

Futures Consultants Ltd

**Cavalier Wool Holdings Limited's
Authorisation Application
February 2011**

**Response to the Commerce Commission's
Draft Determination**

27 April 2011

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INTRODUCTION

1. On the 13th February 2011 the Commerce Commission (the Commission) issued a draft determination¹ relating to the application by Cavalier Wool Holdings Limited (CWH) for an authorisation to give effect to a transaction that would involve CWH, or an interconnected body corporate, acquiring control over New Zealand Wool Services International Limited's (NZWSI) wool scouring business (the Acquisition).
2. The Commission's preliminary view is that it is not satisfied that the Acquisition will not have, or would not be likely to have, the effect of substantially lessening competition in both the North and South Island markets for the supply of wool scouring services.² For this reason, the Commission's preliminary view is it should not give a clearance to the proposed transaction.
3. It is also, however, the Commission's preliminary view that it would be satisfied that the benefits to the public would outweigh the loss of competition arising from the Acquisition. As a result, the Commission's preliminary view is that it would be satisfied that the Acquisition will result, or will be likely to result, in such a benefit to the public that it should be authorised under s 67(3)(b) of the Commerce Act 1986 (the Act).
4. I have been asked by NZWSI to review the Commission's draft determination and provide my independent economic assessment of whether the Commission has reached the appropriate conclusions, having regard to all the circumstances.
5. I agree the Commission's conclusion that it cannot grant clearance to the Acquisition is consistent with the evidence.
6. The Commission has been asked by CWH to approve it obtaining a monopoly over wool scouring in New Zealand, a long established and innovative New Zealand industry with considerable significance to the rural sector of the economy.
7. The Commission has reached the preliminary view that it should bless the monopoly having accepted in full of CWH's claims about the reduction in production and administrative costs it will achieve should the proposed merger proceed.
8. The Commission has also accepted the applicant's assurances that competition from Chinese scourers and the threat of new entry into the scouring business in New Zealand will be effective constraints against it exercising its monopoly power to any material

¹ Commerce Commission, *Cavalier Wool Holdings Limited and New Zealand Wool Services International Limited: Draft Determination*, 13 April 2011. (Hereinafter Draft Determination)

² Draft Determination, para. 124.

degree. In addition, the Commission has accepted the applicant's claims about the values it could realise by rationalising NZWSI's scouring properties.

9. The Commission has estimated the NPV over five years of the total detriments of the monopoly to allocative, productive and dynamic efficiency may be as little as \$1.439 million and would be at most no more than the [XXXXXXXXXX] production and administration cost savings from the merger claimed by CWH. In other words, the cost efficiencies for the merged entity [XXXXXXXXXX] are estimated to be approximately the same as the upper bound estimate of the efficiency detriments to the whole economy.
10. In my opinion, the evidence does not support acceptance of CWH's claims relating to production and administration cost savings, its views about the values of NZWSI's assets that could be realised by rationalisation or acceptance of its assurances that competition from Chinese scourers and the threat of new entry will be effective constraints against it exercising its monopoly power. If the Commission's preliminary view is confirmed and CWH proceeds with the Acquisition, it would be able to exercise its powers to a very considerable degree to the significant detriment of wool producers and the New Zealand economy as a whole.
11. In my opinion, the Commission has over-estimated the benefits and under-estimated the detriments of the Acquisition and its conclusion that the proposed transaction would result in such benefit to the public that it should be authorised is inconsistent with the evidence. In my opinion, in the light particularly of the risks and irreversibility of blessing a monopoly the detriments of allowing the monopoly significantly outweigh the benefits and the Commission should decline authorisation of the Acquisition.
12. More specifically, I believe the Commission has:
 - very materially over-estimated the efficiency gains likely to be achieved by merging the two entities together;
 - very materially over-estimated the competitive constraint Chinese wool scourers would exert upon the pricing behaviour of the merged entity;
 - materially over-estimated the competitive constraint the threat of new entry would exert on the pricing behaviour of the merged entity;
 - very materially under-estimated the detriments of the merger arising from losses of productive and dynamic efficiency in the wool scouring industry over time;

- very materially over-estimated the value of the net benefits available from the merger by rationalising the land and buildings currently used for wool scouring in New Zealand;
- under-estimated the one-off rationalisation costs by failing to account for the economic costs of disruption to the provision of wool scouring services that will occur as the plants are rationalised; and
- failed to take into account the economic costs of the short-term disruption that the merger is likely to have in the market for New Zealand wool.

13. I consider each of these conclusions in turn before making some miscellaneous points about the Commission's draft determination. I hope will assist the Commission in preparing its final decision.

EFFICIENCY GAINS

14. A cost saving due to a merged entity being able to negotiate sharper prices and lower margins with sellers is unlikely to be a true economic benefit for the economy as a whole. It is more likely to reflect a wealth transfer from the seller to the merged entity as buyer. Cost savings which reflect wealth transfers should not be included in a public benefit assessment.

15. The Commission has not considered whether the productive and administrative cost savings claimed by CWH pass this basic test as to whether they are true benefits for the economy. Instead, the Commission has accepted CWH's estimates and assessed the net present value (NPV) of the cost savings from the merger would be [XXXXXXXXXXXXXXXXXXXX] over 5 years.

16. Apart from this matter, which I consider further later, there are two issues with the calculation by the Commission, even if CWH's detailed estimates are accepted. Firstly, the reduction in scour and press operating expenses and administration expenses itemised by CWH in its computer spread sheets total [XXXXXXXXXX] and not [XXXXXXXXXX] per year. Secondly, the implicit assumption in the NPV calculation is that all the efficiency improvements would be captured **in full** from the first year of operation of the merged entity. Since the merging of the plants is likely to take several months and possibly as long as a year, this is unrealistic. A generous estimate would be to assume 50% of the savings are achieved in the first year. After making these two adjustments alone, the NPV over five years falls to [XXXXXXXXXX], or by \$4.62 million below the Commission's preliminary view.

17. NZWSI engaged Mr Gary Forward, an accountant who is a qualified Chartered Accountant. Mr Forward has yet to finalise his report relating to CWH's estimates of the productive and operating efficiency savings. The estimates in my report will be complemented by Mr Forward's estimates of this component when they are available. The Commission has allowed until Friday 29th April for this to happen.

CHINESE COMPETITIVE CONSTRAINT

18. After reviewing the evidence, the Commission's preliminary view is:

*... post-acquisition, Cavalier Wool will not be totally unconstrained in the market. It will face constraints from Chinese scourers, and the potential for new entry. While these constraints taken together are not enough to satisfy the Commission that there will not be, or would not likely to be, a substantial lessening of competition, they are likely to limit the size of any price increase attributable to the acquisition.*³

19. In the draft determination for the Ruapehu and Turoa ski-fields merger case⁴ the Commission developed cost estimates for ski packages for North Island couples and families at Mt Ruapehu, Mt Hutt and Queenstown. I have adapted this quantitative approach to explore the degree of constraint the merged entity would face from Chinese scourers.

20. I have compared the costs of New Zealand and Chinese scouring for three scenarios: the scouring of wool for further processing in New Zealand; China; and Europe. The cost details and results are shown in Appendix A.⁵

21. The conclusion to be drawn from this analysis is that scouring in New Zealand is more cost effective than scouring in China. More specifically:

- Exporting New Zealand greasy wool to China and reimporting it scoured for further processing in New Zealand is very expensive compared with scouring the wool in New Zealand. A monopoly New Zealand scourer, unconcerned by new entry, could lift its scouring price to \$0.96/kg (or by 197.1%) before a local wool processor would find it economic to have its wool scoured in China.
- Exporting New Zealand greasy wool to China for scouring and onward shipment to Europe is also an expensive option compared with scouring in New Zealand. A

³ Draft Determination, para. 159.

⁴ Commerce Commission, *Ruapehu Alpine Lifts Limited and Turoa Ski Resorts Limited (in receivership): Decision 410*, 14 November 2000, para. 96.

⁵ The cells in column D of the spread sheet have notes attached that indicate the sources and bases for the cost estimates.

monopoly New Zealand scourer, unconcerned by new entry, could lift its scouring price to \$0.61/kg (or by 91.2%) before a wool exporter/importer would adopt this option.⁶

- Exporting New Zealand greasy wool to China for scouring and further processing in China is marginally more expensive (\$0.02/kg or 6.6%) than scouring the wool in New Zealand before sending it to China for post-scouring processing.⁷

22. Currently, 14% of New Zealand's wool exports by volume are scoured in New Zealand and exported to China.⁸ It might be argued, therefore, on the basis of the above calculations that a 10+% increase in scouring charges by the merged entity would lead to it losing much of this scouring volume and China does represent an effective constraint on the merged entity's pricing.

23. This argument overlooks the following three points, however:

- The cost estimates in Appendix A do not take into account that Chinese scours are in the main geared up to process fine wool rather than coarse wool, and much of New Zealand's clip and its scoured wool exports to China is coarse wool. The optimal scouring equipment for fine wool, which is what most Chinese scours have, is not the optimal equipment for coarse wool. Moreover, if a fine wool scour line is used to scour coarse wool, extensive cleaning to remove all traces of the coarse wool is required before fine wool can be scoured again because any residual coarse wool will degrade the fine wool product.
- The very high level of price increases that would be tolerated by domestic wool processors and wool exporters to Europe before they would switch to exporting greasy wool to China for scouring is such that it would be profitable for the merged entity to forgo entirely scouring wool for China. An 80% price increase for scouring would not result in shifting scouring for markets such as Europe to China, but an increase of this size on, say, 80% of the New Zealand wool clip would lift scouring revenue for the merged entity by 64%. Even if this was achieved at the expense of all scoured wool sales to China – 14% of all wool exports - the offsetting loss in revenue is 11% because wool exports are 78% of the total wool clip.. This gives a gain in revenue of 64% less 11%, or 53%, for the

⁶ Scouring charges in Europe and Australia are around double those in New Zealand and so the option of sending the wool greasy to these destinations for scouring would not provide a constraint for the merged entity doubling prices.

⁷ This observation is consistent with the current trend for increased scouring of wools destined for China in New Zealand but there being both scoured and greasy wool sent to that country.

⁸ Draft Determination, para. 79.

new entrant in the medium term and would be vulnerable to supply disruption for raw materials to process during the 18 months Commission estimates it would take to establish a competing scour;¹⁴

- according to the Commission the merged entity would be a very efficient operation given its scale and could afford low prices that a new entrant is unlikely to withstand;¹⁵
- higher scouring prices are not likely to be simply absorbed or passed on. Instead they are likely to translate into lower margins for growers; and
- since scouring represents a very small percentage of the total value of scoured wool and wool is small component of sheep farmers total returns “it is very unlikely that a change in the price of wool scouring services by itself will have a significant influence on the amount of wool available for export, either scoured or greasy.”¹⁶

26. Moreover, the argument that potential new entry will provide a reasonable constraint is at odds with estimates of the realistic costs likely to be faced by a new entrant.

27. According to the Commission, the most likely start-up by a new entrant, should there be one, would involve installing a 2.4 metre scour.¹⁷ CWH have conveniently provided the Commission with detailed cost estimates for operating its 2 x 2.4 metre scouring operation in Hawkes Bay.

28. I have taken CWH’s estimates and adjusted them to reflect that a 1 x 2.4 metre operation is likely to face somewhat higher operating and administrative costs per unit for most cost components than a plant double its size. I have also assumed that a new entrant scouring operation will require the appointment of a Chief Executive, a Chief Financial Officer, as well as a Chief Operating Officer and its own Board at a total cost of \$800,000.¹⁸ I have also assumed that the cost of the plant, land, buildings and resource

¹⁴ Draft Determination, para. 104.

¹⁵ Draft Determination, para. 107.

¹⁶ Draft Determination, para. 142.

¹⁷ Draft Determination, para. 100.

¹⁸ These management/governance expenses might be significantly reduced if the scour was established as a subsidiary of an established single wool exporter. I consider this to be unlikely due to the financial losers several exporters made in scouring in the past; their generally low capitalisation and that scouring is not seen as a core business. The need for both a CEO and a COO reflects the amount of international travel that a CEO is likely to have to undertake if the firm is to be successful. Godfrey Hirst are unlikely to be a potential entrant for the next five years because of the long term agreement it has with CWH and the supply disruption it could face if it decided to pursue this course of action.

consents for a 1 x 2.4 metre scouring operating would be \$12 million, \$1 million, \$2 million and \$1.5 million, respectively.¹⁹

29. I further assume investors contemplating entry into the scouring industry facing the merged entity would expect a 15 % return on capital pre-tax, in order to enter and face a monopoly provider in an industry with a history of capital losses for investors. Further, I assume investors would expect the return of their capital investment in plant, equipment and resource consents (\$15.5 million) over 25 years.
30. The results of these calculations are that the charges of the new entrant would have to be above those of CWH by \$0.12/kg greasy or 39.4% for the new entrant to make an economic return. These calculations are set out in Appendix B, along with CWH's data for a 2 x 2.4 metre operation.
31. The clear implication is that the Commission has over-estimated the degree of price restraint that the threat of entry would impose on the merged entity. A price rise of 40% or more would appear likely to be required before a profit maximising new entrant would be tempted to take on the merged entity, even if it was able to secure the requisite 18,000 tonnes to process efficiently prior to start-up. Given the risks and difficulties of achieving this, the merged entity is likely to be able to increase prices well above 40% before it need fear entry.
32. The consequence of the Commission having very materially over-estimated the constraints on the merged entity's pricing presented by Chinese scourers and materially over-estimated the threat of new entry is that the Commission has very materially underestimated the allocative, productive and dynamic efficiency detriments of the proposed transaction.

ALLOCATIVE EFFICIENCY

33. In the context of discussing potential allocative inefficiency detriments the Commission notes that the demand curve facing the merged entity could be stepped so that demand elasticity is not continuous. From this observation it comments:

Volumes of scoured wool to China could switch to greasy exports in the face of a relatively small price increase, but prices may be able to be increased significantly

¹⁹ The Commission claims it has been advised that a new 3 metre scour line, with all associated equipment "may cost" about \$12-\$15 million, and that a new entrant could enter for considerably less with a 2.4 metre wide line. My information is that the plant and associated equipment for a new 3.0 metre scour line would cost approximately \$30 million. The Commission has itself noted that used 2.4 metre lines are now scarce, and if a used line was purchased then the rate of depreciation would increase from what I have assumed in my model.

for other markets without greatly affecting the volumes demanded. In this scenario it may be profitable for the Applicant to forgo most or all scoured wool volumes that currently go to China in order to achieve higher margins on wool destined for other markets. This is the case if sufficient quantities of scoured wool destined for other markets did not switch to greasy exports to China. This would likely lead to relatively high allocative efficiency losses as the demand for scouring in New Zealand would reduce significantly.²⁰

34. My analysis of the relative costs of scouring in New Zealand and China, as reported in Appendix A and discussed above, supports that the possibility recognised by the Commission is very likely to happen in practice, if the Acquisition proceeds. The Commission notes, however, that any ability by the applicant to price discriminate could ameliorate these potentially large allocative efficiency losses. As I noted previously, I think that the merged entity would be able to price discriminate to some degree. However, the greater the price rise for some services, the more difficult it will be for the merged entity to successfully discriminate because the higher the price differential the more incentive for customers to circumvent and break down discriminatory behaviour. In this context, I note that the merged entity would be able to increase prices by upwards of 40% without realistically risking new entry or the diversion of more than 14% of the clip to scouring China. A 40% increase in prices offset by loss of 14% volume would be profitable and corresponds to an (arc) price elasticity of -0.35.
35. I assume a price elasticity of demand of -0.35, a price rise of 40%, a pre-merger market price for scouring of [XXXXXXXXXX], an average pre-merger variable cost of [XXXXXXXXXX] total wool production of 188,500 tonnes, of which approximately 75% is scoured, and that 15% of the wool clip is subject to long term fixed prices and so not susceptible to any price increase over five years. On this basis, the allocative inefficiency is [XXXXXXXXXX] per year and has an NPV of [XXXXXXXXXX] over five years. Even if the half of this allocative inefficiency loss is offset by price discrimination by the merged entity, the inefficiency is [XXXXXXXXXX] per year and has an NPV of [XXXXXXXXXX] over five years.
36. The range for my estimate of the NPV over five years of the allocative inefficiency detriment is [XXXXXXXXXXXXXXXXXXXX]. My lower bound estimate is very materially greater than the lower bound estimate of allocative inefficiency loss by the Commission but my upper bound estimate is very comparable.

²⁰ Draft Determination, para. 164.

PRODUCTIVE EFFICIENCY

37. The Commission considers the upper range for loss of productive efficiency is between 1% and 5% of pre-merger variable costs.²¹ It has justified this relatively low range on the grounds that: declining sheep numbers and wool clip have put downward pressure on costs in the industry; two of the three shareholders of CWH are experienced investors wishing to maximise their investment income and capital growth; and “this small number of shareholders should have the ability and incentive to continue to drive productive efficiencies in the factual.”²² The Commission also points to “the on-going competitive threat from the Chinese scouring industry”²³ to support its estimate.
38. I have already shown that the Commission has very materially over-estimated the competitive threat from the Chinese scouring industry.
39. The continuation of the current share ownership of CWH cannot be a condition for authorisation and there is no assurance that this ownership structure will continue. In my opinion, the Commission cannot take this factor into account when assessing detriments and benefits; the shareholding could change immediately after the transaction occurs and the Commission does not know this will not happen so it cannot include continuation of ownership structure in the factual.
40. I have also noted that, given the lack of competitive pressure on the merged entity, any modest reduction in volumes in future is likely to be able to be more than offset by price rises.
41. For these reasons I continue to believe that productive inefficiencies of 5-10% - the range used by the Commission in the “newco” dairy case, which also proposed the establishment of a single major provider - is realistic. Assuming average variable costs of [XXXXXXXXXX] and production of 188,500 tonnes as reported by the Commission with 75% scoured this equates to total variable costs of [XXXXXXXXXX]. 5% of this figure is [XXXXXXXXXX] and 10% is [XXXXXXXXXX]. Over a five year period at a discount rate of 10% the range of these values has an NPV between [XXXXXXXXXX] and [XXXXXXXXXX].
42. The range of my estimates of the productive efficiency loss is very materially higher than the range of the Commission’s estimates because the Commission has over-estimated the constraints of Chinese scourers and the threat of new entry on pricing by the merged entity and has taken into account the ownership structure of CWH and it should not have done so.

²¹ Draft Determination, para. 174.

²² Draft Determination, para. 172.

²³ Draft Determination, para. 173.

DYNAMIC EFFICIENCY

43. In its draft determination the Commission recognises that it is “very difficult to calculate dynamic efficiency losses with any strong confidence about the precision of the calculation”²⁴ but goes on to state a number of industry characteristics lead it to believe that “any loss of dynamic efficiency in this instance is likely to be moderate, at most.”²⁵
44. In the opinion of the Commission “it is the long-term competitive threat of the Chinese scouring industry that reduces potential dynamic efficiency losses the most.”²⁶ However, I have already demonstrated that the Commission has very materially over-estimated the competitive threat of Chinese scourers; a realistic assessment of the threat does not support the view that it will stimulate dynamic efficiency.
45. The other industry characteristics to which the Commission points to in order to support its view together with my responses to them (in italics) are:²⁷
- The long history of product and process innovation in the industry. *This has all occurred in a highly competitive environment where businesses that did not innovate and cut costs failed and I have already demonstrated the merged entity will not operate in such a market environment.*
 - The presence in New Zealand of manufacturers and research organisations producing new innovations. *Take up of new ideas has been spurred by competition and the need to innovate and cut costs to survive in a shrinking market. Again, the merge entity will not operate in such a market environment.*
 - The well-informed Board and shareholders of CWH are likely to effectively monitor performance. *I have already noted there is no assurance that the shareholders will continue to own CWH after the merger, and there can be no assurance about the composition of the Board either. These factors cannot be assumed to be part of the factual and must be discounted as irrelevant in any assessment of benefits and detriments of the merger.*
 - The difference in business model between CWH and NZWSI has attenuated competition and the stimulus for innovation compared with what it would have been if the two companies had operated the same business model. *Even if this argument is accepted, and is questionable, the comparison is about the*

²⁴ Draft Determination, para. 187.

²⁵ Draft Determination, para. 191.

²⁶ Draft Determination, para. 190.

²⁷ Draft Determination, para. 189.

*counterfactual and what it might otherwise have been. It does not establish that competition will be stronger in the factual than the counterfactual and all assessments of benefits and detriments must involve such a comparison. The Commission has already conceded that the competitive threat from NZWSI has stimulated innovation and this will not happen in the factual.*²⁸

46. Given the low competitive pressure on the merged entity, I believe that in the long-term there will be considerable dynamic inefficiency detriments from the proposed transaction. The scouring business is, as the Commission has noted, one characterised by product and process innovation over a very long period of time. I accept that the upper bound figure of the estimates in my previous submission on the proposal may not be realised in a short period, such as five years, but note that there is no reason why the analysis should be restricted to this time frame. Dynamic efficiency is important in the longer term and the longer term can be relevant even when discounting is applied.
47. In my opinion, the Commission's guestimate of 0% to 1% of total industry revenue is a very material under-estimate in view of the lack of competitive pressure under the factual and the importance of innovation over time in the industry. In my opinion twice the rate assumed by the Commission in the Air New Zealand/Qantas merger case would be more appropriate for this industry over a five-year time frame. This would equate to 1% to 3% of revenue or [XXXXXXXXXX] to [XXXXXXXXXX]. The NPV over 5 years would be [XXXXXXXXXX] to [XXXXXXXXXX].
48. The range of my estimates of the dynamic efficiency loss is very materially higher than the range of the Commission's estimates because the Commission has over-estimated the constraints of Chinese scourers and the threat of new entry on pricing by the merged entity. The Commission has also taken into account the ownership structure and governance of CWH when it is not entitled to do so and has also considered the impact on competition under the counterfactual of the difference in business models of CWH and NZWSI when it should have compared the impact of competition under the factual and the counterfactual.

LAND AND BUILDING RATIONALISATION

49. The Commission has the preliminary view that the most likely value for land sales post Acquisition would be \$8.792 million and has ascribed this amount as the NPV over five years of the benefit of the merger due to this factor. This estimate is very materially too high for several reasons.

²⁸ Draft Determination, para. 188.

50. Firstly, the \$8.792 million figure is the valuation as at 31 December 2010 of the two NZWSI plants to be rationalised as contained in the Information Memorandum issued by the receivers of NZWSI's two major shareholders in February 2011. The Commission prefers this valuation over an alternative provided to it by NZWSI of \$6.03 million because "the Receiver has a duty to be accurate in these matters and would otherwise expose itself to liability for any inaccuracies in its Information Memorandum."²⁹ A further reason the Commission advances for its decision is that NZWSI did not adopt the lower figures in its annual report for the 12 months to June 2010.
51. The lower valuations provided by NZWSI to the Commission were explicitly undertaken by the two valuers on a vacant possession basis. This is very clearly stated in the two valuations right next to the valuation figures. There can be no confusion. Under the factual, CWH's intention is to sell NZWSI's two scouring properties on a vacant possession basis with, presumably, a covenant over their land titles restricting the use of the sites for scouring and wool processing in future.
52. The Receiver when it issued the Information Memorandum was attempting to sell shares in NZWSI as a "going concern" engaged in the provision of wool exporting and wool scouring services. The valuations it used must be appropriate for this purpose and these are valuations based on those in the statutory accounts drawn up in accordance with International Financial Reporting Standards (IFRS).
53. Similarly, for the valuations included in annual reports. These should be, and are, on a going concern basis, provided the firm is a going concern, which NZWSI is, and should, and do, conform to IFRS.
54. The lower valuations on a vacant possession basis provided by NZWSI are the appropriate valuations for the purposes of the Commission assessing a factual which involves rationalisation of these sites, apart from not including a deduction to reflect the covenants that we can safely assume will be placed on the titles by CWH as a precaution against easy entry into scouring in the future using one or both these sites.
55. The Commission's suggestion that NZWSI has provided it with inappropriate lower valuations that favour its submission is totally unfounded.³⁰ The lower valuations are appropriate as a starting point for the Commission's purposes but the valuations of the receiver and those derived from financial accounts are not appropriate.

²⁹ Draft Determination, para. 202.

³⁰ Draft Determination, para. 202.

56. These lower valuations should be reduced further to reflect the impact on valuation of the covenants we can safely assume CWH will place on the titles. Dr Alan Reay an experienced consulting engineer familiar with both the Kaputone and Whakatu sites has provided NZWSI with his expert opinion that, if the buildings cannot be used for wool scouring or processing the alternative use for the properties would require the existing specialised buildings and improvements on the properties to be demolished and therefore any prospective purchaser would take into account the underlying land value and the cost of demolishing and removing the existing structures rather than take into account any economic value for the existing buildings.³¹

57. In short, according to Dr Reay, the value of the properties subject to the expected covenant is the value of the land less costs of demolition and removal. The land valuations of Kaputone and Whakatu on a vacant possession basis are \$2.520 million and \$0.976 million, respectively, or \$3.496 million in total. Assuming that demolition and removal of existing structures costs \$0.750 million at Kaputone and \$0.25 million at Whakatu, the values of the two properties for the purposes of assessing the Acquisition are \$2.746 million and \$0.726 million.

58. The following table summarises the appropriate valuation concepts and their use:

Valuation concept	Application of valuation concepts
Going concern as per IFRS - Depreciated Replacement Cost	Conceptual basis of valuations for financial accounts and receiver's information memorandum
Vacant possession	Conceptual basis of valuations provided to Commission by NZWSI in initial submissions
Vacant possession less economic costs of covenant restricting use of property for wool scouring and processing	Conceptual basis of valuations the Commission should use for the purposes of its assessment of detriments and benefits

59. Secondly, as the Commission notes "any delay in the sale of the land and building would also reduce their present day value of those assets."³² However, the Commission has not applied any discounting, presumably because the Commission believes the properties will be sold immediately on merger. This is an unrealistic assumption to make.

³¹ See Appendix C.

³² Draft Determination, para. 203.

60. The plant and equipment have to be removed from the two NZWSI sites and shifted to their new locations. Moreover, the market for large industrial properties is not particularly liquid and it can take some time to match buyer and seller. In addition, one of the properties is close to Christchurch and the market for properties in that area has been severely disrupted by a sequence of earthquakes in the region. The property is not suitable as a temporary replacement for offices destroyed in Christchurch's central business district. It is likely to be some considerable time before investors will venture into significant industrial property purchases in the area.

61. As I argued in my original submission, the sales value of the land and buildings reflect the benefits those assets will provide their owner (in present day value) over their full life. However, the other factors in the analysis are assessed over just five years. The Commission has responded to this argument by denying the applicants suggestion that the required expenditure on land and buildings to effect the proposed rationalisation should be discounted over a five year period. I can understand the desire of the Commission for a straightforward treatment but a conceptually purer approach would be to include over each of the five years the rental values of the capital on which the expenditure takes place.

62. I have recalculated the NPV over five years at 10% of the benefit from rationalising land and buildings under the factual, net of the costs of upgrading buildings at other sites, assuming:

- The annual rental value of land and buildings is 10% of their current market value;
- Under the factual, Kaputone is sold two years after the merger for its current vacant possession land value, net of an assessed \$750,000 for demolition, removal and dumping of structures (\$2.746 million);
- Under the factual, Whakatu is sold one year after the merger for its current vacant possession land value, net of an assessed \$250,000 for demolition, removal and dumping of structures (\$726,000); and
- Under the factual, Awatoto and Timaru are upgraded by expenditure of [XXXXXXXXXX] as soon as the merger occurs.

63. The result under these assumptions is that the NPV over five years at 10% of the benefit from site rationalisation, net of costs, is a **net cost** of [XXXXXXXXXX]. It is a net cost because the upgrade expenditure occurs upfront but the asset realisations are deferred up to three years.

64. My estimate of the net benefit from property rationalisation is very materially below the estimate of the Commission because the Commission has chosen to use an inappropriate valuation for its purpose and has failed to correctly account for the benefits and costs over a five year period.

RATIONALISATION COSTS – PRODUCTION DISRUPTION

65. One aspect of the one-off rationalisation costs that appears to have been overlooked by the Commission and all commentators on the proposed transaction, including myself, is the economic costs of the disruption to wool scouring in New Zealand that will inevitably occur while NZWSI's plants are being dismantled, equipment shifted and reinstalled. There is not enough spare capacity in the market to allow demand to continue to be met throughout the rationalisation process.

66. Assuming the NZWSI scours are out of service for three months – 9 months, approximately 15.0 – 45.00 million kg of wool will be displaced. The Applicant has not provided in support of its case any evidence in relation to how it proposes to handle this situation.

67. There are several possibilities:

- the greasy wool that is unable to be scoured during the relocation period could be stored until the scours are back in operation;
- the wool could be exported greasy instead of scoured or the merged entity could continue to operate NZWSI's scours for some time so merchants can build up a stock of scoured wool to tide them over the relocation period, although the ability of some merchants to fund this is questionable; or
- CWH could take Clive out of mothball and use it to cover the short-term shortage of capacity

68. Irrespective of the option chosen, there will be an economic cost that will fall on some party in New Zealand. For the purposes of estimating this cost I will assume that the processing of 10 million to 30 million kg's of wool – two-thirds of the NZWSI total needing to be processed - is deferred by three months on average. At an interest rate of 7% and average price of wool of \$5/kg, the interest cost is \$0.88 million to \$2.63 million and extra storage will be on top of this. The total economic cost is likely to be approximately \$1.00 million to \$3.00 million and this should be included in the analysis of the benefits and detriments of the Acquisition.

UPSTREAM DISRUPTION

69. NZWSI is the most significant purchaser in the market for New Zealand wool. According to Figure 2 in the Commission's draft determination, it purchases 52,500 tonnes or 27.9% of the total wool clip.³³
70. Under the factual, CWH intends to immediately sell the wool merchant activities of NZWSI or discontinue them. In the very short-term, if the supply of wool remained fixed and NZWSI's demand of approximately 30% of the market was withdrawn, the static equilibrium price of wool would fall 30%³⁴ and the typical dynamics in a commodity market could accentuate the price drop to be significantly more than this. In reality, supply will not remain fixed as the wool of some producers will be withdrawn as the price falls below their reserve price,
71. Moreover, over time other parties will step in to fulfil NZWSI's current role in the market, although it is likely to be some time before its role is replaced in full as other parties will have to establish significantly increased credit lines and business networks and relationships. For most wool exporters significant increases in credit lines will require increases in capital, and this will take time to organise and put in place, and for some firms will not be possible at all.
72. CWH will not have an incentive to avoid any dislocation in the wool market as it is a commission scour and so does not hold stocks of wool. In fact, the wool processing businesses of its associates would be advantaged by the lower prices likely to follow from a short-term shortage of buying power in the New Zealand wool market.
73. No account of the economic costs such disruption of the wool market would impose on New Zealand wool producers has been factored into the Applicant's case, or the Commission's draft determination.
74. Disruption with costs equivalent to the costs of requiring two month's wool production at \$5/kg to be funded for two months at 7% would cost \$1.83 million. In my opinion this is a conservative estimate of the likely costs of disruption to the wool market under the factual.

³³ CWH may handle more wool but it does so as a commission scourer and not as a principal.

³⁴ The effect of the removal of a buyer for 30% can be viewed as equivalent to a movement inwards of the demand curve by 30%. With an inelastic short-term supply curve this translates to a 30% reduction in price. The demand elasticity is not relevant as it is a movement of the demand curve and not a movement along the demand curve.

75. Disruption that resulted in a 30% drop in the price of New Zealand wool below \$5/kg greasy that lasted only one month would have an economic cost to New Zealand of \$18.85 million³⁵, even if only 80% of the lower commodity realisation fell on wool producers and others in New Zealand.

76. I believe that it is very reasonable to assume that the sudden withdrawal from the new Zealand wool market of a buyer that regularly took 30% of the offering would disrupt the market very significantly for at least one month and to a lesser degree for several months, especially since the new owner, CWH, would have an incentive to see the market disrupted. On this basis, I consider a reasonable range for the estimate of this detriment is \$1.83 million to \$18.85 million, and the upper limit could prove conservative.

MISCELLANEOUS COMMENTS

77. In the draft determination it is claimed that under the factual both CWH's Clive and Timaru plants will be mothballed.³⁶ This is not correct; only CWH's Clive plant is intended to be mothballed.

78. In my opinion, having considered the evidence presented in the draft determination, no weight should be attributed in the cost benefit analysis to:

- the claimed removal of a weak seller benefit;
- CWH's claim that it will be able to achieve quality benefits related to raising the Y-factor; and
- the claimed benefits from a merger being able to introduce a super store concept and achieve efficiency gains as a result.

79. In my opinion, the Commission's preliminary view that because the quantification of benefits has a higher degree of certainty (narrower range of estimates) it should be given greater weight when balancing the public benefits and detriments is inappropriate.³⁷ The Commission should assess the benefits and detriments as a whole to see if it believes that the Acquisition will result, or will be likely to result, in such a benefit to the public that it should be permitted. It should not discount lower bound estimates of detriments further as the broad range already takes account of the uncertainty.

³⁵ 188,500 tonnes x 0.8 x \$5/kg x 1000 kg x 30% x 1/12 year = \$18.85 million

³⁶ Draft Determination, paras. 2 and 62.

³⁷ Draft Determination, para. 242.

SUMMARY

80. The Commission must be “satisfied that the acquisition will result, or will be likely to result, in such a benefit to the public that it should be permitted”. In short, the Commission has to be satisfied that there is sufficient benefit to the public to allow the creation of a monopoly over such a long established and innovative industry in New Zealand. The risks of allowing a monopoly to be established are significant as, once created, market forces will not remove it. I have already shown that barriers to new entry into the industry are high. Nor are there legal provisions to remove or restrain the monopoly, short of the very unlikely event of it being brought under Part 4 of the Act.

81. In my opinion, the onus should be on the applicant to demonstrate the benefits are sufficient to warrant this risk. The applicant has not come close to doing this. In fact, the applicant has:

- overstated the net economic benefit of cost savings it can achieve, partly by counting its private savings as a public benefit and partly by assuming they will accrue immediately when this is not possible;
- overstated the constraints on its pricing it would face as a monopoly from Chinese scourers and the threat of new entry;
- overstated the amount it will realise from the rationalisation of NZWSI’s land and buildings by confusing the valuation approach that is appropriate for assessing the benefits of rationalisation;
- neglected to cost the disruption to wool scouring its rationalisation plans will create; and
- neglected to cost the disruption to the upstream wool market its Acquisition will create.

82. When appropriate adjustments for these matters are made, the proposed Acquisition will result in a clear detriment to the public and the application for authorisation should be declined.

Category	Commerce Commission's 5-year NPV	Futures' 5-year NPV
Allocative efficiency	\$0.733 million - \$15.645 million	[XXXXXXXXXX]
Productive efficiency	[XXXXXXXXXX]	[XXXXXXXXXX]
Dynamic efficiency	[XXXXXXXXXX]	[XXXXXXXXXX]
Total of quantified detriments	\$1.439 million - \$21.736 million	\$13.84 million - \$30.20 million
Reduction in Production and Administrative Costs – excluding the results of Mr Forward's analysis	[XXXXXXXXXX]	[\$XXXXXXXXXX]
Reduction in Production and Administrative costs – additional sums resulting from Mr Forward's analysis		XXXXXXXXXXXXXXXXXXXX
Rationalisation of land and buildings	\$8.792 million	[XXXXXXXXXX]
Capital expenditure on land and buildings	[XXXXXXXXXX]	Included in figure immediately above
Capital expenditure on plant	\$0.880 million	\$0.88 million
One-off rationalisation costs – labour and miscellaneous	[XXXXXXXXXX]	[XXXXXXXXXX]
One off rationalisation costs – production disruption		-\$1.00 million --\$3.00 million
Upstream wool market disruption costs		-\$18.85 million - -\$1.83 million

Total of quantified benefits/(detriments)	\$25.870 million	-\$5.84 million - +\$13.18 million
Removal of weak seller	No weight given at this time	No weight should be given
Wools super store	Not quantified, but benefit recognised	No benefit under factual compared with counterfactual
Quality benefits	No significant weight given at this time	No weight should be given
Net Benefits/(Detriments)	\$4.134 million - \$23.748 million	-\$0.66 million - -\$36.04 million

Brent Layton

27 April 2011