

# COMMERCE ACT 1986: BUSINESS ACQUISITION

## SECTION 66: NOTICE SEEKING CLEARANCE

Date: 10 December 2008

The Registrar  
Market Structure Team  
Commerce Commission  
PO Box 2351  
Wellington

Pursuant to section 66(1) of the Commerce Act 1986 notice is hereby given seeking clearance of a proposed business acquisition.

## EXECUTIVE SUMMARY

### 1. Transaction

This is an Application for clearance to acquire certain assets/shares that will result in the wool scouring businesses of Cavalier Wool and Godfrey Hirst coming under common ownership.

The transaction aims to bring about industry efficiencies by rationalization based on the removal of substantial but far from all, excess capacity.

It also reduces the current level of vertical integration deriving from the current Godfrey Hirst business model under which:

- (a) Godfrey Hirst operates as a scourer of greasy wool focused principally on supplying scoured wool to its own carpet manufacturing business; and
- (b) Godfrey Hirst operates a wool dumping business pressing greasy wool for export and overseas scouring (principally to China) – with the incentive to grow that business limited by the incentive to retain greasy wool for scouring in New Zealand.

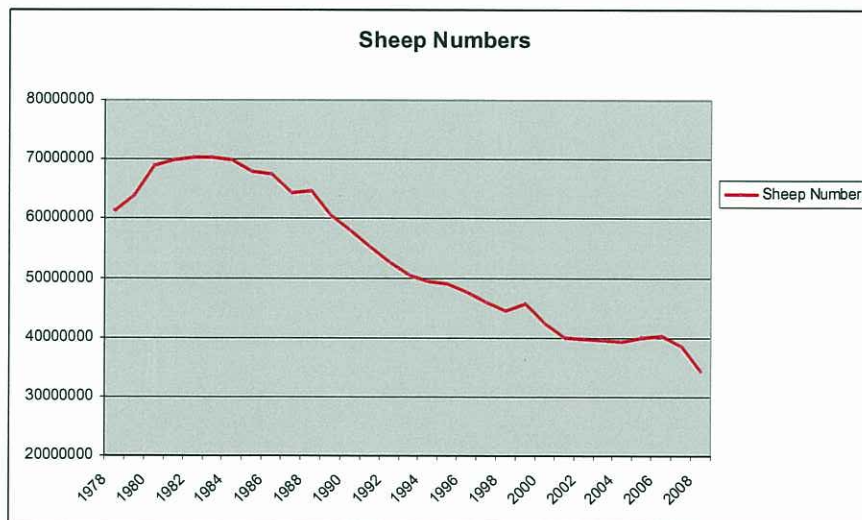
### 2. Industry context

Wool scouring is the process of washing wool in hot water and detergent to remove the non-wool contaminants and then drying it. After washing and drying, the scoured wool is repackaged and transported to intermediary converters/manufacturers for further processing into finished products.

#### 2.1 Historical background

The history of the wool scouring industry is set against the backdrop of New Zealand's once massive but subsidised sheep population and wool clip which supported numerous wool scouring operations. The swift and continuing decline in the sheep flock following removal of subsidies has seen the steady and ongoing rationalisation of scouring capacity.

The New Zealand sheep flock has more than halved from its peak of 70 million in 1982-1983. Sheep numbers fell to 60 million by 1989, continued to decline throughout the 1990s, and now number fewer than 35 million with the past twelve months ended 30 June showing the greatest single drop in the history of the industry.



The continuing decline in the available wool clip for scouring is driven by a number of elements, the most significant being a continuing reduction in the sheep flock due to poor revenue returns relative to other land uses (particularly dairying).

Substantial conversion of sheep farms to dairy farming and dairy support has occurred due to increasing international demand for dairy products combined with negative sentiments about sheep meat and wool prospects. In the past 12 months to June 2008, 330 dairy conversions have been recorded, the second highest number of conversions on record. More are forecast. The reduction in sheep numbers as a result of dairy conversions is significant because the sunk costs involved tend to render the conversion permanent as are the changes to associated pastoral land providing dairy support services.

Drought conditions in recent years in various parts of the country have further aggravated the reduction in sheep numbers due to the killing of substantial numbers of capital breeding ewes.

### **3. Industry response**

The wool scouring industry has responded to the ongoing reductions in sheep numbers and wool clip by steadily reducing scouring capacity. In 1990, there were more than twenty wool scouring plants operating throughout the country. Today, only six remain.

Notwithstanding, capacity still far exceeds the wool that is available for scouring with current overcapacity estimated to be in excess of 40% on a national basis. July to September 2008 national scouring figures are tracking down year on year **12%** in the North Island and **22%** in the South Island and, if anything, are showing a greater decline than the forecasts by Meat & Wool New Zealand. These reductions are on top of the greatest drop ever recorded, in the year to 30 June 2008. While these reductions could be exacerbated by the delays in shearing caused by inclement weather and currently depressed wool prices, they nevertheless, highlight the gravity of the impact of sheep farm conversions and reducing sheep flock for the industry.

The proposed Acquisition is directed at reducing some of that excess wool scouring capacity in an attempt to better align capacity and demand. The Acquisition reflects the view that the ongoing reduction in sheep numbers and hence wool clip requires further scouring rationalisation and the Applicant considers that undue delay in achieving that rationalisation could jeopardise an orderly solution. Post-Acquisition, the Applicant proposes to close the Invercargill plant in the South Island and the 2.0 metre line at Clive in the Hawkes Bay. The 2.4m line at Clive will be retained, making use of the economies of scope arising from being able to operate the facility at Clive in close geographic proximity to Cavalier Wool's Hawke's Bay scour. Despite these closures, substantial excess capacity is forecast to remain.

### **4. Existing competition**

#### **4.1 Constraint from NZWSI**

NZWSI was originally established by New Zealand wool growers in 1991. Today it is a publicly owned company listed on the New Zealand Exchange's Alternative Market (**NZAX**).

NZWSI is a wool exporter and operates a scour in Whakatu, Hawkes Bay (Whakatu Wool Scour Limited) and another in Belfast, just north of Christchurch (Kaputone Wool Scour Limited). It produces scoured New Zealand wool for markets around the world, and has offices in the UK, China and India.

The Applicant believes that NZWSI will be incentivised to increase its commission scouring work post-Acquisition for several reasons, including in particular:

- (a) the fact that profitability is highly dependent on plant utilisation;
- (b) the reducing flock size and wool clip available for scouring (which are not forecast to recover) and the need to compete more aggressively for share in the declining market; and
- (c) customers have historically spread their wool scouring requirements across two competing scourers, to maintain the ability to switch (and to threaten to switch) at will, and this practice is expected to continue in the future.

#### 4.2 Constraint from offshore scouring

While “greasy” (non-scoured) wool volumes are not included within the relevant market definition, the ability and practice of customers to have wool scoured offshore constrains the price and service provided by domestic scourers because it represents a real alternative for a wide range of exporting customers.

Around 85% of all wool is exported and China is by far the biggest importer of New Zealand wool. Given that China has significant excess scouring capacity, if the New Zealand scouring tariff were to go up, those customers currently exporting scoured wool could switch to exporting greasy wool and have that wool scoured in China. Lower tariffs for scouring in China more than off-set any weight related transport disadvantage.

#### 5. Countervailing power of customers

Customers have to date shown a willingness to constrain scours from any attempt to increase prices, even where these increases are aimed at pure cost recovery. Customers are major international wool dealers with vast experience and the knowledge to detect attempts to price above competitive levels. They have options to punish any such attempt, including:

- (a) increasing their use of NZWSI;
- (b) exporting additional volumes of greasy wool; and
- (c) re-entering the scouring market by acquiring a second hand scour, which can be readily purchased on international markets and installed in New Zealand.

Given the size and international connection of these customers, the mere *risk* that they may implement any of those threats, in the Applicant’s opinion, is sufficient to constrain pricing post-Acquisition.

#### 6. No scope for tacit collusion

The market does not currently display any signs of co-ordinated market power and the Acquisition will not affect any of the factors which currently preclude the exercise of co-ordinated market power, including:

- (a) efficiencies available to scourers from increases in throughput (increasing the incentives to cheat) and the scourers having surplus capacity (increasing the ability to increase throughput with little/no capital constraints);
- (b) large (generally international) customers able to detect and punish any attempt to tacitly collude;

- (c) the practice of those large customers to have their wool scoured by at least two scourers (i.e. cheating cannot be detected because there is no way of knowing that a customer has been “lost”); and
- (d) the absence of price transparency – actual prices including a range of discounts, rebates, etc.

## PART 1: TRANSACTION DETAILS

1. Provide the name of the acquirer (person giving notice), and the name and position of the individual responsible for the notice. Please include the:

- registered office address, postal address and physical address of the acquirer;
- telephone and fax numbers and website of the acquirer; and
- email address, telephone number and position of the contact person.

1.1 This application is given by David McDougall Ferrier. Mr Ferrier is the sole shareholder and director of New Zealand Woolscourers Limited (**NZWL**). As set out in section 4, Cavalier Wool Holdings Limited (**Cavalier Wool**) (in which interests associated with Mr Ferrier will have a shareholding in the order of 50%) will acquire certain assets as part of the overall transaction. Cavalier Wool has contributed to, and agrees with, the content of this application.

New Zealand Woolscourers Limited

David Ferrier  
Address: c/- Bell Gully  
Telephone: 021 622 549  
Email: dmferrier@xtra.co.nz

1.2 Both Mr Ferrier and Cavalier Wool request that all correspondence is directed in the first instance to:

Bell Gully  
Vero Centre, 48 Shortland Street  
PO Box 4199  
Auckland 1140

Attention:	Phil Taylor Partner	Torrin Crowther Senior Associate
Telephone:	(09) 916 8940	(09) 916 8621
Fax:	(09) 916 8801	(09) 916 8801
Email:	<a href="mailto:phil.taylor@bellgully.com">phil.taylor@bellgully.com</a>	<a href="mailto:torrin.crowther@bellgully.com">torrin.crowther@bellgully.com</a>

2. Provide the name of the other merger parties, and the name/position of the relevant individual within the relevant merger parties. For each merger party, please include the:

- registered office address, postal address and physical address;
- telephone and fax number and website; and
- email address, telephone number and position of the contact person.

2.1 The participants are the Applicant, Cavalier Wool and Godfrey Hirst NZ Limited (**Godfrey Hirst**).

Cavalier Wool Holdings Limited  
Victor Tan  
c/- Cavalier Corporation Limited

Telephone: (09) 277 6000  
Fax: (09) 279 4756  
Email: vtan@cavbrem.co.nz

Godfrey Hirst  
Tanya Pauling, General Manager  
142 Kerrs Road  
Manukau  
PO Box 97 145

- 2.2 The Applicant and Cavalier Wool request that all correspondence in respect of this application be addressed in the first instance to Bell Gully.
- 2.3 Godfrey Hirst requests that all correspondence in respect of this application be addressed in the first instance to:

Grant David  
Partner  
Chapman Tripp

Telephone: (04) 498 4908  
Fax: (04) 472 7111  
Email: Grant.David@chapmantripp.com

3. **With respect to the merger parties, list the relevant companies and the person or persons controlling these directly or indirectly. Please use organisational charts or diagrams to show the structure of the ownership and control of the acquirer and participant(s) to the acquisition.**

3.1 Acquirer group/associates:

- (a) A diagram setting out Cavalier Wool in the context of the wider Cavalier Group is set out as Appendix 2 below.
- (b) While not giving rise to interconnection or association, interests associated with Mr Ferrier<sup>1</sup> currently own 7.5% of Cavalier Wool. Mr Ferrier is also a director of Cavalier Wool and its wholly owned subsidiary, Cavalier Woolscourers Limited.
- (c) Cavalier Wool will also be issuing such shares in the capital of Cavalier Wool to NZWL to take the shareholding of David Ferrier related interests in Cavalier Wool from 7.5% to a shareholding in the order of 50%.
- (d) It is also envisaged that Cavalier Bremworth (the Cavalier group company that holds the balance of the shareholding in Cavalier Wool) and Mr Ferrier will enter into a shareholders' agreement granting each other pre-emptive rights over their respective shareholdings in Cavalier Wool in the event of a sell-down of their respective interests, and that it is therefore possible that either one of them could end up owning 100% of Cavalier Wool.

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<sup>1</sup> David Mcdougall Ferrier and his wife, Angela Margaret Nelson, as trustees of the Chancery Trust, currently hold 7.5% of the shares in Cavalier Wool. Under the current arrangements, Cavalier Bremworth has granted in favour of interests associated with Mr Ferrier a put option, and those interests have granted in favour of Cavalier Bremowrth a call option, in respect of the 7.5% shareholding in Cavalier Wool held by The Chancery Trust. These arrangements will terminate as a result of the restructure of Cavalier Wool to be undertaken in conjunction with the acquisition. Under the new arrangement, pre-emptive rights flow each way in respect of the shareholder's interests.

- 3.2 Target company group/associates:
- (a) Godfrey Hirst is ultimately owned by the McKendrick family (and their related interests) who also own Godfrey Hirst (Australia) Pty Limited.
  - (b) A Godfrey Hirst group structure diagram will be provided separately by Godfrey Hirst.
    - **If relevant, identify and explain any other links, formal or informal, between the merger parties, including interconnected bodies corporate and other persons identified in question 3 above and its/their existing competitors in each market.**
- 3.3 Cavalier Wool has a subsidiary called Cavalier Woolscours Limited, which also owns 50% of a greasy wool dump located at Timaru, with the other 50% owned by the Timaru Port Company.
- 3.4 As part of the sales process, Godfrey Hirst and the Applicant have agreed that Godfrey Hirst will use its "reasonable commercial endeavours" to have its scouring requirements scoured by Cavalier Wool for six years following the Acquisition, provided Cavalier Wool provide a competitive service. The benefit of that contract will be assigned to Cavalier Wool as part of the overall transactions.
- 3.5 NZWSI will also acquire certain fixed assets from the Applicant. These are certain Godfrey Hirst scouring assets (including a wool press, blending equipment, wool opening equipment, short wool processors and wool grease recovery equipment). These assets will develop the front-end of the NZWSI scours in both the North and South Islands and will enhance quality measures and remove bottlenecks in the scouring process, ultimately improving NZWSI's ability to grow its commission scouring business.
- 3.6 As part of this transaction, NZWSI has sought, and it has been agreed, that:
- (a) Cavalier Wool will provide NZWSI with an underwrite of a minimum increase in NZWSI's commission scouring volumes, subject to NZWSI being obliged to use all reasonable commercial endeavours to grow and thereafter maintain its Commission Scouring business and otherwise carry on its Commission Scouring business in accordance with best industry practice; and
  - (b) NZWL covenants that:
    - (i) it will not use the Clifton Land or any part of it for the purposes of woolscouring, wool processing, wool dumping or wool grease extraction for a period of ten years from the Settlement Date and will execute and register a Memorandum of Encumbrance against the titles to the Clifton Land in favour of the Purchaser to secure performance of the covenant; and
    - (ii) within 20 Working Days following the Settlement Date, it will decommission, dismantle and remove the two woolscouring lines on the Clifton Land and one of the two woolscouring lines on the Clive Land and to destroy or dispose of the relevant equipment so as to render all three of those woolscouring lines permanently inoperable anywhere in New Zealand.
- 3.7 The Applicant considers that the sale of the assets to NZWSI (which encompass the foregoing arrangements) creates a positive base from which competition for commission wool scouring will occur.
- 3.8 The Applicant is unaware of any other links.



4. **Provide details on what is to be acquired.**

4.1 The proposed transactions will involve NZWL acquiring the wool scouring and dumping assets of Godfrey Hirst. NZWL will on-sell certain fixed assets to New Zealand Wool Services International Limited (**NZWSI**) and divest the acquired wool dumps in accordance with the undertaking (attached as Appendix 1). Interests associated with Mr Ferrier will also acquire shares in Cavalier Wool to take their combined shareholding to in the order of 50%. Cavalier Wool (or an interconnected body corporate) will acquire the 2.4m line at Clive and land and buildings from NZWL as well as the assignment of the wool scouring contract with Godfrey Hirst. NZWL will close or dispose of the other assets acquired from Godfrey Hirst. The net effect is that Cavalier Wool and Godfrey Hirst will no longer be independent wool scouring competitors.

4.2 Clearance is sought to effect the above transaction. More particularly, clearance is sought for:

- (a) Mr Ferrier or NZWL (the **Applicant**), or any interconnected body corporate of the Applicant, to acquire up to 100% of:
  - (i) the wool scouring assets<sup>2</sup> of Godfrey Hirst or any interconnected body corporate of Godfrey Hirst; and/or
  - (ii) the wool dumping assets<sup>3</sup> of Godfrey Hirst; and/or
  - (iii) up to 100% of the shares in Cavalier Wool or any interconnected body corporate; and/or
- (b) Cavalier Wool (in which David Ferrier related interests will have a shareholding giving rise to a substantial degree of influence) or an interconnected body corporate of Cavalier Wool, to acquire the 2.4m wool scouring line at Clive and land and buildings located at Main Road, State Highway 2, Clive, Hawkes Bay, an assignment of the contract for wool scouring with Godfrey Hirst and 50 shares in the Lanolin Trading Co Limited,  
  
(the **Acquisition**).

4.3 Paragraph 4.2(b) above accommodates a situation where, technically, the scouring assets could be said to be acquired by Cavalier Wool before interests associated with Mr Ferrier acquire an increased shareholding in Cavalier Wool (as contemplated by 4.2(a)(iii) above). In practice, the transactions will occur simultaneously.

4.4 The Applicant undertakes to divest the wool dumping assets acquired as part of the Acquisition pursuant to the Divestment Undertaking attached as Appendix 1 to this application.

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<sup>2</sup> Being the assets located at Clive, Hawkes Bay and Clifton, Invercargill, 50 shares in Lanolin Trading Co Limited, stock and lanolin.

<sup>3</sup> Being the wool dumping plant and equipment located at Clive, Hawkes Bay, Clifton, Invercargill, Christchurch and Dunedin.

5. **Fully explain the commercial rationale for the proposed merger. Specify whether this is part of an international merger.**

***Historical context***

- 5.1 Traditionally, New Zealand had a large sheep flock and associated wool clip. New Zealand sheep numbers peaked at 70 million in 1983 following the government's introduction of the Supplementary Minimum Prices (**SMP**) wool and sheep meat subsidy scheme in 1978. Under the SMP scheme, the government established an average minimum guaranteed price for wool and sheep meat sold during the season. If these prices were not met on the international market, the government topped up the farmer's return by way of supplementary payments. By 1984, nearly 40% of the average sheep farmer's income came from these government subsidies which protected farmers from the reality of international market conditions.
- 5.2 Following the removal of subsidies and regulatory controls affecting the agricultural sector in 1984, there was immediate and material rationalisation of stock numbers and processing, although the impact of SMP policies both in relation to New Zealand and a similar Australian scheme over-hung the market place for some years to follow.
- 5.3 As a result of the removal of the SMP scheme and for a number of other reasons discussed in more detail below, sheep numbers fell to 60 million by 1989 (i.e. a drop of 10 million sheep in five years), continued to decline throughout the 1990s, and now number fewer than 35 million. They continue to fall.

***Impact of reduction of the wool clip and in demand for scoured wool***

- 5.4 The history of the wool scouring industry is therefore set against a backdrop of New Zealand's once massive sheep population and wool clip which predicated a need for numerous scouring operations. However, the nature of the industry has materially changed with rationalisation necessary in the face of a steadily declining sheep flock and associated wool clip. The impacts of this steady decline have been further exacerbated by the growth in exports of greasy wool to China. In 1994, there were more than twenty scouring plants throughout the country, but because of the constant closures required to offset declining sheep numbers, that has reduced to six plants.
- 5.5 This reduction in scouring capacity to meet a reducing wool clip mirrors what we are seeing in a number of countries where there has been a significant reduction in scouring capacity, e.g. the United Kingdom, Australia, Russia and most of Europe. By way of example, the United Kingdom now has only two wool scours for the whole market (one of which is running only two days a week)<sup>4</sup> and in Australia there is only one scour in the western region and just two<sup>5</sup> scours in the eastern region (with no movement of greasy wool between the two regions and therefore no inter-regional competition). Likewise, the recent growth of greasy wool exports to China is by no means unique to New Zealand. All but an estimated 36% of Australian wool exports are currently exported greasy to China.
- 5.6 Historically, major wool buyers were also wool scourers because they needed clean wool for the offshore markets in which they operated and there were sufficient volumes of greasy wool and sufficient export demand for scoured wool to warrant a major wool buyer operating

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<sup>4</sup> There is a third scour, although that is not understood to commission scour for third parties.

<sup>5</sup> There are also two other plants, but these are specialist processors (concentrating on scouring wool contaminated with vegetable matter and involving a process of carbonisation). The overall process is complex and scouring is a relatively small part of the overall process. These are both relatively small plants. New Zealand does not have any scouring carbonisation process due to low levels of vegetable matter affecting the greasy wool.

its own scour. The wool buying/exporting companies listed below have either closed or have been sold down into rationalised structures. A large proportion are European, family controlled companies who have historically operated in New Zealand for decades and most have had ownership (either outright, or by shareholding) in wool scour companies.

- (a) Chargeurs
- (b) Dewavrin
- (c) CIL
- (d) Kreglinger
- (e) E.Lichenstein
- (f) Modiano
- (g) Michell
- (h) Nissho Roberts
- (i) Cargill
- (j) Raymond Dale (bought by NZWSI)

5.7 These were all companies of significant scale (turnover ranging from 75,000 to 200,000 bales). A significant number of smaller players have also exited the industry.

5.8 However, the decline in wool volumes and demand for scoured wool has led to a shift in focus with those global buyers exiting the wool market altogether and those remaining players having their wool scoured by one of the three incumbent scourers or, alternatively and increasingly due to the fast growing China market, purchasing greasy wool from New Zealand for scouring offshore.

***Factors driving a permanent reduction in the wool clip***

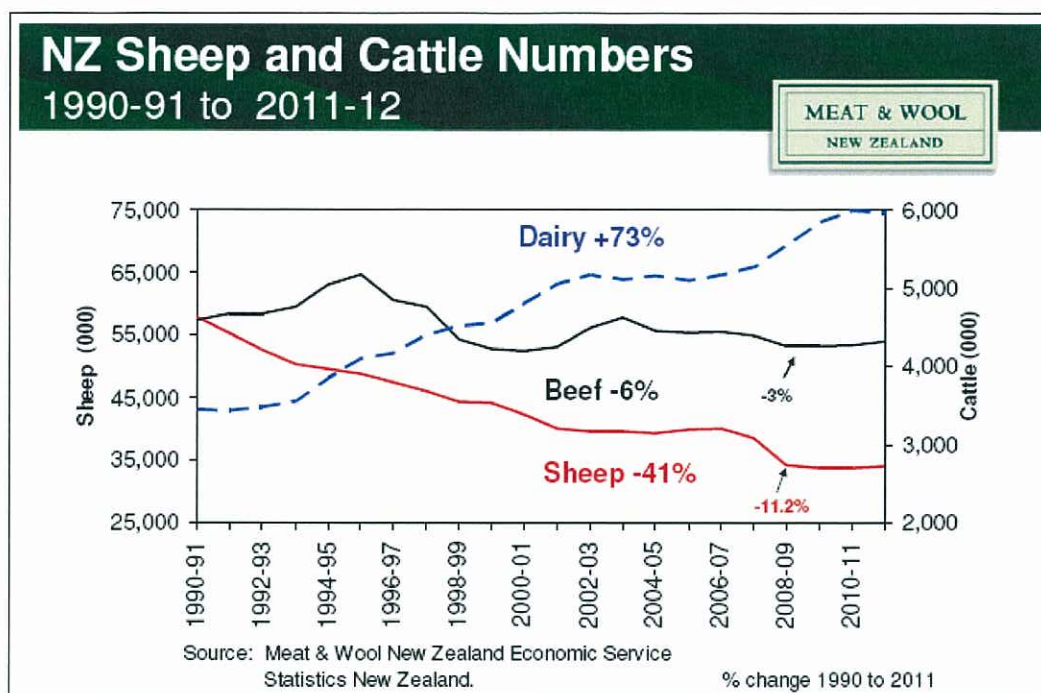
5.9 The key factors have been the substantial fall in sheep numbers, the reduction in international returns and the permanent conversion to dairy (direct and associated land use requirements). More recently, these factors have been further aggravated by a number of droughts.

5.10 The reduction in wool clip and hence scouring throughput has accelerated markedly in recent months. In the three months to September 2008, national scouring figures are tracking down year on year 12% in the North Island and 22% in the South Island.

**Decline in sheep numbers – 1990 to today**

5.11 Following the removal of SMPs, the New Zealand flock has more than halved from its peak of 70 million in 1982-1983. The reduction in numbers has been steady and they continue to decline.

Figure 1 New Zealand Sheep and Dairy Numbers 1990-1991 to 2011-2012



NB: 2008-2011 adopt Meat & Wool New Zealand projections

5.12 This decline is attributable to a number of factors and is projected by Meat & Wool New Zealand<sup>6</sup> to continue into the foreseeable future. The key reasons are set out below. In fact, recent data suggests the reduction is likely to be substantially greater than forecast by Meat & Wool New Zealand.

#### Conversion to dairy farming

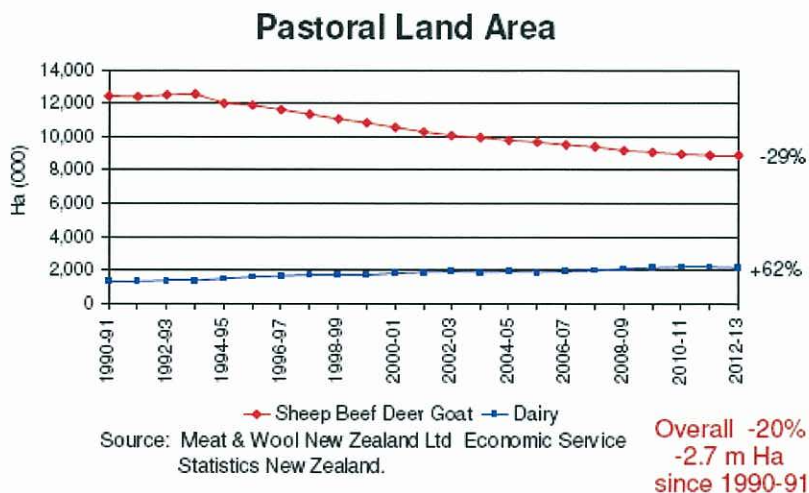
- 5.13 Since the removal of subsidies in 1984 there has been a marked reduction in revenue returns to sheep farmers with a resulting significant rationalization of sheep numbers and processing, as farmers have continually sought alternative and more profitable land use.
- 5.14 Conversion to dairy farming has occurred due to international demand for dairy products combined with negative sentiments about sheep meat and wool prospects. From 2004-08, lamb export prices were down between 16 and 21%.
- 5.15 Meat & Wool New Zealand records that in the 12 months to **June 2008**, the number of sheep and beef farms converted to dairy is estimated to be 330, well up from 70 conversions in the previous year. This is the second highest number of conversions on record.<sup>7</sup> These conversions are estimated to result in the displacement of approximately 871,000 sheep units alone (from a total displacement of 1,327,000 sheep and beef units).<sup>8</sup>

<sup>6</sup> Meat & Wool New Zealand is the industry body for red meat and wool. Its budget for 2006/2007 was \$40.3 million. One of its functions is to forecast stock numbers.

<sup>7</sup> It is only marginally lower than the 360 conversions in 1996-97.

<sup>8</sup> Meat & Wool Services apply a ratio to estimate an outcome (6.732 sheep and beef units are displaced for every Dairy Cow (and replacement, i.e calf)). The actual split between beef and sheep units displaced are ascertained by breaking the figures down to a regional level and then apply regional stocking ratios. Sheep displacement is far higher in the South Island than in the North Island, given the higher prevalence of sheep in the South Island than beef.

- 5.16 Most recent forecasts put the number of conversions in the year to **June 2009** at a further 200-250, which (applying the same beef/sheep displacement ratio) would equate to the displacement of a further 594,000 sheep units. Yet more conversions are forecast for the following years.
- 5.17 The reduction in sheep numbers as a result of conversions should be treated as permanent. This is because the investment required to convert to dairy farming involves substantial sunk costs that cannot easily be reversed, such that the reduction in sheep numbers due to dairy conversion is a permanent one.
- 5.18 The substitution to dairy from other uses (including sheep) is also reflected in the forecast kill figures for sheep and lamb exports (08/09 forecast to be down 26% on last year) and the pastoral land use figures.



- 5.19 Since 1990, there has been a 29% decrease in sheep and beef farm land which amounts to 3.6 million hectares lost to sheep, beef and deer pastoral land. Of this 3.6 million hectares, 845,000 hectares of prime sheep and beef land was switched to dairy production with the remaining 2.7 million hectare loss attributable to other land use changes. These changes include blanket forestry, extensive marginal pasture land closed for conservation, marginal land reverting to scrub and bush, urban encroachment, smallholding lifestyle blocks near towns and cities, viticulture and horticulture. (As recorded in the lower right hand comment, there has been a 20% reduction in pastoral land overall.)

### Drought

- 5.20 The recent drought conditions have aggravated the reduction in sheep numbers from the factors set out above.
- 5.21 Meat & Wool New Zealand has also said that land use changes are expected to contribute to a slower recovery from drought effects than might otherwise occur.
- 5.22 During the year ended 30 June 2008, the South Island's hogget numbers dropped 26.6% with a total drop across the country of 16.2%. Meat & Wool New Zealand notes that the 16.2% decrease in hoggets came about because many replacement ewe lambs were slaughtered this year due to cash constraints, land use change and drought. This led to a decrease in the number of ewe hoggets available for breeding stock.

5.23 The estimated lamb crop for the same 12 month period is also expected to be down. Figures held by Meat & Wool New Zealand suggest a 13.4% drop to 27,599 million. The North Island crop is estimated to decrease by 2.2 million (15.3%) and the South Island by 2.1 million (11.9%). The drop is attributed to the decline in ewe and hogget numbers mated and a lower lambing percentage because of the drought.

***Industry response***

5.24 The wool scouring industry has responded to the ongoing reductions in sheep numbers and the consequent reduction in the available wool clip by steadily reducing capacity. As noted above, in 1990, there were more than twenty wool scouring plants operating throughout the country. Since that time, there has been a regular closure of scours until just six remain, yet capacity still far exceeds demand with current overcapacity estimated to be approximately 40% on a national basis (and if the reductions in the three months to September 2008 are any indication, that excess capacity will be higher still). This should be analysed against the back-drop of further reductions in available greasy wool due to both declining sheep numbers and the growth of greasy wool exports (mostly to China).

5.25 The six scouring plants remaining are:

(a) The Applicant/Cavalier Wool's:

- (i) the Hawkes Bay Scour in the North Island situated near Napier; and
- (ii) the Timaru Scour situated in the South Island.

(b) Godfrey Hirst:

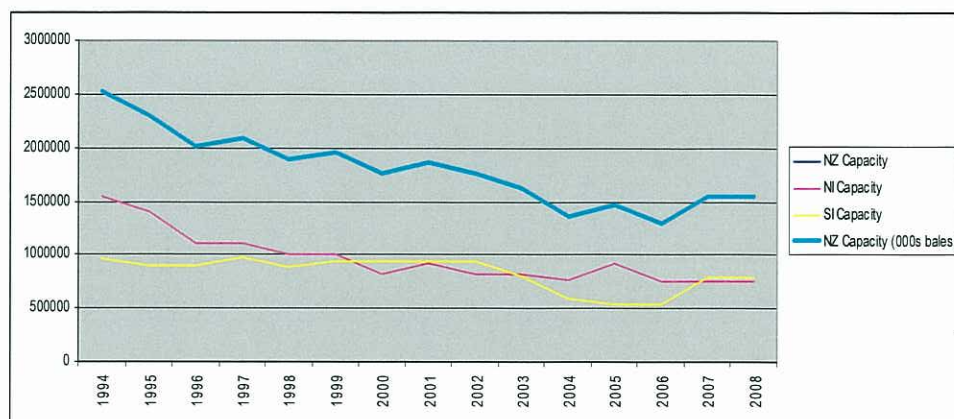
- (i) the Clive Scour situated in the North Island near Napier (not far from the Cavalier Scour); and
- (ii) the Invercargill Scour situated in the South Island.

(c) NZWSI:

- (i) the Whakatu Scour situated in the North Island near Napier; and
- (ii) the Kaputone Scour situated in Belfast, north of Christchurch.

5.26 The ongoing closures are reflected in the following graph, which charts industry capacity over time.

**Figure 2 Capacity (000's bales)**



5.27 The decline ceased in 2004 and industry capacity is now slightly higher than it was in 2004 principally as a result of an upgrade at Cavalier Wool's Timaru plant resulting in the commissioning of a 3m line in an effort to gain operational efficiencies through using more modern technology and by rationalising the two existing plants into one. However, since 2004, sheep numbers have substantially reduced by a further 13.5%.

5.28 The Acquisition reflects the view that the ongoing reduction in sheep numbers and hence wool clip requires further scouring rationalisation and delay in achieving that rationalisation could jeopardise the ability to achieve an orderly reduction. Achieving rationalisation is made more complex because of the fixed costs of operating a wool scour.

5.29 Post-Acquisition, the Applicant proposes to close the Invercargill plant in the South Island and the 2.0 metre line at Clive in the Hawkes Bay (utilising the operational efficiencies due to the close proximity of Clive to the Applicant's Hawke's Bay scour to avoid the need to permanently close both lines). Despite these closures, substantial excess capacity is forecast to remain (at least 24% in the North Island and 18.5% in the South Island).

5.30 For completeness, this transaction is not part of an international merger.

6. **Provide copies of the final or the most recent versions of any documents bringing about the proposed merger (e.g. contracts, sales and purchase agreements, or offer documents if it is a public bid).**

Attached as Appendix 4.

7. **If any other jurisdiction's competition agency has been (or will be) notified of the proposed merger, please list each competition agency notified (or to be notified) and the date of the notification.**

N/A

- **Please indicate whether you would be willing to provide the Commission with a waiver allowing it to exchange confidential information with competition agencies in other jurisdictions in respect of the proposed merger.**

N/A

## PART 2: THE INDUSTRY

8. Describe the relevant goods or services supplied by the merger parties (it is sufficient to refer in general terms to activities in which there will be no aggregation).

### *Mr Ferrier*

- 8.1 Mr Ferrier is a self-employed businessman of Auckland.

### *Cavalier Wool*

- 8.2 Cavalier Wool is the 92.5%-owned subsidiary of Cavalier Bremworth, which is itself a wholly-owned subsidiary of NZX-listed Cavalier Corporation Limited.
- 8.3 Cavalier Wool, through its wholly-owned subsidiary, Cavalier Woolscourers Limited, owns and operates a wool scour in Napier (under the name Hawkes Bay Woolscourers) and a wool scour in Timaru (under the name Canterbury Woolscourers). These scours provide commission wool scouring services to the wool exporting industry at large and Hawkes Bay Woolscourers also scours all the Cavalier Group's carpet wool requirements.
- 8.4 Cavalier Wool also ultimately owns 50% of a wool dump at Timaru, and one-third of the shares in Lanolin Trading Co Limited. Godfrey Hirst owns one-third and NZWSI owns the remaining one-third. Each supplies their wool grease by-product to Lanolin Trading Co Limited, which exports some 90% of total volumes. Given the pre-existing one-third shareholding, there is no change to the competitive landscape as a result of Cavalier Wool moving to a two-third shareholding in Lanolin Trading Co Limited. This application makes no further comment in respect of lanolin although further information can be provided if the Commission requests.
- 8.5 The Cavalier Group is involved in broadloom tufted carpet manufacturing in New Zealand (through subsidiaries Cavalier Bremworth and Norman Ellison Carpets Limited (**NEC**)). Cavalier Bremworth, which has its own yarn spinning operations in Napier and Wanganui, manufactures wool-rich carpets, NEC, which has its own spinning plant in Auckland, manufactures wool-rich and wool-blend carpets.
- 8.6 The Cavalier Group also ultimately owns Elco Direct Limited, a wool procurement business, which is a service provider to both the wool industry and the Group's carpet businesses. Elco Direct has wool buyers covering all major wool growing regions in the North Island.

### *Godfrey Hirst*

- 8.7 Godfrey Hirst is a vertically integrated manufacturer of synthetic and woollen tufted carpets in New Zealand. It also has ownership interests in wool scouring plants located at Clive (Hawke's Bay) and Invercargill. As well as scouring wool for itself, Godfrey Hirst performs wool scouring services for wool exporters and other industry participants.
9. Describe the industry or industries affected by the proposed acquisition. Where relevant, describe how sales are made, the supply chain(s) of any product(s) or service(s) involved, and the manufacturing process. If relevant, provide a glossary of terms and acronyms.
- 9.1 See section 5 above detailing the commercial rationale for the proposed merger.



10. **Describe the current industry trends and developments including the role of imports and exports, emerging technologies, and/or changes in supply and demand dynamics.**

10.1 See section 5 above.

11. **Please highlight any relevant mergers that have occurred in this industry over the past three years. Include:**

- **any acquisition of assets of a business or shares which the merger parties (or any interconnected or associated businesses) have undertaken in the last three years.**

11.1 The Commerce Commission considered the wool scouring market in August 2006 when it granted clearance for Godfrey Hirst to acquire some of the assets of Feltex Carpets Limited<sup>9</sup>. At the time of the application, three of the four carpet manufacturers in New Zealand had ownership interests in wool scouring plants.

11.2 The Applicant is not aware of any other relevant transactions.

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<sup>9</sup> Godfrey Hirst/Feltex Carpets, Decision No. 587, August 2006.

## PART 3: MARKET DEFINITION

### HORIZONTAL AGGREGATION

12. For each area of aggregation of market shares, please define the relevant market(s) for the:

- product(s) or service(s);
- functional level;
- geographic area; and
- customer dimension and timeframe (if relevant).

12.1 There is no aggregation in respect of wool dumps given the Divestment Undertaking.

12.2 The Acquisition gives rise to aggregation between the parties in respect of the supply of wool scouring services in the North Island and the South Island.

#### *Market definition*

12.3 In the Godfrey Hirst/Feltex decision, the Commission defined (among other relevant markets) a North Island market for the supply of wool scouring services. The Commission made the following observations:

- (a) **Product aspect of the market:** The Commission found that wool scouring is a specific service required to clean wool in advance of further processing and that there is no demand-side or supply-side substitutability in the provisions of such services. Therefore, the Commission considered it appropriate to define a discrete market for wool scouring services.

The Applicant agrees with this product definition, although notes the constraint imposed by the ability of many exporters of scoured wool to substitute to the export of greasy wool and the influence of wool dumpers in encouraging the export of greasy wool in furtherance of their competing interests.

- (b) **Functional aspect of the market:** The Commission considered the appropriate functional dimension of the wool scouring market to be the supply of wool scouring services due to the fact that these services are typically provided on a commission basis with ownership of the wool being retained by the end user.

The Applicant agrees with the approach to function market definition.

- (c) **Geographic aspect of the market:** The Applicant submitted that the relevant geographic market was the North Island due to the fact that very small quantities of wool were transported between the North and South Islands. The Commission found that the vast majority of wool sourced in the North Island was scoured in the North Island, and likewise in the South Island. As a result of the Feltex Acquisition, aggregation in the supply of wool scouring services would only result in the North Island. Therefore, the Commission considered it appropriate to define a North Island geographic market.

- 12.4 The current Acquisition involves overlap in both the North and South Islands, in which case it is not appropriate to define separate markets on the basis aggregation only occurs in one island. While there is some scope for wool to move inter island, the Acquisition gives rise to similar competitive outcomes in both islands and on that basis this application adopts separate North and South Island geographic markets.
- 12.5 Having regard to the above, the Applicant has adopted the following markets for the purposes of this application:
- (a) The North Island market for the supply of wool scouring services; (**North Island Scouring Market**); and
  - (b) The South Island market for the supply of wool scouring services (**South Island Scouring Market**).
- 12.6 Consistent with the Commission's previous approach, greasy wool is excluded from the market definition. However, given that the large volume of greasy wool exported for scour offshore imposes constraint on scour prices in New Zealand, greasy wool exports are relevant to the competition analysis (essentially this is akin to an export diversion argument). This argument is explained in further detail at section 16 below.
13. **Where relevant, please explain how products or services are differentiated within the market(s).**
- 13.1 Wool scouring services are standardised. Competition occurs principally on the basis of price, timeliness of service and the technical quality of delivered scoured product.

## VERTICAL INTEGRATION

14. **Provide details of any creation or strengthening of vertical integration that would result from the proposed merger. Please use organisational charts or diagrams to illustrate the structure of the ownership and/or control of the participants and the vertical relationships in question.**
- 14.1 The Acquisition will not result in vertical integration. The Cavalier Group is already vertically integrated. In fact, the Acquisition is likely to reduce the level of vertical integration because the buyer of the acquired wool dumps is – unlike Godfrey Hirst – not expected to have existing interests in wool scouring and wool dumping. At the same time, Godfrey Hirst will no longer have its own carpet wool requirements scoured through its own plants.
- 14.2 Because wool dumps depend on the acquisition of greasy wool for their existence, they represent an alternative source of demand for the same greasy wool that the commission wool scourers rely on. Pursuant to the Divestment Undertaking, the former Godfrey Hirst dumps will be in the hands of an independent firm who can be expected to compete aggressively with the commission wool scours for business. As a result, the Applicant believes the new owner of the dumps will impose an additional constraint on the scouring tariffs.

## **PART 4: COUNTERFACTUAL**

- 15. In the event that the proposed merger does not take place, describe what is likely to happen to the business operations of the merger parties and the market/industry.**
- 15.1 The Applicant believes that the increasing level of excess capacity is likely to result in further capacity rationalisation in the next 12-24 months. In the event the Acquisition does not proceed, this further rationalisation is forecast to occur earlier in the South Island than in the North Island. In the Applicant's view, the ongoing reductions in the wool clip (as discussed in section 5 above) means that some players will not be able to justify the retention of existing capacity.
- 15.2 Nevertheless, for the purposes of this application, the Applicant has adopted a "status quo" counterfactual, which assumes that the level of existing capacity is unchanged.

## PART 5: COMPETITION ANALYSIS

### EXISTING COMPETITORS

16. Identify all of the relevant competitors in the market(s), including near competitors and importers in the market(s), and describe how they all compete in the market(s).

#### *Existing Competition*

16.1 In the Godfrey Hirst/Feltex decision, the Commission acknowledged (at paragraph 91) that both of NZWSI and Cavalier (being the competing scourers in that case), had excess capacity, which the Commission said “will be sufficient to constrain the combined entity in the factual, such that the acquisition is unlikely to result in a substantial lessening of competition in this market.” While the closure by Godfrey Hirst of Feltex’s Kakariki scour following that decision (31 August 2006) would have removed more capacity than the reduction in wool from the decline in sheep numbers, the extent of the industry over-capacity is such that this closure has had no impact whatsoever on the imbalance within the industry.

16.2 In summary, the constraint from existing competition takes two principal forms:

- (a) **Constraint from NZWSI:** There are significant economies of scale associated with wool scouring which – combined with a forecast level of post-Acquisition industry excess capacity of at least 24% in the North Island and 18.5% in the South Island – creates a strong incentive for both NZWSI and Cavalier to compete aggressively for additional volumes to maximise profitability. Given the excess capacity, there are no barriers that would impede either firm taking on additional volumes.
- (b) **Constraint from offshore scouring,** e.g. the exporting of greasy wool to China for scouring: 22% of total production was exported greasy, for scouring offshore. China is New Zealand’s largest wool export market, and already approximately 65% of all wool exported to China is exported greasy. There is ample excess scouring capacity available in China and there is ample room for the mix of wool exported to China to shift from scoured to greasy, if tariffs become uncompetitive or service compromised.

#### *Constraint from NZWSI*

16.3 NZWSI was originally established by New Zealand wool growers in 1991. Today it is a publicly owned company listed on the New Zealand Exchange Alternative Market (NZAX).

16.4 NZWSI is a wool exporter and operates a scour in Whakatu, Hawkes Bay (Whakatu Wool Scour Limited) and another in Belfast, just north of Christchurch (Kaputone Wool Scour Limited). It produces scoured New Zealand wool for markets around the world, and has offices in the UK, China and India.

16.5 It currently processes [●] bales pa ([●] in the North Island and [●] in the South Island).

16.6 It claims that its scours are “technologically superior” and that it has “considerable economy of scale”.<sup>10</sup> NZWSI has modern, efficient 3m lines in both its North Island and South Island plants.

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<sup>10</sup> <http://www.nzwsi.co.nz/scours.php>

16.7 NZWSI currently scours wool predominately for its own wool selling operations, although it is understood that it does carry out commission scouring for several independent exporters. The Applicant believes even at current price levels NZWSI will increase its commission-based wool scouring post-Acquisition for several reasons:

- (a) profitability is highly dependent on plant utilisation;
- (b) the flock size and wool clip have recently fallen substantially, and are not forecast to recover (aggravated by the fact that greasy wool exports have actually *increased*), meaning the need for NZWSI to compete more aggressively for market share in a dwindling market;
- (c) NZWSI will acquire from the Applicant certain ex-Godfrey Hirst scouring assets (including a wool press, blending equipment, wool opening equipment, short wool processors and wool grease recovery equipment). These assets will better equip NZWSI to expand its commission-based operations because:
  - (i) it will facilitate the removal of current wool opening bottlenecks, allowing for greater volumes of wool to be scoured faster and to customer specifications; and
  - (ii) it allows NZWSI to be more agile with enhanced ability to accommodate more varied requests for different customer blends; and
- (d) customers have historically spread their wool scouring requirements across two competing scourers, to retain the ability to switch (and to threaten to switch) at will. This practice is expected to continue in the future, meaning that customers will be incentivised to utilise NZWSI for their scouring requirements. The economies of scale will mean it is commercially rational for NZWSI to pitch for, and accept, those customers/volumes.

16.8 These incentives on NZWSI operate at current prices, and would be even stronger in the event the Applicant attempted to increase price post-Acquisition.

16.9 Further, increasing utilisation, for example from 60% to 80% would involve only some minor capital expenditure in order to fit a better wool press and slightly improve heating capacity. In fact, such increased utilization would reduce costs on a cents-per-kilogram basis because the cost of fixed overheads does not change greatly.

#### ***Constraint from offshore scouring***

16.10 Currently, wool in New Zealand is either scoured, or exported as greasy wool. Total greasy exports in the 12 months to June 2008 were 38,084 tonnes, of which 30,220 went to Northern Asia (and of that 29,435 went to China). Given total exports were 147,462 tonnes, some 26% of exports were of greasy wool.

16.11 While greasy wool volumes have not been included in the relevant market definition, the ability and practice of customers to have wool scoured offshore constrains the price and service provided by domestic scours, because it represents a real alternative to domestic scouring for a wide range of exporting customers.

16.12 Close to 85% of all wool is exported. China is by far the largest importer of New Zealand wool, accounting for around 31% of total exports in 07/08 (up from 22% in 04/05). In 2007/08, approximately 65% of total NZ wool exported to China went greasy and 35% went scoured. Those Chinese customers importing scoured wool are likely to be carpet manufacturers and stand-alone textile mills not associated with a scour. Given that China has significant excess scouring capacity, if the price of scoured wool went up, those

Chinese customers currently importing scoured wool could switch to importing greasy wool and have that wool scoured in China.

16.13 Wool exports to China are projected to continue to increase in the immediate future. More wool is expected to be diverted into the Chinese market as exporters take advantage of the tariff free allocation for 25,000 tonnes negotiated under the 2008 New Zealand/China Fair Trade Agreement. The trend of increasing export volumes, combined with a decreasing wool clip, is likely to ensure that greasy wool exports will increase both in tonnage and as a percentage of the total wool clip, further reducing volumes available to scour in New Zealand.

16.14 The closure of NZ Tops (in Timaru), owned by Chargeurs (a large French Textile Group) is illustrative of the "greasy wool" issue. Traditionally, Chargeurs have purchased up to 20,000 bales of greasy wool and had it scoured in New Zealand. The closure effectively means that quantity of wool will now be shipped greasy to the Chargeurs combing site in China (which has recently expanded). This outcome is consistent with what has happened with top making processing in Australia, all of which have closed with a consequent increase in exports of greasy wool.

16.15 Similar implications arise from the recent closure of Spindor, one of the largest carpet yarn spinners in Europe, and one of the largest users of New Zealand crossbred scoured wool. It previously consumed around 200 tonnes per week, meaning that that single closure will have a material impact on overall demand (and hence scouring throughput).

16.16 There is no cost advantage associated with exporting greasy wool that would prevent greasy export volumes to China increasing:

- (a) The current New Zealand scouring tariff is in the range of approximately [●] NZ cents per greasy kilo while the tariff in China is approximately 23 NZ cents per greasy kilo at the high end, but as low as 17 NZ cents in some areas.
- (b) A 20ft container can accommodate 18 tonnes of scoured wool or 15 tonnes of greasy.
- (c) Based on an assumption of \$2,700 NZD cost for shipping a 20ft container to China, greasy wool costs 18cents/kg to export, and clean (scoured) wool costs 15cents/kg to export.
- (d) This 3cent/kg freight disadvantage for greasy wool is offset by the 3-9 cents/kg saving associated with having the wool scoured more cheaply in China.

16.17 Further, importing greasy wool is a preferable option for many China-based customers because by sourcing greasy wool from several different countries, they then have the option of blending the wool prior to scouring.

16.18 While the Applicant acknowledges that exporting greasy wool is not an alternative for its customers in all instances, the vast majority (if not all) of its customers export to China. This means that the Applicant cannot easily identify, and discriminate against, those volumes for which, for whatever reason, could not be substituted for greasy wool. This is because:

- (a) customers do not always stipulate the final destination at the time price is agreed, (and in any event, if a particular customer's practice was to do so currently it could easily change that practice if it thought the scourer was seeking to charge a higher tariff for those volumes for which exporting greasy was not an alternative).;
- (a) even if scourers could identify the destination of a particular order prior to setting a price, the customers (the majority of which are individually large) would react

extremely aggressively to any attempt by the scourers to impose differential prices. The importance of maintaining throughput (and hence the customers) means that the scourers are unlikely to take the risk of aggravating a particular customer and putting at risk its goodwill, because that would just encourage the customer to use the competing scour and/or increase the volume of greasy wool exports (bearing in mind that already a full one third of volumes to China are still exported clean, and hence could be exported greasy and scoured in China).

17. Outline the estimated market shares in terms of sales, and, where relevant, volume and productive capacity of the merger parties and competitors identified above. Please include:

- the estimated total value of the domestic market; and
- the source of the data provided.

17.1 The post-Acquisition market shares in the North and South Island scouring markets are shown in the tables below:

#### North Island Scouring Market

Firm	Current Operations	Share of total Capacity	Post-Acquisition Operations	Share of total Capacity post-Acquisition
Applicant	Awatoto 2 x 2.4 m lines = [●]% per line ([●] bales per line)	[●]%	Awatoto 2 x 2.4 m lines = [●]% per line ([●] bales per line)	[●]%
GH	Clive 2.0m line = [●]% ([●] bales)  Clive 2.4m line = [●]% ([●] bales)	[●]%	Clive 2.4m line = [●]% ([●] bales)  (2m line closed)	
NZWSI	Whakatu 3.0m line = [●]% ([●] bales)]	[●]%	Whakatu 3.0m line = [●]% ([●] bales)]	[●]%
<b>Total</b>	100%	100% ([●] bales)	100%	100%

Source: Applicant. Estimated to be within +/- 5%. Post-Acquisition capacity takes into account proposed rationalisation.



## South Island Scouring Market

Firm	Current Operations	Share of total Capacity	Post-Acquisition Operations	Share of total Capacity post-Acquisition
Applicant	Timaru 3.0m line = [●]% ([●] bales)  Timaru 2.4m line = [●]% ([●] bales)	[●]%	Timaru 3.0m line = [●]% ([●] bales)  Timaru 2.4m line = [●]% ([●] bales)	[●]%
GH	Invercargill 2 x 2.4m lines = [●]% per line ([●] bales per line)	[●]%	Invercargill closed	
NZWSI	Kaputone 3m line = [●]% ([●])	[●]%	Kaputone 3m line = [●]% ([●])	[●]%
<b>Total</b>	100%	100% ([●] bales)	100%	100%

Source: Applicant. Estimated to be within +/- 5% Post-Acquisition capacity takes into account proposed rationalisation.

## SOURCES OF ESTIMATES

18. To what extent do you consider that the merged entity would be constrained in its actions by the conduct of existing competitors in the markets affected? Where relevant please include a full discussion and examples of:

- the ease with which customers may switch between suppliers, and, if so, how readily;

18.1 Please refer to section 16 above for a discussion of constraint from NZWSI and offshore scouring.

- any local or overseas firms that are not currently producing the product, or providing the service in the market, but could enter the market quickly (using essentially their existing productive capacity) in a response to an attempt by suppliers to raise prices or reduce output or quality (near competitors and importers); and

18.2 The Applicant believes sufficient constraint is imposed by NZWSI alone to undermine any attempt to increase price or decrease service beyond competitive levels.

18.3 However, as set out in 21 onwards, major customers such as Elders/Brooksbank, Dawson, Fuhrman and Masurel are all large enough that they could set up scouring facilities (independently or jointly) if the Applicant attempted to raise prices or reduce output or quality post-Acquisition.

18.4 New scouring equipment can be made and purchased in New Zealand and second hand equipment is available for purchase throughout the world.

- the extent to which existing competitors, near competitors and importers could expand in the market, and any difficulties that they might face in doing so.

18.5 While importing wool is possible, the Applicant is unaware of any imports currently coming into New Zealand and has not placed any weight on the constraint imposed by imports in this application. In any event, the vast majority of a scourer's output (i.e. clean wool) is exported.

18.6 NZWSI would be likely to expand by increasing utilisation of existing capacity. Its acquisition of certain assets from the Applicant suggest it is also preparing to further expand its ability to undertake commission-based scouring.

18.7 NZWSI already has sufficient capacity to undertake additional commission-based wool scouring, in which case "supply" could increase immediately. The assets it is acquiring will enable it to further expand. It is expected these assets could be installed and operational within around 3-6 months.

18.8 There are currently no barriers that would prevent NZWSI expanding its scouring operations. This is because NZWSI has excess capacity and established processes.

18.9 In fact, the economies of scale mean that NZWSI has strong incentives to compete to secure additional volume.

18.10 Given the declining wool clip and decreasing scouring prices in nominal terms, let alone in real terms, there has been no incentive for new entrants to enter to date. That lack of entry

should not be seen as indicative of barriers to entry. There is a real risk for incumbent scours in acting in a manner which would encourage entry by customers as that would give rise to a substantial and permanent loss of throughput.

***Wool dumps***

18.11 As noted earlier, the former Godfrey Hirst dumps (to be divested to an independent buyer) will impose some additional constraint. This is because wool dumps depend on the acquisition of *greasy wool* for their existence, and hence represent an alternative source of demand for the wool that would otherwise be scoured.

18.12 Pursuant to the Divestment Undertaking, the former Godfrey Hirst dumps will be in the hands of an independent firm, which (especially given it has no scouring assets) can be expected to compete aggressively for wool for which might otherwise be scoured if the economics of doing so stacked up.

18.13 As a result, the Applicant believes the new owner of the dumps will impose an additional constraint on scouring tariffs.

## POTENTIAL COMPETITION

### CONDITIONS OF ENTRY

19. Please explain the requirements for new entry and/or importers in the relevant market(s), including:

- a breakdown of the estimated costs;

Estimated Costs might include, for example, raw materials, machinery, specialised assets, sunk Costs and/or any other costs which may be necessary for new entry.

- anticipated timeframes;
- regulatory requirements;
- frontier requirements (e.g. tariffs, import licensing, quarantine requirements); and
- business requirements involved.

Please provide the source for any data used.

19.1 Entry would most likely occur using a scouring line with a capacity of around 100-120,000 bales pa. (which would account for around 14% of current total North Island or South Island capacity).

19.2 The cost of entry, as distinct from barriers, are:

- (a) a wool scour, which could be acquired on the second hand market and installed for approximately \$4.5 million;
- (b) a resource consent, which the Applicant believes could be achieved provided the firm chose a suitable location; and
- (c) suitable expertise, which is readily available.

19.3 None of these could be considered to be a barrier to entry.

20. Include a full discussion on:

- any factors that could impede entry; and
- what might prompt new entry post-merger.

There are no significant barriers to entry, particularly by the substantial customers in this industry which each control the scouring destination, both domestically and in China.

## LIKELIHOOD, EXTENT AND TIMELINESS OF ENTRY (THE LET TEST)

21. **Please name any likely businesses (including overseas businesses) you are aware of that do not currently supply the market but which you consider could supply each of the relevant market(s). Discuss the likelihood of such entry.**

21.1 In the Applicant's view, the most likely candidates for entry are current customers. Many of these have formerly operated scours, and have the expertise to do so again.

21.2 While they closed their scours presumably on the basis that a third party scourer was a more attractive proposition, if the Applicant or NZWSI attempted to move price or service levels beyond competitive levels, then the Applicant believes its major customers would, or would threaten to set up a scour. The Applicant considers such a threat would be plausible, including because:

- (a) historically customers have never permitted scours to increase price or decrease service levels; and
- (b) the ramifications of customers actually setting up a scour are so significant because the change would be permanent and the Applicant would have lost that volume (which would likely be the volume of several customers) "for good".

22. **To what extent do you consider that potential entry would be sufficient to constrain the merged entity in the markets affected?**

22.1 The Applicant believes that the constraint of NZWSI alone will prevent it increasing prices over and above what would exist in the counterfactual. This is principally due to the reducing throughput arising from the ongoing reductions in wool clip and the strong incentives on current suppliers to maximise plant utilisation – which means competing aggressively for volume.

22.2 Post-Acquisition, excess capacity in the North and South Island scouring markets coupled with the decreasing wool clip (and the potential for greasy wool exports to increase), will ensure that sufficient constraint will continue to be imposed on the Applicant.

23. **How long would you expect it to take for entry to occur, and for market supply to increase, in respect of each of the potential entrants named in question 21 above? Provide reasons for your estimates.**

23.1 As detailed in 21 above, given that potential entrants already have the requisite industry knowledge and experience, it is estimated that entry would take somewhere between three to six months.

## COUNTERVAILING POWER OF BUYERS

24. **To what extent do you consider that the merged entity would be constrained in its actions by the conduct of buyers in the markets affected? Where relevant, please include:**

- a full discussion on the ability of buyers to self supply or import, and the alternative sources of supply available to buyers; and
- evidence of buyers seeking alternative supply and/or switching suppliers.

- 24.1 Customers have to date shown a willingness to constrain scours from any attempt to increase price, even when that increase is merely associated with cost recovery. They have the knowledge to detect attempts to price above competitive levels and they have options to punish any such attempt, including:
- (a) increasing their use of NZWSI;
  - (b) exporting additional volumes of greasy wool; and
  - (c) re-entering the scouring market by acquiring a second hand scour, which can be acquired cheaply on international markets or threatening to do so.
- 24.2 Given the size and knowledge base of each of the customers, the mere risk that they may carry out any of the above is, in the Applicant's opinion, sufficient to constrain scour pricing post-Acquisition.
25. **If you consider that there is a constraint from buyers, identify the top five buyers by sales and/or volume (including overseas companies/importers) in the relevant market(s), Where there are significant differences in the size of the buyers please provide details for five medium and five small buyers.**

Relevant market	Acquirer	Owner(s) of the acquirer
North and South Island scouring markets	Godfrey Hirst	Privately owned
	Segard Masurel (NZ) Limited	Privately owned (France)
	J S Brooksbank & Co Australasia Limited	Elders Global Wool Holdings Pty Limited
	Fuhrmann NZ 1983 Limited	Schneider Group International
	H Dawson Sons & Co Wool NZ Limited	Privately owned (UK)
	John Marshall & Company Limited	Privately owned
	Standard Wool New Zealand Limited	Standard Wool (UK) Limited

- 25.1 Masurel is a major exporter of New Zealand wool worldwide, supplying all wool types. It is part of the Segard Masurel worldwide group of companies that also has offices in Australia, South Africa and Europe. Masurel has been steadily increasing its New Zealand operations over the past few years, and this year has established a private merchanting and auctioning business in Napier.
- 25.2 Brooksbank are wool traders owned by Elders who in turn have a stake in a joint venture wool broking business in New Zealand. Brooksbank has consistently been in the top three wool exporters for many years and is the largest supplier of greasy wool to China.
- 25.3 Fuhrmann NZ was established in 1735 and is the world's oldest wool trading company. Today Fuhrmann NZ is part of the Schneider Group International network. Fuhrmann NZ traders are specialists in all aspects of greasy, scoured and slipe wool. Clients use

Fuhrmann supplied wools for a wide range of manufacturing purposes, from the finest merino fabric and apparel to highly specialized carpet producers.

- 25.4 H Dawson are wool suppliers and merchants established in 1888. They specialise in providing wool and fine fibre solutions. They have five partner-offices worldwide – England, China, Australia, India, and Italy, and trade wool into over 40 different countries. The company is run by the Dawson family. Dawsons split their scouring requirements largely because of the geographical location of their private merchanting business HD Farm Direct which is located in several areas in the South Island.
- 25.5 John Marshall & Company has been supplying world wool markets since the 1930s. The company exports greasy, scoured and slipe wool to a wide range of end users. It supplies all types of New Zealand wool from superfine merino to carpet types. John Marshall & Company supplies wool for bedding and has developed a product known as Joma crimped wool. They also market New Zealand Merino for a group of farmers producing wool from the same bloodlines using Forest Range Rams. John Marshall & Company are a customer of Canterbury Woolscourers but have moved most of their production to the NZWSI scour at Kaputone due to a clash of management personalities (this is a good example of a large exporter moving his volume from one scour to the next). Canterbury Woolscourers still scours the very fine end of John Marshall's clip.
- 25.6 Standard Wool New Zealand are exporters of greasy, slipe and scoured New Zealand wool to all processing countries in the world. Standard Wool have companies in the UK, Germany, Italy, China, USA, Argentina, Australia, South Africa, Chile, the Netherlands and New Zealand.

## COORDINATED MARKET POWER

26. **Identify and discuss the various characteristics of the market that, post-merger, you consider would either facilitate or impede coordination.**
- 26.1 Whether an acquisition will increase the scope for the exercise of co-ordinated market power depends on the degree of market share concentration, the product in question, and the nature of the competitive process in the relevant market(s). In considering the scope for co-ordinated conduct, it is necessary to assess whether the market currently shows signs of co-ordinated market power, and assess whether the acquisition affects any of those factors currently precluding, or facilitating, the exercise of co-ordinated market power.
- 26.2 In the Applicant's view, the market does not currently display signs of co-ordinated market power. The main factors currently precluding the exercise of co-ordinated market power are:
- (a) efficiencies available to scourers from increases in throughput (increasing the incentives to cheat) and the fact both players will have excess capacity (increasing the ability to increase throughput with little/no capital constraints);
  - (b) large (generally international) customers able to detect and punish any attempt to tacitly collude;
  - (c) the practice of those large customers to have their wool scoured by at least two scourers; and
  - (d) the absence of price transparency – actual prices including a range of discounts, rebates, etc.

26.3 As the table below indicates, none of the factors currently precluding co-ordinated conduct will change as a result of the Acquisition therefore the Acquisition cannot be said to facilitate tacit collusion.

<b>Scope for co-ordinated market power</b>	<b>Present</b>	<b>Effect of Acquisition</b>
High seller concentration	Yes	Increase
Undifferentiated product	Yes	No change
Static production technology	Yes (some innovation, but little incentive on scouring equipment manufacturers to innovate given reducing demand for scouring equipment)	No change
New entry slow	No	No change
Absence of fringe competitors	Yes	No change
Acquisition of an unusually vigorous or effective competitor	No	No change
Price inelastic market demand	No	No change
History of co-ordinated conduct	No	No change
Absence of countervailing power of acquirers	No	No change
Existence of excess capacity	Yes	No change
Industry associations/fora	Yes	No change
<b>Detection of deviation from co-ordination</b>	<b>Present</b>	<b>Effect of Acquisition</b>
High Seller concentration	Yes	Increase
Frequent sales	Yes	No change
Vertical integration	Yes	Some reduction
Growth in demand	No	No change
Cost similarities	Yes	No change
Multi market contact	No	No change
Price transparency	No	No change

26.4 There are three principal factors that currently, and will continue to, preclude any tacit collusion:



- (a) the presence of excess capacity, coupled with the large marginal gains from increasing throughput given the high proportion of fixed costs – all of which increase the incentives to “cheat”;
- (a) the absence of price transparency. There is no formal “list” price and all rates are subject to negotiation, during which a range of factors (such as the identity of the customer and the order size) are taken into account with plenty of opportunity for customers to play one wool scourer off against the other;
- (b) the practice of customers to utilise the services of at least two competing scours in order to maximise their negotiating leverage. This means that a scourer cannot detect cheating on any tacit agreement by the fact that it has lost a customer.

26.5 Given the absence of price transparency, including the presence of discounts, rebates, etc. the Applicant is unaware of such co-ordination, matching, etc. The industry is certainly not one where a price change by one party can be easily detected because it can be done in a number of ways. Ultimately, the customers’ ability to compare and the willingness and ability to switch or threaten to switch if they do not feel they are being offered attractive price/service suggests that prices are likely to be generally similar.

## EFFICIENCIES

27. **If applicable, provide a description of any efficiencies that you believe the acquisition could bring. Would such efficiencies enhance rivalry, or offset the impact of a lessening of competition? Please include a full discussion on:**

- **how the merger would facilitate the realisation of efficiency improvements. Specify the steps the combined entity anticipates it would take, and the timeframe needed, to achieve the efficiencies. Where relevant, include a discussion of the risks and costs involved;**
- **the magnitude of the efficiencies, whether the impact would be on fixed, variable or other costs, and generally how the cost structure of the merged entity would change;**
- **whether such efficiencies could be realised without the merger, or over a longer timeframe; and**
- **whether, and the extent to which, such efficiencies would be passed on to the customers of the merged entity.**

***For further information on efficiencies, please refer to Part 7.4 of the Mergers and Acquisitions Guidelines.***

- 27.1 The efficiency gains underpin the entire rationale for the transaction, and are discussed in detail in the Executive Summary and section 5 (Commercial Rationale).
- 27.2 The principal efficiency gains resulting from the Acquisition include increased economies of scale, better utilisation of capacity and cost savings.
- 27.3 The wool scouring business is a significant fixed costs business with many expenses either fixed or generally fixed within quite a large range of output. Significant reductions in per unit production costs of scouring are realised when throughput is increased. For example, the Applicant has produced models that demonstrate that a 100% increase in throughput

from 150,000 bales to 300,000 bales would result in total operating expenses increasing by no more than 40%, such is the economies of scale.

- 27.4 By undertaking a measured rationalization of capacity, the Applicant believes that the industry will be far better placed to continue on a viable basis. The ongoing constraints from NZWSI, greasy exports to China and the countervailing power of customers means that a substantial proportion of the efficiency gains can be expected to be passed on to customers.

## **OTHER FACTORS**

28. **Where relevant, provide a description of any other features of the market(s) that should be taken into account in considering the effect of the proposed merger.**

## PART 6: FURTHER INFORMATION AND SUPPORTING DOCUMENTATION

29. Provide the contact details of relevant competitors, buyers and suppliers and any other relevant market participants in the form of the example table shown below.

	Name of company	Contact details	Relevant contact person
<b>Competitors</b>	New Zealand Wool Services International Limited	Ground Floor Unit 3, 585 Wairakei Road PO Box 39 383 Christchurch +64 3 357 8700 www.woolserv.co.nz	Michael Dwyer, Managing Director
	Godfrey Hirst NZ Limited	142 Kerrs Road Wiri +64 9 268 3300 www.godfreyhirst.co.nz	Tanya Pauling
<b>Buyers</b>	Masurel	Level 9, PSIS House 20 Balance Street Wellington Central P O Box 3473 +64 4 472 3596	Peter Whiteman, Managing Director
	Brooksbank	47 Haining Street Te Aro Wellington P O Box 704 +64 4 385 1055	Andrew Campbell
	Fuhrmann NZ	75 Peterborough Street Christchurch P O Box 1164 +64 3 379 6173	
	John Marshall & Company	63 Mandeville Street Christchurch P O Box 8332 +64 3 341 2004	Peter Crone
	Standard Wool NZ	Unit 5, 422 Innes Road Mairehau Christchurch P O Box 1814 +64 3 385 3956	
<b>Trade associations</b>	New Zealand Wool Scourers Association	80 Chester Street East Christchurch +64 3 3797484 www.meatandwoolnz.co.nz	DJ Hargreaves
	Meat & Wool New Zealand	Level 13, Pricewaterhouse-Coopers Building 113-119 The Terrace Te Aro Wellington 6011 P O Box 121	Rob Davison

	<b>Name of company</b>	<b>Contact details</b>	<b>Relevant contact person</b>
	New Zealand Council of Wool Exporters	425 Churchill Street Richmond Christchurch City Canterbury 8013 +64 3 353 1049	Nick Nicholson
<b>Any other relevant market participants or interested parties</b>			

30. **Please provide a copy of the most recent annual report for each of the merger parties. If an annual report is not available, please provide a copy of the audited financial statements of the merger parties (profit and loss account, showing total turnover and profit before tax, and balance sheet). If the merger only relates to a segment of the business of the merger parties, please also provide a copy of any management accounts for the relevant business segment.**

To be provided separately by Godfrey Hirst and Cavalier Wool.

## **PART 7: CONFIDENTIALITY**

**31. If you wish to request confidentiality for specific information contained in or attached to the notice, please state why you consider the information to be confidential and state the reasons for your request in terms of the criteria set out in the Official Information Act 1982.**

31.1 Confidentiality is sought in respect of the information in this application that is contained in square brackets. Confidentiality is sought for the purposes of section 9(2)(b) of the Official Information Act 1982 on the grounds that:

- (a) the information is commercially sensitive and contains valuable information which is confidential to the Applicant and/or Cavalier Wool and/or Godfrey Hirst; and
- (b) disclosure would be likely unreasonably to prejudice the commercial position of the Applicant and/or Cavalier Wool and/or Godfrey Hirst, as the parties providing the information.

31.2 The Applicant also requests it is notified of any request made to the Commerce Commission (the Commission) under the Official Information Act 1982 for the confidential information, and that the Commission seeks the Applicant's views as to whether the information remains confidential and commercially sensitive at the time those requests are being considered.

31.3 The foregoing applies equally in respect of any additional information provided to the Commission that is expressed to be confidential.

**32. Provide a separate schedule of all confidential information claimed in the application.**

**33. Provide two copies of the application. One copy must be a confidential version and the other a public version.**

- **In the confidential version of the application any information for which confidentiality is sought must be highlighted in bold and contained in [square brackets].**
- **In the public version the confidential information should be removed from within the square brackets, with the brackets remaining, thus [●].**

**A hard copy, and an electronic copy of the confidential version and the public version both in Microsoft Word format and in PDF format, should be sent to the email address: registrar@comcom.govt.nz.**

THIS NOTICE is given by:

David Mcdougall Ferrier

I hereby confirm that:

- all information specified by the Commission has been supplied;
- if information has not been supplied, reasons have been included as to why the information has not been supplied;
- all information known to the applicant(s) which is relevant to the consideration of this application? notice has been supplied; and
- all information supplied is correct as at the date of this application/notice.

I undertake to advise the Commission immediately of any material change in circumstances relating to the application/notice.

Dated this                      day of December 2008.

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**David Mcdougall Ferrier**  
Director/Authorised signatory

## Appendix 1 – Divestment Undertaking

### DIVESTMENT UNDERTAKING PURSUANT TO SECTION 69A OF THE COMMERCE ACT 1986

1. On 10 December 2008, David Mcdougall Ferrier (the **Applicant**) gave notice to the Commerce Commission (the Commission) pursuant to section 66(1) of the Commerce Act 1986 (the **Act**) seeking clearance for the transaction described in that notice (the **Notice**).
2. Pursuant to section 69A of the Act, in giving a clearance under section 66(1), the Commission may accept a written undertaking given by or on behalf of the person seeking such clearance to dispose of assets or shares specified in the undertaking.
3. Subject to the conditions described in paragraph 5 of this undertaking, the Applicant undertakes to divest, or procure the divestiture of, the four Godfrey Hirst Wool Dumping businesses as listed in schedule 1 of this undertaking (the **Wool Dumping Businesses**) as a going concern to a purchaser which is not an interconnected body corporate (as defined by section 2(7) of the Act) or an associated person (as defined by section 47(3) of the Act) of the Applicant or of Cavalier Wool Holdings Limited, (the **Purchaser**), within six months from the date that the acquisition for which clearance is sought becomes unconditional.
4. Such divestment will proceed by way of an asset transaction, including transfer, sale, assignment and/or licence or lease as the case may be and in so far as legally permissible. The divestment shall include, to the extent they are necessary to operate the Wool Dumping Businesses:
  - (a) all tangible and intangible assets, by way of transfer, sale, assignment or licence, which are necessary to ensure the viability and competitiveness of the Wool Dumping Businesses;
  - (b) all licences, permits and authorisations issued by any governmental organisation for the benefit of the Wool Dumping Businesses;
  - (c) all contracts, commitments and customer orders;
  - (d) all customer, credit and other records, and
  - (e) a lease of that part of the site at Clive, currently occupied by the Clive wool dumping business.(the **Assets**).
5. For the avoidance of doubt, the divestment of the Wool Dumping Businesses shall not, *inter alia*, include:
  - (f) intellectual property rights which do not contribute to the current operation or are not necessary to ensure the viability and competitiveness of the Wool Dumping Businesses; or
  - (g) books and records required to be retained pursuant to any statute, rule or regulation provided that copies of such documents necessary for the Wool Dumping Businesses shall be provided to the Purchaser upon request.

6. Pending divestment, the Applicant will:
- (h) use reasonable endeavours to operate the Wool Dumping Businesses as viable businesses;
  - (i) preserve the economic viability, marketability and competitiveness of the Wool Dumping Businesses in accordance with good business practice; and
  - (j) minimise as far as possible any risk of loss of competitive potential for the Wool Dumping Businesses.
7. The provisions of this undertaking are subject to the transaction for which clearance is sought becoming unconditional and to the Commission granting a clearance to the Notice.

DATED this                      day of December 2008

**Signed:**

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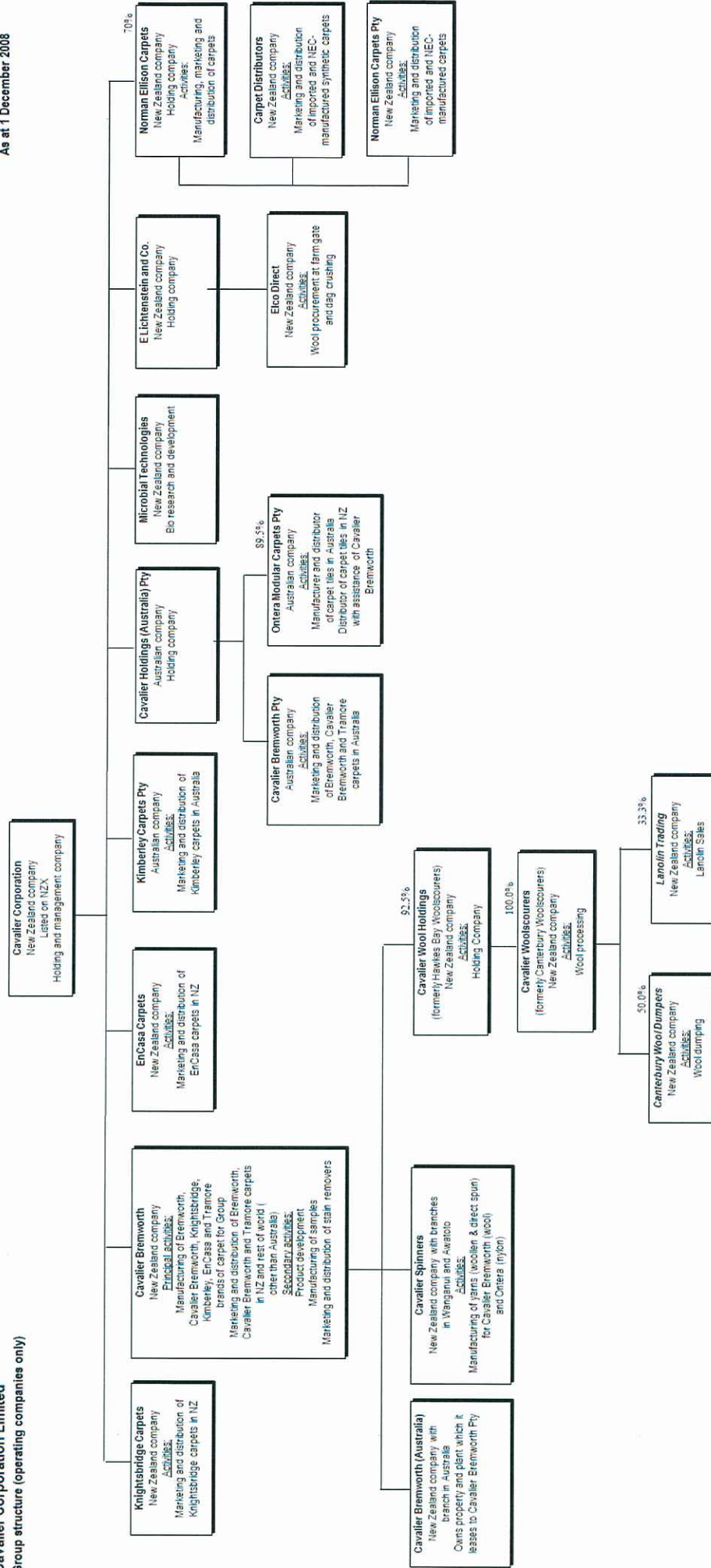
**David Mcdougall Ferrier**



## Appendix 2 – Structure Diagrams

**Cavalier Corporation Limited**  
Group structure (operating companies only)

As at 1 December 2008



### Appendix 3 – Other figures and facts

#### NZ Wool Exports (tonnes)

	Total Exports (NZ Wool)	Total China (NZ Wool)	Total Greasy Exports (China)	Greasy Exports (China) as a % of total wool exports
04/05	143,797	32,204 (22% of total exports)	25,154	17.5%
05/06	160,969	45,822 (28%)	34,370	21.0%
06/07	153,775	40,998 (26%)	28,025	18.2%
07/08	147,462	45,297 (31%)	29,435	20.0%

Source: Meat & Wool New Zealand Economic Service/MAF Situation and Outlook for New Zealand Agriculture and Forestry (2008)

#### Dairy Expansion

New Dairy Farm Conversions Estimates Spring				
Region	2007	2008 f	2009 f	2010 f
North/South Auckland	15	81	20	16
East Coast	0	10	10	3
Taranaki/Manawatu	1	49	20	10
<b>North Island</b>	<b>16</b>	<b>140</b>	<b>50</b>	<b>29</b>
Canterbury/Westland	27	90	70	27
Otago	3	5	10	3
Southland	23	95	70	27
<b>South Island</b>	<b>53</b>	<b>190</b>	<b>150</b>	<b>57</b>
<b>New Zealand</b>	<b>69</b>	<b>330</b>	<b>200</b>	<b>86</b>
Number of Additional Dairy Cows Required				
Region	2007-08	2008-09p	2009-10f	2010-11e
North/South Auckland	6,200	40,100	9,900	8,000
East Coast	0	4,500	4,500	1,400
Taranaki/Manawatu	100	22,100	9,000	4,500
<b>North Island</b>	<b>6,300</b>	<b>66,700</b>	<b>23,400</b>	<b>13,900</b>
Canterbury/Westland	16,200	67,100	52,200	20,200
Otago	1,500	3,200	6,300	1,900
Southland	18,500	59,900	44,100	17,100
<b>South Island</b>	<b>36,200</b>	<b>130,200</b>	<b>102,600</b>	<b>39,200</b>
<b>New Zealand</b>	<b>42,500</b>	<b>196,900</b>	<b>126,000</b>	<b>53,100</b>

<b>Total Sheep and Beef Cattle Stock Units Displaced</b>				
<b>Region</b>	<b>2007-08</b>	<b>2008-09p</b>	<b>2009-10f</b>	<b>2010-11e</b>
North/Southern Auckland	42,000	270,000	67,000	54,000
East Coast	0	31,000	31,000	10,000
Taranaki/Manawatu	1,000	149,000	61,000	31,000
<b>North Island</b>	<b>43,000</b>	<b>450,000</b>	<b>159,000</b>	<b>95,000</b>
Canterbury/Westland	110,000	452,000	352,000	136,000
Otago	10,000	22,000	43,000	13,000
Southland	125,000	403,000	297,000	115,000
<b>South Island</b>	<b>245,000</b>	<b>877,000</b>	<b>692,000</b>	<b>264,000</b>
<b>New Zealand</b>	<b>288,000</b>	<b>1,327,000</b>	<b>851,000</b>	<b>359,000</b>
f: forecast				
Source: Meat & Wool New Zealand Economic Service				

#### **Appendix 4 – Transaction Documents (Confidential)**

The following transaction documents are attached as a separate PDF file. The list of documents is public but the documents themselves are confidential.

1. Agreement for Sale and Purchase of Wool Scouring Businesses between Clifton Wool Scour Limited, NZWL and Godfrey Hirst.
2. Scouring Agreement between NZWL, Godfrey Hirst and Godfrey Hirst Australia Pty Limited.
3. Agreement for Sale and Purchase of Wool Dumping Businesses between Clifton Wool Scour Limited, NZWL and Godfrey Hirst.
4. Agreement for sale and purchase of Assets between NZWL and NZWSI.
5. Agreement in relation to Woolscouring between NZWSI and Cavalier Wool Holdings Limited.
6. Agreement for Sale and Purchase of Real Estate between Clifton Wool Scour Limited and NZWL.
7. Agreement for Sale and Purchase of Assets between NZWL and Cavalier Wool Holdings Limited.