COMMERCE COMMISSION

CAVALIER WOOL HOLDINGS LIMITED

and

NEW ZEALAND WOOL SERVICES INTERNATIONAL LIMITED

SUBMISSION BY JOHN MARSHALL & COMPANY LTD ON DRAFT DETERMINATION
27 APRIL 2011

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SOLICITORS
Christchurch

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Introduction

1. This submission is on behalf of John Marshall & Company Limited ("John Marshall"). John Marshall is a large wool merchant based in Christchurch. The Managing Director of John Marshall is Peter Crone. Mr Crone was interviewed by the Commission as part of its investigation into this application.[1]

2. In its draft determination dated 13 April 2011 the Commission reaches the preliminary view that it would be likely to grant an authorisation for the proposed acquisition pursuant to section 67(3)(b) of the Commerce Act 1986. John Marshall opposes the granting of this authorisation and:

   - Supports the Commission's preliminary determination that it is not satisfied that the acquisition will not have, or would not be likely to have, the effect of substantially lessening competition for the supply of wool scouring services.

   - Strongly opposes the preliminary conclusion that the public benefit of granting the application outweighs the likely detriments, and that an authorisation under section 67(3)(b) should be granted.

3. John Marshall is totally opposed to the monopoly control of the wool scour industry in New Zealand. The company believes that if the proposed acquisition was to proceed this would lead to: increased prices for scoured wool supplied to international and local customers; a reduction in the price paid to farmers for their wool; the deterioration of the quality of the scouring service provided to customers; and, over time, the erosion of market share for New Zealand wool as against international wool suppliers and synthetic substitutes.

4. The particular matters with which John Marshall takes issue are the following:

   - The significance of New Zealand Wool Services International Limited ("WSI") existing commission scour operation as a competitive constraint on the scouring operations of Cavalier Group has been grossly underestimated. The draft determination deals with WSI as though it were solely a vertically integrated scouring and trading operation.

   - The extent to which Chinese scourers could compete with Cavalier Group in its commission scouring operation post acquisition is greatly overestimated. The

[1] This submission has been put together at short notice with the assistance of counsel, unless otherwise indicated the factual statements in it can be verified by Peter Crone.

Commission finds that potential competition from Chinese scourers will limit the potential allocative and dynamic efficiency detriments of the proposed acquisition. John Marshall does not agree with this conclusion.

- John Marshall believes that customers in the markets where it operates, particularly Europe, are highly price sensitive and there would be reduced demand for New Zealand wool in response to increases in the New Zealand price of scouring services if exporters sought to pass these costs on.

- The potential transition costs, and business disruption of closing the Kaputone plant and relocating production to Timaru have not been taken account of.

5. Peter Crone on behalf of John Marshall wishes to attend the Commission's conference on the 4th and 5th of May 2011.

Background

6. John Marshall has a very long history operating as a wool merchant in all of the major export markets for New Zealand wool. The company was founded 1933 and is currently one of the 8 largest New Zealand wool merchants. The company employs five staff from its Christchurch base and turnover has increased significantly over the last five years.

7. John Marshall sells wool under its own name as well as under the brand name *Joma*. *Joma* branded wool is commission scoured before being specially treated via a proprietary system at a factory based in Christchurch and exported for use in the bedding industry. Much of the *Joma* branded wool is supplied to the US bedding market. *Joma* represents approximately 10% of John Marshall's total sales by value.

8. Both the John Marshall and *Joma* brands are positioned at the premium end of the export wool market. John Marshall is able to attract a premium for its scoured wool as a result of the emphasis it has placed over many years on the quality of service it provides to its customers. The company has a reputation for a high level of responsiveness, delivering quality scoured product on time and as ordered.

9. The value of the premium the company is able to command over other suppliers is difficult to gauge however the company achieves a combined gross margin significantly above most of the industry. This higher margin includes the sales from for the *Joma* branded product which has been further processed following scouring. A significant portion of the additional margin John Marshall is able to obtain results from the companies market positioning and focus on quality.

10. John Marshall has built a reputation for operating with a high degree of environmental integrity. All of the company's products are promoted in this way. It is intending to substantially differentiate its products in the future on the basis of environmental integrity. The best example of this is the *Joma* brand, an example of promotional material used in the US for this brand is attached as **appendix 1**.

11. By comparison with other wool merchants operating in the New Zealand market place, John Marshall has historically had a comparatively small percentage of its sales to China, although this has increased within the last few years.

12. The company sells wool to all of New Zealand's major wool markets however there is a significant emphasis on the European market and the US market.

Significance of WSI commission scour operation

13. At paragraph 21 of the draft determination the Commission notes that between 85 and 90% of WSI's scouring activities relate to wool that it purchases itself as a wool merchant. On this basis approximately 10 -15% of wool scoured by WSI is commission scoured. John Marshall understands that it is the largest merchant customer of WSI. However John Marshall is aware that other merchants scour at least some of their wool with WSI.

14. On the basis of the figures set out in paragraphs 20 and 21 of the draft determination WSI commission scour operation represents approximately 3.3 to 4.5% of the New Zealand wool clip. Peter Crone's view is that these numbers intuitively seem quite inaccurate, on the basis of his experience in the industry he believes the volume of wool scoured on a commission basis by WSI is likely to be much larger as a percentage of the total volume of wool commission scoured in New Zealand. Consequently Mr Crone's view is that the significance of the competition provided by WSI in the commission scour industry is much greater than the Commission's figures suggest.

15. Mr Crone understands from industry sources that the total volume of commission scouring by WSI as a percentage of their total volume are, for the financial year 2009/10 18% of the total volume and for the 2010/2011 year 25%. On the basis of these figures WSI's commission scouring would be 5.4% (2009/10) and 7.5% (2010/11) of New Zealand's total wool clip.

16. The Commission's figures in paragraph 26 of the draft determination indicate that 78% of the total New Zealand wool clip is scoured in New Zealand. The remainder is currently scoured by Cavalier and WSI on a commission basis or as part of their trading operations. On this basis WSI commission scouring is 7% (2009/10) and 9.6% (2010/11)

for the total volume of wool scoured in New Zealand. The figures also show an upward trend.

17. Even if the figures quoted by the commission are correct the WSI commission scour operation has in practical terms provided significant competition for Cavalier particularly in areas where there is easy access to both Cavalier and WSI plants, as in Christchurch.

18. Prior to 2007 John Marshall scoured its wool in Timaru at the Cavalier plant. However in 2007 John Marshall shifted most of its production to WSI Kaputone. For the last 4 years more than 90% of John Marshall wool has been scoured at Kaputone with the balance remaining at Timaru. John Marshall understands that the other Merchants operate in much the same way to different degrees.

19. The shift to Kaputone coincided with the setting up of a new *Joma* plant in Christchurch in 2007. Initially John Marshall shifted production for input into the *Joma* factory before subsequently shifting most of the rest of its commission scouring. The prices charged for scouring at Timaru and Kaputone were and remain comparable so that the reasons that led John Marshall to shift the majority of its souring to Kaputone were not price related. These reasons were:

    - Quicker turnaround and greater responsiveness at the Kaputone plant allowing a *just in time* approach to sourcing wool for its *Joma* factory. This resulted in John Marshall being able to improve its responsiveness to its clients initially in the US for the *Joma* product and subsequently for all of its wool.

    - Improved quality of product.

    - Greater environmental emphasis at the Kaputone plant. The most obvious example of environmental emphasis at Kaputone is the installation of a new effluent disposal system at the plant. It is understood that this system is *state of the art,* effluent is a major issue in scouring and has been a major blight on the industry in the past. Since shifting to Kaputone the effluent system is one of the reasons that John Marshall puts forward to its clients when asked why it chooses to scour to with WSI at Kaputone. Kaputone is the only New Zealand plant to have achieved the European Ecolable Standard. The emphasis international clients increasingly place on environmental considerations is underlined by the recent visit by a team from the *Patagonia* clothing brand to inspect aspects of our operation, amongst other visits we were able to take them to Kaputone to inspect the plants operation and effluent systems.

20. On the other side of the equation there is some technology utilised at the Cavalier Timaru plant which provide it with a competitive advantage over WSI Kaputone in some limited respects**.** Cavalier utilise a process whereby certain chemicals are added to the scouring bowls to produce a different finish to the scoured wool which is required by one of our customers.

21. In John Marshall's view competition between Cavalier Timaru and WSI Kaputone has resulted in innovation and improved service delivery in relation to wool scoured on its behalf. This has been key in the development of John Marshall's *Joma* brand and in developing the reputation for high quality service delivery that John Marshall enjoys and the premium prices it is able to charge as a result.

22. The draft determination deals with the significance and impact of WSI's commission scour operation in a peripheral way only at paragraphs 21 and 189. At paragraph 21 the existence of the commission scour operation is noted but overlooked in the context of the Commission's assessment of dynamic efficiency. At paragraph 189 bullet point 5 the draft determination states:

    "*Because Cavalier Wool's commission scour operation is different in nature to WSI's vertically integrated merchant scour model, in the counterfactual the competitive tension between the two would not likely to be as strong as would exist between wool scour competitors using the same model of operation".*

23. This statement does not reflect John Marshall's experience and the company does not believe there is a proper basis in the evidence it has seen provided to the Commission for reaching this conclusion.

China

24. In the draft determination the Commission signals a finding that competition from Chinese wool scourers would not represent a significant competitive constraint on Cavalier post acquisition. John Marshall agrees with the views of the rest of the industry as recorded at paragraph 85 that commission scouring of New Zealand wool in China for re-export to other markets is unrealistic.

25. The Commission states that it interprets these views as meaning that a large New Zealand scouring price increase would be needed before scouring wool in China for resale elsewhere would be viable. In John Marshall's view the magnitude of the price increase that will be required is so large that it would not represent any significant constraint on Cavalier's operation at all. There are a number of reasons some of which are articulated in paragraph 85, these include:

- The lack of control and transparency over product once it is in China.

- Logistical difficulties in getting raw product to China and then redelivered to customers in other parts of the world.

- Most importantly from John Marshall's perspective, the delay involved would be completely inconsistent with John Marshall's emphasis on responsiveness, just in time delivery and quality of service.

- As already noted a significant proportion of John Marshall's business is through the *Joma* brand, sourcing scoured wool from China for this business is unrealistic given that the further processing of this wool is carried out in Christchurch.

26. John Marshall does not agree with paragraph 87 where the draft determination states that:

    "*The Commission does recognise that the Chinese scouring industry poses a significant long term competitive threat to the domestic industry in New Zealand".*

27. John Marshall accepts that this is so to a degree for scoured product exported to Chinese customers but the practical reality of commission scouring in China is such that John Marshall does not believe that this would represent any competitive constraint on the price of commission scouring in New Zealand for export to non-Chinese customers. In addition John Marshall believes that over time China will lose price competitiveness as Chinese wages increase. The is an effect which John Marshall is currently seeing in relation to some of the Chinese manufactured bedding material it deals in.

28. The comparison is drawn with the Australian industry, however it is noted that the Australian industry is completely dominated by exports to China (2009 exports amounted to 84%) whereas Chinese exports represent only a third of New Zealand export receipts. In other words, Chinese scourers will not be able to provide any significant price pressure for the 70% of New Zealand scoured wool heading to non-Chinese customers.

29. John Marshall does not believe that competition from China is likely to result in incentives for existing scours to improve their environmental performance. As a generalisation it is noted that Chinese scouring operations do not operate within the same regulatory environment of the Resource Management Act as New Zealand scours.

Price elasticity in the European market

30. Crossbreed, mid-micron wool supplied to European carpet manufacturers is a significant proportion of John Marshall's business. Crossbreed Wool is supplied to manufacturers of carpet in Italy, Germany and the UK. The manufacturing process for carpet involves blending New Zealand crossbreed wool with wool from the UK and other countrys

31. Wool is blended in this way because of the different characteristics of New Zealand wool as against English wool. New Zealand wool tends to be cleaner and brighter whereas UK wool is valued for its resilience. The proportions of NZ and UK wool used by carpet manufacturers however vary significantly and are able to be changed by manufacturers in response to changes in relative price. One of John Marshall's significant European customers, Brintons Limited, a carpet manufacturer based in the UK have been progressively reducing the proportion of New Zealand wool used in their carpets in response to price increases.

Dynamic efficiency issues

32. As outlined above John Marshall considers that there have been significant benefits in terms of innovation in plant operation and service delivery because of the competition between the two South Island plants. At paragraph 189 of the draft determination the Commission sets out a number of factors which suggest that dynamic efficiency losses may be very limited. John Marshall takes issue with all of these bullet points as follows:

32.1. *The long history of incremental product improvements in New Zealand*.

The scouring industry in New Zealand has always been a competitive market and incremental product improvement has occurred in this context. Put simply the prior history of innovation in the previously competitive market is no indication this will continue when competition ceases to exist;

32.2. *Significant changes in product and process have their origin in New Zealand and overseas and many of the innovations have occurred as a result of input from associated research companies*.

There are a number of points here:

- Any changes in the New Zealand market for scouring services will be highly unlikely to affect incentives for overseas scourers to innovate. Cavalier will continue to be able to adopt overseas technology if it chooses to do so. New Zealand based innovation has however been very significant in the past. New Zealand plants have led the world in process improvements.

- The research institutes have increasingly been required to look to industry rather than to government to fund research; the Wool Research Organisation of New Zealand (now Agresearch) and Agresearch carry out research in a range of areas related to wool production, processing and further manufacture. A reduction in funding and enthusiasm for innovation from the scouring sector would likely cause these organisations to shift focus to other areas of the wool industry.

- Indeed a shift in focus away from scouring research has already occurred. For many years Wool Research operated a *mini scour* facility in Lincoln. This facility was used for research and trialling new scouring techniques. The facility was closed in 2009 and the mini scour sold. John Marshall understands that this is part of a significant down grading of effort into scour industry research.

- Even if research and technological development continue at the current level there is no guarantee the results of this work would be adopted as quickly as at present or at all where there is a reduced competitive driver to do so.

32.3. *The competitive tension between WSI and Cavalier is not as strong because of WSI vertical integration model.*

In John Marshall's view this underestimates the significance of WSI's contract scour operation. As set out above John Marshall's experience has been that there has been significant competition between the two entities which has resulted in innovations in service delivery and performance of the plants it has dealt with.

33. At paragraph 190 the Commission indicates its view that it is potential competition from the Chinese scouring industry that has the greatest potential to reduce dynamic efficiency losses. John Marshall does not agree that if Cavalier does not innovate post-merger there will be a real risk of scouring services being relocated offshore. In John Marshall's view Chinese scouring is not substitutable for New Zealand based scouring under the current industry structure.

34. A major shift for scouring services to China would only occur if there was a major shift away from commission scouring in favour of exporting unprocessed wool directly to China. New Zealand based merchants would be extremely reluctant for this to occur because it would mean abandoning their longstanding customers in other countries such as Europe and the US where they can get better margins.

Transition costs

35. The Cavalier proposal involves closing the WSI Kaputone plant in Christchurch and shifting operations to the Cavalier Plant in Timaru. The Timaru plant however does not currently have capacity to carry out the combined scouring operations of both plants. John Marshall understands that this will be addressed by moving the Kaputone 3 metre scour to Timaru. John Marshall has obtained an estimate that this process would take at least 4-6 months and there would be considerable cost involved.

36. In the meantime while Cavalier's operations were reorganised capacity constraints would mean that there would be significant delays out of Timaru or Cavalier would have to carry out South Island scouring in the North Island. This later possibility could only occur if there was capacity in the North Island. Both possibilities are problematic from John Marshall's point of view and there is significant potential for there to be major disruption to its business particularly because of its *just in time* approach.

37. These potential costs do not appear to have been taken account of by the Commission in its cost benefit analysis.

Cost versus benefit analysis

38. John Marshall takes issue with the cost benefit analysis carried out in the draft determination. At paragraph 242 the Commission indicates that it intends to place greater weight on the benefits of the proposed acquisition because of the higher degree of certainty surrounding the quantification of the benefits against the costs. While not referred to in the draft determination the authority for that approach appears to be *Air New Zealand v Commerce Commission* (No.6) (2004) 11TCLR 347 at paras 415 and 416 where the High Court said;

> *[415] The appellants were critical of the Commission's failure to give consideration in the course of the balancing exercise to unquantified benefits. Based on the way in which the Commission explained its thinking in this area, this criticism seems justified. It may be the Commission thought it unnecessary to discuss unquantified benefits because its quantified detriments so clearly outweighed its quantified benefits. But this is to assume that a benefit (or a detriment) should be accorded less weight simply because it has not been quantified. That approach would be wrong.*

As our discussion has already shown, there may be categories of detriments and benefits which, for one reason or another, cannot be readily expressed in monetary terms. That is no reason to exclude them from the balancing process, as the Commission itself had much earlier in its determination (at para [899]) acknowledged.

[416] At the same time, it may be necessary to reduce the weight to be given to some categories of quantified detriments and benefits if there are doubts about the reliability of the calculation or when the quantification process is necessarily abstract in nature. The balancing process is not to be seen as a purely arithmetical exercise. It should be leavened with a healthy regard for any shortcomings in the way in which detriments and benefits have been quantified.

39. On the face of it these comments provide some support for reducing the weight to be given to a category of detriment or benefit when there are doubts about quantification. The above quoted comments were however made in a context where the identified detriments under section 67 (3)(b) significantly outweighing the benefits, such that a fine balancing was not required. In the present case the table of detriments against benefit on page 43 of the draft determination shows that the calculation is potentially close and the application may well be determined by a detailed weighting exercise.

40. The effect of the approach suggested by the commission at paragraph 242, in this case, would be to give less weight to all three of the Commissions assessments of efficiency: allocative, productive and dynamic, as against one off benefits. The Commission should be careful in adopting that approach given the specific direction in section 3A that the Commission is to consider efficacy in the context of determining public benefit.

41. In John Marshall's view given that the acquisition will be creating a monopoly the focus should very clearly be on the competition analysis and the on-going efficiency effect of that monopoly rather than on off gains.

Appendix One

Advertisements for Joma Wool form US trade magazines