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Public

MEMO

TO:	Phil Taylor, Glenn Shewan, Penny Pasley and Emma Harris, Bell Gully
DATE:	19 February 2015
FROM:	James Mellsop and Will Taylor
SUBJECT:	Review of Neil Quigley and Graeme Guthrie report

1. Introduction

You have asked us to review the brief report by Professors Neil Quigley and Graeme Guthrie titled, "Our Position on the Proposed Merger", attached to Grant David's 9 February 2015 email.

2. Entry

The first part of the Quigley/Guthrie report addresses entry issues. We have previously addressed the arguments made by Professors Quigley and Guthrie,[1] but note the following again:

- If the North and South Island are distinct markets (as the Commission held in *Decision 725*), then entry should be considered on an island by island basis (i.e., a market by market basis), as the Commission found in *Decision 725* (see paragraphs 160 to 163). There is not necessarily a need for simultaneous or joint entry.
- The Quigley/Guthrie report points out that the evidence suggests there is currently too much scouring capacity in New Zealand. We agree with this, and reducing that capacity is a driver of the public benefits of the proposed merger. This is why we noted in our 22 October 2014 report that, "the entry we model is likely to be underwritten (either by ownership or contract) by a combination of large merchants" (page 21). It is not clear to us that Professors Quigley and Guthrie have recognised this feature of our model.
- The Quigley/Guthrie report then argues, "the expected return (hurdle rate) required by any potential entrant would be high, and in fact too high to make it likely that entry would constrain a SSNIP by the monopoly wool scourer". We have two comments on this argument:
  - Firstly, as we pointed out in our review of the Commission's file note of its 15 December 2014 discussion with Godfrey Hirst's advisers, our entry model uses (in the base case) a post-tax, real discount rate of 15%, which is equivalent to 20.83% pre-tax, real. We made this comment in response to the statement of Professor Quigley that a rate of 10% is too low.

[1] See our 24 December 2014 memo and our review of the Commission's file note of its 15 December 2014 discussion with Godfrey Hirst's advisers.

- Secondly, the Quigley/Guthrie report does not provide any quantitative basis for the assertion that "the expected return (hurdle rate) required by any potential entrant would be … too high to make it likely that entry would constrain a SSNIP by the monopoly wool scourer". Other than a critique of the discount rate we use (which as already noted appears to be based on a misinterpretation), the Quigley/Guthrie report does not otherwise review our entry modelling, or indeed even suggest an alternative discount rate. Our modelling finds that entry would be a profitably strategy for price increases of 10% or greater for the [] option and 15% for the [] option, assuming the entrant can obtain the requisite volumes.

We are very cognisant of the capacity issue in the industry, and it is perhaps worth emphasising that there is no claim entry would occur at existing prices. The Quigley/Guthrie report is extrapolating an interpretation of Lempriere's behaviour at the status quo price level to what others might do if prices were to rise, but without taking into account that price rises can change incentives. Our argument, based on our modelling, is that entry would be profitable if prices rose by 10-15%, and if volumes could be obtained. This price increase may well exceed what Professors Quigley and Guthrie have in mind when using the term "SSNIP", but our broader modelling finds that the detriments at this level of price increase would still be lower than the benefits.

3. Chinese constraint

The second part of the Quigley/Guthrie report relates to the constraint from scouring in China. We have nothing further to add to the comments we made in our 24 December 2014 memo and our responses to the Commission's file note of its 15 December 2014 discussion with Godfrey Hirst's advisers, which address this issue.

4. Option

We are advised that the issues raised by the option do not need to be considered any further, as the sale and purchase agreement is being changed to make exercise of the option conditional on Commission clearance or authorisation.

5. Implication for cost benefit analysis

The final part of the Quigley/Guthrie report argues that "any benefits from the merger may not be retained in New Zealand, and the detriments from the merger are likely to be larger than have been calculated by NERA and by the Commission in Decision 725". The Quigley/Guthrie report then provides three specific reasons for this conclusion, which we comment on below.

5.1. Foreign control

The Quigley/Guthrie report argues that, "With Lempriere being controlled by investors in Asia, there can be no guarantee that a high proportion of the benefits from the merger will be retained in

New Zealand". We have already addressed foreign ownership issues in our 22 December 2014 memo.

5.2. Asset stripping

The Quigley/Guthrie report argues that a controlling Lempriere might strip CWH of its assets, or something similar, "with consequent leakage of benefits from the merger outside New Zealand". This argument appears to rely on Lempriere having control via exercise of the option, and accordingly presumably disappears now. Regardless, the argument is speculative, and we refer to our comments on a similar argument made by Grant David – see our responses to the Commission's file note of its 15 December 2014 discussion with Godfrey Hirst's advisers.

5.3. Detriments

Finally, the Quigley/Guthrie report argues that, "With very limited potential for pricing by a monopoly wool scour to be constrained by potential entry or wool scours in China, the detriments are likely to be larger than calculated by NERA". We note that our modelling already assumes prices increases of up to 15%, and for the reasons already noted, the Quigley/Guthrie report does not justify a higher assumption.