

## Determination

### **Cavalier Wool Holdings Limited and New Zealand Wool Services International Limited [2015] NZCC 31**

**The Commission:** Dr Mark Berry  
Sue Begg  
Dr Stephen Gale  
Anna Rawlings

**Summary of application:** Cavalier Wool Holdings Limited seeks authorisation for Cavalier (or an interconnected body corporate) to acquire control over New Zealand Wool Services International Limited’s wool scouring business and assets (whether by way of acquiring shares in the wool scouring subsidiaries, or assets, or both).

**Determination:** The Commerce Commission is not satisfied that the acquisition will not have, or would not be likely to have, the effect of substantially lessening competition in a market. However, the Commission is satisfied that the acquisition will result, or will be likely to result in such a benefit to the public that it should be permitted. Therefore, the Commerce Commission grants authorisation for the acquisition pursuant to section 67(3)(b) of the Commerce Act 1986.

**Date of Determination:** 12 November 2015

Confidential material in this report has been removed. Its location in the document is denoted by [ ].

## CONTENTS

<b>THE APPLICATION</b> .....	<b>6</b>
<b>DETERMINATION</b> .....	<b>6</b>
<b>NOMENCLATURE</b> .....	<b>6</b>
<b>CONSIDERATION FOR THE ACQUISITION</b> .....	<b>7</b>
<b>WHAT WE HAVE BEEN ASKED TO AUTHORISE</b> .....	<b>7</b>
<b>RATIONALISATION OF WOOL SCOURING PLANTS</b> .....	<b>8</b>
<b>HOW THE ACQUISITION MIGHT AFFECT COMPETITION</b> .....	<b>8</b>
<b>STATUTORY FRAMEWORK</b> .....	<b>9</b>
ANALYSING THE COMPETITION EFFECTS OF A MERGER .....	9
<i>When a lessening of competition is substantial</i> .....	10
<i>When a SLC is likely</i> .....	10
ANALYSING THE BENEFITS AND DETRIMENTS OF A MERGER .....	11
<b>COMMISSION PROCEDURES</b> .....	<b>11</b>
CONFIDENTIALITY.....	12
<b>PARTIES</b> .....	<b>12</b>
THE ACQUIRER – CAVALIER.....	12
THE TARGET – NZWSI (WOOL SCOURING BUSINESSES) .....	13
<b>OTHER RELEVANT PARTIES</b> .....	<b>13</b>
GODFREY HIRST.....	13
WOOL MERCHANTS .....	14
BEEF + LAMB NEW ZEALAND .....	14
<b>INDUSTRY BACKGROUND</b> .....	<b>14</b>
REDUCTION IN THE TOTAL WOOL CLIP AND VOLUMES OF SCoured WOOL.....	15
<i>Decrease in the total wool clip since Decision 725</i> .....	15
<i>Decrease in the volumes of wool scoured since Decision 725</i> .....	16
<b>PREVIOUS DECISIONS, THE HIGH COURT JUDGMENT, AND NZWSI’S SUBSEQUENT SALE</b> .....	<b>16</b>
<b>DOES CAVALIER BREMWORTH HAVE A SUBSTANTIAL DEGREE OF INFLUENCE OVER CAVALIER? ..</b>	<b>17</b>
<b>MARKET DEFINITION</b> .....	<b>18</b>
WOOL SCOURING.....	20
WOOL GREASE .....	21
WOOL AND SYNTHETIC CARPETS.....	22
THE RELEVANT MARKETS.....	23
<b>WITH THE ACQUISITION</b> .....	<b>24</b>
<b>WITHOUT THE ACQUISITION</b> .....	<b>24</b>
POTENTIAL SCOURING PLANT CLOSURES .....	24
<i>The Commission’s view</i> .....	26
<b>COMPETITION ANALYSIS</b> .....	<b>27</b>
WOOL SCOURING MARKETS .....	28
EXISTING COMPETITION – DOES NZWSI CURRENTLY PROVIDE A COMPETITIVE CONSTRAINT? .....	28
<i>The parties’ views</i> .....	28
<i>Others’ views</i> .....	29
<i>The Commission’s view</i> .....	30
POTENTIAL POST-MERGER COMPETITIVE CONSTRAINTS ON CWH .....	30
WOULD POTENTIAL ENTRY CONSTRAIN CWH? .....	30
<i>Production site with necessary consents</i> .....	31
<i>Scouring equipment</i> .....	32
<i>Access to sufficient quantities of wool</i> .....	33
<i>Required rate of return and the profitability of entry</i> .....	33
<i>The Commission’s view on entry requirements</i> .....	35
<i>The LET test</i> .....	35
<i>Likelihood</i> .....	35

Extent.....	37
Timely .....	38
Conclusion on the LET Test .....	38
<b>WOULD THE THREAT OF INCREASED EXPORTS OF GREASY WOOL CONSTRAIN CWH? .....</b>	<b>39</b>
<i>Industry trends.....</i>	<i>39</i>
<i>The Australian experience .....</i>	<i>40</i>
<i>Is there sufficient capacity overseas to scour more New Zealand wool? .....</i>	<i>41</i>
<i>What price increase would cause merchants to switch to more greasy exports?.....</i>	<i>44</i>
<i>Would CWH be able to price discriminate between merchants and/or downstream wool users? .....</i>	<i>51</i>
<i>To what extent would merchants be able to pass-through scouring price increases? .....</i>	<i>56</i>
<i>Impact of exchange rate fluctuations.....</i>	<i>58</i>
<i>The Commission’s overall assessment on the constraint provided by greasy exports.....</i>	<i>59</i>
<b>CONCLUSION ON WOOL SCOURING MARKETS .....</b>	<b>59</b>
<b>EFFECTS OF THE ACQUISITION IN THE WOOL GREASE MARKETS .....</b>	<b>60</b>
<i>Large wool grease customers .....</i>	<i>60</i>
<i>Conclusion on large customer wool grease market.....</i>	<i>62</i>
<i>Small customer wool grease market .....</i>	<i>62</i>
<i>Conclusion on small customer wool grease market .....</i>	<i>62</i>
<b>EFFECTS OF THE ACQUISITION ON THE CARPET MARKET .....</b>	<b>62</b>
<b>PUBLIC BENEFITS AND DETRIMENTS .....</b>	<b>63</b>
<b>THE COMMISSION’S ANALYTICAL METHOD .....</b>	<b>64</b>
<b>INITIAL CONSIDERATIONS .....</b>	<b>65</b>
<i>Lempriere’s acquisition of NZWSI and its effect on our analysis .....</i>	<i>66</i>
<i>Estimating the net present value of benefits and detriments .....</i>	<i>66</i>
<b>BENEFITS .....</b>	<b>67</b>
<b>PRODUCTION EFFICIENCIES .....</b>	<b>67</b>
<i>Submissions from interested parties .....</i>	<i>68</i>
<i>The Commission’s view of these approaches .....</i>	<i>68</i>
<i>What is the case law on the treatment of productive efficiency gains derived by foreign shareholders? .</i>	<i>70</i>
<i>The Commission’s approach to treating productivity gains to foreign shareholders .....</i>	<i>70</i>
<b>NON-CAPITAL COSTS SAVINGS.....</b>	<b>72</b>
<i>Rationalisation of plant .....</i>	<i>72</i>
<i>Total non-capital savings attributable to the transaction .....</i>	<i>73</i>
<i>Reduction in salaried and wage staff costs .....</i>	<i>74</i>
<i>Reduction in administration expenses.....</i>	<i>75</i>
<i>Reduction in repairs and maintenance costs.....</i>	<i>75</i>
<i>Reduction in variable electricity costs and electricity lines charges .....</i>	<i>76</i>
<i>Reduction in coal and gas costs.....</i>	<i>76</i>
<i>Reduction in effluent system costs .....</i>	<i>76</i>
<i>Total non-capital cost savings .....</i>	<i>77</i>
<b>SALE OF SURPLUS LAND .....</b>	<b>77</b>
<i>The Commission’s view on the benefits to be attributed to each site .....</i>	<i>78</i>
<i>Clive .....</i>	<i>79</i>
<i>Conclusion on the value to be attributed to Clive .....</i>	<i>80</i>
<i>Whakatu.....</i>	<i>81</i>
<i>Kaputone .....</i>	<i>81</i>
<b>SALE OF SURPLUS PLANT .....</b>	<b>83</b>
<b>CAPITAL COSTS OF RATIONALISATION AND ONGOING CAPEX SAVINGS .....</b>	<b>83</b>
<i>Capital expenditure on buildings .....</i>	<i>83</i>
<b>CAPITAL EXPENDITURE ON PLANT .....</b>	<b>84</b>
<i>One-off rationalisation costs .....</i>	<i>87</i>
<b>DETRIMENTS.....</b>	<b>89</b>
<b>LOSS OF PRODUCTIVE EFFICIENCIES .....</b>	<b>89</b>
<i>The parties’ views .....</i>	<i>89</i>
<i>Others’ views .....</i>	<i>90</i>

<i>The Commission's view</i> .....	91
<i>Quantification of loss of productive efficiency</i> .....	92
<b>INCREASED SUPPLY RISK</b> .....	92
<i>The Commission's view</i> .....	93
<b>LOSS OF DYNAMIC EFFICIENCY</b> .....	93
<i>Others' views</i> .....	94
<i>The Commission's view</i> .....	95
<i>Quantification of loss of dynamic efficiency</i> .....	97
<b>LOSS OF ALLOCATIVE EFFICIENCY</b> .....	97
<i>The parties' views</i> .....	97
<i>Other's views</i> .....	98
<i>The Commission's view</i> .....	98
<i>Estimating allocative efficiency loss</i> .....	98
<b>WEALTH TRANSFERS TO AND FROM NON-NEW ZEALANDERS FROM PRICE INCREASES</b> .....	<b>101</b>
<b>THE CASE LAW ON THE TREATMENT OF WEALTH TRANSFERS</b> .....	101
<b>THE COMMISSION'S VIEW</b> .....	102
<i>Residency status of relevant groups</i> .....	103
<i>Economic incidence of price increases</i> .....	103
<i>Magnitude of wealth transfers</i> .....	104
<i>Components of transfers</i> .....	105
<b>CONCLUSION</b> .....	107
<b>BALANCING OF BENEFITS AND DETRIMENTS</b> .....	<b>107</b>
<b>FIGURE 5: NET PUBLIC BENEFIT, NPV \$</b> .....	109
<b>QUALITATIVE ASSESSMENT</b> .....	110
<i>Conclusion</i> .....	112
<b>THE COMMISSION MUST BE SATISFIED</b> .....	<b>112</b>
<b>DETERMINATION</b> .....	<b>114</b>
<b>ATTACHMENT 1 – POST TRANSACTION STRUCTURE</b> .....	115
<b>ATTACHMENT 2 – OWNERSHIP AND SUBSIDIARIES OF CAVALIER</b> .....	116
<b>ATTACHMENT 3 – OWNERSHIP AND SUBSIDIARIES OF NZWSI</b> .....	117
<b>ATTACHMENT 4 – FUNCTIONAL LEVELS IN THE MOVEMENT OF WOOL</b> .....	118
<b>ATTACHMENT 5 – ESTIMATED WOOL FLOWS 2015</b> .....	119
<b>ATTACHMENT 6 – SUPPLY OF GREASY WOOL BY GROWERS</b> .....	120

## The application

1. On 23 October 2014, the Commission registered an application from Cavalier Wool Holdings Limited (Cavalier) seeking authorisation for Cavalier (or an interconnected body corporate) to acquire control over New Zealand Wool Services International Limited's (NZWSI) wool scouring and wool grease by-product business and assets (whether by way of acquiring shares in the wool scouring subsidiaries, or assets, or both) (the Acquisition).
2. The application relates to the same wool scouring assets that were the subject of an authorisation the Commission granted to Cavalier in 2011.<sup>1</sup> The acquisition that was authorised did not proceed.

## Determination

3. On 26 March 2015 the Commission published a Draft Determination<sup>2</sup> stating that the Commission's preliminary view was that it would be likely to grant authorisation for the Acquisition pursuant to section 67(3)(b) of the Commerce Act 1986 (the Act).
4. After March 2015 the Commission received further submissions and evidence from the applicant and interested parties, held two conferences and tested its own preliminary thinking.
5. The Commission issued a Second Draft Determination on 1 October 2015 upholding its preliminary view that authorisation should be granted.<sup>3</sup>
6. Having considered parties' submissions and cross-submissions on the Second Draft Determination and all the evidence before it, the Commission considers that it is not satisfied that the Acquisition will not have, or would not be likely to have, the effect of substantially lessening competition in a market. However, the Commission is satisfied that the Acquisition will result, or will be likely to result in such a benefit to the public that it should be permitted.
7. Therefore, the Commission grants authorisation for the Acquisition pursuant to section 67(3)(b) of the Commerce Act 1986.

## Nomenclature

8. Throughout this document we refer to Cavalier Wool Holdings Limited as Cavalier and the merged wool scouring and wool grease entity as CWH.
9. In the wool industry various terms are used to describe wool merchants including wool brokers, wool traders and wool exporters. In this document we refer to them as wool merchants.

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<sup>1</sup> Cavalier Wool Holdings Ltd and New Zealand Wool Services International Ltd (Commerce Commission Decision 725, 9 June 2011) (Decision 725).

<sup>2</sup> <http://www.comcom.govt.nz/business-competition/mergers-and-acquisitions/authorisations/merger-authorisation-register/detail/848>

<sup>3</sup> Ibid.

## Consideration for the Acquisition

10. Under the Acquisition, in consideration for Cavalier's acquisition of the shares in NZWSI's Kaputone Wool Scour (1994) Limited and Whakatatu Wool Scour Limited, the merged entity will issue 45% of its shares to NZWSI. The shares in NZWSI will then immediately transfer to a wholly-owned subsidiary of Lempriere (Australia) Pty Limited (Lempriere) (the Lempriere Acquisition). As a result, after the completion of both the Acquisition and the Lempriere Acquisition, CWH will be held:
  - 10.1 45% by Lempriere;
  - 10.2 27.5% by Cavalier Bremworth Limited (Cavalier Bremworth);
  - 10.3 13.75% by the Accident Compensation Corporation (ACC); and
  - 10.4 13.75% by Direct Capital Limited (Direct Capital).
11. See Attachment 1 for a diagram of the post-transaction structure.

## What we have been asked to authorise

12. In this determination, we consider Cavalier's acquisition of the wool scouring business of NZWSI. As set out in the application<sup>4</sup> and noted above, in consequence of that acquisition, and in consideration for the sale of the shares in the wool scouring business, NZWSI (ultimately Lempriere) will acquire 45% of the shares in CWH.
13. While the acquisitions are interdependent and are contained in the same transaction document, the acquisition by Cavalier of the shares in NZWSI's wool scouring business is the only acquisition for which authorisation has been sought under section 67 of the Act. No application for clearance or authorisation has been received in respect of NZWSI's acquisition of a 45% shareholding in CWH and so the section 47 competition effects of the Lempriere Acquisition are not considered in this Determination.
14. The Commission has separately considered whether that acquisition is likely to result in a substantial lessening of competition under section 47 of the Act.<sup>5</sup> The Commission considers it unlikely that Lempriere could unilaterally exercise any market power in the wool scouring market to foreclose its rival wool merchants and therefore considers that the proposed acquisition is unlikely to breach section 47 of the Act.
15. Nonetheless, the Lempriere Acquisition appears to be an indivisible part of the Acquisition which is the subject of the application for authorisation. Accordingly, as we do when considering the effects of any potential merger, the Commission has had regard to any relevant implications arising from the Lempriere Acquisition, as part of the facts and circumstances it is considering in this Draft Determination relating to authorisation of the Acquisition.

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<sup>4</sup> At [4.3] and Executive Summary of the Application.

<sup>5</sup> Lempriere (Australia) Pty Limited Investigation Report 3 November 2015.

## Rationalisation of wool scouring plants

16. Following the Acquisition, CWH intends to rationalise NZWSI's scouring assets. Cavalier currently has three scour lines in the North Island (two 2.4 metre scour lines at Awatoto and one 2.0 metre line at Clive (in Hawke's Bay)) and two scour lines at Timaru in the South Island (one 3.0 metre scour line and one 2.4 metre scour line). NZWSI has a 3.0 metre scour located at each of Whakatu in Hawke's Bay in the North Island and Kaputone near Christchurch in the South Island.
17. The rationalisation will see CWH:
  - 17.1 closing NZWSI's scours at Kaputone and Whakatu;
  - 17.2 relocating NZWSI's scour lines at Kaputone and Whakatu to Cavalier's existing scouring plants at Timaru and Awatoto; and
  - 17.3 decommissioning the scour line at Clive and the 2.4 metre line at Timaru.
18. As part of the transaction, Lempriere will be obliged to impose covenants on the Whakatu site in the hands of a new owner, to exclude future wool scouring or related activities at the site for a period of 50 years.
19. The Clive site will be closed and the plant, land and buildings will be sold. CWH will similarly be required to impose covenants<sup>6</sup> on the Clive site to exclude future wool scouring activity there.
20. CWH will also sell Lempriere's Kaputone site with the same 50 year covenant ensuring the use of the site excludes wool scouring or related activities.

## How the Acquisition might affect competition

21. By reducing the number of scouring firms from two to one, the Acquisition would create a single provider of scouring services in both the North Island and South Island markets. Contingent on the level of competitive constraint provided by the threat of entry, offshore scourers, and/or the ability of wool merchants to export greasy wool, the merged entity could use any market power that it had to raise scouring prices and/or lower its service quality including scouring standards or timeliness.
22. The Acquisition would also bring together the only two producers of wool grease in New Zealand. Although most wool grease is exported, there is a small amount that is sold domestically, chiefly to one New Zealand buyer. Post-acquisition this buyer would have no ability to source wool grease from competing domestic suppliers. The ability of the merged firm to increase the price of wool grease to domestic customers would depend on the degree of constraint provided by wool grease imports.
23. The proposed Acquisition could also give rise to foreclosure in the downstream carpet manufacturing market. Cavalier is 50% owned by carpet manufacturing firm, Cavalier

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<sup>6</sup> For a period of 50 years.

Bremworth. Therefore, Cavalier’s stake in the proposed monopoly scouring company may provide it with both the incentive and ability to raise the costs of its primary rival in the downstream domestic carpet market, Godfrey Hirst.

24. 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. Whether such a result would allow Cavalier Bremworth to gain market power in the carpet market (and so have an incentive to raise costs in this way in the first place), would depend on the extent to which imported wool carpets and/or synthetic carpets (whether manufactured here or overseas) provide a sufficient competitive constraint on the domestic carpet manufacturing market.

### Statutory framework

25. Any person who proposes to acquire assets of a business or shares and considers that the acquisition may breach section 47 of the Act can make an application for an authorisation under section 67 of the Act.
26. Section 67(3)(a) of the Act requires the Commission to give clearance for a proposed acquisition if it is satisfied that the proposed acquisition will not have, or would not be likely to have, the effect of substantially lessening competition in a market.<sup>7</sup> If the Commission is not so satisfied, clearance must be declined, although it may still grant an authorisation under section 67(3)(b) of the Act if the Commission is satisfied that “the acquisition will result, or will be likely to result, in such a benefit to the public that it should be permitted.”
27. If the Commission is not satisfied that the acquisition will result, or will be likely to result, in such a benefit to the public that it should be permitted, or the Commission is in doubt<sup>8</sup> as to whether there is a real chance that the acquisition will create a public benefit, it must decline an authorisation under s 67(3)(c).
28. The burden of proof lies with the Applicant to satisfy the Commission on the balance of probabilities that the acquisition is not likely to substantially lessen competition and if it is likely to do so, that the public benefit is such that the Commission should authorise it.<sup>9</sup>
29. Section 67(3) of the Act requires the Commission to issue a decision within 60 working days after the date of registration of the notice, or such other longer period agreed to by the Commission and the Applicant. The Applicant has agreed to an extension of time until 13 November 2015.

### Analysing the competition effects of a merger

30. Our approach to analysing the competition effects of the proposed Acquisition is based on the principles set out in our Mergers and Acquisitions Guidelines.<sup>10</sup>

<sup>7</sup> The Commission’s approach to assessing whether a merger is likely to give rise to a substantial lessening of competition is set out at paragraphs 30 to 39 below.

<sup>8</sup> *Commerce Commission v Woolworths Limited* (2008) 12 TCLR 194 (CA) at [98] and [107]. In *Woolworths* the Court said that the existence of a “doubt” corresponded to a failure to exclude a real chance of a substantial lessening of competition. It went on to note that the Commission and thus the Court should approach the giving of a clearance by direct reference to the statutory test, that is by granting a clearance only if satisfied that a substantial lessening of competition is not likely.

<sup>9</sup> *Commerce Commission v Southern Cross Medical Care Society* (2001) 10 TCLR 269 (CA) at [7].

31. As required by the Act, we assess acquisitions using the substantial lessening of competition (SLC) test.
32. We determine whether an acquisition is likely to substantially lessen competition in a market by comparing the likely state of competition if the acquisition proceeds (the scenario with the acquisition, often referred to as the factual), with the likely state of competition if the acquisition does not proceed (the scenario without the acquisition, often referred to as the counterfactual).<sup>11</sup>
33. We make a pragmatic and commercial assessment of what is likely to occur in the future with and without the acquisition based on the information we obtain through our investigation and taking into account factors including market growth and technological changes.
34. A lessening of competition is generally the same as an increase in market power. Market power is the ability to raise price above the price that would exist in a competitive market (the 'competitive price'),<sup>12</sup> or reduce non-price factors such as quality or service below competitive levels.
35. Determining the scope of the relevant market or markets can be an important tool in determining whether a SLC is likely.
36. We define markets in the way that we consider best isolates the key competition issues that arise from the acquisition. In many cases this may not require us to precisely define the boundaries of a market. A relevant market is ultimately determined, in the words of the Act, as a matter of fact and commercial common sense.<sup>13</sup>

*When a lessening of competition is substantial*

37. Only a lessening of competition that is substantial is prohibited. A lessening of competition will be substantial if it is real, of substance, or more than nominal.<sup>14</sup> Some courts have used the word 'material' to describe a lessening of competition that is substantial.<sup>15</sup>
38. Consequently, there is no bright line that separates a lessening of competition that is substantial from one that is not. What is substantial is a matter of judgement and depends on the facts of each case. Ultimately, we assess whether competition will be substantially lessened by asking whether consumers in the relevant market(s) are likely to be adversely affected in a material way.

*When a SLC is likely*

39. A SLC is 'likely' if there is a real and substantial risk, or a real chance, that it will occur. This requires that a SLC is more than a possibility, but does not mean that the effect needs to be more likely than not to occur.<sup>16</sup>

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<sup>10</sup> Commerce Commission, *Mergers and Acquisitions Guidelines*, July 2013.

<sup>11</sup> *Woolworths (CA)* above n 8 at [63].

<sup>12</sup> Or below competitive levels in a merger between buyers.

<sup>13</sup> Section 3(1A). See also *Brambles v Commerce Commission* (2003) 10 TCLR 868 at [81].

<sup>14</sup> *Woolworths & Ors v Commerce Commission* (2008) 8 NZBLC 102,128 (HC) at [127].

<sup>15</sup> *Ibid* at [129].

## Analysing the benefits and detriments of a merger

40. The Commission's approach to assessing the benefits and detriments arising from a merger is set out in the benefits and detriments section.

## Commission procedures

41. In reaching this determination, the Commission has obtained information from a wide range of sources. In the course of this process, the Commission has, amongst other actions:
- 41.1 reviewed the information and analysis in the application, including the economic report submitted by the applicant's economic experts (NERA);
  - 41.2 posted a public version of the application on the Commission website;
  - 41.3 sought further information and clarification from Cavalier on a range of subjects;
  - 41.4 sought information from parties making submissions and from other sources in the wool industry;
  - 41.5 interviewed Cavalier and other interested parties;
  - 41.6 considered submissions, including economic evidence, from Cavalier, Godfrey Hirst, and other interested parties;
  - 41.7 made relevant documents and reports available to Cavalier and interested parties, where necessary under expert and counsel only confidentiality undertakings;
  - 41.8 published a Draft Determination on 26 March 2015 stating the Commission's preliminary view that it was not satisfied that the Acquisition would not have the effect of substantially lessening competition in the relevant markets but that it considered the Acquisition would have such a benefit to the public that it should be permitted;
  - 41.9 held a conference with interested parties on 10 June 2015;
  - 41.10 sought and received post conference submissions on matters raised at the conference;
  - 41.11 held a confidential conference with interested parties in respect of land valuations on 1 September 2015;
  - 41.12 published a Second Draft Determination on 1 October 2015 stating the Commission's preliminary view that it remained not satisfied that the Acquisition would not have the effect of substantially lessening competition in the relevant markets but that it considered the Acquisition would have such a benefit to the public that it should be permitted; and

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<sup>16</sup> Woolworths above n 14 at [111].

41.13 sought, received, and considered submissions and cross-submissions on the Second Draft Determination, including further economic evidence from Cavalier and Godfrey Hirst.

## **Confidentiality**

42. During the course of the Commission’s investigation, confidential and commercially sensitive information was released on a restricted-use basis to counsel and independent experts who signed confidentiality undertakings. Godfrey Hirst counsel has submitted that the process by which confidential information has been excluded from the public “imposes real restrictions on those interested parties wanting to make submissions.”<sup>17</sup>
43. In the Commission’s view, it would be commercially prejudicial to Cavalier and Lempriere/NZWSI to disclose their commercially sensitive information to the public including interested parties.
44. Disclosure of such information could provide Cavalier’s competitors and customers with an unfair advantage and the same principles apply to any confidential information provided by other parties. As part of the Commission’s processes, it has attempted to balance, on the one hand, the interests of Cavalier and interested parties in safeguarding their confidential information in a competitive market with, on the other hand, the Commission’s desire to test information in the interests of coming to an informed decision on the Application.
45. The Commission received a wide range of information and submissions from interested parties on the application and Draft Determinations. The disclosure of information on a restricted-use basis to counsel and independent experts enabled interested parties’ counsel and experts to assist the Commission in testing the evidence, while avoiding the potential for commercial prejudice to Cavalier and Lempriere/NZWSI.

## **Parties**

### **The acquirer – Cavalier**

46. Cavalier is 50%-owned by Cavalier Bremworth, which is itself a wholly-owned subsidiary of NZX-listed Cavalier Corporation Limited (together, the Cavalier Group). See the ownership diagram of Cavalier at Attachment 2.<sup>18</sup>
47. The Cavalier Group is involved in the manufacture of woollen and wool blend carpets in New Zealand (through its subsidiaries Cavalier Bremworth and Norman Ellison Carpets Limited (Norman Ellison)).
48. The Cavalier Group also ultimately owns Elco Direct Limited (Elco Direct), a wool merchant, which is a service provider to both the wool industry and the Cavalier Group’s carpet businesses. Elco Direct has wool buyers covering all major wool growing regions in the Central North Island.

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<sup>17</sup> Godfrey Hirst submission, 21 April 2015.

49. The remaining 50% of Cavalier is owned in equal parts by the ACC and Direct Capital. The interests of both parties are represented by one director on the Cavalier Board.
50. Cavalier, through its wholly owned trading subsidiary Cavalier Woolscourers Limited (which trades as Hawke's Bay Woolscourers and Canterbury Woolscourers), owns and operates wool scours in Awatoto, Clive and Timaru. Utilising these scours, Cavalier cleans and processes greasy wool for domestic and export markets on behalf of New Zealand wool buyers and carpet manufacturers. Hawke's Bay Woolscourers also scours all of the Cavalier Group's carpet wool requirements.
51. Cavalier also refines and supplies wool grease. Most of its wool grease is exported. While it has a few domestic customers, it only supplies one domestic customer on a regular basis.

### **The target – NZWSI (wool scouring businesses)**

52. Lempriere, the owner of NZWSI, is an Australian based global business which is involved in the wool industry. In Australia it is a merchant supplier of mainly fine wools. It also has businesses in the United States of America, Argentina and South Africa, and is one of the world's major suppliers of fine wool to European, Japanese and American fashion houses.
53. In March 2013, Lempriere acquired NZWSI which, as discussed, operates scouring businesses at Whakatu in the North Island and Kaputone in the South Island. NZWSI is also the largest wool merchant in New Zealand, supplying wool primarily for export to a number of overseas countries, including India and China.
54. Lempriere recently acquired J S Brooksbank & Co (A'asia) Ltd (J S Brooksbank), a New Zealand wool merchant, and J S Brooksbank is now a wholly owned subsidiary of NZWSI. In addition, NZWSI has a 50% shareholding in Rural Wool-Link Limited (RWL) which buys wool from wool growers and supplies wool merchants.<sup>19</sup> NZWSI's wool merchant businesses including J S Brooksbank and NZWSI's shareholding in RWL will remain with NZWSI post-acquisition.
55. NZWSI also refines and supplies wool grease. Currently NZWSI exports its wool grease, although it has received an order from a domestic customer.<sup>20</sup>
56. The ownership and subsidiaries of NZWSI are set out in Attachment 3.

### **Other relevant parties**

#### **Godfrey Hirst**

57. Godfrey Hirst is an Australian owned manufacturer of woollen and synthetic carpets in New Zealand and is a purchaser of scoured wool. The company previously owned and operated wool scouring plants at Clive and Clifton (near Invercargill), but these were purchased by interests associated with Cavalier in March 2009.
58. Godfrey Hirst's purchases of scoured wool have [ ] since Decision 725. At that time in June 2011, Godfrey Hirst's demand for scoured wool was around [ ] per

<sup>19</sup> Rural Wool-Link Limited is a wool buyer in the North Island that on-sells wool to NZWSI.

<sup>20</sup> Email from Lempriere to the Commission, 20 February 2015.

annum. In the 2013/2014 year, Godfrey Hirst purchased around [ ] of scoured wool, [ ].<sup>21</sup>

### Wool merchants

59. There are a number of merchants that are involved in the purchase of wool by auction, direct from growers, and/or in the case of slipe wool,<sup>22</sup> from meat processors for sale to local and overseas customers. These merchants include Segard Masurel (NZ) Ltd (Segard Masurel), J S Brooksbank, H Dawson Sons & Co Wool NZ Ltd (H Dawson), Bloch & Behrens Wool (NZ) Limited (Bloch & Behrens), and Fuhrmann NZ (1983) Ltd (Fuhrmann). Wool merchants are the major customers of wool scourers, but also engage in the sale of greasy (ie, unscoured) wool, particularly to China.
60. As stated above, NZWSI owns J S Brooksbank, one of the larger wool merchants in New Zealand.

### Beef + Lamb New Zealand

61. Beef + Lamb New Zealand Ltd (Beef + Lamb New Zealand) is a promoter of beef and lamb within New Zealand. It is jointly funded by farmers, New Zealand retailers, and New Zealand processors.
62. As part of its operations, Beef + Lamb New Zealand provide statistical data and reports via its Economic Services Branch.<sup>23</sup>

### Industry background

63. Wool produced by farmers is sold mainly by auction, with the remainder sold directly to buyers by private treaty/contract. Wool merchants comprise the major purchasers of the wool produced by farmers. Additionally, wool merchants purchase slipe wool.
64. As outlined in Cavalier's application, wool produced in New Zealand is either:
- 64.1 scoured and used in New Zealand for the manufacture of carpet, yarn or apparel (8% of the wool clip in 2014 – was 17% in 2011);
  - 64.2 scoured and exported as clean wool (65% of the wool clip in 2014 – was 61% in 2011); or
  - 64.3 exported as un-scoured greasy wool (27% of the wool clip in 2014 – was 22% in 2011).
65. Attachment 4 shows the different functional levels in the movement of wool.
66. Wool scouring essentially involves:
- 66.1 blending of various types of wool to meet an end quality specification – quality means fibre strength, length and diameter, colour, brightness and cleanliness;

<sup>21</sup> Interview with Godfrey Hirst, 3 December 2014.

<sup>22</sup> The process of slaughtering sheep for their meat requires each carcass to have the skin removed. This skin offers two by-products – the pelt for leather and the residual wool, known as slipe wool.

<sup>23</sup> Interview with Cros Spooner, COO of Beef + Lamb New Zealand, 24 November 2014.

- 66.2 opening of the fibres by a flail process to allow full contact between fibres and washing liquid;
  - 66.3 washing (and sometimes bleaching) the wool in hot water and detergent;
  - 66.4 drying;
  - 66.5 extraction of wool grease;
  - 66.6 testing for correct specification; and
  - 66.7 high pressure packing into bales.
67. Wool scouring services are typically provided on a commission basis. Ownership of the wool is retained by the wool merchant, who pays a fee for the wool to be scoured and in some cases delivered to the next destination. In the case of NZWSI, which is a vertically integrated merchant scourer, the ownership of the wool is retained by its merchant division throughout the scouring process.
68. Wool pressing (into bales containing the clean wool end product of a wool scouring plant) is an integral and necessary part of wool scouring plants. Therefore, in these reasons (for brevity) the Commission has included wool pressing as part of its definition of wool scouring services.

#### **Reduction in the total wool clip and volumes of scoured wool**

69. The size of the wool scouring industry is closely aligned to sheep numbers and the available wool clip. For instance, when the New Zealand sheep flock reached its peak of 70 million in 1982-3, there were about 20 separate wool scouring operations. However, the decline in sheep numbers to around 29.8 million<sup>24</sup> at present has been accompanied by a significant reduction in the wool clip. This, along with the development of higher capacity modern scouring plants and presses, has resulted in a reduction in the number and total capacity of wool scours in New Zealand and consequently volumes of wool scoured.
70. Attachment 5 outlines the 2015 estimated volumes of wool flows in New Zealand.

#### *Decrease in the total wool clip since Decision 725*

71. The Commission last considered wool scouring in Decision 725. Table 1 shows the decrease in the total wool clip since then.

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<sup>24</sup> Beef + Lamb New Zealand, New Season Outlook 2014-15.

**Table 1: Total wool clip at the time of Decision 725 compared with 2015**

	Total wool clip (tonnes)		Total wool clip (%)		Percentage change
	Year ended 30/6/10*	Year ended 30/6/15	Year ended 30/6/10*	Year ended 30/6/15	
<b>North Island</b>	91,300	73,111	49%	47%	-20%
<b>South Island</b>	94,500	81,542	51%	53%	-14%
<b>Total New Zealand</b>	185,800	154,653	100%	100%	-17%

Source: Beef + Lamb New Zealand

\*The indicative figures used in Decision 725

72. During our investigation, there was general consensus from industry parties that the decrease has been brought about by two major factors, the global decline in demand for wool and the conversion of sheep farms to dairy farms.
73. Beef + Lamb New Zealand said that it estimates that the total flock number will further drop to around 26-28 million sheep over a five year period (total decline of between 6% to 13% over the period).<sup>25</sup>

#### *Decrease in the volumes of wool scoured since Decision 725*

74. As a consequence of the decreasing wool clip, volumes of wool scoured have also decreased. Table 2 shows the decrease in scoured wool volumes since Decision 725.

**Table 2: Total volume of scoured wool at the time of Decision 725 compared with 2015**

	Total volume scoured (tonnes)		Percentage change
	Year ended 30/6/10*	Year ended 30/6/15	
<b>North Island</b>	[ ]	[ ]	[ ]
<b>South Island</b>	[ ]	[ ]	[ ]
<b>Total New Zealand</b>	[ ]	[ ]	[ ]

Source: Customer volumes provided by Cavalier and NZWSI.

\*The indicative figures used in Decision 725

### **Previous Decisions, the High Court judgment, and NZWSI's subsequent sale**

75. The Commission has previously considered wool scouring in the following decisions.
- 75.1 Godfrey Hirst NZ Limited and Feltex Carpets Limited (Commerce Commission Decision 587, 31 August 2006). This acquisition gave rise to horizontal aggregation in the market for the supply of wool scouring services in the North Island.

<sup>25</sup> Interview with Beef + Lamb New Zealand, 24 November 2014.

- 75.2 David Ferrier and/or New Zealand Woolscourers Limited and Cavalier Wool Holdings Ltd and Godfrey Hirst NZ Limited (Commerce Commission Decision 666, 6 March 2009). This acquisition resulted in the aggregation of market share in the market for the supply of wool scouring services in the North and South Islands.
- 75.3 In Decision 725 the Commission granted Cavalier authorisation to acquire all of NZWSI's wool scouring assets (being the wool scouring assets and stock located at Whakatu and Kaputone and 50% of the shares in Lanolin Trading Company Limited)<sup>26</sup> and/or any interconnected body corporate of NZWSI that holds any of those wool scouring assets. The acquisition, which as noted at paragraph 2 did not proceed, would have resulted in the aggregation of market share in the markets for the supply of wool scouring services in the North and South Islands.
76. Decision 725 was appealed in the High Court by Godfrey Hirst. While the Court found that the margin between the benefits and detriments was much closer than the Commission determined, the likely detriments were still outweighed by the public benefits and consequently there was "such a benefit to the public" that the acquisition should be authorised.<sup>27</sup> The appeal was dismissed by the High Court in November 2011.
77. Subsequent to those events, Cavalier and the NZWSI Board did not reach an agreement for the sale and acquisition of the scouring assets and in early 2013, Lempriere acquired 100% of the shares in NZWSI.

### **Does Cavalier Bremworth have a substantial degree of influence over Cavalier?**

78. When the Commission considers whether an acquisition would have, or would be likely to have, the effect of substantially lessening competition in a market, it must consider the person making the acquisition as including any other person(s) that are interconnected or associated with the Applicant.<sup>28</sup> Therefore, a preliminary question the Commission must determine is whether Cavalier is associated with any other parties in the relevant market(s) such that they are treated as one head in the market(s) for the purposes of the Commission's analysis.
79. Sections 47(3) and (4) of the Act set out when two or more persons are associated. Two corporate entities are associated if one, either directly or indirectly, is able to exert a "substantial degree of influence" over the activities of the other. The Commission is of the view that, in this context, a substantial degree of influence means being able to bring real pressure to bear on the decision making process of the other, even if that pressure falls short of control.<sup>29</sup>
80. In determining whether parties are associated, each case must be considered in light of its particular facts. Typically, the Commission takes into account the:

<sup>26</sup> The Lanolin Trading Company joint venture was subsequently dissolved and CWH and NZWSI now supply wool grease independent of each other.

<sup>27</sup> *Godfrey Hirst NZ Ltd v Commerce Commission* (2011) 9 NZBLC 103,396 at [327].

<sup>28</sup> Section 47(1) of the Act refers to an acquisition by a person. Person is defined as including two or more persons that are interconnected or associated under s 47(2) of the Act.

<sup>29</sup> *Air New Zealand and Ansett Holdings Ltd and Bodas Pty Ltd* (Commerce Commission Decision 278), 3 April 1996.

- 80.1 nature and extent of ownership links between the companies;
- 80.2 presence of overlapping directorships;
- 80.3 rights of one company to appoint directors of another; and
- 80.4 nature of other shareholder agreements and links between the companies concerned.
81. Cavalier is 50% owned by Cavalier Bremworth, which in turn is a wholly-owned subsidiary of Cavalier Corporation Limited. The Shareholders' Agreement<sup>30</sup> in relation to Cavalier (the Cavalier Shareholders' Agreement) sets out  
[ ]<sup>31</sup>
82. In addition, clause 4.2 of the Cavalier Shareholders' Agreement  
[ ]<sup>32</sup>
83. In light of these facts, the Commission considers it likely that Cavalier Bremworth can exert a substantial degree of influence over the activities of Cavalier [ ].  
Accordingly, for the purposes of the present analysis, the Commission will proceed on the basis that Cavalier Bremworth and Cavalier are associated and should be considered as one head in the relevant market(s).

## Market definition

84. As previously discussed, the proposed Acquisition could give rise to competition concerns in respect of wool scouring services, the supply of wool grease and the supply of carpet.
85. Market definition is a tool that helps identify and assess the close competitive constraints the merged entity would face. Determining the relevant market requires us to judge whether, for example, two products are sufficiently close substitutes as a matter of fact and commercial common sense to fall within the same market.
86. We define markets in the way that best isolates the key competition issues that arise from a proposed acquisition.<sup>33</sup> In many cases this may not require us to precisely define the boundaries of a market. What matters is that we consider all relevant competitive constraints, and the extent of those constraints. For that reason, we also consider products which fall outside the market but which still impose some degree of competitive constraint on the merged entity.
87. The standard means to define the market is to use the "hypothetical monopolist test" (HMT).<sup>34</sup> The HMT asks whether a hypothetical sole supplier of a group of products could profitably raise prices by a small, yet significant, non-transitory (SSNIP) amount. If it could

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<sup>30</sup> Shareholders' agreement in relation to Cavalier Wool Holdings Limited, dated 26 August 2009.

<sup>31</sup> Ibid at [5.2]

<sup>32</sup> Ibid at [4.2].

<sup>33</sup> *Mergers and Acquisitions Guidelines*, above n 10 at [3.10] - [3.12].

<sup>34</sup> Ibid at [3.17] - [3.22].

impose the SSNIP, the HMT is satisfied and a market is defined. If it could not, then the market is widened to include the next best substitute and the process repeated. The process continues until a group of products that satisfies the HMT is found.

88. Whether a SSNIP could be profitably imposed depends on the degree of demand and supply-side substitution that would occur. Demand-side substitution is where customers switch to other products outside the candidate market in response to a price increase. Supply-side substitution is where rival firms offering products outside the candidate market could easily, profitably and quickly switch their production processes to supply those products in the candidate market. What matters is whether demand and supply-side substitution together is sufficient to defeat the SSNIP.
89. Where relevant, we also examine the ability of suppliers to discriminate between customers because their competitive alternatives vary.
90. In Decision 725, the Commission concluded that for the purposes of assessing the application, the relevant markets in respect of wool scouring services were:
  - 90.1 the North Island market for the supply of wool scouring services (the North Island scouring market);
  - 90.2 the South Island market for the supply of wool scouring services (the South Island scouring market);
  - 90.3 the national market for the purchase and supply of wool grease (the national wool grease market); and
  - 90.4 the national market for the manufacture, import and wholesale supply of wool and synthetic carpets.
91. Cavalier submitted in its application that these market definitions remain relevant for the consideration of the current application.
92. To assess whether this is the case, the Commission has consulted the wool industry to see whether there have been any developments or changes in the industry since we last looked at it in 2011 that would impact market definition.
93. As outlined below, the Commission still considers that there are separate geographic scouring markets in the North and South Islands. However, given changes in scouring volumes, particularly in relation to domestic wool users, we now consider that there are also different scouring markets for wool destined for export as opposed to wool destined for domestic use.
94. Additionally, we consider that there are separate domestic customer markets for wool grease, these being a market for the single large domestic wool grease buyer and a market for the remaining small domestic wool grease buyers.
95. The Commission considers that there remains a single national market for the manufacture, import and wholesale supply of wool and synthetic carpets.

## Wool scouring

96. We consider that since Decision 725, the main notable change in respect of the supply of wool scouring services has been a reduction in the volumes of wool scoured, particularly in relation to domestic users. As other market dynamics are largely the same, for the purposes of this analysis we adopt the same separate geographic scouring markets that we used in Decision 725:
- 96.1 the North Island market for the supply of wool scouring services (the North Island scouring market); and
  - 96.2 the South Island market for the supply of wool scouring services (the South Island scouring market).
97. As we did in Decision 725, given that the competition concerns are generic to both of the North and South Island wool scouring markets, for the purpose of our current competition analysis, we consider them together.
98. In addition to these geographic markets, the Commission has also considered whether there are separate markets for scouring services provided in relation to wool destined for export as distinct from wool to be used by domestic wool users.
99. Downstream wool buyers (typically manufacturers of wool products) can be placed into two distinct categories: the majority who are located offshore (international wool users); and the minority who are located within New Zealand (domestic wool users).
100. International buyers are able to source suitable quality clean wool or greasy wool from a number of different countries outside of New Zealand. Because of this, domestic wool merchants are constrained in their ability to raise prices to these buyers above an export parity price level. In simple terms the export parity price is equal to the world price of the commodity (clean or greasy wool) less any transport or other costs incurred by domestic wool merchants.
101. In contrast, domestic wool users would incur material additional costs if they were to import clean wool into New Zealand. This means that domestic users would not be able to constrain a price increase above the export parity price up to an import parity price level. In simple terms, the import parity price level equals the world price of wool plus any additional costs of importing wool to New Zealand borne by domestic wool users. As well as transport, these costs could also include costs associated with monitoring and quality control, and ensuring reliability of supply and timeliness of deliveries.
102. Therefore, to the extent that wool scouring costs are passed on by wool merchants to downstream wool users, a hypothetical monopolist domestic wool scour would likely be able to charge higher scouring prices for wool destined for domestic use than wool destined for export.
103. Based on the finding that there are separate markets for the supply of wool to international wool users, and the supply of wool to domestic users, the Commission considers that there

are separate markets for wool scouring services for wool destined for export and for wool scouring services for wool destined for domestic use.

### Wool grease

104. In Decision 725, we defined the relevant wool grease market as the national market for the purchase and supply of wool grease. At the time of that Decision, Cavalier and NZWSI were involved in a joint venture, The Lanolin Trading Company (LTC). LTC acquired lanolin from each of Cavalier and NZWSI and then supplied it to a few domestic customers and to international customers. So there was only one supplier of wool grease at that time.
105. In December 2013, the parties reverted to supplying wool grease independently of one another.
106. The majority of New Zealand wool grease is exported and there is only one domestic customer of any significant size, The Shamrock Group Limited (Shamrock).<sup>35</sup> Shamrock typically purchases in the order of [ ] annually at a cost of around [ ].<sup>36</sup>
107. [ ].<sup>37</sup>
108. [ ]. John Quigley, Managing Director, Shamrock advised that [ ].<sup>38</sup>
109. Mr Quigley said that if faced by a price increase post-acquisition, he would have some options for alternative supply. Mr Quigley advised that he could [ ]  
[ ].<sup>39</sup>
110. [ ] Prolan NZ (Prolan), a manufacturer of industrial lubricants that uses wool grease in its production. Murray Shaw of Prolan advised us that Prolan buys around [ ] of wool grease a year from [ ].<sup>40</sup>  
[ ]

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<sup>35</sup> Shamrock is a chemical manufacturing company specialising in specialty chemicals for textiles and leather industries. Wool grease is a component for a specific product that Shamrock exports. There are around three or four other small domestic buyers of wool grease who each purchase a limited amount, ie, two or three tonnes per year.

<sup>36</sup> [ ]

<sup>37</sup> [ ]

<sup>38</sup> Interview with Shamrock, 5 February 2015.

<sup>39</sup> [ ].

<sup>40</sup> Interview with Murray Shaw, Director Prolan, 5 March 2015.

].

111. [

].

112. There are small customers of wool grease that buy on more of an ad hoc basis and are therefore generally price takers.

[  
Technologies Ltd (Cotec), a paint and coatings manufacturer, is a small wool grease customer, using around [ ] of wool grease a year.<sup>42</sup>

].<sup>41</sup> Coating

113. At present, Cotec buys its wool grease from [ ]. Cotec considers [ ]. Cotec told the Commission that it thought that [ ].<sup>43</sup>

114. CRC NZ, also a manufacturer of industrial lubricants, also buys around [ ] of wool grease from Cavalier each year and pays a price around [ ] than [ ].

115. Because of [ ] and because of these customers' inability to provide any meaningful competitive constraint by importing their wool grease requirements,<sup>44</sup> for the purposes of this analysis we consider that small volume purchasers of wool grease are likely to be in a market discrete from Shamrock.

116. In Decision 725, we considered the wool grease market to be national in geographic scope. We consider that still to be the case.

117. Therefore, for the purposes of analysing the current application, in respect of wool grease we intend to adopt the following market definitions:

117.1 the national market for the refinement and supply of wool grease to large customers;  
and

117.2 the national market for the refinement and supply of wool grease to small customers.

### Wool and synthetic carpets

118. Both Cavalier Bremworth and Godfrey Hirst manufacture and supply wool carpet.

<sup>41</sup> Interview with Cavalier, 26 February 2015.

<sup>42</sup> Interview with Cotec, 18 February 2015.

<sup>43</sup> Ibid.

<sup>44</sup>

[  
]

119. New Zealand has historically had a strong affinity with wool carpets. At the time of the Norman Ellison Decision in 2007,<sup>45</sup> the Commission was advised by carpet retailers that around 75% of carpets sold in New Zealand were woollen, with the balance being synthetic. Since then, we have been advised that there has been a trend towards synthetic carpets such that only about 20% to 25% of the carpet currently sold in New Zealand is woollen.<sup>46</sup>
120. Carpet retailers<sup>47</sup> advised us that the switch away from wool carpets is due to technological advances which have led to improved synthetic fibres. The improved fibres are softer than previously and have characteristics superior to wool such as stain and crush resistance.
121. They further advised that it is commonplace for a customer to enter their store with a firm view to purchasing a pure wool carpet and leaving having acquired a synthetic carpet.<sup>48</sup> Steve Ferris, Head of Product at Flooring Brands Limited, advised us that synthetic and wool carpets are priced comparably at all price points.<sup>49</sup>
122. In the Norman Ellison Decision, the Commission acknowledged that while there was a degree of demand-side substitutability between non-carpet floor coverings and carpet, ultimately the imposition of a SSNIP meant that they fell outside the product market. We consider that this view still holds.
123. We consider that the market remains national in geographic scope.
124. To this extent, we consider that the relevant carpet market continues to be the national market for the manufacture, import and wholesale supply of wool and synthetic carpets.

### **The relevant markets**

125. Therefore, for the purposes of analysing this application, we consider the relevant scouring markets are:
- 125.1 the North Island market for the supply of wool scouring services for wool destined for export ;
  - 125.2 the North Island market for the supply of wool scouring services for wool destined for domestic use;
  - 125.3 the South Island market for the supply of wool scouring services for wool destined for export; and
  - 125.4 the South Island market for the supply of wool scouring services for wool destined for domestic use.
126. We consider the relevant wool grease markets are:

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<sup>45</sup> Cavalier Corporation Limited and Norman Ellison Holdings Limited (Commerce Commission Decision 628, 14 November 2007).

<sup>46</sup> Interview with Flooring Brands, 11 February 2015.

<sup>47</sup> Ibid. Interview with Carpet Mill, 12 February 2015.

<sup>48</sup> Ibid.

<sup>49</sup> Interview with Flooring Brands, 11 February 2015.

- 126.1 the national market for the refinement and supply of wool grease to large customers (the large customer wool grease market); and
  - 126.2 the national market for the refinement and supply of wool grease to small customers (the small customer wool grease market).
127. We also consider that there is a national market for the manufacture, import and wholesale supply of wool and synthetic carpets (the carpet market).

### **With the Acquisition**

128. As noted above, CWH proposes to:
- 128.1 close NZWSI's scours at Kaputone and Whakatu and sell the land and buildings at both sites;
  - 128.2 relocate NZWSI's scour lines at Kaputone and Whakatu to Cavalier's existing scouring sites at Timaru and Awatoto, respectively;
  - 128.3 decommission the scour line at Cavalier's Clive plant and sell the land and buildings.

### **Without the Acquisition**

129. Cavalier has presented its competition analysis and net benefit analysis on the basis that in the absence of the Acquisition, each of Cavalier and Lempriere would run their wool scouring businesses independently of one another as separate scouring entities. Their respective wool grease operations would also be independent of one another. We have confirmed this position with Cavalier and Lempriere.

### **Potential scouring plant closures**

130. Godfrey Hirst submitted that in the scenario without the Acquisition, Cavalier would be likely to discontinue its scouring operations at the Clive site.<sup>50</sup> Godfrey Hirst's economic expert, Professor Graeme Guthrie, argued that the Clive site in isolation is not providing an economic return above that which could be obtained from sale of the site.<sup>51</sup> Professor Guthrie noted that, according to Godfrey Hirst's estimates, Clive is presently scouring around [ ]% of wool currently processed in the North Island.<sup>52</sup> As a result, he concluded that closing Clive would have a negligible effect on the total amount of wool scoured in the North Island by Cavalier.<sup>53</sup>
131. Godfrey Hirst also submitted that it would be likely that Lempriere would discontinue its scouring operations at Kaputone.<sup>54</sup> Similarly, some merchants have also suggested that one of the scouring operations in the South Island could close within the next few years.<sup>55</sup>

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<sup>50</sup> Godfrey Hirst submission, 10 August 2015.

<sup>51</sup> Professor Graeme Guthrie report, 9 August 2015

<sup>52</sup> As noted in Godfrey Hirst's submission 15 October 2015 at [148], this estimation of Clive's output was based on the number of days Clive was said in the Application to have operated annually. Godfrey Hirst notes: "Subsequent information recently provided on behalf of the Applicant shows [ ]."

<sup>53</sup> Professor Graeme Guthrie report, 9 August 2015.

<sup>54</sup> Ibid.

132. [ ]<sup>56</sup>

133. [ ]<sup>57</sup>

134. [ ]:  
[ ]:

134.1 [ ];

134.2 [ ];

134.3 [ ];

134.4 [ ]<sup>58</sup>

135. Based on updated figures provided by Cavalier, Clive was used for [ ] in 2012, [ ] in 2013, [ ] in 2014 and [ ]<sup>59</sup>. This is a [ ] days Clive was used in 2010.<sup>60</sup>

136. Table 3 below indicates that over the previous four years, Clive has accounted for [ ]% of Cavalier’s North Island volumes.

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<sup>55</sup> [ ]

<sup>56</sup> Cavalier submission, 9 September 2015.

<sup>57</sup> Ibid.

<sup>58</sup> Ibid.

<sup>59</sup> Cavalier response, 29 September 2015.

<sup>60</sup> At [5.49] of the Application.

**Table 3: Cavalier’s North Island scouring volumes by site**

	2011/2012		2012/2013		2013/2014		2014/2015		Total	
	Volume (Tons)	%								
Awatoto	[ ]	[ ]	[ ]	[ ]	[ ]	[ ]	[ ]	[ ]	[ ]	[ ]
Clive	[ ]	[ ]	[ ]	[ ]	[ ]	[ ]	[ ]	[ ]	[ ]	[ ]

137. Financial records provided by Cavalier indicate that, on a standalone basis, the EBITD for Clive was [ ] for the 2013/14 financial year, [ ] for the 2014/15 financial year, and is budgeted to be [ ] for the 2015/2016 financial year.<sup>61</sup>
138. Notwithstanding the potential for Cavalier’s North Island scouring volumes to fall (figures indicate that it scoured around [ ] tonnes in 2014),<sup>62</sup> Cavalier has said that the need for sufficient headroom in the peak periods remains with and without the transaction.<sup>63</sup> In Cavalier’s view, all that changes under the proposed merger is that CWH would have access to additional capacity without needing to retain Clive, and hence the disposal is possible. Absent the merger, Cavalier asserts it would not have access to that additional capacity and therefore the same considerations which have led it to maintaining Clive would continue to apply.
139. In response to questions on the effect of the closure of Clive on Cavalier’s sales without the merger, Cavalier submitted that “...there is little (if any) scope to delay scouring services to some merchants so as to avoid the loss of scouring sales.”<sup>64</sup> Cavalier also claims that a loss of confidence by merchants in Cavalier’s ability to provide services in a timely manner would result not only in lost sales at peak times, but the potential loss of sales year round. If, for example, Masurel and Fuhrmann reduced their volumes by 15%, this would have a negative impact of almost \$[ ] per year.<sup>65</sup>
140. Regarding Kaputone, Lempriere indicates that, should the [ ]<sup>66</sup>

### *The Commission’s view*

141. Based on the information provided by Cavalier discussed above, we consider that there is more than one likely without-the-acquisition scenario regarding Clive.

<sup>61</sup> Cavalier Application. Cavalier response, 29 September 2015.

<sup>62</sup> Cavalier submission, 19 December 2014.

<sup>63</sup> Cavalier submissions 19 June 2015, 9 September 2015, 14 September 2015.

<sup>64</sup> Cavalier response to Commission’s information request of 5 October 2015 dated 15 October 2015 at [1.3].

<sup>65</sup> Ibid at [1.11].

<sup>66</sup> Interview with Lempriere, 4 June 2015. Lempriere has also

[ ].

- 141.1 There is a real chance that without the merger Cavalier would retain its scouring plant in Clive and continue to run it in peak periods.
- 141.2 There is also a real chance that, without the merger, Cavalier would close or sell the Clive site in the near future.
142. We acknowledge that even if Cavalier’s North Island volumes were to fall to a point where Clive was not required for peak periods, retaining it would still provide an option value to Cavalier. This is because of the potential for usage for overflows during planned maintenance or emergency outages at Awatoto, or if scouring volumes were to recover.
143. However, we cannot exclude the real chance that absent the merger the Cavalier Board in the near future would [ ] decide to close or sell the Clive site to realise its capital value. This is because:
- 143.1 [ ]  
[ ]; and
- 143.2 [ ].
144. The High Court in *Woolworths*<sup>67</sup> noted that where there is more than one likely without-the-acquisition scenario, the Commission should not choose the without-the-acquisition scenario that we consider has the greatest prospects of occurring. Instead, the Commission should consider the without-the-acquisition scenario that gives rise to the most acute competition concerns. Consequently, in accordance with the High Court in *Woolworths*, we have assessed the proposed acquisition on the without-the-acquisition scenario where Cavalier would close or sell the Clive site in the near future.
145. The implications and impact it has on the value that we have attributed to the Clive site is discussed later in this determination at paragraphs 455 to 466.
146. In respect of Kaputone, based on the information provided by Lempriere, the Commission takes the view that it is unlikely that NZWSI would cease its South Island operations in the without-acquisition scenario. This is because,  
[ ], the likely returns would make this strategy profitable.

## Competition analysis

147. In this section we assess whether the proposed Acquisition is likely to result in a substantial lessening of competition. The paragraphs that follow discuss:
- 147.1 the degree of competitive constraint currently provided by NZWSI in respect of wool scouring;

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<sup>67</sup> *Woolworths & Ors v Commerce Commission* above n 14 at [122].

- 147.2 the prospect of entry into wool scouring in New Zealand providing a constraint on CWH in its ability to increase wool scouring prices (or reduce quality of those services);
- 147.3 the ability of wool merchants to constrain CWH by exporting, (or threatening to export), more greasy wool for scouring overseas, primarily in China; and
- 147.4 the likely impact of the Acquisition on the wool grease and carpet markets.

### **Wool scouring markets**

148. Post-acquisition, NZWSI would be removed as an independent supplier of wool scouring services in all of the affected wool scouring markets. This would leave CWH as the only provider. If NZWSI would have otherwise provided a competitive constraint in these scouring markets, then the merger could provide CWH with enhanced market power.
149. As discussed above, depending on the level of competitive constraint provided by offshore scourers and/or the ability of wool merchants to export greasy wool, CWH could use any enhanced market power to raise scouring prices and/or lower its service quality including scouring standards or timeliness.
150. Any price rises or degradations in quality could be applied across all customers, or could potentially be targeted at those wool merchants who face fewer or more costly alternative sources for scouring services. For example, for those exporting wool to Europe or supplying it to domestic users, the scouring services in Asia may not be a suitable alternative.
151. This is because of the logistical problems and extra costs associated with re-exporting wool from Asia to Europe or back to New Zealand. The extra costs and difficulty associated with ensuring scouring services in Asia are of sufficient quality could also be a barrier to using wool scours in Asia as an alternative.

### **Existing competition – does NZWSI currently provide a competitive constraint?**

152. To determine whether the transaction would increase market power and have the effect of substantially lessening competition in the scouring markets, we have considered whether NZWSI currently provides a competitive constraint in these scouring markets. We have considered the current competitive dynamics because we consider that these are likely to continue unchanged under the counterfactual. Our conclusion is that NZWSI provides a competitive constraint on Cavalier.

### *The parties' views*

153. Regarding the domestic competitive constraint from NZWSI, Cavalier has pointed to the fact that there is little evidence of switching between Cavalier and NZWSI by customers, and that NZWSI's share of the commission scouring sector, (including greasy exports and excluding self-supply by NZWSI)<sup>68</sup> is relatively low, at around [ ].<sup>69</sup> Cavalier and NERA argue that these

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<sup>68</sup> NERA's view is that greasy exports should be included in an assessment of the market because overseas scours are a competitive constraint on domestic scours. NERA further argues that NZWSI's scouring volumes relating to its own merchant activity should be excluded because these volumes are effectively outside of the commission scouring market.

two facts when taken together imply that it is not NZWSI that is currently the main constraint on Cavalier's pricing. Instead, NERA's view is that greasy exports and the ability to increase those exports to scours offshore is the main constraint (discussed below).

154. NZWSI advised that its Whakatapu wool scour [ ]<sup>70</sup>  
 [ ] In the South Island,  
 [ ]<sup>71</sup>

#### *Others' views*

155. When it sold its wool scours to interests associated with Cavalier in 2009,<sup>72</sup> Godfrey Hirst negotiated a scouring agreement with Cavalier which included [ ] This applies to wool owned by merchants that is scoured by Cavalier on behalf of Godfrey Hirst (Godfrey Hirst does not itself purchase greasy wool for scouring). The agreement sets out that Godfrey Hirst [ ]<sup>73</sup>  
 [ ]].
156. Godfrey Hirst advised us<sup>74</sup> that [ ]  
 [ ]].
157. Godfrey Hirst said that [ ]  
 [ ]].  
 However, if the merger proceeds, this option will no longer be available to Godfrey Hirst.<sup>75</sup>
158. Fuhrmann, a wool merchant, advised us that when negotiating with Cavalier the existence of NZWSI acts as a constraint. Fuhrmann noted that it has previously scoured with NZWSI and Cavalier knows that there is a possibility it could shift back.<sup>76</sup>
159. Other merchants indicated that they do not currently consider scouring with NZWSI because it is a direct competitor.<sup>77</sup> However, some suggested that they would do so if Cavalier were to raise its prices substantially.<sup>78</sup>

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<sup>69</sup> NERA submission, 13 July 2015.

<sup>70</sup> Interview with Lempriere and NZWSI, 19 November 2014.

<sup>71</sup> Lempriere submission, 16 April 2015.

<sup>72</sup> David Ferrier and/or New Zealand Woolscourers Limited and Cavalier Wool Holdings Ltd and Godfrey Hirst NZ Limited (Commerce Commission Decision 666, 6 March 2009).

<sup>73</sup> [ ]

<sup>74</sup> Interview with Godfrey Hirst, 3 December 2014.

<sup>75</sup> Interview with Godfrey Hirst, 3 December 2014.

<sup>76</sup> Interview with Fuhrmann, 20 November 2014.

<sup>77</sup> [ ]].

<sup>78</sup> [ ]].

### *The Commission's view*

160. Our assessment included reviewing our findings in Decision 725. In that Decision, the Commission considered that despite NZWSI's limited commission scouring (the majority of its scouring being for its own wool merchant business), NZWSI placed an indirect but real constraint on Cavalier.
161. At the time of Decision 725, NZWSI's commission scouring work accounted for 13.3% of its North Island scouring and 25% of its South island scouring volumes. This amounted to approximately 6.3% and 12.8% shares of North and South Island commission scouring respectively.<sup>79</sup>
162. In the year ending 30 June 2014 NZWSI's commission scouring work accounted for [ ] of its North Island scouring and [ ] of its South Island scouring. This amounts to approximately [ ] and [ ] shares of North and South Island commission scouring, respectively. This would suggest that since 2011, NZWSI has [ ].
163. The Commission remains of the view expressed in Decision 725 that NZWSI's commission scouring business places a real constraint on Cavalier in respect of wool scouring and that with the merger that constraint would be lost.

### **Potential post-merger competitive constraints on CWH**

164. Having determined that the merger would eliminate an existing competitive constraint within the relevant scouring markets, the Commission then considered whether there are other factors that would constrain CWH from acquiring market power. The two potential constraints are:
- 164.1 potential entry by a new scouring operator/s; and
- 164.2 switching by merchants away from domestic scouring and towards greater exports of greasy wool.

### **Would potential entry constrain CWH?**

165. In the Commission's view, new entry into the various scouring markets would be possible after the merger. However, we consider that CWH would likely be able to increase prices by up to 20% before the threat of entry would be likely to provide a competitive constraint. That is to say, we consider it likely that a potential entrant would only enter the market if the merged entity raised the price of scouring by more than 20% over current levels.
166. In assessing whether a merger (whether between competitors or otherwise) would be likely to have the effect of substantially lessening competition, we assess whether, if prices increase, existing competitors would be likely to expand their sales, or new competitors would enter and effectively compete with the merged firm.

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<sup>79</sup> At footnote 39 of Decision 725.

167. We assess whether entry by new competitors or expansion by existing competitors is likely to be sufficient in extent and occur in a timely fashion to constrain the merged firm and prevent a substantial lessening of competition. This is referred to as the 'LET test'.
168. The LET test is satisfied when entry or expansion in response to a price increase or other exercise of market power is Likely, sufficient in Extent and Timely enough to constrain the merged firm.
169. The obstacles to entry and expansion that firms face (entry and expansion conditions) are relevant to the LET test.
170. As in Decision 725, the Commission considered a new entrant into a wool scouring market would need to secure:
- 170.1 an appropriate site for a scouring plant proximate to a port;
  - 170.2 the relevant resource consents;
  - 170.3 a scouring plant; and
  - 170.4 access to sufficient quantities of wool.
171. Below we outline the views and information on these matters put forward by the parties and others.

*Production site with necessary consents*

172. A key requirement for entry is an appropriate site for a new scouring plant. It would necessarily need to be located at the centre of wool production in each island and be proximate to an export port (most likely Hawke's Bay in the North Island and Canterbury in the South Island). An appropriate site requires the necessary resource consents, including water supply and effluent discharge.
173. CWH submits that the sites identified in Decision 725 remain available. Further, it says there are now additional sites available in Timaru due to the council rezoning some industrial land. It estimates that suitable land could be acquired for around [ ].<sup>80</sup>
174. We note that as part of the transaction restrictive covenants will be placed on the Whakatu, Kaputone and Clive sites which will prevent them from being used for wool scouring for 50 years.
175. When we asked Cavalier why it had included the restrictive covenants in the agreement for sale and purchase, Cavalier responded:<sup>81</sup>

The placing of covenants on the CWH / NZWSI sites is not intended to prevent new entrants in the wool scouring market (nor will it have this effect), but rather reflects the parties' desire not to give such a new entrant an advantage.

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<sup>80</sup> At [19.6] and [19.7] of the Application.

<sup>81</sup> Cavalier submission, 19 December 2014.



*Access to sufficient quantities of wool*

185. A potential obstacle for a new entrant would be securing sufficient quantities of wool to ensure the necessary capacity utilisation for an economic wool scouring operation.
186. We previously noted that the size of the wool clip in New Zealand is continuing to decline as sheep numbers reduce. However, it is conceivable that a new entrant could be a wool merchant, or group of merchants, perhaps combined with a downstream user such as Godfrey Hirst, such that the entrant could secure enough wool for an economic scouring operation through its own wool trading and/or wool purchasing arms.
187. As discussed below in the likelihood section, industry expert James Irvine,<sup>87</sup> considers that to be profitable a new entrant would need to scour 15,000 to 16,000 tonnes of wool annually per scour (ie in each island). On a national basis, the total wool clip is around 164,000 tonnes and total domestic scouring is [ ] tonnes. Of this, Segard Masurel accounts for approximately [ ] tonnes (ie, [ ] of total scouring purchases). The next three [ ] independent merchants, Bloch & Behrens, H Dawson and Fuhrmann's, all scour approximately [ ] tonnes to [ ] tonnes each.<sup>88</sup> Given that these merchant scouring purchases are split between both islands, entry would require two or more merchants combining in each island.

*Required rate of return and the profitability of entry*

188. Modelling provided by NERA on behalf of Cavalier and adjusted by the Commission suggests that entry would be profitable with a price increase of 20% if initial capital expenditure costs (including plant, land, buildings and working capital) were [ ], the entrant received an after-tax rate of return of 15%, the average wool grease price did not exceed [ ] per kg, and the entrant's volumes decreased by 1% per annum.<sup>89</sup>
189. Similarly, James Irvine advised us that in his view, entry is unlikely at price increases of less than \$0.05 per kg of greasy wool. This would constitute a 15% increase at current prices. However, "payback" models Mr Irvine has designed to aid with selling wool scours suggests that a price increase of around 20% above current prices would allow for profitable entry.<sup>90</sup>
190. As noted above, according to Mr Irvine, to enter on a commercially viable scale, a new entrant would need to scour around 15,000 – 16,000 tonnes of wool per annum to break even.<sup>91</sup> This amount constitutes around [ ]% of total scouring volumes in the North Island and

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<sup>85</sup> James Irvine is the former owner and managing director of ANDAR Limited (Andar), and was with Andar for over 20 years. Andar is an engineering company in the South Canterbury region. It is the primary supplier of wool scouring equipment in New Zealand. Since 2012 Mr Irvine has been designing, building, and installing wool scouring machinery in China and Malaysia under his own name.

<sup>86</sup> Interview with James Irvine, 17 December 2014.

<sup>87</sup> Interviews with James Irvine, 17 December 2014 and 11 March 2015.

<sup>88</sup> NERA submission, 22 October 2014.

<sup>89</sup> This modelling also assumed the plant would achieve a volume of 20,000 tonnes within two years. It also assumed an exchange rate of NZ\$1:US\$0.8, implying a wool grease price of [ ] per kg. Exchange rates lower than this level (such as the current rate around NZ\$1:US\$0.66) increase the profitability of entry, as returns from wool grease exports are increased. The 1% decline in the entrant's volumes is based on the recent trend in the total wool clip.

<sup>90</sup> Interviews with James Irvine, 17 December 2014 and 11 March 2015.

<sup>91</sup> Interviews with James Irvine, 17 December 2014 and 11 March 2015.

[ ]% in the South Island. He suggested that a 20% price increase would be sufficient to make entry profitable by a comfortable margin within a relatively short timeframe provided the entrant was guaranteed volumes of around 20,000 tonnes per annum.<sup>92</sup>

191. NERA also point to the higher current wool grease prices relative to those used in their model and growing demand for products made from wool grease, which they believe Mr Irvine has not considered, as alternative revenue streams when considering the question of entry.<sup>93</sup> NERA and Cavalier consider [ ] wool grease prices remain firm into the future.<sup>94</sup> This would make entry more likely relative to Mr Irvine's assessment outlined above.
192. Godfrey Hirst's economic expert, Professor Graeme Guthrie, argued that the post-tax 15% rate of return used in the NERA entry model is too low. He referred to theoretical, survey-based, and econometric evidence that suggests that a potential entrant would require a higher post-tax rate of return (ie, the hurdle rate).<sup>95</sup>
193. Professor Guthrie argued that this is a declining industry as evidenced by the falling wool clip, and the risk that an entrant may not have access to a sufficient volume of wool makes it plausible that someone considering entering into this industry would require a higher rate of return. He concluded that a 20% rate of return is a plausible hurdle rate. As a result, he concludes that a price increase of at least 25% would be required to trigger entry.
194. In response NERA pointed out that one of the studies that Professor Guthrie referred to uses nominal rates of return while the entry model is based on real rates, which are lower.<sup>96</sup> Once this adjustment is made, NERA considers that the real rates of return that the survey respondents reveal typically do not exceed 15%.
195. Direct Capital, one of the shareholders of Cavalier also responded to Professor Guthrie's views by saying that required rates of return could vary based on the type of investor. In the present context, the likely potential entrant would be a group of merchants.<sup>97</sup> For merchants contemplating entry into the scouring market, the required rate of return could be significantly lower than for a financial investor. This is because they would be able to effectively guarantee sufficient volume of wool for scouring, thus reducing one of the major risks of establishing a scour, which would be not attracting a sufficient volume of wool.<sup>98</sup>
196. Direct Capital provided data regarding the cost of capital from 2010, which was when it acquired shares in Cavalier. At the time, it applied a 13.84% post-tax cost of capital. This was inclusive of an investor specific risk-premium over and above commonly used risk-premia for

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<sup>92</sup> Ibid.

<sup>93</sup> Cavalier submission, 21 April 2015.

<sup>94</sup> Ibid.

<sup>95</sup> Professor Graeme Guthrie reports, 21 April and 8 May 2015.

<sup>96</sup> NERA submission, 9 June 2015.

<sup>97</sup> The view that merchants would be the most likely entrants was put forward by several merchants, including [ ]. Based on data the Commission obtained from the parties concerning the merchants shares of scouring volumes, the Commission considers that entry in the North Island would require [ ] and entry in the South Island [ ]. NERA submission, 22 October 2014. NZWSI customer information, 3 November 2014.

<sup>98</sup> Direct Capital submission, 19 June 2015.

listed equities.<sup>99</sup> As Direct Capital is a financial investor, a group of merchants may require a lower return as they would be able to control volumes.

*The Commission's view on entry requirements*

197. The Commission considers that there are sufficient alternative sites for entry to occur in either island based on evidence provided by the parties. We also place weight on the feedback obtained from the respective Regional Councils regarding the likely ability of a new entrant to obtain the necessary resource consents. Similarly, we consider that the acquisition of a suitable scouring plant would not be problematic based on evidence provided by industry experts.
198. To ensure there is sufficient wool for viable entry, it is the Commission's view that [ ]. This is based on the current shares of scouring purchases.
199. The Commission has considered all of the above evidence and responses from parties and is of the view that a 15% post tax required rate of return for a potential entrant is a reasonable assumption to make when modelling entry. Based on the evidence provided by merchants and the parties, we consider that any entrants would be likely to be a group of merchants rather than a separate entity not already involved in the wool sector. Because of the ability of merchants to acquire and commit volumes of wool for scouring, they would not face the same business risk that a separate, independent entity would face. We also consider that the evidence provided by NERA and Direct Capital regarding typical required rates of return not exceeding 15% is persuasive. Therefore, we consider that there is sufficient justification for using the 15% post-tax required rate of return.

*The LET test*

200. As set out above for market entry to be a sufficient constraint, entry of new participants in response to a price increase or other manifestation of market power must be likely, sufficient in extent and timely.

*Likelihood*

201. Entry or expansion must be likely. The mere possibility of entry or expansion is insufficient.
202. The likelihood of entry or expansion depends on whether firms can profitably enter or expand the market in light of any entry and expansion conditions.
203. There is now a long history of exit and rationalisation in the wool scouring industry. In addition, sheep numbers have declined substantially in recent years.
204. In Decision 725, we considered that Segard Masurel was a credible and likely entrant.
205. Segard Masurel advised us that if scouring prices were increased to sufficiently high levels, Segard Masurel would "have to" enter wool scouring "at some point".<sup>100</sup> Segard Masurel's

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<sup>99</sup> Ibid.

<sup>100</sup> Interviews with Segard Masurel, 24 November 2014. [ ].

parent company (which has global operations in the wool industry) operates a wool scour in South Africa and therefore has wool scouring expertise.

206. However, Mr Whiteman stated that Segard Masurel would not consider entry unless prices increased by [ ]%, and [ ]. He said that it would not be its wish to enter but would consider it out of necessity if need be. The operation it would commission would be a “boutique type scour” for its own volumes and perhaps for another merchant.<sup>101</sup>
207. We note that Segard Masurel is the [ ] wool merchant in New Zealand and is Cavalier’s [ ]. In 2013 it sold around [ ] of scoured wool nationwide and also sold around [ ] tonnes of greasy wool. Its total wool exports (including greasy wool) accounted for around [ ] of all New Zealand wool exports.<sup>102</sup> Mr Whiteman considered that it may be necessary to [ ].<sup>103</sup> Given Segard Masurel’s [ ]].
208. Other wool merchants that we interviewed did not generally express a desire to enter or re-enter wool scouring markets, [ ].<sup>104</sup> The primary reasons given for not wanting to enter were the high capital costs, and the fact that wool scouring is not a core business for wool merchants. Merchants expressed a view that continued rationalisation in the sector is inevitable, and would follow a well-established long-term trend of fewer scours because of a declining wool clip and declining level of domestic scouring.<sup>105</sup>
209. Two parties told us that they thought that Segard Masurel and Godfrey Hirst would be the most likely to enter wool scouring in the event that CWH exercised any market power that it had gained.<sup>106</sup>
210. In Decision 725, we considered Godfrey Hirst was a potential entrant. When we interviewed Godfrey Hirst in the course of this investigation, Godfrey Hirst advised us [ ].<sup>107</sup> As outlined in paragraph 58, Godfrey Hirst’s own volumes of wool are [ ] than in 2011. [ ]. [ ]. It mentioned, however, [ ].<sup>108</sup>

<sup>101</sup> Ibid.

<sup>102</sup> Interview with Segard Masurel, 24 November 2014.

<sup>103</sup> Interview with Segard Masurel, 11 March 2015.

<sup>104</sup> [ ].

<sup>105</sup> [ ].

<sup>106</sup> [ ].

<sup>107</sup> Interview with Godfrey Hirst, 3 December 2014.

<sup>108</sup> Interview with Godfrey Hirst, 3 December 2014. Godfrey Hirst submission, 23 June 2015.

211. However,  
[ ]<sup>109</sup>
212. The Commission has also reviewed the entry modelling provided by NERA on behalf of Cavalier. This modelling indicates that entry would be unlikely to be profitable with a price increase of 5% if initial capital expenditure costs (including plant, land, buildings and working capital) were as low as [ ], the entrant required after-tax rate of return of 15% and the average wool grease price did not exceed [ ] per kg.<sup>110</sup>
213. In the Commission's view, entry would be more difficult than at the time Decision 725 was decided because any potential entrant would be seeking to acquire market share in smaller markets. The total wool clip has decreased by 12% since 2010 and the total volume of wool scoured in New Zealand has decreased by [ ] over the same period.
214. Furthermore, in recent years there has been a continued global shift of the manufacture of wool products to Asia, in particular China,<sup>111</sup> while at the same time the quantity and quality of the available scouring capacity in that region has increased.<sup>112</sup> Over time this could further reduce the demand for clean wool from New Zealand and could lead to increases in greasy exports. Similarly, the growing substitution of wool products for synthetics, particularly by domestic carpet manufacturers,<sup>113</sup> would continue to reduce the demand for clean wool and therefore also reduce the attractiveness of future entry.
215. These factors, combined with conservative assumptions about the price of wool grease, the exchange rate, and a declining wool clip, imply that there is a real chance that entry may only be profitable if there were a 20% increase in prices post-merger.<sup>114</sup>
216. Therefore, the Commission considers the merged entity would be unlikely to have an incentive to raise scouring prices by more than 20% based on the potential for such an increase to trigger entry.

### *Extent*

217. Entry or expansion must also be of a sufficient extent to constrain the merged firm and prevent a substantial lessening of competition. Entry or expansion may be of sufficient extent

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<sup>109</sup> [ ].

<sup>110</sup> NERA Submission, 22 October 2014. This modelling also assumed the plant would achieve a volume of 20,000 tonnes within two years with no decrease in scouring volumes over a 20 year time period. It also assumes an exchange rate of NZ\$1:US\$0.73, implying a wool grease price of US[ ] per kg.

<sup>111</sup>

[ ]

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<sup>112</sup> Interview with James Irvine 17 December 2014. At Executive Summary and [15.12 – 15.31] of the Application. Interview with Cavalier, 13 November 2014.

<sup>113</sup> Interviews with Carpet Mill 12, February 2015. Interview with Flooring Brands, 11 February 2015.

<sup>114</sup> These assumptions include an international wool grease price of US\$[ ] per kg, a relatively strong exchange rate of NZ\$1:US\$0.80 and a continued reduction in the wool clip of 1% per annum.

even if that entrant or existing competitor remains smaller than either of the merging firms pre-merger.

218. In Decision 725 we considered that a likely minimum commercial scale of entry would be one 2.4 metre wide scour line. Illustrative of such a potential effect were Cavalier's two Hawke's Bay 2.4 metre wide scour lines each of which was processing at that time approximately [ ] tonnes of greasy wool per annum, or about [ ] of the North Island clip at that time.
219. James Irvine informed us during our current investigation, that a new entrant in New Zealand would be more likely to install a 3.0m line.<sup>115</sup> However, we consider that the size of the scour would be dependent on the volumes of wool available to a new entrant. Assuming a minimum volume of 15,000 tonnes per annum scoured using a 2.4 metre scour, entry using such scours in each island this would reduce CWH's market share in both islands by more than [ ]%. The Commission considers that entry of this extent would be sufficient to discipline any substantial lessening of competition.

#### *Timely*

220. Entry or expansion must also be likely to occur within a reasonably short time period following a price increase or other exercise of market power in order for it to constrain the merged firm and prevent a substantial lessening of competition.
221. As discussed above, Mr Irvine advised the Commission that he considers he could have a new wool scour fully operational in around six months. This would be after the decision had been made to enter, financing arranged, consents obtained and so on.<sup>116</sup> Godfrey Hirst submitted that 12 months would be a minimum timeframe for entry and 18 months would be more likely.<sup>117</sup>
222. The Commission's view is that accounting for these factors, if entry were to occur, it would be likely to occur within one to two years.

#### *Conclusion on the LET Test*

223. Despite the fact that entry could occur to a sufficient extent and in a timely manner, the Commission's view is that the LET test is not met. This is because we cannot be satisfied that entry would be likely to occur without a 20% increase in wool scouring prices. We note that in Decision 725, based on the evidence before us at that time, we considered a price increase of more than 5-10% would be required before entry occurred.
224. We consider that given the changes in the wool scouring market since the previous Decision, primarily the decline in the wool clip and associated decline in domestic scouring, entry is unlikely to occur unless scouring prices were to increase by around 20%.

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<sup>115</sup> Interview with James Irvine, 17 December 2014.

<sup>116</sup> Ibid.

<sup>117</sup> Godfrey Hirst submission, 21 April 2015 at [150].

### Would the threat of increased exports of greasy wool constrain CWH?

225. Given that the Commission does not consider that entry would discipline a substantial lessening of competition post-merger, we have considered whether the threat of merchants switching to exporting a greater amount of wool sales to greasy exports.
226. Our view is that we cannot be satisfied that the threat of increased greasy exports would discipline a substantial lessening of competition. 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. Although evidence from some merchants also indicates a likely price increase could be as low as 5%.
227. For wool destined for domestic use by Godfrey Hirst, we consider that the likely primary constraint on scouring prices post-merger would be [ ]. We consider that this threat is only likely to constrain an increase in scouring prices of 25% or higher or could be as low as 5% (see paragraph 312 for further discussion). For other domestic users, primarily Cavalier Bremworth, we consider that a likely price increase would be minimal and would be unlikely to be greater than that applied to wool destined for export.
228. In reaching these conclusions, we have considered four key factors:
- 228.1 whether overseas scours have the ability and capacity to scour more of the wool produced in New Zealand;
  - 228.2 what price increase would cause merchants to switch to more greasy exports and whether that increase varies depending on the ultimate destination of the wool;
  - 228.3 whether CWH would have the ability to price discriminate on the basis of either the ultimate destination of the wool (eg, overseas or domestic use) or the type of merchant (eg, 'clean export only'); and
  - 228.4 whether merchants' incentives to increase greasy exports if scouring prices were to increase would be affected by merchants' ability to pass scouring cost increases through to either downstream customers (wool users) or upstream wool growers.
229. The various industry players' views on each of these matters are outlined below, along with our findings.
230. We also considered any impact from exchange rate fluctuations on constraint from greasy exports as well as overall industry trends that are relevant to the constraint provided by increased exports of greasy wool.

#### *Industry trends*

231. During our investigation, we heard from a number of industry participants that China's demand for wool is increasing.<sup>118</sup> This is backed up by the data which shows that over one-

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<sup>118</sup> For example: Interview with Fuhrmann, 20 November 2014. [ ]



- 236.1 In 1995 there were 25 wool scouring sites in Australia scouring about 600,000 greasy tonnes per annum. This constituted 82% of the total Australian wool production of 730,000 tonnes per annum.
- 236.2 In 2009 there were only three remaining commercial wool scouring sites in Australia processing about 54,000 greasy tonnes per annum (14% of total Australian wool production of about 400,000 tonnes per annum). This constituted a 91% reduction in Australian scouring.
237. Cavalier considers that because the New Zealand scouring industry has rationalised itself by progressively removing overcapacity (unlike the situation that prevailed in Australia), it has so far survived the rise of the low cost Chinese wool scouring industry, but the threat of low cost Chinese scouring services remains.<sup>125</sup>
238. Although the Australian experience may be differentiated to some extent based on the higher proportion of fine wool in the wool clip compared to New Zealand,<sup>126</sup> the Commission considers that the developments in Australia are illustrative of the competitive constraint provided by scouring in Asia in general, and China in particular.

*Is there sufficient capacity overseas to scour more New Zealand wool?*

239. For greasy exports to provide a constraint on CWH's ability to increase prices it must first be the case that there is sufficient scouring capacity overseas to take more New Zealand wool. Where overseas scouring is available and is to be used by merchants as a substitute for domestic scouring, this overseas capacity must also have the ability to scour New Zealand wool, the majority of which is coarse wool, to be sufficiently substitutable for domestic scouring.

The parties' views

240. In its application, Cavalier asserts that there is more than sufficient capacity in China to process increased greasy wool imports.<sup>127</sup> It also points to a large new wool scour in Malaysia, Compass Wool Processors (CWP), that it considers could also be utilised for scouring New Zealand wool. Cavalier's view is that offshore scours are now willing and able to scour a wider range of wool types than previously, including New Zealand cross-bred wool.<sup>128</sup>
241. Cavalier provided the following chart which shows that a significant amount of New Zealand wool exported to China is coarse (ie, strong or crossbred) wool, indicating that the Chinese wool industry uses all sorts of wool, not just fine wool.

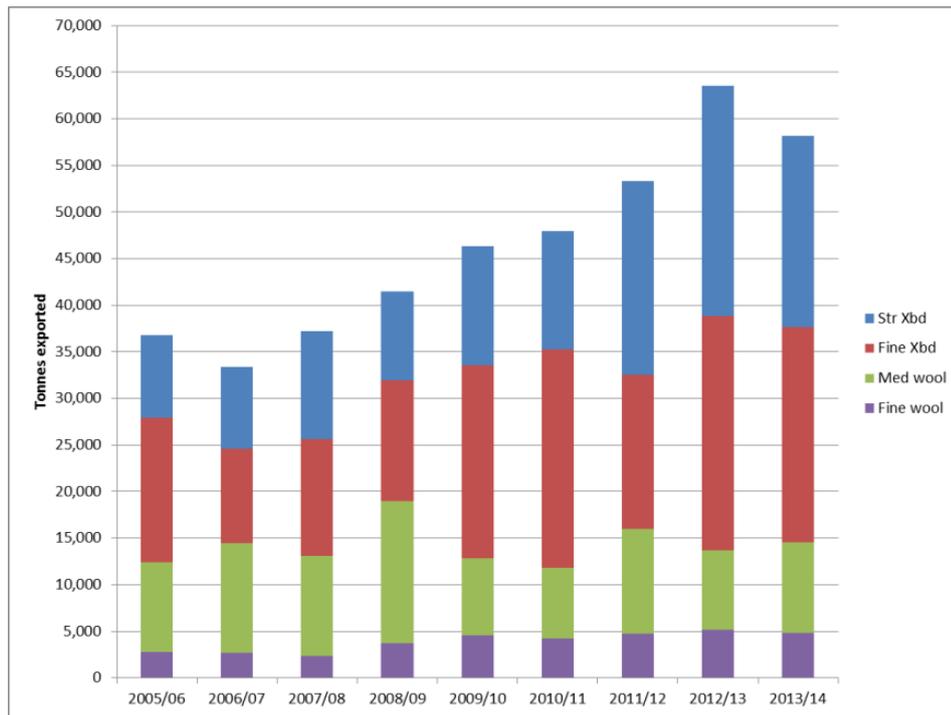
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<sup>125</sup> At [5], [9], [15] of the Application. Cavalier submission, 21 April 2015.

<sup>126</sup> This makes more of Australia's wool clip suitable for textiles, of which China is major manufacturer.

<sup>127</sup> At Executive Summary and [15.12 – 15.31] of the Application. 10 June 2015 Conference transcript.

<sup>128</sup> Executive Summary of the Application and interview with James Irvine, 17 December 2014.

**Figure 1: Types of wool exported from New Zealand to China**<sup>129</sup>

242. Cavalier also stated that there is substantial scouring capacity in other international markets, including the United Kingdom and elsewhere in Europe.<sup>130</sup>
243. Additionally, NERA submitted that [redacted].<sup>131</sup> Given that [redacted] is over a period of increased aggregation in the scouring sector, NERA's view is that this reflects an increased competitive constraint from overseas scours. NERA also provided a partial analysis of Cavalier's costs, suggesting that [redacted].<sup>132</sup> Cavalier has pointed out that the top five destinations for clean wool exports also receive greasy exports from New Zealand.<sup>133</sup>
244. NZWSI submitted information indicating that in 2014, China imported around 280,000 tonnes of greasy wool and, combined with domestic wool production, scoured around 700,000 tonnes.<sup>134</sup> NZWSI also estimated that New Zealand accounts for around 2% of the global production of fine wool, around 12% of global production of medium wool, and around 17% of the global production of coarse wool.<sup>135</sup>
245. NZWSI submitted that these figures indicate that a substantial increase in greasy exports from New Zealand would constitute a relatively minor change in global trading patterns. NZWSI also stated that, together with the information provided by Cavalier, there is

<sup>129</sup> From Beef + Lamb New Zealand Economic Service statistics.

<sup>130</sup> 10 June 2015 Conference. Cavalier submission, 19 June 2015.

<sup>131</sup> NERA submission, 21 April 2015.

<sup>132</sup> Ibid at [2.4.3].

<sup>133</sup> Cavalier, submission, 19 June 2015.

<sup>134</sup> NZWSI submission, 19 June 2015.

<sup>135</sup> Ibid. Source of data: International Wool Textile Organisation 'Market Information' 2014 Edition.

substantial scouring capacity in Asia and elsewhere (as outlined above), and this illustrates how there are unlikely to be substantial constraints in terms of scouring capacity overseas should merchants wish to increase greasy exports.

### Godfrey Hirst's views

246. Godfrey Hirst submitted that exports of greasy wool are unlikely to increase because there is insufficient scouring capacity in China.<sup>136</sup> Godfrey Hirst stated that New Zealand scours offer pre-scour blending and machining of greasy wool, whereas overseas scours do not have such equipment and do not offer the same level of service.<sup>137</sup>
247. In relation to scouring capacity in Malaysia, Godfrey Hirst told us that it considers that CWP scours fine wools only.<sup>138</sup> However, in our interview with Mr Irvine, he advised us that he is presently working at CWP and that the CWP scour can switch from processing fine to coarse wool simply by changing a computer setting. In respect of the Chinese scours, he said that they too can process coarse wool by "changing a few speeds".<sup>139</sup>

### Others' views

248. In contrast to Godfrey Hirst's view, no other party submitted that there is insufficient scouring capacity in China, but one merchant did consider that China scours largely fine wools and would not necessarily cope with New Zealand's coarse wools.<sup>140</sup>
249. Scouring designer James Irvine told us that there is presently excess wool scouring capacity in China.<sup>141</sup> [ ] indicated that there are likely to be wool users located in China that possess scouring plants as 'add-ons' to their current manufacturing operations.<sup>142</sup> These wool users, which include yarn spinners or top makers, would typically import clean wool from sources such as New Zealand when wool grease prices are low, but switch to importing greasy wool when wool grease prices are high.
250. [ ] buyer of scouring services, considered that there was a substantial capacity for increasing greasy exports to China, particularly in the short term, if the return from greasy exports was sufficiently attractive.<sup>143</sup> While this capacity would exist in the short term, [ ] considered that a longer term increase in greasy exports in China would need to be coupled with increased investment in more environmentally friendly scouring operations given the prevailing political concerns with the sector in China.

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<sup>136</sup> Godfrey Hirst submission, 21 April 2015.

<sup>137</sup> Godfrey Hirst submission, 10 August 2015. Godfrey Hirst interview, 3 December 2014.

<sup>138</sup> Godfrey Hirst submission, 21 April 2015.

<sup>139</sup> Interview with James Irvine, 17 December 2014.

<sup>140</sup> [ ].

<sup>141</sup> Interview with James Irvine, 17 December 2014.

<sup>142</sup> [ ].

<sup>143</sup> [ ].

## The Commission's view

251. The Commission considers that there is sufficient capacity for overseas scours to scour a greater amount of New Zealand wool. We consider that excess capacity within China and the ease at which scouring services there could be provided suggests that there are unlikely to be significant capacity constraints to undertake additional scouring in China.
252. China is currently the largest export market for New Zealand wool. In the year ending June 2014, about half of New Zealand's wool clip was exported to China. About 48% of those exports were in greasy form, implying that around one quarter of New Zealand's total wool clip is scoured in China. China is the destination for over 80% of the greasy wool exported from New Zealand. Table 4 sets out the changes in these figures between 2010 and the present.

**Table 4: Greasy wool exports to all countries in 2010 and 2015 (includes slipe wool)**

Greasy wool exports		
	Year ended 30/6/10*	Year ended 30/6/15
<b>Tonnes</b>		
Total New Zealand	43,015	47,102
<b>% of wool clip</b>		
Total New Zealand	23%	30%

Source: Beef + Lamb New Zealand

\* Indicative figures used in Decision 725

253. As can be seen in Table 4, there has been a 9.5% increase in the volume of greasy wool exports from 2010,<sup>144</sup> with the proportion of the total wool clip that is exported greasy now 30%.
254. Further, even though we have heard mixed views on the ability for Chinese and/or Malaysian scours to scour New Zealand coarse wool, the parties we have spoken to that have direct experience with the Chinese and Malaysian scours generally believe the ability is present in both China and Malaysia.<sup>145</sup>

### *What price increase would cause merchants to switch to more greasy exports?*

255. Where there is sufficient scouring capacity available offshore to take increased greasy exports, a key consideration is how much domestic scouring prices would need to increase by before scouring overseas would become a suitable alternative to domestic scouring.<sup>146</sup>

<sup>144</sup> We note that much of this increase has occurred most recently, with a 5.9% increase in greasy exports from 2014 to 2015.

<sup>145</sup> See paragraphs 240 to 250 above.

<sup>146</sup> For the purposes of this analysis, percentage increases in scouring prices are based on a total price for scouring and pressing of [ ] per kilogram. Therefore, a [ ] increase constitutes a 15% increase.

### The parties' views

256. Cavalier submitted that should the merged entity increase its scouring price, merchants would export more greasy wool.<sup>147</sup> Any such greasy exports would either be sold directly to customers that would be responsible for scouring or the merchants would oversee commission scouring themselves, for instance in China or Malaysia. Cavalier submitted that this would render a significant price increase unprofitable.<sup>148</sup>
257. Cavalier argued that the risk of exporters diverting a proportion of their present scouring volumes to China as greasy wool would act as a constraint on Cavalier's pricing post-merger.<sup>149</sup> Any such diversion of volumes would cost Cavalier's currently profitable scouring business. In support of this argument, Cavalier submitted that, [ ]<sup>150</sup>
258. NZWSI, through its merchant operation, accounts for around [ ]% of all domestic scouring, making it the largest single 'buyer' of scouring services. It has stated that the price it is able to obtain on clean wool exported to China is around [ ] per kilogram [ ]<sup>151</sup> more than the price it can obtain for greasy wool. This margin is [ ]<sup>152</sup> NZWSI stated that because Chinese buyers are unwilling to pay a margin larger than this for scoured wool over greasy, any increase in domestic scouring charges would result in increased greasy exports to China.<sup>153</sup>
259. To estimate the level of constraint that overseas scours may provide, NERA provided a Cournot simulation model.<sup>154</sup> This modelling assumed that New Zealand scours are in direct competition with overseas scours. Overseas scours were included in the model as one competitor that scours all the wool that is exported greasy from New Zealand. This let NERA simulate the effects on scouring prices caused by a merger of the two New Zealand scours. The simulated price increases are [ ]% for the North Island and [ ]% for the South Island.

### Godfrey Hirst's view

260. Godfrey Hirst considers that the constraint provided by the ability of merchants to switch to increased greasy exports may be relatively weak. They have suggested that scouring prices may need to rise by [ ] before merchants would consider abandoning scouring in

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<sup>147</sup> At [26.6] of the Application.

<sup>148</sup> NERA submission, 22 October 2014.

<sup>149</sup> At Executive Summary of the Application.

<sup>150</sup> At [15.34] of the Application.

<sup>151</sup> John Dawson, NZWSI, Conference 10 June 2015, transcript page 52. New Zealand dollar values based on an exchange rate of US\$1: NZ\$0.60.

<sup>152</sup>

[ ]  
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<sup>153</sup> Interview with Lempriere and NZWSI, 19 November 2014.

<sup>154</sup> NERA submission, 13 July 2015.

New Zealand and instead export more greasy wool.<sup>155</sup> This is because scouring overseas would provide merchants with less control over the scouring process and less ability to react to scouring issues, for instance by adjusting wool blends.<sup>156</sup>

261. Godfrey Hirst also indicated that scouring overseas would be problematic in terms of ensuring that scouring services were of sufficient quality and scourers were able to provide timeliness of supply.<sup>157</sup>
262. In relation its own requirement for clean wool for its domestic carpet manufacturing business, Godfrey Hirst has claimed that, given the substantial costs of offshore scouring and current market conditions (eg, wool prices and exchange rates), it could be subject to a large increase in scouring prices before it would be economic for it to respond.<sup>158</sup> It has said that [ ]<sup>159</sup>

### Others' views

263. The Commission sought feedback from a range of merchants regarding the likelihood that they would switch to greasy exports if scouring prices were to increase, and what magnitude price increase would cause them to switch. Given the fact that a number of export markets for clean wool do not have or have limited scouring capacity (eg Japan), we also enquired about the possibility of exporting greasy wool to, for example, China and re-exporting to other, existing export markets.
264. Including the merchant arm of NZWSI, we spoke to 13 of the approximately 35 buyers of scouring services in New Zealand. Together, these 13 merchants account for [ ]% of all scouring purchased in New Zealand.

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<sup>155</sup> Godfrey Hirst submission, 10 August 2015.

<sup>156</sup> Ibid

<sup>157</sup> Ibid. Interview with Godfrey Hirst, 3 December 2014. Godfrey Hirst submission, 21 April 2015.

<sup>158</sup> Godfrey Hirst submission, 23 June 2015.

<sup>159</sup> Interview with Godfrey Hirst, 3 December 2014. Godfrey Hirst submission, 23 June 2015.

**Figure 2: [**

]

Source: NZWSI and Cavalier

265. In respect of scouring wool in China or Malaysia for re-export, many industry participants we spoke with said the idea of commission scouring of New Zealand wool in these locations for re-export to other, non-Asian markets (including New Zealand) did not appeal. This is because of a loss of control over the wool and the wool scouring process, as well as the cost of freight and time delays that may arise.<sup>160</sup> [ ]<sup>161</sup>
266. Nevertheless, some of the merchants we spoke with indicated that if they were faced with sufficiently large price increases they would consider switching to overseeing commission scouring wool overseas, for example getting wool destined for end users based in China scoured in China. Other merchants indicated that they would instead seek out new opportunities with wool users that demand greasy wool. Because of these alternatives, some merchants considered a one-off price increase of a substantial magnitude would be unlikely. Instead, as outlined below, these merchants considered that any price increases would be relatively small and incremental.
267. [ ]<sup>162</sup> considered that any post-merger price rise would be unlikely to be a substantial one-off increase. This is because of the threat of either increased greasy exports or new entry. Although unable to speculate as to the likely magnitude of any increase in prices because of the inherent uncertainty, [ ] expected that any price rise would be more likely to be a gradual series of incremental adjustments over time.

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<sup>160</sup> For example:

[

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<sup>161</sup> [ ]

<sup>162</sup> [ ]

268. In light of any such incremental increases, [ ] considered that the impact which would confront CWH in the first instance would be unlikely to be an immediate large scale move by merchants to increase scouring overseas.<sup>163</sup> Rather [ ] considered that it would be more likely that incremental price increases could result in a growing loss of orders by merchants from their overseas downstream customers (end users) of clean New Zealand wool. This could occur as these end users either substituted away from New Zealand wool to similar wool from other countries, or substituted away from wool altogether to the greater use of synthetic fibres.
269. [ ] considered that this incremental (step-by-step) reduction in scouring demand could be the response CWH would be most likely to face if it were to increase prices in a manner [ ] suggested was most likely.<sup>164</sup> Given a scouring operation is a volume-based business in which operators typically seek to maximise throughput, [ ] considered that this would place some pricing pressure on CWH, although [ ] was unsure as to the degree of this constraint. [ ] was also of the view that if CWH were to increase scouring prices too high it would lose volumes because merchants would switch to greater greasy exports.<sup>165</sup>
270. [ ]<sup>166</sup>. Overall, [ ] considered that a price increase of greater than 15%<sup>167</sup> would be unlikely because of the potential for merchants to switch to more greasy exports, particularly those merchants exporting to China.
271. [ ]<sup>168</sup> considered that if CWH increased the price of scouring, any increase would be minimal. He considered that CWH would not be able to profitably increase prices by more than a maximum of [ ] cents per kilogram (ie, equivalent to 15%). This is because of the ability that [ ], and other merchants, would have to export more wool in greasy form.
272. [ ] explained that [ ] would not necessarily sell more wool greasy for delivery directly to overseas customers, but would instead oversee scouring undertaken offshore and continue to sell clean wool. Although this approach would be awkward and increase costs, it is “definitely feasible” and would ultimately be preferable to incurring a 15% rise in scouring prices.<sup>169</sup> Unlike [ ], [ ] expected that other merchants would be more likely to switch to exporting more greasy wool directly to end users (who would be responsible for scouring themselves) or to merchants overseas, as facing a price increase of 15% would be “unpalatable”.<sup>170</sup>

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<sup>163</sup> [ ]

<sup>164</sup> [ ]

<sup>165</sup> [ ]

<sup>166</sup> [ ]

[ ]

<sup>167</sup> That is, equivalent to [ ] cents per kilogram on a combined scouring and pressing price of [ ]

<sup>168</sup> [ ]

<sup>169</sup> Ibid.

<sup>170</sup> Ibid.

273. John Henderson and Peter Christensen of Fuhrmann, New Zealand's [ ] largest wool merchant, told the Commission that it previously exported [ ] of its wool in scoured form, and it is now exporting approximately [ ] in scoured form.<sup>171</sup> [ ]  
 ]. Approximately [ ] of Fuhrmann's current business is with China.
274. [ ] considered that if CWH were to increase prices, [ ] would consider other scouring options, such as scouring more wool in China or Malaysia, although these options would not be ideal.<sup>172</sup>
275. [ ] believed that either the threat of greasy exports or entry would mean that, if scouring prices were to increase, any such increase would be limited to around 10% at the highest.<sup>173</sup>
276. We also spoke with [ ].<sup>174</sup>  
 [ ] purchases both greasy and scoured wool from New Zealand. [ ] stated that if CWH were to impose a 10% price increase, "this would be around the tipping point" and [ ] would begin to consider whether to switch to exporting more greasy wool and have it scoured in [ ]. [ ] further stated that if prices were to increase by 20% it would be viable for [ ] to export all of the wool [ ] purchases in New Zealand in greasy form, have it scoured [ ] and re-export it to his downstream customers [ ].
277. [ ] considered that CWH would be very aware of the scouring prices in Asia, in particular China.<sup>175</sup> This is because of the threat of increased greasy exports, not just for processing in China but potentially also for use elsewhere after being scoured in China. [ ] considered that while he expected CWH to eventually increase prices by [ ] cents (6% to 9%) given that scouring prices have been unchanged for years while their costs have increased, [ ] would be surprised if it increased prices by more than [ ] cents (15%).
278. [ ] considered that the proposed merger would not have much impact on scouring prices. They considered that increased greasy exports and/or potential entry would be a credible threat if prices were to rise too much.
279. In contrast, two other merchants we spoke to, [ ], were against the merger and considered that the ability of merchants to export more greasy wool would not be sufficient to constrain prices increases to less than 20% or perhaps even higher.<sup>176</sup>

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<sup>171</sup> Interview with John Henderson and Peter Christensen of Fuhrmann, 20 November 2014. Fuhrmann's accounts for

[ ].

<sup>172</sup> [ ]

<sup>173</sup> [ ].

<sup>174</sup> [ ].

<sup>175</sup> [ ].

<sup>176</sup> [ ].

While these merchants export some greasy wool, because their business models are focused largely on clean exports, they considered that they would be unlikely to switch to increased greasy exports to any great extent in the face of a substantial price increase.

280. [ ] considered that issues around quality control and speed would limit the constraint of scouring wool offshore, and that greasy exports to China were scoured and blended in China. In contrast, New Zealand scoured wool is sought after specifically. In his view, the result would be that if scouring prices were increased by 20% only a small proportion of scouring would be lost.
281. [ ] considered that [ ] would probably deal with 25% increases before it would be start to reduce its reliance on domestic scouring.

### The Commission's view

282. Based on the feedback provided by merchants, and our analysis of the threat posed by increased exports of greasy wool, the Commission considers that if CWH were to increase prices by more than 15% in relation to wool destined for export, larger merchants would respond by switching a significant proportion of clean wool exports to greasy exports. Although a real possibility, the Commission is less certain whether price increases lower than this level would cause sufficient switching so as to discipline CWH. Some merchants considered that the merger would not have much impact on prices and that only a small price increase is likely, while others considered price increases would be incremental over a period of years. Taking into account the views received from those merchants, we consider that the likely price increase would be between 5% and 15%.
283. In particular, [ ] merchants considered that, if prices were to rise, any price increases would be incremental. One merchant thought that over time such increases could cause New Zealand clean wool users to switch elsewhere and that this loss of volume could constrain price increases by CWH. However, we have taken a conservative approach and consider that a price increase could be as large as 15%.<sup>177</sup>
284. The Commission also accepts that there may be some merchants who would be vulnerable to scouring price increases greater than 15% because they are less able to switch to a business model based on greasy exports.<sup>178</sup> However, as outlined in the section on price discrimination below, we consider it unlikely that CWH could successfully identify and price discriminate against any such 'clean export only' merchants. Even if CWH could, such a price increase could not be sustained because these 'clean export only' merchants would face competition from larger merchants who would be able to undercut those merchants facing higher scouring prices.
285. The Commission also acknowledges that Godfrey Hirst and Professor Guthrie, having reviewed the feedback provided to the Commission by merchants, have come to a different

<sup>177</sup> We have used this conservative approach of an immediate price increase of 15% in our estimation of allocative efficiency detriments (see the Benefits and Detriments section).

<sup>178</sup> Professor Guthrie submission, 13 July 2015. Godfrey Hirst submission, 10 August 2015 (includes notes dated 8 July 2015), [ ].

view regarding the constraint that would be provided by greasy exports.<sup>179</sup> In their view, the maximum likely price increase would be at least as high as 20%. This is primarily because two of the merchants we spoke with would be unable and/or unwilling to respond to price increases of 15%. This is considered in our consideration of the likelihood of price discrimination across merchant types.

286. In relation to wool destined for domestic use, the Commission considers that merchants or downstream domestic wool users would have less scope to switch to overseas scouring if prices were to increase. This is because the wool scoured offshore would need to be re-imported back to New Zealand. This would present further potential logistic and quality control issues. Therefore, a price increase to domestic users may be higher than 15%. We consider this in the price discrimination section below.
287. We accept that different parties may have different views on the precise degree of this constraint.<sup>180</sup> Nevertheless, a key rationale for our judgement is that most merchants we spoke to, including those responsible for the majority of commission scouring purchases, have indicated that they would attempt to respond to price increases in the vicinity of 15%, and in some cases lower. Combined with other features and recent trends in the wool sector resulting in decreasing domestic scouring volumes (ie, falling wool clip, increased scouring in China, increased competition from synthetic fibres in downstream product markets) leads us to consider that CWH would be unlikely to risk further losses in volume and raise prices by more than 15%.
288. Several merchants we spoke with considered that CWH would be unlikely to implement an immediate substantial price increase for fear of prompting a backlash in the form of a substantial demand response.<sup>181</sup> The Commission agrees that such an incremental approach to any price increase is to be expected because it would allow CWH to effectively “test” the market over time in terms of assessing the responsiveness of demand. This approach would reduce the risk to CWH of losing valuable scouring volumes by pushing prices too high.
289. Even if some merchants would be unlikely to respond to an increase larger than 15%, the ability for other merchants to discipline a price increase would, in our view, be sufficient to constrain CWH to price increases no greater than this. This is because CWH would not have the ability to price discriminate between merchant types, with the exception of wool scoured on behalf of domestic wool users. This is discussed further in the next section.

*Would CWH be able to price discriminate between merchants and/or downstream wool users?*

290. Given the wide range of destinations and users of scoured and greasy wool, the Commission has considered whether any constraint provided by the threat of increased greasy export is

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<sup>179</sup> Godfrey Hirst submissions, 15 October 2015, 22 October 2015; Professor Guthrie submissions, 15 October 2015, 22 October 2015.

<sup>180</sup> We note that Cavalier, having reviewed the same information provided by merchants as Godfrey Hirst and Professor Guthrie, arrives at a different conclusion, ie, that CWH would be unlikely to increase prices by 15% and that any price increases would be incremental. See Cavalier submission, 22 October 2015. Cavalier suggests that Godfrey Hirst and Professor Guthrie have been selective in their use of comments from merchants and point to the fact that few merchants raised objections to the proposed merger.

<sup>181</sup> For example, see: [ ].

likely to differ across either merchants or downstream end users. Demand could be more inelastic for domestic markets, in export markets that do not have sufficient scouring capacity, for example Japan or certain destinations in Europe, or for specific merchants that are particularly reliant on exporting clean wool.<sup>182</sup> If CWH were able to identify any such 'captive' demand, it may be able to implement a price increase greater than 15% for such scourments.<sup>183</sup>

291. This has required evaluating the likely ability CWH would have to price discriminate across different merchants and/or downstream wool users. Our view is that CWH would be able to price discriminate against wool scoured for domestic use. In contrast, we consider CWH would have limited, if any, ability to price discriminate either against wool destined for specific export locations, or against specific merchants that are heavily reliant on exporting clean wool and have little ability to switch to greasy exports.

### Parties' views

292. In relation to price discrimination generally, Cavalier stated that scouring prices are typically established in advance of providing scouring services.<sup>184</sup> These are mostly a result of negotiations between the scourers and merchants. Cavalier indicated that to date this has generally made it difficult for scourers to charge a price based on end user, since the scours do not usually know who that end user might be when contracts are negotiated.<sup>185</sup>
293. Regarding wool destined for export, Cavalier submitted that its lack of knowledge and oversight of the ultimate destination of much of the wool it scours severely restricts its ability to price discriminate. They told us that often merchants do not reveal the details of a particular scouring shipment before the scouring has been done.<sup>186</sup>
294. Regarding wool destined for domestic use, Cavalier acknowledged that it is able to identify wool that is scoured for Cavalier Bremworth and Godfrey Hirst. This is because of the specific scouring specification, including how the wool is to be scoured, the type of wool and the delivery instructions.<sup>187</sup>

### Godfrey Hirst's view

295. Godfrey Hirst stated that it believes that CWH would be able to discriminate against wool destined for domestic use, in particular wool used by Godfrey Hirst in its domestic carpet manufacturing business.<sup>188</sup>

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<sup>182</sup> In the year to June 2014, Japan received 3,200 tonnes of clean wool from New Zealand (approximately 4,300 greasy equivalent tonnes), but only 2 tonnes of greasy wool.

<sup>183</sup> Such an increase could be in the form of targeted rebates that are not provided to scourments of wool destined for certain 'inelastic' export markets. The Commission notes that  
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<sup>184</sup> Hawkes Bay Woolscourers site visit, 14 November 2014.

<sup>185</sup> [ ]

<sup>186</sup> Cavalier submission, 8 December 2014.

<sup>187</sup> Interview with Hawkes Bay Woolscourer, Cavalier Group, and Direct Capital, 13 November 2014.

<sup>188</sup> Interview with Godfrey Hirst, 3 December 2014.

296. Godfrey Hirst considered that a domestic scourer would be able to identify Godfrey Hirst's scouring requirements based on peroxide use, wool length and the percentage of short fibre in the scoured product.<sup>189</sup>

### Others' views

297. Peter Whiteman of Segard Masurel stated that if it were to face substantially different pricing based on the ultimate destination of the wool, it would be able to take measures to hide this destination.<sup>190</sup> These measures could include withholding shipping information and/or having scoured wool returned to its premises before being shipped. This view was supported by [ ], who considered that CWH would not be able to price discriminate on the basis of the wool's ultimate destination.<sup>191</sup>
298. [ ].
299. [ ] informed us that he does not consider that there are other viable options for the supply of scoured wool outside of New Zealand. [ ] did not consider getting wool scoured in China as a realistic alternative.<sup>192</sup> [ ] also claimed that if scouring prices were to increase at all [ ] would struggle to stay in business. [ ].

### The Commission's views

300. The Commission considers that if CWH were able to identify scourments that were destined to end users for whom the demand for scoured New Zealand wool is inelastic, CWH could attempt to increase prices for these scourments.
301. As in Decision 725, the Commission considers that while there may be some scope for price discrimination against wool destined for certain export destinations, this scope would be limited.
302. The Commission has based this conclusion on the views of both the parties and merchants, in particular those merchants who stated that they would be able to hide the ultimate destination of wool destined for export if necessary to defeat attempts at price discrimination.<sup>193</sup>
303. Further, the Commission considers that CWH would be unable to successfully sustain any significant price discrimination against 'clean export only' merchants. This is because, if faced with substantially higher targeted scouring prices, these smaller, 'clean export only' merchants would face competition from other, larger merchants with lower scouring costs.

<sup>189</sup> Interview with Godfrey Hirst, 3 December 2014.

<sup>190</sup> Interview with Peter Whiteman of Segard Masurel, 24 November 2014.

<sup>191</sup> [ ]

<sup>192</sup> [ ]

<sup>193</sup> Interview with Segard Masurel, 24 November 2014. [ ]

This would allow these larger merchants to undercut the ‘clean export only’ merchants and take their business.<sup>194</sup>

304. Therefore, any price increase to ‘clean export only’ merchants would be unlikely to be sustainable because ultimately ‘clean export only’ merchants would exit the market and their business would go to the larger merchants. Therefore, we consider that CWH would be unlikely to engage in such a strategy, even in the short term, because there is a risk that these volumes would be lost from New Zealand altogether. As set out above, CWH would not be able to increase the prices by more than 15% to these larger merchants.
305. However, the Commission considers that CWH would have the ability to discriminate against domestic wool users. Indeed, Cavalier acknowledged that it is able to identify wool that is scoured for domestic wool users.
306. The extent to which CWH would in fact price discriminate against all domestically used wool is uncertain. We understand that Cavalier Bremworth [ ].
307. Godfrey Hirst submitted that as a domestic user [ ], Cavalier Bremworth would also be subject to a price increase similar to Godfrey Hirst.<sup>195</sup> However, the Commission considers it unlikely that Cavalier would proceed with the merger if its related downstream carpet manufacturing business, Cavalier Bremworth, was at any risk of substantial increases in scouring prices that were in excess of any general price increase to merchants (ie, price increases between 5% and 15%).
308. Cavalier Bremworth also advised us that:<sup>196</sup>
- 308.1 Cavalier Bremworth has had high level discussions with each of Cavalier and Lempriere in respect of Cavalier Bremworth’s scouring rate post-merger;
- 308.2 CWH is a volume based business and it would need Cavalier Bremworth because of its size and importance;
- 308.3 if CWH substantially increased the price of scouring to Cavalier Bremworth post-merger:
- 308.3.1 Cavalier Bremworth could [ ]; or

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<sup>194</sup> Given the relatively competitive nature of the merchant market (outlined in the next section), the Commission considers that it is unlikely that any ‘clean export only’ merchants, who are necessarily small in scale, would be earning sufficiently large margins to sustain targeted scouring price increases over an extended period.

<sup>195</sup> Godfrey Hirst submission, 15 October 2015.

<sup>196</sup> Interview with Cavalier Bremworth, 5 November 2015.

<sup>197</sup> [ ]

308.3.2 [ ]].

309. As a result, we consider that Cavalier Bremworth is unlikely to face similar maximum price increases to those faced by Godfrey Hirst.

310. [ ]].<sup>198</sup>  
Therefore, it is unlikely CWH would have the incentive to increase prices to [ ] more than wool destined for export because it may lose its volumes altogether.

311. Consequently, the Commission considers that any price discrimination against the wool for domestic use would only apply to the wool scoured on behalf of Godfrey Hirst. This constitutes around [ ] tonnes per year.<sup>199</sup>

312. The Commission considers that the price charged for wool scoured for Godfrey Hirst could exceed that charged to wool destined for export, although it may not. Based on discussions with Godfrey Hirst and merchants, the Commission considers that Godfrey Hirst could face a price increase of between 5% and 25% over current levels.

313. [ ]].<sup>200</sup>  
[ ]].

314. [ ]].<sup>201</sup>  
[ ]]

315. [ ]].

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<sup>198</sup> [ ]  
<sup>199</sup> Wool exports constitute 92% of the total wool clip, implying the remaining 8% of the total would be used domestically, equating to around 13,000 (greasy) tonnes. Source: Beef + Lamb New Zealand, New Season Outlook 2014/15. Around [ ] of greasy wool is scoured for use by Godfrey Hirst, source: Interview with Godfrey Hirst, 3 December 2014.

<sup>200</sup> [ ]].

<sup>201</sup> Ibid.

316. [

].<sup>202</sup>

317. [

Therefore, we have used the same lower bound of 5% as for merchants.

].<sup>203</sup>

*To what extent would merchants be able to pass-through scouring price increases?*

318. A further factor that could affect the scope of CWH to increase scouring prices is whether merchants would have the ability to pass-through scouring price increases. Merchants could either:

318.1 pass-through scouring price increases to their downstream customers (wool users);

318.2 pass-through scouring price increases to upstream suppliers (growers);

318.3 absorb price increases; or

318.4 any combination of the above.

319. If merchants have the ability to pass-through scouring price increase without incurring significant negative impacts on their sales, this could reduce the incentive they would have to attempt to constrain CWH post-merger. A high degree of pass-through could mean that CWH would face demand for its scouring services that is relatively inelastic and could therefore institute larger price increases.

#### Parties' views

320. On behalf of Cavalier, NERA provided a view regarding the likely degree to which merchants could pass-through scouring price increases to other players in the supply chain, and therefore, lessen the incentive on merchants to switch to greasy exports. NERA stated that "in reality there would be some sharing of the incidence [of a price increase] between merchants, [downstream] buyers, and growers."<sup>204</sup>

321. NERA further submitted that the level of pass-through is likely to increase over time.<sup>205</sup> In relation to the rate of pass-through to growers of 90% previously estimated by the Commission, NERA stated:

In the absence of any empirical evidence of previous pass-through, there is not really a rigorous way in which to make pass-through assumptions, but one approach would be to assume 50 percent pass-through in year 1, building linearly to 90 percent by year 5.

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<sup>202</sup> [ ].

<sup>203</sup> [ ].

<sup>204</sup> NERA submission, 22 December 2014.

<sup>205</sup> NERA submission, 21 April 2015.

### Godfrey Hirst's views

322. Godfrey Hirst has not provided any substantive view on the issue of pass-through.

### Others' views

323. Several merchants advised the Commission that while some overseas wool users have a strong preference for scoured New Zealand wool if New Zealand prices became too high, these customers would switch away from New Zealand wool to some degree.<sup>206</sup> This is consistent with information provided by merchants in 2011, including [ ] who advised the Commission that while some customers must have New Zealand wool as part of their wool blends, if New Zealand prices became too high, those customers could remove the product from their ranges, or adjust their blends to use less New Zealand wool and use more wool from elsewhere and/or equivalent synthetic-based products.<sup>207</sup>

324. In relation to whether merchants would absorb price increases, [ ] stated that while growers "do take a share of the hit" from a price increase, some of it is definitely absorbed by the merchants themselves.<sup>208</sup> [ ] considered that passing on price rises to end users would be difficult.<sup>209</sup>

### The Commission's view

325. Notwithstanding NERA's views on the pass-through of scouring costs (see paragraph 320), it is the Commission's view that higher post-acquisition scouring prices would not, in general, be passed on to wool users in downstream export markets to any significant degree.<sup>210</sup> This is because scoured New Zealand wool competes in international markets against wool from other countries and, in many cases, against other fibres, including synthetic fibres.

326. If scouring prices were to rise in New Zealand post-acquisition, evidence from merchants suggests it is unlikely merchants would be able to pass these price increases onto international customers to any significant degree because of the competitive nature of wool export markets. These sentiments were supported by a number of merchants who advised that wool is sold in a global market and that New Zealand cannot dictate the price.<sup>211</sup>

327. Therefore, the Commission considers that, over time, it is likely that a large proportion of any wool scouring price increase to wool merchants would be passed back upstream to wool growers.<sup>212</sup> Such pass-through back to farmers would ultimately manifest itself as a decrease

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<sup>206</sup> [ ].

<sup>207</sup> [ ].

<sup>208</sup> [ ].

<sup>209</sup> [ ].

<sup>210</sup> In contrast, price increases in relation to the 11% of total scouring that relates to wool destined for domestic use could be passed onto domestic downstream wool users, as discussed in the previous section.

<sup>211</sup> [ ]. This position was also supported previously in Decision 725 by Andrew Campbell of J S Brooksbank, 22 February 2011.

<sup>212</sup> This is notwithstanding the exceptions of pass-through to the relatively small share of domestic downstream customers and the likelihood that some proportion of price increases would be absorbed by merchants, at least in the short-term.

in the farm gate price for wool paid by merchants to growers. This is based on the Commission's view that, over the relevant range of prices, the supply of greasy wool at the farm gate would be relatively inelastic.<sup>213</sup>

328. It is difficult to obtain any evidence concerning pass-through to growers and the level of pass-through, but such a view would imply that merchants may not face a strong incentive to 'push-back' against price increases.
329. However, although a substantial proportion of any scouring price increases could ultimately be passed-through to growers over the medium- to long-term, the Commission considers that, in the short-term at least, many merchants would be faced with absorbing significant proportions of any scouring price increase. That is, any pass-through is unlikely to be immediate and 'seamless' so merchants would necessarily have to absorb some proportion of any price increase in the first instance.
330. Further, the Commission considers that many merchants would have limited ability to absorb a substantial proportion of any significant increase in prices. In Decision 725 the Commission considered that merchants work in a highly competitive environment and operate within tight margins. Therefore, faced with such a scenario, the Commission expects merchants would seek to cost-minimise and attempt to discipline price increases wherever feasible by switching some scouring services to offshore scours and/or seek new opportunities to sell wool in greasy form directly to offshore buyers.
331. In addition, lower farm gate prices would provide greater scope for merchants seeking to expand exports of greasy wool as they would be able to outbid merchants seeking wool for scoured exports.<sup>214</sup> This would place competitive pressure on those merchants seeking to continue to export clean wool.<sup>215</sup> Again, this pressure would provide clean exporters with an incentive to cost minimise so as to be able to compete with merchants focused on exporting greasy, or, if they were faced with exiting the market, switch to exporting greasy themselves.
332. Therefore, the Commission considers that, despite pass-through, merchants would continue to have an incentive to switch a sizeable proportion of the wool currently scoured in New Zealand to be exported greasy and scoured in China in response to sufficiently large price increases.

#### *Impact of exchange rate fluctuations*

333. Another relevant factor in evaluating the constraint provided by greasy exports is potential exchange rate fluctuations. Therefore, we also asked merchants about the potential effects of a depreciation in the New Zealand dollar against relevant currencies, such as the Chinese Yuan.
334. A fall in the dollar would effectively make scouring offshore more expensive; therefore, reducing the price constraint this alternative would impose on CWH. Merchants we spoke to were of the view that, although a depreciation might have some (partial) effect, a fall in the

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<sup>213</sup> See Attachment 6 for further discussion.

<sup>214</sup> [ ].

<sup>215</sup> NERA submission, 21 April 2015.

New Zealand dollar would, in general, have an offsetting impact to some degree because it would increase the returns from wool grease.<sup>216</sup>

335. Increased returns from wool grease make scouring activity more valuable. In isolation, the more valuable wool grease is, the lower the incentive for CWH to increase prices because price increases would risk reducing scouring volumes. Of note is that, at current prices, around [ ] of Cavalier's revenue is derived from wool grease. Should wool grease prices continue to recover over time, a view which the parties and others have suggested is likely,<sup>217</sup> this source of revenue will become more important.

*The Commission's overall assessment on the constraint provided by greasy exports*

336. In Decision 725, the Commission concluded that the ability of exporters to divert more greasy wool to China for scouring was unlikely in itself to sufficiently constrain the merged entity to avoid a substantial lessening of competition in the relevant wool scouring markets.
337. Our view then was that while exports to China would place constraint on prices to wool merchants who already export scoured wool to China, they would not provide a sufficient constraint on prices to most wool merchants exporting scoured wool to other countries or selling to domestic customers.
338. The Commission's view now is that, notwithstanding the fact that an increased amount of wool is exported to China in both greasy and scoured forms, we still cannot be satisfied that there is a sufficient competitive constraint to prevent a substantial lessening of competition post-merger.
339. Specifically, the Commission cannot rule out as unlikely a scouring price increase of between 5% to 15% for wool destined for export. However, as discussed above, we consider that it is likely that a price increase greater than this would cause merchants to switch away from scouring wool in New Zealand in favour of increased exports of greasy wool to such an extent that it would make such a price rise unprofitable.
340. Additionally, the Commission considers that the potential for CWH to price discriminate against wool destined for Godfrey Hirst's use means that CWH would be able to charge substantially higher prices for scouring this wool. We cannot rule out as unlikely an increase in scouring prices for this wool of between 5% to 25%.

**Conclusion on wool scouring markets**

341. In summary:

- 341.1 the proposed Acquisition would remove Cavalier's nearest existing competitor – NZWSI;
- 341.2 the potential for new entry into the scouring market would provide only a weak constraint on CWH;

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<sup>216</sup> [ ]

<sup>217</sup> Canterbury Woolscourers site visit, 21 November 2014. Interview with Curtis Wool, 26 November 2014.

341.3 the ability for exporters to switch to greasy exports to China would provide only a moderate constraint on CWH for scouring prices relating to wool destined for export; and

341.4 the ability of Godfrey Hirst to shift its wool manufacturing activities offshore would provide only a weak constraint on CWH for scouring prices for wool destined for Godfrey Hirst.

342. Therefore, the Commission is not satisfied that the Acquisition will not have, or would not be likely to have, the effect of substantially lessening competition in both the North and South Island markets for the supply of wool scouring services.

### Effects of the Acquisition in the wool grease markets

343. As discussed in the section on market definition, the proposed Acquisition would involve a horizontal aggregation of the parties' wool grease interests as was the case with the LTC. We are of the view that there are two groups of customers on whom this would impact, large customers and small customers.

#### *Large wool grease customers*

344. [ ]  
<sup>218</sup>  
 [ ]].

345. Shamrock advised us [ ]].

346. While not currently supplying domestically, domestic customers advised us that they do seek quotes from NZWSI from time to time.

347. Shamrock previously purchased its domestically-sourced wool grease from the LTC, but since the closure of the LTC, it now purchases [ ] from Cavalier. [ ]]. In 2014, Shamrock [ ], which accounted for around [ ] of its total wool grease purchases. In recent years [ ] has varied substantially in line with its overall purchases of wool grease, which in turn have varied in line with fluctuations in wool grease prices. [ ]].

348. The Commission understands that wool grease prices, both in New Zealand and internationally, whilst being set directly between buyers and sellers, tend to follow global prices.

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<sup>218</sup> [ ]].

349. As discussed in the market definition section, [ ].  
[ ].<sup>219</sup>
350. When negotiating a price for its supply contract with Cavalier, the Commission understands that  
[ ].<sup>220</sup>
351. As a result of the proposed Acquisition, Shamrock would no longer have a second potential source of domestic supply. Whilst Shamrock indicated that this would reduce its domestic purchasing options, they would be able to import wool grease from elsewhere.<sup>221</sup> Syd Mansfield, Shamrock, stated that there was little difference in quality between domestic and offshore sources of wool grease, although there would be additional logistical complexities if a greater percentage of its purchases were from offshore suppliers.
352. Though Shamrock prefers to use New Zealand certified wool grease,<sup>222</sup> it could potentially switch to non-New Zealand certified wool grease. This would only require additional scrutiny of the non-certified wool grease to ensure the specifications like water content were suitable.  
[ ].
353. John Quigley, Managing Director of Shamrock, stated that he did not think the Acquisition would affect the price of wool grease domestically as wool grease price is mostly affected by the world price. This view was supported by Cavalier.
354. Mr Quigley also did not believe that there would be any reason for the new monopoly supplier to increase the price or reduce the supply of wool grease to Shamrock as logistically it would be easier for CWH to sell domestically to Shamrock than to export.  
[ ].
355. [ ]. In fact data from 2011 and 2012 when the LTC was the sole source of domestic supply show that the cost (including freight) of domestic wool grease was closer to the cost of imported wool grease than in 2014 when both Cavalier and NZWSI were rival domestic suppliers.<sup>223</sup>

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<sup>219</sup> Interview with Cavalier, 26 February 2015.

<sup>220</sup> Ibid.

<sup>221</sup> Interview with John Quigley, Managing Director, the Shamrock Group Limited, 5 February 2015 and Syd Mansfield, Shamrock 18 February 2015.

<sup>222</sup> New Zealand certified wool grease is wool grease extracted from New Zealand wool; this includes wool grease extracted from international scours.

<sup>223</sup> In 2011 the average cost of imported wool grease was \$[ ] per kilogram compared to [ ] for domestic wool grease from the LTC. In 2012 the figures were [ ]. In 2014 after the closure of the LTC the average cost of imported wool grease was [ ] whereas wool grease from Cavalier was [ ]. Note some proportion of the difference between sources may arise because of different contract dates.

### *Conclusion on large customer wool grease market*

356. The Commission considers that the Acquisition is likely to lead to a lessening of competition in the large customer wool grease market; however, this lessening is unlikely to be substantial. Shamrock's ability to [ ] imports of wool grease (both New Zealand certified and non-certified) would likely provide a constraint on the merged entity's ability to raise prices.

### *Small customer wool grease market*

357. As discussed in the market definition section, there are a small number of customers against whom Cavalier is likely able to price discriminate, in particular, Prolan, Cotec and CRC. In the event that CWH raised the price of wool grease to these customers, they would have no alternative supplier, given their inability to import wool grease because it would not be economic for them.

358. As wool grease is a by-product of wool scouring, unless there is entry into wool scouring, post-acquisition there would remain a single domestic supplier of wool grease. In our competition analysis of the wool scouring market, we could not be satisfied that entry would be likely unless there was a price increase greater than 20%. However, given that the constraint provided by the threat of increased greasy exports is likely to prevent a price increase of greater than 15%, at least for the majority of scouring services, entry is unlikely. Cournot modelling provided by NERA on behalf of Cavalier suggests that the likely price increase that small wool grease customers could be faced with in this market is [ ]%.<sup>224</sup> The Commission accepts this position based on the modelling provided by NERA.

### *Conclusion on small customer wool grease market*

359. To the extent that entry into domestic scouring markets is unlikely, the Commission is not satisfied that the proposed Acquisition would not give rise to a substantial lessening of competition in this market. The detriments arising in this market will be assessed in the detriments section.

### **Effects of the Acquisition on the carpet market**

360. Vertical acquisitions are those that involve the merger of businesses operating at different functional market levels in the production of a particular good or service. To the extent that Cavalier (operating in scouring markets) and Cavalier Bremworth (operating in downstream carpet markets) are associated parties (as discussed in paragraphs 78 to 83), the proposed scouring merger could raise the potential for adverse vertical effects in the downstream carpet markets.

361. In its application, Cavalier submitted that the proposed merger would not give rise to vertical effects in the carpet market because of the threat of new entry to wool scouring as well as the competition from imported carpets and synthetic carpets.

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<sup>224</sup> NERA submission, 9 March 2015. The Commission notes that this modelling generates an estimated allocative efficiency loss that is a similar proportion of total market revenue as the allocative efficiency loss in the wool scouring markets.

362. As discussed in paragraphs 305 to 312, the Commission considers it likely that the merged entity could have the ability to increase prices for scouring for wool destined for Godfrey Hirst's use by up to [ ].
363. Despite this, the Commission considers that a price increase of this magnitude would not necessarily foreclose Godfrey Hirst from the downstream carpet market. This is because the price of scouring is a relatively small component of the cost of producing carpet (around 0.2% of the final carpet price).<sup>225</sup> Rather, non-price effects could be of greater competitive impact than those of any conceivable scouring price increases.
364. [ ].
- However, CWH's other shareholders, ACC, Direct Capital and NZWSI, have no interest in the downstream carpet market. Therefore, these shareholders have no incentive to support Cavalier Bremworth in respect of any strategy to discriminate against Godfrey Hirst. This is because it would not be profit maximising for CWH if Godfrey Hirst reduced its demand for wool scouring services.
365. In addition, it is unlikely that Cavalier Bremworth could recoup those lost scouring profits by increasing prices in the downstream carpet market because that market is competitive and it could not guarantee it would capture any of Godfrey Hirst's lost sales.
366. In addition to Godfrey Hirst and Cavalier Bremworth, there are a number of other market participants and imports now make up a significant proportion of the carpet market. Further, in our interviews with Godfrey Hirst<sup>226</sup> and Cavalier<sup>227</sup> both parties advised us that the use of wool in carpets is declining because of the increasing use of synthetic fibres in carpets as well as the use of other flooring materials. Flooring retailers that we spoke to confirmed this to be the case.<sup>228</sup> This would suggest that Cavalier Bremworth faces increasing competition from imported carpets and other flooring materials.
367. Therefore, the Commission is satisfied that the Acquisition will not have, or would not be likely to have, the effect of substantially lessening competition in the downstream carpet market.

## Public benefits and detriments

368. As we have identified a substantial lessening of competition in wool scouring markets in terms of section 67(3)(a) of the Act, we must now consider whether we can be satisfied that the proposed Acquisition will result, or be likely to result, in such a benefit to the public that it should be authorised in terms of section 67(3)(b) of the Act.

<sup>225</sup> Submission from Cavalier, 8 December 2014. See paragraph 6.10. Cavalier suggest that a 15 % increase in scouring costs would [ ].

<sup>226</sup> Interview with Godfrey Hirst, 3 December 2014.

<sup>227</sup> Interview with Cavalier, 12 November 2014 at which a director of Cavalier Bremworth was present.

<sup>228</sup> Interview with Flooring Brands, 11 February 2015. Interview with Carpet Mill, 12 February 2015.

369. The Commission is tasked with assessing whether the public benefits, which stem largely from rationalisation within a sector that is facing a declining demand, are sufficient to outweigh the competitive detriments arising from having only one domestic scourer.

### The Commission's analytical method

370. To assist with determining whether the Commission can be satisfied that the test in section 67 is met, since the *Telecom AMPS-A* decision,<sup>229</sup> it has been clear that the Commission must so far as possible quantify benefits and detriments rather than rely on purely intuitive judgement. In *Ravensdown* the High Court confirmed that assessing benefits and detriments within an analytical framework helps the Commission to guard against missing elements that require consideration, or from double-counting elements.<sup>230</sup>
371. Our view on the likely benefits and detriments that make up our overall assessment<sup>231</sup> may comprise a point estimate, or a range. As noted by the High Court in *Godfrey Hirst*, it would be wrong for the Commission to attribute greater certainty to estimates of benefits and detriments than is warranted on the facts.<sup>232</sup>
372. It is therefore legitimate for the Commission to be left with a value range for a particular detriment or benefit where the level of uncertainty indicates that any further precision would be unwarranted.<sup>233</sup> The Court went on to note, however, that this is not to say that the Commission cannot find that a single figure is the likely benefit or detriment.<sup>234</sup> It may be legitimate for the Commission to consider that a value falls at a particular point within a range.<sup>235</sup>
373. However, the High Court indicated that:<sup>236</sup>
- ...unless the Commission has good reasons for excluding other values within the (likely) range that it has determined, it is the range rather than any point within the range that should form the basis for the balancing exercise.
374. Where we accept a likely range for our estimated impacts, we consider the highest end of the range for detriments and the lowest end of the range for benefits to assess the bottom of the range for the estimated overall net impact. Similarly, we consider the lowest end of the range of detriments and highest end of the range of benefits to arrive at the top of the range for the estimated overall net impact.
375. It is also not only those gains and losses that can be measured in dollar terms that are included in the assessment. Impacts of an intangible nature, which are not readily measured in monetary terms, must also be assessed.
376. In *Ravensdown* the Court also noted that quantification was not the end of the analysis.<sup>237</sup>

<sup>229</sup> *Telecom Corporation of New Zealand Ltd v Commerce Commission* (1992) 4 TCLR 648 (CA) at 667 per Richardson J.

<sup>230</sup> *Ravensdown Corporation Ltd v Commerce Commission* HC Wellington, AP 168/96, 9 December 1996 at 47 and 48.

<sup>231</sup> *Godfrey Hirst* above n 27 at [105].

<sup>232</sup> *Ibid* at [104].

<sup>233</sup> *Ibid*.

<sup>234</sup> *Ibid* at [105].

<sup>235</sup> *Ibid* at [102].

<sup>236</sup> *Ibid* at [105].

Where evidence was available to arrive at a quantitative assessment, that was done, but equally in the absence of sufficient evidence no endeavour to quantify in dollar terms was attempted. It is also significant that the analysis included both a separate examination of the benefit and detriment elements, followed by a more holistic exercise. In other words, the Commission stood back and looked at benefits and detriments in the round. We are not persuaded that the methods employed were inadequate or wrong.

377. This view was approved by the same court in *Godfrey Hirst*. Justice Mallon stated:<sup>238</sup>

...a purely quantitative assessment is not sufficient. A judgment (also referred to as a qualitative assessment) is required as to whether the Commission is satisfied on the evidence before it that the public benefits do outweigh the detriments such that an authorisation should be granted. That judgment will include an assessment of the quality of the information on which the quantitative analysis was carried out. If the quantitative analysis, allowing for uncertainties, shows that efficiency gains outweigh efficiency losses and if unquantifiable factors are not sufficient to “tip the balance”, we consider it would be wrong then to stand back and ask what is so “good” about this merger that it should be permitted.

378. Further, as part of its assessment, the Commission has regard to the quality of the evidence before it. It may be that in making its assessment, the Commission gives more weight to one piece of evidence over another.<sup>239</sup>

### Initial considerations

379. On a qualitative level, any merger that leaves only a single firm operating in the domestic market is a potential cause for concern. However, a high (or even total) market share is not, in and of itself, sufficient to establish that the detriments of a transaction exceed the benefits.

380. In this proposed Acquisition, the detriments from a reduction in competition may flow from a number of sources:

380.1 higher scouring prices and/or lower quality scouring services as well as higher wool grease prices to small domestic customers (ie, allocative efficiency losses);

380.2 increased costs of production because of a lower level of competitive pressure on CWH (ie, productive efficiency losses); and

380.3 lower levels of innovation and/or sub-optimal investment patterns over the longer term (ie, dynamic efficiency losses).

381. There are a range of benefits that could potentially offset the detrimental impacts of a merger. In this instance, the claimed benefits are reductions in the costs of production (ie, productive efficiency gains) brought about by rationalisation. This reduction in costs would

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<sup>237</sup> *Ravensdown Corporation* above n 230 at 48.

<sup>238</sup> *Godfrey Hirst* above n 27 at [115].

<sup>239</sup> As set out in Attachment B of the Commerce Commission *Authorisation Guidelines*, July 2013 at [B2]: “We give less weight to a statement or submission that a party cannot support with corroborating evidence, than a statement or submission that a party can support with corroborating evidence.”

increase the returns to CWH (ie, producer surplus) and this gain constitutes a public benefit.<sup>240</sup>

#### *Lempriere's acquisition of NZWSI and its effect on our analysis*

382. In Decision 725 the Commission granted Cavalier authorisation to acquire all of NZWSI's wool scouring assets. That decision was appealed to the High Court but the appeal was dismissed by the High Court in November 2011. As noted above in paragraph 77, subsequent to those events, Cavalier and the NZWSI Board did not reach an agreement for the sale and acquisition of the scouring assets, and in early 2013, Lempriere, a foreign-owned company, acquired 100% of the shares in NZWSI.
383. Although changes in the distribution of income are not generally incorporated into the Commission's assessments, an exception can arise if one of the groups affected is comprised of non-New Zealanders.<sup>241</sup>
384. With Lempriere's purchase of NZWSI, a proportion of the transfers (ie, benefits and detriments) arising from the transaction would accrue to non-New Zealanders. This leads to a significant difference in the quantification of benefits and detriments to Decision 725. This issue is discussed further in the Wealth Transfers section of this determination.

#### *Estimating the net present value of benefits and detriments*

385. In its application for authorisation, Cavalier used a five year time period and a 10% discount rate to estimate the net present value (NPV) of benefits and detriments. This approach is broadly consistent with approaches previously taken by the Commission, including in Decision 725.
386. The use of the five year time period and the 10% discount rate recognises the fact that most detriments and benefits become increasingly less certain over time. Beyond five years it is difficult to forecast the effects of the proposed Acquisition. While the Commission considers this framework to be pragmatic and appropriate in this case, there are two specific issues in respect of quantification that this approach may not address:
- 386.1 Benefits and detriments beyond five years: As noted previously, the Commission considers that prediction of merger effects beyond five years is particularly troublesome.<sup>242</sup> However, the uncertainty is unlikely to be so stark that detriments and benefits reduce to zero after five years. Therefore, the five year timeframe would only provide a snapshot and not reflect the true lifespan of effects from the merger. To address this, we have undertaken sensitivity analysis and estimated the net public benefit over a longer ten year period as well as the standard five year period.

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<sup>240</sup> The Commission acknowledges that efficiency considerations are not the only relevant public benefits. See *Godfrey Hirst* above n 27 at [51]. While potential non-market impacts, such as social or environmental effects, may be relevant to some assessments, they are unlikely to be material concerns here.

<sup>241</sup> When one group gains from higher prices and another group loses, the resulting wealth transfers do not typically result in a net change to the overall well-being of the wider public (which includes both the buyers and the sellers). Consequently, wealth transfers are not generally relevant to the Commission's assessment of benefits and detriments.

<sup>242</sup> At [218] of Decision 725.

386.2 Whether the proportion of benefits to detriments stay roughly the same over that period of analysis: They may not if:

386.2.1 some impacts take place only within a five year period – for example the immediate sales of surplus assets; and

386.2.2 some impacts take place after five years and thus get insufficient weighting in a five year period – for example the detrimental impacts of ongoing higher prices.

In this transaction, this issue is particularly relevant because many of the benefits are one-off, upfront impacts whereas many of the detriments are ongoing. Therefore, as outlined above, we have undertaken sensitivity testing by also using a 10 year timeframe.

386.3 Realisation of benefits: In our analysis we have used the estimated market value of assets post-merger as an estimate of these benefits. This is because Cavalier would gain the economic value from these assets becoming available for sale even if these assets are not sold. These assets may not be sold if CWH would expect to obtain a greater return from an alternative use. For example, surplus scouring plant may provide a greater return if it is used to derive scouring income from [ ].<sup>243</sup>

387. These assets would only be put to these alternative uses if CWH would expect to earn a return than is greater than from sale. Because of this, it is the Commission's view that using estimated sale values is a conservative approach to estimating the likely benefits from these assets no longer being required post-merger.

## Benefits

### Production efficiencies

388. The primary benefits of the proposed transaction arise from the consolidation of Cavalier's and NZWSI's scouring operations from five sites to two sites. This would generate cost savings and improved economies of scale and enable the Whakatu and Kaputone sites to be released for other uses.<sup>244</sup>

389. In our initial analysis,<sup>245</sup> we estimated these public benefits without regard to the residency of the individuals who would ultimately obtain these benefits. In response to this, the Commission received divergent submissions from Godfrey Hirst's expert, Professor Guthrie, and Cavalier's expert, NERA, on whether the portion of these benefits that would flow to the foreign shareholders of CWH should constitute public benefits to New Zealand.

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<sup>243</sup> [ ]

<sup>244</sup> See paragraphs 455 to 466 for discussion as to why we have not attributed any value to the Clive site.

<sup>245</sup> The Commission's first Draft Determination, 26 March 2015.

### *Submissions from interested parties*

390. In summary, Professor Guthrie’s view is that any increased returns to foreign shareholders of the merged entity are not gains to New Zealanders. Therefore, these gains should not be included in assessing the net public benefit to New Zealand. This approach does not imply that these gains would constitute a detriment to New Zealand, but instead should merely be excluded from the assessment. That is, these impacts would be neither benefits nor detriments, but would be neutral.<sup>246</sup>
391. In contrast, NERA’s initial view was that by ‘releasing’ resources for alternative uses, the proposed transaction would provide a gain to New Zealand regardless of whether the financial benefit of these productivity gains flow to foreigners. A key factor in this approach is assessing whether the freed-up resources would be available within New Zealand for another use. Therefore, if a resource becomes redundant as a result of a merger, for example plant and machinery that is sold and shipped overseas to a foreign buyer, this resource is not available for use in New Zealand and there is no public benefit.<sup>247</sup>
392. In response to the Second Draft Determination, NERA put forward a refined view of the benefits from resources being freed up.<sup>248</sup> NERA’s view is that by utilising fewer resources, the merged entity would release the capital that is currently tied up in these resources. This freed-up capital would generate additional benefits to New Zealand regardless of the nationality of shareholders. NERA pointed to the High Court’s finding in *Godfrey Hirst*,<sup>249</sup> in which the Court considered that the benefits arising from the proposed rationalisation in the scouring sector would include the fact that resources currently used for scouring could be released for other productive uses.<sup>250</sup>

### *The Commission’s view of these approaches*

393. The Commission considers that a ‘resource-based’ approach as initially suggested by NERA is inappropriate. This position can be explained by reference to a hypothetical situation in which a merger authorisation is sought by two New Zealand-owned firms who, once merged, will sell off an item of plant to a foreign buyer. In this case the redundant plant would depart New Zealand and would not be available for use within the domestic economy. This approach would exclude the value of this plant from the benefit calculations because the resource has been freed up for the benefit of another jurisdiction. However, this ignores the net gain to New Zealand in the form of the funds received by the New Zealand shareholders from the foreign buyer.
394. A similar hypothetical example which illustrates the shortcoming of a ‘resource-based’ approach is where a merger leads to a resource that is unable to be used in any other market becoming redundant. This could arise if a specific asset is used in production, but that asset has no resale or scrap value. The use of this asset may impose costs, such as ongoing repair and maintenance expenses. However, these costs could be avoided if the asset is no longer required because of a merger. In this case there is, likewise, no gain to New Zealand from a

<sup>246</sup> Godfrey Hirst submission, 21 April 2015. 10 June 2015 Conference transcript pages 102 – 108.

<sup>247</sup> 10 June 2015 Conference transcript pages 109-110.

<sup>248</sup> NERA submission, 21 October 2015.

<sup>249</sup> *Godfrey Hirst*, above n 27.

<sup>250</sup> *Godfrey Hirst*, above n 27 at [281].

resource being freed up, because the resource has no alternative use. Nevertheless, there is a gain to the shareholders because their costs have been reduced.

395. The Commission is similarly unconvinced by NERA's refined view of the 'resource-based' approach, ie, that any capital that would be freed-up from the proposed transaction (as opposed to specific assets) would constitute a direct benefit to New Zealand regardless of the residency of shareholders. The Commission's view is that the proceeds from the sale of surplus resources, or reduced costs, flows to shareholders regardless of whether these proceeds are reinvested in New Zealand or elsewhere. Therefore, if these shareholders are not New Zealand residents, these proceeds do not provide a direct benefit to New Zealanders, although there are flow-on (feedback) benefits that should be accounted for (as discussed further below).
396. With respect to the comments of the High Court in *Godfrey Hirst*,<sup>251</sup> in that particular case the issue of foreign ownership did not arise. Where all relevant parties to a transaction are New Zealand residents, it is the case that the value of resources released for alternative use and the direct gain to New Zealand shareholders can be equivalent. However, that is not the case in this transaction as the merged entity would be partially foreign owned.
397. In contrast to a 'resource-based' approach, Professor Guthrie's approach focuses on the residency of the shareholders of the merged entity. This is because, he argues, it is these shareholders who will ultimately obtain any net benefit of merger-related asset rationalisations and cost reductions.
398. To illustrate, consider a hypothetical example in which two foreign-owned firms merge and obtain productivity efficiency improvements. The merged entity hires less labour and also sells off several redundant assets, including both land and plant. The foreign shareholders obtain a benefit in terms of some associated increased producer surplus (profits) from the labour cost reductions and the proceeds from the asset sales.
399. Those who hire the newly available labour and buy these assets will benefit from the use of these resources. However, assuming there is a competitive process for acquiring these newly available resources, these new employers and new owners will first pay an amount which is (almost) equal to the value they will subsequently obtain from these resources. Therefore, these new owners and employers will not derive a (substantial) net benefit from buying or hiring these resources.<sup>252</sup>
400. Consequently, as the benefits from these productive efficiency gains will flow to foreign shareholders, these are not direct public benefits to New Zealand.
401. However, while focusing on shareholder residency may provide an accurate estimate of the immediate, direct benefits that arise within the market of interest, it is the Commission's

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<sup>251</sup> *Godfrey Hirst*, above n 27.

<sup>252</sup> At the Cavalier conference Professor Guthrie suggested that any such gain should not be counted until such benefits are actually realised. The Commission disagrees with this view and considers that the current value of an asset will reflect any potential future gains, even if those gains are yet to be realised. 10 June 2015 Conference transcript.

view, following the Court's decision in *AMPS-A*,<sup>253</sup> that this approach ignores other longer-term or wider public benefits.<sup>254</sup> We explain our reasons for this view below.

*What is the case law on the treatment of productive efficiency gains derived by foreign shareholders?*

402. Incorporating efficiency enhancing gains captured by foreign shareholders into net public benefits has previously been the approach of the courts, primarily in the *AMPS-A* case. In this case, the Commission excluded the gains captured by foreign shareholders from an assessment of the public benefits. However, the court disagreed with the Commission and found that these impacts should be included as public benefits.

403. In its reasoning, the court stated:<sup>255</sup>

... what redounds to the benefit of NZ society will not always be immediately obvious. We reject any view that profits earned by overseas investment in this country are necessarily to be regarded as a drain on New Zealand. New Zealand seeks to be a member of a liberal multilateral trading and investment community. Consistent with this stance, we observe that improvements in international efficiency create gains from trade and investment which, from a long-run perspective, benefit the NZ public.

While this approach to benefit to foreign investors can, we think, be justified on quite general and fundamental grounds, its appropriateness is reinforced by the insertion of s 3A into the Commerce Act.

*The Commission's approach to treating productivity gains to foreign shareholders*

404. The Commission considers that the productivity enhancements that would be obtained by CWH in terms of asset realisations and cost reductions should be included in the assessment of public benefits. This is despite the fact that some proportion of these gains would flow directly to foreign shareholders in the first instance. This approach, consistent with case law,<sup>256</sup> recognises that enabling foreign shareholders to undertake such cost minimisation can provide significant flow-on benefits to New Zealand.

405. There are two main flow-on (feedback) benefits that are relevant in this case.

406. The first is that real cost savings brought about by the merger could ultimately enable the merged firm to better compete against international rivals. This may improve the likelihood that the domestic scouring sector would continue to operate profitably over the longer term. This could produce greater public benefits to New Zealand than may otherwise be the case if denying the merger would prevent the sector from undertaking beneficial cost rationalisation.

407. For instance, to the extent foreign scours are close substitutes to domestic scours for at least some scouring, blocking the merger may prevent the domestic scouring sector from reducing costs so as to be more competitive with foreign scours. Although any future rationalisation of

<sup>253</sup> *Telecom Corporation of New Zealand Ltd v Commerce Commission* (1991) 4 TCLR 473 (HC) and *Telecom Corporation of New Zealand Ltd v Commerce Commission* (1992) 4 TCLR 648 (CA) (*AMPS-A*).

<sup>254</sup> Regardless of the residency of the owner, variable cost savings should always be counted to the extent that they have a price decreasing effect on the post-merger price. The portion of variable cost savings that are retained by the shareholders are otherwise subject to the arguments in regard to potential longer term or wider feedback effects.

<sup>255</sup> *Telecom Corporation of New Zealand Ltd v Commerce Commission* (1991) 4 TCLR 473 (HC).

<sup>256</sup> *Telecom* above n 253.

the domestic scouring sector as a result of competition (ie, a “fight to the death” between the two remaining scours) may ultimately allow cost reductions to be realised, by the time such a rationalisation occurs it may be more difficult to win back scouring services lost to international rivals in the meantime.

408. The potential for increased competitive pressure stems largely from an ongoing global trend of wool scouring and manufacturing shifting from regions such as Europe, Australia and New Zealand to Asia, and China in particular. As the demand for clean wool in Asia has increased over time, scouring services in Asia have also increased in both quality and quantity. There is no indication that this trend has ceased and could continue in the foreseeable future. To enable the domestic scouring sector to be more competitive over the longer term, given the real possibility of such an eventuality, the Commission considers there is a public benefit associated with accounting for these savings.
409. Given the likely high degree of pass-through of scouring prices from merchants to farmers, at least over time,<sup>257</sup> to the extent that lower scouring costs were reflected in lower scouring prices, the benefits of this could in large part be passed through to farmers, the overwhelming majority of which are New Zealand residents. Any such future downwards movement in prices would also generate allocative efficiency gains.
410. Although the Commission recognises the potential for merger-related productivity gains to feed through into lower future prices in the long term, because of the uncertainty regarding such an effect both in terms of merger-specificity, scope and timing, we have not incorporated this potential impact in our estimates of allocative efficiency detriments.<sup>258</sup> Nevertheless, it is the Commission’s view that recognising these cost reductions, even if the immediate direct benefit may flow to foreign shareholders, helps ensure the future viability of the sector, which could carry with it lower prices.<sup>259</sup>
411. The second reason to account for productivity efficiency gains flowing to foreign owners from a merger is that to do otherwise would effectively discriminate against such shareholders in comparison with domestic shareholders. Placing foreign owned businesses at a relative disadvantage in merger authorisations, would create a disincentive for foreigners to undertake investment into New Zealand more generally. Such a disincentive could be detrimental given the wider benefits that arise from inbound foreign investment. These benefits include a higher stock of available capital and lower cost of capital for the New Zealand economy, as well as improved technology and knowledge transfer.
412. This is not to say that the Commission considers that merger-related benefits to foreign shareholders should be included in the analysis of net public benefits in all cases. The Court

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<sup>257</sup> See our discussion of pass-through by merchants in the Competition Analysis section.

<sup>258</sup> This issue was raised by Professor Guthrie, see his submission on behalf of Godfrey Hirst 15 October 2015.

<sup>259</sup> Godfrey Hirst also submitted in its 15 October 2015 submission at [34.2] that any perceived benefit from retaining the scouring industry must be counterbalanced by “...the potential for Lempriere to shut down the domestic scouring industry altogether – given its ultimate Chinese ownership...Lempriere could exercise its option, take control of the merged entity, and shut down the industry, ending the benefits the Commission has posited, and moving all funds offshore.” We have not been provided with any evidence supporting the suggestion that this transaction is part of an international strategy by Chinese interests to obtain control over wool scouring globally.

outlined in the *AMPS-A* case<sup>260</sup> that if such returns are “functionless” economic rents, they should not be included as public benefits.<sup>261</sup>

413. We consider that the domestic scouring sector faces a non-trivial competitive constraint from offshore scours and this competitive pressure may well increase over time. Furthermore, the degree of international transferability of scouring services and the ability for scouring activities to relocate to different countries, such as has occurred with the Australian scouring sector, means that without ongoing productivity improvements, ongoing competitive pressure could ultimately see the closure of the domestic scouring sector.
414. Therefore, we consider that productivity gains to the domestic scouring sector are unlikely to constitute functionless economic rents, at the very least over the medium to long term.
415. Regarding the specific value of these feedback effects, the Commission acknowledges that the public benefits to New Zealand from these effects are unlikely to exactly equal the direct productive efficiency gains obtained by foreign shareholders from the merger.<sup>262</sup> Although there is a real possibility that the benefits from these feedback impacts may be substantial, these effects may be unquantifiable.<sup>263</sup> Nevertheless, because of the feedback effects identified, we do not consider it appropriate to exclude efficiency gains to foreign owners, consistent with the Court’s view in *AMPS-A*.
416. Therefore, we do not consider that in this case there is a sufficiently strong rationale to depart from the approach that has been endorsed by the courts to date.<sup>264</sup> For this reason, the following productive efficiency benefits have been estimated and these estimates included in their entirety.<sup>265</sup>

## **Non-capital costs savings**

### *Rationalisation of plant*

417. Rationalising the five plants currently operated by Cavalier and NZWSI to two would enable CWH to reduce both the operating and overhead costs associated with operating the remaining scours.

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<sup>260</sup> *Telecom* (HC) above n 255.

<sup>261</sup> In fact, the Court held that if such functionless rents come at the expense of New Zealand residents they should be treated as detriments.

<sup>262</sup> See also Professor Guthrie submission, 15 October 2015, and Godfrey Hirst submission 15 October 2015. The Commission acknowledges the apparent inconsistency of this approach but, in our view, it is appropriate to account for productive efficiency gains as we have outlined given that these can provide for price reduction benefits over the long term.

<sup>263</sup> For instance, it is difficult to estimate the amount of foreign investment that would be deterred, or the corresponding increase in returns that would be required, if foreign investors were effectively treated less favourably than domestic investors with regards to merger authorisations. Any such “deterrent effect” would apply across the entire economy and to all future investment opportunities.

<sup>264</sup> The Commission considers that departing from the approach outlined by the Court in *AMPS-A* may be justified if there would be little, or no, feedback effects from improving returns to foreign owners of New Zealand businesses.

<sup>265</sup> The Commission has not reduced potential productive efficiency losses or dynamic efficiency losses to account for what would be the proportion of foreign ownership of CWH. This is consistent with our approach regarding other transfers to or from foreigners; that these efficiency losses reduce socially valuable returns to capital that incentivise efficient inbound foreign investment. Consequently, the Commission’s view is that these impacts should be treated as detriments to New Zealand despite their effect on non-New Zealanders.



cautious in analysing the level of savings and considered no further downward adjustment was required.<sup>267</sup> The main areas where savings are expected are as follows.

*Reduction in salaried and wage staff costs*

425. Rationalisation of scour lines post-transaction would allow cost savings from the avoided salaries and wages of workers that would no longer be required.

426. [ ]<sup>268</sup>

427. [ ]<sup>269 270</sup>

428. [ ]<sup>271</sup>

429. The Commission previously accepted the reduction in staff costs of \$[ ] as a public benefit likely to occur and this was upheld by the High Court which noted:<sup>272</sup>

...the same amount of wool can be scoured in the factual as in the counterfactual, but with fewer employees. Those employees no longer required will be available to produce other goods and services for New Zealand consumers. It follows that New Zealand's labour use is more efficient in the factual. In the absence of any evidence or submission otherwise, the Commission was not wrong to value that available resource at the price an employer is willing to pay for it (here, as evidenced by Cavalier's saved salaries and wages), allowing for the social cost of redundancy.

430. Given a [ ] staff cost saving was accepted by the Commission and the High Court in Decision 725, the Commission's position is to accept the estimate provided by Cavalier in its application. However, the Commission has reduced this estimate by staff cost savings associated with the Clive site<sup>273</sup> and made adjustments to account for potentially lower post-merger volumes arising from a potential price increase by CWH.<sup>274</sup> We estimate staff cost

<sup>267</sup> *Godfrey Hirst* above n 27 at [260].

<sup>268</sup> At [25.20] of the Application.

<sup>269</sup> [ ]<sup>268</sup>

<sup>270</sup> At [25.21] of the Application.

<sup>271</sup> At [25.22] of the Application.

<sup>272</sup> *Godfrey Hirst* above n 27 at [264].

<sup>273</sup> The staff cost savings associated with Clive are approximately [ ]<sup>273</sup>

<sup>274</sup> [ ]<sup>274</sup>

savings to be between \$[ ] and \$[ ]. The social cost of redundancy is included in the one-off rationalisation costs calculation below.

*Reduction in administration expenses*

- 431. Cavalier expects a reduction in administration expenses as a result of the transaction, including cost savings from: ACC levies; fire protection; information systems; insurance; general office expenses; repairs and maintenance of buildings and grounds; and security. The Commission previously accepted these as “claims of the kind that would result from a reduction in staff numbers and a reduction in the number of operating sites.”
- 432. Cavalier has updated this figure, and expects cost savings of [ ] per year.<sup>275</sup> This is in comparison to the administrative cost savings in Decision 725 which were expected to be [ ].<sup>276</sup> The Commission has reduced this estimate by cost savings associated with the Clive site. The Commission’s view is that administration cost savings would be \$[ ]

*Reduction in repairs and maintenance costs*

- 433. The reduction of scour lines in the factual compared to the counterfactual would result in savings in repair and maintenance costs. In addition to the reduction in scour lines, the 3.0 metre scour line currently at Whakatu would be run for fewer hours and savings would be made from roller lap and separator service reductions. In addition, [ ]<sup>277</sup>
- 434. Cavalier has submitted that it expects [ ]<sup>278</sup> savings in repair and maintenance costs. The Commission previously considered the reduction in scour lines to result in a savings in repair and maintenance costs of [ ] in Decision 725.<sup>279</sup> [ ]<sup>280</sup>
- 435. [ ]

[ ]<sup>281</sup>  
 [ ]<sup>282</sup>  
 [ ]<sup>283</sup>

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<sup>275</sup> At [25.24] of the Application.  
<sup>276</sup> At [363] of Decision 725.  
<sup>277</sup> At [25.25] of the Application.  
<sup>278</sup> At [25.26] of the Application.  
<sup>279</sup> At [364] of Decision 725.  
<sup>280</sup> [ ]  
<sup>281</sup> [ ]  
<sup>282</sup> [ ]  
<sup>283</sup> The repair and maintenance costs savings associated with the Clive site is approximately [ ]

[ ]].

*Reduction in variable electricity costs and electricity lines charges*

436. Electricity savings are expected to arise as a result of the transaction because of the rationalisation of lines and savings arising from the modification of the 3.0 metre Kaputone line. With the closure of Kaputone and Whakatu, the electricity lines, transformers and switchgear resources used at these sites would be able to be used elsewhere. Against this, additional charges would apply to Cavalier’s existing plants in the factual as a result of the increased production (and hence increased kilowatt requirement) from Awatoto and Timaru.
437. Savings in variable electricity costs and lines charges were considered separately by the Commission in Decision 725. Efficiency gains were expected to result in variable electricity cost savings of \$[ ].<sup>284</sup> The Commission also previously accepted a reduction in lines charges as a result of ceasing wool scouring at Whakatu and Kaputone of \$[ ]<sup>285</sup> giving an overall electricity cost saving of \$[ ].
438. In this merger, Cavalier has allowed for efficiency savings of [ ]%, resulting in a cost saving for lines and variable electricity costs of [ ].<sup>286</sup> The Commission expects efficiency gains from electricity savings, but, as outlined above, we have reduced this figure by electricity savings associated with the Clive site<sup>287</sup> and adjusted it for a potential lower post-merger volume. Consequently, we estimate cost savings for electricity to be between \$[ ] and \$[ ]

*Reduction in coal and gas costs*

439. The Commission previously considered energy savings as a result of decreased gas consumption of \$[ ]<sup>288</sup> in Decision 725.
440. Cavalier expects gas cost savings as a result of the transaction because of a decrease in consumption.<sup>289</sup> Cavalier’s estimate of energy savings from the merger was[ ].<sup>290</sup> Commission has reduced this estimate by gas cost savings associated with the Clive site<sup>291</sup> and made adjustments depending on post-merger volumes. We estimate gas cost savings to be between \$[ ] and \$[ ].

*Reduction in effluent system costs*

441. [ ]

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<sup>284</sup> At [370] of Decision 725.

<sup>285</sup> At [371] of Decision 725.

<sup>286</sup> At [25.27] of the Application.

<sup>287</sup> [ ]].

<sup>288</sup> At [25.30] of the Application.

<sup>289</sup> At [25.29] of the Application.

<sup>290</sup> At [25.29] of the Application.

<sup>291</sup> [ ]].

]<sup>292</sup> [ ]<sup>293</sup>

442. Cavalier has estimated a benefit of [ ] from the sale of the system based on the value of the system as parts.<sup>294</sup>  
 [ ]<sup>295 296</sup> The Commission's position is to accept these estimates because we consider that avoided expenditure on [ ]  
 [ ] However, the Commission adjusted these estimates to account for potentially lower post-merger volumes arising from a potential price increase by CWH. We estimate that effluent system cost savings to be between [ ] and [ ].

*Total non-capital cost savings*

443. Total non-capital cost synergies range from [ ] in years one and two, and [ ] per year for subsequent years.

**Sale of surplus land**

444. Following the restructuring described above, the NZWSI sites at Whakatu and Kaputone, would be surplus to scouring requirements and would be available for other uses. At the time of the previous application Cavalier had not determined whether it would sell the Clive site, but Cavalier now considers this site to also be surplus to requirements given CWH would have access to additional capacity without needing to retain Clive (see paragraphs 132 to 134 above). However, for the reasons discussed above in paragraphs 141 to 144 we cannot dismiss the real chance that absent the merger, in the near future, the Cavalier Board would decide to close or sell the Clive site to realise its capital value.<sup>297</sup>
445. Freeing up surplus land and buildings is a public benefit, as these resources can be redeployed to other productive uses. This was accepted in the Commission's consideration of the application resulting in Decision 725 and agreed by the High Court.<sup>298</sup>
446. The Commission previously considered a total benefit from sales ranging from \$6 million to \$10 million for both the Whakatu and Kaputone sites in Decision 725. This was based on likely sales prices of \$2.5 million for Whakatu and \$5.5 million for Kaputone. Cavalier submits that Kaputone is likely to have risen in value due to the area being marked for rebuild and the land being re-zoned residential.<sup>299</sup>

<sup>292</sup> At [25.31] of the Application.

<sup>293</sup> Ibid

<sup>294</sup> At [25.32] of the Application.

<sup>295</sup> Lempriere/NZWSI submission, 28 October 2014.

<sup>296</sup> [ ]

<sup>297</sup> As set out in paragraph 144, we have therefore assessed the proposed acquisition on the without-the-acquisition scenario where Cavalier would close or sell the Clive site in the near future.

<sup>298</sup> *Godfrey Hirst* above n 27 at [281].

<sup>299</sup> At [25.38] of the Application.

447. During this investigation, Cavalier submitted that Whakatu, Clive and Kaputone would each contribute a benefit of:
- 447.1 \$[ ]<sup>300</sup> for Clive (valued by Telfer Young in March 2014);
- 447.2 \$[ ]<sup>301</sup> for Whakatu (valued by Logan Stone in August 2014); and
- 447.3 \$[ ] for Kaputone (valued by Telfer Young in July 2014).
448. The Commission engaged Knight Frank and Turley & Co to independently value these properties on its behalf in May and June 2015. We also received submissions on the valuations from Darroch Limited (representing Godfrey Hirst) and heard from all parties expert valuers at the property valuations conference on 1 September 2015.
449. The market valuations provided to us by our independent valuers are:<sup>302</sup>
- 449.1 \$[ ] for Clive (valued by Turley & Co in June 2015);
- 449.2 \$[ ] for Whakatu (valued by Turley & Co in June 2015); and
- 449.3 \$[ ] for Kaputone (valued by Knight Frank in May 2015).
450. We appreciate that different valuers can reach different valuations based on the same evidence.<sup>303</sup> This can be due to the individual valuer's professional judgement, based on their interpretation of the evidence, or their past experience in the industry for example. A degree of difference in valuations is therefore not unexpected and the valuers figures of around +/- [ ] is a reasonable expected variation.<sup>304</sup>

*The Commission's view on the benefits to be attributed to each site*

451. Based on the submissions we received during our investigation and at the 1 September property valuations conference, the Commission has reached a view on the values to adopt as the benefits that would arise from the sale of these properties.
452. We note detailed [ ] reports have not been produced at the time of these valuations.
453. We have proceeded on the basis that the benefits are likely to accrue once the sales are actually complete. Based on the evidence we have obtained,<sup>305</sup> we consider that this may take approximately a year. We have therefore discounted the benefits arising from these sales by one year.

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<sup>300</sup> [ ] .

<sup>301</sup> [ ] .

<sup>302</sup> [ ] .

<sup>303</sup> [ ] .

<sup>304</sup> All valuations used the same methodology - the income capitalisation approach.

<sup>305</sup> 10 June 2015 Conference, see transcript pages 123 to 126, and 134 to 137.

454. Also, given the uncertainty regarding the values of these sites, we have considered ranges as the likely values of each site, with the exception of Clive.

*Clive – value adopted \$zero*

455. As discussed above at paragraph 144, we have assessed the proposed acquisition on the without-the-acquisition scenario where Cavalier would close or sell the Clive site in the near future, as this is the without-the-acquisition scenario that gives rise to the most acute competition concerns.

456. For completeness, we have also considered the value that we would attribute to Clive if we had adopted the without-the-acquisition scenario that Cavalier would retain its scouring plant in Clive and continue to run it in peak period.

457. We therefore begin our analysis, as we do with the other sites, by considering the valuation put forward by Telfer Young on behalf of Cavalier as well as the independent valuation provided to us by Turley & Co.

458. The difference in the valuations for Clive is for three main reasons.

458.1 [ ].

458.2 [ ].

458.3 [ ].

[ ]

459. [ ].

460. [ ].

[ ]

461. [

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462. [

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463. [

].<sup>306</sup>

[ ]

464. [

].<sup>307</sup>

*Conclusion on the value to be attributed to Clive*

465. If we considered that Cavalier was likely to retain the Clive site in the without-the-acquisition scenario, we estimate that the benefit from sale would likely be between \$[ ].

466. However, as discussed above at paragraphs 132 to 144, we consider that absent the merger there is a real chance that Cavalier would close or sell the Clive site in the near future. On this basis, we do not consider that we can attribute any benefit to the sale of Clive, as in this scenario any post-acquisition sale would not be considered a merger-specific benefit.<sup>308</sup>

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<sup>306</sup> [ ].

<sup>307</sup> [ ]

<sup>308</sup> As stated in *Air New Zealand and Qantas Airways Limited v Commerce Commission* (2004) 11 TCLR 347 at [319]: “The benefits must result from the acquisition or arrangement. Benefits which would or would be likely to accrue whether or not the proposed Alliance proceeds should be disregarded.”

*Whakatu – value adopted \$[ ]*

467. The difference in the valuations from Turley & Co and Logan Stone for Whakatu appear to arise because of two main points:

467.1 [ ]; and

467.2 [ ].

468. [ ].

469. [ <sup>309</sup> ].

*Kaputone – value adopted \$[ ]*

470. [ ].

[ ]

471. [ ]:

471.1 [ ]; and

471.2 [ ].

472. [ ]<sup>310</sup>  
[ ]

] <sup>311</sup>

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<sup>309</sup> [ ]

<sup>310</sup> [ ] .

<sup>311</sup> [ ] .

473. [ ]<sup>312</sup>  
 [ ]<sup>313</sup>  
 [ ]  
 . ]

[ \_\_\_\_\_ ]

474. [ ]  
 ].

475. [ ]<sup>314</sup>  
 [ ].

476. [ ]  
 ].<sup>315</sup>

477. [ ].

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<sup>312</sup> [ ].  
<sup>313</sup> [ ].  
<sup>314</sup> 1 September 2015 Conference transcript.  
<sup>315</sup> [ ].

**Table 5: Commission views on the public benefits from the sale of land and buildings**

Property	Benefits
Clive	\$ zero
Whakatu	[\$ [ ] ]
Kaputone	[\$ [ ] ]

### Sale of surplus plant

478. Cavalier also anticipates sales of plant and equipment worth [ ]. This consists of the Clive 2.0 metre scour line, the Timaru 2.4 metre scour line, [ ], a blending system with decotters and short wool processors, a choice of either coal or gas boilers, an extensive wool grease recovery system with multiple tanks and a high density wool press.<sup>316</sup>
479. Godfrey Hirst submitted that there is a cost of dismantling, removing, cleaning and packing of scour lines and that this cost would be up to \$100,000 for each scour. Godfrey Hirst says that their view comes from their own experience of selling a scour overseas. Godfrey Hirst believes the net sales value for two scours would be no more than [ ]. Cavalier responded by stating that this cost would be paid for by the purchaser and would be reflected in the purchase price.
480. This benefit was not included in the Decision 725. This is because these scour lines were not intended to be sold at the time of the previous application, but were to be mothballed. Therefore, the Commission has sought an alternative view on the potential re-sale value of this plant. According to James Irvine, the re-sale value of the scours alone would be between \$500,000 to \$650,000 each.<sup>317</sup> Added to this would be the value of the additional plant, so that the total value would be greater, perhaps up to [ ].
481. The Commission has considered the views of the parties and is comfortable with using Cavalier's initial value of [ ] as a starting point. This is based on the fact that Cavalier's suggested value is supported by independent industry expert James Irvine. The Commission has reduced this by [ ], to account for the Clive 2.0 metre scouring line being sold in the without acquisition scenario. The net benefit the Commission has used is therefore, [ ].

### Capital costs of rationalisation and ongoing capex savings

#### *Capital expenditure on buildings*

482. To accommodate NZWSI's scours from Whakatu and Kaputone, CWH would undertake capital works on the Awatoto and Timaru sites. It would also expand the capacity for wool storage at Awatoto given the closure of the Clive site. Cavalier estimates that the total capital outlay on

<sup>316</sup> Cavalier submission, 21 April 2015.

<sup>317</sup> James Irvine email correspondence, 2 and 4 February 2015. These values rely on the age of the scours, the prevalence of potential purchasers and the expense of installing and obtaining permits for old scours, and the cost of new scours.

these alterations would be approximately [ ]. This compares to the [ ] estimated in the Decision 725 when more extensive works were required. As in Decision 725, the Commission has netted this amount off the benefits arising from the rationalisation, outlined below.

*Capital expenditure on plant*

483. As part of the proposed transaction, the parties expect to incur a significant upfront capital cost associated with relocating and modifying scouring lines. Against this, they expect to save substantial amounts by avoiding capital expenditure they would otherwise incur related to:

483.1 ongoing regular capital expenditure;

483.2 [ ]; and

483.3 [ ].

484. Cavalier estimates that the additional (non-building) expenditure required to relocate the NZWSI scour lines at Whakatu and Kaputone to Awatoto and Timaru, relocate the Kaputone boiler to Timaru, reinstate the buildings at Whakatu, Kaputone so that they can be sold and to carry out necessary modifications to the remaining scour lines is [ ]. In contrast the estimate in Decision 725 was [ ].

485. Cavalier spends approximately [ ] annually on capital projects for enhancements and improvements in productivity. NZWSI has also submitted that they historically invest an additional [ ] in capital expenditure at their Kaputone and Whakatu sites and there is no reason to believe that this would change going forward.<sup>318</sup> We are also not aware of any reason why this would change in the counterfactual.

486. This capital expenditure would be avoided in the first year after the transaction (year one) as it is encompassed in the expenditure on rationalisation described in the preceding paragraph. Cavalier also claims that there would also be on-going savings from this expenditure on rationalisation.

487. Cavalier considers that the maintenance programme it currently employs at its existing plants has sufficient capacity to encompass maintenance for the NZWSI scour lines, particularly given the same number of lines would be located at Timaru. Accordingly, it believes its maintenance costs would not increase post-acquisition and, additionally, it would avoid expenditure currently incurred by NZWSI on winter maintenance and improvements in productivity. Further, Cavalier considers economies of scale in capital expenditure would result in savings as the duplication of some expenditure would be avoided. As a result, Cavalier claims this would result in a cost saving of [ ] per year.

488. [ ]<sup>319</sup>  
[ ]

<sup>318</sup> NZWSI submission 16 April 2015, paragraph 3.

<sup>319</sup> [ ]

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489. [ ].<sup>321</sup>  
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490. [ ].<sup>322</sup>

491. [ ].<sup>323</sup>

492. [ ]<sup>324</sup>  
[ ]<sup>325</sup>  
[ ].

493. [ ].

494. [ ]<sup>326</sup>  
[ ]<sup>327</sup> [ ].

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<sup>320</sup> [ ].

<sup>321</sup> [ ].

<sup>322</sup> [ ].

<sup>323</sup> [ ].

<sup>324</sup> [ ] [ ]

<sup>325</sup> [ ]

<sup>326</sup> Lempriere submission, 16 April 2015.

<sup>327</sup> Ibid.

495. [ ]<sup>328</sup>  
[

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496. [ ]<sup>329</sup>  
[ ]<sup>330</sup>  
[ ]<sup>331</sup>

497. [ ]  
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498. [ ]<sup>332</sup>  
[

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499. [ ]:  
499.1 [ ]; and  
499.2 [ ].

500. [ ]<sup>333</sup>

501. [

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<sup>328</sup> Godfrey Hirst submission, 23 June 2015.

<sup>329</sup> [ ]

<sup>330</sup> [ ]

<sup>331</sup> [ ]

<sup>332</sup> [ ]

<sup>333</sup> [ ]

].<sup>334</sup>

502. [ ].

503. To determine the net capital expenditure savings, the savings outlined above are offset against the initial [ ] rationalisation cost. These savings are:

503.1 avoided ongoing regular capital expenditure;

503.2 [ ]; and

503.3 [ ].

504. The net impact is total avoided capital expenditure on plant over five years of [ ]. This compares with the Commission’s estimate of [ ] for total avoided capital expenditure in Decision 725.

*One-off rationalisation costs*

505. In its application, Cavalier estimated that the proposed rationalisation would result in redundancy costs of [ ]. This contrasts with [ ] in Decision 725. On 15 June, Cavalier submitted a letter to the Commission along with [ ]:<sup>335</sup>

[ ]

506. Cavalier recently reviewed the maximum redundancy exposure and now expects the actual redundancy costs to be lower than those calculated and submitted as part of its application. Cavalier attributes this to the opportunity that [ ] has now had to look at the employment contracts at both sites.

[ ]:<sup>336</sup>

507. [ ].

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<sup>334</sup> [ ]  
<sup>335</sup> [ ]  
<sup>336</sup> [ ]

508. [ ]<sup>337</sup>  
[ ]<sup>338</sup>  
[ ]

509. [ ]

510. [ ]<sup>339</sup>  
[ ]

511. [ ]<sup>340</sup>  
[ ]

512. [ ]

513. [ ]

514. The revised figures for the costs of redundancy therefore are the following:

For Whakatu: [ ]

For Kaputone:  
[ ]<sup>341</sup>

515. Cavalier also incorporated contingency rationalisation costs of [ ] in the first year of the factual as in Decision 725. In addition, Cavalier has allowed for [ ] in cartage

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<sup>337</sup> [ ]  
<sup>338</sup> [ ]  
<sup>339</sup> [ ]  
<sup>340</sup> [ ]

<sup>341</sup> Spreadsheet received as Attachment D in Cavalier response dated 13 July 2015, [ ] With the exception of one employee who was not attributed a redundancy pay out by [ ] but for whom the Commission has included a pay-out.

costs during the rationalisation period.

[ ]. We have taken this into account in our benefit calculation.

516. Having reviewed the submissions and after analysing the claims, we consider the aggregate benefit is a one-off rationalisation cost of the transaction of [ ].

## Detriments

517. As in the previous authorisation, Cavalier has stated that, given the constraints imposed by the continued growth of the Chinese wool scouring industry, it considers that the proposed Acquisition would result in little if any detriment.<sup>342</sup> However, the Commission has assessed that the level of detriment that could arise from the loss of NZWSI as a competitive constraint would likely be significant.
518. In undertaking the assessment of detriment, the Commission has used the following categories – loss of allocative efficiency, loss of productive efficiency, and loss of dynamic efficiency.

## Loss of productive efficiencies

519. One outcome that can be associated with a loss of competition is that a firm gaining market power has less incentive to minimise costs and to avoid waste. Organisational slack may creep into its operations, and costs may increase, because a satisfactory level of profit is assured even when the firm is less than fully efficient.
520. However, determining whether a firm may be susceptible to losses of productive efficiency is difficult. A firm seeking to maximise its profits will have an incentive to minimise its costs, irrespective of the level of competition in the market. For this reason the Commission does not assume that reductions in competition will necessarily lead to productive inefficiency.<sup>343</sup>
521. In this case the Commission has allowed for a relatively modest loss of productive efficiency of between zero and 1% of pre-merger variable costs, which has a maximum value of [ ] over a five year period.

## *The parties' views*

522. Cavalier has submitted that this transaction is unlikely to produce productive efficiency losses.<sup>344</sup>
523. Cavalier has pointed out that a substantial proportion of its staff have incentive-based remuneration schemes.<sup>345</sup> Cavalier has stated that, post-merger, similar remuneration schemes would be extended to many of the additional staff that CWH would employ and that

<sup>342</sup> At [26.1] of the Application.

<sup>343</sup> *Authorisation Guidelines*, above n 239 at [68] to [71].

<sup>344</sup> At [26.17] of the Application.

<sup>345</sup> Interview with Cavalier, 13 November 2014. Cavalier submission, 11 March 2015 and 19 June 2015. 10 June 2015 Conference transcript.

this would reduce the likelihood that the transaction would result in a loss of productive efficiency.<sup>346</sup>

524. Cavalier has provided details about how these schemes work both for staff and for management.<sup>347</sup>

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[  
[  
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525. [  
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526. Cavalier also submitted that, over the last four years, its monitoring of productivity has improved.<sup>351</sup>

[  
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527. [  
].<sup>352</sup>

*Others' views*

528. Professor Guthrie, on behalf of Godfrey Hirst, submitted that the incentive-based remuneration schemes outlined by Cavalier above cannot necessarily be relied upon to achieve productive efficiency gains.<sup>353</sup>

529. For instance, Professor Guthrie has pointed to the 'ratchet effect' which can apply to incentive schemes. This suggests that a worker does not perform to his or her capacity because management, in response to high performance, will further revise targets upwards, making it harder for workers to earn bonuses in the future.

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<sup>313</sup> Cavalier submission, 11 March letter 2015 10 June Conference transcript at pages [27 to 28]. Cavalier submission, 19 June 2015.

<sup>347</sup> Cavalier submission, 19 June 2015.

<sup>348</sup>

[  
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<sup>349</sup> [  
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<sup>350</sup> Cavalier submission, 19 June 2015.

<sup>351</sup> Ibid.

<sup>352</sup> Ibid.

<sup>353</sup> Professor Graeme Guthrie report, 21 April 2015.

530. Godfrey Hirst also submitted that, in the same manner that the Commission has considered that there are different pricing constraints in the two separate customer markets (ie, for wool destined for export or for domestic users), there should be different levels of productive efficiency detriment for these markets.<sup>354</sup> Godfrey Hirst's specific suggestion is that because CWH would face less competitive pressure in markets for scouring services for wool for domestic use, productive efficiency detriments would be larger in these markets.

*The Commission's view*

531. While the Commission considers competition to be an important driver of productive efficiency, we also consider that the weight which should be given to competition as a factor is difficult to quantify. We note the efforts made by the domestic scouring sector to operate efficiently in recent years (including the incentive-based staff remuneration schemes detailed below) and consider that important drivers of this have not only been the competition between the two firms, but also the external pressures placed on both Cavalier and NZWSI by the declining wool clip and the possibility of increased greasy export to China. Irrespective of whether these two firms merge, we expect that these external pressures, and the consequent internal efficiency efforts, are likely to continue, and in fact intensify, over time.<sup>355</sup>
532. CWH would only have four shareholders. These are Cavalier Bremworth, a subsidiary and major customer of Cavalier, Lempriere, ACC and Direct Capital. The latter two are experienced investors without significant interests elsewhere in the wool sector who wish to maximise their investment income and capital growth. This small number of overall shareholders is likely to have the ability and incentive to continue to drive productive efficiencies in CWH. The Commission considers any future shareholders would similarly have the incentive to continue to drive productive efficiencies.
533. During the course of this investigation, the Commission has obtained extensive information from Cavalier regarding the comprehensive coverage of incentive schemes, and detailed performance and environmental monitoring, as outlined above.<sup>356</sup> We consider that this illustrates that productivity performance within this sector is rewarded to a relatively detailed level.<sup>357</sup> However, the Commission acknowledges that, as pointed out by Professor Guthrie, these productivity monitoring and improvement mechanisms do not necessarily result in optimal productivity enhancements. However, the Commission considers that there would be little difference in the outcomes from such schemes with or without the merger.
534. The combination of these three factors leads the Commission to view that any losses in productive efficiency as a result of the merger would be likely to be relatively small and may, in fact, be negligible.
535. Nevertheless, there is the possibility that a firm's management, without the day-to-day pressures from a close competitor and the competitive benchmark against which the firm's

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<sup>354</sup> Godfrey Hirst submission, 15 October 2015.

<sup>355</sup> The Commission points to the experience of the scouring sector in Australia as evidence in this context, see the Competition Analysis section.

<sup>356</sup> Cavalier submissions, 11 March 2015 and 19 June 2015.

<sup>357</sup> Regarding the ratchet effect issues raised by Professor Guthrie, the Commission does not consider that any such impact would likely differ with and without the merger since the effect is not merger dependent.

management can be measured, may become less productively efficient. In its submission on behalf of Cavalier's application, NERA included an estimate of the potential productive efficiency detriments based on the approach used by the Commission in Decision 725. This approach involved applying a percentage factor of between 1% and 5% to the dollar value of pre-merger variable costs. The potential productivity loss using this approach was estimated by NERA to range from between a total of [ ] to [ ] over a five year period.

536. However, because of the continued and likely intensifying external pressures (reducing wool clip and greasy exports), and because of the ability for shareholders to monitor and reward productivity performance in this sector, we consider that any loss of productive efficiency is likely to be minimal. Therefore, for this transaction the Commission has used a lower range than we used in Decision 725. For this analysis we have used a range of between 0% and 1% of pre-merger variable costs.
537. In response to Godfrey Hirst's suggestion that there should be different productive efficiency losses across different customer markets, Cavalier and NERA submitted that this is not appropriate as the same production processes are used to supply customers in each of these markets.<sup>358</sup> The Commission considers that because the overall scouring process is largely identical for wool scoured for different customers, there is no reason to separate productive efficiency detriments on this basis.

#### *Quantification of loss of productive efficiency*

538. Based on the range which the Commission considers is appropriate, ie that the likely productivity efficiency losses would be between 0% and 1% of pre-merger variable costs, we have estimated that productive efficiency losses are likely to have a value of between zero to [ ] over a five year period.

#### **Increased supply risk**

539. The rationalisation of scouring services would decrease the number of plants to one in both geographic markets and therefore increase the risk of a plant outage causing significant losses.
540. This risk may be mitigated by two factors:
- 540.1 post-acquisition, CWH's scouring plants would not be operating at full capacity and CWH would have comprehensive insurance to cover freight between islands in the case of a plant shutdown. Based on production forecasts, even with the rationalisation of scours, Cavalier has estimated that CWH would retain around [ ] spare capacity in the North Island and [ ] spare capacity in the South Island; and
- 540.2 comprehensive risk management infrastructure and processes are in place at both plants.

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<sup>358</sup> Cavalier submission, 22 October 2015; and NERA submission, 22 October 2015.

541. Nevertheless, the Commission considered the extent to which plant closure post-acquisition should be taken into account in the detriment analysis. In assessing the likely magnitude of these risks and costs, the Commission considered the historical incidents of plant outages.
542. The Commission has found only one example of a scouring plant emergency – during 1999, one scour line at Cavalier’s Awatoto plant was shut down for a short period due to a small fire in a control cubicle. Cavalier previously submitted that any electrical failure at a time of high demand on one of their scouring plants would be repaired within 48 hours.
543. A further concern raised by Godfrey Hirst regarding supply risks related to the potential capacity constraints at peak times, typically during January and February.<sup>359</sup> Cavalier provided information which indicated that CWH would have sufficient capacity to deal with peak scouring demand.<sup>360</sup>

#### *The Commission’s view*

544. Based on historic industry experience there appears to be a relatively low level of supply risk. The ability to store greasy wool until the plant problem is resolved also limits the potential cost to the industry of an outage. The Commission considers that these factors mean that there would be only a small increase in risk arising from the consolidation of scouring activities into a single location per island. Because of the limited nature of the risk and the precautions already taken by Cavalier, the Commission view is that any likely detriment is likely to be de minimis.
545. Regarding supply risks at peak times, in light of the data provided by Cavalier, the Commission does not consider that any shortage of capacity during peak times would be materially different to that which would occur without the merger.

#### **Loss of dynamic efficiency**

546. Dynamic efficiency typically refers to improvements made by firms over the long term concerning product quality, product variety, and cost efficiency through innovations in processes, equipment or managerial practices. A loss of a competitor might cause a firm to invest fewer resources in such improvements. In the present context, a merger would create a monopoly scourer and might raise concerns that there might be a significant loss of dynamic efficiency.
547. As is the case with the loss of productive efficiency, it is difficult to measure with any precision the cost to society of a lessening in dynamic efficiency attributed to a substantial lessening of competition in a market. Even if firms possess market power, they still have an incentive to innovate and achieve dynamic efficiency as doing so would lead to increased demand for their products and maximise profits. Consequently, a qualitative element is always a significant part of this assessment.
548. The Commission’s view is that the long-term competitive threat of the scouring industry in Asia, particularly China, is likely to reduce the risks of substantial dynamic efficiency losses. CWH would be acutely aware of the experience of the scouring sector in Australia, which has

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<sup>359</sup> Godfrey Hirst submission, 21 April 2015.

<sup>360</sup> Cavalier submission, 29 April 2015.

all but disappeared because of greasy exports to China. Furthermore, while there is a risk that poor decision-making from CWH could lead the company to fail, this does not preclude other owners from taking over the assets and altering key business strategies if this provides an opportunity for profitable activity.

549. The Commission stated in the reasons for its decision on the *Air NZ/Qantas* matter:<sup>361</sup>

Dynamic inefficiency arises when a business or industry is less innovative than it might be. Innovations bring benefits to consumers either through the introduction of improved new products that buyers value more highly (“product innovations”), or through the use of new, lower cost ways of producing existing products (“process innovations”).

and

Monopolists in general have a reputation for being poor innovators. Although they have the resources to undertake innovative activity, and are well-placed to appropriate the gains from the introduction of a significant innovation (because of the absence of imitating rivals), the lack of any competitive spur to take risks and embrace new ideas has the opposite effect. The removal of competitive pressure lessens the incentive for companies to innovate in order to match or keep ahead of rivals.

and

A reduction in innovation may cause social welfare to suffer in two ways: buyers may be deprived of the benefit of product innovations; and the public as a whole would lose the benefit from the introduction of process innovations that save on inputs, measured by the additional outputs that could be produced by the saved inputs being used in alternative employments.

550. NERA has provided an estimate of potential dynamic efficiency losses based on the approach used in Decision 725 by the Commission. This approach assesses a loss of innovation by multiplying total sales by factors of 0.5% to 1.5% (this contrasts with the 0.5% to 1% range used by the Commission in the *Air NZ/Qantas* case).<sup>362</sup> It has assessed the NPV sum of the detriments from a loss of product innovation and process innovation for five years as falling within the range of [ ] to [ ].

#### *Others' views*

551. Godfrey Hirst suggested that the approach undertaken by NERA to estimate dynamic efficiency losses has too narrow a focus.<sup>363</sup> Godfrey Hirst and their expert Professor Neil Quigley submitted that the method of estimating such losses does not take sufficient account of the effect of close competition on more general decisions regarding investment and divestment decisions, such as plant location and scale, and that these decisions may be more important sources of dynamic efficiency. They further argued that having two players that operate with different business models, ie, in terms of different degrees of vertical integration, reduces the risks of any one business model being less efficient over time.

552. As a result, Professor Neil Quigley, on behalf of Godfrey Hirst, considers the dynamic efficiency loss estimates appear implausibly low and suggests that, in the extreme, poor decision-making from CWH could lead to the failure of the domestic wool scouring industry.

<sup>361</sup> Air New Zealand Limited and Qantas Airways Limited (Commerce Commission Decision 511, 23 October 2003).

<sup>362</sup> Ibid.

<sup>363</sup> Professor Quigley's submission, 3 December 2014.

He also states that it is inappropriate to assume that the interests of the shareholders in CWH to minimise costs would be sufficient to eliminate this risk.<sup>364</sup>

553. In addition to Professor Quigley's views, Professor Guthrie has further reservations because of the existence of an option for Lempriere to increase their shareholding at a future date.<sup>365</sup> He argues that the presence of this option introduces asymmetries in shareholder objectives. In Professor Guthrie's view, this option provides Lempriere with an incentive to pursue high risk strategies to try and maximise the value of the firm. High risk strategies could include delaying routine maintenance or selling off assets that are not essential to day-to-day operations but may be of occasional use in certain circumstances.<sup>366</sup>
554. This approach would enable them to gain from exercising this option if the strategies succeed. This is because they could use the option to acquire the additional shares at a price lower than true market value. Conversely, if the strategies fail, Lempriere's losses would be limited by the level of their initial shareholding in CWH as they would choose not to exercise the option.
555. Godfrey Hirst also submitted that, similarly to its position on productive efficiency detriments, the Commission should estimate different levels of dynamic efficiency detriments for different customer markets.<sup>367</sup> Godfrey Hirst's specific suggestion is that, because CWH would face less competitive pressure in markets for scouring services for wool for domestic use, CWH would be less incentivised to innovate its scouring services in relation to this wool. Consequently, dynamic efficiency detriments would be larger in relation to markets for wool scoured for domestic users.

#### *The Commission's view*

556. The Commission considers that there are a number of reasons why dynamic efficiency losses are likely to be limited. First, the shareholders of CWH would have a strong profit maximising incentive to maximise dynamic efficiencies.
557. Second, many innovations are the result of work by equipment manufacturers both in New Zealand and abroad. While the Commission accepts that the industry innovates in respect of process and product, these innovations are typically of the kind whereby the equipment provided by the manufacturer is improved by the scourer to suit local conditions and requirements. Moreover, most of the innovation tends to relate to improvements of existing processes, rather than radically new products and processes. Given the relatively mature state of the technologies involved in wool scouring, any such innovations are likely to be incremental in nature.
558. The Commission considers that while some innovation in the scouring industry has occurred as a result of competitive pressures within the domestic scouring market, major innovations have occurred outside this particular environment. This is as a result of improvements by

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<sup>364</sup> Ibid.

<sup>365</sup> The CWH Shareholders' Agreement contains an option clause in favour of Lempriere. Under the option clause, ACC and Direct Capital grant to Lempriere the right to acquire all the shares they hold (27.5% in total) at any time by Lempriere giving written notice within certain timeframe/s and if certain share values are reached.

<sup>366</sup> Professor Graeme Guthrie report 21 April 2015.

<sup>367</sup> Godfrey Hirst submission, 15 October 2015.

equipment manufacturers, who no doubt wish to remain competitive in their manufacturing markets.<sup>368</sup>

559. As noted above, post-acquisition, CWH would have a strong incentive to utilise new ideas where it contributes to profit and helps ensure competitiveness with overseas scouring plants. This would mean in the best case scenario no loss of dynamic efficiency post-merger. However, accounting for the fact that there will be one less competitor in the scouring industry, we consider it appropriate to make allowance for a small degree of dynamic inefficiency.
560. Third, in relation to the potential for the Lempriere option to encourage Lempriere towards undertaking high risk strategies, it is the Commission's view that this would not have a material impact in practice. While there could theoretically be an effect, the strike price of this option is not fixed and depends on the performance of the firm in terms of its actual and expected earnings and profitability.<sup>369</sup> In NERA's view this effectively eliminates any incentive for Lempriere to undertake such high risk strategies.<sup>370</sup> The Commission agrees with NERA's viewpoint and considers that, although there may be some lag between the effect of these strategies and the revised strike price, in practice this would not have a material effect on any incentive Lempriere faces to engage in high risk strategies.
561. The Commission acknowledges the point raised by Professor Quigley that, in extreme cases, poor decision-making by CWH could lead to failure in the scouring sector and wool industry more widely.<sup>371</sup> We accept that the risk of this would increase as a result of the merger because there would only be one business model instead of two rival models. However, the Commission considers that the risk of such decisions would still be sufficiently low so as to make this outcome unlikely.
562. In response to Godfrey Hirst's suggestion that there should be different dynamic efficiency losses across different customer markets, Cavalier and NERA submitted that this is not appropriate as in practice, any dynamic efficiency effects would be either very small or non-existent, and the examples of potential new wool products that were suggested by Godfrey Hirst as requiring innovation in scouring could actually be achieved with little or no additional cost.<sup>372</sup>
563. The Commission's view is that there is a theoretical argument that the lower degree of competitive pressure in relation to the scouring of wool for domestic use could lead to larger dynamic efficiency detriments. However, in practice we do not consider that any such impact would be material. This is based on two factors. The first is that information provided by Cavalier suggests that the likely innovation would be relatively low cost. The second is that the relatively competitive nature of the downstream domestic carpet markets means that CWH would be incentivised to undertake innovation requested by downstream domestic

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<sup>368</sup> Decision 725 at [288].

<sup>369</sup> Shareholders agreement, clauses 9.1 to 9.5 inclusive.

<sup>370</sup> Statements from James Mellsop of NERA at 10 June 2015 Conference [pages 17-18, 23-24]. NERA submission, 29 April 2015.

<sup>371</sup> Professor Quigley's submission, 3 December 2014.

<sup>372</sup> Cavalier submission, 22 October 2015; and NERA submission, 22 October 2015.

carpet manufacturers otherwise the demand for wool by these parties could ultimately diminish.

564. Therefore, the Commission's view is that any dynamic efficiency losses the Acquisition is likely to give rise to would be relatively minor and in the range of 0% to 0.5% of sales.

*Quantification of loss of dynamic efficiency*

565. Using the range of 0% to 0.5% of total sales revenue as the likely loss in dynamic efficiency, the estimated potential detriment is likely to have a value of between zero to [ ] over five years.

**Loss of allocative efficiency**

566. In general, when the price of a product increases because of a loss of competition (for example, as a result of a merger), demand for that product will fall as some consumers switch to alternative products. These alternatives may meet consumers' requirements in a less satisfactory way and/or are more costly to produce than the product they replace. Alternatively, consumers may simply make fewer purchases, losing the benefit that they otherwise would have obtained from a product. In effect the net result is that the country's resources are allocated less efficiently.
567. The size of the allocative efficiency loss depends to a large extent on the degree of price increase post-merger.<sup>373</sup> The higher the price increase, the larger the loss of allocative efficiency.
568. If authorised, the proposed transaction would create a single wool scouring company in New Zealand. This could give the merged firm power to sustain a significant non-temporary increase in the price of scouring wool.
569. However, the degree to which a single domestic scouring company can increase price might be constrained by potential entry or, more likely, by the competitive threat posed by merchants switching to increased exports of greasy wool.
570. Another consideration is the ability of a monopolist to price discriminate. If CWH was able to price discriminate on the basis of the end-user of scoured wool, this could make some buyers of scoured wool, or at least some scourments of wool, more vulnerable to price increases.

*The parties' views*

571. Cavalier has submitted that it considers that there are unlikely to be any significant allocative efficiency detriments<sup>374</sup> Cavalier has expressed this view because the threat of greasy exports means that there are unlikely to be significant increases in scouring prices.<sup>375</sup> These submissions are outlined above in the Competition Analysis section.

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<sup>373</sup> It also depends on the elasticity of demand; that is, the sensitivity of buyers to changes in price.

<sup>374</sup> At [26.4] of the Application.

<sup>375</sup> At [26.6] of the Application.

*Other's views*

572. Godfrey Hirst has submitted that allocative efficiency losses are likely to be substantial because CWH would be likely to raise prices substantially post-merger.<sup>376</sup> Godfrey Hirst and Professor Guthrie have submitted that CWH would be able to increase prices by more than 15%, up to at least 20%.<sup>377</sup> Their submissions state this is because the costs of entry are higher than were initially estimated by Cavalier and the Commission, and because the threat of increased greasy exports is not strong as has been claimed by Cavalier. These submissions are outlined above in the Competition Analysis section. Godfrey Hirst has also suggested that it could face price increases that are even higher in relation to wool that is scoured on its behalf.<sup>378</sup> This is because it does not have the option of exporting greasy wool offshore for scouring and re-import back to New Zealand.

*The Commission's view*

573. As detailed in the Competition Analysis section, the Commission considers that the merger could substantially lessen competition in domestic scouring markets. 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 between 5% and 15% in relation to wool destined for export, by between 5% and 25% for wool to be used by Godfrey Hirst, and by 10% for wool grease sold to domestic customers. With price increases of these levels, we consider that there is likely to be a negative demand response, leading to a loss of allocative efficiency.

574. We note that estimates relate to the upper end of ranges for maximum likely price increases. It is also likely 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.

*Estimating allocative efficiency loss*

575. To estimate the potential loss of allocative efficiency in the with-the-acquisition scenario, the Commission must consider the likely price increase and determine the likely impact this would have on the quantity of scouring services purchased in the various markets post-merger.

576. Based on the available evidence and our analysis of the competitive constraints that CWH would face post-merger (see Competition Analysis section), the Commission considers that the likely maximum price increases that CWH would be able to apply to scouring services post-merger would be between 5% and 15% for wool destined for export.<sup>379</sup> We consider CWH would be able to increase prices by between 5% and 25% for purchases of wool to be used by Godfrey Hirst.

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<sup>376</sup> Godfrey Hirst submission, 23 June 2015.

<sup>377</sup> Ibid, submissions 15 and 22 October 2015. Professor Graeme Guthrie report 23 June 2015, 15 October 2015.

<sup>378</sup> 10 June 2015 Conference transcript.

<sup>379</sup> Based on views put forward by merchants and the parties, the Commission considers that an immediate price increase of 15% is unlikely, and any actual price increases are likely to be smaller and incremental over time. However, we have used as immediate price increase of 15% as a conservative estimate.

577. To estimate the allocative efficiency loss that would arise from these potential price increases, we must assess the likely elasticity of demand for wool scouring in the various markets. There appear to be no studies to inform us as to the extent to which the quantity of scouring services demanded in New Zealand would change as scouring prices change.
578. As in Decision 725, the Commission posits that in practice CWH would face stepped demand curves in the various markets which would affect the composition of allocative efficiency losses. For example, some exports of scoured wool to China could undoubtedly switch to greasy exports in the face of a relatively small price increase because this wool could easily be scoured in China. However, it may be that scouring prices for wool required by certain end users in other export markets who have a strong preference for clean New Zealand wool could increase significantly without greatly affecting the volumes sold. This could be more likely in export markets where there is no local scouring industry and re-exporting wool from China or other locations is more costly and problematic.<sup>380</sup>
579. However, further precise specific detail regarding these aspects of the demand for scouring services in the relevant markets is not available. Therefore, the Commission has taken a more simplified approach and assumed a linear demand curve in the relevant markets.
580. In Decision 725 the Commission applied a range of potential elasticities of -0.05 to -1 to the estimated likely price increase. In this analysis the Commission proposes to use a narrower range of elasticities to estimate the potential allocative efficiency loss; that is, -0.5 to -1. In relation to wool destined for export, this narrower range of elasticities reflects that an increased proportion (over a third) of the wool currently scoured in New Zealand is destined for China,<sup>381</sup> and more generally that greasy wool exports are more of an option than they were in 2011.
581. In our modelling of allocative efficiency losses in relation to wool destined for export, the Commission has also used a simplified approach which assumes that the maximum price increase of 15% would occur immediately after the transaction. However, as discussed in the Competition Analysis section above, the Commission considers that any actual post-merger price increase may be incremental in nature rather than an immediate, one-off substantial increase.<sup>382</sup>
582. Given this, the Commission considers that a 15% price increase is likely to over-estimate the actual detriments. However, the Commission considers that there is insufficient certainty regarding the precise price increase steps and the timing of those increases to quantitatively model an incremental price increase.<sup>383</sup>
583. In relation to wool scoured on behalf of Godfrey Hirst, the Commission proposes using the same, wider, range of elasticities used in Decision 725, ie, -0.05 to -1. This reflects the greater uncertainty regarding the likely demand response by Godfrey Hirst. For instance, scouring

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<sup>380</sup> Decision 725 at [224].

<sup>381</sup> Beef + Lamb New Zealand, Wool export data July 2013 to June 2014.

<sup>382</sup> An incremental increase would apply to the maximum likely price increase of 15% but not to the lower bound of price increase of 5%.

<sup>383</sup> We note that NERA has modelled a potential incremental price increase, which assumes an increase of 5% for each of the first three years after the merger. See NERA submission, 15 October 2015.

costs constitute a relatively small percentage of total wool input costs (around 8%).<sup>384</sup> Therefore, a 25% increase in scouring costs may have only a small impact on Godfrey Hirst's use of wool, implying a relatively low elasticity, ie, -0.05.

584. Conversely, Godfrey Hirst's use of wool has [ ] in recent years as the use of synthetic fibres in carpet manufacturing has increased.<sup>385</sup> This suggests that the relevant elasticity of demand may be higher, ie, -1.
585. In modelling provided by NERA (on behalf of Cavalier) and amended by the Commission, this range of potential average elasticities has been applied to the range of likely maximum price increases to estimate likely allocative efficiency losses. These estimates also incorporate price-cost margins at current prices to account for the exploitation of any existing market power.<sup>386</sup>
586. In addition to allocative efficiency losses for scouring price increases, NERA provided an estimate of the potential allocative efficiency losses for small wool grease customers should they face a price increase post-acquisition price increase of 10% and have an elasticity of demand of -0.5.<sup>387</sup> The Commission accepts this estimate, which is [ ] per year which corresponds to a net present value over five years of [ ].<sup>388</sup>
587. The overall range of total potential allocative efficiency losses over a five year period is between \$2.19 million to \$15.03 million depending on the size of the price increase and the elasticity of demand.
588. The estimated allocative efficiency losses are broken into the following components in Table 6.

**Table 6: Estimated allocative efficiency losses by category (NPV over 5 years)**

Estimated price increase	NPV, 5 years
5% to 15% price increase for scouring of wool for export	[ ]
5% to 25% price increase for scouring of wool for Godfrey Hirst	[ ]
10% price increase for wool grease to small customers	[ ]
<b>Total</b>	<b>\$2.19 million to \$15.03 million</b>

<sup>384</sup> See Attachment 6.

<sup>385</sup> See paragraph 58.

<sup>386</sup> Estimated pre-merger price-cost margins are approximately [ ] in the North Island and approximately [ ] in the South Island, based on estimated variable costs as a proxy for marginal costs. High margins are typically a sign of relatively inelastic demand and can indicate the exploitation of existing market power. However, to the extent that market power has already been exploited it may be that any further price increases may face relatively elastic demand. Consequently, these estimates use a range of elasticities.

<sup>387</sup> NERA submission, 9 March 2015.

<sup>388</sup> Ibid.

## Wealth transfers to and from non-New Zealanders from price increases

589. All transfers from merchants and farmers (whether domestically- or foreign-owned) to the New Zealand shareholders of CWH are treated as neutral; all transfers from merchants or farmers (whether domestically- or foreign-owned) to the foreign shareholders of CWH are treated as detriments. We discuss the reasons for this below.

### The case law on the treatment of wealth transfers

590. If the proposed transaction allows CWH to exercise market power by raising prices post-merger, it would, in addition to the associated allocative efficiency loss, result in a transfer of wealth from its customers to CWH. Where one group gains at the expense of another in this manner, the transfer of wealth is not generally included in the Commission's analysis of benefits and detriments. This is because there is typically no net impact to New Zealand from such a transfer.<sup>389</sup>

591. This applies even if such transfers comprise "functionless monopoly rents".<sup>390</sup> Functionless monopoly rents are those returns which are over and above those needed to incentivise efficient investment. They may arise from the exploitation of market power. These can be distinguished from "functional" returns to capital that are necessary to incentivise efficient investment.

592. However, an exception to the approach of ignoring such transfers is if one or more groups are non-New Zealanders. The Authorisation Guidelines state:<sup>391</sup>

Wealth transfers may become relevant where the transfer is between New Zealanders and non-New Zealanders. This is because the public benefit test focuses on benefits to New Zealanders. As a result, transfers of wealth from non-New Zealanders to New Zealanders may be a public benefit. Similarly, transfers of wealth in the opposite direction may be a public detriment.

However, in addition to considering the direct effects of wealth transfers, we also consider any effects on non-New Zealanders that may ultimately feedback to impact New Zealanders. For example, if a transaction would lead to a New Zealand firm charging higher prices to tourists, that would result in a transfer of wealth from those tourists to the New Zealand firm resulting in a public benefit. However, equally, those higher prices could lead to fewer tourists coming to New Zealand, which in the longer term could negatively affect New Zealanders.

593. As made clear by the *Air New Zealand/Qantas*<sup>392</sup> decision, not only does the nationality of those who receive the wealth transfer as a result of their exercise of market power matter, but so might the nationality of those who incur the price increase (in the case of *Air New Zealand/Qantas*, the foreign tourists). The implication of this in the case of wool scouring are that the nationality of both of the owners of CWH and of those purchasing wool scouring services (wool merchants) and/or those in related upstream or downstream markets (carpet manufacturers and wool growers) may be considered when determining how the wealth transfer is to be treated in the benefits and detriments analysis.

<sup>389</sup> This is distinct from allocative efficiency impacts described above, which relate to the lost consumer and producer surpluses arising from lower quantities of output bought and sold in the market.

<sup>390</sup> This is outlined in *Telecom* (HC) above n 255.

<sup>391</sup> *Authorisation Guidelines* above n 239 at [54] and [55].

<sup>392</sup> *Air New Zealand* above n 308.

594. This is not to say that all returns to non-New Zealanders from investments in New Zealand should be considered detrimental transfers of wealth to foreigners. New Zealand benefits to a large degree from the inflow of foreign capital.

### **The Commission's view**

595. The Commission's view is that any exploitation of market power by CWH to increase scouring prices above current levels, arising from a lessening of competition because of the transaction, would be likely to generate functionless monopoly rents. This is because current prices appear sufficient to incentivise investment into the market, at least to date.
596. Therefore, any increase in prices, particularly when coupled with a reduction in costs, is likely to result in functionless monopoly rents. These rents would consist only of that portion of CWH's returns that flow from an increase in prices above competitive levels.
597. This means that the Commission considers that any incremental transfer of wealth from New Zealanders (eg, New Zealand wool merchants, carpet manufacturers and wool growers) to the non-New Zealand shareholders of CWH that arises from an increase in scouring prices would constitute a detriment of the transaction.
598. In contrast, whether an incremental transfer to the New Zealand shareholders of CWH from non-New Zealanders (that is, foreign-owned wool merchants, overseas wool users and wool growers) constitutes a benefit to New Zealand depends on whether such a transfer would generate negative feedback effects. If there were no negative feedback effects, such a transfer would be a public benefit to New Zealand. However, it may be appropriate to treat such an impact as neutral if it were likely to generate negative feedback effects. This is because these feedback effects would offset the gain to New Zealand shareholders of CWH.
599. To determine the nature (benefit or detriment) of any wealth transfers, it is first necessary to determine the residency status of those who would receive the transfers, ie, CWH shareholders, as well as those who may incur the burden of any price increase. Possible feedback effects are next considered.
600. Should that step suggest that non-New Zealanders should be treated differently from New Zealanders in the consideration of wealth transfers, then a next step is to assess the economic incidence of a price increase, ie, determine who bears the ultimate financial burden of a price increase. A key element of this assessment is determining whether the immediate buyers of scouring services (merchants) would incur the full cost of a price increase, or whether, and to what extent, these merchants are able to pass this cost on to other parties. If such pass-through is likely, the residency of those parties must then be considered (in this case, the residency of the owners of sheep farms).
601. A further step is to consider the likely magnitude of any wealth transfers to or from non-New Zealanders as a result of a price rise.

*Residency status of relevant groups*

602. In determining benefits and detriments to the public of New Zealand, New Zealanders are considered to be those who are domiciled in New Zealand.<sup>393</sup>
603. On this basis, post-acquisition 55% of the shareholding of CWH would be held by Cavalier Bremworth, ACC and Direct Capital. The Commission understands that these are New Zealand resident companies with New Zealand resident shareholders and therefore has treated any increase in returns to these parties as a transfer to New Zealanders. And as discussed above, as a consequence of the Acquisition, 45% of CWH would be transferred to Lempriere. Lempriere is an Australian company which itself has some degree of ultimate ownership located in China.
604. The Commission understands that around 80% of scouring purchases are made by merchants who themselves are foreign-owned.<sup>394</sup> As well as NZWSI, which is owned by Lempriere, these merchants include Segard Masurel, Bloch & Behrens, J S Brooksbank, H Dawson, Fuhrmann, Curtis Wool Direct, Standard Wool, and others.
605. Although the Commission has not obtained detailed ownership statistics for sheep farms, it understands that around 1% to 2% of farms in New Zealand are foreign owned.<sup>395</sup>
606. The Commission has assumed that all offshore buyers of New Zealand's wool exports are non-New Zealanders. In addition, there are three main domestic buyers of clean wool, consisting of carpet manufacturers Cavalier Bremworth and Godfrey Hirst, and yarn spinner, New Zealand Yarns. The Commission understands that both Cavalier Bremworth and New Zealand Yarns are New Zealand-owned while Godfrey Hirst is Australian-owned.

*Economic incidence of price increases*

607. Any price increase by CWH would in the first instance be incurred by the buyers of scouring services, ie, merchants. However, the Commission considers that, over time, a substantial proportion of a price increase is likely to effectively be passed back upstream to wool growers in the form of lower farm-gate prices. The rationale for this position is outlined in the Competition Analysis section.<sup>396</sup>
608. In practice it is likely that at least some portion of scouring price increases would either be borne by (at least some) merchants in the form of lower profits or possibly passed onto some downstream wool users, particularly domestic wool users (see Competition Analysis section).
609. Although it is our view that, at least over time, the majority of any scouring price increases would be passed back upstream to growers, the Commission has not been able to estimate with precision the likely rate of this pass-through.<sup>397</sup> However, it is our view that the rate of pass-through does not have a material impact on overall wealth transfers. This is because the

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<sup>393</sup> *Authorisation Guidelines*, above n 239 at footnote 44 of those Guidelines.

<sup>394</sup> Cavalier submission, 22 December 2014.

<sup>395</sup> Telephone call with Overseas Investment Office (OIO), 24 March 2015. The OIO notes that because of various factors it is difficult to determine exact figures for foreign land ownership.

<sup>396</sup> The Commission also came to this position in Decision 725 at [233].

<sup>397</sup> The Commission's best estimate regarding the likely rate of average pass-through over time across all merchants that export wool is around 90%.

Commission considers transfers from merchants and farmers as detrimental, regardless of whether these businesses are domestically-owned or foreign-owned.

610. While increased prices to either foreign-owned merchants or foreign-owned farmers would transfer wealth from foreigners to the New Zealand shareholders of CWH, this transfer could generate negative feedback effects. In particular, reducing the return to these foreign owners of New Zealand-located businesses reduces the incentive for these owners to maintain their investment in New Zealand. This could ultimately lead to reduced inbound investment and a loss of the benefits that flow from such investment, including knowledge and technology transfers, improved links and potentially access to overseas markets, and a higher cost (and/or lower quantity) of capital.
611. Therefore, to allow for these potential negative feedback effects, the Commission's position is:
- 611.1 to treat all transfers from merchants and farmers that flow to the New Zealand shareholders of CWH as neutral. This is because the negative impacts to New Zealand arising from reduced returns for merchants and farmers, irrespective of ownership, are offset by the gains to the New Zealand shareholders of CWH; and
  - 611.2 to treat all transfers from merchants and farmers that flow to the foreign shareholders of CWH as detriments. This is because the negative impacts to New Zealand arising from reduced returns for merchants and farmers, irrespective of ownership, are not offset by the gains to the foreign shareholders of CWH.
612. Essentially, our approach in this case is to treat all domestically-resident parties affected by scouring price increases the same, regardless of the residency of these parties' ultimate ownership.

#### *Magnitude of wealth transfers*

613. The potential size of the total transfer to CWH has been estimated for different price increases (5% to 15% for wool destined for export and 5% to 25% for wool destined for Godfrey Hirst) and for different price elasticities (-0.5 to -1 for wool destined for export and -0.05 to -1 for wool destined for Godfrey Hirst).<sup>398</sup> The estimated total transfer ranges from \$1.9 million to \$5.1 million per year. The present value of these transfers over a five year period ranges from \$7.9 million to \$21.2 million.
614. Because these transfer estimates are gross pre-tax figures, the Commission has scaled down these figures by an assumed effective marginal tax rate on foreign shareholders of 28%.<sup>399</sup> This accounts for the fact that it is only the after-tax portion of these amounts that may be transferred to or from non-New Zealanders.

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<sup>398</sup> These estimates are based on a given level of pre-existing market power.

<sup>399</sup> This is based on the corporate tax rate.

Components of transfers

615. Figure 3 illustrates the wealth transfer from buyers (merchants) to producers (CWH) that arises from a price increase. This net wealth transfer received by CWH can be divided up into eight components, as indicated in Figure 4.

Figure 3: Wealth transfer from price increase

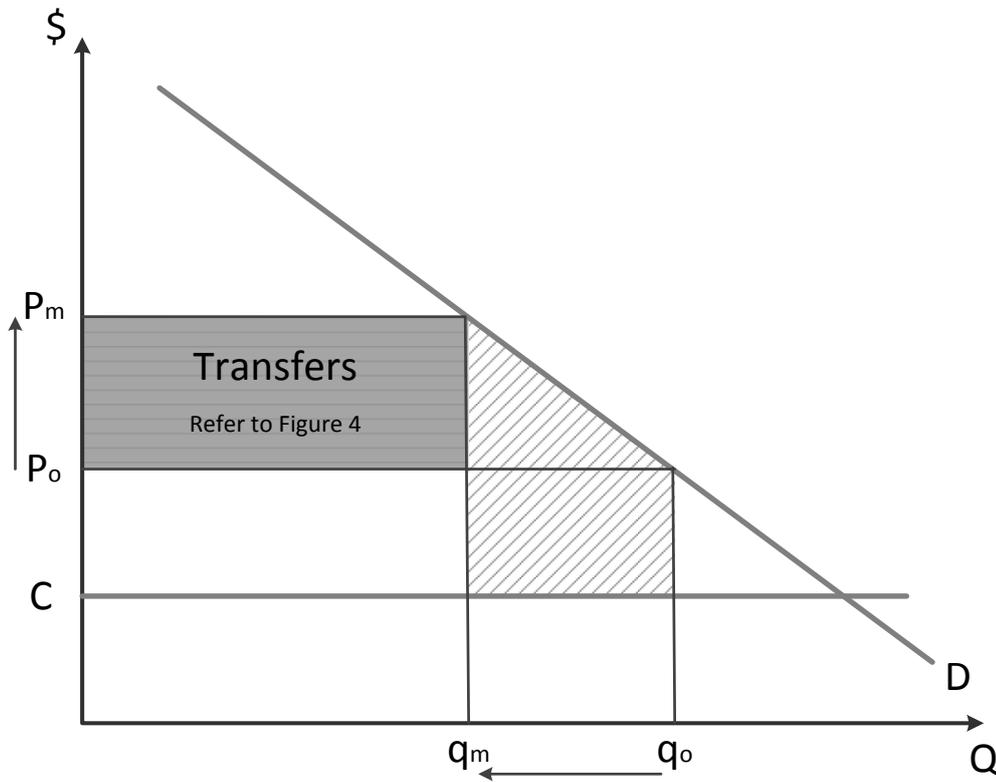
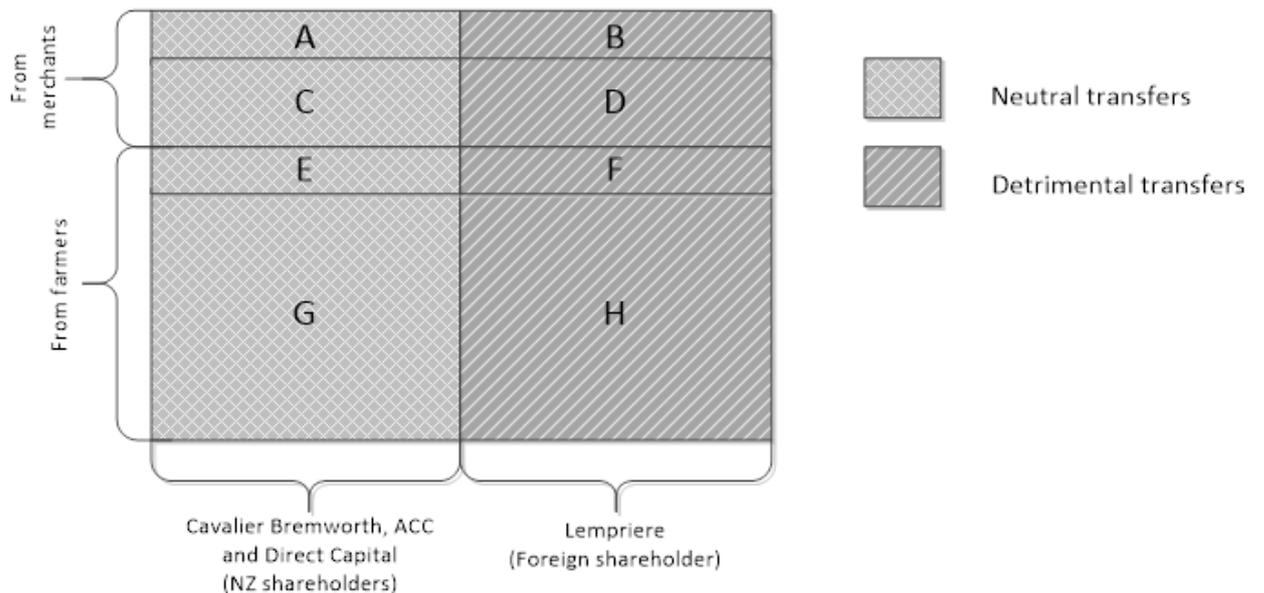


Figure 4: Components of wealth transfer



616. In Figure 4, segment A represents the transfer that arises from the approximately 20% of purchases that are made by New Zealand-owned merchants to the New Zealand shareholders of CWH (Cavalier Bremworth, ACC and Direct Capital). This does not have impact on the net public benefit to New Zealand because it is a 'neutral' transfer between New Zealanders. Segment B reflects the transfer from these same New Zealand merchants to the foreign shareholders of CWH, ie, Lempriere. This is a detrimental wealth transfer from New Zealanders to foreigners.
617. Segment C represents a transfer to New Zealand shareholders of CWH from foreign-owned merchants. The Commission considers that this transfer should be treated as neutral. As outlined above, this is because increased prices incurred by domestic firms that are foreign owned, whilst consisting of a transfer of wealth from foreigners to New Zealand, could generate negative feedback effects that are detrimental to New Zealand.<sup>400</sup>
618. Segment D represents a transfer from foreign-owned merchants to foreign shareholders of CWH. The Commission's view is that this should be treated as a detriment. As outlined above, the Commission's view is that the reduction in returns to local merchants that are foreign-owned could have negative feedback effects. This detrimental impact to New Zealand is not offset by the gain to foreign shareholders of CWH.
619. Segment E represent the transfer from the approximately 2% of farms that are foreign owned to the New Zealand shareholders of CWH. The Commission considers that these transfers should be treated as neutral. The Commission's view is that the reduction in returns to farms that are foreign-owned could have negative feedback effects. However, this detrimental impact to New Zealand is offset by the gain to New Zealand shareholders of CWH.
620. Segment F represents a transfer from foreign-owned farms to the foreign shareholders of CWH. The Commission considers that these transfers should be treated as a detriment. The Commission's view is that the reduction in returns to farms that are foreign-owned could have negative feedback effects. This detrimental impact to New Zealand is not offset by the gain to foreign shareholders of CWH.
621. Segment G represents transfers from New Zealand farmers to the New Zealand shareholders. This does not impact on the net public benefit because it is a neutral transfer from one group of New Zealanders to another. Segment H is a transfer from New Zealand farmers to the foreign shareholders of CWH, and therefore constitutes a detriment.
622. Together, segments A, B, C and D represent the total transfer from merchants to CWH. Segments E, F, G and H represent the total transfer from growers to CWH. Total wealth transfer detriments are represented by segments B, D, F and H, which are returns to the foreign shareholders of CWH. Total neutral transfers are represented by segments A, C, E and G, which are returns to the New Zealand shareholders of CWH.

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<sup>400</sup> An example of this is given in the *Authorisation Guidelines*, above n 239 at [55]. A transaction that led to higher prices to tourists may generate beneficial wealth transfers to New Zealanders. However, higher prices may also lead to fewer tourists visiting New Zealand, which could be detrimental.

## Conclusion

623. In summary, we have treated all transfers from merchants and farmers (whether domestically- or foreign-owned) to the New Zealand shareholders of CWH as neutral; all transfers from merchants or farmers (whether domestically- or foreign-owned) to the foreign shareholders of CWH are treated as detriments.
624. Based on these ownership splits, and the range of elasticities considered likely, the Commission calculates that the maximum net wealth transfer to non-New Zealanders ranges from \$0.61 million to \$1.65 million per year. The corresponding present value of the estimated detriment over a five year period ranges from \$2.56 million to \$6.87 million.

## Balancing of benefits and detriments

625. This application involves a balancing of the public benefits and detriments which will, or will be likely to result, from the Acquisition. Only when there is such a benefit can the Commission be satisfied that the Acquisition should be permitted and that it should grant an authorisation for the Acquisition.
626. Tables 7 and 8 summarise the Commission's quantitative assessment of the detriments and benefits arising from the Acquisition.

**Table 7: Summary of detriments**

<b>Category</b>	<b>Evaluation</b>	<b>5-year NPV</b>
Allocative efficiency	\$0.53 million to \$3.60 million per year	\$2.19 - \$15.03 million
Productive efficiency	[                    ]	[                    ]
Dynamic efficiency	[                    ]	[                    ]
Net wealth transfers	\$0.61 million to \$1.65 million per year	\$2.56 - \$6.87 million
<b>Total of quantified detriments</b>		<b>\$4.75 – 23.98 million*</b>

\* The maximum estimated allocative efficiency detriment arises from an elasticity of -1.0 whereas the maximum wealth transfer detriment arises from an elasticity of -0.5. The opposite is true for minimum estimates. Therefore maximum and minimum total quantified detriments sums to different values than the maximum and minimum of individual detriment ranges.

**Table 8: Summary of benefits**

Category	Evaluation	5-year NPV
Reduction in Production and Administration Costs	On-going benefits	[ ]
Sale of land and plant**	One-off benefit	[ ]
Capital expenditure buildings	One-off cost	[ ]
Capital expenditure on plant	[ ]	[ ]
One-off Rationalisation Costs	One-off cost	[ ]
Cartage to North Island	[ ]	[ ]
<b>Total of quantified benefits</b>		<b>\$24.79 - \$28.17 million*</b>

\* Figures have been rounded to two decimal places after calculations have been made and therefore all columns may not sum.

\*\* As discussed above at paragraphs 455 to 464, we consider that absent the merger, there is a real chance that Cavalier would close or sell the Clive site in the near future. Therefore, we have not included a value for the Clive site, or the cost savings arising from its sale in our analysis of the benefits arising from the Acquisition.

627. The Commission has also considered the likely magnitude of the benefits and detriments over a longer timeframe to gauge the sensitivity of the findings to the period considered. The results of this are included in Table 9.

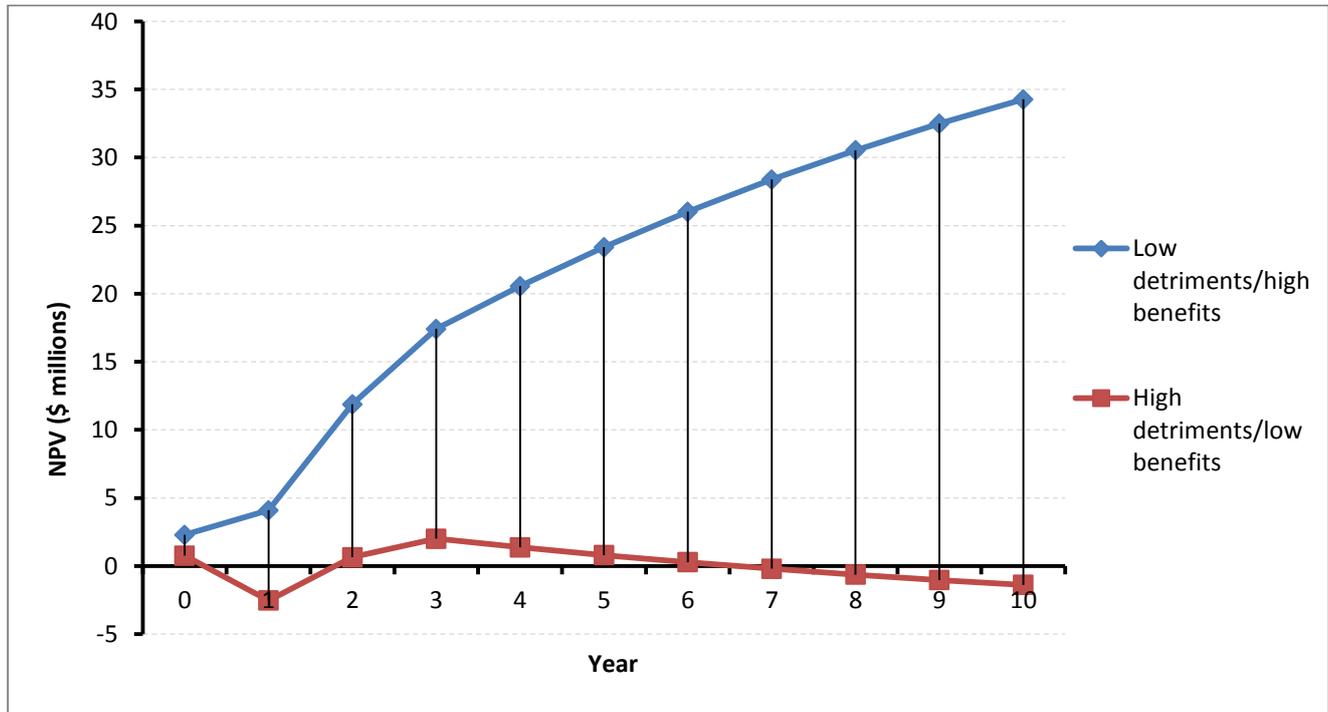
**Table 9: Estimated net impact (5-year NPV)**

Time frame	Overall net impact	
	High detriments / low benefits	Low detriments / high benefits
<b>5 years</b>	\$0.81 million	\$23.42 million
<b>10 years</b>	-\$1.37 million	\$34.27 million

628. Under the high detriment/low benefit scenario (ie, taking into account the greatest efficiency detriments and the lowest efficiency benefits), the estimated net impact of the transaction is positive in the five year time frame but negative over 10 years (see Table 8).
629. As can be seen from Table 9, while the estimated net impact of the transaction is positive in a five year time frame, ranging from \$0.81 million to \$23.42 million, the total quantified range of our estimated overall net public benefit over 10 years spans from minus \$1.37 million to a positive \$34.27 million. The bottom of these ranges is based on the value of each benefit being the lowest likely value and the value of each potential detriment being the highest likely value.

630. The estimated net impact of the transaction is reflected in Figure 5 below. The red line represents the quantified net public benefit of the transaction at any point in time up to 10 years assuming the lowest likely value of benefits and the highest likely value of detriments. The blue line represents the quantified net public benefit of the transaction at any point in time up to 10 years assuming the highest likely value of benefits and the lowest likely value of detriments.

**Figure 5: Net public benefit, NPV \$**



631. Godfrey Hirst submitted that in this scenario where the values span both negative and positive values, the Commission should decline to grant authorisation.<sup>401</sup>
632. We do not agree that a negative value or values determines that the outcome of the application is necessarily a decline decision.
- 632.1 The statutory test requires us to be satisfied that the Acquisition will result in, or will be likely to result in, such a benefit to the public that it should be permitted.
- 632.2 The Commission is required to exercise its specialist judgement in considering whether there is such a benefit to the public, and it is not permitted to move directly from a quantitative analysis to a finding of satisfaction without exercising its judgement on the application in the round.<sup>402</sup>
633. The Commission considers here that the red-line scenario is not determinative of the likely benefits and detriments of the acquisition. The red-line and blue-line are each predicated on assumptions as to what we consider to be likely effects arising from the acquisition. However, we consider that there is only a remote possibility that the values would align in such a way

<sup>401</sup> Godfrey Hirst submission, 15 October 2015 at [185] – [186].

<sup>402</sup> *Godfrey Hirst* above n 27 at [115] – [117].

that, over the 10-year timeframe, the extremities near the lower-bounds and upper bounds would be realised.

634. We consider that it is reasonable to reach this view because in order for the lowest overall net benefit scenario to eventuate the following would need to take place:
- 634.1 the largest estimated price increase would need to occur immediately after the merger;
  - 634.2 an elasticity of demand would need to be at the highest end of the range (ie, -1);
  - 634.3 all the assets would need to be sold at the low end of their estimated ranges;
  - 634.4 productive efficiency detriments would need to be at the top of the estimated likely range; and
  - 634.5 dynamic efficiency detriments would need to be at the top of the estimated likely range.
635. Conversely, if any price increase was not immediate and instead phased in over, say, three years this would increase the overall net public benefit under the high detriment/low benefit assumptions by approximately \$4 million.<sup>403</sup> Similarly, if [ ], this would add \$[ ] to overall net public benefit under the high detriment/low benefit assumptions.
636. Therefore, although the ranges span both negative and positive values, we are satisfied that the benefits are likely to exceed the detriments.

### Qualitative assessment

637. As the Courts have advised, a purely quantitative assessment is not sufficient.<sup>404</sup> The Commission acknowledges that quantification is only one tool to be used in reaching its view in such a case. The Commission is required to exercise its judgement (also referred to as making a qualitative assessment) as to whether it is satisfied on the evidence before it that the acquisition will result, or will be likely to result, in such a benefit to the public that the acquisition should be permitted.<sup>405</sup>
638. In the section above, Quantifying the Benefits and Detriments, we observe that there is a net detriment in year one in the high detriment/low benefit scenario. This reflects the up-front costs that maybe incurred through CWH implementing the transaction. But we do not consider this figure in isolation from subsequent years, because we are considering the overall public benefit that is likely to arise from the transaction.

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<sup>403</sup> See NERA submission, 15 October 2015.

<sup>404</sup> *Godfrey Hirst* above n 27 at [115] to [117].

<sup>405</sup> Section 67(3)(b); and note *Godfrey Hirst* above n 27 at [115] and *Ravensdown Corporation* above n 230 at 61 where the Court noted that "...it was legitimate for the Commissioners to stand back and notice that Ravensdown would be largely free from competitive restraint in the South Island markets and bring that consideration to account as part of the balancing exercise".

639. Our assessment of the acquisition must also take future years into account to allow for the realisation of likely future benefits and detriments.<sup>406</sup> Over the 10 year period, we observe that there may be a negative impact of minus \$1.37 million. But we note above at paragraph 386.1 that that prediction becomes less certain the further out we look; beyond five years it is difficult to confidently forecast the effects of the acquisition, so we attach less weighting to the benefit and detriment values beyond five years.<sup>407</sup>
640. Finally, on the predicted benefits and detriments, we restate our view in paragraph 633 above that we consider it a remote possibility that the values will align so as to produce the red-line and blue-line outcomes over time.
641. We turn also to consider other factors apparent from the evidence regarding New Zealand's wool scouring industry, and the likely constraints that CWH would face post-merger.
642. The wool scouring industry is a declining industry in New Zealand. The industry has for some time been characterised by rationalisation in the face of a declining wool clip and increasing greasy wool exports to China. Many merchants expressed a view that continued rationalisation in the sector is inevitable. Some merchants also stated that the merger is necessary to ensure a viable wool scouring industry in New Zealand and pointed to the loss of the Australian wool scouring industry to China.
643. We also acknowledge that the wool scouring industry in Asia poses a significant long term competitive constraint on the domestic industry in New Zealand. The rationalisation of New Zealand's wool scouring industry would improve the industry's ability to compete with China's low cost scouring services.
644. While our Competition Analysis assumes that CWH will be in a position to increase prices, those price rises may be lower than the upper bounds and/or are likely to be imposed in incremental steps. These incremental price increases have the likely effect – compared to a 'big bang' price increase – of reducing the detrimental effects of the acquisition, and of increasing the benefits of it, taking the likely effects of the acquisition up and away from the indicated red-line. The potential allocative efficiency losses would be reduced to a material extent through these stepped price increases.
645. The external pressures of the forecast decline in the wool clip, and the continual threat of increased greasy wool exports, are also likely to place pressure on the merged entity to maintain its efficiency efforts. CWH's shareholders will have the incentive to continue to drive productive efficiencies.
646. In addition, while wool scouring is not an industry characterised by rapid change and dynamism, such as fast-moving technological innovation, these external pressures would also ensure that the merged entity is incentivised to improve and maintain dynamic efficiency.

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<sup>406</sup> As discussed by the High Court in *Telecom* above n 255 "...we reject an approach that would seek to take into account only concrete predictions regarding specific conduct of particular firms: our predictions may well be of market propensities."

<sup>407</sup> Re Carter Holt Harvey Ltd/Elders Resources NZFP Ltd (1990) 2 NZBLC (Com) 104,549, 104,555-6.

### Conclusion

647. Taking these factors into account, in our qualitative judgement we are satisfied that the acquisition will result, or will be likely to result, in such a benefit to the public that it should be permitted.

### The Commission must be satisfied

648. As set out in the Competition Analysis section above, the Commission is not satisfied that the Acquisition will not have, or would not be likely to have, the effect of substantially lessening competition in a market. This is on the basis that we consider that:
- 648.1 NZWSI's commission scouring business currently constrains Cavalier in respect of wool scouring;
  - 648.2 post-merger, CWH would be able to increase prices by up to 20% before the threat of entry would be likely to provide a competitive constraint; and
  - 648.3 while greasy exports would provide some price constraint post-merger, we consider that the maximum likely price increase could be between 5% and 15% for wool destined for export, between 5% and 25% for wool destined for Godfrey Hirst, and 10% for wool grease for small domestic customers.
649. However, the Commission shall authorise the application under section 67(3)(b) of the Act if it is satisfied that the Acquisition will result, or will be likely to result, in such a benefit to the public that it should be permitted.
650. In this case, as can be seen from Table 9 above, the benefits outweigh the detriments in the five year timeframe by between \$0.81 million (using high detriment assumptions) and \$23.42 million (using low detriment assumptions) in an industry with annual turnover in the vicinity of \$60 million to \$80 million.
651. In weighing the benefits and detriments, we have considered the evidence and tested the assumptions that underpin the quantitative analysis.
652. We have allowed for uncertainties in our quantification exercise, such as considering different timeframes for quantifying the likely effects of the acquisition, and our choice of the upper bounds in the likely ranges for allocative inefficiencies and net wealth transfers. We have also allowed for concerns over the quality of the evidence before the Commission.<sup>408</sup>
653. As Justice Mallon noted in *Godfrey Hirst* the size of the margin between the net public benefits and the detriments may not matter, providing allowance has been made for uncertainties in the analysis:<sup>409</sup>

The size of the margin between the net public benefits and the detriments may not matter, providing allowance has been made for uncertainties in the analysis. For example, the uncertainties may have led the Commission to take an upper point in a range for an efficiency loss and to have carried that point through to the balancing of benefits and detriments. If so, it would be wrong to then effectively double

<sup>408</sup> *Godfrey Hirst* above n 27 at [327].

<sup>409</sup> *Ibid* at [116].

count this uncertainty in the balancing exercise. Or, as a further example, the quality of the information relied on may be such that the Commission is satisfied with the robustness of the analysis. Where, however, the net public benefits and detriments are finely balanced it will be particularly important for the Commission to set out its reasons for being satisfied that these are “such” benefits to the public that the proposed acquisition should be permitted.

654. Finally, we have applied our specialist judgement to assessing the application in the round, in the industry context which is being considered.
655. Therefore, the Commission is satisfied on the evidence it has considered that the acquisition is likely to result in such a benefit to the public that it should be authorised.

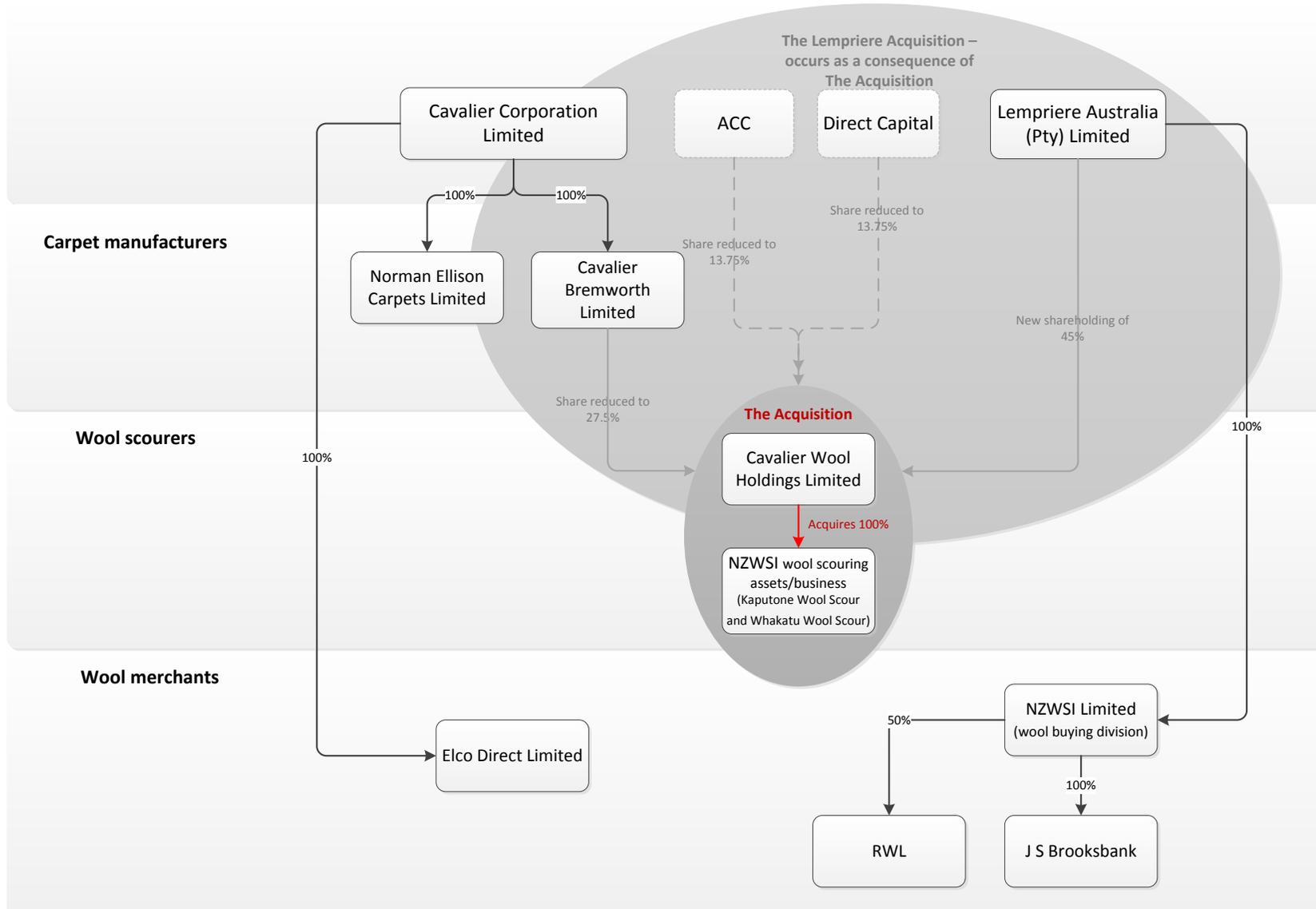
## **Determination**

656. The Commission's view is that it is not satisfied that the Acquisition will not have, or would not be likely to have the effect of substantially lessening competition in the markets for the supply of wool scouring services or the small domestic customer wool grease market.
657. The Commission's view is that it is satisfied that the Acquisition will result, or will be likely to result, in such a benefit to the public that it should be permitted.
658. Therefore, the Commerce Commission grants authorisation for the Acquisition under section 67(3)(b) of the Commerce Act 1986.

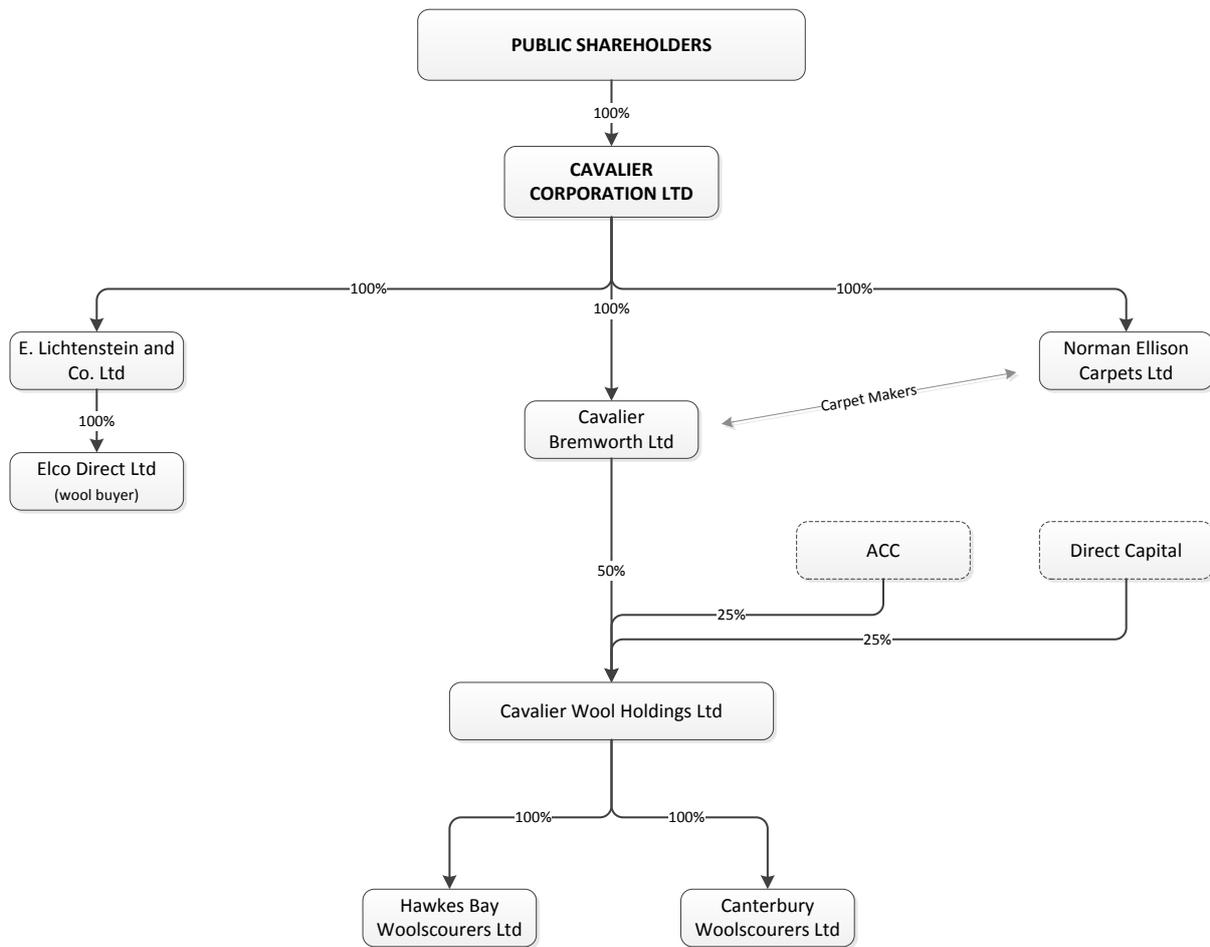
Signed on this 12<sup>th</sup> day of November 2015

Dr Mark Berry  
Chairman

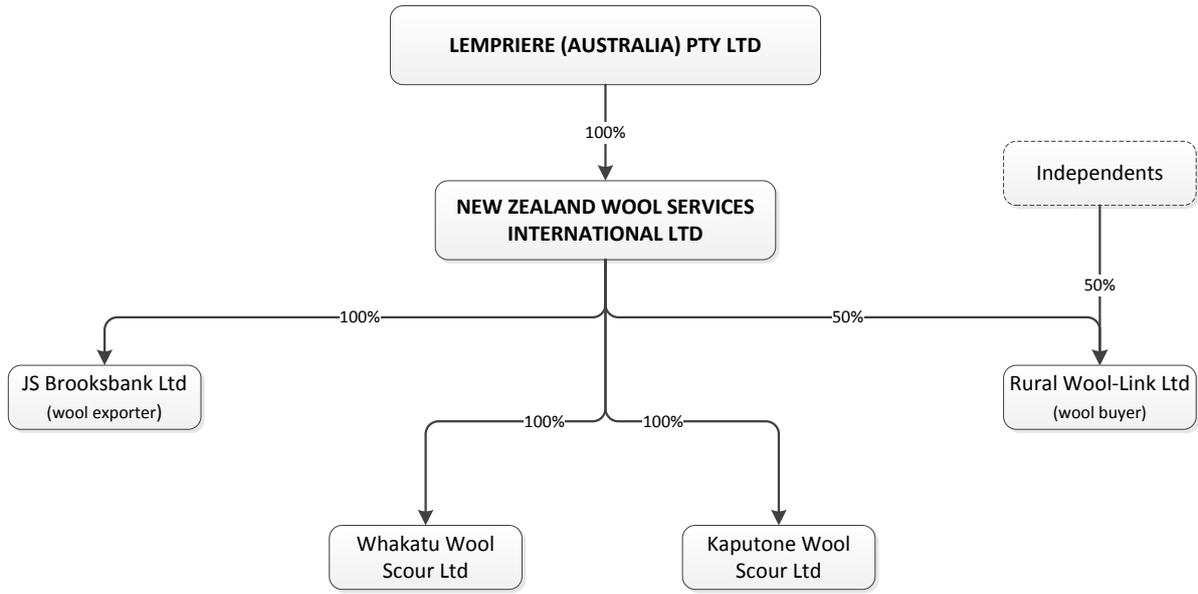
# Attachment 1 – Post transaction structure



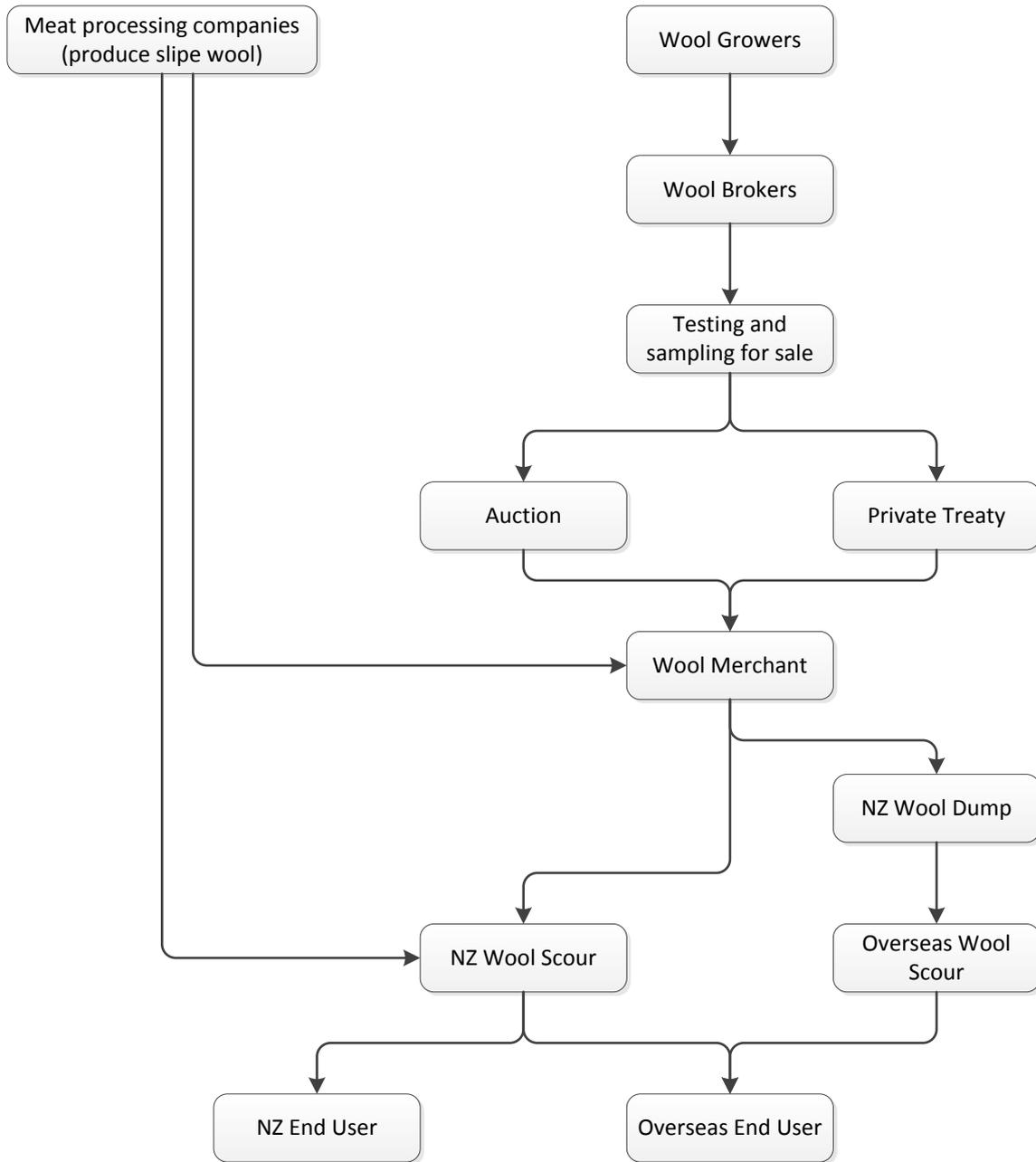
## Attachment 2 – Ownership and subsidiaries of Cavalier



**Attachment 3 – Ownership and subsidiaries of NZWSI**

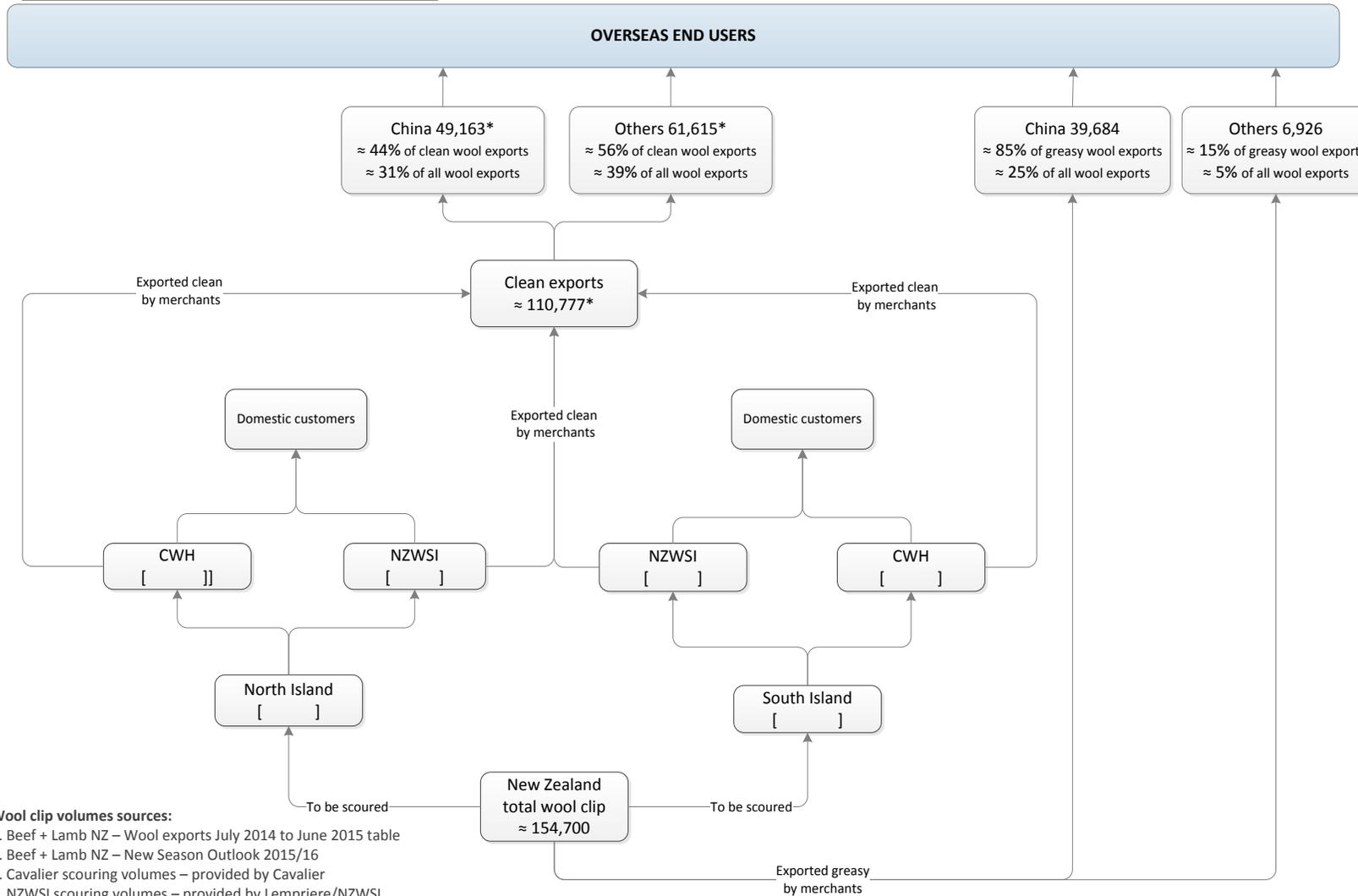


**Attachment 4 – Functional levels in the movement of wool**



# Attachment 5 – Estimated wool flows 2015

Estimated wool flows – greasy kg (000) 2014/2015



**Wool clip volumes sources:**

- 1. Beef + Lamb NZ – Wool exports July 2014 to June 2015 table
  - 2. Beef + Lamb NZ – New Season Outlook 2015/16
  - 3. Cavalier scouring volumes – provided by Cavalier
  - 4. NZWSI scouring volumes – provided by Lempriere/NZWSI
- \*Clean scoured kg have been converted into greasy kg (000) by using a 0.75 conversion rate.

**Note:** Confidential information in square brackets and red font.

## Attachment 6 – Supply of greasy wool by growers

1. Wool supply is a function of the size of New Zealand's sheep flock. In turn, flock size is influenced not only by wool prices but also by sheep meat prices and the prices of production obtainable from alternative use of farm land such as beef, dairying or forestry.
2. In Decision 725 the Commission noted that wool provides about 18% of farmers' sheep alone revenue.<sup>410</sup> This remains consistent with Beef + Lamb New Zealand's Sheep and Beef Farm Revenue and Expenditure calculations.<sup>411</sup> This suggests that farmers make their sheep stocking decisions on parameters other than just their returns from wool sales.
3. Further, it is unlikely that farmers' sheep stocking decisions would be materially affected by an increase in wool scouring prices of up to 15%. Wool scouring services account for only about 8% of the current value of wool. It is, therefore, unlikely that a 15% change in the price of wool scouring services by itself would have a significant influence on the total amount of wool available for sale at the farm gate, even if depressed farm gate prices.
4. A 15% increase in scouring prices would be relatively small in comparison to farm-gate prices for greasy wool.<sup>412</sup> Such an increase, if passed-through, would represent a \$[ ] per kilogram reduction in farm-gate prices. In comparison farm-gate prices for greasy wool typically range from around \$3 per kilogram for strong wool and up to \$10 per kilogram for fine wool.<sup>413</sup> Therefore, a \$0.05 change in scouring prices could affect prices for strong wool at the farm-gate by less than 2% and is unlikely to elicit a substantial supply response.
5. To put this in perspective, farm-gate prices are largely determined under an auction system and are often prone to relatively large fluctuations, whether because of changes in global demand and supply conditions or changes in exchange rates. For example, average annual auction prices for strong wool fell by almost 25% from \$4.21/kg at June 2012 to \$3.17/kg at June 2013.<sup>414</sup> These prices are estimated to then have increased by over 20% to \$3.84/kg over the following 12 months to June 2014.
6. There is little evidence that there is likely to be a substantial supply response from growers in relation to a \$0.05/kg price reduction. Some growers may reduce the level of shearing they undertake if farm-gate prices fall too low to compensate them for shearing costs, but at prices above this level, shearing activity is likely to be unaffected. A change of this magnitude therefore is unlikely to be the determining factor in whether a significant proportion of growers reduce their shearing activity.
7. Additionally, while some sheep farms are able to convert to other forms of farming such as dairy, many are not suitable for conversion because of the hilly terrain upon which many sheep farms are located. More sheep farms may be able to be converted to forestry, but given the long-term pay-off periods required for forestry investments, the Commission

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<sup>410</sup> Ministry of Agriculture and Forestry, Farm Monitoring Report 2010.

<sup>411</sup> Beef + Lamb New Zealand, New Season Outlook 2014/15.

<sup>412</sup> The Commission has not considered the impact of price increases larger than 15% because at this level the threat of greater greasy exports is likely to limit pricing.

<sup>413</sup> Beef + Lamb New Zealand Economic Service, Mid-Season Update 2013-14.

<sup>414</sup> Ibid.

considers that a change in farm-gate prices of \$[ ] per kilogram is unlikely to be a deciding factor in such decisions.

8. The Commission also understands that, as is common across many agricultural commodity markets, farm-gate wool prices closely follow clean wool prices in downstream export markets.<sup>415</sup> This means that changes in prices in export market markets are typically passed back up the supply chain by merchants to wool growers.
9. The result of the relatively inelastic supply of greasy wool at the farm gate over the likely range of price increases combined with the reduction in the amount merchants would be willing to bid for a large share of greasy wool at the farm-gate means that the Commission considers that the majority of a scouring price increase would ultimately be passed through to growers. The Commission also considers that farmers are unlikely to further pass on any losses they make to other parties, eg, suppliers of farming inputs, to any significant extent.

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<sup>415</sup> [ ].