BELL GULLY

Mya Nguyen
Commerce Commission
Wellington

FROM **Torrin Crowther / Penny Pasley**
DDI +64 9 916 8621 / +64 9 916 8715
MOBILE +64 21 867 746 / -
EMAIL torrin.crowther@bellgully.com
EMAIL penny.pasley@bellgully.com
MATTER NO. 400-4888
DATE 13 July 2015

Dear Mya

Response to the Commission's query of 30 June 2015 regarding greasy exports

1. **Summary**

1.1 The Commission has confirmed the need to further understand the relationship between greasy exports and the domestic scouring price. In the parties' view, the notion that a 20% price increase may be needed before greasy exports might constrain is inconsistent with the current reality of the market – further switching to greasy exports is the factor which constrains *current* pricing. It will remain the principal constraint, with or without the transaction.

1.2 We set out below the context in which the parties see the constraint from greasy exports/offshore scours as binding on them *today*. Within this context we provide additional data to support the parties' view, alongside suggestions of data the Commission could seek to further its analysis in this regard.

1.3 The Commission's comment that a 20% price increase might be likely in the factual rests on the premise that the presence of NZWSI as an alternative commission scour currently constrains any price increase by CWH, and that the next closest constraint does not become relevant until after a 20% price increase.[1] NZWSI, however, has a commission scouring market share of only around **[REDACTED]**% once greasy exports are taken into account.

1.4 This **[REDACTED]** share is because it is a direct competitor to CWH's merchant customers. Consequently, CWH believes a significant price increase would be required before these customers would even consider switching to scouring through their competitor, NZWSI. That real prices are **[REDACTED]** is clear evidence that a constraint from elsewhere is occurring. In the parties' view, it is the ability to export greasy and scour wool offshore that is constraining domestic scouring prices.

1.5 The following factors demonstrate this constraint.

(a) **[REDACTED]**. Merchants will evaluate the expected price of scoured wool, which is set globally[2] via competition between many players (including the merchants

[1] In relation to the potential for a 20% price increase, the Commission's Draft Determination noted various factors in support of 20% being a trigger for entry. Given the extremely serious implications for CWH of such entry, even if it were accepted that entry was only profitable at a 20% price increase and that it was the 'first' constraint to kick in, CWH would not rationally push prices up to such a level given the ramifications of getting it wrong – rather it would maintain a (not immaterial) buffer to ensure it did not prompt such entry.

[2] See paragraph 371 of the Draft Determination.

themselves, NZWSI and others) and the equivalent price for greasy. The comparative volumes of greasy and clean exports depend heavily on the additional margin available for clean wool over greasy on the international market, versus the cost of scouring domestically.

(b) While historically there may have been some structural barriers limiting the volume of wool that can be exported greasy (including in the ability of overseas scours to take certain wool types, location of end customer etc.) the IWTO figures demonstrate that the barriers have decreased markedly in recent times and there is ample capacity in China and elsewhere to scour New Zealand wool, significantly increasing the potential for greasy exports.

(c) The constraint from greasy exports is demonstrated by the substantial increase in the share of the New Zealand wool clip, as well as an increase in absolute wool volumes, being exported greasy over recent years. This is almost exactly mirrored by the **[REDACTED]**.

(d) Price competition manifests through switching: suppliers seek higher prices until switching to alternatives "defeats" such a price increase. In CWH's case, when it has **[REDACTED]** quickly enough merchants have responded by switching to greasy exports, not to NZWSI.

(e) The lack of switching by merchants between NZWSI and CWH demonstrates starkly the lack of competitive constraint that each currently exercises upon the other. Conversely, both CWH and NZWSI are constrained today by increased competitiveness of scouring offshore as opposed to onshore. NZWSI have separately evidenced this fact in their market pricing claims between greasy and scoured made at the Commission's conference.

(f) CWH's real prices for scouring have **[REDACTED]** in response to the competitive threat from greasy exports (and scouring offshore). **[REDACTED]**, that New Zealand has not managed to stem the level of greasy exports reflects the on-going increase in the competitiveness of offshore scouring (including breaking down some of the structural barriers as set out above). Had New Zealand prices **[REDACTED]** in real terms, the volume loss to greasy exports and the consequent impact on volumes, throughput and profitability would have been **[REDACTED]** that is, the profit maximising response was to **[REDACTED]** try and mitigate the impact from yet further increases in the volume of wool exported greasy.

(g) Further switching to offshore scours is and has been the major threat to the local industry, and is factored fully into current scouring prices. A 20% price increase would cause a wholesale reduction in volumes that CWH believes would render its business, and the New Zealand industry, totally uncompetitive. A major shift to greasy exports would be the result and the viability of CWH, merged or not, would be at serious risk.

(h) Finally, the above constraints mean a price rise will not occur in the factual and so the issue of pass-through etc. is largely moot.

1.6 We expand on these matters below. We also set out some possible data points which would assist the Commission to test the constraint from greasy exports / offshore scours.

2. Merchants can and do switch volumes to greasy exports

2.1 Fundamentally, the New Zealand wool industry is part of a global market, and the market will ensure the most efficient supply chain is utilised to deliver the final product to the ultimate customer. CWH, along with NZWSI and scours in other countries (China, Malaysia, Italy, the Czech Republic and elsewhere) are currently all participants in this wider supply chain.

2.2 CWH's customers are wool traders. They buy and sell wool. They are indifferent to whether they export wool in greasy or scoured form: they will seek the highest margin for their product. For this reason, **[REDACTED]**. The key determinant as to the respective proportions exported clean and greasy is the profit made from each.

2.3 Accordingly, domestic scours must ensure their commission scouring tariffs make their scouring customers better off scouring in New Zealand compared to offshore, i.e. the scouring tariff is more competitive than the value of any scoured wool price premium on the open market (taking into account the extent to which scouring may allow some wool traders to blend, and hence sell, some lower value wool).

2.4 This substitution to offshore scouring – which is on-going in New Zealand (more than **[REDACTED]** of wool acquired in New Zealand (other than by NZWSI) is exported greasy) and has caused the complete demise of a domestic industry in Australia – is the principal constraint on CWH's scouring rates. It is not the risk that merchants will switch to scouring with NZWSI, which CWH knows is most unlikely to happen due to the merchant traders not wanting to support a competing merchant.

3. 20% price increase would result in significant switching

3.1 The Commission is concerned that the only constraint on CWH's pricing, up to a 20% price increase, is potential switching to NZWSI. For such a price increase to be likely, it would suggest merchants are currently making a material additional margin from scouring domestically than they are from exporting greasy. In CWH's view, such an argument is not plausible. If such a margin was available there would be no greasy exports at all.

3.2 On the contrary, NZWSI's John Dawson provided evidence during the Commission conference (and supported by subsequent evidence provided by Lempriere of the price achieved in two different trades on the same day of greasy and scoured wool) that NZWSI would expect to lose sales of scoured wool to greasy wool if the differential in price is over US$0.15 cpk/gsy in China (NZ $0.22 on today's exchange rate). **[REDACTED]**. If the price increased, the work would be lost to China and elsewhere. **[REDACTED]** they continue to scour with CWH reflects the benefit obtained from CWH skilfully blending together wool of differing quality (although, as noted below offshore scours are increasingly able to offset this average). The net result of these margin considerations is that an increase from *today's* scouring prices will further tip the balance in favour of scouring offshore – and it is certainly not the case that a material price rise (let along 20%) would be required before this constraint kicked in.

3.3 CWH is similarly constrained by greasy exports and so seeks to price up to the level where the merchant's margin from post domestic scouring is slightly higher than it is exporting greasy. The increased volume of greasy exports in absolute terms (both to China and total exports), and the **[REDACTED]** real scouring tariffs (to all customers, not just those focussed on China) to mitigate the extent of merchants switching to greasy exports is entirely consistent with substitution to offshore scouring being the key competitive constraint, not NZWSI. As previously submitted and accepted by the Commission in Decision 725 (see paragraphs 289 and 495), given the importance of throughput for scours to maintain economies of scale, scours are highly sensitive to losing volumes offshore.

4. Lower "structural barriers" to exporting greasy

4.1 Historically, there have been some factors that may have limited the extent of wool sent greasy for scouring offshore, including the location of end customers, the ability of offshore scours to deal with New Zealand wool types, the need for an offshore intermediary etc.

These “structural barriers” have broken down considerably or even been eliminated in recent years, further increasing the constraint from greasy exports. The changes in these factors are set out below.

(a) Offshore scours are now able and willing to scour a wider range of wool types (as demonstrated by, for example, Chinese scours installing lines dedicated to New Zealand and British cross-bred wool and the increasing volume of strong cross-bred wool that is exported to China).[3]

(b) Merchants are no longer reliant on intermediaries to have wool scoured in China. These intermediaries preferred to transact only higher quality wool, which limited the range of wool qualities that could be exported greasy to China, and therefore increased costs. With the advent of direct dealings with participants further ‘down’ the supply chain, such restrictions have been largely eliminated. This means that exporters of greasy wool can now export scourments which are akin to that which CWH receives in its scours.

(c) Offshore scours are now approaching New Zealand suppliers direct (e.g. Compass Wool Processors marketing its services directly to New Zealand merchants, with the ability to scour all New Zealand wool types).

(d) A continued shift of textile manufacturing to China and Asia more generally, with scouring capacity growing accordingly. This has significantly reduced any limitations on greasy exports arising from customers being located in countries without domestic scours available.

(e) Chinese consumption continues to account for a greater and greater proportion of New Zealand’s wool exports (up from 38% for the year ending June 2010 to 50% for the year ending June 2014, as per Beef + Lamb Export Statistics).

(f) China has significant excess scouring capacity (as do other overseas scours) meaning that willing exporters of greasy wool will readily find scouring services.

(g) The proven willingness of merchants to switch their export focus to selling greasy wool to China rather than scoured wool to other countries (see market shares below and the specific example of **[REDACTED]** referenced by the Commission in the Draft Determination).

(h) The ability of merchants to use their ability to export greasy (e.g. to China) to constrain scouring rates across the board, including in relation to any volumes which, for whatever reason, may not be able to be exported greasy (even assuming for the moment there are such cases and that CWH could charge higher rates for that volume, neither of which CWH believes is possible). As noted above, **[REDACTED]** and are likely also to export significant volumes of clean wool to China or elsewhere in Asia. These volumes could readily be switched to greasy exports and the mere threat of such switching would be sufficient to constrain CWH’s pricing across the board).

4.2 Further information on these factors can be found in the Application for Authorisation (see paragraphs 15.12 – 15.47), NERA submission of 24 December 2014, Appendix 1 to the Bell Gully submission of 16 February 2015, Bell Gully submissions of 29 April 2015 and 18 June

[3] As evidenced by Figure 1 on page 25 of the Commission’s Draft Determination. The percentage of wool exports to China accounted for by strong cross-bred wool increased from 27% for the year ending June 2010 to 35% for the year ending June 2014, according to Beef + Lamb New Zealand Export Statistics.

2015, the Lempriere submission of 18 June 2015, as well as information provided at the Commission's conference in June.

5. Market shares show limited constraint from NZWSI

5.1 The Commission has said at this stage it cannot discount the real possibility that prices could rise by up to 20% before a relevant competitive constraint will begin to bind (whether entry or greasy exports). However, changes in market shares over time (alongside absolute volume measures) support CWH's position that switching to greasy exports / offshore scours is the binding constraint on CWH, not switching to NZWSI. The following graph illustrates the relative size of the three options available to merchants, being: (a) commission scouring through CWH; (b) exporting greasy; and (c) commission scouring through NZWSI.

5.2 This graph demonstrates the increasing impact of greasy exports/offshore scours and the very minor presence of NZWSI.

[REDACTED]

5.3 **[REDACTED]**. This is consistent with:

(a) close competition between CWH and greasy exports; and

(b) very limited competition between CWH and NZWSI.

5.4 The market share movements (particularly the switching between greasy exports and CWH) are consistent with the information provided above that:

(a) CWH's scouring tariff is set at a level that seeks to make it attractive to scour wool in New Zealand rather than export greasy (a 20% price increase would see a substantially greater level of switching to greasy exports compared to that already shown in the graph above); and

(b) the structural barriers to scouring in China and elsewhere have decreased substantially in recent years.

5.5 The following section sets out why we do not see similar levels of switching between CWH and NZWSI and why the parties are not each other's primary price constraint.

6. Limited competitive constraint between CWH and NZWSI

6.1 Any view that the merger may allow a 20% price increase relies on there currently being strong competition between CWH and NZWSI (despite the latter having a **[REDACTED]** market share) for commission scouring and that such competition is substantially stronger than that between the New Zealand scours and offshore scours, i.e. that NZWSI is an absolute constraint on any price increases and when it is removed prices will increase by 20%.

6.2 However, various market factors contradict this view. If there was strong competition between CWH and NZWSI, we might expect to see at least some switching of customers between the parties. Switching provides a price discovery mechanism for suppliers: suppliers try to push price as high as possible, without triggering a level of switching that would defeat such a price increase (i.e. some switching can be tolerated but not sufficient that the revenue loss outweighs the gain from higher prices to remaining customers). Therefore, switching between competitors shows a high degree of competition between them.

6.3 While a lack of switching does not necessarily indicate an absence of competition, it is an important factor to consider when assessed alongside other evidence of competitive constraints (such as market shares, as discussed above). Certainly, the complete absence of customers switching in nearly a decade strongly suggests there is very limited competitive interaction between the parties, all the more so given the customer base are traders, i.e. not beholden to any one supplier.

6.4 No customers have switched from supplying CWH to supplying NZWSI (or vice versa) in the past 8 to 9 years (since Peter Crowe of J Marshall and that was for reasons other than price).[4] In this time, real prices have **[REDACTED]**. This suggests that their closest competitor is actually greasy exports (to which they, **[REDACTED]**, have lost volume) rather than each other. The facts supporting this conclusion include:

(a) J S Brooksbank, who was formerly New Zealand's largest scoured wool trader, switched very quickly from trading both scoured wool and greasy wool to selling predominantly only greasy wool. Other examples of traders who have materially increased their volumes of greasy wool are **[REDACTED]**;

(b) merchants are constantly testing the margin available from exporting scoured vs exporting greasy and this drives their decisions *as traders* to export scoured or greasy. Indeed, **[REDACTED]** scoured wool. They will frequently engage on this point with CWH when discussing scouring tariffs;

(c) merchants have made it patently clear they do not wish to scour with NZWSI given NZWSI is a direct competitor of theirs. This is why NZWSI scours **[REDACTED]** of commission scoured wool (including that scoured overseas).

6.5 For the reasons set out above, the parties do not believe that a lack of switching between CWH and NZWSI is evidence of on-going competition (as per the concern raised by the Commission). Indeed, the position is quite the opposite – while the scours constantly make pricing decisions in order to avoid customer switching, this is aimed at mitigating the level of switching to greasy exports, not to domestic competition.

7. Greasy export volumes have been constrained by domestic real price [REDACTED]

7.1 The Commission has queried whether the continued increase in greasy wool exports, in the face of domestic real price **[REDACTED]**, indicates that the domestic and offshore industries do not closely compete. However, this analysis does not account for a "counterfactual" situation. In the parties view, had the domestic price **[REDACTED]** in real terms, the volumes of wool exported greasy would have increased to a far greater level.

7.2 The continued increase in greasy exports has largely resulted from the lowering of structural barriers to do so as set out above. In light of these changes, CWH has been forced to **[REDACTED]** prices in order to avoid a substantially greater exodus of greasy wool from New Zealand, and ultimately the outcome seen in Australia.

8. Pass through argument

8.1 Finally, the parties do not believe there will be a pass through to farmers simply because they do not believe the transaction will give rise to any meaningful scouring price increase due to the constraints discussed above.

---

[4] The very minor percentage change in commission scouring market share between CWH and NZWSI since Decision 725 relates to changes in NZWSI customer volumes compared to CWH customer volumes, not to any customers being won / lost between the parties (which has not occurred).

9. Further data sources

9.1 The Commission has asked for input as to the data it could seek to assist its analysis. The following are suggestions of the type of data the Commission may consider obtaining.

(a) The extent to which the margin merchants can make from scoured wool vs greasy wool exports is the key determinant in the price they are willing to pay for scouring in New Zealand.

(b) The percentage of wool that merchants currently scour with NZWSI (in most cases this will be 0%).

(c) To what extent merchants would switch to commission scouring with NZWSI if long-term scouring prices:[5]

(i) increased by **[REDACTED]** cpk/gsy (including HD press but excluding transport costs);

(ii) increased by **[REDACTED]** cpk/gsy (including HD press but excluding transport costs);

(iii) increased by **[REDACTED]** cpk/gsy (including HD press but excluding transport costs); and

(iv) increased by **[REDACTED]** cpk/gsy (including HD press but excluding transport costs).

(d) The percentage of wool that merchants currently export in greasy form.

(e) To what extent merchants would switch wool to exporting in greasy form if long-term New Zealand scouring prices:

(i) increased by **[REDACTED]** cpk/gsy (including HD press but excluding transport costs);

(ii) increased by **[REDACTED]** cpk/gsy (including HD press but excluding transport costs);

(iii) increased by **[REDACTED]** cpk/gsy (including HD press but excluding transport costs); and

(iv) increased by **[REDACTED]** cpk/gsy (including HD press but excluding transport costs).

(f) Whether (in the event of a substantial scouring price increase) merchants who focussed on greasy wool exports would be more competitive in acquiring wool from farmers compared to those who focussed on domestic scouring.

---

[5] The price increases set out in paragraphs 9.1(c) and (e) are calculated based on average per-merger market prices to all customers of **[REDACTED]** cpk/gsy in the North Island and **[REDACTED]** cpk/gsy in the South Island, as set out at 3.3.2 of NERA's 22 October 2014 report. An average between the two rates has been taken to provide a national rate of **[REDACTED]** cpk/gsy, with a 5%, 10%, 15% and 20% price increase attributed respectively. This base price includes charges such as HD press, but excludes additional costs, such as transport.

(g) Where merchants can increase greasy volumes to some countries, does CWH charge them higher prices to scour wool destined for a country without domestic scouring operations.