

MEMORANDUM

BELL GULLY

TO **Mya Nguyen**
OF New Zealand Commerce Commission

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

BY EMAIL

MATTER NO. 400-4888

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Private and confidential

Privileged

Response to Godfrey Hirst's submission and meeting with the Commission

1. General points

- 1.1 Cavalier Wool Holding's (**CWH's**) response to Godfrey Hirst's submission of 19 December 2014 and file note recording their interview with the Commission on 3 December 2014 is set out below. The response refers to the paragraph numbers of the file note recording the interview where relevant.
- 1.2 Generally speaking, there has been such widespread redacting of confidential information, particulating to scouring in China, that it is difficult for CWH to respond specifically to the allegations made. CWH considers that the Commission cannot rely on Godfrey Hirst's claims regarding scouring in China and other aspects detailed unless it can independently confirm each allegation or claim, CWH have, however, drafted a broad response, attached as Appendix 1 based on the information that was made public and its guesses about the content claimed as confidential.

2. Submission by Godfrey Hirst "Overseas Scouring" – 19 December 2014

- 2.1 This submission generally records why exporting wool to China for scouring before re-importing this wool back to New Zealand for processing by Godfrey Hirst is not viable. However, as CWH has previously mentioned, it has never suggested using Chinese or Malaysian scours to scour wool that is to be imported into and processed in New Zealand would be viable. To the extent that the Godfrey Hirst submissions address that possibility it is irrelevant to the investigation.
- 2.2 Godfrey Hirst has a range of options outside of exporting and reimporting wool.
 - (a) Using the merged scouring entity – as previously emphasised, the Godfrey Hirst volumes are very important to the merged entity. The whole transaction is incentivised by the need to gain volume efficiencies. Acting in a manner which puts those efficiency gains at risk defies the economic incentives. Further, given the merged CWH share structure the majority of shareholders, having control of the Board of Directors, have absolutely no incentive to foreclose Godfrey Hirst. Indeed the opposite is the case.
 - (b) If Godfrey Hirst did not wish to use the merged entity for its scouring, for whatever reason, it could do any of the following.
 - (i) Buy scoured product via local merchants. The merchant is the party having the scouring agreement with the merged CWH, not Godfrey Hirst.
 - (ii) Buy non New Zealand scoured product from overseas merchants.

- (iii) Buy yarn locally or overseas. Indeed, CWH believes Godfrey Hirst to have historically imported yarn to New Zealand to use in the production of its carpets.
- (iv) Enter the scouring market itself or by underwriting another merchant or market participant or a combination of them.

2.3 In particular, CWH considers imported yarn to be a viable alternative for Godfrey Hirst should it no longer wish to use the merged entity's scouring services. Indeed, CWH estimates approximately 9% of the wool weight of wool used to produce woollen carpets in New Zealand is imported yarn. CWH believes it is likely Godfrey Hirst is importing this yarn, suggesting it is a viable alternative to scoured New Zealand wool.

2.4 As set out in the attached Appendix 1 regarding Chinese scours and contrary to Godfrey Hirst's allegations, there are a number of viable commission wool scours in China, highlighted by the fact that currently 266,000 greasy bales are exported from New Zealand for scouring in other countries, with 200,000 of these bales heading to China.

3. File note recording the interview at Godfrey Hirst offices – 3 December 2014

3.1 Para 6-8: Any profit downgrades or share price changes of Cavalier Bremworth are irrelevant to the merger proposal.

3.2 Para 16: That 50% of carpet sold in New Zealand is imported emphasises why it will not be in Cavalier Bremworth's interest to attempt to use CWH to discriminate against Godfrey Hirst post-transaction. As previously noted, Cavalier Bremworth would suffer from the loss in volume through the scour, but would not attract all of Godfrey Hirst's lost business, as some would be lost to imports.

3.3 Para 21: It is not the case that there will be a short fall in capacity once the proposed rationalisation occurs. As previously stated, the merged entity will retain surplus capacity of 41.7% in the North Island and 28.4% in the South Island.

3.4 Para 22: As noted above, there will be considerable excess capacity post-rationalisation. Further, it is in CWH's interests to achieve as much throughput as it can and it has a variety of methods in which it can deal with any shortage in capacity that arises, as set out in the application at 26.27, including storing wool in the interim, transporting wool between islands, and re-commissioning the Timaru pilot plant. However, with the excess levels of capacity in both islands, it is unlikely that capacity constraints are ever likely to be an issue, particularly with long term reduction trends in the wool clip.

3.5 Para 23: CWH cannot respond to this paragraph while it remains confidential and without more detail regarding the allegation it contains. The suggestion that somehow Godfrey Hirst considers it may have difficulty in achieving scouring in New Zealand does not fit well with Godfrey Hirst's voluntary decision to not renew its scouring contract with CWH or to negotiate a new contract.

3.6 Para 24: Godfrey Hirst state they cannot easily scour overseas. CWH intends to keep Godfrey Hirst's business as throughput is essential to retain profitability of its scours. CWH will therefore attempt to avoid Godfrey Hirst being unhappy and looking for other options. As noted above, CWH has never stated scouring wool overseas and having it returned to New Zealand for processing would be viable, but Godfrey Hirst retains a number of viable alternatives. CWH cannot respond to the remainder of this paragraph as it is confidential.

3.7 Para 25: It is not possible to respond to the claims made in this paragraph due to the extensive confidentiality blackout and only CWH and NZWSI as the only wool grease manufacturers have the ability to put the statements to the test or put the claimed facts into perspective.

- 3.8 Para 28-31: CWH has previously advised the Commission regarding their knowledge of wool destinations and ultimate customers and the ability for merchants to change this information during the scouring process. CWH is advised when wool is for Godfrey Hirst due to the set scouring rate with Godfrey Hirst.
- 3.9 Para 32-42: CWH cannot respond to these paragraphs while the information contained is confidential. Only CWH can test these claims.
- 3.10 Para 43: NZWSI will be the largest customer of the combined scour post-transaction and would expect to receive a volume discount.
- 3.11 Para 44-46: CWH notes post-transaction it will not operate at 75% capacity yearly. Further, as set out in the authorisation application, entry would be profitable scouring a much smaller amount of wool. For example, CWH understands Kaputone processes 130,000 bales yearly using a 3.0m scour. CWH cannot respond to and test the remaining points in these paragraphs while the information contained is confidential.
- 3.12 Para 47-48: While the combined entity would be the only scouring company remaining in New Zealand, as has been previously emphasised, a large proportion of New Zealand wool is now scoured in China, showing that the combined entity would not be a true monopoly. CWH cannot respond to or test the remaining information in these paragraphs while it is confidential.
- 3.13 Para 50: That 24% of the total New Zealand wool clip is currently scoured in China highlights that Chinese scouring remains competitive and CWP in Malaysia is another viable alternative. CWH has separately set out in the attached document that Chinese wool scours largely remain operational following the new environmental restrictions in China.
- 3.14 Para 51: CWH cannot respond to this paragraph while the information it contains is confidential.
- 3.15 Para 52: Closure of scours and relocation of textile equipment to China has also occurred in the United Kingdom over the past 15 years.¹ Like New Zealand, the majority of wool grown in England is from English long wool breeds for coarse apparel and carpet wool, making it an apt comparison for New Zealand in terms of scour closures. The examples of Australia and the United Kingdom emphasise that CWH will be constrained in terms of pricing and quality to downstream customers post-transaction. CWH would not want to risk the closure of New Zealand processors which would ultimately risk the closure of the scours, as the examples of the United Kingdom and Australia show. CWH cannot respond to the allegations in the remainder of the paragraph while it is confidential.
- 3.16 Para 54: Godfrey Hirst is claiming that there have been no innovations made by CWH. This would seemingly limit concerns arising from a potential loss in incentives to innovate as a result of the merger.
- 3.17 Para 55: CWH cannot respond to this paragraph while the information it contains is confidential.
- 3.18 Para 56: Godfrey Hirst has stated that leaving two separate entities would give wool a chance to be competitive. However, wool carpets are decreasing in sales even with two scours remaining, and the real issue seems to be cheap imports of synthetic carpet, rather

¹ As stated in our application, only two scouring companies remain in the United Kingdom – Howarth Woolscouring and Standard Wools operating in Bradford, only one of which is operating at full capacity. Bradford in Yorkshire used to be one of the world's main textile hubs.

than scouring costs. As previously stated, a 5 cent price increase in the scouring fee would add less than 25 cents to a metre of carpet.

- 3.19 Para 57-58: Merchants previously used CWH as their scour and theoretically had the same amount to lose by voicing any opposition. It is not the case that the addition of NZWSI as a proposed shareholder will prevent them from voicing opposition currently, particularly as NZWSI is a competitor, not a current supplier, to these merchants. Godfrey Hirst is managing to actively partake in the process despite the time, energy and resources involved, and there is no impediment to merchants doing likewise (or indeed voicing opposition without taking a central role as has Godfrey Hirst).
- 3.20 Para 59-60: As the Commission is aware, CWH and Lempriere have put in place information protocols to prevent the flow of confidential information between CWH and NZWSI during and after the merger.
- 3.21 Para 61-66: Again, CWH have never advocated that greasy wool should be sent offshore for scouring and then returned to New Zealand for processing. In any case, while CWH is unable to see exactly what Godfrey Hirst have stated about blending systems etc., it notes that blending systems are not uniform, including across the current New Zealand scours. While international scours may not have blending systems to the level of CWH, neither does NZWSI. For example, CWH understands CWP has similar blending systems to that of NZWSI. Further, CWH understands CWP intends to put in high density packing machinery, which coupled with cheap transport out of Malaysia could potentially make shipping wool back to New Zealand more affordable. However, it is not an argument advanced by CWH that Godfrey Hirst could scour overseas and reimport. However, if Godfrey Hirst wanted to ensure wool was scoured to its specifications it could station an employee at CWP in Malaysia, as CWH understands occurred following its acquisition of Summit. CWH cannot respond further to the statements contained in these paragraphs while they are confidential.
- 3.22 Para 67: Scour processes have continued to develop in New Zealand since the 1950's, from both local developments and as a result of world trends. For example, mini bowl scours were introduced in New Zealand, along with the WORNZ operating system, in 1982 which was a major change in scouring technology. The Andar scour and WRONZ system have continued to be modified since then. There is nothing preventing such continual development and upgrades in other scouring countries. Indeed CWH has detailed recent upgrades to Chinese scours previously (e.g. new Tianyu lines and improved environmental systems) and believes such developments are likely to continue.
- 3.23 Para 68-70: CWH is unable to respond to or test the allegations contained in these paragraphs given the heavy redactions of its content.
- 3.24 Para 71: Bell Gully would like to point out in this regard that CWH redactions have been kept to a minimum necessary to protect its commercially sensitive information, with counsel and experts able to access all arguments to respond on Godfrey Hirst's behalf. Further, the redactions in this meeting note do appear excessive and to go well beyond protecting commercially sensitive information.
- 3.25 Para 72: As a new entrant with dedicated volumes could profitably enter with a small scouring line, entry is not necessarily a "winner takes all" contest. Further, as the Commission has previously found in Decision 725, entry is not necessary in both islands. A new entrant such as Godfrey Hirst could enter in one island with a packing facility in the other island, allowing quicker transfer of wool between islands. Indeed, CWH understands Godfrey Hirst is already transporting wool between islands.
- 3.26 Para 73: As previously discussed, the restrictive covenants on the sites intended to be vacated by the merged entity are for the purposes of preventing offering a new entrant a step

up advantage as a result of CWH/NZWSI's hard work and expertise. As plenty of alternative sites are available for new entry such covenants will not prevent entry.

- 3.27 Para 74: NERA have separately responded to concerns on the calculation of possible dynamic efficiency losses arising as a result of the proposed merger. Further, CWH notes Godfrey Hirst have disputed that CWH has made any innovations since the 1950s. CWH has previously detailed why two plants will be sufficient following the transaction.
- 3.28 Para 75: CWH notes it does not trade wool, including internationally, and nor will the merged scour.
- 3.29 Para 76: CWH cannot respond to or test the allegations in this paragraph while the information is confidential.
- 3.30 Para 77: As the parties have previously detailed, Lempriere's trading entity will be an entirely separate business post-transaction and information protocols have been put in place to prevent any inappropriate flow of information. The directors will not be involved in the day to operation of the business. Further, Lempriere will not be able to control the board of the scouring entity and it will not be in the best interests of the remaining shareholders to allow Lempriere to favour its own trading entity. They would share in all of the losses from the loss of custom arising from such a strategy, but share in none of the gains. Finally, the Shareholders' Agreement specifies the directors must act in the best interests of the scouring entity, and favouring a related merchant entity would not be in the best interests of the scouring business.
- 3.31 Para 78: CWH notes that New Zealand produces less than 10% of the world's wool grease, and local users can import wool grease from other destinations. A considerable volume of lanolin is currently imported into New Zealand, along with other products made from wool grease. Up until 12 months ago, wool grease was marketed and sold by a single entity in New Zealand, the Lanolin Trading Company