PUBLIC VERSION

Memorandum

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To: The Chairman and Members
Commerce Commission

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GODFREY HIRST CROSS SUBMISSION

Introduction

1 On behalf of Godfrey Hirst NZ Limited (**Godfrey Hirst**) in this cross-submission we address issues which have been raised in Bell Gully's submission dated 15 October 2015 on the Commission's Second Draft Determination.[1]

2 The Bell Gully submission attaches a memorandum dated 15 October 2015 responding to the Commission's information request of 5 October 2015 (which request we note has not been provided to us) and a brief memorandum also dated 15 October 2015 from NERA Economic Consulting.

3 In responding to issues which have been raised in the Bell Gully submission and attachments Godfrey Hirst relies upon and reasserts all of the information that it has provided already to the Commission in relation to this matter.

4 Included with and forming part of this cross-submission is a further brief report from Professor Graeme Guthrie dated 22 October 2015, which is attached as Appendix A.

5 Consistent with the Commission's instructions this cross-submission addresses only the issues raised in the Bell Gully submission and attachments.

Godfrey Hirst is exposed to price increases in excess of 25%

6 Paragraph 2.4 of the Bell Gully submission claims that Godfrey Hirst will be subject only to the same maximum 15% price increase (as the Commission concludes will apply to merchants who supply wool destined for export), on the basis that Godfrey Hirst only buys scoured wool from merchants and "CWH would have to identify the merchants scourments destined for Godfrey Hirst and then heavily discriminate in respect of that particular volume". Bell Gully then claims in paragraph 2.5 that that view is supported by the Commission's interviews with various merchants who speculated as to what CWH's and/or Godfrey Hirst's future conduct might be.

[1] It would appear that that submission is made only on behalf of Cavalier Wool Holdings Limited (**CWH**) although it does make detailed reference to information relating to redundancy exposure [ ], both of which matters presumably ought properly to be confidential to Lempriere/NZWSI.

7 To deal first with the comments drawn from the merchant interviews, Godfrey Hirst has been refused access to those comments – even on an anonymous basis – by the Commission. In light of that refusal, Godfrey Hirst has been unable to express its own view, and to correct and counter inaccurate views and assertions made by third parties, and repeated by Bell Gully. Natural justice requires that Godfrey Hirst be advised of, and have adequate opportunity to respond to, views and assertions made as to its likely future conduct.

8 As Godfrey Hirst's advisers, we are unable to speculate as to what commercial decisions Godfrey Hirst might make in relation to various hypothetical scenarios. Only Godfrey Hirst itself can respond.

9 Having denied Godfrey Hirst that opportunity to respond, the Commission must disregard all of the speculation by third parties described in paragraph 2.5 of the Bell Gully submission as well as Bell Gully's own assertions in relation to that speculation.

10 Clearly, the best – indeed only – evidence of Godfrey Hirst's likely response to price increases, and point at which such response would be triggered, is provided by Godfrey Hirst itself. In the Commission's initial meeting with Godfrey Hirst – at the Commission's express and repeated request – on 3 December 2014 the Commission was told unequivocally by Godfrey Hirst's owner and Chairman, Kim McKendrick that,[ ].

11 The Commission were also told unequivocally by Mr McKendrick that [

].

12 In paragraphs 108 to 113 of Godfrey Hirst's post-conference submission of 23 June 2015 Godfrey Hirst responded in detail to the Commission's specific question:

> *Assuming the price of wool and all other imports were to remain constant at current levels, what increase in scouring prices over current levels would be sustained before Godfrey Hirst would become uncompetitive such that its New Zealand manufacturing option would become unviable.*

13 Very briefly, Godfrey Hirst's response indicated that [ ][2]
[ ].
The Commission has advised that because it cannot fully test that assertion with Cavalier, it must disregard it (despite Godfrey Hirst having agreed a detailed précis of those paragraphs for release on a confidential to counsel and experts basis). It is difficult to see why that should be; given that Cavalier have no insight into Godfrey Hirst's financial drivers. Certainly, all the Commission would be inviting Cavalier to do is speculate.

14 But, if the Commission is right that it should not have regard to [ ] indicated by Godfrey Hirst, then it must surely also disregard the merchant statements that we are unable to test with our client.

[2] This figure is confidential, including from counsel and experts.

15 In any event, as the submission noted, [ ][3]
[ ]. Post-acquisition CWH would have both the incentive and ability to inflict higher scouring charges on Godfrey Hirst than its own downstream manufacturing firm, Cavalier Bremworth, giving Cavalier Bremworth a cost advantage. Such cost advantage could render Godfrey Hirst a less effective competitor (as the Commission has recognised).

16 The Commission has also been told, previously, that the particular specifications of wool being scoured for carpet manufacturing mean that scourments destined for Godfrey Hirst could be readily recognised by the monopolist scourer. That is confirmed by [ ] said:

[

] GH has very specific specs.

17 In short, having the merchant as intermediary affords Godfrey Hirst no protection.

18 Godfrey Hirst's subsequent encounters with CWH with regard to a new scouring rate bear out Godfrey Hirst's concern. The Commission has been provided already with [

].

19 [ ].

Greasy exports are an imperfect constraint

20 The Bell Gully submission claims in paragraph 3.1 and 3.2 that threat of further switching to greasy exports "is the principal constraint on current pricing – with or without the transaction". It states specifically that "almost all of CWH's export customers export at least some greasy wool alongside their clean wool products".

21 This claim is significantly overstated, when compared with what the merchants in fact have told the Commission.
[

]. In [ ] later interview [ ] says
[

]. In other word, merchants that export to other places do not have the same alternatives as those who export to China, and even those who export to China face quality constraints.[4]

[3] This figure is confidential, including from counsel and experts.

[4] [

].

22 In [ ] interview of
[

]
[

].

23 [
].
[

]

24 [

].

25 In summary, these interviews with [ ] independent merchants indicate that:
[

]. This is quite inconsistent with Bell Gully's interpretation of the merchants' comments.

Price increases unlikely to be "incremental" or "smaller than 15%"

26 The Bell Gully submission claims at paragraph 3.3 that any price increase "would likely be incremental" and "would also be smaller than 15%". That claim is repeated in paragraph 6.4(f) in relation to allocative efficiency loss.

27 The sole basis for that assertion is footnote 342 of the Second Draft Determination, where the Commission states:

> *Based on views put forward by merchants and the parties, the Commission considers that an immediate price increase of 15% is unlikely, and any actual input price increases are likely to be smaller and incremental over time.*

28 That footnote does not survive close scrutiny.

29 Dealing first with "views put forward by the parties", these clearly must be regarded with a high degree of scepticism. First, the Applicant and its prospective major shareholder are hardly disinterested in the outcome of the authorisation process and are unlikely to volunteer details of their potential monopolistic pricing. The Commission acknowledges that post-acquisition CWH will be left as the only scourer of wool in New Zealand with the ability to increase prices by up to 20% before the threat of entry would be likely to provide a competitive constraint.

30 As yet, CWH, as future monopolist supplier, has not entered into – or even yet discussed – [

] there is no basis to assume that CWH would have considered likely post-merger rates for other customers. On the contrary, for CWH to consider transactions that will only be entered into post-acquisition, [

].

31 The Commission acknowledges that at present NZWSI, as a rival supplier of scouring services, also provides a competitive constraint on CWH. Post-acquisition however NZWSI will cease to be a rival supplier and instead become a major customer of CWH. As a prospective major customer of CWH, NZWSI [

].

32 In short, the views put forward by both CWH and NZWSI as to amount and speed of price increases should have been given little weight by the Commission. [

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33 Turning now to the views put forward by merchants, they contain no clear statement that price increases are likely to be either "incremental" or "smaller than 15%". **Attached** as Appendix C is a detailed analysis of what the merchants in fact said in relation to the quanta and rate of increases.

34 The Commission says at paragraph 258 that:

> *Because of the alternatives [i.e. switching to overseeing the Commission scouring wool overseas and seeking out new opportunities with wool users that demand greasy wool], some merchants considered a one off price increase of a substantial magnitude would be unlikely. Instead, as outlined below those merchants considered that any price increases would be relatively small and incremental.*

35 On close analysis they mostly did not. Paragraph 259 cites [ ] as saying "any post-merger price rise would unlikely to be a substantial one off increase". Further, at paragraph 262 the Commission quotes
[ ].

36 In fact, as is acknowledged in paragraph 272, only [ ] of 12 merchants interviewed by the Commission indicated a belief that any price increases would be incremental. [
]. As is shown in paragraphs 90 to 92 of Godfrey Hirst's submission of 15 October, the Commission has mis-quoted [
]. That is much larger than the Commission's summary of [ ] view [ ].

37 [
]. The Commission cannot take [ ] statement as to a response to a single [ ]% increase as evidence that a one off 15% increase (or smaller) is unlikely.

38 In summary, there is no evidence from views put forward from the merchants that an immediate price increase of 15% is unlikely or that actual price increases are likely to be incremental overtime as footnote 342 states and Bell Gully relies upon.

39 Moreover, as we have previously noted, before the Commission accepts the predictions of these [ ] merchants over the majority of merchants who do not indicate that an incremental increase is the likely option, it will need to explain why it considers these merchants' powers of prediction to be superior to their competitors.

40 Even if the Commission were to consider that incremental price increases are more likely than a one-off increase – which Godfrey Hirst disputes - all that does is make it more likely that the ultimate aggregate increase will be significantly greater than 15%. It is plainly the case that a number of merchants envisage and would accept large price increases.

41 But if smaller, annual, price increases are seen as more palatable, then over time they are inevitably going to end up being larger than a one-off increase. This is particularly likely when merchants are negotiating an annual fee, which is then set for the year. They can use that figure in their discussions with their own customers and plan accordingly. So each increase, by itself, is unlikely to be enough to cause the merchant to go through the inconvenience of investigating an alternate approach – one that most of them indicate they find "not the desired option". This makes it likely that if an incremental approach is adopted the ultimate price rise will be even higher than it would be as a one-off increase.

42 **Attached** as Appendix A is Professor Graeme Guthrie's comments of the possibility of a sequence of small price rises.

Redundancy exposure is not overstated

43 The Bell Gully submission at paragraph 4 complains that the Commission's conclusions in relation to redundancy costs overstate the merged entity's exposure

to redundancy costs especially in relation to [ ] staff whose services will no longer be required post-acquisition. [

].

44 The situation in relation to [ ] staff has been made even more opaque by the incremental provision of supposedly clarifying information from Cavalier's employment expert, [ ].

45 It may be helpful to return to first principles here. The Commission's *Guidelines to the Analysis of Public Benefits and Detriments* indicate that a public benefit can occur through cost reductions due to reduced labour costs. However, the *Guidelines* emphasise that in identifying public benefits, it is a "with" and "without" comparison which must be made, not a "before" and "after" comparison. This means that in the normal course of events the benefits claimed must be shown to be dependent on the acquisition being permitted to go ahead. Further, in the event that the Commission is required to focus on the public benefit arising from certain parts of an application, it can do this only where clear cordial relationships are established between individual measures and specific outcomes.

46 We note that Lempriere, in its application dated 29 October 2012 to the Overseas Investment Office, stated that NZWSI, which company it was seeking consent to acquire, operated two wool scouring plants (at Kaputone and Whakatu) and in total NZWSI employed more than 80 people in New Zealand. Elsewhere in the application it was claimed that:

46.1 NZSWI currently purchases and trades about 30% of New Zealand's total wool clip and is New Zealand's largest wool trader (paragraph 3.7); and

46.2 NZWSI's wool plants at Kaputone and Whakatu regularly operate 24 hours per day at full capacity processing approximately 45% to 50% of New Zealand's coarse wool (paragraph 3.9).

47 Significantly however in the Investment Plan forming part of that application, Lempriere indicated that the statutory criterion "Creation of new job opportunities or retention of jobs in New Zealand" was "not relevant" to that application. In other words, Lempriere was giving no assurance then to the OIO that it would retain existing employment levels at the NZWSI scours.

48 Of course the Commission has received detailed evidence that since that time the total wool clip has declined by approximately 12%. Lempriere has also subsequently discovered that it is required to make substantial expenditure [

].

49 Given those changes, it must be that Lempriere/NZWSI anticipates some reduction from previous staffing levels [ ] without the acquisition. [

].

50 NZWSI has not provided, and presumably has not been asked by the Commission to provide, a detailed operational budget [ ] for 2015/16, showing anticipated staffing requirements in the event that the merger does not proceed.

51 We note that that should have been done to satisfy the with/without comparison required by the *Guidelines*. We are not suggesting that that exercise now be done. But, we do say that estimation of prospective redundancy costs with and without the merger is not an exact science, especially when the Commission must operate on initially inadequate and still incomplete information.

Land valuations require an even more conservative approach

52 The Bell Gully submission at paragraph 5 raises several objections as to the value of the Clive, Whakatu and Kaputone properties adopted by the Commission. This is after having considered the market valuations provided to the Commission by its own independent valuers together with information obtained at the Commission's property valuation hearing on 1 September.

53 We note the value adopted by the Commission for Clive in fact was somewhat above the market valuation provided by the Commission's independent valuers.

54 Bell Gully's initial complaint is that the valuations originally provided by the Applicant were undertaken "by registered valuers and for purposes other than the authorisation application". So they were. The valuations were dated and prepared at a time when contingent risks were less important, [ ] because of the existing and continuing use. The current activity for those properties is now at an end by the application of a 50 year restrictive covenant. Because of these factors – and because Godfrey Hirst challenged those original valuations - the Commission prudently required its own valuations.

55 The next objection is made at the Commission's dismissal of [

]⁵.

56 In paragraph (d) of the Bell Gully submission the "conservative approach" adopted by the Commission in relation to sale of surplus land is argued against in great detail. Given the limited information provided to the valuers in relation to some matters that can have significant risk impact on potential sale price, [ ] a conservative approach is commercial common sense. [

].

57 Finally, the Bell Gully submission argues that sales of the sites will occur much sooner than the one year the Commission has allowed. They claim "these sites can be ready for sale in a matter of weeks". We disagree. It can take years to sell specialised property of this nature. There are many examples where specialisation creates obsolescence which limits market appraisal and, as a consequence, value. Buyers at this level often find it economic to move onto "greenfield" development.

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[5] See page 37 of the transcript of the Commission conference on valuation. [ ]

58 [ ].

Conservative approach

59 Paragraph 6 of the Bell Gully submission more generally reiterates its arguments of 10 August 2015 regarding the appropriate framework for analysing net public benefit. Bell Gully argues, again, that:

59.1 the Commission is required to determine whether net public benefits are "likely";

59.2 the term "likely" means, in this context, a threshold of less than 50% likelihood; and

59.3 accordingly, the Commission has erred to the extent it has taken a "conservative" approach to its assessment of net public benefit.

60 First, we reject Bell Gully's assertion that the Commission's approach (and the examples Bell Gully outlines at paragraph 6.4 of its submission) reflect the Commission taking a "conservative" approach, in the sense that the Commission has conducted its analysis on the basis of a "worst case" scenario. Rather, all of the examples provided by Bell Gully reflect either: (i) the Commission's articulation of the upper or lower bounds that define the range estimate for the relevant parameter, or (ii) the Commission's best estimate, given the available evidence. Where the Commission has characterised its estimates as "conservative", we understand the Commission to be saying that, given the available evidence, a value towards one end of the range represents the Commission's best estimate under the circumstances.[6] We do not read the Commission's use of the term "conservative" as suggesting that the Commission is adopting values that are lower than its best estimate, in light of the available evidence, or defining upper and lower bounds for its range estimates that are outside the scope of what is "likely".

61 Second, as we explained in Godfrey Hirst's submission of 15 October, Bell Gully's explanation of the appropriate analytical framework for assessing net benefit reflects a misreading of the law. Bell Gully's argument that judicial interpretation of the term "likely" in the context of section 66 entails the conclusion that the Commission, in the context of section 67, must grant authorisation even if it concludes that there is *less than a 50% likelihood of net public benefit* is patently absurd, and demonstrates the error of reading-across too literally from section 66 to section 67.

62 Moreover, Bell Gully overstates the ratio of the Court of Appeal's decision in *Woolworths*. The Court's discussion of the 1991 amendments to section 66 simply served to illustrate the High Court's error in concluding that the Commission's decision-making role is a binary one, in which the Commission must take a position that the proscribed effect is either likely or unlikely. Properly understood, the Court's reliance on the 1991 amendments does not imply any particular approach to the interpretation of section 67.

[6] For the avoidance of doubt, we also do not necessarily agree that the Commission's estimates are in fact "conservative" in light of the evidence. As explained elsewhere in this submission, we disagree with a number of the conclusions reached by the Commission in its assessment of the evidence.

63 Critically, Bell Gully's submission ignores the requirement that the Commission be "satisfied" of the requisite net public benefit, which, as the Court of Appeal has consistently held, means that the Commission must decline approval of the transaction where it is left in doubt. As the Court of Appeal held in *Woolworths*, the existence of "doubt" corresponds to a failure to exclude a "real chance" of the proscribed effect occurring (in the case of section 67, that detriments exceed benefits). It was the failure of the High Court in *Woolworths* to recognise this possibility that the Court of Appeal identified as that court's principal error.

64 The approach set out in Godfrey Hirst's submission of 15 October represents an internally consistent reading of the statutory language of sections 66 and 67. Moreover, it brings coherence to the overall scheme of merger control in the Commerce Act, by requiring the Commission to apply the same evidential standards to the clearance and authorisation processes. As we explained in that earlier submission, there is no reason to believe that Parliament would have intended the Commission to adopt a lower threshold for authorisation than for clearance.

65 On the contrary, when giving clearance the Commission is stating that it is satisfied that the effect prohibited by section 47 will not be likely to occur. When granting authorisation the Commission is stating that, although that prohibited effect will occur, nevertheless it is satisfied that there will be such a benefit to the public that the acquisition should be permitted.

Clive is closed/will close without the merger

66 Bell Gully's memorandum in response to the Commission's (unseen) information request is an attempt to defy reality. As set out in paragraphs 147 to 169 of Godfrey Hirst's submission of 15 October 2015,
[ ].

67 In summary, we have shown:

67.1 [ ];

67.2 [ ];

67.3 [ ];

67.4 [ ];

67.5 [ ]; and

67.6 [ ].

68 The only response the Bell Gully memorandum provides to that reality is that some customers might be adversely affected at the height of the processing season if Clive is not kept available. There is then speculation as to grave consequences if all merchants' needs cannot be met. In particular, greasy exports might increase and merchants lose confidence in CWH; with the spectre of lost margins on future customers.

69 Against this "disaster scenario" is the simple truth is that Awatoto and Whakatu between them have managed to process [ ] wool produced in the North Island for [ ] now; and Table 1 of the Second Draft Determination indicates the 14% decline in the North Island wool clip with no evidence of recovery.

70 And there is the reality – which Bell Gully does not engage with – that Cavalier Corporation is attempting wherever possible to sell assets to reduce debt. An unused asset like Clive cannot avoid the axe.

71 Second, the Commission has direct evidence from a number of merchants that exports of greasy wool to Chinese customers are increasing because those purchasers have their own scours and want to scour the wool themselves. The Commission notes in paragraph 244 of the Second Draft Determination that China now accounts for about half of New Zealand's wool clip. However, China is also the destination for over 80% of the greasy wool exported from New Zealand. So, there will be reducing demand.

72 Third, on the supply side, as with most of the primary sector, processing capacity is always scarce at the height of the season. Historically, that phenomenon is dealt with by experienced merchants booking scouring space well in advance of when they will require it. Presumably that is what happens at the moment in the South Island where neither NZWSI nor CWH has a surplus scour to fall back on. Without Clive reopening, CWH could simply revert to the traditional scouring space booking system.

73 Overall, the Commission is being asked to exercise its judgement as to whether CWH would continue to operate Clive occasionally in the counterfactual; or instead, as we argue, it is likely that CWH would dispose of Clive. That requires the Commission to test the credibility of CWH's claims regarding the business case for retaining Clive. The Commission should not accept uncritically CWH's assertions as to the need to retain Clive in the counterfactual, but should instead weigh the evidence. As a matter of commercial common sense CWH would not continue to operate Clive given that:

73.1 disposing of Clive would avoid [ ] and would allow CWH to realise the capital value of the asset (which they say is substantial). This is a factor of critical importance given CWH's current financial performance and need to reduce costs and free up capital;

73.2 it is apparent from the information provided by Bell Gully on 29 September 2015 that Clive's [ ]:

(a) [ ];

(b) [ ]; and

(c) [ ].

73.3 given the [ ] volumes that Clive is called upon to process on the occasions that it has been active, it is likely that relatively straightforward operational adjustments (for example space booking) would address the needs of customers;

73.4 even in the counterfactual, merchants have limited alternative options, and therefore it is not credible to suggest that the [ ] inability to accommodate the preferences of all merchants would result in a loss of future revenues that would outweigh the savings to be realised by disposing of Clive; and

73.5 [

].

74 Once the evidence is weighed, the assertion that CWH would continue to operate Clive in the counterfactual is simply unsupportable. Applying its judgement to that question, the Commission should conclude that CWH would dispose of Clive whether or not the transaction is allowed to proceed.

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APPENDIX A

COMMENTS ON THE POSSIBILITY OF A SEQUENCE OF SMALL PRICE RISES

Graeme Guthrie

October 22, 2015

I have reviewed Cavalier Wool Holdings Limited's submission on the Revised Draft Determination on CWH's application for authorization. In its submission, CWH suggests that the calculation of the loss of allocative efficiency should assume that post-merger price increases occur in a series of small steps rather than in a single jump at the time the merger occurs.

The Commission raises the possibility that price rises will occur in steps in footnote 342 of the Revised Draft Determination. The Commission states that this assumption is "[b]ased on views put forward by merchants and the parties". While some merchants do raise this possibility in the file notes available to me, only a minority of merchants do so. All merchants are trying to predict the behaviour of a firm that does not yet exist, has a proposed ownership structure that many merchants appear not to fully understand, and will operate in a market with a monopolist replacing competing scours. The Commission therefore needs to be very careful in attaching too much weight to the predictions that these merchants make regarding the behaviour of a monopoly scouring operation.

I believe the Commission needs to consider the following if it considers deviating from the approach it adopted in both the Original and Revised Draft Determinations.

In the Revised Draft Determination the Commission assumes that the merged firm's concentrated ownership structure and competition from overseas scours means that the merged firm will have a strong profit-maximization motive. (For example, paragraph 504.) Absent other factors, increasing the scouring price in a series of small increments simply delays the price rises, delays the firm's increased profits, and reduces the present value of those increased profits. That is, the behaviour being suggested is inconsistent with profit maximization.

One possible rationale for increasing the scouring price incrementally would be that a small initial change would induce merchants into investing in ways that allow them to operate efficiently when facing that slightly higher price. If the cost of that investment is sunk then merchants might be "tricked" into making a series of small sunk investments that they would not have made if they had to be made all at once. There are at least two problems with this argument. First, merchants will anticipate an ongoing sequence of small price changes, so are unlikely to behave with the myopia necessary for this rationale to be viable. Second, I do not recall any suggestions that merchants could make such investment; the suggested merchant strategies have involved merchants choosing between maintaining their current business model and switching to exporting wool in greasy firm. I think this rationale for incremental price changes can safely be rejected.

Another possible rationale for increasing the scouring price incrementally would be that the merged firm is uncertain about the demand response to price changes. Undertaking a series of small changes would allow the firm to learn about the demand response while limiting the risk that it overdoes the price rise and loses an unexpectedly high level of demand. As with the first possible rationale, this one has its share of problems.

First, it is clear from the merchant interviews that it will
[ ].
Therefore, even if the "learning option" rationale were valid, it would not be sensible for the merged firm to start with a small initial price rise. A relatively large initial price rise, followed by smaller subsequent price rises, would be optimal. For example, NERA's scenario with annual price increases of 5%, 5%, 5%, 0%, and 0% is likely to be too gradual to be optimal.

Second, if the merged firm did adopt this approach then the Commission should anticipate that it would be able to "fine tune" its pricing to get the absolute maximum price rise out of merchants. There is no need to "aim low" with a series of small price rises. Thus, if the Commission were to assume a series of small price rises, it would be appropriate to assume that the total price rise is at the high end of likely possibilities.

Third, the merged firm would only impose small price increases in the first few years in return for achieving the maximum possible price rise in the long term. The Commission's current approach of concentrating its analysis on just the first five years would have the effect of including the period when the firm is "investing" in learning about demand (by accepting sub-optimal short-term profits) and excluding the period when the firm gets the payoff of this investment (in the firm of high long-term profits).

Thus, while the second rationale for a series of small price increases is more plausible than the first, its implementation poses very real difficulties. It would introduce even more noise into the calculation of the loss of allocative efficiency without any apparent offsetting benefit.

APPENDIX B – [ ]

APPENDIX C

MERCHANT'S VIEWS AS TO "INCREMENTAL INCREASES"

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