as the likely loss of dynamic efficiency.

Approach

[209] The three potential approaches to quantifying dynamic efficiency loss which the Commission considered were:

(a) Multiplying total revenue by a factor (ie the approach used in *Air New Zealand*[203] and proposed by Cavalier and Godfrey Hirst);

(b) Estimating the change in consumer surplus from an inward shift of the demand curve (an approach used in *Ruapehu Alpine*);[204]

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203 *Re Air New Zealand Limited* [2003] NZComCom 27 (23 October 2003) (Decision No 511).
204 *Ruapehu Alpine Lifts Ltd* Commerce Commission Decision No 410, 14 November 2000.

(c) Multiplying the combined allocative and productive inefficiency detriments by a factor of 100-150%) (the approach advocated on behalf of NZ Wool Services).

[210] The Commission rejected the second of these because it attempted to measure only product innovation. For the wool scouring industry, process innovation was likely to be significantly more important. It would also require estimation of the assumed percentage demand shift (as well as demand elasticity), which is difficult. The Commission rejected the third approach because it was not convinced that there was a sufficient link between the loss of dynamic efficiency and the combined allocative and productive inefficiencies. It said that the concepts overlapped at the edges but innovation was not linked by a certain ratio to the on-going pressures for cost minimisation. It said that even though dynamic losses have a cumulative effect, cost increases through productive inefficiencies may have a greater detriment over the five year period analysed.

[211] This left the first approach. The Commission noted that the experts for NZ Wool Services and Godfrey Hirst said there was a need for the Commission to be consistent with previous cases and they had therefore in part relied on the *Air New Zealand* approach. The Commission said that, although this approach was not fully robust in its ability to predict dynamic efficiency losses, it was the most pragmatic approach. That was because all case-specific factors could be taken into account in assessing the loss, which could then be compared to the range of losses used in previous cases and losses that have been empirically quantified in academic literature.

[212] Wool Equities submits that "dynamic efficiency has a closer relationship to the two static efficiencies than the Commission would apparently allow and there was some merit in the submission" as to approach advanced by NZ Wool Services. Wool Equities referred to three extracts from the Commission's conference where economists were discussing efficiency detriments. However, even if there was merit in the approach Wool Equities advanced, counsel did not expand on why these extracts show that the Commission erred in the approach it took. It is not an error to take one approach merely because there might be merit in taking another.

[213] The Commission gave reasons for the approach it took. Nothing has been advanced to show that it was wrong to take the approach it did. Its approach was consistent with that taken in *Air New Zealand*; it had been put forward by Cavalier, Godfrey Hirst and NZ Wool Services (although the latter had also advanced an alternative approach); and was relatively simple to carry out. The Commission acknowledged that the approach was not "fully robust". It has not been shown that the other approaches would have been more robust.

[214] However, because dynamic efficiency losses are in the Commission's words "very difficult to calculate ... with any strong confidence about the precision of the calculation" (whichever approach is taken), the Commission must be careful not to settle on a single "likely" figure within a range as establishing the likely loss in dynamic efficiency, unless it has a clear basis for doing so. It is open to the Commission to settle on a likely range and to take into account the uncertainty of the level of detriment when balancing detriments against public benefits.

Should the range start at zero?

[215] Applying the *Air New Zealand* approach, the Commission's "estimate" of the appropriate factor to apply to industry revenue ranged from zero to 1%. This equated to a dynamic efficiency loss in the range of $0 to $[ ] million per annum or a five year NPV of $0 – $[ ] million, from which the Commission took its mid-point. Godfrey Hirst submits that the idea that there could be no loss of dynamic efficiency is not plausible. It refers to Cavalier having submitted to the Commission a factor range of 0.5% - 1.5%, giving rise to a detriment range of between $[ ] million to $[ ] million.

[216] Cavalier responds that its view was that there would be little if any detriment from the proposed acquisition. It instructed its expert to estimate dynamic efficiency losses on the basis of the Commission's approach in other cases to quantifying this detriment, while maintaining the view that if there was any such loss it would be at the low end of the range. Consistent with this view, its notice of intention to support the Commission's decision on other grounds said that "productive and dynamic

efficiency losses (if any) are likely to be at the low end of the ranges identified by the Commission".

[217] The Commission does not say why it started its range at zero, only that from its "qualitative analysis" it considered the detriment was "likely to be small". The Commission refers to the constraint from China's scouring industry (with the consequent risk of lost volumes removing the benefit of the acquisition for Cavalier) as providing the incentive for Cavalier to utilise new ideas.

[218] The analysis required is whether or not that incentive to innovate (or adopt innovations) is less in the factual than in the counterfactual. The constraint from China is common to both the factual and counterfactual. The presence of NZ Wool Services is not. To conclude that the likely range of dynamic efficiency loss begins at zero the Commission must have reached the view that the presence of NZ Wool Services provides Cavalier with no additional incentive to innovate. However, its reasons for doing so are unclear.

[219] The Commission's analysis appears to be focussed on whether NZ Wool Services' vertically integrated business model provides a different constraint, the loss of which would lead to greater dynamic efficiency losses than if it were not vertically integrated. The Commission does not appear to have considered whether the loss of a "significant competitive constraint" in the factual (as it had earlier found) was likely to have any effect on Cavalier's incentive to innovate. If the Commission is correct that NZ Wool Services is a significant competitive constraint in the counterfactual, there is no obvious reason why that constraint would only apply to Cavalier's pricing conduct or to the potential for Cavalier to engage in non-price discriminatory behaviour.

[220] That said, the constraint from NZ Wool Services, while found to be "significant", has its limits. This constraint is affected by NZ Wool Services' comparatively small commission business, the fact that it runs at full capacity at peak times scouring its own wool, and that merchants are reluctant to use NZ Wool Services.[205] This appears to be demonstrated by its performance in commission

205 Refer n 19 and [38] above.

scouring since Cavalier's acquisition of Godfrey Hirst.[206] Cavalier Board minutes show concern at losing volume to NZ Wool Services but also consider that this may be attributable to merchants who supply Cavalier holding back on wool exports for a period due to export wool prices. The China constraint and the need to keep volumes in New Zealand to maintain the benefits of the acquisition will, as the Commission said, provide a major spur to on-going innovation by Cavalier.

[221] The Commission refers to the three metre scour as being "[o]ne of the major efficiency developments" in wool scouring in New Zealand. This was first installed at NZ Wool Services' Kaputone site.[207] The Commission plays down this and other major industry innovation by drawing a distinction between the *source* of the innovation, eg equipment manufacturers, and the *adoption* of the innovation.[208] While the competitive dynamic amongst manufacturers (in many industries) can result in major equipment improvements, the competitive dynamic amongst users of equipment (wool scourers in this case) is equally important for incentivizing their adoption. The Commission's observation that the exclusivity of innovations could be lost if quickly copied (in the counterfactual)[209] seems to miss the point that the New Zealand industry as a whole will be better off through the adoption of any innovation benefits.

[222] For these reasons we do not accept that zero is a plausible lower boundary of the range.

Was it appropriate to take the mid-point?

[223] For reasons of consistency and pragmatism, the Commission applied the approach it used in *Air New Zealand*, ie multiplying total sales by an estimated factor. In that case the factor was 0.5 – 1.0%, although the Commission settled on a single "most likely" figure which was somewhere within that range.[210] The Commission in this case applied a factor range of zero to 1% as the "likely" range.

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206 Refer [37] above.
207 At [290] of Decision No 725.
208 At [290] – [295] of Decision No 725.
209 At [304] of Decision No 725.
210 The Commission in that decision did not disclose how that figure was arrived at: refer *Air New Zealand v Commerce Commission (No 6)* at [304].

It then said that its "qualitative judgment" was that the "most likely" loss was the mid-point, ie 0.5% of industry revenue. It was this "most likely" figure that was carried through to the balancing of detriments against public benefits.

[224] Godfrey Hirst says that it was wrong for the Commission to conclude that dynamic efficiency losses would be less than determined in *Air New Zealand*. It refers to the Commission's view in *Air New Zealand*,[211] also referred to in its decision in this case, that "[m]onopolists in general have a reputation for being poor innovators", because of the removal of the competitive pressure to innovate to match or keep ahead of rivals. It submits that the removal of a competitor must result in a proportionately larger disincentive than the Commission accepted in *Air New Zealand*, where the airlines would continue to face competitors in most of the relevant markets.

[225] The statement relied on by Godfrey Hirst is the position "in general". It does not mean that dynamic efficiency losses from a 2:1 merger will necessarily be greater than a merger which leaves more than one competitor in the market. Godfrey Hirst has not taken us to anything in the *Air New Zealand* case to show us that innovations in the airline and other relevant markets have any parallels to innovations in wool scouring markets. Given the inherent difficulties in selecting a robust method, the Commission can only make its call on a case by case basis. The approach it applied enabled case-specific factors to be taken into account as well as enabling a comparison with ranges in other cases (or in any other helpful empirical work). However, in light of the general theory, the Commission ought to have said why in this market a 2:1 merger would be less detrimental to dynamic efficiency than in *Air New Zealand*.

[226] Having decided on a "likely" range the Commission went on to determine a "most likely" figure. As we have said above in relation to the loss of allocative efficiency, this is a confusing approach because other figures above and below the

211 Decision No 511 at [1144].

"most likely" figure are still said to be "likely". The Commission seems to have approached the matter as though it needed to settle on a single figure and then to use that single figure in the balancing of detriments against public benefits. In our view it did not need to do this, particularly where the range is narrow, the potential loss is relatively small, and dynamic efficiency losses are accepted as being difficult to quantify.

[227] As with the productive efficiency loss, the other difficulty with the Commission's "most likely" figure is the absence of reasons for deciding upon the mid-point. It is not clear whether the Commission decided upon the mid-point simply because it was the mid-point or whether there was some other reason for it, although the former appears to be the case. If it was the former then it suffers from the problem that the likely range began at zero. In taking a mid-point of a range that started too low, and in the absence of reasons for taking that mid-point, we consider that the Commission may have under-stated the dynamic efficiency losses. We also note that the Commission's final figure was lower than the low end of the range put forward by Cavalier (albeit that Cavalier maintained that there would be little if any dynamic efficiency loss).

[228] The Commission's view was that the dynamic efficiency losses are likely to be small. While we consider that the Commission was wrong to start its range at zero, and that in doing so it played down NZ Wool Services' role in innovations, we nevertheless agree with the Commission that the losses are likely to be small. Beyond that, it is difficult for us to substitute our view of likely dynamic efficiency losses given that there is no settled approach to quantifying them. Because of the uncertainties in quantifying dynamic inefficiencies, and in the absence of reasons for adopting the mid-point, we consider that the appropriate approach would have been to take the top of the Commission's range in the balancing of detriments against public benefits.

Conclusion

[229] The Commission was not wrong to adopt a consistent and pragmatic approach to calculating the potential loss of dynamic efficiency. It should not have started its range at zero, nor taken a mid-point without providing reasons for doing so. On the basis of its estimates, the Commission should have allowed for a dynamic efficiency loss up to $[ ] million. This is quite consistent with its view that the loss in this case was likely to be small. At the same time, it should have pointed out that this upper limit was well below most other estimates, including that of Cavalier, and provided reasons why this was so.[212]

Other detriments?

Effect on growers' returns and wool production

[230] As referred to above,[213] Wool Equities submits that the Commission failed to have regard to the potential detriments to farmers through decreased returns on wool (if scouring prices were passed on to farmers) and/or a reduction in wool production. As also discussed above,[214] the Commission found that if increased scouring prices were passed on to growers this was not likely to have a significant impact on wool production.

[231] To the extent that price increases were passed on to growers this would be a wealth transfer. As such it is not a detriment to be taken into account. To the extent that price increases were passed on but did not cause a supply response from farmers (in terms of a decline in wool production), the Commission's allocative efficiency loss calculation (which is based on a relatively high degree of demand responsiveness) would be over-stated. There is no further detriment in any wool production market to be considered.

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212 At [281] of Decision No 725.
213 At [62].
214 Refer [62].

Disruption to wool prices

[232] Wool Equities submits that the Commission failed to consider properly the detrimental impact to farmers of Cavalier disposing of NZ Wool Services' trading division. The submission to the Commission was that the closing down of NZ Wool Services' trading division would see the dilution of working capital by $45 million, which is currently used to fund its trading. Working capital is needed because merchants pay farmers for the wool as they go. It was said that it would be difficult in the current environment to raise so much capital in the absence of the substantial asset base that NZ Wool Services currently has. NZ Wool Services' expert submitted that, as a result, the price of wool may drop by 30% in the short term.

[233] The Commission rejected this submission because:

(a) Whether Cavalier acquired the trading division or not, the trading division was not likely to be closed immediately;

(b) There are no significant barriers to merchants readily expanding their businesses to take advantage of the opportunity to increase their market shares;

(c) In the past, when a large trader in the market had closed abruptly, wool prices had not dropped; and

(d) As wool is an internationally traded commodity, returns to New Zealand farmers were "unlikely to decrease and any temporary drop in wool prices within New Zealand would tend to be a wealth transfer rather than a public detriment".[215]

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215 At [335] of Decision No 725.

[234] Wool Equities submits that this analysis was superficial and based on inadequate information. It submits that Cavalier has said it will acquire the trading division; NZ Wool Services has said it would not continue to operate the trading division if Cavalier did not acquire it; and, in either case, there was no evidence that there was any buyer for the trading division. It says that there is no sufficient evidence that merchants have enough capital to step in and fill the gap. It says that the previous exit of a trader is not analogous because it was effectively part of Cavalier. It says that the Commission has concluded that any temporary drop in price is just a wealth transfer, but it has not supported this conclusion with any analysis. It says that an obvious potential consequence of a 30% price reduction in the short term is a reduction in the production of wool.

[235] We do not accept Wool Equities' submissions. The Commission did not accept the argument that without NZ Wool Services' trading division there would be a price reduction as claimed. It was unlikely (indeed implausible) for the reasons it gave. It does not matter whether there was an identifiable buyer for the trading division. Cavalier was intending to run the trading division for a period. Access to capital is not necessarily a barrier and in this case the information from merchants indicated it would not be. If Wool Equities and NZ Wool Services had a different view about this then it was up to them to put forward information to demonstrate that. Otherwise, the Commission was entitled to accept the information it had obtained from Cavalier and merchants. Wool Equities did not elaborate on why it made any difference that the previous exit by a trader was part of Cavalier.

Vertical impacts

[236] Godfrey Hirst says that the Commission failed to take into account that the proposed acquisition would create a vertically integrated monopolist. It submits that Cavalier, with its important downstream interests in the market for manufacturing wool carpets, has the incentive and potential to sabotage downstream competitors. It refers to the Commission's acceptance that non-price discrimination by Cavalier

would potentially have a "significantly greater impact" on Godfrey Hirst than a simple increase in the price of scouring.[216]

[237] Having taken this view, Godfrey Hirst submits that the Commission did not have regard to the detriment it had acknowledged. It submits that Cavalier's use of its vertical advantages "can result in efficiency losses for the competitors, and in the loss of welfare for carpet buyers from reduction in choice and other quality-related benefits among wool carpet makers". Godfrey Hirst's submissions did not elaborate on this other than to say that, if there was uncertainty in how this detriment should be quantified, then a qualitative judgment needed to be made.

[238] The Commission's discussion of vertical impacts arose when it was considering whether the proposed acquisition was likely to have the effect of substantially lessening competition in the downstream carpet markets. It concluded that it was not.[217] There has been no challenge to this conclusion. Therefore, in contending that the Commission failed to have regard to this detriment, Godfrey Hirst is also contending that the Commission is required to take into account detriments in markets other than those in which a substantial lessening of competition is likely to arise. (We refer to the discussion on this topic above.)[218]

[239] In any event, Godfrey Hirst does not explain what efficiency losses it considers are likely to arise from the non-price impacts. The Commission's view was that any attempt at price or non-price discrimination in relation to Godfrey Hirst would be limited by entry or the threat of new entry into wool scouring by Godfrey Hirst. It considered that if new entry did occur then this would be costly to Cavalier as it would lead to: a decrease in scouring volumes (both from Godfrey Hirst and from potentially other merchants switching to Godfrey Hirst); a decrease in margins through the loss of economies of scale; and the potential for a decrease in scouring prices (from the increase in competition).

[240] Cavalier describes this as the "why would you do this?" point. That is, such behaviour would lead to either Godfrey Hirst re-entering the scouring market or

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216 At [205] of Decision No 725.
217 At [210] of Decision No 725.
218 At [63] to[75].

relocating its carpet business out of New Zealand. When Cavalier has acquired Godfrey Hirst's wool scouring assets in order to achieve economies of scale, there is no reason to think that Cavalier would now wish to forego those advantages by putting the volume required to achieve those efficiencies at risk.

[241] [To these points, Cavalier adds that the present contract in place with Godfrey Hirst has [ ] left to run and the contract contains [ ].[219] Cavalier also says that the Commission took a conservative approach to Cavalier's incentives because it approached the issue on the basis that Cavalier would operate solely with the objective of maximising the Cavalier Group profits even though experienced professional investors (Direct Capital and ACC) are 50% shareholders of Cavalier. It says that based on evidence and economic theory applied by competition regulators around the world, Cavalier's external 50% shareholders would constrain such behaviour.

[242] Godfrey Hirst's submissions did not respond to these points. Its submission was based on a general claim of efficiency detriments from vertical impacts. That general claim does not persuade us that there was any error in the Commission's assessment of whether there were likely to be additional detriments as a result of vertical integration in the factual.

Production efficiency benefit

Introduction

[243] Of the total public benefits of (five year NPV) $31.6 million accepted by the Commission as likely to arise from the proposed acquisition, $[ ] million was made up of likely production efficiencies.[220] Costs per kg of greasy wool scoured were accepted as likely to be less in the factual because the scours would be consolidated on fewer sites; one (or two) scours would be mothballed; and the increased volumes would justify additional investment in capacity improvements.

219 [ ]
220 Refer [61] above.

[244] Godfrey Hirst submits that the cost savings have or may have been over-stated because:

(a) The savings are "functionless monopoly rents";

(b) The Commission has not focused on whether the cost savings are merger-specific efficiencies;

(c) There is a tendency for applicants to over-state efficiency benefits; and

(d) It is not safe to assume that the savings in salaries and wages are a public benefit; and the redundancy costs do not necessarily reflect the detriment that may arise.

The Commission's decision

[245] The cost savings claimed by Cavalier were $[ ] million per annum or $[ ] million five year NPV (which amounted to [ ]% of the industry's pre-acquisition operating and administration costs).[221] They arise from the avoidance of cost duplication; spreading operating and administration costs over greater volumes, thereby reducing unit costs; and raising machine productivity to 'best practice' through technical modifications. The cost savings were calculated by Cavalier using a model which set out the combined entity's projected costs as compared with the industry's pre-acquisition costs (made up by Cavalier's actual costs and Cavalier's estimates of NZ Wool Services' costs). An expert appointed by NZ Wool Services reviewed the model.[222]

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[221] At [343] of Decision No 725.

[222] NZ Wool Services suggested on the appeal that the review carried out by the expert could not be given much weight because he did not have expertise in the wool scouring industry. The expert was however appointed by NZ Wool Services. He had access to NZ Wool Services' management accounts and provided his analysis. Through this process the Commission had an independent view of the figures put forward by Cavalier.

[246] The Commission's decision sets out Cavalier's estimates of cost savings by major categories as follows:[223]

Table 3: Most significant annual cost savings from proposed acquisition[224]

Expense category*	Department	Amount	Percentage reduction in factual
Operating expenses (scour and press)	Electricity - Unit Charges	$[ ]	36%
	Electricity - Fixed	$[ ]	34%
	Gas/Coal	$[ ]	18%
	Repairs & Maintenance	$[ ]	12%
	Total Wages & Salaries	$[ ]	14%
Administration expenses	Salaries	$[ ]	31%
	Other administration	$[ ]	24%

[* Because it is just major categories the amounts do not add up to $[ ] million]

[247] The Commission set out in some detail how the cost savings were expected to be achieved. It was "satisfied that $[ ] million per annum in cost savings would be achieved" if the acquisition proceeded and that they would not occur in the counterfactual. This equated to savings of about 14% of pre-merger operating and administrative costs and a five year NPV of $[ ] million. In reaching this view the Commission did not accept claimed savings of $[ ] and $[ ] relating to fringe benefit taxes for cars and council rates respectively. It viewed these as "transfers" rather than public benefits. It also discounted the electricity savings by $[ ] and coal and gas savings by $[ ]. Otherwise the claimed savings were accepted

Functionless monopoly rents

[248] Godfrey Hirst submits that the Commission did not address whether the usual benefit of reduced costs (reduced prices, increased output or higher quality) would arise. It submits that without the prospect of those benefits, reduced costs are "functionless monopoly rents". As such, Godfrey Hirst submits that they should be given less weight. It submits that the reduced costs accruing to Cavalier here have

223 Table 3, at para [343] of Decision No 725.
224 For an almost identical output of scoured wool that occurs in the counterfactual.

no prospect of being passed through and will serve only to contribute to Cavalier's bottom line. It submits that the private benefit to Cavalier is not the same as the public benefit. It submits that here the public benefit should be weighted at zero because the private benefits come at the expense of competition.

[249] We reject this submission. Godfrey Hirst's reference to "functionless monopoly rents" comes from the High Court decision in *Telecom.*[225] There the Court was referring to "supra-normal profits that arise neither from cost savings nor innovation". Because they were accruing to overseas shareholders the High Court considered that they were a detriment to the New Zealand public. The High Court's decision, which had upheld the Commission's decision to decline an authorisation, was overturned on appeal to the Court of Appeal. It was on that appeal that the Court of Appeal emphasised the need to quantify efficiency gains and losses rather than to rely on intuitive judgment. In light of the Court of Appeal's decision, the question is whether there are efficiencies and at what level (quantum), not whether they might be described as "functionless monopoly rents" and therefore given less weight.

[250] In any event, the cost savings to Cavalier are not "functionless" as suggested by Godfrey Hirst. They are a public benefit because fewer resources (electricity, gas, land, labour) are used to scour the same volumes of wool. That reduced inputs to achieve the same outputs are public benefits was not in dispute before the Commission. That is so regardless of whether Cavalier passes on the cost savings in the form of lower prices, increased output or improved quality.[226] In accordance with the Court of Appeal's direction in *Telecom,* the cost savings (production efficiencies) are balanced against the detriments from the loss of competition. (Higher prices, decreased output and loss of innovation are all accounted for in the efficiency detriments assessment.) To then devalue the cost savings (ie give them less weight) because Cavalier does not pass them on, would be to discount further the real resource savings to the economy.

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[225] *Telecom Corporation of New Zealand Ltd v Commerce Commission* (1991) 4 TCLR 473 (HC) at 533.

[226] Cavalier submits that there will be a quality improvement in the brightness of the wool.

Merger-specific production efficiencies

[251] Godfrey Hirst submits that the Commission failed to consider whether the cost savings exceeded those that would be achieved by efficient operators (ie NZ Wool Services) in the counterfactual. In support of this submission Godfrey Hirst relies on a passage in Areeda.[227] That passage is to the effect that two vertically integrated firms, which would be more efficient if they were not vertically integrated, cannot claim efficiency gains from the merger when, if they ceased to be vertically integrated, they could achieve those gains. That is dealing with a different situation than here.

[252] Godfrey Hirst submits that in the present case the question is whether the claimed efficiencies would be achieved by NZ Wool Services and Cavalier through competition anyway. It does not provide any specific example of a claimed cost saving that would be so achieved. It says that it is advancing a "conceptual proposition". It acknowledges that this conceptual proposition was not advanced before the Commission. The point appears only to have been raised in a general way by NZ Wool Services, as the Commission determination records its expert as asking why NZ Wool Services would not achieve the cost savings in the counterfactual.

[253] The Commission answers this point where it concludes:[228]

> The Commission considers that the budgeted costs of rationalisation are plausible and that the cost reductions that Cavalier Wool anticipates, are within the range of the efficiencies that might be expected from a reduction in the number of scouring plants from five to two (with one other mothballed) between the counterfactual and the factual, whilst still maintaining a similar level of production. Moreover, as stated, the cost savings would not be achievable in the counterfactual by either of Cavalier Wool or [NZ Wool Services]. In order for the rationalisation benefits to occur there must be consolidation of all operating scour lines onto two sites with an associated increase in production of scoured wool at each site. Clearly that cannot occur in the counterfactual.

[254] In-so-far as the cost savings come from operating from fewer sites, these cost savings are not available in the counterfactual. Godfrey Hirst had submitted to the Commission that with the additional wool going through these sites there might not

[227] At [974c].
[228] At [389] of Decision No 725.

be the electricity savings claimed. However, the Commission was provided with the details of the savings anticipated. That is apparent from the Commission's decision. As part of its process, the Commission also spent some time on a site visit with Cavalier's chief financial officer going through the items that made up the claimed savings. On the appeal, Cavalier also took us through the analysis that was before the Commission to demonstrate the care with which this was carried out. The Commission's conclusion on the basis of its analysis was that there were cost savings arising from "consolidation of all operating scour lines onto two sites". It is difficult to see what other analysis the Commission could have undertaken here and Godfrey Hirst did not identify what would have been involved in any further analysis.

[255] Having said that, there is one area where we are not clear why the Commission considers the savings would be achieved in the factual but not in the counterfactual. The most significant of the proposed technical machine modifications are to the two NZ Wool Services' 3 metre scours to be relocated to Cavalier's Awatoto and Timaru sites. These modifications are expected to increase significantly the hourly throughput of greasy kilograms.[229] This increase in the run-rate would contribute to better capacity utilisation.[230]

[256] It is common ground that capacity utilisation of any scouring plant (whatever its size and whoever its owner) is important to the future of the New Zealand industry. It is also common ground that the constraint from China's scouring industry, which is present in both the factual and counterfactual, is an important impetus for increased efficiency. In light of these factors, it is not clear why the Commission has concluded that NZ Wool Services would not make these modifications in the counterfactual. But this was not raised by Godfrey Hirst either before the Commission or on appeal except by way of the general "merger-specific" submission. As it was not raised as an issue we do not know how the estimated public benefit (net of relevant capital expenditure) would alter if these modifications to 'best practice' are also attainable in the counterfactual. We do know that Cavalier's position was that the capital expenditure it intended to undertake was only justified with the increased volume. We do not know whether NZ Wool Services

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229 At [341] and [342] of Decision No 725.

230 At [368] of Decision No 725.

would also need increased volume in the counterfactual to warrant undertaking the capital expenditure. However, NZ Wool Services does not seem to face the excess capacity issue faced by Cavalier[231] and apparently has not made modifications to better engage in commission scouring.

[257] As Cavalier submits, it is not for this Court to second-guess the Commission's conclusions where Godfrey Hirst has not shown any error. We consider that at the conceptual level (which was all that was advanced) the Commission did consider whether the production efficiencies were merger-specific.

Tendency to over-state?

[258] The Commission refers to but does not expressly address the proposition put forward on behalf of Godfrey Hirst and NZ Wool Services[232] that there is a general tendency for merger proponents to over-state efficiency benefits. While it would have been better for the Commission to expressly state how it had taken the point into account, we consider that no error has been shown in the approach the Commission took.

[259] As discussed below,[233] the Commission considered the savings in wages and salaries were likely because of the reduction in sites from five to two. The Commission commented that the administrative expenses were "of the kind that would result from a reduction in staff numbers and a reduction in the number of operating expenses". It described the reduction in repairs and maintenance costs (on the basis of a reduction in scouring plants from seven to five) as "conservative". It discussed the source of energy savings and concluded these savings were feasible. It did, however, make some small discounts to both the electricity and the coal and gas savings. It is unclear why these discounts were made but they do suggest that the Commission was cautious about accepting the cost savings claimed.

[260] While it may be true as a general point that there is a tendency for merger proponents to over-state benefits, the issue is whether the claimed cost savings in the

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231 Refer n 19.
232 At [347] and [348] of Decision No 725.
233 Refer [261] to [270].

particular case are robust. The Commission carefully reviewed the claimed cost savings. Their robustness was supported by past experience: Cavalier had claimed that the past experience of cost savings following its acquisition and rationalisation of Godfrey Hirst's wool scouring plant provided reliable evidence of the cost savings that were likely to be achieved in the present case. The Commission reviewed the relevant accounts and agreed that Cavalier had provided accurate information about that experience. It further noted that the cost savings claimed had been relied on by the Board in deciding to pursue the acquisition. We consider therefore that any further downward adjustment to Cavalier's estimates was not required. Even if it had been, this result would not have been material in the balancing exercise.

Salaries and wages

[261] The cost savings claimed by Cavalier included savings in salaries and wages from reducing the scouring sites from five to two and reducing the scouring businesses from two to one. Cavalier provided a breakdown of the type and number of staff who would no longer be needed at the sites and the savings in salaries and wages as a result. There is no indication in the Commission's decision that any party submitted that such savings were not a public benefit. Nor were we referred to anything in the record to suggest that there was any issue about this. The Commission accepted Cavalier's claim that there would be such savings, commenting that the reduction in sites and scours was a "strong indication" that there would be a reduction in salary and wages costs.

[262] Cavalier included the cost of redundancy payments as a one-off rationalisation cost. The Commission recorded the submission from NZ Wool Services' expert that there are two ways to look at these payments. One way is to say that they are a straight wealth transfer from the employer to the former employee. In that case they are not included in the calculation of net public benefit because they are a transfer between members of the public which net out. The other way is to view them as compensation to employees for the loss of human capital in the form of on-the-job experience. In that case they represent a social cost and so should be included in the calculation of net public benefit. The Commission said

that it accepted the second of those views and, accordingly, it included the cost of redundancy payments as a one-off rationalisation cost.

[263] Godfrey Hirst submits that the Commission failed to consider whether the value of the availability of the resource (here, labour) is a cost saving to Cavalier (less the redundancy payment). That is, it says that the benefit to Cavalier is not necessarily the same as the benefit to the public. It says that unless the freeing up of these employees for other productive outputs exceeds the productivity lost in the factual, there is just a wealth transfer from old to new employer. It says that there may even be a detriment. It does not appear that these submissions were made to the Commission but nevertheless we address them.[234]

[264] We do not accept Godfrey Hirst's wealth transfer submission. As Cavalier submits, 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.

[265] In relation to that social cost, Godfrey Hirst refers to the Commission's Guidelines,[235] where the Commission expresses the view that employment creation/retention can be interpreted "in appropriate circumstances" as an efficiency improvement.[236] The Commission expresses the view that the employment of persons who would otherwise be unemployed or under-employed can be an efficiency improvement. Godfrey Hirst says that it follows conceptually that it is implausible to view employment destruction as a public benefit. It says that in the current economic climate it is not safe to assume that the surplus employees will be

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[234] Refer n 85.

[235] "Guidelines to the Analysis of Public Benefits and Detriments".

[236] The passage in the Guidelines relied on by Godfrey Hirst start with the general principle that the creation or retention of jobs is not an efficiency improvement or a net economic gain and would therefore fall outside the definition of public benefits.

able to achieve equally remunerative employment; and, further, the redundancy payments which tend to be determined by contract do not sufficiently reflect the cost of substantial dislocation and time on state welfare support.

[266] Godfrey Hirst seeks to draw support for its submission from the Commission's decision in *Whakatu.*[237] That was a 1987 decision in which the Commission granted authorisation to an arrangement to close two meat works in circumstances where there was considerable over-capacity in the industry. The unions representing the workers argued that the loss of employment that would follow was a detriment that the Commission should take into account. The Commission accepted that there was "a detriment relating to employment flowing from the agreement". This was not because the loss of employment was itself a detriment. Rather it was because "the evidence was that skilled meat workers in particular found it difficult (and impossible in some cases) to relocate their skills in the meat industry generally or in other industries in the Hawkes Bay area".[238] The Commission considered that under the agreement this relocation cost had to be faced earlier than in the absence of the agreement.

[267] The applicants in *Whakatu* claimed that lower unit wage costs and enhanced job security for the remaining employees were public benefits. These were said to flow from the greater likelihood of union acceptance of productivity agreements and the potential, because of the greater throughput at the remaining works, for investment in labour-saving technology. The union argued that there was already acceptance of the need for change and changes were already underway prior to the closure of the meat works. The Commission rejected the claimed benefit saying that "[t]here was insufficient evidence presented ... to convince the commission that the employment-related benefits argued for by the participants are more likely post-closures than pre-closures".[239] It also said that even if it were satisfied about that it would need to weigh such benefit against the detriment to employees it had found to exist.[240]

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237 *Re Weddel Crown Corporation Ltd* (1987) 2 TCLR 215 (Com).
238 At [56].
239 At [67].
240 At [67] and referring back to [56].

[268] Cavalier queried whether the Commission in that case was referring to the same kind of savings as are claimed here. We agree that it is not clear that it is. At least some of the claimed savings in *Whakatu* were said to have come from a longer season as opposed to a freeing up of employees in the factual compared with the counterfactual. Also, the Commission appeared to have rejected the claimed benefit because the changes were already underway and there was insufficient evidence that those changes were more likely as a result of the proposed arrangement than without it. Cavalier also makes the point that this decision pre-dated the introduction of s 3A of the Act[241] and the direction in *Telecom* to quantify claimed efficiency benefits and detriments. We consider that there is nothing in that case which requires a different approach to that which the Commission took here. This is because *Whakatu* appears not to be dealing with the same kind of savings; the evidence in that case did not establish the claimed savings; it is not a decision that was binding on the Commission (nor this Court); and it pre-dates the approach set out in *Telecom*.

[269] Cavalier also contrasts the evidence about the difficulty of re-employment in that case with the places where sites would be closed in the present case (Christchurch and Hawke's Bay), which it describes as major commercial areas. We note that Hawke's Bay is an area common to both cases. More importantly, we consider that we cannot place much weight on this distinction in the absence of any evidence about unemployment rates and the availability of jobs suited to the redundant employees. Cavalier also refers to the New Zealand Treasury's Cost Benefit Analysis Primer which uses a default assumption of full employment. We accept that the Commission's approach was consistent with that.

[270] In the absence of any evidence directed to any particular difficulties that might arise for the employees who will not be required by Cavalier in the factual, the Commission was not in error to quantify their present salaries and wages as a gain, less the redundancy payments as a proxy for the social cost. No other approach had been put forward. In the context of the authorisation process, (which provided interested parties with a full opportunity to put forward any issues they considered relevant, to make submissions on the Draft Determination in which the Commission set out its preliminary views and to participate at the conference which followed) the

[241] Refer [50] above.

Commission was entitled to proceed on the basis of the information before it and on that information to be satisfied about the likely public benefit from net savings in labour costs.

Conclusion

[271] We conclude that it has not been shown that the Commission was in error when including a reduction in production and administration costs of $[ ] million (five year NPV) as a public benefit to be weighed against detriments. The claimed savings were analysed by the Commission and some claims were disallowed. It has not been shown that any lower figure was likely.

Sale of surplus land and buildings

Introduction

[272] Of the total public benefit which the Commission accepted as likely to arise from the proposed acquisition, $8 million (five year NPV) related to the sale of surplus land and buildings at Whakatu and Kaputone, the sites at which the scouring operations would be closed. Although this was not in dispute before the Commission, on this appeal Godfrey Hirst and Wool Equities raise whether this is a public benefit at all. If it is a public benefit, they say that the Commission has erred in quantifying that benefit.

The Commission's decision

[273] The Commission started its discussion of this topic by saying that freeing-up surplus land and buildings is a public benefit as those resources can be redeployed to other productive uses. The Commission noted that there had been no dissention from that concept and that it was proceeding on the basis that it was a public benefit. The Commission's quantification of the benefit was based on the various valuation evidence it had received, which it set out in the following table:

Table 4: Summary of land and building valuations

Valuation by	**Date**	**Comment**	Kaputone ($)	Whakatu ($)	**Total** ($)
Christchurch City Council Hastings District Council	1 August 2007	Capital value	8,100,000	 900,000	 9,000,000
Information Memorandum of the Receiver	February 2011	Both sites provided by WSI			8,800,000
WSI annual report	30 June 2010	Both sites			9,100,000
Colliers International Crighton Stone	8 April 2010 6 April 2010	Vacant possession Vacant possession	[ ]	 [ ]	 [ ]
Cavalier Wool	8 February 2011	Both sites, in the Application	[ ]	[ ]	[ ]
[ ]	10 May 2011	Whakatu only – indicative bid		[ ]	
[ ]	May 2011	Kaputone only – indicative bid	[ ]		
Bayleys Realty	May 2011	Kaputone – sale and leaseback Kaputone – vacant possession	5,400,000 – 8,500,000 5,000,000 – 5,400,000		

[274] Cavalier's submission was that the value of both properties was $[ ] million (rounded to $[ ] million in the above table), which it based on ratings valuations, recent comparable sales and market intelligence (including the approaches it had received from two prospective purchasers). NZ Wool Services disagreed with this value. It relied on the valuation it had received from Colliers in April 2010. It considered this valuation should be preferred because it was carried out on a vacant possession basis,[242] whereas the higher valuations in its annual report and in the

242 The land was intended to be sold by Cavalier with an encumbrance preventing the land from being

receivers' memorandum were on a going concern basis. The Commission's view in the Draft Determination was that the receivers' valuation was the most appropriate valuation. This was because it was the most up-to-date and the receivers would expose themselves to liability if they provided inaccurate information.

[275] In its decision authorising the acquisition, the Commission considered the arguments as to whether or not vacant possession was the appropriate valuation method, but did not give a conclusion. It considered information about the demand for sites in the commercial area of Christchurch and the competing submissions about the cost of reinstatement, again without expressing a view on the differences. It referred to some information about the price at which other properties were for sale in Christchurch which it said provided "some comfort" about its conclusion on value. It considered that the mid-point of [ ] price range of $2-3 million for the Whakatu land and buildings was the most appropriate value for that site. It considered that "the likely range" for Kaputone was between $4-7 million and that the value was more uncertain because of the earthquake and the wider range of possible valuations.

[276] It concluded:[243]

> The Commission has received a broad range of evidence on the likely value of the Kaputone and Whakatu wool scour sites. All valuations are to some degree subjective. It is not until the sale is made that the true value is revealed. As such, the Commission considers the range for the two sites of $6-10 million, although it recognises that the actual combined sale prices could be significantly larger than this amount. The Commission's judgement is that the midpoint of $2.5 million for Whakatu and $5.5 million for Kaputone are the most likely sale prices. The Commission considers that the full estimated sale price should be ascribed as a benefit as the sales would be likely to take place soon after the proposed Acquisition would proceed. Hence the five year NPV for this benefit is $8 million.

Is there a public benefit at all?

[277] The submission that the sale of land is not necessarily a public benefit was not one that was made to the Commission. Wool Equities submits that the Commission had reservations about whether the sale of surplus land and buildings

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used for wool scouring.

243 At [416] of Decision No 725.

was a public benefit. It refers to a Commissioner asking the conference participants if anyone disputed that it was "generally accepted" that it was a benefit and no-one responding with any comment. It submits that this reservation was demonstrated by the Commission considering it necessary to refer to this in its decision and to the absence of any dissent on the point.

[278] We do not accept that this shows any reservation on the part of the Commission that the sale of the surplus land and buildings was a public benefit. All it shows is that the Commission gave interested parties the opportunity to comment on the point and no-one considered it necessary to do so. There being no opposition to the Commission's view as to the generally accepted position, there was no reason for the Commission to take any different position. To record this in the decision is not to indicate any doubt about the point. In any event, what is more relevant is whether it is correct as a matter of principle to treat the sale of the surplus land and buildings as a public benefit.

[279] The submission now made on that issue is that the sale of land and buildings is not a public benefit in that there is no net economic benefit in the disposal of land in and of itself. (It is said that land held by the vendor has a value. That value is transferred to the purchaser in exchange for its value equivalent.) Wool Equities says that the surplus land may be used less productively than in the counterfactual. Godfrey Hirst says that any benefit can only arise if there is improved productivity from a reduced landholding, while making surplus land available for additional productivity. It says that, here, "the merged firm's overall productivity is to reduce, and any additional productivity from its surplus land is met by the purchase price transfer to the merged firm".

[280] Godfrey Hirst seeks to support this submission with reference to the Commission's Guidelines on the topic of the receipt of cash for the sale of state-owned assets. There the Commission expresses the view that "in an arm's length bargain ... the consideration must be assumed to be equal on both sides, so there can be no net gain to the public from such a transaction".[244] This discussion is about the

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[244] "Guidelines to the Analysis of Public Benefits and Detriments" at [8.8].

transfer of an asset for consideration (ie a change in ownership of an asset) which in and of itself does not increase the productivity of a resource.

[281] We agree with Cavalier's submission that this is dealing with a different situation than here. At present there are five sites at which all New Zealand scouring is carried out. Under the proposed acquisition, all scouring in New Zealand will be carried out from two sites. The public benefit is that fewer land and building resources are needed for the scouring operations in the factual compared with the counterfactual, thereby releasing land for other productive uses. It is not necessary to inquire into the relative level of productivity of the alternative use. The benefit lies in the release of surplus resources for other economic uses; and the best evidence of the value of those alternative uses is the price that is likely to be paid for the surplus resources.

[282] Further, we agree with Cavalier's submission that the calculation of the public benefit from the sale of surplus land and buildings is not dependent on the productivity performance of the merged entity. Whether there are productivity losses or gains from the merger is quantified separately as efficiency detriments and benefits. To disregard or discount any benefit from the release of land on the basis of productivity performance in the factual, would be to double-count any productivity detriment.

Valuation

a) Colliers' valuation for Kaputone

[283] Wool Equities submits that in taking a mid-point of the valuation ranges for Kaputone the Commission has given equal weight to all the valuations. It submits that it was wrong to do so when the Colliers' valuation for Kaputone was a formal valuation, comprising 35 pages,[245] undertaken by a "highly respected Christchurch valuer". Wool Equities notes that the Commission spoke to the valuer who

[245] It seems that only the two page summary of the valuation was provided by NZ Wool Services to the Commission for reasons that are unclear**.**

confirmed that his valuation was still his view of the current valuation, even though it had been prepared in April 2010.

[284] Wool Equities contrasts this evidence with the Bayley's valuation obtained by Cavalier after the conference. It says that this was entitled to less weight than the Colliers' valuation because it had not been tested with interested parties and because it was a "desk-top" valuation, the Bayley's valuer not having been to the sites. Wool Equities also submits that not much weight can be put on the approach from the prospective purchaser because, if the purchase required bank funding, the bank would require a valuation from Colliers or someone similar. It also says that the Commission's view of other comparable sales was entitled to less weight than the Collier's valuation, which had taken into account comparable sales.

[285] We reject this submission. The Colliers' valuation was for vacant possession. Cavalier submitted to the Commission that this was not appropriate when the land and buildings were suitable for alternative uses and reinstatement work would be minor. It provided information supporting its submission. If that submission was accepted by the Commission, then the receivers' valuation (which was relatively close to NZ Wool Services' valuation in its annual report and the rating valuations) was entitled to weight. It would not then have been appropriate for the Commission to proceed on the basis that the Colliers' valuation was the most reliable.

[286] Such an approach would also require the Commission to give no weight to the approach Cavalier had received from a prospective purchaser. As the Commission recognised, the true value was what someone paid in a sale. Although it is unclear if the prospective purchaser required bank funding, it cannot simply be assumed that the valuer instructed by a bank would have taken a similar view to Colliers as to value. The Commission spoke to the prospective purchaser who explained his intended use for the property, that he was familiar with the property and that he did not agree with NZ Wool Services' submission about its condition.

[287] Further, the Bayley's valuer had a different view of value (albeit not having been to the site). That the valuation had not been seen by interested parties was not particularly significant because the valuation was an expert independent view of

value. Even so, the Commission expressly stated it was not putting significant weight on it because of this. It must therefore be assumed that the Commission did not do so when it decided on its $5.5 million value.

b) Unchallenged evidence re Kaputone

[288] Wool Equities submits that the Commission ought to have relied on "unchallenged evidence" about the state of land at Kaputone rather than gaining encouragement from the availability of comparable properties that were offered for sale. The so-called unchallenged evidence was a view expressed by NZ Wool Services' solicitor at the Commission's conference that the site was in an area where there had been difficulty selling a neighbouring property; there was a lot of spare space; and there had been bad earthquake damage nearby.

[289] We consider that this evidence was not entitled to much weight in light of the expert evidence of value (from the two valuers, the receivers' memorandum, NZ Wool Services' annual report and the rating valuations) and the information from the prospective purchaser, which the Commission had before it. There was other information before the Commission which suggested that the effects of the earthquake may have created a demand for undamaged property and thereby increased the market value of the Kaputone site. The Commission noted this, as well as Colliers' response that the earthquake was unlikely to have increased the market value of the site. Finally, the price at which other properties were offered for sale was said only to have provided some comfort about the conclusion the Commission had reached. So that last factor does not appear to have been a principal reason for the conclusion the Commission reached.

c) Was the Commission in error in taking the mid-point?

[290] Godfrey Hirst submits that there was "much uncertainty" around the Commission's estimation of the value of the properties. It refers to the Commission's discussions with Cavalier about this, to submissions made by NZ Wool Services, and to the Commission obtaining further valuation evidence on the Kaputone site just days before it gave its authorisation determination. Godfrey

Hirst's submission that the Commission has erred in taking mid-points of valuation ranges, without reasons, arises in relation to the quantification of the benefit from the sale of the surplus properties.

[291] Although the Commission had carefully set out the competing evidence and submissions made about value, it did not explain on what basis it selected the mid-point of its range as "the most likely" outcome. As we have said above,[246] that a figure is the mid-point is not in itself a reason for adopting it. Nor did the Commission explain why it considered that the actual combined sale price could be "significantly larger" than $10 million when none of the evidence and submissions seemed to provide support for this.

[292] Adoption of the mid-point does, however, suggest that the Commission considered it was taking a conservative view in light of the range of values it had before it. But a conservative view is a different test from a likely outcome and if a conservative view is taken that becomes relevant when detriments are weighed against benefits. That conservative view was not for the reason that the combined sale prices could be significantly larger than $10 million (when there was no evidence or submissions to support this). However, it was a conservative position in the light of [ ], the rating valuations, the receivers' valuations and the valuation in the NZ Wool Services' annual report, which indicated valuations higher than the mid-point, of the range. In opting for the mid-point the Commission has given this evidence no more weight than the Colliers' valuations which were at the bottom end of the range.

[293] Despite the absence of reasons for the mid-point, we consider that there was evidence which supported the conclusion the Commission reached. The value was below the rating valuations, the receivers' value and NZ Wool Services' value in its annual report. We agree with the view the Commission expressed in the Draft Determination that the receivers' value was up-to-date and likely to be reliable. Although NZ Wool Services said that this was not done on a vacant possession basis, the evidence Cavalier put forward indicated that there may not have been much difference in value, even though the land and buildings would not be sold as a going

246 Refer [199] above.

concern. Most significantly, prospective purchasers were indicating prices in the range of $8 to $10 million combined. The Commission's value of $8 million was at the bottom of this range.

[294] We therefore consider that we should not interfere with the Commission's judgment about the value to be given to this public benefit. Although the Commission should have more clearly stated why it adopted the mid-point value, the evidence before the Commission supported this as at the conservative end of the likely range.

d) Was it relevant that no undertaking was given?

[295] Godfrey Hirst submits that the value should have been further discounted because, in the absence of an undertaking from Cavalier,[247] there is no certainty that the land will be sold. Cavalier says that the Commission had to assess what was likely. The evidence was that the freeing up of the land was likely. We agree. The benefits of the proposed acquisition are intended to come from increased throughput at less cost. The savings in costs would come partly from operating at fewer sites. The land and buildings will no longer be needed; and Cavalier, acting rationally, would sell them at the best available price. As the Commission said, undertakings are ordinarily given for disposal of assets and shares which a party acting rationally might otherwise wish to retain. That was not the position with the land and buildings at Kaputone and Whakatu. While an undertaking could have been given, it was not necessary to secure what was both intended and rational.

Conclusion

[296] Godfrey Hirst has not shown that the Commission's view that the sale of surplus land and buildings should be valued as a public benefit of $8 million was in error. We consider that there was evidence before the Commission to support this value as being at the conservative end of the likely range. A "conservative view" is

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[247] Section 69A of the Commerce Act 1986 permits the Commission to accept undertakings in respect of business acquisitions.

however a different test from a "likely outcome"; and if such a view is taken, that becomes relevant when detriments are weighed against benefits.

Wool superstore benefits

Introduction

[297] The third most important benefit accepted by the Commission (accounting for benefits of $7.2 million five year NPV) relates to giving effect to the concept of a "wool superstore".

[298] Greasy wool that is to be scoured needs to be transported and stored prior to scouring. Currently, wool brokers operate their own collection and storage facilities. Wool to be scoured domestically is then transported to the wool scour site. A wool superstore would involve a centralised consolidation of greasy wool at purpose built superstores sited adjacent to the wool scour sites in both markets. This aggregation, together with wool sorting, classing, testing and storage, could then all occur under one roof. It is said that this will lead to efficiencies (including freight savings) by eliminating the duplication of resources in the storage and handling of wool.

[299] Godfrey Hirst and Wool Equities submit that the causal nexus between the proposed acquisition and the claimed benefit was not established because:

(a) the Commission was wrong to view the superstore as sufficiently likely in the factual; and

(b) the Commission erred by not considering whether the superstore was unlikely to occur in the counterfactual.

The Commission's decision

[300] Cavalier's estimate of the potential for annual cost savings to growers from a superstore was not in dispute.[248] However, the Commission made a significant downward adjustment of the savings in the North Island from $[ ] million to $4.1 million[249] per annum in years four and five (with a five year NPV of $7.2 million) in view of uncertainty as to the level of both wool volumes and cost savings at this stage in the planning process.[250] That figure included rental (being the implicit lease costs of current stores) and was described by the Commission as "conservative and most likely estimate".[251] As a South Island superstore was a more distant prospect (ie beyond five years), the Commission did not include this as a public benefit.

[301] The Commission noted that it was required to decide "whether it [was] satisfied that the superstore concept would be likely to occur in the factual, but not in the counterfactual".[252] The Commission referred to the main contention being whether the superstore could also occur in the counterfactual.[253] The Commission then set out the reasons Cavalier advanced about that. It rejected a submission from Godfrey Hirst that if Cavalier implemented the superstore concept it would need an authorisation from the Commission. It concluded that it was "satisfied that benefits from the superstore will, or will likely, occur in the factual".[254] It did not expressly state that it was satisfied that the superstore was not likely in the counterfactual. Nor did it consider whether or not some rationalisation and consolidation in wool storage, handling and freighting, might occur in the counterfactual.

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[248] At [441] of Decision No 725.
[249] At [465] of Decision No 725.
[250] At [444] of Decision No 725.
[251] At [444] of Decision No 725.
[252] At [449] of Decision No 725.
[253] Godfrey Hirst had also submitted that there were too many contingencies with the concept for it to be counted as a benefit. The Commission did not refer to this issue, except that it dismissed the argument that Cavalier would need an authorisation for it. It is, however, apparent that the Commission was aware of this issue because its decision focussed on whether the benefit was likely in the factual.
[254] At [465] of Decision No 725.

Likely in the factual?

[302] Godfrey Hirst's submissions on this appeal focussed on whether the superstore would occur in the counterfactual. However it also added that "even then, there would need to be a higher degree of certainty that it *would* occur in the factual". To similar effect, NZ Wool Services submits that the concept "hangs on little more than a concept requiring agreement and participation by many parties. Standing back, it is just too speculative and uncertain."

[303] The Commission explicitly considered this issue: it said "[g]iven that the superstore concept is still in its development stage, the Commission has had to carefully consider whether the concept will, or will be likely to go ahead, if the proposed Acquisition goes ahead".[255] The Commission concluded that in the North Island it was likely to go ahead because of the broad industry support[256] and the underlying commercial justification for it. The Commission dealt with the uncertainties about the performance of a superstore once established, by significantly discounting the claimed savings.

[304] The Commission's reasons were brief. The restructuring required to give effect to the superstore concept will be in (undefined) markets outside the wool scouring markets. The Commission's reasons did not address the dynamics (the participants, their conduct and the constraints) in these other market(s). If the Commission considered whether, outside the support of some large industry players, there were any impediments to the establishment of a superstore or to its success, we have not been referred to that. Other than referring to the reduction in costs per bale from the concept, there was no further reference to growers, who it seems would be the beneficiaries of these lower costs. Cavalier submitted it would only proceed with the concept with the certainty provided by the additional volumes it would secure from the acquisition of NZ Wool Services. However, Cavalier had also advised the Commission that there would be no obligation on farmers or transporters to provide

[255] At [454] of Decision No 725.

[256] Referring (at [455]-[456] of Decision No 725) to the second largest wool exporter, another large exporter and [ ].

wool directly to the superstore, but the Commission did not directly address this point.

[305] That said, from an efficiency perspective there seems little doubt that the superstore concept is potentially beneficial through reducing the resources involved in wool storage, handling and freighting. We also accept that broad industry support and commercial justification for a superstore, from Cavalier's perspective, were factors that supported the prospect of a superstore in the factual. However, although the Commission was not required to be certain that the superstore would proceed in the factual (only that it was likely), we consider there may be merit in the submission that the concept is just too speculative and uncertain.[257]

[306] We know that the Commission proceeded cautiously by discounting any benefit from a superstore in the South Island because the planning for it was less advanced. We do not know how advanced Cavalier's planning was for a North Island superstore (except that there were uncertainties about its likely performance that led the Commission to significantly discount the claimed benefit). If Cavalier had done no more than carried out modelling showing the commercial justification for it, and establishing that there was broad industry support for the concept, we consider that this falls short of providing a sufficient basis for concluding that a superstore by Cavalier was likely in the factual. We have not been referred to any evidence before the Commission about this.[258]

Unlikely in the counterfactual?

[307] Godfrey Hirst and Wool Equities are correct that the Commission failed to make an express finding that the benefits from the superstore would not arise in the counterfactual. Cavalier accepts that there is no express finding but say that it is

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[257] Godfrey Hirst referred to parts of the discussion of a superstore concept in *Woolworths Ltd v Commerce Commission* (2008) 8 NZBLC 102,128 (HC) at [168]-[171] in support of its submission that the superstore here was not dependent on the proposed acquisition. Godfrey Hirst did not refer to a finding in that case that the concept was "uncertain" because the applicants for the clearance had not confirmed that they would continue with the concept. That conclusion has parallels here and provides support for Godfrey Hirst and NZ Wool Equities' submission on this aspect of the superstore benefit.

[258] Cavalier submitted that this issue was not raised in the points on appeal. However, we consider it is captured by the appeal point that the Commission was incorrect to find that the concept had a causal connection to the acquisition.

evident on the face of the Commission's decision that it examined this and concluded that it would not.

[308] We agree that it is apparent that the Commission considered this issue and that it must have concluded that the superstore was unlikely to occur in the counterfactual (as it had set out, at the outset of its discussion, the need to be satisfied about this and that it was the main point of contention). However, the Commission gives no reasons for that conclusion other than that it considered that NZ Wool Services was unlikely to develop a superstore in the counterfactual. Instead it simply recites the submissions that had been advanced. Those submissions were that:

(a) NZ Wool Services had investigated the concept but was put off by the potential capital cost;

(b) Cavalier submitted that the concept relied on promotion and eventual operation by an independent third party and it is the only industry third party capable of successfully implementing the concept;

(c) A merchant was not likely to set up and operate a superstore because other merchants would be reluctant to use a store operated by a competitor;

(d) Without the volumes from the acquisition Cavalier would not have sufficient certainty that it would get a return on its investment.

[309] Godfrey Hirst says that the Commission has failed to consider that if there is industry support and commercial justification for the concept then it could still be implemented in the counterfactual. We would add that there is presently over-capacity in wool storage,[259] so there is an incentive in the counterfactual to rationalise and consolidate, even if NZ Wool Services is not the instigator. The China constraint – present in both the counterfactual and factual – must be an inducement to reduce costs throughout the supply chain. The question is whether the

[259] At [433] of Decision No 725.

Commission could be satisfied that it was unlikely that anyone would be the instigator.

[310] The only possible instigator Godfrey Hirst suggests is a joint venture. It says that the "fact that an industry participant-backed joint venture could take place is, by itself, enough to conclude that the superstore concept is not dependent on the proposed merger". According to the part of the record that Godfrey Hirst relied on here, it submitted to the Commission that a joint venture could pursue the concept. Apparently, however, there was no suggestion that a joint venture was under active consideration or in the planning phase. We do not know whether the Commission rejected the possibility for this or some other reason. We also do not know, for example, whether Cavalier's claim that it was necessary for the instigator to be "independent" made all other potential instigators unlikely.

[311] If there is commercial justification and broad industry support for the concept, we have doubts about whether it can be safely concluded that the concept is unlikely in the counterfactual.[260] The fact that it has not been implemented to date is relevant but not determinative. The proposed rationalisation of the two North Island scouring sites in and of itself seems an unlikely reason for the superstore to be developed in the factual but not in the counterfactual, when the two main sites in the North Island (putting aside Clive which is used intermittently) are both located near Napier. If the concept is a viable one and has industry support, it also seems unlikely that Cavalier's volumes provide the necessary impetus only in the factual, when Cavalier does not own the wool and cannot say where it is to be stored.

[312] It was suggested that the Commission itself had doubts about its conclusion. This was because when it came to balance detriments against public benefits it said that the benefits "in total and in various combinations, are sufficient to outweigh the detriments. For example, the Acquisition would be authorised even without the Commission's acceptance of the superstore benefits."[261] We consider that to say that this shows doubt is to read too much into the comment. Our interpretation of that

[260] Refer n 113.
[261] At [505] of Decision No 725.

comment is that in emphasising the gap between benefits and detriments, the Commission was providing additional comfort in the conclusion it had reached.

Conclusion

[313] The Commission accepted Cavalier's submission that it is the only likely industry participant to instigate a wool superstore and that it would only do so in the factual and not in the counterfactual. However, we consider that the reasons given by the Commission provided an insufficient basis for it to conclude that the superstore was likely in the factual but not in the counterfactual. In particular, commercial justification and broad industry support provide an insufficient basis on which to conclude that the superstore was likely in the factual; and, in the counterfactual, it was not enough to reject the prospect of NZ Wool Services developing the concept without discussing why any other instigator was unlikley. If the benefit found from the North Island superstore had been crucial to whether or not the authorisation should be upheld, we would have considered further whether the issue should be referred back to the Commission for reconsideration or whether we had sufficient information on which we could base our own view.

Quality improvements (brighter wool)

[314] The Commission rejected Cavalier's claim that there would be a quality improvement benefit of up to (five year) NPV $[ ] million from the proposed acquisition. Cavalier says that the Commission was wrong to reject the claimed quality improvement benefit.[262]

[315] The claimed quality improvement relates to the brightness of scoured wool. Brightness is measured by the "Y value" of wool. There was a consensus in the views put forward to the Commission that an increase in the brightness of the wool would have a value of 4 cents per kilogram. Cavalier claimed that it presently has superior scouring techniques to those of NZ Wool Services. It contended that if it acquired NZ Wool Services:

[262] Cavalier's notice to support the Commission's decision on other grounds refers to this issue.

(a) it would be able to achieve this improved quality for the wool currently scoured by NZ Wool Services (estimating that the potential benefit from this was between $[ ] and [ ] million over five years); and

(b) with restructuring modifications there would be a further uplift in the Y value (estimating a further potential benefit from this of between $[ ] and [ ] million over five years).

[316] The Commission had doubts about the data on which Cavalier relied to show that it achieved a higher Y value on its wool than NZ Wool Services. These doubts led it to say that the evidence was not "conclusive" of Cavalier's ability to out-perform NZ Wool Services in relation to the Y value.[263] However, the Commission went on to say that even if those benefits were "real", it was "not satisfied that the benefits ... would not be achieved in the counterfactual".[264] Cavalier submits that the Commission was wrong about both of those conclusions.

[317] The Commission gave four reasons for expressing doubt about the data. Cavalier took us through, in detail, the information before the Commission about the data; other information which it said supported its claim that it out-performed NZ Wool Services on the Y value; and why it viewed the four reasons given by the Commission as inadequate. Perhaps the strongest of Cavalier's points were that:

(a) the Commission did not refer to Cavalier's evidence of individual scour samples to show that improvements were not due to changes in wool procurement practices or to sampling errors; and it was within NZ Wool Services' power to provide/obtain the information to show whether or not its greasy Y value had declined;

(b) the Commission failed to place any weight on the evidence from two independent (and well qualified) experts that in their opinion Cavalier had achieved the claimed increase in Y value. (Cavalier had provided

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[263] At [488] of Decision No 725.
[264] At [498] of Decision No 725.

reasons as to why the Commission might have doubts about the evidence put forward by and on behalf of NZ Wool Services);

(c) the Commission was not correct in stating that the test results for May 2006 to March 2007 were missing (there was an error in the spreadsheet but the data had been provided) and, more importantly, the other missing data referred to by the Commission were not material because the trend line was unaffected.

[318] In respect of whether the increased Y value could be achieved in the counterfactual, the Commission was of the view that "any quality enhancing improvements, if achievable, are likely to be attainable in the counterfactual".[265] The Commission referred to the estimated cost of the investment necessary to make the improvements as against the claimed quality benefits. It considered that on these figures it would be rational to make the investment in the counterfactual. On this basis it said that Cavalier would "be able to capture at least a proportion of the quality benefits in the counterfactual".[266] Cavalier says that the Commission failed to address the reasons it (Cavalier) advanced as to why it would not make commercial sense to invest in these improvements in the counterfactual and why Cavalier would not have the commercial appetite to do so. The Commission had noted this but appears to have rejected it on the basis of its assessment of the investment costs versus the claimed benefits. This does not, however, answer Cavalier's point that it was not necessarily Cavalier that would get the return from the quality improvement. Cavalier and NZ Wool Services were of the view that the benefits (if achievable) might be shared by growers, merchants, wool scourers and end customers.

[319] A further difficulty with the Commission's conclusion about the counterfactual is that it only addressed whether Cavalier would make the investment to gain an uplift in the Y value of its own volumes. Part of Cavalier's claim was that it would improve the Y value of NZ Wool Services' volumes by bringing them up to Cavalier's current specification. The expert for NZ Wool Services said that the

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[265] At [493] of Decision No 725.
[266] At [497] of Decision No 725.

technology to achieve brighter wool was not proprietary. Godfrey Hirst also submitted that NZ Wool Services could achieve the quality improvement by developing the technology, or by licensing it from Cavalier or another supplier. The Commission recorded these views but does not say whether it accepted them. In confining its conclusion about the counterfactual to "at least a proportion of the quality benefits" (ie in respect of Cavalier's volumes) it cannot be assumed that it has.

[320] The response from Godfrey Hirst on this topic was brief. Essentially it says that the claimed benefit was heavily debated before the Commission; the Commission had all the relevant information before it; and it had the skill and was better placed than this Court to consider the issue. It also says that the critical issue for the Commission was whether the Y benefit was achievable by NZ Wool Services in the counterfactual and, on the basis of the expert evidence from NZ Wool Services, the Commission was entitled to conclude that it was.

[321] If the claimed quality improvement benefit had been crucial to whether or not the authorisation should be upheld, we would have considered further whether to refer the issue back to the Commission for reconsideration (with direction as to the matters to be addressed). In part this is because if, on a reconsideration, the Commission were to take a different view about what was likely in the counterfactual (whether in relation to NZ Wool Services' volumes only, or based on any additional uplift in Y value from the proposed investment in the factual), it may then need to consider obtaining the necessary data from NZ Wool Services. (The Commission had not pursued this because its view was that its concerns about Cavalier's data "would not be rectified by access to [NZ Wool Services'] data"). The Commission was not satisfied on all the evidence before it that the quality improvement claim should be given any weight. We accept that the Commission may have been in a better position than we are on this appeal to make the assessment. However its reasons are sparse and important components of the claim are not addressed. In these circumstances, we find that we are unable to defer to the Commission's process and expertise on this matter.

Balancing of detriments against public benefits

[322] We have set out above[267] the Commission's conclusions when balancing detriments against public benefits. Its approach was to:

(a) show a range of values for each of the "likely" detriments it had assessed as well as for the public benefit from the sale of land and buildings; but to show a single figure only for each of the other likely public benefits;

(b) note that this quantitative assessment is only a tool for the judgment it was required to make; this was supplemented by its qualitative judgment of the "most likely" benefits and detriments within any range, but with the quantitative assessment informing "the ultimate qualitative assessment of both benefits and detriments";

(c) use the mid-point of the value ranges which gave "the likely" (or "most likely") net present values.

[323] There is some circularity in this method. It is not clear what has gone into the qualitative assessment other than the quantitative assessment of most likely detriments and benefits. Further, as we have discussed above,[268] in selecting mid-points for productive and dynamic efficiency detriments the Commission has not revealed the "wider qualitative *analysis*"[269] to which it had referred as being necessary – either in terms of the implied probability symmetry, the likelihood of the mid-point (as distinct from some other point) being realized, or the exclusion of all other points. As we have also discussed,[270] it may be legitimate to reach a judgment that losses or gains could fall anywhere within a "likely" range; and unless the

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267 Refer [61].
268 Refer [200] and [277].
269 At [218] of Decision No 725 (emphasis added).
270 Refer [102].

Commission has a clear basis for concluding that a particular figure in the range is likely, it is the range rather than any point within it on which the balancing should be carried out.

[324] Further, as the ranges themselves are uncertain, and only as good as the assumptions on which they are based, there has to be good reason for "plumping for" mid-points or any other point in the range. Otherwise there is a risk of creating an artificial sense of precision and certainty by ruling out the likelihood of other outcomes within the numerical ranges that the Commission has determined are "likely". As was said in *Air New Zealand*, the exercise is not "purely arithmetical" and there needs to be "a healthy regard for any shortcomings in the way in which benefits and detriments have been quantified".

[325] In response to a submission from Godfrey Hirst on the statutory authorisation test, the Commission said: "It is not clear on what basis the Commission could justify declining an authorisation if there was a positive margin in favour of benefits (that is, there were net public benefits)."[271] Further, "unspecified subjective views of different Commissioners" would not be an appropriate basis for over-riding such a positive margin.[272] We agree with the Commission, but this is subject to the Commission having properly accounted for any uncertainties in the numbers on which it is carrying out its assessment.

[326] In the following table we have set out the actual estimates of detriments and benefits used by the Commission in its balancing exercise. We have also set out the adjusted estimates in respect of the productive and dynamic efficiency detriments where we consider the Commission has failed to provide reasons for the mid-point estimates it used, or where we have expressed doubts about the Commission's conclusions on the basis of the reasons given.

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271 Refer [78] above.
272 Refer [78] above.

Comparison of Commission and Court Detriments

Category	Commission final estimates $million	Adjusted estimates $million	Reason for adjustment
Allocative efficiency	**14.7**	**14.7**	
Productive efficiency	**[ ]**	**Up to [ ]**	**No reasoning for mid-point**
Dynamic efficiency	**[ ]**	**Up to [ ]**	**No reasoning for mid-point**
Total of quantified detriments	**$18.1**	**$20.8**	

Comparison of Commission and Court Benefits

Category	Commission final estimates $million	Adjusted estimates $million	Reason for adjustment
Reduction in Production and Administration Costs	**[ ]**	**[ ]**	
Sale of land	**8.0**	**8.0**	
Capital expenditure on land and buildings (deduct)	**[ ]**	**[ ]**	
Capital expenditure on plant	**0.9**	**0.9**	
One-off Rationalisation Costs (deduct)	**[ ]**	**[ ]**	
Superstore	**7.2**	[Possible reference back to the Commission]	**Question as to causal connection between claimed benefit and merger**
Quality Benefits	0	[Possible reference back to the Commission]	**Inadequate reasons given for rejecting claim**
Total of quantified benefits	**$31.6**	**$24.4**	

[327] Putting to one side the claimed benefits from the superstore and from the quality improvements, it can be seen that the margin between detriments and benefits is much closer than the Commission determined. However, likely detriments are still

outweighed by likely public benefits. We consider that because there were reasons supporting the intermediate level of allocative efficiency loss as setting the upper bounds of the likely range, because uncertainties in the quantification have been further allowed for (by including the upper points of the likely ranges for productive and dynamic efficiency detriments), and because the Commission had been cautious about the claimed public benefits and had carefully considered whether they were "merger-specific", there can be confidence that the public benefits are likely to outweigh the detriments. We conclude that the analysis establishes that there is "such a benefit to the public" that the proposed acquisition should be authorised. If we were to "stand back" from this analysis there is nothing that causes us concern about this conclusion. Rationalisation to achieve efficiencies in markets where there is significant over-capacity, where there is constraint from overseas competition, and where customers have sufficient volume to credibly threaten new entry, is the kind of acquisition which may well "give rise" to net public benefits. The quantitative analysis (allowing for uncertainties) has shown that this is "likely" in this case.

Result

[328] The appeal is dismissed. Costs are reserved but it is hoped that the parties will be able to resolve this in accordance with the High Court Rules. If they cannot do so, then they have leave to submit brief memoranda on the points of difference within 30 days of the date of this decision.

"Mallon J"

"K M Vautier CMG"