MEMORANDUM

BELL GULLY

TO **Mya Nguyen**
OF Commerce Commission

FROM **Torrin Crowther / Penny Pasley**

BY EMAIL

MATTER NO. 400-4888
DATE 10 August 2015

Submission

On behalf of the parties, we set out below further comment on various issues which have arisen during the authorisation process. This submission contains confidential information, including as between CWH and Lempriere/NZWSI.

The submission contains three parts: Part A (an executive summary), Part B (specific comment on particular issues), and Part C (comment on the balancing of benefits and detriments required by section 67 of the Commerce Act). A report from NERA is also included.

PART A: EXECUTIVE SUMMARY

1. The wider context for authorisation

1.1 At the outset, it is worth stepping back from the detail in order to understand the case for authorisation in its entirety.

1.2 The Commission concluded the former proposal gave rise to a net benefit such that it should be authorised (Decision 725). The decision to authorise was appealed by Godfrey Hirst, but upheld in the High Court in November 2011. Justice Mallon in that decision concluded:[1]

> …that the analysis establishes that there is "such a benefit to the public" that the proposed acquisition should be authorised. If we were to "stand back" from this analysis there is nothing that causes us concern about this conclusion. Rationalisation to achieve efficiencies in markets where there is significant over-capacity, where there is constraint from overseas competition, and where customers have sufficient volume to credibly threaten new entry, is the kind of acquisition which may well "give rise" to net public benefits.

1.3 The need for the proposed rationalisation has only become more acute since 2011. Since Decision 725 there has been:

(a) a further loss of nearly 3 million sheep and an associated fall in the available wool clip for New Zealand scours (in an industry reliant on volume efficiencies to keep prices competitive with greasy exports/offshore scours);

(b) forecasts from Beef + Lamb that this decline in sheep numbers will continue;

(c) a new overseas scouring alternative in Malaysia which **[REDACTED]** and marketing directly in New Zealand; and

[1] *Godfrey Hirst v Commerce Commission* (2011) 9 NZBLC 103,396 at [327].

(d) an increased proportion, as well as actual volumes, of wool exported to China in greasy form, coupled with further developments of scour lines in China aimed at British and New Zealand cross-bred wool.

1.4 Year to June 2015 figures are now available from Beef + Lamb and show that greasy export volumes are up **5.8% in the year to June 2015**, including to China (+2.3%), Italy (+68%), Germany (+6.5%) and Malaysia (+350%, albeit from a low base).[2] The latest statistics, coupled with the continued decline in wool clip, suggest the customer base of merchants is increasingly offshore.

1.5 While the further decline in the wool clip may mean that the threat of entry is not quite as strong a constraint as it was at the time of Decision 725, CWH believes it remains a real threat. Further, the declining wool clip, coupled with the continued rise in offshore scouring, has only made the need for rationalisation more acute. The parties are all too aware that the constraint from offshore scouring has resulted in the complete demise of the Australian scouring industry. Virtually all of the considerable production of Australian wool (with Australia the second largest wool producer in the world behind China) is now scoured offshore.

1.6 The transaction also avoids material costs which will otherwise be incurred **[REDACTED]** and it results in the release of additional surplus land in the form of the Clive property. While Godfrey Hirst has argued that the higher degree of foreign ownership is a key difference from the previous proposal, this has no material effect on the benefits of the merger, and only increases the detriments slightly (via the wealth transfer).

1.7 As consistently emphasised by CWH throughout this process, the driver of the proposed merger in New Zealand is not to gain monopoly rents, but a defence of the industry by gaining volume efficiencies in the face of the declining wool clip and increasing greasy exports. If volume efficiencies cannot be maintained there will be an inevitable and increasing loss of volumes to China, Malaysia and elsewhere.

1.8 One of the most vital benefits to New Zealand is therefore not the quantifiable synergistic benefits arising from the merger, but that gaining those benefits ensures New Zealand can retain an economically viable scouring industry.

1.9 The transaction brings together CWH (who has washed nearly 1 billion kilograms of wool for a loyal customer base over the past 15 years) and Lempriere (an established, family run business who trades some of the world's most valuable fibre) in order to secure a competitive New Zealand-based scouring business. Overall, the loss of the wool scouring industry in New Zealand, with a resulting impact on downstream processing, is a very real prospect if steps are not taken now to ensure a sustainable industry.

2. Comments on specific issues which have arisen

2.1 In Part B the parties respond to various points raised by Godfrey Hirst and explain why the Commission can be satisfied the benefits arising from the merger will outweigh any detriments.

2.2 In regard to benefits:

(a) The Commission can be satisfied the expenditure on **[REDACTED]**, as evidenced by NZWSI / Lempriere, will be avoided as a result of the transaction. The need for such expenditure has been verified by **[REDACTED]**.

[2] The NZD fell over this period, from around USD 0.875 to USD 0.68 (www.xe.com).

(b) The independently determined and tested redundancy exposure of $**[REDACTED]** is a likely (and conservative) figure that the Commission can have confidence in. The redundancy figure adopted in the Application of $**[REDACTED]** was noted to be historical and likely to be overly conservative. The actual figure determined by the independent Employment Relations Expert, **[REDACTED]**, is based on **[REDACTED]** managers.

(c) The best evidence of the value of the release of land made available as a result of the merger is sales values for those properties. **[REDACTED].** The independent valuations received by the parties for Clive and Whakatu **[REDACTED]**. The best evidence of the value of Clive and Whakatu is therefore $**[REDACTED]** and $**[REDACTED]** respectively. In addition, we set out further evidence below as to why the Commission should be satisfied there is market demand for all three properties.

2.3 In regard to detriments:

(a) The principal constraint on scouring prices – the threat of increased greasy exports – is unaffected by the transaction. This is the constraint currently binding on domestic pricing, not the threat of a merchant switching to NZWSI, a direct competitor of those merchants. Indeed, there has been substantial switching as between local scouring and exporting greasy, yet not a single merchant has switched between the parties for the past 8-9 years (with the exception of J Marshall for reasons other than price).

(b) While it is acknowledged that the declining wool clip may mean that the threat of entry is not quite as strong of a constraint as it was at the time of Decision 725, CWH believes it remains a real threat. The availability of land and buildings is not an issue, covenants notwithstanding. The principle issue is the profitability of entry. The entry model shows entry would be profitable for price increases of 10% or greater for the **[REDACTED]** option and 15% for the **[REDACTED]** option. The only real criticism of this has been that the hurdle rate employed is too low. As previously explained by NERA, the suggested 20% hurdle rate is at the high end of the range referred to in the literature cited by Professor Guthrie. Further, as Direct Capital has explained, this does not accord with the incentives of the most likely entrant, i.e. wool merchants, which have other commercial incentives for such entry. (More generally, CWH believes that entry is a greater constraint in practice than these models predict.)

(c) The declining wool clip and increasing threat from offshore scours are the main factors that ensure CWH is productively and dynamically efficient currently, rather than NZWSI, and these constraints will remain post-transaction. These factors, along with the profit maximising incentives of the shareholders and schemes such as the employee incentive mechanisms, mean the Commission is justified in its preliminary finding that any dynamic and productive efficiency losses will be low.

3. Authorisation test mandated by section 67

3.1 Having regard to the 'high detriment/low benefit' approach to quantification adopted in the Draft Determination (albeit presumably for pragmatic purposes given the result of the calculation) and also some of the language used by the Commission since (e.g. that it "cannot discount the real possibility" of a 20% price increase) we also make some comments below and in Part C on the balancing exercise called for by section 67 of the Commerce Act.

3.2 Under s67, the Commission shall authorise an acquisition if it is satisfied (on the balance of probabilities) that it "will result, **or** will **be likely to result, in such a benefit** to the public that it should be permitted".[3]

3.3 There is therefore a critical distinction between the authorisation and clearance tests:

(a) in a clearance application the applicant must satisfy the Commission that the adverse outcome (the SLC) **is not** "likely"; whereas

(b) in an authorisation application the applicant must satisfy the Commission that the positive outcome (such a benefit to New Zealand) **is** "likely".

3.4 Put another way, the different wording makes clear that the authorisation test does not require that the Commission be satisfied that a net detriment is not likely.

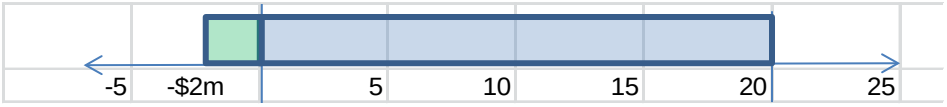
3.5 The distinction is crucial when it comes to assessing the overall question of whether to grant or decline authorisation, especially given (i) the manner in which the courts have interpreted the word "likely" and (ii) how the clearance assessment has developed as a result – namely that the applicant disprove the likelihood of an adverse outcome in any likely scenario.

3.6 In its Draft Determination, the Commission focussed on the "worst case" (high detriment/low benefit) scenario when undertaking the balancing of benefits and detriments. Notwithstanding the wording of s67, CWH accepts that this approach is nevertheless a pragmatic initial test, and CWH agrees that if this number is positive then the acquisition will result, or will be likely to result, in such a benefit to the public that it should be permitted. (It is not dissimilar to adopting a narrow market definition in a clearance situation on the basis that if no issues arise in a narrowly defined market, none are likely in a wider market.)

3.7 *However, this 'worse case' scenario approach is not the test proscribed by s67.* Where the distinction between the authorisation and clearance tests becomes acute is where the overall range includes a negative number. While the parties are firmly of the view that the transaction gives rise to a net public benefit under all credible scenarios, in a scenario where the range included a negative number, the Act requires that the Commission stand back and assess whether it is satisfied, on balance, that such a benefit would occur, **or** would be "likely" to occur, by reference to the facts.

3.8 The Commission is not entitled, unless such a conclusion is supported by reference to the facts (e.g. there is evidence that the likely values within the range are especially skewed in one direction), to discount or ignore the figures in the positive area of the range when undertaking the final balancing called for by s67, on the basis that under a certain set of assumptions (e.g. high detriment / low benefits) a net detriment may occur. This is because the legislative test is whether the Commission is satisfied a net benefit will result, or is "likely" to result – not whether a net detriment is not likely.

3.9 Graphically, in a scenario where the range of potential benefits lies between, say, $-2.0m and $20m, the issue is whether the Commission is satisfied that the actual net benefit would lie, or would be "likely" to lie, somewhere in the blue positive range below such that it should be authorised.



[3] Commerce Act 1986, s 67(3)(b). The balance of probabilities test is not set out in the statutory language, but has been accepted through numerous court and Commerce Commission cases. See for example *Godfrey Hirst v Commerce Commission* (2011) 9 NZBLC 103,396*, Decision 725 and Decision 511.*

3.10 The requirement that the Commission is "satisfied" does no more than import the balance of probabilities standard. The threshold for whether such a benefit is "likely" can be no more than the "more probable than not" threshold of the civil standard of proof and – based on judicial interpretation of the word "likely" in the Commerce Act context – may well imply a lower threshold.

3.11 If the Commission is satisfied that such an outcome is "likely", then it must grant authorisation, notwithstanding that it may not be able to discount entirely the prospect it lies in the green (negative) area.

3.12 Such an approach in the authorisation context is also consistent from a policy perspective. Were the Commission to apply a test which required that it err on the side of declining authorisation in circumstances where, notwithstanding it considered a net benefit to New Zealand likely, it could not entirely discount the possibility it may give rise to a net detriment in a particular set of circumstances, then over time New Zealand would be worse off. This policy reason is further support for a plain reading of the s67 wording.

3.13 The statutory and judicial basis for this position is set out in more detail in Part C.

PART B: SPECIFIC ISSUES WHICH HAVE ARISEN

This Part B contains comment on various specific issues which have arisen during the process. It does not purport to be a summary of all the points made by the parties and should be read in addition to the other evidence on the record.

4. Price impacts

4.1 In Decision 725, and endorsed by the High Court, the Commission assessed allocative efficiency impacts based on a price increase of a maximum 10%. In the current process, the Commission has suggested that it "cannot discount the real possibility that the merged entity would be able to raise scouring prices by up 20%".

4.2 The Commission's draft conclusion on pricing was that the constraints on price increases from the threat of entry, while similar, are not as strong as they were previously. More generally, the premise that a 20% price increase cannot be discounted requires that:

(a) NZWSI's presence as an alternative commission scour *currently* constrains any price increase by CWH; and

(b) the next closest constraint would not bind until prices increased by 20%.

4.3 To the contrary, it is the applicant's contention that further substitution to greasy exports is the constraint which *currently* binds domestic pricing, not the threat of merchants switching to NZWSI, a direct competitor of those merchants. Indeed:

(a) NZWSI has a market share of around **[REDACTED]** once greasy exports are taken into account;

(b) no merchants have switched between the parties for the past 8-9 years (with the exception of J Marshall for reasons other than price);

(c) the threat from overseas scours has **increased** since Decision 725;

(d) the merged entity would have materially lower variable costs than the merging parties would have under the counterfactual (mitigating the expected price increases);

(e) the results of the Cournot simulation suggest much lower price increases are possible; and

(f) CWH has provided compelling evidence that its real prices have **[REDACTED]**.

4.4 Given the limited constraint currently from NZWSI as an alternative Commission scour, and increasing constraint from greasy exports, CWH does not believe any material price rise is likely in the factual – and certainly not in the order of 20%.

4.5 The following graph (previously provided) illustrates the relative size of the three options available to merchants, being (a) commission scouring through CWH; (b) exporting greasy; and (c) commission scouring through NZWSI. It shows the increasing impact of greasy exports/offshore scours and the very minor presence of NZWSI. The market shares show **[REDACTED].** This is consistent with: (a) close competition between CWH and greasy exports; and (b) very limited competition between CWH and NZWSI.

[REDACTED]

4.6 If there was strong competition between CWH and NZWSI, we might expect to see at least some switching of customers between the parties. However, as set out in the submission of 13 July 2015, no customers have switched from supplying CWH to supplying NZWSI (or vice versa) in the past 8 to 9 years (since Peter Crowe of J Marshall and that was for reasons other than price). In this time, **[REDACTED]**. This suggests that their closest competitor is actually greasy exports (to which they, **[REDACTED]**, have lost volume) rather than each other.

4.7 In addition, merchants have made it patently clear they do not wish to scour with NZWSI given NZWSI is a direct competitor of theirs. This is the reason why NZWSI's share, once greasy exports are taken into account, is only around **[REDACTED]**.

4.8 In the Applicant's view, unless merchants have provided evidence to the Commission that the threat of them switching to NZWSI for their scouring needs constrains CWH's current pricing (as opposed to the loss of volumes to greasy exports), the only conclusion that can be drawn from the evidence on the record (as the applicant understands that evidence to be) is that some other constraint is currently operating on domestic scour prices. In the Applicant's view, that constraint is greasy exports.

4.9 Finally, the confidentiality around the submission by Chapman Tripp/Professor Guthrie dated 13 July 2015 has rendered that submission incapable of proper testing by either the Commission or the parties. If the Commission proposes to place any weight on these arguments then we request that full details of the interviews with the two merchants be made available, at least to external counsel and experts. As it stands, it is impossible to know:

(a) what questions were asked and – just as importantly – what questions were avoided;

(b) why those particular questions were asked;

(c) how the two merchants in question were chosen (especially given their statements as recorded are at odds with the parties' knowledge of how merchants operate);

(d) what discussions were had with other merchants which did not feature;

(e) the extent to which the merchants' responses were included in full;

(f) etc.

4.10 Regardless, based on the material which has been provided, the hearsay material which has been provided is inconsistent with market practice, and the parties' make the following observations in relation to it.

(a) It is not the case that exporters have to entirely change their business model to switch from exporting wool in clean form to exporting in greasy form. Approximately **[REDACTED]**% of CWH's customers (accounting for **[REDACTED]**% of its volume) and **[REDACTED]** of NZWSI's merchant customers export both greasy and clean wool.

(b) Merchants will constantly be weighing the decision to export wool in greasy or scoured form depending on what is most profitable, and therefore a decision to switch more wool to greasy is certainly not "all or nothing", nor irreversible.

(c) It is also not the case that customers only purchase clean or greasy wool, as wool traders in China generally purchase both clean and scoured wool.

(d) Even if it were the case that one merchant, as claimed, would not switch to exporting greasy wool until prices rose by 25-30%, this customer would be protected from such price rises by merchants who already export both clean and greasy wool and could readily switch more wool to greasy, effectively defeating CWH's price rise.

(e) Concerns about the quality of scours in China and Malaysia is inconsistent with the fact that around a full quarter of New Zealand's total wool clip is currently scoured in China alone, and the volume of New Zealand wool scoured in Malaysia is rapidly increasing.

(f) Complaints of existing CWH scouring constraints do not accord with reality. CWH currently **[REDACTED]** and with the use of Clive during the peak season is able to process all of its customers' requirements in a timely fashion. Further, as CWH has previously shown,[4] there will be no issue with post-rationalisation capacity, with CWH maintaining excess capacity across all months of the year.

(g) Finally, discussions with two merchants out of many can in no way evidence that "Merchants are extremely unlikely to enter the scouring industry in response to price rises."

4.11 The attached NERA report also contains some observations in this regard.

5. **Avoided Capital Expenditure**

[REDACTED].

6. **Redundancy**

6.1 The independently determined and tested redundancy exposure is $**[REDACTED]**. In fact, **[REDACTED]**, and so the overall figure is likely to be $**[REDACTED]**.

6.2 The redundancy figure adopted in the Application of $**[REDACTED]** was noted to be (i) a historical figure compiled for the purposes of the previous proposed transaction; and (ii) likely to be overly conservative. This has proven to be the case.

6.3 An independent Employment Relations Expert, **[REDACTED]**, has determined the actual redundancy exposure. **[REDACTED]** has been able to review the actual employment agreements (where written agreements exist) and has now also been able to talk directly to the Whakatu and Kaputone site managers.

6.4 We are not aware of any substantive critique of **[REDACTED]** calculations, although Godfrey Hirst has suggested that the timing of the provision of the information suggests it should be given lesser weight. The parties do not dispute the Commission should test all material and submissions advanced to it as part of this process, but the timing of the information per se has no bearing on the weight which ought to be given to it. In this regard, material requested by the Commission has been made available, and the parties have also facilitated a teleconference with **[REDACTED]** during which he explained the process he undertook and responded to various questions the Commission put to him. Having regard to the material on the record, and in particular **[REDACTED]** detailed analysis and explanation, the parties are unaware of any reason why the revised figure should not be accepted as representing the true redundancy cost.

6.5 Indeed, the process adopted and explained to the Commission by **[REDACTED]** has revealed that:

[4] See p 10 - 11 of Bell Gully "Response to Information Request", dated 19 June 2015.

(a) a number of conservative positions were adopted by **[REDACTED]** when quantifying the exposure. For example, it is not correct, as Godfrey Hirst has claimed, that the **[REDACTED]** the redundancy payments required;

(b) **[REDACTED]** has further assumed that:

(i) **[REDACTED]**; and

(ii) **[REDACTED]**,

[REDACTED]; and

(c) **[REDACTED]**

6.6 In the parties' view, the evidence underpinning this value, and in particular the information provided by **[REDACTED]** as an independent expert, is such that the Commission ought to treat the figure he has arrived at as a likely (and conservative) figure.

7. Public benefit of surplus land

7.1 We set out some further comments in relation to the benefit to be ascribed to the release of surplus land below. As we are yet to hear from the Commission in relation to the reconvened conference, it may be that additional information in relation to the issue of valuations is provided.

7.2 According to the High Court "[t]he benefit lies in the release of surplus resources for other economic uses; and the best evidence of the value of those alternative uses is the price that is likely to be paid for the surplus resources."[5] In Decision 725 the Commerce Commission stated that "[a]ll valuations are to some degree subjective. It is not until the sale is made that the true value is revealed."[6] When referring to the weight to give an approach by a prospective purchaser, the High Court further stated "[a]s the Commission recognised, the true value was what someone paid in a sale."[7]

Kaputone

[REDACTED]

Clive and Whakatu

7.9 The Clive and Whakatu properties have also very recently had a value attributed to them by well-informed parties with a very real commercial incentive to ensure those valuations accurately reflected their true realisable value on the open market. The Telfer Young and Logan Stone valuations were undertaken for reasons other than the transaction and predated the establishment of the eventual merger structure (explained below).

7.10 These two properties will not form part of the merged entity but rather will be disposed of separately. The transaction involves an enterprise value being determined for each of CWH and NZWSI: CWH at $**[REDACTED]** and NZWSI at $**[REDACTED]**. Those enterprise values necessarily encompass the benefits of the Clive and Whakatu properties respectively. The transaction brought together those two enterprises but without the use of Clive and

[5] *Godfrey Hirst v Commerce Commission* (2011) 9 NZBLC 103,396 at [281].

[6] Decision 725 at [416].

[7] *Godfrey Hirst v Commerce Commission* (2011) 9 NZBLC 103,396 at [286].

Whakatu – hence the need to value each property and adjust the funds which will flow as between the parties accordingly.

7.11 The parties were strongly incentivised to determine a fair market value for each property because under the sale Agreement between the parties *the value assigned to each property directly affects the cash payment that each shareholding group will receive as part of the transaction:*

(a) the cash payable to the CWH shareholders is reduced by $**[REDACTED]**, being the figure the parties believe accurately reflects the value of Clive;[8] and

(b) the cash payment to Lempriere is reduced by $**[REDACTED]**, being the value of Whakatu.[9]

7.12 Accordingly, by way of illustration, if the valuation for Clive was overstated by $1m, then the shareholders of CWH would be $1m worse off in cash terms as a result, because their cash receipt from completion of the sale Agreement is reduced by the $**[REDACTED]** yet they would subsequently realise only $**[REDACTED]** from the sale of Clive. In contrast, the Lempriere shareholders would be better off. Likewise, to the extent Whakatu was overvalued, Lempriere would be worse off and the CWH shareholders better off.[10]

7.13 There is no mechanism to 'make good' any difference between the valuation and the actual sale proceeds, further incentivising the parties to reach independent views as to each property's value – each party bares its own risk and the values applied therefore reflect an arms-length sale value.

7.14 Overall, this meant there was a reciprocal tension on the parties to ensure the valuations utilised accurately reflect what each property would likely fetch when on-sold.

7.15 The two parties are very well placed to test the values ascribed to each property – each property is close by and the parties are well experienced with dealing with, and disposing of, wool scouring properties.

7.16 In summary, it is agreed that these properties will be transferred out of the respective 'enterprises' at $**[REDACTED]** and $**[REDACTED]** respectively, pursuant to a transaction which has direct cash impacts on the parties. That they each determined that the value of the properties was as per the valuations provided and agreed to transact accordingly, knowing full well there are direct cash impacts if they got it wrong, must be compelling evidence that the value of the properties is in the order of $**[REDACTED]** and $**[REDACTED]**.

7.17 Quite apart from this commercial transaction, the valuations reached separately by Telfer Young and Logan Stone, and in particular **[REDACTED]**, further supports the value of Clive and Whakatu being in the order of $**[REDACTED]** and $**[REDACTED]** respectively. Of course, as the Commission is now aware from material provided by the Applicant, Mr Nyberg previously valued the Clive site at $**[REDACTED]** in 2008.

[REDACTED]

[8] The value ascribed to the scouring site and attached residential property in the Telfer Young valuation.

[9] The value ascribed to the scouring site and attached residential properties in the Logan Stone valuation.

[10] Similarly, to the extent that either property was deflated in value, it would generate a taxable gain on subsequent realisation when the property was sold.

8. Constraint from new entry

8.1 NERA's model illustrates that entry would be a profitable post-merger strategy for price increases of 10% or greater for the **[REDACTED]** option and 15% for the **[REDACTED]** option, assuming that the entrant can obtain the requisite volumes.[11] Entry by a merchant or collaboration of merchants (which CWH considers to be the most likely entrant) would, of course, have captive volumes. NERA's entry model uses (in the base case) a post-tax real discount rate of 15%, which is equivalent to 20.83% pre-tax, real.

8.2 Such entrants would not have any difficulty finding suitable sites for a scouring operation. As set out in the application for authorisation, plenty of sites in the same areas identified in Decision 725 are available for entry and CWH offered further examples of the many possible sites currently available in its submission of 8 December 2014. With such a large number of alternative sites currently available, the restrictive covenants would not create a barrier to new entry. Notably, Segard Masurel, a credible and likely entrant, has expressed the view that the covenants would not deter any entry that might occur.[12] At the time of Decision 725, the properties at Whakatu and Kaputone were also to be sold with non-scouring covenants. The Commission found that new domestic entry would in part constrain the acquirer and found that there was available land for that new entry to occur.

8.3 Accordingly, the issue for the Commission is at what point would entry be profitable. The main opposition raised by Godfrey Hirst to NERA's entrant model is an assertion that a higher cost of capital should be used, to account for the loss of a real option when entry occurs.[13] This reasoning leads Godfrey Hirst to a price increase of 25% before entry becomes a viable constraint. NERA has shown however, that Professor Guthrie's assertion relies on adopting a hurdle rate (20%) that is at the high end of the range referred to in the various pieces of academic literature his report cites. Direct Capital has demonstrated why such a high hurdle rate is not applicable where the most likely entrant is wool merchants who have other commercial incentives for such entry; the incentive to protect their trading entities likely taking precedence over the need to achieve an arbitrary hurdle rate.[14]

8.4 CWH does not agree that a price increase of 20% would be needed for profitable entry, but even if it were, such entry would have disastrous consequences for CWH. The loss of volume by the merchants involved in undertaking entry would likely be permanent, effectively negating any benefits of the proposed merger and would reduce volume efficiencies more generally, even putting aside that the new entrant may win other scouring customers. Even assuming entry was the first constraint which kicked in, CWH would not rationally push prices up to such a level given the permanent ramifications of 'getting it wrong'. Rather, CWH would maintain a (not immaterial) buffer to ensure it did not prompt such entry.

8.5 This suggests that, even in the scenario where entry was the 'first' constraint which kicked in and where a 20% price increase were needed for profitable entry (both of which are denied), the maximum price increase you would rationally see from the merged entity would be in the order of 15%, rather than 20%.

9. Productive / dynamic detriments

9.1 The Commission concluded in its Draft Determination that any productive and dynamic efficiency losses arising from the transaction would be limited and as a result adopted estimates at the low point of the identified ranges, as estimated by NERA.[15] This preliminary

[11] NERA Report accompanying the application for authorisation, dated 19 February 2015.

[12] Draft Determination at [175].

[13] Report by Professor Guthrie on the Draft Determination, dated 21 April 2015.

[14] See Direct Capital response to the Commission's request for follow-up information of 12 June 2015, and NERA response to the report by Graeme Guthrie, dated 29 April 2015.

[15] Draft Determination at [289] and [302].

view was primarily based on the on-going external pressure placed on CWH and NZWSI by the declining wool clip, the long term competitive threat of the scouring industry in Asia, as well as the shareholders having strong profit maximising incentives, driving productive and dynamic efficiencies in the factual.[16]

9.2 The main opposition Godfrey Hirst has raised in this regard relates to an assertion that the shareholders have differing incentives as a result of the Lempriere Option.[17] CWH has shown, however, that both parties would have the incentive to ensure the firm is productively efficient.[18] In relation to dynamic inefficiencies, there is minimal scope for a distinction between "high-risk business strategies" and "low-risk business strategies" in the context of the wool scouring industry. As James Mellsop explained at the conference of 10 June, Godfrey Hirst's argument assumes the strike price of the option is fixed.[19] To the contrary, the strike price reflects the value of the firm at the time it is exercised. Even if such "high-risk" strategies existed, the value of CWH increases as a result of a pay-off from such a "high risk" strategy, and so the other shareholders would also benefit in this regard. Accordingly there is no conflict of interest.

9.3 The merged entity will remain subject to strong pressures from overseas scours and the declining wool clip to minimise productive and dynamic efficiency losses.[20] This pressure is reflected by the **[REDACTED]**.[21] In addition, and while they may have some limitations, the employee incentive mechanisms in place will also continue to restrict the degree of productive inefficiency under the factual.[22]

9.4 Finally, as set out by Justice Mallon, it is justifiable for the Commission to reach a judgment that a value falls at a particular point within a range, provided it has sufficient reasons for doing so.[23] For all of the reasons stated above, the Commission is justified in adopting a low point in its assessment of the likely productive and dynamic efficiency losses arising out of the merger and for dismissing the mid and upper ranges as unlikely.

PART C: BALANCING BENEFITS & DETRIMENTS [s67]

10. The legislative test

10.1 As noted, the authorisation and clearance tests differ in an important way.

10.2 While this difference is clear from the plain wording of the Act, the legislative history and judicial interpretation of the two tests provide further clarity as to the distinction. As set out below, Parliament made a conscious decision to change the clearance threshold when it was changed to frame it in the negative (as per its current wording). At the same time, it had the opportunity to amend the authorisation test, but left it framed in the positive. This further underscores that there should be no presumption towards declining authorisation merely because, in a particular scenario, the range of net benefits spans negative and positive values.

[16] Draft Determination at [285] to [300]. See also NERA Report of 22 October 2014.

[17] See report by Professor Guthrie, dated 21 April 2015.

[18] NERA Report of29 April 2015, and Bell Gully post-conference submission, dated 19 June 2015.

[19] Cavalier Wool Holdings and NZ Wool Services - Conference Transcript, 10 June 2015 (amended 26 June 2015) at pages 17-18.

[20] Bell Gully submission on the Draft Determination, dated 21 April 2015 and NERA Report, dated 21 April 2015.

[21] NERA Report, 21 April 2015 at 2 and 4.

[22] See NERA Report of 29 April 2015 and Bell Gully post-conference submission, dated 19 June 2015.

[23] *Godfrey Hirst v Commerce Commission* (2011) 9 NZBLC 103,396 at [102]-[105].

10.3 In *Commerce Commission v Woolworths Ltd*[24] the Court of Appeal specifically considered the rationale for framing the clearance test in the negative, by comparison to an earlier clearance test, which was framed in the positive (i.e. the Commission must clear unless it is satisfied that there would be an adverse competition impact). Section 66(7) previously provided:

> "The Commission shall give a clearance … unless it is satisfied that the merger or takeover …would result or would be likely to result in … a dominant position.

10.4 The Court of Appeal made the following observation when assessing the current clearance test of whether the Commission is satisfied the acquisition will not have, or would not be likely to have, the effect of an SLC:[25]

> We are of the view that the binary approach of the High Court was erroneous.
>
> If the Legislature intended clearances to be refused unless the Commission is satisfied that a proscribed effect was likely, it would have said so. This, after all, is pretty much what s 66(7), ie the precursor to s 66(3), provided (…). **We do not accept that the change in statutory language between the old s 66(7) and the current s 66(3), associated, as it was, with a major change in the role of the Commission, was so inconsequential.** [Emphasis added]

10.5 In summary, the Court of Appeal found that by framing the clearance test in the negative (clearance to be granted only if the adverse competition effect is not likely), Parliament raised the threshold from one that is effectively binary (either there is an SLC or not) to one where the Commission is required to decline clearance if it is "in doubt".[26] That is, the Commission must decline clearance if it cannot "exclude a real chance of a substantial lessening of competition." Critically, this higher threshold is imported *directly from the fact that the Legislature amended the clearance test so that it was framed in the negative*. As noted, it did not make the same change to the authorisation test.

10.6 As set out above, section 67(3)(b) does not require the Commission to be satisfied the acquisition *was not likely* to result in *such a detriment* to the public. Instead, it requires that the Commission be satisfied that the acquisition will result or be likely to result in such a benefit that is should be permitted. For the reasons set out in *Woolworths,* Parliament did not intend to import the same degree of conservatism into the authorisation test that it did into the clearance test. Rather, the Commission is called upon to determine, on the balance of probability, whether net public benefits are "likely".

10.7 This view is further reinforced both by public policy considerations and judicial interpretation of the authorisation test as described below.

11. Judicial approach to authorisation test

11.1 The judicial approach to authorisations has been to require robust analysis of each public benefit and detriment category, based on a standard of what is "likely". In undertaking the final balancing, the courts have not imported any requirement to err on the side of conservatism or to ascribe more weight to potential detriments than benefits. Indeed, the courts have specifically warned against replacing an assessment of what is likely with a conservative view. In *Godfrey Hirst,* Mallon J observed that "a conservative view" is not the same test as a "likely" outcome, and that if a conservative approach was taken to a particular category, then "that becomes relevant when detriments are weighted against benefits."[27]

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

[25] *Commerce Commission v Woolworths Ltd* (2008) 12 TCLR 194 (CA) see [105] - [106].

[26] See [98].

[27] *Godfrey Hirst v Commerce Commission* (2011) 9 NZBLC 103,396 at [292].

11.2 As set out in *Godfrey Hirst,* the Commission is not obliged to determine (on a balance of probabilities basis) a single figure for each particular detriment or benefit, noting that it may be difficult to make such a precise quantitative assessment.

11.3 Once the benefits and detriments assessed for each category are aggregated, including the ranges, Mallon J specifically (at 292) required that any conservatism in the choice of values within particular ranges *must then* be taken into account. This is, in our view, a clear direction that the final balancing must **not** assume a conservative "worst case scenario" as being the appropriate measure.

11.4 This position is consistent with the High Court's views in *Ravensdown.* In assessing the authorisation test, the High Court found:[28]

> [t]his means that the Commission must be satisfied of at least the likelihood of benefit to the public, resulting from the acquisition, before authorisation is appropriate. It is that end result which must be likely. […] What is required is that the Commission make a facts-based assessment of benefits and detriments, adopting a quantitative approach where possible, and on the basis of that assessment decide if it is satisfied that the acquisition is at least likely to result in such a benefit to the public that it should be permitted. In short, the test of likelihood is to be applied at the end of the process.

11.5 Applying *Ravensdown*, it is clear that the assessment of the values in each of the benefit and detriment categories is a first step. While the Commission must assess during this determination what value or value range is "likely", this is in addition to, not instead of, making an assessment at the end of whether "such a benefit" is likely. Accordingly, the Commission is required to make a further assessment in circumstances where the possible range of net benefits spans negative and positive values. This is also consistent with Mallon J's views in *Godfrey Hirst*[29] where she cited the above reference to *Ravensdown.*

12. Commission must be "satisfied"

12.1 In its Draft Determination the Commission refers to the *Telecom AMPS-A*[30] decision when setting out what is required for it to be "satisfied". The Commission states that to be "satisfied" it must so far as possible quantify benefits and detriments rather than rely on purely intuitive judgment. This is to be overlaid by an assessment of whether unquantifiable factors are not sufficient to "tip the balance" back the other way.[31]

12.2 CWH agrees with this assessment. In addition, those cases make clear that when assessing whether the Commission is satisfied a particular outcome will or would be likely to occur the relevant standard is the balance of probabilities, i.e. the requirement that the Commission be satisfied that such a benefit is likely merely imports the balance of probabilities standard into the authorisation test. This is clear from the way in which the courts have approached the test. For example, in *Telecom AMPS-A* Cooke P described the balancing test as follows.

> Weighing is far from easy, but on the evidence the scales appear to me to come down on the side of greater public benefit.

12.3 Accordingly, in order to be "satisfied", the Commission must undertake a balancing exercise that does not give greater weight to possible detriments than it does to benefits.

[28] *Ravensdown Corporation Ltd v Commerce Commission* AP168/96, High Court, Wellington at pages 50 – 51.

[29] At [105].

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

[31] Draft Determination at [398] applying *Godfrey Hirst* at [115].

13. **Such a benefit is "likely"**

13.1 The meaning of the term "likely" must be assessed by reference to the wording of the authorisation test. The test includes two limbs. The Commission must be satisfied either that:

(a) the acquisition *will result*; or

(b) the acquisition will be *likely to result*,

in such a benefit to the public that it should be permitted.

13.2 The Commission must satisfy itself on the balance of probabilities. Accordingly, if decided under the first limb, the Commission would need to be satisfied that such a benefit was "more probable than not" – i.e. a greater than 50% chance of occurring. If the Commission's decision is made under the second limb, the addition of the word "likely" must, by definition, import a **lower** threshold than a 50% likelihood.[32]

13.3 Whether the necessary probability is closer to 30% as in *Woolworths*[33] is not clear either from the words of the authorisation test or judicial consideration of the test, although there is nothing in the Act suggesting the term "likely" should be interpreted differently in s66 and s67. In any event, what is clear is that when faced with a range spanning negative and positive values, the Commission must undertake a further assessment of whether, on the balance of probabilities, net benefits are likely – which in turn involves applying a threshold of no more than a 50% probability that there are net benefits (and could in fact be lower).

13.4 This interpretation is supported by case law. In the Commerce Act context, no New Zealand court has ever interpreted the threshold of "likely" to mean more than 50% probability. In most instances, the threshold has been much lower. For example, one of the earliest examples of New Zealand courts considering the meaning of "likely" in relation to an authorisation is *Air New Zealand v Commerce Commission.*[34] Citing the Australian decision of *Re Queensland Co-operative,* Davison CJ set out that "likely" refers to probable outcomes rather than possible or speculative effects – "a state of mind where one has some degree of assurance that the contemplated result will eventuate."[35]

13.5 While this decision was made in the context of the 1975 Act, and accordingly a different iteration of the public benefit test, Davison CJ's approach was subsequently adopted in *Air New Zealand v Commerce Commission* (No 6)[36] in the context of the 1986 Act, reiterating that the test laid down is one of probability not certainty.

13.6 Similarly, the Commerce Commission in *Weddel* found:[37]

> The test of probability (as distinct from possibility) has been laid down by the High Court in relation to mergers or takeovers. A further necessary refinement to the test of probability is added by the Australian case of *Howard Smith Industries* (1977) ATPR 40-023:

[32] See *Woolworths* (CA) at [97] for a discussion of this issue in the context of the clearance test.

[33] *Woolworths v Commerce Commission* (2001) 8 NZBLC 102,108 (HC) at [111] – [113]. While the decision was ultimately overturned on the facts, the Court of Appeal did not disagree with the High Court's reasoning in relation to the meaning of "likely".

[34] *Air New Zealand v Commerce Commission* [1985] 2 NZLR 338.

[35] *Air New Zealand v Commerce Commission* [1985] 2 NZLR 338 at 6.

[36] *Air New Zealand v Commerce Commission (No 6)* (2004) 11 TCLR 347.

[37] *Re Closure of Whakatu* (1987) at 229.

> "*this does not mean that the likely effects must be more probable than not, but rather that there must be a tendency or real probability of a particular result*…"

13.7 This approach was also adopted in *Rugby Union Players' Association Inc v Commerce Commission*[38] where it was noted that it appeared to be "in line with the Court of Appeal's approach to section 27 (where the relevant test is whether a contract or an acquisition is "likely" to have the prohibited effect) in *Port Nelson Ltd".* Here "likely" was expressed as "a real and substantial risk" that the stated consequence or effect will happen, meaning "above mere possibility but not so high as more likely than not".[39] The court in *Ravensdown* also applied this test.

13.8 More recently, in the context of sections 47 and 27 it has been held that "likely" means a "real" rather than a remote "chance" or "prospect" that the effect will occur.[40] The High Court in *Woolworths* also determined that "likely" contemplated a 30% probability of occurrence, setting out that "it involves more than a possibility" but the effect does not need to be "more likely than not".[41]

14. Factors to consider in undertaking the final assessment

14.1 For the reasons set out above, when considering a range that spans both negative and positive values the Commission must go on to determine whether a positive value of net benefits is "likely". Conceptually, when considering a range that spans both negative and positive values, especially where an overall negative value requires that each of the major categories is at the far end of the range, a question to ask is:

> Is there any evidence to suggest that the distribution of outcomes over the net benefit range is heavily skewed towards the negative?

14.2 In the absence of such information, in an assumed range of say -$2m to +$20m, it would be odd to assume an expected value of less than zero, as this would imply the distributions over each of the variables (e.g., demand elasticity, price increase and property value) that underlies the net benefit range were extremely skewed towards the bottom end of the benefit range and top end of detriment range.

14.3 We are not aware of any evidence in the current case to justify such an assumption. In fact, there is strong evidence on the record to the contrary.

14.4 In this respect, the language used in the Commission's 30 June email that it "cannot discount the real possibility that the merged entity would be able to raise scouring prices by up 20%" does not suggest that it believed a 20% price rise was likely, but rather that it could not be discounted – an important distinction given the difference between the clearance and authorisation tests.

14.5 While we are not advocating the Commission assign probabilities to various outcomes, it is instructive to consider even a very conservative case involving three categories, each in which the Commission considered there was a 50% chance the absolute worst case outcome would occur. (That is, even assuming the Commission concluded there was a range of outcomes in each range, it thought the range was very heavily skewed one way.) In this case, the likelihood that all values would, in fact, be at that far end of each range would be only 12.5% (0.5 x 0.5 x 0.5 = 12.5%).[42] That is, even if a particularly high likelihood was

[38] *Rugby Union Players' Association Inc v Commerce Commission* [1997] 7 TCLR 671 at 690.

[39] *Port Nelson Ltd v Commerce Commission* [1996] 3 NZLR 554.

[40] See for example *Woolworths Ltd v Commerce Commission* (2008) 8 NZBLC 102,108 (HC) and *Commerce Commission v Port Nelson Ltd* (1995) 6 TCLR 406.

[41] *Woolworths Ltd v Commerce Commission* (2008) 8 NZBLC 102,108 (HC) at [111].

[42] This calculation assumes the values in the ranges are independent – e.g. price increases, land valuations, etc.

ascribed to the "worst case" in each category, there would remain a likelihood of more than 85% that the true figure would not be at the far (worse end) of the aggregate range.

14.6 Again, we are not advocating the Commission undertake such a calculation formally, but we nevertheless believe it does illustrate an important conceptual point.

15. Public policy underpins balancing approach

15.1 There are sound public policy reasons underpinning the legislature's choice to set a different standard for clearance and authorisation proceedings. The legislature has recognised that mergers can be efficiency enhancing and benefit the whole country even where they substantially lessen competition. The wording of the Act has been set in order to encourage such efficiency enhancing mergers, because of the benefits to society. The Commission's assessment is designed to determine whether the public is better off or worse off if a merger is authorised. Accordingly, there are no public policy reasons why the wording of the authorisation test should be interpreted conservatively or in favour of declining authorisation.

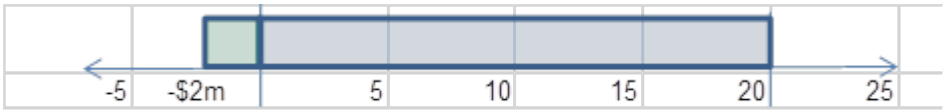
15.2 Indeed, one could envisage a series of authorisations as described above where the net benefit range went from a small negative (say negative $4 million) to a larger positive (say $30 million). For the purposes of exposition, we assume that there are 10 such instances. Taking an approach that focusses solely on the negative detriment figure would lead to the Commission declining each such authorisation. However, absent some very odd distribution of probabilities, it is fair to assume that over time the average net benefit that would accrue from these mergers would be somewhere around the midpoint, i.e. $13.0 million.

15.3 Because the authorisation process requires the Commission to assess the likely net benefit to the public, declining these authorisations would lead to a net detriment to the country of somewhere in the order of $130 million. In CWH's view, this is not what was intended by the legislature when it framed the authorisation test, and indeed avoiding such an outcome over time is why the authorisation test is framed in the way that it is.

16. Conclusion

16.1 Again, the parties believe the evidence on the record is such that even on a 'worse case' approach, the net benefit is positive.

16.2 However, in a scenario where the Commission's final assessment is that there is a range of net benefits spanning negative and positive values, it must not, without further analysis, simply decline the transaction. What s67 requires is a balancing of benefits and detriments and consideration of whether **such a benefit to the public is "likely",** such that it ought to be permitted. Again, the issue can usefully be illustrated graphically.



16.3 How the Commission does this will depend on the facts in front of it, but it should remain cognisant that the very bottom of the overall range itself requires that **all** categories of benefits and detriments are simultaneously at their absolute extreme "worst case" values. While it is correct that the Commission must assess a range of possible outcomes (if its factual findings support the need to assess a range), the Act requires that it then reach a view as to whether, on the balance of probabilities, a net benefit would occur, **or** would be **likely** to occur.

16.4 The threshold that the Commission must apply in order to be satisfied that such a benefit is likely is no more than a 50% probability and *could well be significantly less*, i.e. in the case of

the diagram above, the question for the Commission would essentially be whether it is satisfied, on the balance of probabilities, that the prospect the acquisition gives rise to a benefit which **lies within the positive (blue) range** above could be described as being likely / having "**a real chance**"[43].

[43] *Woolworths v Commerce Commission* (2001) 8 NZBLC 102,108 (HC) at [111] – [113].