

MEMORANDUM

BELL GULLY

TO **Mya Nguyen**
OF Commerce Commission

FROM **Phil Taylor / Penny Pasley**
PARTNER Haydn Wong

BY EMAIL

MATTER NO. 400-4888

DATE 21 April 2015

Submission on Draft Determination

1. Summary

1.1 Having reviewed the Commerce Commission's Draft Determination on CWH's application for authorisation,¹ CWH considers the Commission to have produced a well-reasoned and considered determination. However, CWH notes a small number of issues require correction, clarification or expansion, some of which CWH addresses in this submission and others of which are addressed by NERA in its attached report (**NERA April Report**). CWH also addresses the submission from Godfrey Hirst requesting a conference.

2. Unquantified benefit of the retention of a sustainable New Zealand wool scouring industry

2.1 In its application for authorisation, CWH claimed the retention of a sustainable New Zealand wool scouring industry as an unquantified benefit of the merger that should be taken into account by the Commission. While the Commission recognised in its Draft Determination that the loss of other countries' wool scouring industries (such as Australia and the United Kingdom) would be front of mind for wool scourers,² it did not explicitly take the next step with the recognition that if the merger did not go ahead, the risk of material damage to or gradual loss of the industry in New Zealand would be materially increased.

2.2 While the size of the New Zealand wool clip has decreased since 2011, the percentage of that wool clip exported to China has increased, resulting in the greasy wool available for scouring in New Zealand reducing. In the period since Commerce Commission Decision 725, New Zealand sheep numbers have dropped by close to three million sheep (from 32.6 to 29.8 million). As the Commission has said in its Draft Determination, Beef + Lamb New Zealand expects this trend to continue, estimating that the total flock number will drop to around 26-28 million sheep over a five year period (with a total decline of between 6% to 13% over the period).³

2.3 CWH agrees with Beef + Lamb's estimates, and notes that 120 sheep farms have already been identified to be converted to dairy. It is generally accepted that for every new dairy farm, another farm will be required as a dairy support farm, meaning it is likely 240 sheep farms will be converted for the use of the dairy industry in the next few years. CWH calculates the loss of these farms alone will decrease sheep numbers by 1,050,240 sheep (or 5,566,272 greasy kgs),⁴ without considering conversions of sheep farms to other uses

¹ Cavalier Wool Holdings Limited and New Zealand Wool Services International Limited, Commerce Commission Draft Determination, 26 March 2015 (**Draft Determination**).

² Draft Determination at [159]-[162].

³ Draft Determination at [68], referencing an interview with Beef + Lamb New Zealand on 24 November 2014.

⁴ Land Information New Zealand calculates 1,094 acres for an average specialised sheep farm. With 4 to 5 animals per acre depending on farm type, there is approximately 4376 sheep on each of the farms, with approximately 5.3 greasy kilograms per head (including slipe etc.).

(such as urbanisation, crops or forestry), farms that will be converted to dairy within the next five years that have not been currently identified, or other means by which total wool clip decreases (such as the favouring of better quality meat animals over high wool yielding sheep). Given the history of the wool industry in New Zealand over the past three and a half decades there is every reason to believe that this downward trend in the wool clip will continue.

- 2.4 With a continuing decline in sheep numbers, a decline in the wool clip available to be scoured in New Zealand, along with the expanding and upgrading of the wool scouring industry in China and Malaysia, there is an increasing threat to wool scouring in New Zealand. As a result, both CWH and NZWSI have concerns for the long term viability of the wool scouring industry in New Zealand unless steps are taken now to create a sustainable industry.
- 2.5 Wool scouring is an industry which depends on volume efficiencies to keep prices competitive. As available scouring volumes reduce, firms must increase prices to cover costs, or if they cannot increase prices due to the threat from increasing greasy exports (as has been the case in the respect of the New Zealand industry, see NERA April Report at 2.4.3) their businesses will be unsustainable. It was a combination of those outcomes that destroyed the Australian and United Kingdom scouring industries (among others) and it is what will ultimately destroy the New Zealand industry unless appropriate steps are taken.
- 2.6 The demise of the Australian scouring industry began with a slow decline in wool clip and in volume scoured in Australia as greasy exports to China grew. Once volumes reached a tipping point the rate of that decline accelerated rapidly as volume efficiencies were lost in Australia, until the final demise arrived comparatively quickly. In 1996/7 23.3% of Australia's total wool exports were to China, increasing to 42% in 2001/2, 67.1% in 2006/7, 78.1% in 2009/10 and 75.1% in 2010/11, with Chinese buyers increasingly requiring wool in greasy form (by 2010/11 of the total 75.1% of wool sent to China, 99% was in greasy rather than scoured form, i.e. 74.3% of the total Australian wool clip was being scoured in China).⁵ Today, 87% of Australia's total wool exports are in greasy form, with 13% only in processed form (based on clean equivalent weights).⁶
- 2.7 While Australia supplies predominantly fine wool, it does not mean the example is not applicable to New Zealand's coarse wool. 33,994 tonnes of coarse wool are already going to China in greasy form (out of a total 38,801 tonnes exported to China greasy for the year ending 30 June 2014⁷). There is absolutely no reason to believe these volumes will not continue or in fact grow, just as China's scouring of fine wool from Australia started off relatively small and grew to the majority of Australian grown wool. While China historically focussed on fine wool, it is increasingly utilising coarse wool. The Commission has recognised in its Draft Determination that excess capacity exists in China and Malaysia⁸ and as James Irvine stated, Compass Wool Scours in Malaysia can easily switch between scouring fine and coarse wool, which is likely to be the case for Chinese lines too.⁹ As displayed in Figure 1 of the Draft Determination at paragraph 149, the proportion of coarse wool sent to China has consistently increased since 2005/06. It can be expected that the same process that played out with Australian fine wool will occur in New Zealand as the

⁵ Submission from the Australian Council of Wool Exporters & Processors Inc to Inquiry into a more competitive Victorian Manufacturing Industry, 2011: <http://www.vcec.vic.gov.au/files/3ed324b5-c8df-458b-ac23-a37000e9f3ca/DR52-Australian-Council-of-Wool-Exporters-and-Processors.pdf>.

⁶ The rolling 12 months to February 2015. The 13% exported in processed form comprises 7% scoured and 7% carbonised wool (an extra process required for wool that is contaminated with very high vegetable matter). Australian Wool Exchange Limited, Australian Wool Exports Snapshot, July 2014 to February 2015.

⁷ Beef + Lamb New Zealand Wool Export Data July 2013 to June 2014.

⁸ Draft Determination at [156].

⁹ Draft Determination at [152].

growing Chinese middle class increases demand for coarse wool products, such as wool rich carpets, interior textiles, clothing, blankets and uniforms.

- 2.8 The driver of the proposed merger in New Zealand is not to gain monopoly rents, but a defence of the industry by gaining volume efficiencies in the face of the declining wool clip and increasing greasy exports. If volume efficiencies cannot be maintained there will be an inevitable and increasing loss of volumes to China and now Malaysia. As New Zealand scouring becomes more expensive compared to China, merchants will increase greasy exports (as the Commission has pointed out [REDACTED]¹⁰) which will exacerbate the problem. As in other countries (Australia in particular) the process will continue until there is little or no wool scouring in New Zealand. One of the most vital benefits to New Zealand therefore is not necessarily the quantifiable synergistic benefits arising from the merger, but that by gaining those synergistic benefits, it puts aside the risk of the scouring industry ceasing to be economically sustainable and protects the ability of New Zealand scouring to compete with Chinese and Malaysian scours.

3. Other unquantified benefits

- 3.1 The merger will provide a base from which the merged entity can diversify its processes to add increased value, for example adopting an additional step of further refining wool grease into lanolin and the implementation of the wool super store concept (as set out in CWH's application for authorisation).

4. James Irvine's views and new entry

James Irvine's views

- 4.1 CWH considers that James Irvine is a talented engineer and machinery manufacturer, but considers that he lacks experience in the operation of a wool scour, and has only limited knowledge of the various costs and revenues involved. CWH has not viewed his entry model and is unable to therefore test the accuracy of his calculations, but makes the following points regarding his conclusions that a "price increase of around 20% above current prices would allow for profitable entry".¹¹

- (a) CWH considers that James is unlikely to fully comprehend the nuances of revenues involved given he has no experience of scouring tariffs or access to long term scour pricing schedules. In particular, CWH considers he is unlikely to have factored in the income a scour can receive from related areas, such as woolpacks, core testing, selling of waste etc. CWH believes in all likelihood he has also underestimated revenue from wool grease. CWH assumes James has based his calculations on wool grease at USD3.00 with a \$0.80 exchange rate as those are the calculations which the Commission has noted at footnote 83 of its Draft Determination. The current wool grease price is USD[REDACTED] with a \$0.75 exchange rate. The earlier drop in world wool grease price which appears to have misled the Commission's estimation of wool grease value was due to a disease that hit Asian fish farms in 2011/12. This disease caused a build-up in wool grease stocks and, as a consequence, resulted in lower prices. At the same time several large refiners stopped production to upgrade and modernise their equipment. Since then the wool grease market has been in a recovery phase and is returning to normal – see the Confidential Annexure to this submission which sets out CWH's recent wool grease contract prices in US Dollars. This graph shows a recent [REDACTED] in wool grease prices resulting in CWH's current contract price of USD[REDACTED], which CWH expects to [REDACTED].

¹⁰ Draft Determination at [REDACTED].

¹¹ Draft Determination at [193].

The demand and growth in D3 products will ensure that wool grease prices remain firm into the future.

- (b) CWH also considers James is unlikely to fully understand the overhead structure and costs involved. It notes steam and coal costs can vary between the islands. It is possible James' modelling is either solely in relation to entry in one island, or has somehow averaged the costs involved.

New entry

- 4.2 The more merchants working together to cause new entry, the more CWH's costs will increase due to the loss of throughput. This would have the associated effect of further raising CWH's scouring price, making it less able to compete with the new entrant – again why it would be counterintuitive for CWH to enter into the merger in order to gain cost synergies and then raise prices and encourage increased volumes exported greasy and new entry which would result in the loss of those synergies.

5. Ten year sensitivity test

- 5.1 In its application for authorisation CWH assessed merger effects over a five year period recognising that while some benefits and detriments may occur beyond this time period, most benefits and detriments become increasingly less certain over time. While the Commission acknowledged in its Draft Determination that it is difficult to forecast the effects of the proposed acquisition beyond five years,¹² it also undertook sensitivity testing with a ten year timeframe. CWH submits that the Commission's focus should remain on the five year time period to assess the merger effects, as beyond this time period it is increasingly less certain the identified benefits and detriments will in fact occur. While in the merger scenario most of the synergetic benefits are locked in permanently, the level of detriment is determined only as a mathematical proxy which will continue to be constrained (perhaps increasingly) by the threat from China.
- 5.2 The Commission has consistently recognised the uncertainty of assessing benefits and detriments beyond a five year time period. For example, in Decision 511 the Commission stated that "benefits and detriments may extend beyond a five year period, but considers that projections beyond this time horizon are too uncertain to be of any value."¹³ This is because market conditions, market structure and other relevant facts and competitive dynamics change over time. For example, even in the four year period between the current application before the Commission and Decision 725, a number of changes in the wool scouring industry have occurred. In Decision 725 the Commission considered Godfrey Hirst to be a potential entrant. However, as is outlined at paragraph 195 of the Draft Determination, Godfrey Hirst's volumes are [REDACTED] than in 2011, and the Commission considers Godfrey Hirst [REDACTED]. In addition, while the Commission assumed flat wool production levels for the next five years in Decision 725¹⁴, over the four year period New Zealand sheep numbers have in fact declined by nearly three million sheep and there has been a consistent increase in the proportion of the wool clip sent offshore in greasy form.
- 5.3 A ten year period is simply too long to predict with any certainty what a market will look like, or whether identified benefits and detriments would continue to have an impact. The Australian wool scouring industry provides an example of the radical changes that can occur

¹² Draft Determination at [246].

¹³ Decision 511 at [11].

¹⁴ Decision 725 at footnote 97.

in a market. Between 2000 and 2011, the industry experienced a sharp contraction, with 14 out of 17 Australian wool scourers exiting the market.¹⁵

- 5.4 These examples serve to emphasise that lengthy periods of assessment cannot be relied upon to show an accurate picture of the effects of a transaction; certainly not when analysing the merger effects of a trading operation which is subject to many variables, including international pressures. Accordingly, the Commission should not rely on a period beyond five years to assess benefits and detriments. This is not to ignore the fact that some benefits and detriments occur beyond this timeframe, but rather to acknowledge that placing any real weight on those that do is problematic and inherently uncertain. Rather, the Commission would be better to rely on the Cournot modelling reported in the NERA April Report for the purposes of carrying out its sensitivity testing.

6. Land Values

- 6.1 The Commission, at paragraph 334 of the Draft Determination, concluded to adopt the valuations of land and buildings supplied by the Applicant for each of the three properties that will no longer be utilised by the merged entity in the factual. The land and buildings in each case will be available in the factual as a valuable resource for other productive uses outside of the wool scouring industry.
- 6.2 However, the Commission has also determined to make an adjustment of plus and minus ten per cent of each of the valuations to "account for variability in actual sale values."¹⁶
- 6.3 CWH does not agree with the Commission's decision to make such an adjustment. It considers that by doing so the Commission is effectively double counting a variability assessment already undertaken by each valuer in the course of reaching their valuation. Examination of the valuation documents provides evidence of the many variables each valuer has taken into account, including location influences, rental variables, market evidence of variability of demand and value, investment yield with adjustments etc. All of the variability issues likely to arise in respect of each property have already been taken into account by a skilled valuation expert.
- 6.4 Adding or deducting ten per cent as an arbitrary variation unrelated to any specific property factor contributes no level of skilled assessment in a valuation or market demand sense. It does, however, risk double counting all of the variability factors already taken into account by the valuer. The plus and minus ten per cent adjustment simply creates a different figure than that determined by each valuer and there is less certainty about those figures than the figures provided by the original valuation. Indeed, in respect of the latter, the figure is derived from a skilled and accepted valuation methodology.
- 6.5 CWH also draws to the Commission's attention that these are extremely detailed valuations by recognised and skilled valuers which were not made for the purposes of evidencing the values of the premises for the Application, [REDACTED]. Therefore, the valuations already have an in-built conservatism.
- 6.6 CWH requests the Commission adopt the detailed valuations provided in support of the Application without further addition or discount.

¹⁵ Submission from the Australian Council of Wool Exporters & Processors Inc to Inquiry into a more competitive Victorian Manufacturing Industry, 2011.

¹⁶ Draft Determination at [334].

7. Sale of scouring plant

- 7.1 The Commission has discounted the sales values of scouring plant as estimated by CWH by [REDACTED] million. CWH considers this reduced estimate is likely based upon information that does not account for added accessories that will be sold with the equipment. Usually when scours are sold, the scour line will be sold with perhaps some blending equipment and some wool grease recovery equipment. In addition to the identified scour lines, however, CWH will be selling a comprehensive 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. CWH considers the extent of the equipment to be sold means the Commission's discounted figure materially undervalues the conservative sales figure CWH has attributed to the equipment. For example, CWH understands a second hand high density wool press is worth \$350,000 alone.

8. Substantial degree of influence

- 8.1 In paragraphs 73 to 80 of the Draft Determination, the Commission undertakes an analysis of whether Cavalier Bremworth currently has a substantial degree of influence over CWH, concluding in the affirmative; including because Cavalier Bremworth has a 50% shareholding in CWH and the right to appoint two of four directors of the CWH board.
- 8.2 In paragraph 224, however, the Commission refers to this analysis and states that Cavalier Bremworth is "associated with Cavalier and would be associated with CWH post-merger." In neither this section, nor in paragraphs 73 to 80, however does the Commission consider whether Cavalier Bremworth's substantial degree of influence over CWH would continue post-merger. With a reduced minority shareholding of 27.5% and given three out of four directors of CWH will be independent of Cavalier Bremworth and have different profit maximising drivers, Cavalier Bremworth will not have a substantial degree of influence over CWH post-merger and should not be treated as being associated with CWH.

9. NERA April Report

Maximum price increase of 20%

CWH considers that a price increase of 20% before greasy exports offshore would constrain the merged entity is implausible. The more appropriate position is a maximum price increase not exceeding 15% – see section 2 of the NERA April Report.

Wealth transfers

- 9.1 CWH considers that 90% of a price increase post-transaction would not be passed through to growers in year one, but should be treated as passed through in increasing percentages from 50% to 90% over the five year period – see section 3 of the NERA April Report.

Productive and dynamic efficiency losses

- 9.2 CWH considers the Commission is correct in determining likely productive and dynamic efficiency losses to be relatively minor and at the low point of estimated ranges – see section 4 of the NERA April Report.

10. Response to Godfrey Hirst's request for a conference

- 10.1 CWH has received Chapman Tripp's submission on behalf of Godfrey Hirst requesting that a conference be held regarding CWH's application for authorisation. In the view of CWH a

conference is not necessary for the Commission's proper determination of this matter, but would simply serve to delay the authorisation process.

- 10.2 The Godfrey Hirst submission has produced nothing new in its request that suggests holding a conference would be a useful or necessary step. There are no complexities contemplated by the submission that require testing that have not already been tested with the relevant parties, including Godfrey Hirst, during the current process for authorisation, or during the previous application for authorisation. The previous application included a lengthy conference and the final Determination was followed by a High Court proceeding which tested the issues that Godfrey Hirst considered relevant. The Commission's Determination was confirmed by the High Court with only minor amendment.
- 10.3 A conference is unnecessary to properly test the Commission's preliminary views or for the parties to comment on each other's views, given only one significant opposing interested party exists. The Commission has constantly sought views from Godfrey Hirst since the application for authorisation was lodged. Godfrey Hirst has already had and will continue to have the ability to comment on CWH's application and submissions, and make further submissions to the Commission, as well as on the Draft Determination.
- 10.4 There is nothing fresh raised by Godfrey Hirst since the Commission concluded at paragraph 38 of the Draft Determination – "We have not currently scheduled a conference in respect of this matter". The only factors raised are unrelated to the authorisation application for the merger of the scouring businesses of CWH and Lempriere, which is the subject of the Application:
- (a) The proposed shareholding of CWH does not make the current application for authorisation materially different from the previous application. The acquisition of shares by Lempriere in CWH is not relevant to the authorisation application before the Commission, except when determining what will be the percentage ownership of CWH held by foreign owners for the purpose of calculating a wealth transfer.
 - (b) The Commission has already considered the existence of the Lempriere Option, discussed this with the parties involved and Godfrey Hirst and following an amendment to ensure the Option is conditional upon future clearance or authorisation, concluded it is satisfied that the Option has no relevance to its investigation of the Application. To hold a conference to reopen an issue that has already been submitted on by Godfrey Hirst and concluded would waste the Commission's and the Applicant's time.

Bell Gully – 21 April 2015