MEMORANDUM

BELL GULLY

TO **Mya Nguyen**
OF Commerce Commission

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

BY EMAIL

MATTER NO. 400-4888
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Preliminary CWH response to Godfrey Hirst's submission on the Draft Determination

1. Introduction

1.1 CWH provides a response to Godfrey Hirst's submission on the Commerce Commission's Draft Determination.

1.2 The Godfrey Hirst submission repeats many of the arguments dealt with and disposed of in Decision 725 and the High Court determination which followed, or in the lead up to the release of the current Draft Determination. Despite a claim in the Chapman Tripp Request for a Conference Memorandum of 23 April 2015, there is very little factual or submission material which is relevant to the Application for Authorisation and which could be described as fresh, or which creates a new light on the relevant issues. The content of the Godfrey Hirst Submission simply repeats in a multiplicity of ways the same claims that have been made in the previous application and in the High Court and in various submissions leading up to the Draft Determination.

1.3 This initial response will address the focal points of the opposition raised by the Godfrey Hirst papers only (and does not purport to respond to every issue raised by Godfrey Hirst that it disagrees with).

2. Confidentiality

2.1 Godfrey Hirst claim they have been disadvantaged by delayed release of CWH submissions or information that had been retained confidential. However, Chapman Tripp and its economic consultants have had access to almost all information provided to the Commission from CWH, with plenty of time to comment. By way of example, the transaction documentation was released to Chapman Tripp and its experts on Christmas Eve 2014, now some four months ago.

2.2 It is not the case that a conference is required to rectify information having been withheld (as Godfrey Hirst claims at paragraph 32). The only information withheld from Godfrey Hirst is commercially sensitive information relative to the CWH and Lempriere businesses. Holding a conference will not mean that confidential information will be released for discussion – it will remain commercially sensitive information regardless of whether a conference takes place or not. The Godfrey Hirst submission seems to misunderstand the purpose of holding a conference, which is to enable Commissioners to clarify matters which give rise to material uncertainty, not to further disclose confidential information.

3. Ownership of Lempriere

3.1 The ultimate owner of Lempriere is of no significance to the application for authorisation from a competition law perspective. The only issue is whether or not Lempriere is owned by overseas interests, a fact that has been clear from day one. It makes no difference to the competitive effects of the proposed transaction whether Lempriere is ultimately owned by

Australian, or other country, owners. The submission on foreign ownership which includes a substantial volume of the Godfrey Hirst annexures is irrelevant. In addition, the Commission has been in possession of the Lempriere ownership information from Godfrey Hirst since December 2014 and has reached its Draft Determination on that basis, with paragraph 357 of the Draft Determination specifically referring to it. Again raising irrelevant information that has already been considered by the Commission is simply a waste of the Commission's time. A number of inaccurate conclusions and assumptions have also been drawn by Godfrey Hirst in its submission that Lempriere would be happy to clarify if the Commission has any issues or concerns in this regard.

3.2 Despite the Lempriere Option being commercially sensitive to the parties, CWH and Lempriere have released the section of the Shareholders Agreement relating to the Lempriere Option in full and third parties have had (and clearly continue to have) ample opportunity to comment in this regard. The Godfrey Hirst submission suggests it is inevitable the Lempriere Option will be exercised, which as CWH has previously emphasised is not the case.

3.3 Godfrey Hirst has had the benefit of the Commission's response of 20 February 2015 outlining its reasons for not undertaking its analysis on the basis of Lempriere having a 72.5% shareholding in CWH; i.e., any increase in Lempriere's shareholding via the Lempriere Option would require the Commission's approval. The Commission referred Godfrey Hirst to the Commission's Mergers and Acquisitions Guidelines and the Court of Appeal's reasoning in *New Zealand Bus Ltd v Commerce Commission* (***NZ Bus***).[1]

3.4 Tellingly, Godfrey Hirst's submissions simply do not respond to the Commission's explanation of its approach. Rather, the submissions proceed in rather stridently expressed terms on the basis of an unexplained premise that the Commission must approach the determination on the basis that Lempriere is likely to acquire the "option shares".

3.5 The Commission's approach is plainly correct as a matter of law. Where the acquisition of assets or shares is conditional on clearance or authorisation by the Commission, an equitable or legal interest in the assets or shares is not acquired until that clearance or authorisation is obtained.

3.6 That proposition is established by Hammond J's judgment in *NZ Bus*, in which the Court of Appeal considered an acquisition which was conditional on clearance being granted by the Commission. The clearance application was subsequently withdrawn, part way through the clearance process, and the condition as to clearance was waived. Legal title to the shares did not pass, because the Commission intervened to prevent settlement of the acquisition. However, the Court of Appeal concluded that, following withdrawal of the clearance application and waiver of the clearance condition, the purchaser had acquired an equitable interest in the shares. In other words, until that point, the agreement remained conditional and no equitable interest had arisen.

3.7 The same view was taken in the High Court decisions in *NZ Bus*.

(a) "It was common ground before me that NZ Bus acquired the shares in equity at that time, the agreement having become unconditional on the waiver."[2]

(b) "By agreement, the parties waived the clearance condition. Because the agreement was then unconditional, NZ Bus acquired a beneficial interest in the shares."[3]

[1] [2007] NZCA 502.
[2] *Commerce Commission v New Zealand Bus Limited* HC WN CIV 2006-485-585 at [113].
[3] *Commerce Commission v New Zealand Bus Limited* (2006) 3 NZCCLR 854 (the High Court's separate judgment on penalties and costs) at [1].

3.8 The legal proposition in *NZ Bus* accords with the well-established principle that equitable interests in assets arise from a beneficial entitlement to the assets or the right to specific performance of the contract for the transfer of those assets. However, a person who holds an option – the exercise of which is subject to a condition precedent of clearance or authorisation by the Commission – has no equitable interest in the property which is the subject of the grant. The grantee of such an option therefore has no legal or equitable property interest in the relevant assets.

3.9 The Lempriere Option provides no interest in the shares for which Lempriere is able to sue for specific performance, or which Lempriere may protect by seeking injunctive relief in equity. Until the Commerce Commission has authorised or cleared Lempriere's right to exercise the option, Lempriere has no right to restrict the current shareholders from dealing with the relevant shares as they see fit. In short, the conditional option creates no equitable interest or other ownership interest in the shares.

3.10 Godfrey Hirst then submits that the Commission must in any event consider the possibility of Lempriere holding 72.5% of the CWH shares because of the possibility that:

(a) the Deed creating the Lempriere Option could be amended to remove the requirement that the Lempriere Option is conditional on the Commission's approval; and

(b) Lempriere could then exercise the Lempriere Option without seeking authorisation.

3.11 That alternative submission also lacks merit. If the parties were to proceed in that way, they would risk injunctive action and penalty proceedings by the Commission. The Commission is not required to consider that scenario – just as the Commission would not be required to consider the scenario of the parties entering into a new agreement for the sale of the shares without seeking the Commission's authorisation.

3.12 It follows, as a result, that all of the Godfrey Hirst demands that the Commission must treat the "option shares" as already belonging to Lempriere and calculate wealth transfers accordingly have no merit and collapse like a pack of cards. Those demands have no merit in fact or at law.

3.13 Further, Godfrey Hirst appears to see it as inevitable that CWH will at some stage be sold to foreign owners in its entirety. There is no factual basis for Godfrey Hirst to make such a claim which accordingly should be ignored.

4. The application is largely unchanged

4.1 The transaction insofar as it relates to a horizontal merger of two wool scours is unchanged from Decision 725. The only variation from that application is that one of the shareholders of the future CWH will be Lempriere, which is an overseas company. This fact was disclosed in the application for authorisation and nothing produced or submitted by Godfrey Hirst changes that position in any relevant manner.

5. Impact of the transaction on Godfrey Hirst

5.1 The Godfrey Hirst submission makes much of the risk to its business created by the transaction yet there is no evidence to support its claims, nor has it responded to the evidence from CWH that a 15% price increase would only add **[REDACTED]**% to the overall wool carpet price.[4] Godfrey Hirst is unlikely to be "driven from the market completely" as a result of the transaction. Given the **[REDACTED]** in the wool volumes required for the

[4] See CWH submission entitled "Submissions in response to Commerce Commission queries – confidential", Phil Taylor / Glenn Shewan, 8 December 2014.

Godfrey Hirst business (as the Commission has noted, Godfrey Hirst's wool volume has **[REDACTED]**% since Decision 725) and the ultimately limited impact of any scouring price increase on Godfrey Hirst, it is unlikely the transaction would have any substantial impact on its business. Godfrey Hirst's business is increasingly focused on synthetic carpets.

5.2 Indeed, Godfrey Hirst's principle interest in this transaction seems to be as a competitor of Cavalier Bremworth, rather than as a customer of CWH. Godfrey Hirst has failed totally to logically explain why a company, CWH, (and the majority of its directors) with no corporate or commercial interest in wool carpet making would set out to cause financial damage to one of its significant customers in order to benefit what will be a minority shareholder (Cavalier Bremworth with one director out of four) when the profitability of CWH will depend on volume throughput and Godfrey Hirst in its own submission suggests that the result would be to force its business off-shore. There would be no logic in the majority shareholders concurring with such action. Rather the Godfrey Hirst submission on this issue is emotive and implausible and appears to be driven solely by a desire to cause damage to its carpet competitor.

6. Wealth transfers at 72.5%

6.1 As discussed above, Godfrey Hirst has submitted that wealth transfers to Lempriere as an overseas owned entity should be considered at 72.5% rather than 45% to account for the exercise of the Lempriere Option. The New Zealand law position on share options that are conditional on clearance or authorisation is set out in section 3 above which clearly renders these Godfrey Hirst claims without factual or legal merit.

7. Valuations

7.1 The submission by the Godfrey Hirst valuer offers no evidence for the claims about **[REDACTED]**. It simply draws on exclusions to the valuation report and makes unfounded claims in an attempt to conclude that the valuation is overstated. The same applies to the impact of the 50 year covenant excluding the use of the site for wool scouring. Attached is an email from the Lempriere valuer confirming that the valuation was **[REDACTED]**.

7.2 Also, **[REDACTED]**, the findings of which are summarised below.

(a) **[REDACTED]**.

(b) **[REDACTED]**.

7.3 While there are no **[REDACTED]**.

7.4 Further, **[REDACTED]**.

8. **Clive Site**

8.1 Godfrey Hirst has queried the reason for the sale of CWH's Clive site, given it was proposed to be used as a back-up facility at the time of Decision 725. The reason for the proposed sale with the current application for authorisation is simply that despite the Commission's statement in Decision 725 that the wool clip would remain constant in the following five years, there has been a loss of nearly three million head of sheep in this period. This reduction has made the retention of Clive unnecessary and inefficient once the proposed amalgamation of the businesses and restructuring of the scour lines of NZWSI and CWH occurs post-transaction. As CWH has previously explained, it has extensive measures in place to deal with any breakdown in the remaining scours, and Clive is not necessary in this regard. If an emergency arose, and inter island transport was required, as previously advised to the Commission, CWH holds insurance to cover the cost of that transport.

8.2 Regardless of whether the sale of identified land, buildings and plant takes place immediately or in the five year period of consideration, there is no doubt that CWH and its shareholders will act in a profit maximising way by gaining revenue from the use of these land, buildings and plant pending sale.

9. **Sale of plant**

9.1 Godfrey Hirst has claimed that an additional $100,000 per scour needs to be accounted for when considering the net return from the sale of the scour lines to cover the cost of dismantling, removing, cleaning and packing the lines (at paragraph 234). However, CWH has never sold plant FOB, rather all of these costs are picked up by the purchaser and the sale process is separate from the sales price estimated by CWH.

9.2 A purchaser of the plant may request CWH undertake this process for an additional charge. However, it is often the case that a purchaser will prefer to come to the site to dismantle the scour line themselves in order to assess how best to reassemble the line. Alternatively, companies such as P&W Engineering and Andar can be used to undertake this service as they are experts in moving wool processing equipment. In choosing any of these options, however, the purchaser/s of the scour lines will need to pay (or arrange themselves) for the process described by Godfrey Hirst to occur. The cost of this process does not therefore need to be accounted for in the expected sales price of the scour lines.

10. **Overseas dimension**

10.1 Godfrey Hirst has argued (at paragraph 83) that CWH's statement in the application for authorisation that the acquisition has no overseas dimension is untrue, given the ultimate ownership of Lempriere. However, Godfrey Hirst does not appear to understand that this section in the Commission's proforma application is not seeking to understand foreign ownership, but rather seeking to understand if the transaction will have an impact overseas such that there will be merger filings in other jurisdictions which require coordination.

11. **China**

11.1 Godfrey Hirst uses information discovered and photographs taken when visiting China in 2011 to argue that scouring in China "is not a viable alternative" given quality, environmental concerns and inadequate equipment.[5] CWH has had substantial engagement with Chinese wool scouring concerns over many years and Nigel Hales the CEO of CWH is an acknowledged expert in respect of treatment of wool (see the attached confidential schedule for some brief examples of Nigel's experience in central and northern Asia). Nigel makes annual visits to China to review the Chinese industry in order to maintain awareness of advances by CWH's most formidable competitor which has such a current and future impact

[5] Godfrey Hirst submission at [122] and [124].

on the CWH wool scouring business. This regular assessment of the impact of Chinese scours compares with a one off visit by Godfrey Hirst in 2011. Further, the Godfrey Hirst information is out of date. **[REDACTED]**. **[REDACTED]** that the particular scour line photographed by Godfrey Hirst has since been closed down. The closure of this line has had no effect on the volume of wool exported greasy to China. The Godfrey Hirst submission ignores the fact that 24% of the New Zealand wool clip is currently scoured in China, as CWH has consistently emphasised and that China accounts for 47% of the world's wool imports of raw wool, as set out in the application for authorisation[6].

12. **Price increases**

12.1 Godfrey Hirst has argued at paragraph 174 "[t]he economic literature and econometric evidence all indicate that a range up to 25% is at least plausible." Given the commercial factors at play, CWH explained in its submission on the Draft Determination[7] why a price increase of up to even 20% is not plausible. The need for volume efficiencies means CWH will not risk the loss of volumes to China or encouraging new entry or losing Godfrey Hirst volumes. Godfrey Hirst may determine to re-enter the scouring market or leave the New Zealand carpet manufacturing market altogether, both of which it has threatened in each of the investigations leading to Decision 725 and the current Draft Determination. Godfrey Hirst has indicated they could use the purchase of the Clive site to enter were it not restricted for wool scouring use by the covenant, indicating such entry is clearly a possibility and in its mind. CWH will not be incentivised post-transaction to take short term functionless price increases and risk the loss of wool volumes which not only result in lower wool volumes for CWH, but also a loss of the efficiencies gained by higher throughput.

13. **Productive / Dynamic efficiency losses**

13.1 Godfrey Hirst (in paragraphs 186 and 187) have stated that CWH was wrong to say performance-based incentive schemes would extend to additional staff CWH would employ when CWH does not intend to employ additional staff. CWH was referring to NZWSI staff that would be hired by CWH. Further, these schemes were not pointed to as a comparison of staff subject to such schemes in the factual compared to the counterfactual, but rather as a mitigation of the potential losses of dynamic and productive inefficiencies that are suggested occur when competition is lessened. Indeed, CWH will continue to be incentivised to manage costs and innovate by the very real competition posed by scours in China and Malaysia.

13.2 Godfrey Hirst has stated the Commission erred in not determining to take a range following the High Court's determination. In fact the High Court stated the Commission should take a range unless it provides good reasons for taking a specific value. The Commission has done just that in determining productive and dynamic efficiency losses to be relatively minor.

14. **The Guthrie Paper**

14.1 See attached for a NERA response to the paper produced by Professor Graeme Guthrie (the **Guthrie Paper**). What is clear is that while the Guthrie Paper discusses technical issues which could potentially affect the economics of merger analysis, those discussions do not marry the issues raised to the evidence of this merger. For example:

- when considering price increases, the Guthrie Paper does not take account of the constraint from China which is clearly acknowledged by the Commission and the High Court in respect of Decision 725 and in the Draft Determination. Nor does the Paper acknowledge that the likely entrants will be either Godfrey Hirst or one or more wool merchants who each will have their own greasy wool to underwrite the entry;

[6] Paragraph 5.20, referencing IWTO Wool Market Information, 2013, p 22.
[7] See CWH submission entitled "Submission on Draft Determination", Phil Taylor / Penny Pasley, 21 April 2015 and the attached "NERA April Report".

- when considering the likely price increases resulting from the horizontal merger, the Guthrie Paper discusses the likely WACC and concludes that it will be relatively high because it assumes that because of the scale of "a new wool scouring operation, it is likely to be financially unsophisticated". This ignores that the likely entrant/s are Godfrey Hirst (a former owner of wool scours) or any one or more of a series of major international wool merchants, all of whom would not fit the Paper's assessment of being unsophisticated financially;

- when considering conflict of incentives, the Guthrie Paper does not take account of the nature of a wool scouring business and whether the conflict is real in relation to that business and the ownership spread – all of the post-transaction investors of CWH are investors in a business with the Shareholders Agreement requiring that the Directors must at all times act in the best interests of the company[8];

- when considering distribution of increased surplus from efficiencies; the Guthrie Paper does not consider that the efficiencies are not functionless but treats them as arising in the same way as functionless price increases;

- when considering the third party land and buildings valuations, the Guthrie Paper adopts the assumptions expressed by the Godfrey Hirst valuer that **[REDACTED]** lead to the view that the up and down range should be 20%, but does not acknowledge that there is no evidence produced by Godfrey Hirst that any of those assumptions are correct. Indeed the evidence provided by CWH and Lempriere show that the assumptions made are incorrect.

14.2 Indeed the Guthrie Paper does not make any real attempt to relate its review points to the facts of and surrounding the application. Picking up on the first bullet point in 14.1 above, nowhere in the Paper is the constraint from China discussed, indeed there is no reference at all in the Paper to China. Given the emphasis of the Application on the constraints from China and the extent of discussion of that subject in Decision 725 and the High Court and the Draft Determination, that suggests that the findings in the Guthrie Paper at best must be considered suspect.

14.3 Furthermore, in carrying out the assessment of various scenarios of quantified detriments on page 17 of the Guthrie Paper, the Paper adopts its earlier already implausible price increase of 25% based on an implausible WACC and then applies that price increase to an equally implausible set of ownership claims that have no support as a matter of New Zealand law. Apart from Scenario A, none of the scenarios can occur without a further Commission clearance or authorisation of the exercise of the Lempriere Option. This renders the conclusions in the Guthrie Paper at best suspect and at worst impossible.

15. Godfrey Hirst's further request for a conference

15.1 For the various reasons set out in this response to Godfrey Hirst's submission on the Draft Determination, there are no legal, economic or competition law complexities which the Commission has not already considered and determined or which are not finally dealt with or clarified in this response. There is no need for a conference which would only further draw out an already lengthy process for no material benefit to the process of reaching a final determination.

Bell Gully
29 April 2015

Phil Taylor, Consultant / Penny Pasley, Solicitor

[8] Agreed form of the Shareholders' Agreement, clause 3.14.