PUBLIC

Memorandum

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To: Chairman and Members
Commerce Commission

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by email

CAVALIER WOOL HOLDINGS AND NEW ZEALAND WOOL SERVICES INTERNATIONAL - GODFREY HIRST CROSS SUBMISSION

This Cross Submission

1 On behalf of Godfrey Hirst NZ Limited (**Godfrey Hirst**) in this cross-submission we address issues which have been raised in submissions made by other parties. So doing, Godfrey Hirst relies upon and reasserts all of the information that it has provided already to the Commission in relation to this matter.

2 Included with and forming part of this cross-submission are:

2.1 A further report from Professor Graeme Guthrie dated 8 May 2015 (Further Economist's Report);

2.2 A further report from C W Nyberg of Darroch (Further Valuer's Report).

3 Consistent with the Commission's instructions, this cross-submission addresses only the issues raised in the submissions already received.

4 So far as Godfrey Hirst is aware, this cross-submission contains only minor references to information that should properly be regarded as confidential by any party. Accordingly a public version will shortly be provided. If the Commission (of its own volition or at the request of any party) delays publication on its website of the public version of this cross-submission, we ask that to preserve procedural fairness no other cross-submissions be published for so long as such delay persists.

CWH Submission of 21 April 2015

Unquantified benefit of the retention of a sustainable New Zealand Wool Scouring industry

5 As is explained in Godfrey Hirst's submission (at paragraph 197) the Australian experience was that downstream processing relocated offshore and the attempted rationalisation – and ultimate loss – of the Australian wool scouring industry occurred *after and because of* that relocation of further processing.

6 What should be front of mind for wool scourers (such as CWH and NZWSI) is that any proposal that risks material damage to their further processing clients puts demand for their wool scouring services at risk. Such risk to further processors – which is expressly recognised by the Commission in paragraphs 224-234 of the draft determination – represents the unquantified *detriment* of the proposal.

7 The CWH submission offers no evidence of the scouring industry ceasing to be economically sustainable without the proposal. The absence of cost savings being claimed, anticipated returns from scour closures, putative sale of sites and plant, and foregone expenditure and redundancies do not automatically equate to the demise of the scouring industry. Prudent management and strategic leadership by directors (who are not distracted by options that potentially divide their Board) of scouring companies, and dynamic competition, can play an important role in preventing that demise. Benefits – whether quantified or not – must arise from the transaction; and not occur without the transaction.

8 The Court's enjoinder for the Commission to also consider impacts of an intangible nature (i.e. as well as quantified benefits) is not licence for inventiveness.

New entry

9 The CWH submission points to James Irvine's claimed lack of experience in the operation of a wool scour and lack of comprehension of "the nuances of revenues involved". Godfrey Hirst, having owned and operated its own scours for a number of years, does not suffer from those same short comings. Godfrey Hirst's estimate of the minimum cost to set up a new scour, assuming a suitable existing site could be found, is at least $11.5 million and an excess of $15.5 million if a Greenfields development is necessary. Godfrey Hirst in its submission provided its full costing of a new scour, for scrutiny.

10 Godfrey Hirst executives with the requisite expertise and experience in establishing and operating wool scours in New Zealand are available to comment on CWH's full costing of a new scour, if those costings were made available to them. So far they have not been.

11 Instead, the CWH submission simply suggests that peripheral income streams from "related areas, such as wool packs, core testing, selling of waste etc" might supposedly tip the scales to profitability.

Ten year sensitivity test

12 CWH claimed in the Application that some merger effects will occur beyond the 5 year period, but the CWH submission complains that the Commission undertook sensitivity testing with a ten year time frame. It says beyond 5 years there is too much change and outcomes are too uncertain. Besides "..while…most of the synergetic benefits are locked in permanently, the level of detriment is determined only as a mathematical proxy."

13 Godfrey Hirst agrees that beyond 5 years benefits and detriments become less certain over time; but disputes the contention that outcomes claimed as benefits are inherently more certain. Indeed, in explaining its recourse to the longer time frame,

the Commission expressly points to the uncertainties surrounding claimed benefits, namely:

13.1 when will scour sites and assets be sold,

13.2 will they be used in a joint venture instead,

13.3 will they derive rental income in the meanwhile.

14 As for the claimed inaccuracy of the mathematical proxy used to measure detriments, the solution is that proposed by the Court in *Godfrey Hirst v Commerce Commission* – namely, for the Commission to take a range value for a particular detriment (rather than a point dollar value) where the level of uncertainty indicates that any further provision would be unwarranted.

15 That is precisely what Godfrey Hirst proposes.

Land values

16 The CWH submission disputes the Commission's determination (at paragraph 334) to make an adjustment of plus and minus 10% to each of the valuations for the three scour sites provided by CWH to "account for variability in actual sale values". It claims that such variation is arbitrary; is effectively "double counting" a variability already allowed by each valuer; and these were "extremely detailed valuations by recognised and skilled valuers" which were made for purposes other than the Application.

17 The Valuer's Report attached to Godfrey Hirst's submission puts those claims as to the quality and detail, purpose and certainty of the valuation reports provided by the Applicant into proper perspective. Those valuations do not provide any certainty that the sale of the scour sites to which they relate will return the figure indicated on the valuation. That is especially so when, as the Commission expressly recognises, there is a possibility that the sale of those sites would not occur within a five year period.

18 As the Valuer's Report demonstrates, there are major contingencies associated with each of the properties which any prospective occupier or prudent purchaser would need to investigate further. All of those contingencies, to the extent that they arise or are not discounted, potentially involve significant reduction of the price indicated in the valuations. Further, at time of valuation the scour sites were being used and configured specifically for the activity that will be expressly excluded by covenant.

19 Godfrey Hirst asked the author of the Valuer's Report, C W Nyberg of Darroch, to review his original report in light of all the further materials in relation to the valuations subsequently provided by CWH. His Further Valuer's Report is attached as Attachment 2. That concludes that all of the contingencies identified in his Valuer's Report cannot be excluded in respect of any of the three sites without much further work. Were those contingencies to eventuate, the effect could well be to [

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20 As to the range that should be built into a valuation to allow for such contingencies, his previous expert observation stands that "although the overall 20% range suggested by the Commission is possible, there is nothing to indicate that the top of the range should be at any point above the valuation given in the relevant valuation report. [ ]

21 In short, the Further Valuer's Report reaffirms that, while the Commission's 20% range to account for variability is appropriate, that range should be wholly applied by way of discount to the valuations.

Sale of scouring plant

22 The CWH submission disputes the claimed "discount" to the sales value of the scouring plant (being the value propounded by CWH itself).

23 To be clear, there is no "discount" involved. Rather, the Commission has properly sought an alternative independent industry source that has estimated the resale value of each scour to be within a range. The Commission has properly taken the bottom of that range, consistent with the approach mandated by the Court.

24 The figure consequently adopted by the Commission is consistent with Godfrey Hirst's own experience as to what a scour, if sold offshore as a complete line, could realise. As Godfrey Hirst points out however, there is substantial – and quantifiable – cost involved in dismantling, removing, cleaning and packing a scour before it can in fact be sold to realise anything. The effect of such costs would be, in Godfrey Hirst's experience, to reduce the net return from the sale of both scours to no more than $800,000. Those are quantifiable costs which must be taken into account.

25 CWH's claims as to possible "add ons" which might also be sold - were they to in fact exist - are irrelevant.

Substantial degree of influence

26 The CWH submission disputes the Commission's statement (in paragraph 224) that "Cavalier Bremworth … would be associated with CWH post-merger". It objects that the draft determination nowhere considers whether Cavalier Bremworth in fact will have a substantial degree of influence over CWH with its reduced shareholding.

27 Godfrey Hirst agrees with CWH that the effect of ownership links between CWH's post-merger shareholders, their respective rights to appoint directors, the nature of the Shareholders' Agreement and other links between them post-acquisition have not been fully and adequately examined by the Commission. Indeed Godfrey Hirst submits that some of those links between CWH and its prospective shareholders and between those shareholders post-acquisition may well constitute restrictive trade practices for which authorisation should also be sought. The issue is not addressed at all by the Commission in the draft determination.

28 As to the "reduced minority shareholding of 27.5%" of Cavalier Bremworth which CWH refers to, this of course comes about through the advent of the new shareholder, Lempriere, with its own unchallenged ability to have a substantial degree of influence over CWH post-merger. Further, as is shown in the Further

Economist's Report, the existence of the Lempriere Option will give rise to substantial conflict within CWH post-acquisition.

NERA April Report

29 Professor Graeme Guthrie in his Further Economist's Report attached as Attachment 1 deals fully with the matters addressed in the NERA April Report.

Request for a conference

30 Godfrey Hirst's position is clear. Namely, it is only by the Commission holding a conference and all interested parties having the ability to participate fully and openly at that conference, that the vital matters raised by this matter affecting the public interest can properly be determined by the Commission and, if necessary, by the Court.

Preliminary CWH response (to Godfrey Hirst's submission) of 29 April 2015

Introduction and confidentiality

31 These sections mis-state Godfrey Hirst's position.

Ownership of Lempriere

32 The claim that "ultimate ownership of Lempriere is of no significance to the Application for authorisation from a competition law perspective" cannot go unchallenged.

33 Put simply, authorisation is a process whereby an agreement or merger that would harm competition - and thus is prohibited by the Commerce Act – may be allowed if the Commission is satisfied that it is likely to benefit New Zealanders sufficiently in a way that otherwise would not occur.

34 The person applying for authorisation is required to do so in the form prescribed for that purpose by the Commission pursuant to s109 of the Commerce Act. If some of the information specified in that form is not relevant, applicants are instructed to specify why such information is irrelevant for the purpose of the Commission's ability to determine the Application.

35 Paragraph 3 of the prescribed form states that:

> *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 the participants.*

36 Paragraph 1.3 of the CWH Application identified Lempriere Australia (Pty) Limited as a party to the transaction and gives contact details for Lempriere and NZWSI. Lempriere was represented to be a company domiciled in Australia.

37 Paragraph 2 of the CWH Application described the operations of Lempriere and NZWSI in further detail. Lempriere Group was described as having "a comprehensive global footprint in all sectors of the wool market, making it one of the world's largest wool merchants and processors". Meanwhile NZWSI's business

was stated to include "the purchase of wool in New Zealand, primarily for export to a number of overseas countries, including India and China".

38 In discussing the factors relevant to competition in the markets for wool scouring the CWH Application did not confine itself to New Zealand. On the contrary, paragraphs 5.17 to 5.26 made detailed reference to increased competition from overseas – in particular from the increase in the capacity of the Chinese wool scouring industry which was stated to be "expanding aggressively". The overall effect of that Chinese growth on issues facing the New Zealand scouring industry was described in alarming detail.

39 Paragraph 9 of the CWH Application, under the heading "New Zealand's wool scouring industry" described merchants operating globally, with the ability to have their wool scoured offshore instead of using a New Zealand scourer. Similarly, in paragraphs 15.12 to 15.47 there was further detailed description of the constraint that Chinese scouring and greasy wool exports pose. By way of illustration, there was description at paragraphs 15.29 and 15.30 of the closures of scours in Australia as a result of the expansion and constraint imposed by Chinese wool scourers.

40 Against that background of detailed reference to Chinese scours and exports in the CWH Application, Lempriere was represented as an Australian domiciled company but with the ultimate ownership of that company not disclosed. Publicly available information subsequently accessed by Godfrey Hirst suggested that Lempriere in fact is controlled by Shandong RuYi Science and Technology Group Limited, being a company incorporated in China, operating as a textile manufacturer and owned by a consortium of investors in China and Japan.

41 The question must be what involvement does RuYi or any investor having the ability to exert substantial influence over RuYi, have in either the Chinese scouring industry or greasy wool exports to China.

42 These questions must be addressed by the Commission.

43 Returning to the prescribed form, paragraph 5 requires the Applicant to "fully explain the commercial rationale for the proposed merger" and to specify whether it is part of an international merger. The commercial rationale of Lempriere for entering into the transaction whereby it will acquire both an immediate 45% shareholding in CWH and the Lempriere Option giving it the ability to move to 72.5% is nowhere explained. Lempriere has chosen not to apply for clearance for that initial acquisition. When in October 2012 Lempriere sought Overseas Investment Office approval to acquire NZWSI it told the OIO:

> *[Lempriere] is currently aware of Cavalier Wool Holdings Limited's interest in the wool scouring assets of the NZSWI business. [Lempriere] has no intention to dispose of those assets.*

44 The question must be: What changed in so short a time? The trend of declining sheep numbers is not a recent phenomenon.

45 Finally, but certainly not least, there is the dichotomy between domestic and foreign shareholders relevant to the analysis of public benefits and detriments as set out in chapter 6 of the Commission's 1994 *Guidelines.* The relevance of foreign ownership is fully explained in the Further Economist's Report.

46 In short, the foreign ownership of Lempriere – including the identity, interests and intentions of those foreign owners – are highly relevant information to the Commission's assessment of whether there will be sufficient resulting benefit to New Zealanders.

Lempriere Option

47 The CWH submission and Commission response of 20 February 2015 place too much reliance upon the High Court and Court of Appeal decisions *New Zealand Bus v Commerce Commission* to support the contention that "the conditional option creates no equitable interest or other ownership interest in the shares".

48 The starting point is the extended meaning given the term "share" in section 2(1) of the Commerce Act, namely:

> *Share includes –*
>
> *(a) A beneficial interest in any such share;*
>
> *(b) …*
>
> *(c) A power to acquire or dispose of, or control the acquisition or disposition of, any such share;*
>
> *(d) …*

49 Supposedly dealing first with paragraph (a) of that extended definition, Hammond J in *New Zealand Bus* said in the Court of Appeal (at 29)

> *It followed that, on waiver, the agreement between NZ Bus and Mana became unconditional and NZ Bus acquired an equitable interest in the shares in Mana.*

50 That states the effect of the waiver of a condition upon which the agreement, until that point, had been conditional.

51 It does not necessarily follow that an agreement which has been entered into on an unconditional basis by the parties – and which had existed in that unconditional form for three months - giving rise to extant rights – ceases to constitute a beneficial or equitable interest simply because the parties, post facto and for extraneous purpose, have inserted a condition, which condition they subsequently have the unfettered power again to remove.

52 The Court of Appeal does not say that subsequently inserting a condition into an extant unconditional agreement defeats the statutory definition. That is several steps too far.

53 That is not the end of the matter however. Turning to paragraph (c) of the extended meaning given to the term "share", that paragraph is widely drawn and intended to have a separate meaning from the extended meaning in paragraph (a). While a beneficial interest may only be acquired upon satisfaction of condition, the power to acquire or control the acquisition of a share may in fact be acquired earlier. In this case, the power to acquire the shares or to control the acquisition of the shares covered by the Lempriere Option was acquired at the time the Shareholders Agreement, in the Agreed Form, was agreed by the parties as part of the Sale and Purchase Agreement dated 21 October 2014. Those transaction documents clearly gave Lempriere the power to increase its shareholding to 72.5% immediately upon completion, by then exercising the Lempriere Option.

54 There was at that time no restriction or impediment on such power to acquire those shares. As is detailed in Godfrey Hirst's submission, the restraint upon that power only came about after the Commission, in late January 2015, had advised Bell Gully that it intended to conduct its analysis on the basis that Lempriere has a 72.5% shareholding in CWH. Subsequent telephone discussions between Bell Gully and the Commission resulted in the Deed supposedly inserting the condition that the clearance or authorisation was required.

55 That Deed itself can be amended simply by written agreement of the parties to remove that requirement or indeed to terminate the Deed. Thus, Lempriere has the power together with its fellow shareholders in CWH to remove the conditionality supposedly effected by the Deed.

56 As stated in Godfrey Hirst's submission, there is nothing to prevent CWH and its shareholders immediately upon authorisation being granted, amending the Deed to remove the conditionality requirement or to terminate the Deed.

57 The claim that this suggestion lacks merit because the parties "would risk injunctive action and penalty proceedings by the Commission" if they would act in this way, itself lacks merit. As soon as the Commission has granted authorisation, the parties may implement the arrangements contemplated by the transaction documents with impunity from section 47 so long as the shares or assets are acquired in accordance with the authorisation and while the authorisation is in force.

58 Although an authorisation may be void if an undertaking that forms part of that authorisation is contravened, that provision has no application here. Indeed, that provision was inserted expressly to deal with the Commission's lack of practical remedy in situations where formal undertakings entered into were not complied with. Here, no formal undertaking has been or could be given to the Commission. The parties have simply executed a Deed upon which the Commission should not be prepared to rely. It has no enforcement powers in relation to that Deed.

59 In conclusion, Godfrey Hirst submits that the Commission must return to its earlier view and carry out its analysis on the basis that Lempriere will have a 72.5% shareholding in CWH from the outset.

Application is largely unchanged

60 That "the transaction insofar as it relates to a horizontal merger of two wool scours is unchanged" is acknowledged by Godfrey Hirst.

61 But, that is all that is unchanged from the previous application.

62 The ownership of the merged entity will be very different. The various and potentially competing drivers of the shareholders of CWH post-acquisition will be different. The effect on competition will be more severe given the now dismantling of the redundant scours. The public benefits claimed to result from the transaction have become more distant and less certain. And proper economic analysis demonstrates that the resulting detriments will be substantially greater.

Impact of the transaction on Godfrey Hirst

63 The impact of the transaction on Godfrey Hirst – and on other downstream further processors of wool generally – is succinctly stated in paragraphs 224 to 234 of the draft determination. In particular, post-acquisition CWH will have both the incentive and ability to provide Godfrey Hirst with higher scouring rates than its own downstream carpet manufacturing firm, Cavalier Bremworth. This would give Cavalier Bremworth a cost advantage over its primary rival. As the Commission notes:

> *226 Such a cost disadvantage for Godfrey Hirst could render it a less effective competitor and either reduce its market share or drive it from the market completely.*

64 Godfrey Hirst views that risk identified by the Commission as very real.

Wealth transfers at 72.5%

65 Godfrey Hirst's response in relation to the Lempriere Option above, applies here, too.

Valuations

66 CWH's brief rejoinders to the detailed criticisms contained in Valuer's Report are fully dealt with in the Further Valuer's Report.

Clive site

67 Presumably the "moth-balling" of the Clive site intended in Decision 725 meant that that capacity was immediately available in the event that breakdown or disruption occurred in the remaining scours. This time the Clive scour will not be available as a back-up facility. However, CWH claims that "it has extensive measures in place to deal with any breakdown in the remaining scours, and Clive is not necessary in this regard." Indeed, if inter-island transport were required, CWH "holds insurance to cover the cost of that transport".

68 Presumably those "extensive measures" and insurance are an alternative to the previous retention of Clive as a back-up facility. Thus, presumably they involve additional costs that would have been avoided by the previous proposed retention of Clive. As such, those additional costs which will no longer be avoided by the retention of Clive must be off-set against any proceeds from the sale of the Clive

site and scour. Presumably too, those "extensive" alternative measures and the costs associated with those measures will need to run from the outset.

Sale of plant

69 CWH's further commentary simply demonstrates the very real uncertainty as to price that attaches to the sale of redundant plant to an unidentified purchaser at an uncertain time.

70 Highly relevant here is the Court's observation in *Godfrey Hirst v Commerce Commission* (at 105) that:

> *It may well be that the uncertainties surrounding [a precise quantitative] assessment mean that the best the Commission can do is to say that (on the balance of probabilities) a particular gain or loss falls within a likely range …*

71 The discussion here indicates that that range should be a broad one.

Overseas dimension and China

72 These matters are dealt with above.

Price increases

73 The draft determination at paragraphs 224 to 226 identifies Godfrey Hirst's vulnerability to price increases. CWH's conduct has done nothing to allay Godfrey Hirst's concerns.

Productive/dynamic efficiency losses

74 The inadequacy of the reasons given in the draft determination for adopting the lowest point of the range in determining productive and dynamic efficiency losses is discussed fully in Professor Guthrie's Further Economist's Report. Put simply, the Commission cannot be satisfied that either future shareholder incentives or putative incentive-based remuneration schemes will be sufficient to contain loss of productive and dynamic efficiency.

Guthrie Paper

75 Professor Guthrie addresses NERA's response in his Further Economist's Report.

76 However, the general assertion that the Guthrie Paper "at best must be considered suspect" has an element of "Alice in Wonderland" about it, to the extent that it claims constraint from China must be discussed simply because CWH says it is so.

77 In fact, the Commission itself significantly discounts CWH's claims as to the constraint imposed by the Chinese wool scouring industry (for example, at paragraph 247 of the draft determination). The point is that for Godfrey Hirst, and other New Zealand carpet makers and other further processors of New Zealand wool, Chinese scours simply provide no relief from CWH's ability and incentive to increase prices.

NZWSI submission of 16 April 2015

78 NZWSI's mostly confidential submission is not so much a commentary on the Commission's draft determination as a claim for further public benefit on the basis of

previously undetermined capital expenditure and operating expenditure which had not be planned for at the date application for authorisation was made, but subsequently has been planned for for the 2017 and 2018 financial years.

79 The net effect is that the recently discovered but now to be avoided expenditure items are claimed as public benefits.

80 First, it is wrong in principle for the Commission to accept claims for additional public benefit so late in the authorisation process – that is, almost six months after application was made.

81 Second, all of the items claimed are confidential, not only as to amount but also as to the nature of the particular item. Other interested parties have no ability to either query the need for the particular item, nor to test the sum allowed for it.

82 Third, the introduction of the claim for further capex and opex at so late a stage means that the claim has not been considered in the draft determination.

83 The approach mandated by the Court in relation to such dubious claimed benefit is clear. The Court in *Godfrey Hirst v Commerce Commission* said (at 115):

… a purely quantitative assessment is not sufficient. A judgment, (also referred to as a qualitative assessment) is required …

That judgment will include an assessment of the quality of the information on which the quantitative analysis was carried out.

84 Godfrey Hirst submits that the quality of the claim made by NZWSI together with its lateness is such that no quantitative benefit can attach to it.

Wool Equities Limited Submission

85 Godfrey Hirst concurs with Wool Equities' submission that the real issue for those dependent on scoured wool for downstream processing is:

> *How long before the majority foreign owners of the merging scouring company decide to exit all scouring in New Zealand?*

Lempriere Response to Godfrey Hirst Submission

86 Aside from making intemperate allegations as to Godfrey Hirst's conduct and intentions in its participation in the authorisation process (which participation in fact was at the express and repeated request of the Commission), the Lempriere response simply states that:

> *Lempriere has identified in Godfrey Hirst's submission a number of inaccuracies, materially misleading assumptions and untrue allegations…*

87 But, the Lempriere response does not endeavour to identify any such inaccuracy, misleading assumption or untrue allegation.

88 Godfrey Hirst would be pleased to acknowledge and correct any inaccuracy in the material it has provided to the Commission. Godfrey Hirst is fully aware of its responsibility not to attempt to deceive or knowingly to mislead the Commission; and indeed that it is a criminal offence for any party to attempt to do so.

89 If there is any error or omission in the material Godfrey Hirst has provided to the Commission, that error or omission was not intentional. So far as it is aware, all of the information provided to the Commission by or on behalf of Godfrey Hirst remains correct as at the date of this cross-submission.

90 Turning to the claim of irrelevance, the relevance of Lempriere's ownership and intentions to the Commission's authorisation process are explained fully above.

91 But speaking more generally, any party applying for (or seeking the protection of) authorisation of a merger (or other arrangement that would otherwise contravene the Commerce Act) – whether that party is controlled by domestic shareholders or foreign owners – must subject itself to full scrutiny and assessment in terms of the Commission's authorisation process to demonstrate that the net benefit to the public of New Zealand is such that the merger (or other arrangement) should be allowed.

92 As the Commerce Commission itself notes, that authorisation process "is a public process".

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ATTACHMENT 1: FURTHER ECONOMIST'S REPORT

ATTACHMENT 2: FURTHER VALUER'S REPORT