

Confidential

MEMO

TO: Phil Taylor, Glenn Shewan, Penny Pasley and Emma Harris, Bell Gully
DATE: 24 December 2014
FROM: James Mellsop and Will Taylor
SUBJECT: CWH/WSI - review of Neil Quigley's comments

1. Introduction

We have been asked to review notes on the proposed CWH/WSI merger prepared by Professor Neil Quigley (dated 3 December 2014). We understand that Professor Quigley has been engaged by Godfrey Hirst. Professor Quigley's notes are focussed on our cost benefit analysis of the merger, as set out in our 22 October 2014 report.

We set out our review of Professor Quigley's notes in this memo, using the same headings as he does.

2. The post-merger constraints provided by scouring in China and Malaysia

At paragraph 1, Professor Quigley states that we do not appear to have considered certain costs and capacity issues in respect of scouring in China and Malaysia. It is correct that our report does not analyse transport costs and capacity in detail, but this is for a reason. Our approach has been to adopt the Commission's price rise assumptions from *Decision 725*, against the evidence that if anything, the constraint from scouring overseas has strengthened since that decision:¹

- A greater proportion of New Zealand's wool clip is exported to China in greasy form (over 24% versus 14% last time) – in other words, the “market share” of Chinese scours has increased;
- A number of new scour lines have opened in China since the last process; and
- Compass Wool Processors has established a scour in Malaysia, and is marketing its services in New Zealand.

¹ See the 22 October 2014 authorisation application for further detail.

3. The post-merger constraints provided by potential entry

At paragraph 2, Professor Quigley argues that our entry model should consider the impact of resource consenting issues, particularly delay and cash costs. Professor Quigley states it “is unlikely that production could commence until the beginning of the third year ...”

As noted in section A1 of our 22 October 2014 report, our entry model is the same one that was adopted by the Commission in *Decision 725*. The model assumes that production would commence with a delay and then ramp up in year 1, i.e., the same year as the initial capital expenditure, including that on land. The implication of Professor Quigley’s critique is that there would be a greater delay between some of that initial capital expenditure (particularly on land) and production, due to the need to obtain a resource consent.

The most appropriate assumption to use in respect of timing should be informed by resource consent expertise. We will report back on this issue once we receive further advice on it.

Regarding the cash costs of obtaining consents, the CWH inputs to our model do not include a specific item for resource consents, although they do include unallocated consulting costs of \$60,000 per year. We are advised by CWH that the cash costs of obtaining consents are unlikely to exceed this.

Professor Quigley argues that the (cash) costs of obtaining the consent “should make allowance for the incumbent to oppose the issue of a consent and thus raise the costs of an entrant”. However, we understand that 2009 changes to the Resource Management Act mean that a “trade competitor” can only make a submission on a resource consent application if it is directly “affected by an effect of the activity to which the application relates, that (a) adversely affects the environment and (b) does not relate to trade competition or the effects of trade competition” (section 308B). Therefore this aspect of Professor Quigley’s critique appears to be misplaced.

At paragraph 3, Professor Quigley outlines a possible entry deterrence strategy, being that the merged entity could “reduce prices to the level of avoidable costs to deter entry”. Professor Quigley argues that we have not considered this strategy. However, this is not correct. We explicitly note in Appendix A of our 22 October 2014 report that “the entry we model is likely to be underwritten (either by ownership or contract) by a combination of large merchants”. As is recognised in the economics literature,² underwriting in this way is precisely to address the risk of the merged entity dropping its price to deter entry.

At paragraph 4, Professor Quigley appears to be arguing that simultaneous entry in both Islands should be modelled. However, the Commission explicitly considered this same argument during the last process, and rejected it (see paragraphs 160 to 163 of *Decision 725*), and Professor Quigley has not provided any reason for a change in approach this time.

² See, e.g., chapter 11 of Carlton, Dennis and Jeffrey Perloff (2005), *Modern Industrial Organization*, Prentice Hal, 4th Ed

We are not sure we understand what Professor Quigley means by “winner take all” competition in the present case (in paragraphs 4 and 6). As we have already noted, we have assumed that sufficient volumes for entry would be underwritten, reducing the risk for the entrant. There are also numerous wool scouring customers, and it is difficult to see why customers and volumes would not be split if there was entry (just like they are today).

At paragraph 5, Professor Quigley argues that we have ignored the real option that would be destroyed by entry. He asserts that, “NERA uses a discount rate that is much too low to capture the returns that a potential entrant would require before investing in entry”, without providing any evidence.

The option to delay has value when there is uncertainty and the costs incurred are sunk. As already noted, Professor Quigley appears to overlook the risk-reduction of the underwriting contracts (or vertical integration). In addition, we understand that scouring equipment is internationally transportable and can be sold second hand relatively easily, and the land and buildings would have alternative uses to another buyer. These factors suggest that the delay option in the present case may not be as valuable as Professor Quigley implies.

Furthermore, the cost of capital we use is 20.83% pre-tax real, or 15% post-tax real.³ While we have not carefully analysed the appropriateness of this cost of capital (as we note in Appendix A), on its face it would be surprising if 20.83% real was too low.

4. Vertical foreclosure following merger

At paragraph 8, Professor Quigley argues that with “no ongoing supply contracts to protect Godfrey Hirst, NERA should have considered the potential for the vertically-integrated merged entity to use non-price mechanisms to foreclose GH from the market for clean wool”.

We carefully analysed this issue during the last process (see in particular our 18 May 2011 report), and we concluded that:

- The upstream merged entity (CWH) would likely suffer a reduction in profits from implementing a foreclosure strategy; and
- The ACC and Direct Capital, as half-owners of CWH, would accordingly have no incentive to engage in foreclosure.

Foreclosure is even less likely in respect of the current case, as the non-Cavalier Bremworth financial and control interests in CWH would be even higher (72.5%). In other words, the vertical integration that Professor Quigley refers to is so partial that it is unlikely to have a foreclosure effect.

³ Our entry model uses *real* cash flows so we use a *real* WACC. If we instead used *nominal* cash flows, the equivalent *nominal* WACC (which is how the WACC is typically reported) would be higher.

Note that the analysis in our 18 May 2011 report:

- Did not depend on whether Godfrey Hirst had a long-term contract with CWH; and
- Covered both price and non-price foreclosure.

5. Dynamic efficiency

At paragraph 10, Professor Quigley argues that, “NERA refer to dynamic efficiency only in relation to the incentive to invest in innovation”. However, this is not correct – we actually explicitly adopt the Commission’s *Decision 725* dynamic efficiency detriment quantification technique because it is very general, and covers more than just product innovation.⁴

Professor Quigley then goes on to describe the merged entity as having “an absence of competitors” (paragraph 11). We disagree with this characterisation, and we emphasise the view we expressed in our 22 October 2014 report that the most material of the pressures to be (productively and) dynamically efficient would remain post-merger, being:

- The threat of increased exports of greasy wool to China and Malaysia;
- The continued threat of entry; and
- The declining supply of wool grown in New Zealand (meaning that the merged entity’s demand curve will be shifting inwards).

We agree with the Commission’s conclusion in *Decision 725* that “any loss of dynamic efficiency in this instance is likely to be small” (paragraph 310).

⁴ See page 16 of our 22 October 2014 report.