

MEMORANDUM

BELL GULLY

TO **Mya Nguyen**
OF Commerce Commission

FROM **Torrin Crowther / Phil Taylor**

MATTER NO. 400-4888

DATE 15 October 2015

Response to Commission's information request of 5 October 2015

We set out below Cavalier Wool Holdings' (**CWH**) response to the Commission's additional questions regarding the Clive site.

1. The effect of a closure of Clive on CWH's sales

Customers affected by a closure of Clive and whether there is scope for delay

- 1.1 During the peak season, all of CWH's customers are active. As such, all stand to be affected by a closure of Clive.
- 1.2 Merchants enter into binding contracts with their customers in advance assuming ready availability of the scour. These contracts will cover all aspects of the process including wool specifications, payment details and fixed delivery dates. CWH has no ability whatsoever to influence any of these agreed terms. If scouring delays occur and shipping schedules are missed, then the merchant risks defaulting on its contractual obligations to its customers (e.g. the mill overseas runs out of wool) which obviously carries with it substantial consequences for the merchant, and in turn CWH.
- 1.3 In CWH's view, there is little (if any) scope to delay scouring services to some merchants so as to avoid the loss of scouring sales: each one considers its scourments to be most important. CWH is a service provider and its business model demands that it be available and provide scouring space at short notice – merchants compete on the international market meaning their requirements for timely scouring are entirely independent of any domestic capacity constraints CWH might be facing. Generally speaking, **[REDACTED]**. The peak period is the most important period for merchants when large volumes are bought greasy and sold scoured. It is this period when delays give rise to maximum damage.
- 1.4 More particularly, at the height of the processing season (when the constraint arises) wool is constantly being placed on the market. Farmers often cannot hold the wool in their woolshed as they do not have room, and brokers charge storage/handling fees which means the farmer needs to sell the wool quickly once it is in a broker's store. Cash flow constraints, exacerbated by the fact that shearers normally require immediate payment at the end of the job, strongly incentivise farmers, and hence merchants, to move the wool quickly through the supply chain, especially at the peak season.
- 1.5 Finally, *even if* there might be some merchants who might tolerate a slight delay in their scouring at a particular time, there is a lasting impact from the mere fact that the merchant customer base will no longer have confidence CWH will always be able to meet their requirements. This will prompt them to investigate alternative options so as to mitigate the risk of them being affected the next peak season (e.g. undertaking small trial shipments etc. to test alternatives), even if they avoided such an impact this season.

Economic value of any lost sales

- 1.6 Season fluctuations in both wool volume and wool style are common. For example, in the past 12 months [REDACTED]. CWH must have the head room capacity to be able to process its customers' wool in a timely fashion and cope with the inherent uncertainty in the demand for scouring. Something as simple as an increase in [REDACTED]. A failure to meet merchants' needs would result in lost business, most likely to greasy exports. The importance of volumes and throughput means there are very real costs of such reduced volumes. However, predicting the financial impact of such losses is difficult.
- 1.7 Clive has been used, on average, [REDACTED] days per annum since [REDACTED]. However, there have been [REDACTED]. Not only does this bear out the inability to predict from year to year the extent to which Clive might be used, but the near [REDACTED] in days used occurred in a period in which CWH's *overall North Island volumes* [REDACTED].¹
- 1.8 However, the lost margin on direct sales at the time is only a small part of the story. A larger issue is the flow-on impact of merchants not having confidence that CWH will have capacity to scour when those merchants need it to, and the constraints placed on CWH's ability to compete (competing to regain particularly exports of greasy wool) for volume and expand. Naturally, CWH would try and mitigate the loss of Clive by encouraging merchants to delay scouring, trying to spread the impact across merchants, etc. but even so, the impact of only one or two large merchants exporting only a small additional proportion of their wool greasy would be substantial.
- 1.9 While the possible economic loss that could result from a closure of Clive would vary depending on the particular circumstances, it is likely to be significant, and would need to take into account:
- (a) lost margin on the volumes which CWH cannot scour due to capacity constraints at *the time*;
 - (b) lost margin on *future* volumes which CWH loses because the customer was forced to turn elsewhere at the time and elects to stay with that alternative; and
 - (c) lost margin on additional volumes that CWH may have otherwise secured had it had the capacity to do so, e.g. due to an increased wool clip, inability of NZWSI to process volumes, substitution from greasy to domestic scouring, etc.
- 1.10 Ascribing a figure to such 'lost sales' is difficult ([REDACTED]). That said, for illustrative purposes, even a capacity constraint which caused, say, Masurel and Furhmans to turn elsewhere for only 15% of their peak wool (Feb-April), would result in a loss of marginal contribution in that period alone of around [REDACTED].
- 1.11 If those alternative supply lines which they utilised over the peak in turn gave them confidence to use them year round (or they chose to do so to maintain that channel), then the impact would be much greater – approximately \$[REDACTED] in terms of lost contribution per annum if volumes dropped by 15% year round for those two merchants. Of course, the impact would be much greater where other merchants also investigate / test alternatives.
- 1.12 Finally, the loss of Clive would constrain CWH's ability to capture **additional** volumes in the counterfactual. Again, this is difficult to measure but missing out on even a comparatively minor increase in volumes during the peak (e.g. because NZWSI was capacity constrained,

¹ [REDACTED]

or because CWH's merchant customers increased their share of wool clip purchases) would have a substantial impact on overall profitability.

Lost sales volumes likely to be exported greasy

1.13 It is theoretically possible that volumes would be diverted to NZWSI. However, given the merchants' strong reluctance to scour with a key wool trading competitor, even if there was such substitution it would most likely be limited to the short term, with the most likely result from a general loss in confidence in the ability of CWH to scour wool on demand being that the volume of greasy exports would further increase (and permanently).

2. Maintenance and upgrades at Awatoto

2.1 While there are [REDACTED] for Awatoto in the counterfactual, all scours require on-going maintenance and Awatoto is no exception.

2.2 CWH must continue to do maintenance and enhancements each year. Inevitably, certain repairs can be achieved much more efficiently if Awatoto is closed completely and production diverted to Clive, as was the case in [REDACTED].

2.3 More generally, wool is very harsh and wears out equipment regularly. The dirt in the effluent is very abrasive and also wears out the pipes and pumps. Downtime caused by mechanical failure has a marked effect on the volume of scoured each week, and such downtime cannot be predicted. For example, if the plant is running at an average of 3000 greasy kgs/hour and there is 5% downtime, the result is a loss of an equivalent of [REDACTED] productive hours or [REDACTED] greasy kgs per plant.

3. Declining wool clip

3.1 As noted, the overall clip does not determine when Clive is used, but rather it is the timing and the type of wool that CWH's merchant customers require to be scoured. Evidence of this is that Clive's usage in 2013 was around [REDACTED].

3.2 In addition, the loss of Clive in the counterfactual would substantially limit CWH's ability to compete for volumes which are currently exported greasy, or which might be available to it if NZWSI spilled volume, e.g. due to capacity constraints, or because it fell out of favour with those limited merchants it does deal with; or because CWH's merchant customers themselves could secure a larger share of the wool clip, all of which could occur even if the overall wool clip was declining.

4. Alternatives to Clive

4.1 Given the strategic rationale for retaining Clive, [REDACTED].

4.2 Retaining the ability to meet merchants' requirements without Clive would require additional capacity at Awatoto. However, the costs of relocating the Clive line to Awatoto cannot be justified when measured against retaining Clive given expected counterfactual volumes. The capex required to relocate the 2.0m line from Clive would be in the order of \$[REDACTED], which clearly makes such a move less desirable than retaining Clive.

5. Viable options in light of current circumstances

5.1 See above.

6. Economic value of Clive as a back-up scouring facility

- 6.1 For the reasons set out above, and in earlier submissions, the value of the Clive site to CWH is not just the gross margins earned on expected peak volumes scoured onsite, but also in managing the uncertainty inherent in demand for wool scouring. The importance of this is illustrated by CWH's decision to retain Clive after a [REDACTED] – notwithstanding a [REDACTED].
- 6.2 Another benefit of Clive is in providing CWH with the ability to close down Awatoto for maintenance or upgrades, as occurred in [REDACTED].
- 6.3 Finally, Clive is used to [REDACTED].

7. Consistency with the factual scenario

- 7.1 The modification and transfer of the 3.0 scour line at Whakatu to Awatoto will provide considerable surplus headroom, enabling CWH to process volumes during the peak season, as well as situations where Awatoto requires maintenance or there are wool mix issues – all clearly negating the need to maintain Clive in the factual. As such, the requirement for Clive as a back-up in emergencies in the counterfactual is in no way inconsistent with selling Clive in the factual.

8. Evidence of previous emergency closures or issues with Awatoto that have required the use of Clive

- 8.1 In recent times there have been no emergency closures etc. with Awatoto which have **required** the use of Clive, but rather Clive has been used at various times where it has been efficient to do so, e.g.:
- (a) In [REDACTED], Clive was used as a back-up for Awatoto while [REDACTED].
 - (b) As noted, Clive has been used on various occasions over the past five years as an overflow scouring plant.