Net benefits of closing Clive and Kaputone

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I have been asked to calculate the adjustment that would need to be made to the net benefits of the proposed merger of Cavalier Wool Holdings Limited and New Zealand Wool Services International Limited if the scours at Clive and/or Kaputone are closed under the counterfactual.

The precise adjustment required depends on the assumptions that the Commission adopts when calculating the net benefits of the merger. I report two sets of figures here. One corresponds to the assumptions the Commission made in its Draft Determination.[1] The other reflects information that has been provided to the Commission since it released its Draft Determination.

The results are summarized in the table below, which reports the amount (in millions of dollars) by which the net benefits of the proposed merger should be reduced if Clive and/or Kaputone are closed under the counterfactual.

	Clive		Kaputone	
	Draft Det	Subsequent	Draft Det	Subsequent
Revenue (annual)	[ ]	[ ]	[ ]	[ ]
PV	[ ]	[ ]	[ ]	[ ]
Operating costs (annual)	[ ]	[ ]	[ ]	[ ]
PV	[ ]	[ ]	[ ]	[ ]
Sale of land & buildings	[ ]	[ ]	[ ]	[ ]
Sale of surplus plant				
Scour	[ ]	[ ]	[ ]	[ ]
Effluent plant			[ ]	[ ]
Avoided capex				
[ ]			[ ]	[ ]
[ ]				[ ]
Redundancy costs	[ ]	[ ]	[ ]	[ ]
Total claimed benefits	$[ ]- $[ ]	$[ ]	$[ ]- $[ ]	$[ ]

Of course, a scour will be closed under the counterfactual only if it is in the best interests of its owners to do so. The table above shows the *public* benefits of closing a scour, but the scale of the likely *private* benefits to the owners is immediately apparent.

[1] Information on claimed non-capital cost savings is taken from the spreadsheet "aSholpan Sum Syn v4 17-09-14_NERA edit.xls" and the Commission's discussion in its Draft Determination.

- **Clive:** Operating this scour requires annual operating expenditure of $[ ] and generates negligible revenue. If the independent owner of the scour ceased operating it would lose the option to carry out scouring operations there in the future, but in return it would avoid $[ ]in annual (pre-tax) operating costs and be able to sell the land and buildings for an amount that the owner's valuer estimates to be $[ ].

- **Kaputone:** Unlike the scour at Clive, the one at Kaputone is currently scouring a significant quantity of wool. Shutting it down would reduce Lempriere's EBITD by $[ ] annually. However, shutting it down would allow Lempriere to avoid capital expenditure that it has claimed will cost it $[

  ] it would also allow Lempriere to sell the land and buildings for $[ ]. Once we allow for the proceeds of selling plant and redundancy payments to workers, shutting down Kaputone would effectively give Lempriere an immediate lump sum cash inflow of $[ ]; it would lose future annual cash inflows, currently estimated to be $[ ] (pre-tax), but which are likely to fall if the wool clip declines further.

In each case, the net cash flows generated by shutting down the scour are such that a prudent independent owner would surely seriously consider shutting down their scour. In the case of Clive, shutting down the scour generates net cash inflows immediately and in the future. In the case of Kaputone, shutting down the scour generates a very large risk-free net cash inflow immediately in return for small (and, if the wool clip continues to fall, declining) risky net cash outflows in the future.

Given the apparent net private benefits from shutting down the scours, I believe that the Commission should incorporate the very real possibility that one or both scours shuts down when the Commission constructs the counterfactual scenario for the proposed merger.

The remainder of this report describes the calculations underlying the table above.

Closing Clive

The application describes Clive as being required in the counterfactual simply as "an overflow facility" (p. vi), which is used to "cover emergencies and peaks in demand" (para 5.51). Specifically, reference is made to its operating for [ ] days per year, which I understand would account for a mere [ ]% of wool currently scoured in the North Island. I therefore assume that closing the scour at Clive would have a negligible effect on the total amount of wool scoured by CWH in the North Island, so that closure of the scour generates public benefits in the form of non-capital cost savings, ongoing capex savings, and the release of land and plant for other uses. These benefits would potentially be offset by one-off capital costs and redundancy costs.

When the Commission calculated the non-capital cost savings of the proposed merger (para 306-330 of the Draft Determination), it accepted CWH's estimate that the total annual operating cost synergies attributable to shutting down Clive equal $[ ]. The 5-year present value equals $[ ].[2]

When estimating the public benefit from the sale of surplus land and buildings (para 331-334), the Commission used the $[ ] valuation of the land and buildings at Clive that was provided by the applicant, plus or minus 10%. The implied benefit from releasing the land and buildings at Clive for non-scouring purposes is thus $[ ]. Subsequent to the release of its Draft Determination, the Commission's valuer estimated that the land and buildings at Clive are worth $[ ].

When estimating the public benefit from the sale of surplus plant (para 335-336), the Commission estimated the resale value of the 2.0 metre scour line at Clive to be $[ ]. The implied benefit from releasing the plant at Clive is thus $[ ].

The only mention of Clive in the Commission's discussion of the capital costs of rationalization and ongoing capex savings (para 337-346) is the cost of reinstating buildings at Clive ready for sale. However, the cost of this does not appear in the relevant supporting spreadsheet and so is presumably negligible. [ ], I have set redundancy costs to zero, so that the total costs of rationalization and ongoing capex savings equal 0.

In total, the figures reported in the Draft Determination imply that the net benefits of closing the scour at Clive equal $[ ]. If the subsequent valuation of the land at Clive is used instead, then the net benefits of closing the scour at Clive equal $[ ].

If the scour at Clive is to be closed under the counterfactual, then the net benefits of the proposed merger calculated in the Draft Determination should be reduced by $[ ]. If subsequent information is used, the net benefits should instead be reduced by $[ ].

Closing Kaputone

Unlike the scour at Clive, the one at Kaputone is currently scouring a significant quantity of wool. Closing the scour at Kaputone would result in some (perhaps all) of the scouring activity being transferred to other plants and some being lost to overseas. I will take the (extremely) conservative approach of assuming that none of the wool currently scoured at Kaputone would be scoured under the counterfactual: the plant is closed and the wool is left unscoured. Clearly this understates the benefits of shutting down the scour, and therefore understates

[2] See cell AY171 of the sheet "Synergies_Detail_Stat_Lineup" in "aSholpan Sum Syn v4 17-09-14_NERA_edit.xls".

the adjustment that the Commission should make to the net benefits of the proposed merger.

With this conservative assumption in place, closing the scour at Kaputone would generate public benefits in the form of non-capital cost savings, ongoing capex savings, and the release of land and plant for other uses. These benefits would potentially be offset by the lost benefit of the wool being scoured, as well as one-off capital costs and redundancy costs.

When the Commission calculated the non-capital cost savings of the proposed merger, it accepted CWH's estimates that the total annual revenue from scouring activities at Kaputone was $[ ] and the total annual operating cost was $[ ]. I use the difference, $[ ], as my estimate of the benefit to NZ of scouring wool at Kaputone. The 5-year present value equals $[ ].[3]

When estimating the public benefit from the sale of surplus land and buildings (para 331-334), the Commission used the $[ ] valuation of the Kaputone land and buildings provided by the applicant, plus or minus 10%. The implied benefit from releasing the land and buildings at Kaputone for non-scouring purposes is thus $[ ]. Subsequent to the release of the Draft Determination, the Commission has been presented with [ ].

The Commission has accepted Cavalier's estimate that the effluent system at Kaputone could be sold for $[ ](para 329). Based on the Commission's estimate of the resale value of 2.0 metre and 2.4 metre scours of $[ ], I assume that Kaputone's 3.0 metre scour would sell for at least $[ ]. The implied benefit from releasing the plant at Kaputone therefore exceeds $[ ].

In its Draft Determination, the Commission accepted Lempriere's estimate that it would avoid spending [ ]. Therefore, closing Kaputone under the counterfactual would generate public benefits of at least $[ ] in the form of avoided capex. Subsequent to the Draft Determination, Lempriere claimed that an additional $[ ]. When this item is included, closing Kaputone under the counterfactual would generate public benefits of at least $[ ] in the form of avoided capex.

In its Draft Determination, the Commission accepted Cavalier's estimated redundancy costs of $[ ] associated with closing scours at Clive, Kaputone, and Whakatu. These costs were not broken down by scour in the Draft Determination or, as far as I can tell, in Cavalier's application. Therefore I allocate them between the three scours in proportion to the wage costs at the three scours, implying redundancy costs of $[ ] at Kaputone. Subsequent to the Draft Determination, Cavalier has claimed that redundancy costs at Kaputone would actually be $[ ].

[3] See cells BF170-BF172 of the sheet "Synergies_Detail_Stat_Lineup" in "aSholpan Sum Syn v4 17-09-14_NERA_edit.xls".

In total, the figures reported in the Draft Determination imply that the net benefits of closing the scour at Kaputone are at least $[ ]. If the Commission instead uses [ ] then the net benefits of closing the scour at Kaputone equal $[ ].

If the scour at Kaputone is to be closed under the counterfactual, then the net benefits of the proposed merger calculated in the Draft Determination should be reduced by $[ ]. If subsequent information is used, the net benefits should instead be reduced by $[ ].