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CHAPMAN TRIPP

Memorandum

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To: Chairman and Members
Commerce Commission

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CAVALIER WOOL HOLDINGS AND NEW ZEALAND WOOL SERVICES INTERNATIONAL - GODFREY HIRST SUBMISSION ON DRAFT DETERMINATION

GODFREY HIRST'S VIEW

This submission

1 This submission has been prepared on behalf of Godfrey Hirst New Zealand Limited (Godfrey Hirst) by Chapman Tripp.

2 Godfrey Hirst sought expert economic advice from Professors Neil Quigley and Graeme Guthrie of the School of Economics and Finance, Victoria University of Wellington in relation to the Application (as described below). Professor Quigley was obliged to withdraw his involvement from mid-February when he took up his new role as Vice Chancellor of the University of Waikat . However, the attached report by Professor Graeme Guthrie dated 21 April 2015 (Economist's Report) incorporates work contributed earlier by Professor Quigley.

3 Chapman Tripp also sought assistance from an experienced valuer, C W Nyberg of Darroch, in relation to the valuations of the Whakatu, Kaputone and Clive scour sites provided to the Commission by the applicant and released to Chapman Tripp under the Official Information Act. Mr Nyberg's report (Valuer's Report) is also attached.

4 A considerable amount of information relating to the Application was provided to us by the Commission on a "confidential to counsel or experts basis". That is, could we not disclose that information to or discuss it with our client, Godfrey Hirst, or anyone else. That restriction – which is intended to protect the commercial position of the supplier of the information (being primarily the applicant) imposes very real restrictions on those interested parties wanting to make submissions.

5 By way of graphic illustration, the majority of the public benefits claimed in the Application comprise various categories of claimed reductions in production and administration costs. Both the fact and quanta of those claimed savings in relation to the operation of scouring plants have been provisionally accepted by the Commission in the draft determination, without close scrutiny of or detailed reasons for its accepting those claimed savings. Indeed for one category – [ ] - the Commission has allowed a saving that is much greater than the saving claimed

by the Application itself, without detailed reasons for that greater saving being allowed.

6 It was very difficult for Godfrey Hirst (as opposed to Chapman Tripp) to comment on the claimed cost savings or other benefits because of the extensive redactions in the draft determination.

7 Further, those claimed benefits and savings can only be fully tested by persons with requisite industry knowledge as to the detailed operation of wool scouring businesses. Counsel and experts engaged on behalf of Godfrey Hirst to whom confidential versions of the draft determination were made available, do not themselves have the requisite expertise.

8 Nor, it is suggested, do Commission staff.

9 A number of the claims made in the Application cannot be properly tested without much more information being released to interested parties with first-hand experience in the operation of wool scours. In that regard, Godfrey Hirst of course is uniquely qualified having operated scours (including Clive) itself in the past. That information should be released immediately to allow the Application to be fairly considered at a conference.

The Application

10 The Cavalier Wool Holdings Limited Authorisation Application dated 22 October 2014 (**Application**) states that while the proposed "acquisition reduces the number of domestic scourers from two to one" it will "strengthen and enhance New Zealand's wool scouring industry". More particularly, the benefits that will arise from the consolidation and rationalisation of New Zealand's existing scouring capacity upon CWH acquiring control of NZWSI's assets, it is claimed, will result in net benefits that exceed the net benefit of $13.5 million previously calculated by the Commission in Decision 725.

11 However, the Application does not disclose publicly either the actual net benefit claimed or the quanta of the different categories of benefits supposedly making up that figure. Nor, does the Application disclose the fact that the Court in *Godfrey Hirst v Commerce Commission* subsequently reduced the Commission's net benefit figure down to $3.6 million.

12 That is not all the Application does not reveal. As will be shown in detail below, the applicant:

12.1 Misrepresents the transaction and its substance as being "largely unchanged" from Decision 725;

12.2 Fails to disclose details of the new shareholder that will concurrently acquire a substantial degree of influence over CWH, Lempriere, or Lempriere's majority shareholder, or of the commercial rationales and industry interests of those newcomers;

12.3 Endeavoured to withhold both the fact and detail of the Lempriere Option and Drag-along right;

12.4 Subsequently negotiated with the Commission supposedly to make exercise of that Lempriere Option subject to a condition;

12.5 Engaged economic analysis by NERA that was erroneously carried out on the basis that the economics of the proposed merger are very similar to those previously authorised;

12.6 Adds the sale of the further site and scour to get the net benefit figure across the line.

Draft determination

13 The Commission's Draft Determination on the Application (**draft determination**) identifies the North and South Island wool scouring markets and small customer wool grease market as those markets where the Commission is not satisfied that the proposed acquisition would not give rise to a substantial lessening of competition. However, the Commission considers CWH would face "moderate" constraints on its ability to raise prices, supposedly because merchants have the ability to export more wool in greasy form and there is the possibility of new entry. Those supposed constraints allow the Commission to divine that a price increase of more than 20% is unlikely.

14 The draft determination does recognise that overseas scours would provide no constraint to CWH inflicting price increases on Godfrey Hirst especially given that Godfrey Hirst's previous scouring agreement with CWH now has expired. The Commission acknowledges that CWH would have the incentive and ability to disadvantage Godfrey Hirst with higher scouring rates than those available to its downstream carpet manufacturing rival, Cavalier Bremworth. Further, that such a cost disadvantage could render Godfrey Hirst a less effective competitor "or drive it from the market completely".

15 However, the Commission sees the other shareholders of CWH as having no direct interest in carpet manufacturing (and thus presumably not incentivised to countenance such price discrimination).

16 The Commission's own quantification of public benefits and detriments stemming from the rationalisation (as set out in the draft determination) results in a total benefit range that exceeds the confidential total benefits figure claimed by the applicant itself. That is for reasons only recently revealed to Chapman Tripp on a confidential to counsel basis by the Commission.

17 However, the range for total detriments assessed by the Commission is $10.57 million to $28.69 million. Most of the Commission's range of detriments substantially exceeds the total detriment figure – again confidential – claimed as "most likely" in the Application.

18 In its final reckoning, the draft determination's "worst case" (high detriments/low benefits) scenario produces a net impact figure of $2.86 million. That slender net benefit impact margin was reduced by the Commission on 14 April to $2.51 million, to take account of its calculation error in relation to the sale of surplus plant.

Godfrey Hirst's interest

19 It will be apparent from the foregoing that Godfrey Hirst has a vital interest in this matter. Godfrey Hirst is a major acquirer and processor of scoured New Zealand wool. It is New Zealand's (and Australia's) largest manufacturer of woollen carpets. It is a major exporter of products derived from New Zealand growers. And it is currently a major employer of skilled New Zealand workers.

20 But, continued access to efficient and competitively priced scouring services is essential to Godfrey Hirst's operations. Exports of greasy wool and foreign-based scours do not provide a practical alternative for Godfrey Hirst. Further, Godfrey Hirst's detailed calculations show that cost and delay make new entry unlikely – except perhaps if the Clive site were available to the potential new comer. But the 50 year covenant to be imposed on this site ensures that it will not be.

21 If Godfrey Hirst has to face unconstrained prices from a single local scourer as a result of the Application being authorised, Godfrey Hirst's "being driven from the market completely" and relocating its own carpet manufacturing operations closer to foreign scours, becomes a real prospect.

22 Put bluntly, this Application is not simply about wool scouring services and wool grease. It involves the very survival in New Zealand of a major primary processor and significant employer.

The Commission must not gamble the industry

23 As will be shown in detail below, and in the Economist's Report and Valuer's Report attached to this submission, the draft determination errs in crucial aspects. In particular, the draft determination:

23.1 Fails to have proper regard to Lempriere and its controlling shareholder, and the commercial rationales and industry interaction of those parties;

23.2 Omits any reference to the Lempriere Option, despite the Commission having advised Bell Gully that it saw a real prospect of that option being exercised to give Lempriere a 72.5% shareholding in CWH;

23.3 Ignores the various alternative factual scenarios to which the existence of the Lempriere Option and Drag-along right give rise;

23.4 Over estimates the constraint that foreign scours and possibility of new entry would impose on CWH;

23.5 Under estimates CWH's ability, as New Zealand's sole remaining scourer, to increase prices;

23.6 Pays little heed to the severe consequences for New Zealand's carpet manufacturing industry.

24 Despite those errors, even by the Commission's own assessment, the draft determination shows benefits exceed detriments by the narrowest of margins. Indeed, that margin (i.e. now $2.51 million) is much less than the margin the Court assessed in relation to CWH's previous application (i.e. $3.6 million).

25 That Court also stressed that, when the matter is finely balanced, the Commission must be careful both to satisfy itself as to the quality of the information on which it bases its assessment and to give reasons. However, as the detailed analysis of the draft determination set out below shows, the Commission has failed to heed both those judicial warnings.

26 Dealing first with the quality of information, the Application begins with the misrepresentation that "the substance provided in the course of the previous authorisation process [Decision 725] remains largely unchanged." It does not.

27 Further, the Application fails to outline the consequences of the changed shareholding of CWH that occurs as an integral part of that transaction. Lempriere becomes an immediate 45% shareholder with different incentives and a different commercial rationale for the proposed acquisition. Nowhere are these disclosed. Also not disclosed are the ultimate shareholders of Lempriere and their interests, (for example, in potentially procuring the assets or customers of CWH).

28 Even more shrouded are the Lempriere Option and Drag-along right provided for in the Shareholder's Agreement. That document (and the other transaction documents) were excluded in their entirety from the public version of the Application. It was only after repeated requests to the Commission that the transaction documents were eventually released on 26 November 2014 to Chapman Tripp, on a confidential to counsel basis. Public versions of the transaction documents – which openly revealed for the first time the existence of the Lempriere Option and Drag-along right - were finally released on Christmas Eve.

29 The alternative factual scenarios to which exercise of the Lempriere Option and Drag-along right give rise – and competition and economic consequences of those various factual scenarios – are outlined in full below and in the Economist's Report.

30 Further, documents much later disclosed by the Commission have revealed the Commission's subsequent lengthy interaction with CWH's counsel, Bell Gully, in an ultimately failed attempt to insert an element of conditionality into the exercise of the Lempriere Option. For the reasons also detailed below, that conditionality could be easily avoided. Thus, the Commission must revert to its previous stance that there is a real risk that Lempriere will proceed to acquire 72.5% of CWH; and carry out its analysis of the Application on that basis.

31 Alarmingly, there is no reference to the Lempriere Option, or the Commission's lengthy dealings with Bell Gully in relation to it, in the draft determination. Authorisation is a procedure whereby the applicant is seeking the Commission's indulgence to do what the Commerce Act otherwise forbids, on the basis of a careful

balancing of claimed benefit against harm to the public. All the Commission's dealings with any applicant should occur subject to scrutiny by other interested parties (representing the public interest as well as their own) so far as practical.

32 Godfrey Hirst submits the conference procedure must now be used. To date, too much has been withheld for too long; or not disclosed at all. The disinfectant of sunlight – to allow proper public scrutiny - is required.

33 Turning now to the importance of the Commission giving reasons where the matter is finely balanced, the draft determination fails in its endeavours to do so. Its attempted assessment of productive and dynamic efficiency losses departs from the Court's mandated approach by taking the low point rather than a range. Similarly, with its proclaimed acceptance of "recent third party valuations" for the surplus sites.

34 But, as is shown below, none of the "reasons" given for the Commission's approach survives close scrutiny.

35 Further, the Commission has not sought to extract from the applicant reasons why the Clive scour – which was to be retained as a contingency back up facility in the previous application – is now proposed to be sold. The Application simply claims (at paragraph 25.35) that:

> *While at the time of the previous application CWH had yet to determine whether it would sell the Clive site, CWH now considers this site to be surplus to requirements given the continued decline in sheep numbers.*

36 That claim needs to be treated with real care by the Commission. The alternative explanation is that it is only by including the benefit that can be attributed to freeing up the Clive site that makes the Commission's own amended net impact figure positive rather than negative.

37 Inclusion of that Clive site, or otherwise, is not vital to the alternative benefits/detriments analysis which the Economist's Report provides. But Clive is an important symbol. Indeed, its use is described as "best for scouring" by its present owner. Removing Clive as a contingency back-up would be an operational gamble on the part of CWH's new shareholders.

38 But, granting authorisation - effectively on the basis of the sale price that might be realised for the Clive site some five or more years in the future – would be an enormous gamble on the part of the Commission.

39 The Economist's Report demonstrates that the measurement of benefits, and especially detriments, is not straightforward. A small change in the factor applied, or the margin allowed for variation, can make a very big difference.

40 So, too, can foreign ownership of a relevant party. Benefits to foreigners must be counted only to the extent that they also involve benefits to New Zealanders. Lempriere's immediate 45% shareholding of CWH, 72.5% shareholding of CWH upon exercise of the Lempriere Option, and ability to procure the sale of CWH in its

entirety to a foreign buyer upon exercise of the Drag-along right, all make for substantial discounts to the benefits claimed by the applicant. The effect of those discounts, when applied to the varying factual scenarios relating to ownership of CWH, are shown in the Economist's Report.

41 To cut to the chase, the conclusions in the Economist's Report and quantification of benefits and detriments in light of those conclusions, substantially change the estimated net impact as described in Table 8 of the draft determination .

42 Very briefly, the Commission's best case (low detriment/high benefits) figure reduces from $23.23 million to $10.83 million for the factual scenario where Lempriere takes only its initial 45% shareholding. If however Lempriere exercises the Lempriere Option in year 1, that best case net benefit reduces to $1.13 million.

43 The worst case (i.e. high detriment/low benefits) scenario presents a much bleaker picture. The Commission's current small overall net benefit figure of (now) $2.51 million reduces to an overall net detriment of -$22.15 million on the basis that Lempriere stays at 45% of CWH. Again, if Lempriere exercises the Lempriere Option in year 1, that overall net detriment figure increases to -$32.10.

44 But it gets even worse. If, in year 1 Lempriere exercises both the Lempriere Option and the Drag-along right to procure the sale of all of the shares in CWH to a foreign entity, the effect is that the best case outcome becomes an overall net detriment of -$8.58 million, with a worst case scenario outcome of -$42.06 million.

45 Godfrey Hirst submits that, on the basis of the above revised assessment of benefits and detriments, the Commission cannot be satisfied that the acquisition will result, or be likely to result, in such a benefit to the public that it should be permitted.

46 Further, even on the Commission's own best case as set out in the draft determination, the acquisition should not be permitted. Having regard to the quality of the information provided to the Commission, the paucity of the reasons given to or by the Commission, and the propensity for calculation error, that perceived net income margin is simply too small to gamble a vital industry on.

COMMENTS ON DRAFT DETERMINATION

Paragraph 2

47 This states that the Application "relates to the same wool scouring assets that were the subject of an authorisation the Commission granted to Cavalier in 2011". That brief description is misleading to the extent that it omits any reference to:

47.1 The intended consequences for those assets, which now are that the Clive scour also be decommissioned and that site and plant sold;

47.2 The agreement that covenants be imposed on the Clive, Whakatu and Kaputone sites to exclude future wool scouring or related activities at those sites for a period of 50 years; and

47.3 The fact that the acquirer of those assets, CWH will, change substantially as the result of and immediately upon completion of the acquisition to the effect that CWH will be held –

(a) 45% by Lempriere;

(b) 27.5% by Cavalier Bremworth;

(c) 13.75% by Accident Compensation Corporation (**ACC**); and

(d) 13.75% by Direct Capital Limited (**Direct Capital**).

48 But that is not the end of the matter. The "Lempriere Option" set out in paragraph 9 of the Shareholders Agreement provides that each of Direct Capital and ACC grants Lempriere a call option to acquire all of their shares. When that call option is exercised, Lempriere – being a company that itself is majority owned by Shandong RuYi Science & Technology Group Limited (**RuYi**) being a company incorporated in the People's Republic of China and itself owned by a consortium of investors based in China and Japan will hold 72.5% of the shares and control of the composition of the Board of CWH.

49 Despite those fundamental and other changes from the matter previously authorised, the claim is made in the executive summary of the Application that "the substance provided in the course of the previous authorisation process remains largely unchanged". The introduction of the NERA report accompanying the application similarly proceeds on that basis. It states:

> *The economics of the proposed merger appear to be very similar to those previously authorised*.

50 Those claims that the present proposal is "largely unchanged" or "very similar" to the previous application in Commission Decision 725 are factually incorrect. The Commission's own description of the Application should not perpetuate that misrepresentation.

Paragraph 3

51 The indication of the Commission's preliminary view should draw attention to the "relatively small" margin of net benefit that the Commission perceives to enable it to grant authorisation. The draft determination makes no acknowledgement that –by the Commission's own calculation - that margin of net overall benefit would be as low as $2.51 million until paragraph 394. That margin has already been reduced by some $0.35 million to take account of a calculation error on the part of the Commission.

52 The fact that the Commission's preliminary view depends on so narrow a margin – which, the Economist's Report shows, becomes a substantial overall net detriment on more detailed analysis – should be highlighted. That margin leaves very little room for further error or variance.

53 Second, the information provided to the Commission by the applicant in support of its benefits (and detriments) claims requires close qualitative scrutiny. The criticisms made in Godfrey Hirst's Valuer's Report of the valuation methodology used in so-called "recent valuations" of the Clive, Whakatu and Kaputone sites illustrate that need for extreme caution by the Commission.

54 The Court in *Godfrey Hirst v Commerce Commission* expressly warned (at 116) that:

> *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.*

55 The Court (at 115) mandated an approach that would assess the quality of such claims:

> *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.*

Paragraph 4

56 The draft determination adopts nomenclature that endeavours to differentiate between Cavalier Wool Holdings Limited under its present and post-acquisition shareholdings. It refers to the former entity as "Cavalier", presumably on the basis that Cavalier Bremworth (which itself is wholly owned by Cavalier Corporation Limited) exerts a substantial degree of influence over the activities of Cavalier Wool Holdings Limited. Given the Commission's finding that Cavalier Wool Holdings and Cavalier Bremworth are associated persons, use of the term "Cavalier" is appropriate in the pre-merger context.

57 Consistent with that approach however, Cavalier Wool Holdings in terms of its post-merger guise should also be described in terms of its then largest shareholder, Lempriere. Given the factors set out in paragraphs 73 to 80 of the draft determination outlining the circumstances where parties are associated, it is clear that, post-acquisition, Lempriere – and its own controlling shareholders – will similarly exert a substantial degree of influence over the activities of Cavalier Wool Holdings. That will certainly be the case upon exercise of the Lempriere Option.

58 Thus, a more consistent method of describing Cavalier Wool Holdings in its respective pre- and post-merger guises would be to use the terms "Cavalier CWH" and "Lempriere CWH".

Paragraph 6

59 The draft determination acknowledges that, in consideration for CWH's acquisition of NZWSI's wool scouring assets, the merged entity will issue shares that will transfer to Lempriere resulting in Lempriere acquiring its 45% shareholding of CWH. However, that is not the only consideration Lempriere receives.

60 Upon completion of the acquisition, an agreed form of Shareholders Agreement relating to CWH (which is referred to in clause 6.1(b) of and attached to the Application) will also be entered into by Lempriere and the other shareholders of CWH. That agreement confers upon Lempriere specific rights in relation to the future shareholding of CWH. In particular, clause 9 confers upon Lempriere the Lempriere Option, granting Lempriere the right to acquire the shareholdings of Direct Capital and ACC at a specified price.

61 Clause 8.1 meanwhile confers on one or more shareholders holding an aggregate of at least [ ]% of the shares in CWH a Drag-along right to require the other shareholder to sell all its shares to a buyer and at a price specified by the party exercising the Drag-along right. By virtue of its immediate shareholding of 45%, and potential 72.5% shareholding upon exercise of the Lempriere Option, Lempriere in fact is the only party that can exercise the Drag-along right.

62 Thus, both the Lempriere Option and Drag-along right under the Shareholders Agreement confer upon Lempriere significant commercial benefit. Those contractual rights under the Shareholders Agreement themselves constitute intangible assets being acquired by Lempriere as part of its consideration for the NZWSI assets.

Paragraph 7

63 Given that Lempriere acquires not only an immediate 45% shareholding in Lempriere but also the contractual right to acquire a further 27.5% by virtue of the Lempriere Option together with the right to procure the sale of all of the shares in CWH to a third party, the diagram attached to the draft determination purportedly to show the post-transaction structure, shows only one of three potential post-transaction scenarios.

64 The recent decision of the Court of Appeal in *Todd Pohukura v Shell & OMV* makes it clear that:

> *… where authorisations are sought under the [Commerce] Act for proposed actions, the analysis of both factual and counterfactual must necessarily include the future effects and considerations.*

65 In other words, both factual and counterfactual are forward looking. That "forward looking" analysis of the factual – like the counterfactual – necessarily includes a hypothetical element. Thus, a future factual might be different from the present or immediate factual. Indeed, the Commission in the draft determination already recognises this futurity in paragraph 246 where it allows that sale of scour sites and scour assets be included in benefit analysis although such sales may not occur within five years.

66 Here, a forward-looking factual includes not only CWH's acquisition of NZWSI's scouring assets, which in turn gives rise to Lempriere acquiring a 45% shareholding in CWH; but also the contractual rights which Lempriere concurrently acquires in terms of clauses 8 and 9 of the Shareholders Agreement. Thus, proper consideration of post-transaction scenarios must incorporate Lempriere's ability to exercise both the Lempriere Option and the Drag-along right. For the reasons outlined below, the Commission must still regard the exercise of the Lempriere

Option as a real possibility. Attached as Appendix A are additional diagrams representing those further post-transactional structures.

Paragraphs 8 to 17

67 The draft determination notes that although CWH's acquisition of the scouring assets of NZWSI and Lempriere's acquisition of a 45% shareholding in CWH are "inter-dependent and contained in the same transaction document", it is only the former acquisition for which authorisation is sought. Specifically, no application for clearance or authorisation has been made in respect of Lempriere's acquisition of a 45% shareholding in CWH; and no reference at all is made to Lempriere's acquisition of contractual rights in the form of the Lempriere Option and Drag-along rights under the Shareholders Agreement.

68 The Commission notes that "regard must be had to the Lempriere aspect as an indivisible part of the commercial transaction". If so, that "Lempriere aspect" must also include Lempriere's contractual rights under the Shareholders Agreement.

69 Further, Lempriere's deliberate failure to seek clearance or authorisation for acquisition of its initial 45% shareholding in CWH must be contrasted with Lempriere's subsequent willingness – as a result of its correspondence and interaction with the Commission post-application – to insert an obligation to seek clearance or authorisation to acquire an additional 26.5% shareholding in CWH, prior to exercise of its rights under the Lempriere Option.

70 It is Lempriere's initial acquisition of the 45% shareholding that will give Lempriere a substantial degree of influence, and effective control, over CWH. That is where any competition concerns mostly arise. The additional 27.5% shareholding affords little more in terms of future effective control. But, that additional 27.5% shareholding in the hands of a foreign company does make a very substantial difference to the quantification, especially of benefits, in the context of the Commission's current consideration of the Application.

71 Put simply, the current promise to seek clearance (or authorisation) in the future is no more than a device to confine the Commission's scrutiny of the Application to a single factual where the Lempriere Option can be ignored. If clearance is not being sought for Lempriere's initial 45% shareholding, why is it to be sought for the additional 27.5%? Given its own involvement in the drafting of the Deed intended to amend the Lempriere Option, the Commission should explain.

Paragraphs 11 to 15

72 The draft determination euphemistically states that post-acquisition CWH intends to "rationalise" NZWSI's scouring assets. That rationalisation would see CWH:

72.1 Closing NZWSI's scours at Kaputone and Whakatu;

72.2 Relocating those scour lines to the scouring plants at Timaru and Awatoto and

72.3 Decommissioning the scour line at Clive and 2.4 metre scour line at Timaru.

73 Presumably those two "redundant" scours will not be available for purchase locally, so would most likely be relocated to China, India or South America. [ ] not to sell those scours; but rather to enter into joint venture arrangements with partners. There is no indication as to who, or where, those potential partners might be.

74 While not currently operating at capacity, both the Clive scour and the 2.4 scour line at Timaru currently are required to meet demand during the peak summer period. This may be for as little as one month, but can be as long as two months. That is unlikely to change even with projected continued decline in sheep numbers. Without those scours lines available, it is inevitable that the remaining scours will come under pressure and processing delays will occur. In this situation, even a relatively minor breakdown can have significant flow-on effects in terms of late delivery to a "just in time" processor or missed shipping connections. With "just in time" processing, the window available for testing and, if required, re-processing is also shortened. Obviously it is not possible to scour wool in advance of seasonal peaks as it is processed as it becomes available.

75 The draft determination notes that, in addition to closure of the scours at Kaputone, Whakatu and Clive, the various owners of those respective sites will be obliged to impose covenants to exclude future wool scouring or related activities at the site for a period of 50 years. For the Kaputone site, CWH is required to register the requisite covenant. For the Whakatu site, Lempriere is obliged to effect the requisite covenant. For the Clive site the "Covenantors" being Direct Capital, ACC and Cavalier Bremworth, have the obligation to procure the covenant. Those respective obligations are set out in clause 13 of the Sale and Purchase Agreement.

76 To the extent that closure of those scours has the purpose or effect of reducing existing scouring capacity and the proposed covenants that are agreed to be opposed have the purpose or effect of preventing use of those sites for scouring or related activities in the future, those obligations potentially breach sections 27 and 28 of the Commerce Act. Put another way, the decision to close the scours at Kaputone, Whakatu and Clive are not unilateral decisions on the part of the existing owners of those scours. Similarly, the decisions to impose covenants on the future use of those scouring sites are not unilateral decisions on the part of the existing owners of those sites.

77 Further, despite the fact that those obligations are contained in the Sale and Purchase Agreement, they do not relate to the "acquisition of the assets of a business or shares", being the only matters in respect of which the Commission may grant authorisation in terms of section 67. The fact that those obligations may have been inserted in the Sale and Purchase Agreement when in fact they would be more properly contained in the Shareholders' Agreement (or other document) does not change their status.

78 While consolidation and rationalisation of wool scouring plants may occur as a result of consequential actions on the part of various parties involved as shareholders of CWH, the actions giving rise to rationalisation do not result from the business acquisition for which authorisation is sought. To qualify as benefits, they must be "transaction specific" in the sense that they arise with the transaction but not

without the transaction. The relevant transaction here should properly be confined to CWH's acquisition of NZWSI's scouring assets.

79 Any such post-acquisition rationalisation arrangements - including the agreement of existing owners to impose the covenants – more properly constitute additional contracts, arrangements or understandings between CWH, its shareholders and Lempriere for which authorisation for restrictive trade practices pursuant to section 58 should also have been sought. So, too do the non-compete and business undertakings contained in clause 10 of the Shareholders' Agreement and, potentially, [ ].

80 This need for "dual authorisation" (i.e. of both the business acquisition and the other arrangements required to effect and support rationalisation) has been raised previously with the Commission by Chapman Tripp. But nowhere has it been addressed in the draft determination or elsewhere.

Paragraph 20

81 The Commission's willingness to accept an application seeking authorisation of a business acquisition in a form which does not fully describe the implications of that acquisition must be criticised. Chapman Tripp's letters to the Commission of 10 and 11 December 2014 (copies attached as Appendix B) complained that the Application was presented as effectively a re-run of what Cavalier had sought to do (and the Commission and Court had approved) last time. That representation by the applicant is factually incorrect. In the previous application, Cavalier Bremworth would have acquired 50% of Cavalier Wool Holdings and clearly been the driving force post-acquisition. This time, Lempriere with its initial shareholding of 45%, clearly would be in the driving seat.

82 Further, and potentially more seriously, the transaction documents, which were not finally made available in redacted form until Christmas Eve, provided that Lempriere's shareholding could be immediately increased to 72.5% by exercise of the Lempriere Option. The shareholding and ultimate ownership of Lempriere, and its commercial rationale for the acquisition, are nowhere accurately described in the Application. On the contrary, under the heading "No Overseas Dimension" the Application specifically claims that:

> *7.1 The proposed acquisition has no overseas dimension.*

83 Given the foreign ownership of Lempriere, and ultimately RuYi, clearly that it untrue.

84 That is not the end of the matter. On 4 March 2015 the Commission released to Chapman Tripp under the Official Information Act, its detailed interaction and correspondence with Bell Gully in relation to the above concerns that Chapman Tripp had expressed relating to the Lempriere Option. That released correspondence is attached as Appendix C.

85 It reveals that on 27 January 2015 the Commission had advised Bell Gully that its preliminary view was to take a conservative approach and consider there was a real chance that Lempriere may exercise the option and therefore the Commission would conduct its analysis on the basis that Lempriere has a 72.5% shareholding in CWH.

There was then a telephone discussion on 4 February between the Commission and Bell Gully as to whether making the option conditional would change the Commission's analysis. The next day Bell Gully provided the Commission with a draft Deed purporting to make the exercise of the Lempriere Option conditional upon the Commission granting clearance or authorisation to Lempriere acquiring the additional shareholding.

86 On 9 February the Commission responded with its thoughts on and proposed amendments to the draft Deed. Bell Gully responded the same day accepting the Commission's proposed amendments and provided a further draft Deed reflecting the changes sought by the Commission. These changes were:

86.1 An amendment to paragraph 2.2 of the Deed providing that the condition requiring clearance or authorisation cannot be waived; and

86.2 An amendment to clause 3.1 removing the previous requirement that the Deed cannot be amended except with prior written consent of the Commission.

87 The practical effect of those changes is that while the provision making exercise of the Lempriere Option conditional cannot be waived, the Deed itself can be amended to remove that requirement, or terminated, simply by written agreement of the parties.

88 Put simply, the conditionality supposedly effected by the Deed is illusory. There is nothing to prevent CWH and its shareholders, immediately upon authorisation being granted, amending the Deed to remove the conditionality requirement, or indeed to terminate the Deed in its entirety. The Commission through the amendments which itself proposed, has expressly removed itself from the picture.

89 Leaving aside the appropriateness of the Commission so closely involving itself in the post-facto restructuring of an extant application, the practical effect of the Deed in the form as executed is that it may be amended or terminated. Thus, the Commission cannot be sure that it will have the chance subsequently to consider the competition and/or benefit/detriment consequences of the Lempriere Option.

90 Further, the Commission cannot be satisfied that any subsequent consideration of the consequences of the Lempriere Option exercise will address all the benefit/detriment consequences of the option. The issue is not one of incremental impacts on competition, each of which may be independently analysed. Rather, in the context of the current authorisation, there is an acknowledged substantial lessening of competition. Whether the claimed public benefits of this outweigh the detriments is dependent in part on whether the Lempriere Option is exercised in the future.

91 Put simply, the conditional nature of that option does not mean the Commission can ignore it in reliance on a later assessment: any later assessment will be of the option only, (that is, acquisition of the further 27.5% shareholding in CWH). The implications of the option for the benefits and detriments relevant to this Application cannot be reconsidered.

92 That being so, Godfrey Hirst submits that the Commission must return to its initial approach and conduct its analysis on the basis that Lempriere potentially has a 72.5% shareholding in CWH, which shareholding, on amendment or termination of the Deed, can be acquired without further intervention by the Commission.

Paragraph 23

93 While this states that the burden of proof lies with the applicant to satisfy the Commission on the balance of probabilities with regard to both no substantial lessening of competition and public benefit, it does not allude to the additional evidentiary concerns that arises out of the nature of the authorisation process. The Court in *Godfrey Hirst v Commerce Commission* (at 104) warns as follows:

> *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 rests on assumptions, often suggested, and on the signing dollar values it 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 provision would be unwarranted.*

94 As detailed below and in the Economist's Report, Godfrey Hirst submits that, in ascribing a specific dollar value to productive efficiency and dynamic efficiency losses, and to the claimed benefits from sale of surplus land and plant, the Commission has ignored the Court's warning.

Paragraph 38

95 Godfrey Hirst has already requested that the Commission hold a conference for the reasons set out in Chapman Tripp's email of 8 April 2015. It will be further apparent from the seriousness and substance of the matters raised in this submission that a full and public hearing is required.

Paragraphs 41 to 46

96 While the acquirer, CWH, is presently 50% owned by Cavalier Bremworth and associated with Cavalier Bremworth (as the Commission determines in paragraph 80), implementation of the acquisition will result in Cavalier Bremworth's (and ACC's and Direct Capital's) shareholdings being substantially reduced and Lempriere becoming a 45% shareholder. Further, as discussed above, Lempriere has the contractual right to proceed immediately to a 72.5% shareholding by acquiring the shareholdings of Direct Capital and ACC. The Commission cannot be satisfied that any conditionality attaches to exercise of the Lempriere Option.

97 Further, given Lempriere's initial 45% shareholding, its right to appoint two directors and contractual arrangements, it is clear that Lempriere and CWH will be similarly associated and should also be considered as one head in the relevant markets.

98 Further, and importantly, the scenario of Lempriere acquiring a 72.5% shareholding either upon the outset or at some time within the exercise period of the Lempriere Option must also be considered in the context of the Commission's benefit and detriments analysis. Critically, Lempriere by virtue of its own oblique shareholding

is a foreigner - and benefits to foreigners are to be counted only to the extent that they also involve benefits to New Zealanders. That is clear from the Commission's own *Guidelines to the Analysis of Public Benefits and Detriments*.

Paragraph 53

99 The observation that Godfrey Hirst's purchases of scoured wool have "decreased significantly" since the Decision 725 is misplaced and potentially misleading. Godfrey Hirst remains a major acquirer and processor of scoured wool. As such it has a major interest in the fate of New Zealand's wool scouring industry. To the extent that Godfrey Hirst's wool purchases may have reduced owing to changing consumer preferences and increasing import competition, those same factors are relevant to Cavalier Bremworth. Godfrey Hirst's interest in this matter remains as vital as it was in 2011; and certainly as vital as the interest of Cavalier Bremworth.

Paragraph 54

100 The wool merchants should include W G Robinson, J L Crichton and John Marshall.

Paragraph 59

101 The use of percentage changes in this paragraph distorts the picture because the size of the total wool clip has also decreased. In particular, the implication in paragraph 59.3 that exports of unscoured greasy wool have increased from 22% to 27% of the total wool clip. This conceals the fact that actual volume of exports of unscoured greasy wool has only increased slightly. It is the fact that the overall clip has reduced which results in greasy exports now representing a greater share.

Paragraphs 64 to 68

102 The focus on the reduction of the total wool clip and the consequent volumes of wool scoured overlooks the fact that demand for scouring services - like demand for milk processing and livestock processing – occurs at the peak of the season. Wool cannot be processed before sheep are shorn; and climatic conditions and wool growth determine when shearing can occur. Once the sheep are shorn and wool becomes available, it is usually processed and sold as soon as possible.

103 The peak for scouring may be for as little as one month or as much as two. Its duration is dictated by wool supply, with the busy period for cross-bred wool being through the summer – the North Island usually starting in January and the South Island following a few weeks later. The season usually lasts for two to three months after which volumes coming from growers gradually declines. The South Island also experiences a Merino season which peaks around August or September. However as most of the Merino wool is exported greasy, scouring it is comfortably accommodated.

104 The proposed rationalisation – which would see Awatoto left as the only scour in the North Island and Timaru as the only scour in the South Island – would exacerbate exposure to under capacity or catastrophic event at the peak of the season.

105 Shifting wool between those two remaining scours would not provide a solution to peak demand or breakdown as that would involve substantial additional cost. The cost of moving greasy wool inter-Island between Napier and Timaru is around $25 per bale or 15c per kilogram for greasy wool and then around $1,600 per container

or 6.25c per kilogram greasy for the return of the scoured wool. That results in a total of 21.5c per kilogram for Inter-Island movement. However, this figure takes no account of the cost of capital required to fund the delay which would be at least two weeks. Two weeks' funding at the current price of wool adds another 1.15c per kilogram. In total resort to inter-Island scouring would add an additional 22.65c per kilogram.

106 All that exposure – at least for North Island growers – could be averted by retaining the Clive scour as a back-up facility as was proposed in Decision 725. The applicant must explain why this has changed.

Paragraph 71

107 The Court in *Godfrey Hirst v Commerce Commission* also made some observations as to how the Commission should properly approach its analysis of benefits and detriments, which are highly relevant to the present application. In particular, its mandate (at 116) that:

> *Where 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.*

108 Equally relevant is the Court's observation (at 115) that:

> *Judgment will include an assessment of the quality of information on which the quantitative analysis was carried out.*

109 Further, there is the Court's observation (at 105) that:

> *It may well be that the uncertainties surrounding [a precise quantitative] 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 … 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 of the balancing exercise.*

Paragraphs 73 to 80

110 Clearly given its 50% shareholding, ability to appoint two directors, supply arrangements and the close interaction with CWH means that Cavalier Bremworth (together with its own parent company, Cavalier Corporation Limited) should be properly treated as associated and regarded as one head in the market. As indicated above, however, this section should go on to state that upon, and by virtue of, the acquisition, Lempriere in turn will have a substantial degree of influence over CWH.

Paragraphs 81 to 89

111 Godfrey Hirst acknowledges that the market definitions proposed in the application are appropriate to isolate the key competition issues that arise from the application.

Paragraphs 92 to 105

112 Godfrey Hirst makes no comment at this time.

Paragraph 114

113 The proposal to decommission the scour at Clive from the outset and sell the Clive site (subject to a covenant to exclude future wool scouring or related activities on the site for a period of 50 years) is a substantial departure from the rationalisation which the Commission authorised in Decision 725. CWH argued throughout the previous authorisation process that it was necessary that Clive be retained for over-run processing and as an emergency contingency site. This was expressly acknowledged by the Commission. The onus must be on the applicant to demonstrate – on the balance of probabilities – why that over-run capacity and contingency site is no longer required.

114 That is especially so, given that the one-off benefit claimed by the applicant and allowed by the Commission in the draft determination for the sale of the land and plant at Clive is what makes the net impact positive. Put simply, without the sums allowed for sale and land and plant at Clive, the Commission's own analysis in Table 8 would show that (under the worst case scenario) there would be overall net detriment.

115 The same point arises in relation to the proposed sale (or relocation) of the 2.4 metre scour line at Timaru, which last time was simply to be moth-balled but retained for contingency. This time a substantial resale value has been claimed, and accepted in the draft determination, for that scour. While that figure of itself is not sufficient to remove the whole of the small overall net benefit figure shown in Table 8, it does reduce that net benefit figure substantially.

116 Put bluntly, it would appear that the proposal this time to sell both scours and the scour site at Clive are driven not by any considered rationalisation proposal so much as the need to inflate the benefits figure. Even the Commission's own analysis (at paragraph 246.2) recognises the uncertainty that surrounds the supposed sale of the scouring sites and surplus scouring assets.

117 There is even more speculation attached to the supposed "possibility of contributing scouring assets to a potential joint venture rather than sale". That uncertainty falls well below the threshold mandated by the Court in *Godfrey Hirst v Commerce Commission*.

Paragraph 140

118 The decline in volumes of greasy wool not being exported is not a result of increased demand from China for wool. It is a result of reducing demand for woollen carpets resulting in reduced woollen carpet production within New Zealand. In addition there have been two spinning mill closures (Summit Wool Spinners and Christchurch Yarns) which have resulted in a permanent reduction in the volume of wool being further processed in New Zealand. This would be obvious from woollen yarn export statistics and is not a result of increased competition for wool scouring from China. Competition from China for woollen yarn together with increasing competition from synthetic fibre are the real reasons for the change.

Paragraph 143

119 To put the increase in greasy wool exports to China into context, it should be noted that greasy wool exports to other countries, especially North America and Europe, have declined over the same period. Thus, total greasy wool exports are only slightly above volume, but given the reduced wool clip this seems more significant in percentage terms. As Godfrey Hirst showed at the conference held in 2011, taken over a longer period, greasy wool exports are still substantially below levels of the late 1990's. In this respect greasy wool export volumes have not increased but are still substantially less than what they were previously.

Paragraph 151

120 Godfrey Hirst's recollection is that it told the Commission that CWP scours mostly fine wools (rather than fine wools only).

Paragraph 152

121 Godfrey Hirst approached James Irvine and asked him to obtain some competitive scouring tariffs from Chinese scourers for New Zealand cross-bred wool. James Irvine was able to identify two Chinese scours which expected to be able to process New Zealand cross-bred wool in the future; but declined to provide current tariffs on the basis that they could not provide the service required at present.

Paragraph 156

122 Godfrey Hirst has detailed recent experience at assessing the suitability and availability of overseas scours, which it has already shared with the Commission. Godfrey Hirst visited China in 2011. While there was some capacity to scour crossbred wool, the only companies which were interested were not suitable, mostly for reasons regarding quality, environmental concerns and inadequate equipment.

123 With regard to equipment, Godfrey Hirst was unable to find a single overseas wool scour with the equipment necessary to blend and open wool which is an integral part of the scouring of New Zealand wool. The other vital component was pressing, which would result in significant additional shipping costs.

124 Godfrey Hirst's experience of wool scoured in China, and elsewhere, resulted in heavily entangled, poorly scoured wool which was not able to be further processed. It is not a viable alternative.

125 Attached as Appendix D are some photos from two scours that Godfrey Hirst visited in 2011, at least one of which is included on CWH's schedule included in the Application.

126 [

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127 The processing capacity of Chinese scours identified by CWH is also a concern, particularly the medium and smaller operations of less than 5000T p/a. To put this in perspective, only the first five Chinese scours recorded have an annual capacity

even close to Godfrey Hirst's annual wool requirement. Broken down, of the 34 Chinese scours suggested as viable options seven have an available annual capacity equivalent to less than one month of Godfrey Hirst's annual wool requirement, 13 less than three months and more than half less than six months. Further, of the top five that apparently have the capacity, two do not offer commission scouring.

128 In comparison, the annual capacity of each of the three 3 metre wool scours currently working in New Zealand is approximately 33000T or more than three times the capacity of the largest Chinese example cited by CWH.

129 Put simply and notwithstanding the complete lack of any wool preparation and inadequate pressing equipment, the Chinese scours suggested by CWH do not have the scale necessary to offer a viable alternative.

Paragraph 158

130 The draft determination suggests that Chinese scouring poses a long term threat to the domestic industry in New Zealand. That is inconsistent with all of the information that Godfrey Hirst provided to the Commission, which has not been refuted. Certainly, it is inconsistent with Godfrey Hirst's own experience, as further described above.

131 The draft determination deduces that availability of Chinese scouring places constraint on CWH's ability to increases prices – albeit to a level higher than 5-10%. But that constraint is only relevant to those customers for whom overseas scouring is practicable. Overseas scours provide no constraint for any New Zealand manufacturer who wants to process New Zealand wool, or indeed to New Zealand growers who want to see their wool further processed in New Zealand.

Paragraph 161

132 In fact the Australian industry also endeavoured to rationalise by removing over-capacity; but eventually was unable to do so sufficiently. The reason that scouring remains a viable industry in New Zealand is because the local yarn spinning and carpet manufacturing industries require access to scoured wool. This is also why the survival of a competitive and efficient scouring industry is vital to local carpet manufacturers including Cavalier Bremworth and Godfrey Hirst.

133 In reality, both those carpet manufacturers have a vital practical interest seeing the Application declined. In Cavalier Bremworth's case, that interest will become very real once the Lempriere Option is exercised and shareholders' interests radically diverge.

134 Without a local carpet manufacturing industry in New Zealand the wool scouring industry would also move offshore in a very short timeframe as has happened in Australia.

Paragraph 169

135 Godfrey Hirst cannot comment on the claimed suitability for continued availability of the sites identified in Decision 725 as those sites remain confidential. However the former Louis Woods site at Awatoto has been sold and is no longer available.

Paragraph 171

136 The starting point here is that the restrictive covenants to be placed on the Whakatu, Kaputone and Clive sites have been included in the Agreement for Sale and Purchase in an attempt to characterise them as integral and inter-dependent components of the acquisition for which authorisation is sought. The plain fact is that they are not. Rather, they are elements of a rationalisation process that is intended to occur at some time following the acquisition, which rationalisation process has been agreed between all of CWH and its current shareholders, and Lempriere. That agreed process itself constitutes a restrictive trade practice for which separate authorisation is required.

137 The fact that the Commission recognises (at paragraph 246.2) that the sale of the Kaputone, Whakatu and Clive sites may not occur within a five year period, demonstrates that the rationalisation process – and especially imposition of the covenants – is not part of the acquisition proper. As such they should not have been included in the Agreement for Sale and Purchase as opposed to the Shareholders Agreement or other document. They are included in the Sale and Purchase Agreement solely for the purpose that they been seen as part of the Commission's authorisation if that were granted.

138 The explanation provided to the Commission by CWH as to the supposed commercial reason for the restrictive covenants is equally fatuous. Having sites that are redundant to CWH available to a new entrant would not "give such a new entrant an advantage", as is claimed. Rather, it would put the new entrant on a similar competitive footing. Any new owner of the site would still have a significant amount of work to do to transfer any existing consents and would have to work within whatever legislative and other restrictions presently exist.

139 As regards the Clive site, Godfrey Hirst acknowledges that that site is unusual in that the buildings are configured in a manner that especially suits a wool scour. In particular, it has an open floor plan that will accommodate a scour which is over 100 metres long, with room for wool preparation, grease recovery and effluent treatment and storage at each end. But, CWH has not "invested significant time, effort and money [in that site] to set it up in a manner that reflects the parties' belief that it is best for scouring", as is claimed. Rather, CWH has purchased that site with existing consents in place with no effort required other than payment of the then market price.

140 What CWH omits to mention – and what the Commission's acceptance of CWH's claims in respect of sale of surplus land fails to reflect - is that the "recent third party valuations" of the Whakatu, Kaputone and Clive sites submitted to the Commission make no allowance for [ ] of those sites as a result of the covenants being imposed.

141 Cavalier cannot have it both ways. If those covenants are being imposed to prevent any new entrant having a "step up" because those sites are regarded as "best for scouring" as the current owners themselves have told the Commission (Cavalier submission quoted in paragraph 171 of the draft determination refers), the imposition of covenants which deny that "best [use] for scouring" for a period of 50 years must substantially reduce the value of those sites.

142 All this is explained more fully below and in the Valuer's Report.

Paragraphs 179 to 180

143 The total cost of new entry of $10 million suggested by James Irvine is not feasible. James Irvine has provided Godfrey Hirst with a price estimate of US$3 million for a new 3m wide wool scour including grease recovery. Additional to this would be a wool press (including dust handling), bale corer and wool analyser and greasy wool preparation equipment. Full costing of a new scour is summarised as follows.

PLANT AND EQUIPMENT				
Item	**Details**	**Qty**	**Cost**	**Totals**
Sorting Floor	Feed hoppers	4	320,000	
Sorting Floor	Weighbelts	4	140,000	
Sorting Floor	Controller	1	50,000	
Sorting Floor	Short wool openers	2	200,000	
Sorting Floor	Decotter	1	180,000	
Sorting Floor	Conveyors etc	1	60,000	
Sorting Floor	Opener/blender	1	120,000	1,070,000
Scour	Scour USD3M per James Irvine	1	4,000,000	
Scour	Scour install/electrical	1	200,000	4,200,000
Press	Press, ducting & install	1	2,000,000	
Press	Corer	1	300,000	
Press	Wool testing	1	150,000	
Press	Dust system	1	120,000	2,570,000
Automation and Control	Included in scour cost			0
Grease recovery	Included James Irvine price			0
Services	Compressed air and reticulation	1	100,000	
Services	Included James Irvine price	1	50,000	
Services	Not needed (direct gas burners)	1	0	150,000
Consultancy	Engineering & Design			80,000
Total - Plant and Equipment				**$8,070,000**

144 Land and buildings are additional to the above. Godfrey Hirst summarises the estimated cost of these, both on a Greenfields development and existing property purchase scenarios as follows:

LAND AND BUILDINGS				
	Greenfields Site		**Existing Site**	
Site	Assume undeveloped	1,000,000	Assume existing property,	2,000,000

	site in established Industrial Park, 15000m2		approx 15000m2, 8000m2 buildings	
Buildings	8000 m2 building, $700 psm	5,600,000	Building modifications	1,000,000
Yards	Sealing/landscaping	500,000	Improvements/repair only	100,000
Water	Bore	100,000	Assume existing	0
Effluent services	Connect to Municipal sewer	150,000	Assume existing, connections	50,000
Consultancy	Resource consent	100,000	Resource consent	100,000
	Engineering & design	100,000	Engineering & design	100,000
Total - Land and Buildings		**$7,550,000**		**$3,350,000**

145 Godfrey Hirst has not considered the possibility of a new entrant becoming established with second-hand plant because there are simply no suitable second-hand plants available. Presumably, the equipment that will be surplus to CWH's requirements at Clive and Timaru would not be made available to any potential competitor.

146 As can be seen from the above costings, the minimum cost to set up a new scour , assuming a suitable existing site could be found (which itself is doubtful) is at least $11.5 million and in excess of $15.5 million if a Greenfields development is necessary. Only if an existing site (such as Clive) that is "best for scouring" could be acquired, would it be possible to set up a scour for around $10 million.

147 Plant location would also be critical to the new entrant's success' with its site needing to be close to the wool supply and an export port. Locating a new scour in Dannevirke, for example, would disadvantage the new entrant by several cents per kg of scoured wool due to higher inwards and outwards cartage costs. To put this in perspective, assuming an annual throughput of 100000 bales (16.5Mkg), every cent of additional cost would equate to $165K.

Paragraph 183

148 All the merchants identified split their wool scouring between both islands so either the new entrant would require a plant in each island (thereby doubling their establishment cost) or accept, at least 20c/ kg of additional cost to account for the inter-island freight.

Paragraph 199

149 A new entrant would be disadvantaged if they installed anything less than a 3 metre wide scour. This is because the extra working width comes at a minimal additional cost and costs little more to operate than a 2.5 metre scour so is therefore much more efficient on a cost per kg processed basis.

Paragraph 201

150 Godfrey Hirst challenges the statement by James Irvine that a scour could be established (including buildings and plant) within six months. A more likely timeframe is 12 months minimum and more likely 18 months total.

Paragraph 202

151 The draft determination indicates that entry fails the LET Test as entry is unlikely to occur without at least 10% increase in wool scouring prices. It then refers to the discussion at paragraphs 250 to 260 of the draft determination indicating that a potential scouring price increase of more than 20% is unlikely because of the customer's ability to switch to exporting more greasy wool. That option of course is not available to Godfrey Hirst or other New Zealand manufacturer that wants to use New Zealand grown wool.

152 For the reasons set out in the Economist's Report, Godfrey Hirst submits that it is quite plausible for price increases of up to 25% to be imposed by CWH post-acquisition without triggering new entry. The extent to which threat of new entry would provide a cap on the levels of detriment needs to be adjusted accordingly.

Paragraph 204

153 Godfrey Hirst submits that price increases of up to 25% could occur without triggering entry.

Paragraph 205

154 Godfrey Hirst agrees with the Commission's conclusions in relation to its finding as to the effect of substantially lessening competition in both the North and South Island markets for supply of wool scouring services.

Paragraphs 206 to 223

155 Godfrey Hirst agrees with the Commission's conclusion as to a substantial lessening of competition in the wool grease market.

Paragraphs 224 to 235

156 The Commission's finding that the acquisition is unlikely to have the effect of substantially lessening competition in the downstream carpet manufacturing market under estimates CWH's ability to price discriminate in favour of its shareholder, Cavalier Bremworth. The involvement of Lempriere as a 45% shareholder is no panacea - Lempriere might well acquiesce if its own use of scouring services were subsidised by the additional scouring charges imposed on Godfrey Hirst. The Commission already recognises that Godfrey Hirst and other users face a price increase of up to 20% before exporting greasy wool and threat of entry becomes a constraint. Exporting greasy wool is not a prospect for Godfrey Hirst of course.

157 Benefits and Detriments generally The Economist's Report deals with the detriments and benefits referred to in the Application, wealth transfers to and from New Zealanders; and carries out its own quantification of detriments and benefits having regard to its own conclusions and the various factual scenarios to which the application gives rise. Those scenarios include:

157.1 Lempriere holding 45% of CWH for all of the five years under consideration;

157.2 Lempriere holding 45% of CWH for some of that time and then extending its shareholding to 72.5%;

157.3 Lempriere exercising the Lempriere Option immediately and increasing its shareholding to 72.5%; and finally

157.4 Lempriere exercising the Lempriere Option and subsequently exercising the Drag-along right to procure the sale of all of the shares in CWH to an overseas person.

158 To cut to the chase, the conclusions in the Economist's Report and quantification of benefits and detriments in light of those conclusions, substantially change the estimated net impact as described in Table 8 of the draft determination . Very briefly, the Commission's best case (low detriment/high benefits) figure reduces from $23.23 million to $10.83 million for the factual scenario where Lempriere takes only its initial 45% shareholding. If however Lempriere exercises the Lempriere Option in year 1, that best case net benefit reduces to $1.13 million.

159 The worst case (i.e. high detriment/low benefits) scenario present a much bleaker picture. The Commission's current small overall net benefit figure of (now) $2.51 million reduces to an overall net detriment of -$22.15 million on the basis that Lempriere stays at 45% of CWH. Again, if Lempriere exercises the Lempriere Option in year 1, that overall net detriment figure increases to $32.10 million.

160 But it gets even worse. If, in year 1 Lempriere exercises both the Lempriere Option and the Drag-along right to procure the sale of all of the shares in CWH to a foreign entity, the effect is that the best case outcome becomes an overall net detriment of -$8.58 million, with a worst case scenario outcome of -$42.06 million.

Paragraph 246

161 The Commission states that its use of the five year time period and 10% discount rate recognise the fact that most detriments and benefits become increasingly uncertain over time. That it especially the case with the current application. While it may be assumed that if authorisation were again granted, CWH's acquisition of the NZWSI assets might occur within the prescribed 12 months from date of authorisation, there are a range of potential post-transaction factual scenarios affecting CWH as acquirer. They include not only Lempriere acquiring a 45% shareholding in CWH; but also Lempriere's ability to exercise both the Lempriere Option and the Drag-along right.

162 The Lempriere Option itself contains a temporal element to the extent that the Original Option must be exercised by 31 December 2016. There is then a Second Option, exercisable at a presumably higher price, which must be exercised no later than 31 December 2018. If the Second Option expires, further options may then be agreed, presumably at prices that become higher again.

163 This three-tiered regime suggests that it will be in Lempriere's commercial interest to exercise the Lempriere Option sooner rather than later.

164 The timing of exercise of the Lempriere Option of course has implications for the exercise of the Drag-along right, which in effect requires Lempriere to have acquired a [ ]% shareholding before that right can be exercised.

165 At least there is reasonable predictability as to prospective timing of those factual scenarios.

166 With the claimed benefits, especially the benefits claimed to arise from the sale of redundant scour sites and scouring assets, there is no predictability as to timing. The Commission acknowledges that these sales may not occur within the five year period. Indeed, the Commission also acknowledges that the redundant scours may not be sold at all but rather employed in some future joint venture.

167 Dismantling, removal, cleaning and packing of a scour to effect its transfer to a new location is not a simple matter, especially [ ]. Considerable delay and costs will be involved in freighting the scour [ ], then reassembling and commissioning it in its new location. Scours are not "plug in and play" machines. They need to be properly set up and have complex co-ordinated electrical reticulation as well as process piping and services.

168 In short, considerable time passes while all that occurs; and that relocation process cannot even start until either sale or joint venture arrangement has been negotiated. Importantly, as the Court noted in *Godfrey Hirst v Commerce Commission* (at 281): "The benefit lies in the release of surplus resources for other economic uses." No benefit flows until those surplus scours and sites are in fact released.

169 There will be no income stream at all resulting from the scouring assets in the interim.

170 Turning to the Whakatu, Clive and Kaputone scour sites, there is no factual basis for the unsubstantiated claim in the draft determination that "these sites may be used to derive rental income". As is shown in the Valuer's Report, [

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Paragraph 247

171 The finding that constraints are imposed by the continued growth of the Chinese wool scouring industry is misplaced. The export of greasy wool for scouring in China is only an alternative for those parties who do not intend to further process that wool in New Zealand. Godfrey Hirst is a significant user of local scouring services, as are other New Zealand carpet manufacturers, Cavalier Bremworth and Carpet Mill. Indeed, there is the possibility that Cavalier Bremworth itself may become exposed to price gouging by CWH once its current shareholding in that company potentially disappears upon exercise of the Drag-along right. When Cavalier Bremworth becomes a minority shareholder, or ceases to be a shareholder in CWH, CWH will have every incentive to increase its scouring tariff and/or decrease rebates paid to Cavalier Bremworth, too.

172 No reference is made in the Application or draft determination to Cavalier Bremworth's ongoing scouring arrangements with CWH. This contrasts with the detailed provision made in the agreed form of letter agreement and clause 10 of the Shareholders Agreement [

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173 Given those potential consequences for both major New Zealand users of scouring services, there is no foundation for the Commission's finding of "little if any detriment".

Paragraphs 249 to 282

174 The Commission's estimated allocative efficiency losses, amounting to the not insignificant range of $4.58 million to $20 million, is based on its assessment of price increases potentially ranging from 10% to 20%. As is explained in the Economist's Report, that range of potential price increase is too modest. The economic literature and econometric evidence all indicate that a range up to 25% is at least as plausible.

175 The Commission's reason for stopping its range at 20% is simply its speculation that at this price level merchants could switch to exporting more greasy wool. The correct analysis however shows that the price for scouring services for "captive" wool could be considerably more than 20%, as shown in the Economist's Report. Confining the prospect of a price increase to 20% is too modest.

176 Allowing for the real chance that CWH will increase its scouring prices by up to 25%, the Economist's Report recalculates the range of allocative efficiency losses as between $4.58 million to $25.96 million.

Paragraphs 283 to 293

177 In Decision 725 the Commission estimated that the upper range for loss of productive efficiency would be between 1% and 5% of pre-merger variable costs. It then adopted a midpoint of that range namely, 3%. The Court in *Godfrey Hirst v Commerce Commission* criticised the Commission for not giving reasons for adopting the midpoint and indicated that unless there were reasons why any other figure in that range was unlikely, any other figure within the range may be just as likely as that midpoint. The Court thus adjusted the Commission's estimate for productive efficiency losses by applying the whole of the 1-5% range instead of the midpoint.

178 The draft determination seeks to obviate the Court's advice by adopting the lowest point of its former range on the basis that there would be future shareholder incentive to continue to drive productive efficiencies (paragraph 286); and additionally, a substantial proportion of CWH's current staff have "incentive-based remuneration schemes" and similar remuneration schemes would be extended "to many of the additional staff that CWH would employ".

179 Neither of those reasons survives close examination. The Economist's Report details the literature demonstrating the diverse and diverging shareholder incentives. In particular, the existence of the Lempriere Option motivates Lempriere to seek different outcomes and pursue different incentives to its co-shareholders. Put bluntly, the Commission's expectation of shareholder unanimity ignores the very real prospect of option-induced conflict.

180 The Commission's reasoning based on staff remuneration schemes is equally vulnerable.

181 Attached as Appendix E is the Commission's response to Chapman Tripp's Official Information Act request for all information regarding the staff claimed remuneration schemes. That information is confined to a letter dated 11 March 2015 from CWH to Bell Gully which refers very briefly to:

181.1 [ ] for all staff members that are designed to improve quality and productivity;

181.2 For [ ].

182 Later in that memo under the heading "staff monitoring and bonus incentives" there is slightly more detailed reference as follows:

> *[ ].*

183 The Commission confirmed that this is the only material that it has received on the topic. Many firms – and many failed firms – could claim similar [ ] arrangements. They are a blunt tool that can lead to perverse outcomes and provide no guarantee of productive efficiency.

184 The Economist's Report explains in detail why performance-based remuneration schemes cannot be relied upon to ensure productive efficiency.

185 Turning then to the claim that these schemes would be extended to "many of the additional staff as CWH would employ", there are no proposals that additional staff will be employed.

186 On the contrary paragraphs 313 to 319 of the draft determination refer seriatim to: "workers that would no longer be required; [ ]; [ ]; [ ]; [ ] and of course not least, "the social cost of redundancy".

187 In summary, fewer staff supposedly are going to be incentivised by incentive-based remuneration schemes that are bog-standard across many industries.

188 More real is the question of how effective those incentive-based remuneration schemes have been in driving CWH's productivity performance to date?

189 There is no proper basis for the Commission adopting the lowest possible point for loss of productive efficiency rather than the range previously mandated by the

Court. Thus, the Economist's Report applies the 1% to 5% range of productivity efficiency loss to produce a range of $[ ] million to $[ ] million.

Paragraphs 294 to 303

190 The position adopted by the Commission with regard to dynamic efficiency loss is similar to its position in relation to loss of productive efficiency; and that approach may be similarly criticised.

191 Again, some historical context is required. In Decision 725 the Commission adopted the quantification approach of multiplying total industry revenue by a factor. It estimated the appropriate factor to range from 0 to 1%, from which range the Commission took its midpoint of 0.5%.

192 The Court in *Godfrey Hirst v Commerce Commission* criticised this approach to the extent that the Commission had not stated why it started its range at zero or why it determined the midpoint of that likely range as a most likely figure. The Court found this approach "confusing" because other figures above and below that most likely midpoint figure were still said to be likely. Because of uncertainties in quantifying dynamic inefficiencies and the absence of reasons for adopting the midpoint the Court substituted a figure for dynamic efficiency losses that went to the top of the Commission's range.

193 With the Application, the Commission acknowledges that it is difficult to calculate precise dynamic efficiency losses with any strong confidence (paragraph 298). But it gives "a number of reasons" why such losses may be "limited". Those reasons are:

193.1 Shareholders have a strong profit maximising incentive;

193.2 Innovation tends to be limited to improved processes rather than new products;

193.3 Long-term competitive threat of the scouring industry in Asia.

194 On the basis of those reasons, the Commission takes a point estimate of 0.5% being effectively the same as its midpoint as previously adopted in Decision 725 (and criticised by the Court), but arrived at differently.

195 To address them sequentially, as outlined in the Economist's Report the potential for Lempriere Option –induced conflict among shareholders applies with equal effect in relation to dynamic efficiency losses. As indicated elsewhere the advent of Lempriere as a shareholder and the potential for the Lempriere Option to make it the majority shareholder represent a significant departure from the scenario under Decision 725.

196 Second, the claim that innovation in the sector is limited, was a factor raised and taken into account last time. It is not a new reason.

197 Third, the Commission appears to misunderstand the nature of the competitive threat posed by the scouring industry in Asia. In particular, it misinterprets the

Australian experience. Greasy wool exports from Australia became more attractive to China once downstream processing had relocated and this resulted in reduced demand for scouring in Australia. The rationalisation of scouring in Australia occurred *after* and *because of* the relocation of further processing, largely to China. New Zealand is different in that there is still further processing in New Zealand (mostly by Godfrey Hirst and Cavalier Bremworth), so it is still necessary for wool scouring to be carried out locally. The comment that scouring "has all but disappeared because of greasy exports to China" confuses the cause and effect of the Australian experience.

198 In any event, Asian interests may well prove less of a threat to Lempriere, as that company itself is majority owned by RuYi, which itself is believed to be owned by a consortium of investors with industry involvement in China and Japan. The Commission has not considered Lempriere's or RuYi's overseas involvement in relevant industries.

199 Against that uncertain backdrop as to Lempriere's own incentives and intentions, the Commission cannot revert to its previous midpoint but in different guise.

200 The Economist's Report calculates dynamic efficiency losses using the range up to 1% of industry revenue previously mandated by the Court.

Paragraphs 304 to 305

201 As indicated above, the productive efficiencies claimed to constitute public benefits arising from the transaction are not in fact "transaction specific". To the extent that those efficiencies do not themselves arise directly from CWH's acquisition of the assets of NZWSI. Rather, they are benefits that are claimed will arise from a rationalisation that has been agreed between CWH and its present shareholders and Lempriere (as the present owner of the NZWSI assets and the potential shareholder of CWH). Those agreed future arrangements include the imposition of restrictive covenants, the rearrangement or disposition of scouring assets, and the sale of scouring sites.

202 As submitted above, proposed rationalisation will be given effect to by restrictive trade practices, which also require authorisation by the Commission.

Paragraphs 306 to 330

203 The biggest item, by far, claimed in the Application as public benefit are the non-capital cost savings/economies of scale claimed to result from consolidation of Cavalier's and NZWSI's scouring lines from five sites to two sites. Significantly, such consolidation this time will include the dismantling of the scour at Clive and the eventual sale of that site and scour, rather than its "moth-balling" as was the position in Decision 725. This time, too, the "surplus" 2.4 metre scour at Timaru and the effluent equipment at Kaputone will also be sold. These items were also not included in Decision 725.

204 In reality, the claimed cost savings are a composite of various items, the detail of which is almost impossible for any interested party to unpick without reference to the "one-year" model to which the NERA report refers.

205 The NERA report also notes (at paragraph 2.1) that "the expected timing of these benefits varies, and it is likely that not all of the benefits will be realised on day one of the merged firm's operations". However, despite this, when NERA calculates the present value of the merger's benefits and detriments it assumes that they all will occur from the day CWH obtains total control of all New Zealand's scouring capacity, being the "pragmatic" approach the Commission is said to have applied in Decision 725.

206 But, for the reasons already described, the various transactions required to effect consolidation are different than previously and are anticipated to occur over different timeframes. This time, the Commission has expressly accepted that the sale of the Kaputone and Whakatu sites – together now with the Clive site – may not occur within five years. There is similar uncertainty as to when – even whether – the now redundant scours will be sold.

207 Those scours, and certainly those sites, all will require maintenance, insurance, electricity lines and electricity and other services until they are sold – or at least until they can be leased to cover in part some of those ongoing costs pending sale. But as is pointed out in the Valuer's Report, leasing of those sites will not be easy; is unlikely to comprise the whole of the site; and cannot be assumed to derive a particular level of rental income.

208 In contrast, NERA's casual aside that "the same could be said for the expected detriments" is sloppy economics.

209 The merged firm's increased market power will run from the day CWH obtains total control of all New Zealand's scouring capacity. Parties having to negotiate scouring rates will know on day 1 that the newly merged CWH has the ability to increase prices/reduce service levels with little constraint.

210 The same applies to productive and dynamic efficiency losses. Management will know, again from day 1, that going forward they will be the only game in town. The monopolist's double curse of inefficiency and lack of innovation will apply from the very day CWH acquires control of the NZWSI assets.

211 What NERA's attempt to equate timing of benefits and timing of detriments does is illustrate the truth of Godfrey Hirst's submission that consolidation in fact – and certainly in law – involves two separate elements, both of which require Commission authorisation. The first element is the acquisition of control of NZWSI's scouring assets, from which date the detriments inevitably will apply. The second element involves the various arrangements – including the sale of redundant sites and scours - from which consolidation and rationalisation the benefits are claimed to materialise. Those benefits will not appear on day 1; are likely not to appear on day 366; and possibly may not arise until after five years.

212 Set out below are the particular categories of proposed cost savings to which the Application points. These are set out together with the figure for that saving claimed in the Application; the figure accepted provisionally in the draft determination; and the figure for the equivalent saving previously allowed by the Commission/Court in Decision 725.

Table : Claimed non-capital cost savings ($ million)

		Application	Draft Determination	Decision 725
(i)	Reduction in salaried and waged staff	[ ]	[ ]	[ ]
(ii)	Reduction in administrative expenses, e.g. insurance	[ ]	[ ]	[ ]
(iii)	Reduction in repairs and maintenance	[ ]	[ ]	[ ]
(iv)	Reduction in variable electricity costs and line charges	[ ]	[ ]	[ ]
(v)	Reduction in coal and gas costs	[ ]	[ ]	[ ]
(vi)	Reduction in effluent costs	[ ]	[ ]	[ ]
Total annual savings		[ ]	[ ]	[ ]
5 year NPV		[ ]	[ ]	[ ]

213 That table is very revealing. First, its shows that substantial savings are claimed for items, such as insurance, repairs and maintenance and line charges, all of which will continue to apply to the Clive site until eventual sale.

214 Second, a substantial increase in savings (from Decision 725) is claimed for repairs and maintenance on the basis that the redundant Clive and Timaru scours will be sold rather than "moth-balled" as previously. The savings presumably attributable to the cost of having to repair and maintain those two scours is equivalent to the amounts that the Application claims CWH will receive from the eventual sale of those scours. That does not seem right.

215 Third, and most surprisingly, the Commission's total non-capital cost savings figure of $[ ] million to $[ ] million (paragraph 330 of the draft determination) substantially exceeds the total savings of $[ ] million claimed in the Application (paragraph 25.15) – with significant consequences for the 5 year NPV figures.

216 The reason for that difference is the Commission's differing treatment of savings attributable to reduction in [ ] costs. While the Application (paragraph 25.32) claims $[ ] million for this category, the draft determination (at paragraph 329) allows a saving of $[ ] million.

217 The draft determination (at footnote 106) attributes that higher figure to a Lempriere/NZWSI submission of 28 October 2014.

218 That raises very serious questions, namely:

218.1 What changed in the 6 days between the date of the Application and Lempriere's submission;

218.2 Why has the Commission preferred Lempriere's figure to that used in the Application and by NERA;

218.3 How has Lempriere's figure been tested?

218.4 Why was attention not drawn to the discrepancy immediately upon the Commission's receipt of the Lempriere submission?

218.5 Why was the Lempriere submission only released - among seven documents not previously provided to Chapman Tripp under the Official Information Act on16 March 2015 - despite Chapman Tripp's earlier extant request under that Act?

219 The effect of that discrepancy from the Application and NERA report is substantial; and Godfrey Hirst has been significantly disadvantaged by its non-disclosure.

220 The difference between the competing claims of CWH and Lempriere is highly relevant, especially when the Commission's margin for error is so very narrow.

Paragraphs 331 to 334

221 The draft determination notes the Court's finding in *Godfrey Hirst v Commerce Commission* (at 281) that:

> The benefit lies in the release of surplus resources for other economic uses; and the best use of the value of those alternative uses is the price likely to be paid for the surplus resources.

222 The Commission goes on to attribute likely sale prices for the Whakatu, Kaputone and Clive sites based on "recent third party valuations" provided by the applicant.

223 Those valuations were provided to Chapman Tripp in accordance with its Confidentiality Undertakings and released, to an experienced valuer under confidentiality undertakings, C W Nyberg of Darroch, with a request that he comment on the valuation methodology used in the preparation of those "recent third party valuations".

224 His Valuer's Report notes:

224.1 The reports were prepared in early-mid 2014 for financial and accounting purposes of CWH;

224.2 The historical use going forward is to be a different use with a covenant that would expressly exclude use of the premises as a wool scour;

224.3 Because of these changed circumstances, a high degree of reliance needs to be placed on the alternative use – vacant possession valuation methodology;

224.4 There[

].

224.5 The valuations prepared for financial reporting [ ] based on an alternative use value – vacant possession.

225 In addition to those criticisms in the Valuer's Report, Chapman Tripp make the following observations. First, the valuations provided to the Commission are neither "recent" nor "third party". They are already quite dated (having been prepared in March, July and August 2014); and will be much more so by the time the properties to which they relate are to be sold. The Commission itself accepts that the properties might not be sold within five years of the acquisition.

226 Second, those valuations were not "third party" to the extent that term connotes independence. Rather, they were valuations obtained from valuers employed by CWH – presumably on a continuing basis - for the purpose of determining net current value of the properties as at 30 June 2014 for financial reporting purposes. The price for financial reporting purposes is not the same as the price that is likely to be paid on a willing buyer/willing seller basis.

227 Further, it is certainly not the price that will be paid for a property where the present owner's acknowledged "best use" of that property is to be effectively excluded by restrictive covenant for a term of 50 years.

228 By way of analogy, the valuation of an inner city commercial building occupied mostly by lawyers and accountants would have a value ascribed for financial reporting purposes that takes account of an expected occupancy factor and the rental that can be extracted from such firms. That would be quite different to the price likely to be paid for that same building if its use going forward expressly excluded that class of tenants. That would be especially the case if the building were not expected to be sold for five or more years.

229 The draft determination's attempt to allow for these contingencies is to apply "an adjustment of plus and minus 10%" to account for the variability in actual sale values. But none of those contingencies indicate the prospect of *any* increase in price above the valuation. On the contrary, *all* of the factors – especially those identified in the Valuer's Report – indicate that the adjustment of minus 10% is likely to be far too modest.

230 While it is better for the Commission to take a range rather than a single point where there is uncertainty, that range must be confined to figures that are likely – that is, there is a real prospect of all the figures within that range applying. Applying a "plus", when all the contingencies indicate only minus, is wrong.

231 The Economist's Report also looks at the value to society ascribed to the sale of surplus land. It notes that the Commission's calculation should begin only at the time the land starts to be used for its new, non-scouring purpose, not at the time the acquisition is approved. The land will only produce minimal benefits until the land's conversion to that other use is completed. Thus, it applies a formula to allow for varying links in this delay period.

232 The Economist's Report also notes that given the valuers who provided CWH with the valuations did not know what the land would be used for or even when the land would be sold, a much wider margin than minus 10% would be required.

Paragraphs 335 to 336

233 The benefit attributable to the release of surplus plant is equally problematic. The applicant provides its estimate of the anticipated sales of plant and equipment (being the 2 metre scour line from Clive, 2.4 metre scour line from Timaru and effluent equipment at Kaputone). According to James Irvine the resale value of each scour would be between $500,000 to $650,000. The Commission takes a purportedly conservative approach by using the lower aggregate of those estimates.

234 Godfrey Hirst, having sold scours in the past, estimates that if they were sold offshore as complete lines they could realise up to $500,000 per scour. However, to achieve that sale price they would have to be carefully dismantled, removed, cleaned and packed ready for transport from the Clive and Timaru sites. That process would cost at least $100,000 per scour. That reduces the net return from sale of the plant to no more than $800,000.

235 In addition, as the Economist's Report points out, the Commission's approach implicitly assumes that the sale occurs immediately, rather than at the end of the rationalisation period. Assuming a 10% discount, that further reduces the price effectively paid.

236 Further, closure and removal of the effluent equipment at Kaputone where cost to discharge is at Timaru. Those discharges will create greater environmental loading because the effluent will not have been treated before being discharged straight into the sea. At present Kaputone has a higher level of environmental accreditation because of its effluent plant. That accreditation will permanently be lost as a result of removal of the effluent equipment.

Paragraphs 347 to 360

237 The principle regarding treatment of all of the transfers to and from non-New Zealanders is succinctly stated in the Commission's own *Guidelines to the Analysis of Public Benefits and Detriments*. That is:

> *[B]enefits to foreigners are to be counted only to the extent that they also involve benefits to New Zealanders;*

And:

> *In general, expenditure per se by foreigners in New Zealand cannot be viewed as a public benefit; benefits only arise to the extent that such expenditures somehow generate efficiency improvements which flow to New Zealanders.*

238 The analysis in the draft determination describes in some detail the concept of wealth transfers, the potential magnitude of such transfers and the "residency status" of the various transferors and transferees. However, that analysis is confined to its calculation of the *detriments* due to loss of allocative efficiency (that is, increased prices and/or reduced service levels to users of scouring services).

239 Significantly, the Commission's analysis makes no allowance for overseas ownership when it calculates productive efficiency losses and dynamic efficiency losses.

240 Even more significantly, it makes no allowance for the effects of overseas ownership when it calculates *the benefits* of the proposed merger. Given that Lempriere will acquire an immediate 45% shareholding in CWH, and potentially a 72.5% shareholding as soon as the Lempriere Option is exercised, there is obviously substantial leakage of the benefits to foreigners.

241 The Economist's Report takes a more holistic approach and considers the effects of overseas ownership in all of its calculations of the benefits and detriments of the proposed merger, which is what the Commission's analysis should have done. In particular, the Economist's Report illustrates how the New Zealand public receives no benefit from a significant proportion of the claimed benefits that arise from reduced production and administration costs, sale of surplus land, and sale of surplus plant.

242 That "leakage of" benefit increases under the various factual scenarios that arise by virtue of the Lempriere Option and Drag-along right. Very generally, by ignoring the effects of overseas ownership, the Commission estimated total quantified benefits of the merger to be in the range of $31.5 million to $33.8 million. But, this total falls by more than a third when Lempriere's initial overseas ownership is incorporated into the calculation. When the effects of the Lempriere Option to increase its ownership stake are also incorporated, its total falls by half.

243 Allowing for the consequences for the calculation of benefits when proper account is taken of overseas ownership, even under the most favourable scenario, detriments range from $9.91 million to $39.06 million; and public benefits range from $16.91 million to $20.74 million.

244 As the Economist's Report notes, there is thus "a very substantial risk that the public detriments of the merger will exceed its public benefits".

Paragraphs 387 to 394

245 The Economist's Report corrects Table 6 of the draft determination to reflect significantly larger detriments by allowing for allocative efficiency losses in the event of the merged firm increasing prices by up to 25% and reverting to the ranges for determining losses of productive and dynamic efficiency mandated by the Court in *Godfrey Hirst v Commerce Commission*. The "reasons" that the Commission gives for adopting point estimates at the bottom of the range cannot on proper analysis be sustained.

246 The effect is to substantially broaden the potential total of quantified detriments, even where Lempriere's shareholding is confined to the initial 45%.

247 Similarly, the Economist's Report adjusts Table 7 of the draft determination to allow for leakage of benefits due to varying levels of overseas ownership of CWH and resulting leakage of those benefits to foreigners. Those adjustments are conservative to the extent that they take no account of the fact that the one-off

benefits allowed for by the sale of land and sale of plant adopt as their basis sale prices that are demonstrably too generous.

248 Even without adjusting the benefits from sale of land and plant, the public benefits range reduces to$16.91 million to $20.74 million, even in the most favourable scenario, compared to the $31.5 million to $33.8 million in the draft determination.

249 The effects of those adjustments to Table 6 and Table 7 become manifest in the corrected Table 8 as it appears in the Economic Report. In the best case (low detriment/high benefits) for the most favourable ownership scenario, the overall net benefit is $10.83 million. In the worst case (high detriment/low benefits), with Lempriere exercising the Lempriere Option in the first year, the net detriment increases to -$32.10 million. In the scenario where Lempriere also exercise the Drag-along right to procure the sale of 100% of CWH to an overseas third party, that worst case figure extends to -$42.06 million.

250 In short, there is a potential net impact range of over $50 million; with 80% of that range being negative.

Paragraphs 395 to 398

251 As noted above, the Court has advised previously that "… 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…".

252 As also noted above, that same Court said that "where … the net public benefits and detriments are finely balanced it will be particularly important for the Commission to set out its reasons …".

253 In fact, as the Economist's Report demonstrates, public benefits and detriments are *not* finely balanced here, as only in the best case with the Drag-along right not exercised do net benefits prevail. In every other scenario, and with any level of overseas shareholding in CWH in that scenario, detriments exceed benefits, and mostly by a very substantial margin.

254 To that unfavourable quantitative outcome must be added the paucity of the evidence provided by the applicant to support its claims.

Paragraphs 406 to 408

255 Put simply, the Commission cannot be satisfied on the balance of probabilities that the acquisition will not have, or be likely to have, the effect of substantially lessening competition in relative markets.

256 Equally the Commission cannot be satisfied, on the balance of probabilities that the acquisition will result, or will be likely to result, in such a benefit to the public that it should be permitted.

257 As noted at the outset, while this Application may relate to the same wool scouring assets as were subject of the Commission's scrutiny in Decision 725, it is there that the similarity ends. The acquirer, CWH, will have a much changed – and changing –

shareholder composition. That shareholder composition – far from providing "the incentive to continue to drive productive efficiencies" that the Commission divines, in fact gives rise to destabilising option - induced conflict.

258 Further, the new dominant shareholder, Lempriere, with its own oblique ownership gives rise to the leakage of a significant proportion of the benefits (to the extent that they arise to overseas interests).

259 Despite the claims on behalf of the applicant that the economics of the proposed merger appear to be very similar, that claim too is untrue.

260 What is true is that the Commission ought to have applied the same approach to quantifying losses of allocative, productive and dynamic efficiency as the Court previously mandated in relation to those same wool scouring assets, unless there were valid reasons for departing from those approaches. Loose references to shareholder unanimity and "incentive-based remuneration schemes" do not provide such reasons.

261 Finally, there is the conundrum of the Lempriere Option. The Commission was right to take a conservative approach and consider there is a real chance that Lempriere will exercise that option; and thus conduct its analysis on the basis that Lempriere would have a 72.5% shareholding in CWH.

262 But, the Commission was wrong subsequently to engage in detailed interaction with the applicant's lawyers to modify the Lempriere Option some five months after it received the Application. By involving itself so closely in the rewriting of a crucial element of the transaction, the Commission puts its own independence at risk.

263 In the event, the Commission's collaboration at rewriting it, has failed. The Commission cannot be sure that the changes it inserted to make the exercise of the Lempriere Option conditional, will not be subsequently amended or removed.

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APPENDIX A: DIAGRAMS REPRESENTING FURTHER POST-TRANSACTIONAL STRUCTURES

APPENDIX B: CORRESPONDENCE FROM CHAPMAN TRIPP TO COMMISSION REGARDING THE SIGNIFICANCE OF THE LEMPRIERE OPTION AS SOON AS THE EXISTENCE OF THE OPTION WAS REVEALED

APPENDIX C: MATERIALS RELEASED UNDER OFFICIAL INFORMATION ACT RELATING TO COMMERCE COMMISSION'S AND BELL GULLY'S DRAFTING OF DEED INTENDED TO AMEND LEMPRIERE OPTION

APPENDIX D: PHOTOS OF CHINESE SCOURS VISITED BY GODFREY HIRST IN 2011

APPENDIX E: MATERIALS RELEASED UNDER OFFICIAL INFORMATION ACT RELATING TO EMPLOYEE REMUNTERATION SCHEMES

ATTACHMENT 1: ECONOMIST'S REPORT

ATTACHMENT 2: VALUER'S REPORT