

MEMORANDUM

BELL GULLY

TO **Mya Nguyen**
OF Commerce Commission

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

MATTER NO. 400-4888
DATE 15 January 2015

Confidential
Privileged

Response to Commission request of 5 January 2015

We set out below information from Cavalier Wool Holdings (**CWH**) in response to the Commission's request of 5 January 2015 for further information to assist with the Commission's benefits and detriments analysis. The numbering follows the questions set out by the Commission.

1. **Cost savings**

- 1.1 CWH sets out below information to support the calculations in the merger model contained in the synergies spreadsheets as provided to the Commission.

Overview

- 1.2 The estimated reduction in total scouring costs to New Zealand as a result of the transaction is based on a comparison of the estimated costs of a merged wool scouring industry, against a status quo wool scouring industry using the estimated available scouring volume in FY2016 of 701,000 bales (determined from Beef & Lamb projections). The methodology used is consistent with the modelling used in Decision 725. In Decision 725 however, NZWSI scouring costs were estimated by CWH, as CWH did not have access to NZWSI's financial information. In this case, actual costs have been used where available.
- 1.3 The synergy spreadsheets provided to the Commission are unchanged from those provided to CWH's bank and to KPMG who undertook due diligence on the transaction for both CWH and Lempriere.

Data and methodology

- 1.4 The data used in the calculations include:
- (a) CWH 2013 statutory accounts;
 - (b) Whakatu Woolscour 2013 statutory accounts;
 - (c) Kaputone Woolscour 2013 statutory accounts; and
 - (d) Beef & Lamb FY2016 wool volume projections.
- 1.5 Because the verifiable cost information is for FY2013, but the merger would not take effect until FY2016, a methodology is needed to estimate factual and counterfactual costs for FY2016 using FY2013 data. To do so, constant costs were assumed between FY2013 and FY2016¹ (i.e. the model is a real model) and the following methodology was applied:

¹ All input prices (coal, gas, detergent, labour etc.) are also assumed to be constant between the factual and the counterfactual.

- (a) Line up FY2013 CWH and NZWSI statutory account costs as best as possible, as NZWSI accounts are not in the same format as those of CWH.
- (b) Use the CWH standard budget model to model FY2013 costs for CWH (this incorporates the known current cost structure, such as the new effluent charging mechanism at Awatoto and Timaru which results in higher charges than in 2013²).
- (c) Cross-check the modelled CWH FY2013 costs with CWH's actual costs taken from the 2013 stat accounts to ensure robustness of model.
- (d) Using the CWH model, calculate the CWH counterfactual costs based upon the lower FY2016 volumes, assuming the entire forecast reduction in wool volumes falls upon CWH.^{3,4} Add this figure to NZWSI's FY2013 costs to obtain the total FY2016 counterfactual costs.
- (e) Using the same model templates and volumes as the counterfactual, the factual plant configuration (Awatoto 2*2.4m & 3.0m and Timaru 2*3.0m) was modelled using FY2016 volumes.⁵ This gives the factual total costs for FY2016.
- (f) The difference between the FY2016 counterfactual total costs and the FY2016 factual total costs is the estimated synergies.

1.6 The FY16 Variance Merged to Status Quo sheet then shows a line-by-line match up of the variance between the FY16 status quo and merged costs. Although all cost variances are captured, on a line-by-line basis some anomalies appear to exist because of the different cost allocation that exists between NZWSI and CWH financial information. The "Synergies High to Low" page accumulates the various lines from the "Synergies Detail Stat Lineup" page to give a better reference by cost grouping. This allows a better high level assessment of the key areas of synergies.

2. Re-sale value of plant

2.1 Surplus equipment to be sold includes:

- (a) Kaputone effluent equipment: \$0.01m;
- (b) Timaru 2.4m scour line: \$0.75m;
- (c) Clive 2.0m scour line: \$0.5m; and
- (d) spare pilot plant: \$0.25m.

2.2 Though CWH believes the value of this equipment to shareholders would be considerably more if it were sold into a joint venture arrangement, the value of this surplus equipment has

² Effluent charges for FY2016 will be different to FY2013 at both Awatoto and Timaru due to a change in charging mechanism at both sites (largely from a fixed to a variable cost mechanism).

³ I.e., total NZ FY2016 volumes (701,000 bales per Beef & Lamb) less NZWSI FY2013 volumes (268,000 bales) equals wool available for scouring by CWH in FY2016 (455,000 Bales).

⁴ It was assumed the NZWSI scouring volumes and scouring costs will not change from FY13 to FY16. This was necessary as CWH does not have available the NZWSI base data to build a robust model.

⁵ (a) For ease of modelling, the existing Awatoto scours (2*2.4m) and existing 3.0m scour at Timaru were run at capacity. The re-located ex NZWSI scours are used as overflows to scour the available volumes. The models flex costs depending on volume inputs.

been estimated using sale value to a third party to be conservative and for ease of estimation.

- 2.3 CWH has considerable experience with selling used scouring equipment and follows with interest sales of second-hand equipment in the worldwide market. Two recent sales of “semi-complete” scour lines of note include a 2.0m Andar line by Jandakot, Perth for AUD 850,000 and a 2.0m Andar line by Buckfast Spinning, England for USD 900,000.
- 2.4 CWH has also been approached in recent years from prospective buyers of the Clive 2.0m plant from Libya, Peru and India. The Libyan company were offered the plant for USD 1 million but put the sale on hold due to the outbreak of war in Libya. Further, a Mongolian company offered USD 400,000 for the spare pilot plant 2 years ago.
- 2.5 The Clive 2.0m and Timaru 2.4m line are complete wool scours with greasy blending, scour line, woolgrease recovery and post scouring opening. CWH will have the ability to supply the scour lines with High Density wool presses, along with boilers if required by the purchaser, which makes them very valuable from a sales perspective (as opposed to sales of “semi-complete” lines). Given the high quality of these lines (and the pilot line), the recent overseas sales value of second hand plants, and previous offers for these lines, CWH believes its estimated sales value is very conservative.
- 2.6 The residual value of the Kaputone effluent equipment has also been conservatively estimated. Following discussions with the General Manager at Kaputone, CWH has estimated the value based on second hand parts, rather than as a complete working system.

3. **Capital expenditure**

- 3.1 Capital expenditure for Clive over the past three years:
 - (a) 2011/12: \$182,000 (\$138,000 on plant and \$44,000 on buildings);
 - (b) 2012/13: \$38,000 (on buildings);
 - (c) 2013/14: \$16,000 (on buildings).
- 3.2 Capital expenditure for Kaputone and Whakatu over the past three years (gathered from NZWSI Statutory Published Accounts):
 - (a) 2010/11: \$549,000;
 - (b) 2011/12: \$496,000;
 - (c) 2012/13: \$2,054,000.

4. **Moving plant/machinery and building costs**

- 4.1 CWH, and in particular Chief Executive Officer Nigel Hales, has had considerable experience at moving, closing down or relocating scours. Over the past 20 years, Nigel has lead teams that have moved, closed or relocated at least 10 full scouring sites: eight in New Zealand, one in England and one in Kazakhstan. In late 2013, CWH relocated two high density wool presses from Australia to New Zealand and in 2010 CWH moved three scour lines from Godfrey Hirst’s scour, and shut down two of their sites. This considerable experience means CWH has a good understanding of the exact process involved in dismantling, relocating, and reassembling the plant and machinery, allowing accurate estimations of the time and cost involved.

- 4.2 Attached as Confidential Appendix 1, is a worksheet that sets out the estimated costs of relocating the scours. For ease of calculation, CWH has not included any value to be gained by the sale of other equipment that becomes a consequence of the merger of the sites. Please note there was an earlier iteration of the model showing \$2,030,000 for capital expenditure on plant and equipment at Awatoto. A final iteration of the model showed this figure as \$1,930,000 but that was not drawn to NERA's attention and included in the model and should therefore be corrected. We will ask NERA to submit an addendum to their report picking up this anomaly.
- 4.3 CWH has engaged the Strata Group to provide a feasibility budget for the proposed extension to the Awatoto site, attached (along with plans) as Appendix 2. For Timaru, CWH has calculated costs based on known square meter building rates, please refer to Confidential Appendix 1. The cost of the pit under the 3.0m scour has been provided for in a quote by CWH's regular builder, Garth Leroy (see Confidential Appendix 1).
- 5. Redundancy costs and contingency allowance**
- 5.1 Estimated redundancy figures were calculated based on due diligence employment information provided by NZWSI in 2012. The total estimated redundancy figure was calculated by an independent employment expert, David McLeod. His workings have been included as Confidential Appendix 3.
- 5.2 To be conservative, CWH has assumed the highest possible exposure in its calculations ("Exposure 2"). CWH expects total redundancy costs to be lower than calculated because as staff have left since 2012 with natural attrition, they have generally been replaced by casual staff.
- 5.3 The contingency allowance of \$200,000 is the same as that employed in the previous authorisation application. This is a conservative figure. Given the conservative cost estimates used elsewhere in the model and consistent with CWH's previous experience, it considers that the contingency allowance is unlikely to be required.