

MEMORANDUM

BELL GULLY

TO **Mya Nguyen**
OF Commerce Commission

FROM **Torrin Crowther / Phil Taylor**

MATTER NO. 400-4888

DATE 15 October 2015

Submission on the Second Draft Determination

1. Summary

- 1.1 Having reviewed the Commerce Commission's Second Draft Determination on CWH's application for authorisation,¹ CWH generally accepts and supports the majority of the Commission's conclusions. CWH believes it has already provided sufficient evidence in support of its application; however, it has the following comments in relation to a limited number of issues.
- 1.2 CWH attaches **Appendix 1** as a response to the Commission's information request of 5 October concerning the Clive site.

2. Revised relevant markets

- 2.1 The Commission has concluded there are separate scouring markets for wool destined for export as opposed to wool destined for domestic use.² Its rationale being that domestic wool users (in particular Godfrey Hirst) would incur material additional costs if they were to import clean wool into New Zealand, exposing domestic wool users to higher price increases relative to international buyers. Such costs are said to include transport, costs associated with monitoring and quality control, and ensuring the reliability of supply and timeliness of deliveries.
- 2.2 Market definition is a tool to help identify potential competitive impacts. In the authorisation context, once the initial "SLC" question is answered, a key issue then becomes whether a particular customer or customers might face price increases as a result of the merger, and if so to what extent. If one or more customers are likely to face greater or lesser price impacts then it is appropriate to consider those customers separately.
- 2.3 However, irrespective of market definition, CWH does not agree with the Commission that the maximum price increase could be up to 15% in the case of merchants exporting offshore, and 25% in the case of Godfrey Hirst. The reasons for CWH's view vis a vis merchants has been set out in detail previously and the key considerations are set out in 3 below.
- 2.4 In respect of Godfrey Hirst, the applicant considers that the Commission's conclusion overstates any potential price increase. That is because Godfrey Hirst only buys scoured wool *from merchants*, being the same merchants as the Commission concludes will constrain CWH to a maximum 15% price increase. The contracts for supply that Godfrey Hirst enters into with merchants provide for delivery to Godfrey Hirst by a nominated date of a specified volume of scoured wool. Absent any special agreement to scour Godfrey Hirst wool at a lesser rate than would normally apply to merchant volumes, the merchants determine the scouring rate applicable to Godfrey Hirst scourments. In essence, for Godfrey Hirst to (indirectly) incur a 25% increase in scouring tariff, CWH would have to identify the

¹ Cavalier Wool Holdings Limited and New Zealand Wool Services International Limited, Commerce Commission Second Draft Determination, 1 October 2015 (**Second Draft Determination**).

² Second Draft Determination at 91.

merchant scourments destined for Godfrey Hirst, and then heavily discriminate in respect of that particular volume, in circumstances where the merchant has already negotiated a contract for supply to Godfrey Hirst of scoured wool. In CWH's view that is not going to happen as it risks the relevant merchant deciding to discipline CWH by exporting, or more likely by threatening to export, more of its other wool in greasy form to China. Merchants will be incentivised to make such threats (and carry them out if needed) because each will be conscious that competing merchants will similarly be doing what they can to secure competitive tariffs and in turn the Godfrey Hirst volumes.

2.5 **[REDACTED]**

2.6 More generally in relation to market definition, also see the comments from NERA, attached as **Appendix 2**.

3. **Greasy wool constrains CWH from increasing prices above 15% for wool destined for export**

3.1 For the reasons previously set out,³ CWH does not believe the merger would give rise to any relevant price increase. In this regard, it agrees with the Commission's view that the constraint from greasy applies at less than 20%, but believes that the maximum likely price increase is materially lower than 15%.

3.2 The relevant arguments are summarised below.

- (a) Further switching to greasy exports is the principal constraint on current pricing – with or without the transaction. The constraint from greasy exports is demonstrated by the substantial increase in the share of the New Zealand wool clip (as well as an increase in the absolute wool volumes) being exported greasy. This share has increased over time.
- (b) Almost all of CWH's export customers export at least some greasy wool alongside their clean wool exports. Merchants will evaluate the expected price of scoured wool, which is set globally via competition between many players and the equivalent price for greasy. Merchants are indifferent to whether they export wool in greasy or scoured form; they will seek the highest margin for their product. The key determinant as to the respective proportions exported clean and greasy is the profit made from each.
- (c) NERA has provided compelling evidence CWH's **[REDACTED]** in response to the competitive threat from greasy exports (and scouring offshore).⁴ CWH has been **[REDACTED]** in order to avoid a substantially greater exodus of greasy wool from New Zealand, and ultimately the outcome seen in Australia. As recognised by the Commission, the Chinese scouring industry poses a significant long term threat to the domestic industry in New Zealand.⁵
- (d) There is sufficient capacity for overseas scours to scour a greater amount of New Zealand wool, as recognised by the Commission.⁶
- (e) The need for volume efficiencies means CWH will not attempt to increase price and risk further loss of wool volumes, which not only result in lower volumes for CWH, but also a loss of the efficiencies gained by higher throughput.

³ See for example, submissions of 29 April 2015, 13 July 2015, 19 June 2015 and 10 August 2015.

⁴ NERA "CWH/WSI merger – review of draft determination", 21 April 2015.

⁵ Second Draft Determination at 226.

⁶ Second Draft Determination at 243.

3.3 However, importantly, CWH believes the Commission ought to reflect in its allocative efficiency calculations its conclusion that, even assuming there was a price increase, it would likely be incremental (see footnote 342 of the Second Draft Determination). We note here the Commission's conclusion that it was "likely" that any price increases would also be smaller than 15%.

3.4 As set out in the NERA note attached as Appendix 2, the decision to assume the full price increase occurs on day 1 has a substantial impact on the overall position. In addition, an incremental approach which reflected merchant comments would be consistent with the Commission's approach in relation to the sale of surplus land – where it said that because the sales may take up to one year to occur, the benefits should not commence until year 2.

4. **Redundancy**

4.1 The Commission rejects CWH's claim that the redundancy exposure for [REDACTED]. CWH disputes this finding.

4.2 However, even putting aside the [REDACTED]. We do not know how this has been calculated, and it may be in error. At paragraph 485, the Commission refers to [REDACTED].

4.3 In terms of support for the [REDACTED]:

- (a) As set out in the Commission's file note of the discussion with Mr McLeod, in calculating the revised redundancy exposure figure, [REDACTED].
- (b) It is also significant that the original document from [REDACTED]. This significantly limits the exposure under the current scenario.
- (c) [REDACTED].

5. **Land Valuations**

5.1 The Commission, at paragraph 433 of the Second Draft Determination, stated ranges for the "likely" values of the relevant sites, but used the lower end of these ranges as the value for each property.⁷ In doing so, it referred to the market valuations submitted by CWH and Lempriere respectively, as well as the valuations provided to it by its independent valuers, Turley & Co and Knight Frank.

5.2 The parties disagree with the valuations obtained by the Commission for the reasons set out previously. There is no basis to dismiss the valuations of Telfer Young or Logan Stone, all three of which were undertaken by registered valuers and for purposes other than the authorisation application. CWH and Lempriere/NZWSI consider that the valuations provided by their valuers are robust and reflect an appropriate value for the purposes of the Commission's analysis.

5.3 In addition, the Commission does not appear to have [REDACTED].

5.4 CWH also has concerns with the Commission's [REDACTED]⁸

5.5 [REDACTED]⁹

⁷ Second Draft Determination at 452.

⁸ Decision 725 at [416].

5.6 [REDACTED].

5.7 In addition, the Commission has proceeded on the basis that the benefits arising from the sale of the surplus properties are likely to accrue once the sales are actually complete, which in its view is one year.¹⁰ The Commission has discounted the benefits arising from these sales by one year as a result. CWH disagrees with this approach. The sales would be likely to take place earlier than that. The sites can be ready for sale in a matter of weeks and there is no incentive to delay such sales on CWH's behalf (given that the resulting cash flow either reduces debt or creates a dividend cash flow to investors, creating value). The premise that such sales would take a year to complete is at odds with commercial realities. In any event, [REDACTED].

6. Conservative approach

6.1 As set out in detail in the submission of 10 August, the test for authorisation, as set out in section 67(3)(b) of the Commerce Act, requires that the Commission be satisfied that the acquisition will result, or be likely to result, in such a benefit that it should be permitted. The statutory test does not require that the Commission be satisfied the acquisition was *not likely* to result in *such a detriment* to the public. Parliament did not intend to import the same degree of conservatism into the authorisation test that it did into the clearance test. Rather, the Commission is called upon to determine, on the balance of probability, whether net public benefits are "likely".

6.2 The judicial approach to authorisations has been to require a robust analysis of each public benefit and detriment category, based on a standard of what is "likely", which, for the reasons set out in the submission of 10 August, imports a threshold of lower than a 50% likelihood of occurring. In undertaking the final balancing, the courts have not imported any requirement to err on the side of conservatism or to ascribe more weight to potential detriments than benefits. Indeed, the courts have specifically warned against replacing an assessment of what is likely with a conservative view. In *Godfrey Hirst*, Mallon J observed that "a conservative view" is not the same test as a "likely" outcome, and that if a conservative approach was taken to a particular category, then "that becomes relevant when detriments are weighed against benefits."¹¹

6.3 In the Second Draft Determination, the Commission has taken a conservative approach in relation to its assessment of a number of issues including the greasy constraint, redundancy, valuations and allocative efficiency losses. While we acknowledge that from a pragmatic view identifying the "worst case" situation may be a useful filter, it is not the statutory test. In addition, [REDACTED].

6.4 Listed below are the instances where the Commission has opted for a conservative approach in the Second Draft Determination. The cumulative effect of these examples is likely to have a material impact on the overall net benefits analysis.

(a) Greasy constraint / ability of the merged entity to raise prices

At 218 - "While we consider greasy exports would provide some constraint on prices, we consider that the maximum likely price increase post-merger could be as high as 15% for wool destined for export."

(b) Cost savings

At 417 - "Consequently, we estimate a lower bound for this cost saving for electricity of [REDACTED] per year."

⁹ *Godfrey Hirst v Commerce Commission* (2011) 9 NZBLC 103,396 at [281].

¹⁰ Second Draft Determination at [432].

¹¹ *Godfrey Hirst v Commerce Commission* (2011) 9 NZBLC 103,396 at [292].

At 419 – “As outlined above, we also made an adjustment for potentially lower post-merger volumes and estimate a lower bound of [REDACTED] per year [for gas savings].”

(c) Redundancy

At 486 – [REDACTED]

(d) Sale of surplus land

(i) At 431 – “since detailed [REDACTED] reports have not been produced at the time of these valuations, we have taken a conservative approach when coming to our view on the valuations.”

(ii) At 433 – “...given the uncertainty regarding the likely values of these sites, we have considered ranges for the likely values. Adopting a conservative approach, we have used the lower end of these ranges as the value for each property.”

(iii) At 436 – [REDACTED]

(iv) Footnote 277 – [REDACTED]

(v) At 444 – [REDACTED]

(vi) At 449-450 - [REDACTED]

(vii) At 452 – [REDACTED]

(e) Productive and dynamic efficiency loss

In its discussion of productive and dynamic efficiency impacts, the Commission estimates a likely range for each. However, the Commission uses the maximum cost figure when it comes to balancing benefits and detriments. (Please see Table 6: Summary of detriments in the Second Draft Determination.)

(f) Allocative efficiency loss

At [541]-[542] – “As a consequence of the market power that CWH could obtain, we consider that there is a real chance that it could raise scouring prices post-merger by as much as 15% in relation to wool destined for export, by as much as 25% for wool to be used for Godfrey Hirst, and by as much as 10% for wool grease sold to domestic customers... We note that estimates relates to the upper end of ranges for maximum likely price increases. It is also possible that the constraints provided by greasy exports and the threat of Godfrey Hirst shifting its wool manufacturing business offshore, combined with cost reductions from the merger could alternatively lead to scouring prices remaining stable or even reducing post-merger.” [Emphasis added.]

Footnote 342 – “Based on views put forward by merchants and the parties, the Commission considers that an immediate price increase of 15% is unlikely, and that any actual price increases are likely to be smaller and incremental over time. However, we have used a[n] immediate price increase of 15% as a conservative estimate.”

Bell Gully – 15 October 2015