MEMORANDUM

BELL GULLY

TO **Mya Nguyen**
OF Commerce Commission

FROM **Torrin Crowther / Phil Taylor**

BY EMAIL

MATTER NO. 400-4888
DATE 22 October 2015

Submission in response to Godfrey Hirst's submission on the Second Draft Determination

Other than the applicant, only one party has submitted on the Commission's Second Draft Determination, being Godfrey Hirst. On behalf of CWH, we respond to that submission below.

Included as **Appendix 1**, is a report by NERA in relation to this matter.

1. Summary

1.1 *Wealth Transfers*

Godfrey Hirst's arguments on wealth transfers must fail because there is clear precedent on this very point. The Commission has previously sought to exclude transfers to foreign shareholders and the High Court in *AMPS-A* said this was not the correct approach. This finding was not disturbed on appeal. The Commission's approach in the current case is correct, and in any event there is no scope for the Commission to reach a different view in light of the clear precedent. Godfrey Hirst's argument is also wrong as a matter of economic principle – the focus should properly be on the underlying resources which are freed up for an alternative use.

1.2 *Balancing*

Godfrey Hirst's comments on the correct approach to balancing benefits and detriments, do not engage on the critical fact that the statutory language in the authorisation and clearance contexts differ in a very important way.

In addition, Godfrey Hirst mischaracterises the Commission's position on net benefits in order to present the final calculus as a very close-run thing. Contrary to Godfrey Hirst's assertions, the revised net benefit position is not "so narrow" and nor was the net benefit position in the First Draft Determination only $2.51m. In fact, the First Draft Determination had a range of **$2.51-$22.88m** and the Second Draft Determination has a range of **$4.51-23.85m ([REDACTED]** when the apparent error in the **[REDACTED]** redundancy figure is corrected), i.e. mid-points of $12.7m and $14.2m **[REDACTED]** respectively.

1.3 *Merchant Comments*

The Chapman Tripp review of the merchant interviews focusses on selective references and in our view, is not an accurate reflection of the merchants' views. On proper analysis, **[REDACTED]**.

1.4 *Other*

We also set out below why there is no basis for the Commission to depart from its conclusions in relation to matters such as Clive, productive and dynamic efficiencies and

other capex benefits, and nor should it assume Cavalier Bremworth would face a price increase of up to 25%.

2. Wealth Transfers

2.1 The law on the issue of foreign ownership in the authorisation context is settled in New Zealand. The position was succinctly stated by the High Court in *AMPS-A*[1] as follows:

> We reject any view that profits earned by overseas investment in this country are necessarily to be regarded as a drain on New Zealand. ….
>
> On the other hand, if there are circumstances in which the exercise of market power gives rise to functionless monopoly rents, supranormal profits that arise neither from cost savings nor innovation, and which accrue to overseas shareholders, we think it right to regard these as an exploitation of the New Zealand community and to be counted as a detriment to the New Zealand public.

2.2 As the Second Draft Determination correctly points out, the Commission had in that earlier Telecom decision sought to exclude gains captured by foreign shareholders from its assessment of public benefits. The High Court specifically considered this point and held the Commission's earlier approach in Telecom was incorrect. This finding was not disturbed on appeal. There is therefore no scope for the Commission to adopt a different approach in the current case.

2.3 Focussing on the more efficient use of society's resources rather than the nationality of a particular shareholder is further supported by the High Court's observation in *AMPS-A* (at 530 – 531) that it agreed with the position the Ministry of Commerce expressed in *Reports and Decisions: Review of the Commerce Act 1986* that "[E]conomic efficiencies are real and of benefit to the public in terms of overall resources allocation and economic welfare even if little or none of the benefit directly accrues to others than the owners of the business."

2.4 The Court concluded (at 531) that:

> While this approach to benefit to foreign investors can, we think, be justified on quite general and fundamental grounds, its appropriateness is reinforced by the insertion of s 3A into the Commerce Act.

2.5 Similar sentiments were expressed by the High Court in *Air NZ*[2] at 241:

> … Determinations of authorisation applications under the Act are properly concerned with balancing any efficiency detriments associated with breaches of the statutory competition standard, against any efficiency gains that may result from the business acquisition or contractual arrangement in question. It is the balancing of **these real resource impacts** on the economy that best serves the long-term interests of consumers...[3] [Emphasis added]

2.6 Notably, *Air NZ* involved Qantas taking a 22.5% equity stake in Air New Zealand and neither the Commission nor the High Court found the benefits should be discounted by 22.5% as a result.

2.7 Not only is the case law clear on this point, it is also relevant that the use of the likely purchase price as the value to be ascribed to, for instance, a parcel of land, is no more than a proxy for the value of the underlying **actual** benefit, being the release of that underlying resource in New Zealand for an alternative use.

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[1] (1991) 4 TCLR 473 at 531.

[2] (2004) 11 TCLR 347.

[3] The Court went on, at paragraph 242, to say "This issue is confined to wealth transfers within New Zealand. Transfers between New Zealand and other countries are not necessarily regarded as welfare neutral." In our view, this is a direct reference to observation in *AMPS-A* that functionless monopoly rents arising neither from cost savings nor innovation but which accrue to foreign shareholders should be treated as a detriment.

3. Balancing of benefits and detriments.

3.1 We reiterate the views expressed previously in relation to the correct approach to balancing, namely that the different statutory language in sections 67 and 66 means a different approach is required in the authorisation context.

3.2 Under section 67, the Commission shall authorise an acquisition if it is satisfied (on the balance of probabilities) that it "will result, **or** will **be likely to result, in such a benefit** to the public that it should be permitted". There is therefore a critical distinction between the authorisation and clearance tests:

(a) in a clearance application the applicant must satisfy the Commission that the **adverse** outcome (the SLC) **is not** "likely"; whereas

(b) in an authorisation application the applicant must satisfy the Commission that the **positive** outcome (such a benefit to New Zealand) **is** "likely".

3.3 Notwithstanding the plain wording of sections 66 and 67, Godfrey Hirst (at paragraph 14) claim that section 67 requires the Commission to "decline authorisation unless it can exclude a real chance that the detriments outweigh the benefits", i.e. the same approach as adopted by the Commission in relation to clearances.

3.4 Contrary to Godfrey Hirst's view, section 67 does not require that the Commission satisfy itself a net detriment is not likely. If it did, section 67 would read like the clearance provisions in section 66 and section 67(3)(a), i.e.:

> If it is satisfied that the acquisition will not result, or will not be likely to result, in such a ~~benefit~~ detriment to the public [etc].

3.5 But it does not. And Godfrey Hirst's submission on this point makes no attempt to reconcile its view that the clearance and authorisation provisions mandate the same approach with the fact the statutory language in each section is very different.

3.6 We also note Godfrey Hirst's assertion (at paragraph 197) regarding judicial interpretation of the term "likely" in the clearance context and the correct approach to section 67 authorisations. Noting that the word "likely" is used in both provisions, Godfrey Hirst point to Justice Mallon's observation in *Godfrey Hirst* that "it is not necessary to rationalise why the legislature has used slightly different wording in the authorisation provisions." However, Justice Mallon's comment was in relation to a different point – which was the issue of whether there was any meaningful difference in the RTP and merger *authorisation* provisions, **not** whether there was any difference between the *clearance* and authorisation regimes.

3.7 It is only using the absolute worse-case benefits/detriments approach that allows Godfrey Hirst to argue that the net benefit in the initial draft determination was $2.51m[4] and that the Commission's revised margin is "so narrow."[5] Neither is correct.

(a) The Commission's First Draft Determination recorded its view the net benefit was likely to be between $2.51-$22.88m. To illustrate, that gives a mid-point of **$12.7m**.

[4] Godfrey Hirst submission of 15 October, at paragraph 7.

[5] Godfrey Hirst submission of 15 October, at paragraph 12.

(b) The Second Draft Determination concluded the net benefit was likely to be between $4.51-23.85m (**[REDACTED]** when the apparent error in the **[REDACTED]** redundancy figure is corrected), i.e. a mid-point of **$14.2m [REDACTED]**)

3.8 The $2.51 figure (in the First Draft) and the $4.51m figure (in the Second Draft) reflect the outcome if the ***lowest*** *figure for* ***every single benefit*** *was adopted*, and the ***highest*** *figure for* ***every single detriment*** *was adopted*. The likelihood of such an outcome is extremely low, which is part of the reason why we say such an approach – which is **in**consistent with a plain reading of section 67 – should not be read into section 67. Of course, if such an approach was mandated then it begs the question of why bother with the ranges at all.

3.9 Finally, Godfrey Hirst suggest, at paragraph 204, that the approach advanced in our 10 August submission was that the Commission must adopt the mid-point of any range and if it is positive then authorisation must be granted. This is not what we said. What we did say was:

> For the reasons set out above, when considering a range that spans both negative and positive values the Commission must go on to determine whether a positive value of net benefits is "likely". Conceptually, when considering a range that spans both negative and positive values, especially where an overall negative value requires that each of the major categories is at the far end of the range, a question to ask is:
>
> > *Is there any evidence to suggest that the distribution of outcomes over the net benefit range is heavily skewed towards the negative?*
>
> In the absence of such information, in an assumed range of say -$2m to +$20m, it would be odd to assume an expected value of less than zero, as this would imply the distributions over each of the variables (e.g., demand elasticity, price increase and property value) that underlies the net benefit range were extremely skewed towards the bottom end of the benefit range and top end of detriment range.

3.10 We remain of this view.

4. Price increases will not exceed 15%

4.1 While CWH considers that the Commission is overstating any potential price increase in respect of wool destined for export[6], CWH supports the Commission's conclusions to the extent that the merged entity is constrained from increasing prices <u>*by more than*</u> 15% for the following reasons:

(a) the Chapman Tripp review of the merchant comments is selective; and

(b) **[REDACTED]**. Such a view is also consistent with the evidence[7] of a **[REDACTED]** over an extended period; and a period which included industry restructuring resulting in higher scouring plant concentrations.

4.2 Accordingly, the assertion in the Godfrey Hirst submission that allocative efficiency losses should be substantially higher than the Commission estimates, is not supported by the merchant interviews overall.

4.3 Section 1 of the report by Professor Guthrie largely covers the same points as Chapman Tripp and, in our view, adds little weight to the argument. (We also note the comments in this section are in the nature of interpretation of interviews and not the application of expert economic opinion.)

[6] For reasons previously stated, CWH believes the maximum likely price increase is materially lower than 15%.

[7] See NERA "CWH/WSI merger – review of draft determination" 21 April 2015.

Merchant Interviews – price increases for wool destined for export

4.4 In the Second Draft Determination the Commission concluded the merged entity would be constrained from increasing prices above 15% for wool destined for export due to the ability of merchants to switch towards greater exports of greasy wool. Chapman Tripp, on behalf of Godfrey Hirst, argues that the Commission's conclusions are based on a flawed analysis of the views of merchants that "does not support the conclusions drawn". (Although notably, Chapman Tripp does not dispute the basis for the Commission's conclusion that any price increases would be incremental which, as noted in our earlier submission, has a substantial impact on the allocative efficiency calculation.)

4.5 Contrary to the view expressed by Chapman Tripp based on extracts of the interviews, the **[REDACTED]**. As such, a significant price increase of any sort is also unlikely.

4.6 The Chapman Tripp analysis depends on some inconsistencies in what certain merchants have said to the Commission. However, in our view, there is no doubt what merchants intend. The broad principles they enunciate are clear and unambiguous.

4.7 In any event, as Chapman Tripp has rightly pointed out, the merchants' views are "mere predictions" and what one merchant believes is an action it would take, will not necessarily align with the view of its competitors. In this sense, any differences in opinions must be tested against the individual merchant and its respective business. It is also interesting that Chapman Tripp makes the point that there is "no basis" to favour the "guesstimates" of one or two larger merchants over those with smaller market share[8], and then goes on to **[REDACTED]**[9].

4.8 The correct interpretation to draw from the interviews is as follows.

[REDACTED]

4.9 **[REDACTED]**

4.10 In summary, therefore, the correct position of the merchants appears to be as follows.

Merchant	Chapman Tripp's analysis	Position
[REDACTED]	**[REDACTED]**	**[REDACTED]**

4.11 What is apparent from this discussion is that there is a strong evidentiary basis for the Commission to dismiss a price increase of more than 15%. **[REDACTED]**.

4.12 The Commission at paragraph 235 of the Second Draft Determination acknowledges CWH's view that there have been **[REDACTED]**. The Commission also acknowledges the CWH view that this indicates a greater constraint imposed by greasy wool exports rather than any constraint imposed by domestic scourers. This evidence is not mentioned by Chapman Tripp when reviewing the Commission's finding of a 15% maximum potential price increase. While the Commission has referred to this evidence, it is not clear what weight if any, has been placed on it by the Commission when reaching its conclusions. In CWH's view, this is vital actual evidence which predates the transaction and provides strong evidence of the on-going greasy constraint and hence of likely industry outcomes in the future.

[8] Godfrey Hirst Submission on Second Draft Determination at 78.

[9] Godfrey Hirst submission on Second Draft Determination at 102.

Merchant views – wool destined for domestic use

4.13 The Godfrey Hirst submission does not mention the merchants' comments in respect of **[REDACTED]**.

4.14 **[REDACTED]**.

4.15 While the Commission considers that the price charged for wool scoured for Godfrey Hirst could exceed that charged for wool destined for export (at 25%), CWH submits that this is not the case (refer to the CWH submission of 15 October 2015 at 2.4). **[REDACTED]**.

Merchant views – general

4.16 The Godfrey Hirst submission does not refer to the more general comments **[REDACTED]**. It is important to recognise that these **[REDACTED]**.

4.17 This evidence clearly supports the wider context for authorisation. It only serves to further emphasise that the loss of the wool scouring industry in New Zealand, with a resulting impact on downstream processing, is a very real and near prospect and is a real concern for merchants, if steps are not taken now to ensure a sustainable industry.

5. Pricing to Cavalier Bremworth

5.1 CWH does not believe Cavalier Bremworth would face any meaningful price increases as a result of the transaction.

5.2 Cavalier Bremworth, **[REDACTED]** impact throughput and other efficiencies.

5.3 Further, and this is also relevant to the likelihood of any material price increases for Godfrey Hirst, CWH understands that Godfrey Hirst import finished carpets from China, and also import woollen yarn ex China for use in carpet making in New Zealand. At the moment, CWH understands that Cavalier Bremworth does not import carpet or yarn from China. However, it absolutely remains a credible risk. Obviously such imports, all things being equal, mean less demand for wool scouring domestically. This is yet another reason why CWH would be reluctant to do anything which would cause further substitution away from New Zealand-scoured wool by increasing the price to Godfrey Hirst or to CWH, all the more so given the volume/efficiency implications.

5.4 Moreover, it would be an odd outcome if Cavalier had entered into such a transaction, which resulted in a domestic monopoly among its suppliers (save for entry), if it were concerned about material price increases. The more likely explanation is that it is well aware of the constraints which CWH will continue to face on its pricing and is therefore comfortable that it will not face such price increases in the factual.

5.5 **[REDACTED]**.

6. Productive and Dynamic Efficiency

6.1 Godfrey Hirst's assertion that CWH might be less productively and dynamically efficient in relation to domestic users than international users is wrong.

6.2 The nature of wool scouring simply does not support such an (un-evidenced) assertion:

(a) As to productive efficiencies, there is no difference from a production perspective to scouring wool destined for domestic use to scouring wool for a merchant exporting

offshore. The process is exactly the same. Moreover, scouring is by and large a continuous process – the time period between CWH scourments is typically less than 5 minutes and a scourment for a domestic customer will often immediately precede or follow one for an export customer. Any suggestion that CWH could somehow become less productively efficient as between such scourments is nonsensical.

(b) In relation to dynamic efficiencies, the reasons underpinning the Commission's own conclusions in its First and Second Draft Determinations that such impacts are non-existent or very small apply equally to domestic and customers scouring for export. To the extent that new products might require scouring innovation then the pressures on CWH outlined in the Draft Determinations will motivate CWH to secure that innovation, irrespective of whether the particular customer is scouring for domestic or offshore use.

Godfrey Hirst's comments in relation to dynamic efficiency run to several pages, but most of that relates to innovation in the form of new wool *products*. The link to *scouring* is not evidenced, rather there is an assertion at the end of the commentary that these new wool products will require innovative scouring services, but there is no evidence for that. And even if there were, there is no basis to suggest that CWH will not be strongly motivated to work with all such customers in their endeavours. If it does not, then those customers (if domestically based) will go offshore, or their innovative new products will not come to bear – in both scenarios CWH would be the loser.

7. Clive in the Counterfactual

7.1 We do not repeat here our earlier comments in relation to the strategic value of Clive, although we make a few observations for completeness.

(a) Godfrey Hirst (at paragraph 151) claims that changes in the Board Composition of Cavalier Corporation have "changed substantially" as has Cavalier Corporation's financial performance, and that this somehow means less weight should be put the view of the directors of **CWH** that Clive was a strategic asset. But the key point is that the majority of the directors of the owner of Clive, **CWH**, have not changed for a number of years. Put simply, even if they wanted to, Cavalier Corporation does not control Clive and cannot force a sale of Clive.

(b) Godfrey Hirst assert (at paragraph 157) that the **[REDACTED]**. However, as explained in our 29 September Response to the Commission's Information Request, given the volatility and variability in the factors which impact the need for Clive, CWH does not seek to predict the following year's Clive volumes and nor has it done so for at least the last three years. Accordingly, nothing should be read into a lack of forecast for the 2016 years – as previous information makes clear, **[REDACTED]**.

(c) Finally, and while it is academic given CWH's confirmation that Clive will be retained in the counterfactual, there is an error in Professor Guthrie's calculation of what is said to be the impact on net benefits if Clive was to close in the counterfactual – it would be a **[REDACTED]**.

8. Capex

8.1 **[REDACTED]**

8.2 **[REDACTED]**

9. Conclusion

9.1 As consistently emphasised by CWH throughout this process, the driver of the proposed merger in New Zealand is not to gain monopoly rents, but a defence of the industry by gaining volume efficiencies against a backdrop of a declining wool clip and ever increasing greasy exports. The benefits of such a rationalisation have now been accepted on five separate occasions – the Commission (three draft determinations and one final determination) and the High Court. **[REDACTED]**. The Australian experience further reinforces this need. In contrast, Godfrey Hirst appears to be the only party who does not recognise the need for rationalisation. If volume efficiencies cannot be maintained, the industry has to be realistic about the repercussions – the loss of the wool scouring industry in New Zealand is a very real prospect if this transaction does not go ahead.