MEMORANDUM

BELL GULLY

TO	**Mya Nguyen**	FROM	**Phil Taylor / Penny Pasley**
OF	Commerce Commission	PARTNER	Haydn Wong
MATTER NO.	400-4888	**Confidential**	
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Submission on the use of a midpoint for assessing allocative efficiency detriments

As decided by the Commission in Decision 725, and ultimately endorsed by the High Court, taking a point on a range is the correct approach to assessing allocative efficiency losses where there is sufficient evidence for the Commission to conclude that point is the likely point. As set out in CWH's Response to the Valuations, dated 23 June 2015, CWH submits that this is the approach the Commission should take when considering land valuations, as well as allocative efficiency detriments in the current process. We expand on this further below.

1. Decision 725

1.1 In Decision 725, the Commission modelled allocative efficiency losses for a range of price increases (5%, 10% and 15%) together with a range of low to high demand elasticities (-0.05, -0.5 and -1.0). This range of demand elasticities reflected the Commission's assessment of the extent to which greasy wool exports to China were a close substitute for wool scouring in New Zealand. The Commission's view was that the demand elasticity would be relatively low for small to moderate price increases, but would increase significantly for larger price increases.[1]

1.2 The Commission went on to make a "qualitative judgment", ultimately opting for "an intermediate value" of detriment as "the most likely value of detriment", which corresponded to a 10% price increase (the midpoint of the Commission's price range) and a corresponding elasticity[2] of -1.0.[3] This intermediate level of detriment was $14.7 million (NPV) over a 5 year period. This decision was based on the following findings by the Commission:

(a) entry could occur at price levels well below a 15% price increase and as such, CWH would likely restrain from increasing prices too far;

(b) CWH's lack of knowledge, and oversight, into the quantities of wool that would be switched to greasy exports in the face of a price increase;

(c) volumes of wool losses to China are likely to be permanent and could undermine the economies of scale benefits from the proposed acquisition;

(d) the possibility for some price discrimination would limit allocative losses. The Commission noted CWH's ability to price discriminate would be limited by its lack of knowledge as to the scoured wool's destination as well as the merchants' ability and incentive to arbitrage[4]; and

(e) the presence of long term contracts in both the factual and counterfactual.

[1] See Decision 725, at 254.

[2] The Commission did not expressly note that it was assuming a demand elasticity of -1.0. However, this was apparent from the conclusion that the likely allocative efficiency loss was $14.7 million.

[3] Decision 725 at 257.

[4] Decision 725 at 253.

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2. High Court

2.1 In the High Court judgment, Justice Mallon found that the Commission was not in error in using an actual figure for the likely allocative efficiency loss because it had set out the various reasons why it had chosen that figure.[5]

2.2 Even though the High Court did not consider the possibility of price discrimination and the presence of long-term contracts to be strong constraints (and therefore those factors did not provide much support for taking a midpoint level of the Commission's price range for allocative detriment), it did identify evidence *in addition* to those factors the Commission relied upon in support of its decision to adopt an actual figure.

2.3 In particular, Justice Mallon noted the Commission's observation that it was "very unlikely that a change in the price of wool scouring services by itself would have a significant influence on the amount of wool available for export, either in scoured or greasy form"[6] but that "the Commission (whether by conscious decision or not) did not model its allocative efficiency losses on the basis of an assumed pass-back of price increases to farmers."[7]

2.4 The High Court saw this approach as "an important reason why the Commission, in adopting its intermediate value, is unlikely to have under-stated" the allocative efficiency losses.[8] More particularly, the Court went on to say:[9]

> "*In assuming that merchants would be sensitive to price increases and respond by exporting more greasy wool to China, the Commission has, if anything, over-stated the allocative efficiency losses."*

2.5 In Decision 725, the Commission concluded that the ability of exporters to divert more greasy wool to China for scouring was unlikely, in itself, to sufficiently constrain the merged entity to avoid a substantial lessening of competition in the relevant wool scouring markets. In the Draft Determination of the current process, the Commission similarly recognised this constraint to be limited (in terms of preventing a substantial lessening of competition). Nevertheless, it recognises that the Chinese scouring industry poses "a significant long-term competitive threat to the domestic industry in New Zealand" and therefore the threat of losing scouring revenues to increased greasy exports would provide "some" constraint on the ability of CWH to increase prices.[10]

2.6 Justice Mallon in the High Court considered there was nothing to suggest the Commission's elimination of a greater than 10% price increase as the cap on allocative efficiency losses was incorrect.[11] **[REDACTED].**

2.7 Overall, after a thorough consideration of the Commission's approach in Decision 725, the High Court endorsed the Commission's approach on the basis that there was sufficient evidence for the Commission to conclude its determined point as the likely point of allocative efficiency losses. Justice Mallon was ultimately of the view that the Commission was cautious in its approach and sufficiently allowed for uncertainties. The Commission can be comfortable in following the reasoned approach of Justice Mallon.

[5] See paragraph 188 of the High Court Decision.

[6] High Court Decision at 174.

[7] High Court Decision at 175.

[8] High Court Decision at 182.

[9] High Court Decision at 188.

[10] Draft Determination at 158.

[11] High Court Decision at 187.

3. **Draft Determination**

3.1 In the Commission's Draft Determination on the current application for authorisation, the Commission has again considered a range of price increases (10%, 15% and 20%) on the basis of demand elasticities of -0.5 and -1.0, though it has no longer considered -0.05 (indicating a recognition by the Commission that the constraint from China has increased). A narrower range of elasticities is proposed to reflect that an increased proportion of the wool currently scoured in New Zealand is destined for China.[12] These elasticities and assumptions as to range have allowed the Commission to identify "potential" allocative efficiency losses.[13] However, the Commission has not yet determined what allocative efficiency losses it considers to be likely.

3.2 The Applicant submits the factors which led to the Commission adopting (and the High Court endorsing) a midpoint of the identified range of price increases regarding allocative efficiency losses remain fundamentally applicable, albeit with some differences in degrees. The Commission has made the following factual findings in the current Draft Determination which support this view.

(a) The Commission considers entry likely to occur if prices increased by at least 10%[14], but estimated allocative efficiency losses based on a higher range of "potential" price increases, in comparison to Decision 725, of 10% to 20%. The Applicant has submitted that entry remains likely at levels below 15%. In any case, while this price level is higher than the Commission's conclusion at the time of Decision 725, the threat of entry will continue to restrain CWH from increasing prices too far in the factual. Indeed, even if entry was only likely with a 20% price increase, CWH (not knowing exactly what price increase would trigger entry) would likely not increase its prices beyond 15%. To do so would give rise to too great a risk such entry would occur, with a permanent impact on greasy wool volumes available to CWH and its throughput efficiencies. In addition, the Commission described its identified range of price increases as "potential".[15] The Commission has not determined these to be the *likely* range of price increases. For the reasons CWH has previously submitted (as summarised below), a maximum price increase of 20% is simply not plausible and should be excluded when the Commission makes its assessment of what price increases it considers "likely".

(b) There is a continued lack of visibility into the quantities of wool that would be switched to greasy exports in the face of a price increase.[16] The Commission has stated that China "poses a significant long term competitive threat"[17], with 24% of the total wool clip currently being exported to China in greasy form (up from 14% of the total wool clip at the time of the previous application, which the High Court at that time described as "significant"[18]). This provides strong constraint on the ability of CWH to raise prices in the factual.

(c) The Commission considers that CWH would have some scope for destination-based price discrimination, but this scope would be limited.[19] This is consistent with the High Court's previous view.[20]

[12] Draft Determination at 278.

[13] Draft Determination at 250.

[14] Draft Determination at 202.

[15] Draft Determination at 250.

[16] Draft Determination at 265-267.

[17] Draft Determination at 158.

[18] High Court Decision at 165.

[19] Draft Determination at 146.

(d) As recognised by the Commission, Godfrey Hirst has elected not to renew its contract with CWH and so this factor does not remain relevant. However, as mentioned at 2.2 of this response, the High Court did not consider that long-term contracts provided an additional reason for taking a midpoint (on the basis that the Commission had already excluded the relevant quantities of wool from its analysis), irrespective of the fact that they were present in both the factual and counterfactual in the context of the earlier process.[21]

(e) Importantly, the Commission has also reached the same conclusion as it did in Decision 725 as to the likely lack of any supply response to a price rise, meaning the High Court's observation (at 188) that the Commission's allocative efficiency figure was therefore conservative also applies in the current case. The Commission has stated:[22]

> "*To the extent that a large proportion of any price increase was to be passed back up to farmer, the Commission does not consider that this would result in a large supply response. This is because wool supply is a function of the size of New Zealand's sheep flock. In turn, flock size is influenced not only by wool prices but also by sheep meat prices and the prices of production obtainable from alternative use of farm land such as beef, dairying or forestry. In Decision 725 the Commission noted that wool provides about 18% of the farmers' sheep alone revenue. This remains consistent with Beef + Lamb New Zealand's Sheep and Beef Farm Revenue and Expenditure calculations. This suggests that farmers make their sheep stocking decisions on parameters other than just their returns from wool sales.*"

3.3 As the Applicant has consistently submitted, a post-transaction price increase of 20% is simply not plausible. The threat from overseas scours has increased since Decision 725[23], the merged entity would have materially lower variable costs than the merging parties would have under the counterfactual (mitigating the expected price increases), the results of the Cournot simulation suggest much lower price increases are possible, and **[REDACTED]**.[24] Taking these factors into consideration, the Applicant submits that the Commission should consider a range of price increases with 15% as the maximum upper level. Taking a midpoint would result in a likely price increase of 10%.

3.4 Even if the Commission includes a 20% price increase as its upper level, for all of the reasons discussed above it should not be considered to be the "likely" level of price rise. Instead, the Applicant submits in keeping with the Commission and High Court's previous findings the Commission should consider the likely allocative efficiency losses at a midpoint price increase of 15% and an elasticity of (at the highest) -1.0 (assuming the Commission continues its current assessment of price increases with a maximum 20% increase). Given the majority of factors which supported a midpoint finding previously remain accurate, there is no apparent reason for the Commission to depart from its previous approach. (Indeed the weight of evidence suggests the likely allocative efficiency losses should be lower than what was considered in Decision 725 and the High Court.)

3.5 Given the price (10%, 15% and 20%) and elasticity (-0.5 and -1.0) ranges the Commission has adopted (see Table 4 of the Draft Determination), it would be odd to place much weight on the combination of a 20% price increase and a -1.0 elasticity. The probability of a 20%/-1.0 scenario is low, particularly given that there would in fact (as recognised by the Commission at paragraph 255 of Decision 725) be a trade-off between these two variables - the more elastic the demand curve, the lower the expected price increase, and vice versa.

[20] The High Court said there was nothing to suggest that Cavalier can price discriminate in respect of wool destined for export markets. However it agreed with the Commission to the extent that the ability to price discriminate would lower allocative efficiency losses

[21] High Court Decision at 185.

[22] Draft Determination at 273.

[23] Please refer to paragraphs 253 and 59.3 of the Draft Determination. Also see NERA April Report at 2.2.

[24] Refer to the NERA April Report at 2.

3.6 Accordingly, the Commission has more than sufficient information on the likely price increase post-merger to conclude a point of the likely allocative efficiency losses that is likely rather than a range – for the same reasons it did in Decision 725 and for the same reasons the High Court endorsed this approach.

3.7 To reiterate, the maximum upper bound of plausible price increases the Commission should accept is 15%, resulting in a midpoint price increase of 10%. However, even if the Commission were to continue with its assessment of possible price increases up to 20%, the midpoint of what the Commission considers to be the possible range of price increases also equates to 15%. In addition, if it continues to take the same elasticity as it did in the previous process (-1.0) this would be the upper range of elasticities and is conservative in that regard. Of course this also has a resulting impact on the upper bounds of wealth transfers the Commission should consider. A maximum price increase of 15% reduces the maximum upper bound of estimated net wealth transfers from $6,569,535 to $5,235,098, based on Table 5 of the Draft Determination (although on the basis of NERA's 21 April 2015 Report, CWH considers that the net wealth transfer should be even lower again ($3,772,654)).

4. Conclusion

4.1 The major factors which enabled the Commission and the High Court to take the midpoint of the price increase range of allocative efficiency loss assessed in Decision 725 remain equally true in the current case, as evidenced by the Commission's factual findings in the current Draft Determination and including those reasons which enabled Justice Mallon to uphold that midpoint.[25]

4.2 The factors which are no longer present were both factors which Justice Mallon considered to have little strength so that their absence will have no measurable impact on the current determination.

4.3 Accordingly, the Commission has sufficient reasons on which to adopt the midpoint of likely price increases and corresponding elasticity as the likely level of allocative efficiency loss post-transaction and should do so. To do otherwise would be to depart from the direction of the High Court.

[25] (see paragraphs 186 to 190 of the High Court Decision).