

1 **CAVALIER AUTHORISATION CONFERENCE**

2 **5 MAY 2011**

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13 **[8.59 am]**

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15 **POTENTIAL PRODUCTION DISRUPTION**

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17 **CHAIR:** Okay, if we can make a start please. Welcome to the second day of the conference,
18 the conference relating to the Cavalier proposed acquisition of WSI.

19 The first topic today is the potential production disruption topic which I think's
20 going to not be a particularly lengthy session, but there are some quite targeted new
21 issues which have arisen in response to our Draft Determination on this topic and
22 there's a related topic about the price of wool as a further effect of this proposed
23 merger. But I'll start off first of all with the rationalisation delay questions.

24 John Marshall, in their submission, highlight that the Timaru/Belfast
25 rationalisation will take four to six months to complete and they see that during this
26 time there will be significant disruption in services provided to them and they
27 articulate in their submission a number of reasons how this causes them some
28 significant concerns.

29 Dr Layton in his submission highlighted for the first time that in his view the
30 WSI stores would be out of service for three to nine months and that approximately 15
31 to 45 million kilos of wool would be displaced during this period.

32 I'd like to start off by inviting Cavalier to respond to those submissions relating
33 to the disruption effect to those persons who would need access to scouring services

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1 post merger.

2 **MR HALES:** Mr Chairman, Nigel Hales speaking. Firstly I'd like to start off by saying that
3 I've personally got a great deal of experience in undertaking rationalisation of scouring
4 businesses. In fact this is going to be my eighth rationalisation in ten years that I've
5 been involved with.

6 The opportunity for this rationalisation first arose in December 2009 when we
7 were approached by Meteor Foods. So we've been thinking about this rationalisation
8 and how we would carry it out ever since then. So we've had a great deal of time to
9 prepare for it and we've prepared for multiple scenarios.

10 We don't have any incentive to let the moving of scours disrupt the flow of
11 income through our factories. So we will be doing everything that we can to ensure
12 that every kilogram of wool that's available to us is scoured in a timely manner.

13 The benefits to this merger to us are primarily from creating greater
14 efficiencies and by removing costs which we will want to achieve. Simply we won't
15 be putting up a lot of capital to make this happen and then not achieving what we've
16 suggested we're going to do.

17 Throughout this year we've had a good look at how this merger may unfold.
18 We've put a lot of thinking into how the business structure may look as a rationalised
19 business. Part of this is actually rationalising the business and the other part is
20 rationalising down to one scour site in each island.

21 In terms of putting the businesses together, we've identified how we would
22 take the business into our own and how we would structure our management team and
23 look at what costs are currently being duplicated between the two models.

24 The savings that we're predicting to come from this merger would actually start
25 happening on day one of us taking control of the sites.

26 **CHAIR:** What would your capacity be? As I understand the answers to questions yesterday,
27 we have seasonal effects in this industry. So in that first four to six months that John
28 Marshall is worried about, you know, would that be in a peak season time, would you
29 have capacity during a peak season time to accommodate all parties who come to you
30 for scouring services in the South Island?

31 **MR HALES:** Yes, most definitely we've got that in mind. There are definite peaks and
32 troughs also in the seasonal flows, and we would have to co-ordinate the timing of the
33 physical moving of the scouring equipment to accommodate those peaks and troughs.

1 But nevertheless bearing in mind that we do have equipment that we would be
2 mothballing in the future to call on to take us through that seasonal downturn, if you
3 like, while we're moving the Whakatu and Kaputone plants to our site.

4 So we've looked at those calculations and we're very confident that we have
5 enough capacity to service the existing volumes of wool that come through basically in
6 the winter months and that would be at the time when we would affect the
7 rationalisation of the physical moving of the plants.

8 **COMMISSIONER GALE:** In the North Island does that mean Clive? Is Clive a sort of
9 backstop in the North Island?

10 **MR HALES:** Yes, we'd have Clive and we'd have the two 2.4-metre plants at Awatoto.

11 **CHAIR:** Have you got anything else to say on this topic?

12 **MR HALES:** Yes, I have. Is it okay to carry on?

13 **CHAIR:** Yeah.

14 **MR HALES:** So from day one we'd look at where we could make the cost savings. And
15 firstly we'd be looking at removing the duplicated administration costs.

16 **CHAIR:** I'm just asking questions about this production disruption, we'll come through to
17 those other issues later. This is only responding to this concern of John Marshall and
18 the point raised by Dr Layton that, you know, there's being to be people wanting to
19 have wool scoured and you won't have capacity to be able to do it. So your answer is
20 that there will be no production disruption?

21 **MR HALES:** No, there will be no production disruption.

22 **CHAIR:** Okay. Can I seek views of other parties who have now had the benefit of hearing
23 that. Are there any comments from WSI or any other party who may have a concern
24 on this issue?

25 **MR FERRIER:** Excuse me, Commissioners, if I could make a further point. Through
26 previous rationalisations we have frequently had the ability to work with customers at
27 no cost to customers to manage throughputs. We have very good relationships with a
28 large number of the parties who process wool with us and starting with Cavalier, for
29 example, they're a material contributor, and obviously it's in their interests to facilitate
30 the moving and shuffling and management of their wool.

31 They're one customer who's prepared to do it but I could name a number of
32 other of them who have been happy to do that in various circumstances in the past.
33 There's no reason to expect that those relationships won't facilitate that happening, as I

1 say, just as a management and communication exercise in the future through this
2 process.

3 **CHAIR:** I'm just mindful of the difficulty the stenographer may have identifying people.

4 **MR FERRIER:** Sorry, David Ferrier, Cavalier.

5 **CHAIR:** We have a slightly different composition today, so can we just go around the table
6 again for the record for parties to identify themselves please. If we can just start with
7 you, sir, at the beginning.

8 **MR CHUNG:** Wayne Chung.

9 **MR GEORGE:** Ross George, Cavalier Wool Holdings.

10 **MR BLACKTOP:** David Blacktop, Bell Gully for Cavalier Wool Holdings.

11 **MS FRANKISH:** Kate Frankish, Bell Gully for Cavalier Wool Holdings.

12 **MR TAYLOR:** Phil Taylor, Bell Gully, Cavalier.

13 **MR HALES:** Nigel Hales, Cavalier.

14 **MR DRAKE:** Jim Drake, Cavalier.

15 **MR FERRIER:** David Ferrier, Cavalier Wool Holdings.

16 **MR MELLISOP:** James Mellisop, NERA Economic Consulting.

17 **MR COWAN:** Keith Cowan, Wool Equities.

18 **MR HEATH:** Cliff Heath, Wool Equities.

19 **MR KIRKE:** Derek Kirke, Wool Services.

20 **MR CARADUS:** Ian Caradus, New Zealand Wool Services.

21 **MS PAULING:** Tanya Pauling, Godfrey Hirst.

22 **MR PIKE:** Kevin Pike, Godfrey Hirst.

23 **MR SUNDAKOV:** Alex Sundakov, Castalia.

24 **MR DAVID:** Grant David, Chapman Tripp for Godfrey Hirst.

25 **MR DEAKINS:** Geoff Deakins, New Zealand Wool Services.

26 **MR DWYER:** Michael Dwyer, Wool Services.

27 **MS BRANSON:** Johannah Branson, independent consultant.

28 **MR STOCK:** David Stock, counsel for Wool Services.

29 **MR J M TAYLOR:** Peter Taylor, Wool Services.

30 **CHAIR:** Thank you. We've heard from Cavalier on this production disruption argument.
31 Can I repeat my invitation to any other parties who may wish to express a view on the
32 topic. I gather WSI has a view.

33 **MR CARADUS:** Yes, Ian Caradus, Wool Services. I just wanted to point out some of the

1 difficulties I think that will be experienced in shifting particularly the Kaputone scour,
2 because that plant has been in operation for 14 years now and if you start uplifting
3 some of the larger sections I'm sure that there's quite a lot of corrosion and I think that
4 the period to uplift and reinstate that plant will be a lot longer than perhaps has been
5 anticipated.

6 So I'm just concerned that that timeframe, I'm not sure of the exact time that
7 Nigel's mentioned, but it will take a considerable period of time, and in my estimate
8 four to five months to undertake that job efficiently and effectively.

9 **CHAIR:** Do you have an opinion on the issue whether or not in high season peak demand
10 that Cavalier would have the capacity to meet all the demand for scouring?

11 **MR CARADUS:** Well, not knowing exactly their Fairlie plant's capacity, but I assume that
12 you're going to take out a 2.4-metre? Are you going to take out a 2.4-metre plant?

13 **MR HALES:** No.

14 **MR CARADUS:** So you're just going to place the 3-metre beside the existing plant?

15 **MR HALES:** Yes.

16 **MR CARADUS:** Okay, so that your full capacity can still be maintained while this is being
17 undertaken?

18 **MR HALES:** Yes.

19 **MR CARADUS:** Well, subject to the period, it would be essential to undertake this in the off
20 season, definitely.

21 **CHAIR:** So that would sound feasible to you in the off season, if the rationalisation's done
22 off season, that sounds to you feasible on that plan?

23 **MR CARADUS:** I think it could be achieved.

24 **MR DEAKINS:** Geoff Deakins from New Zealand Wool Services. Just on that matter of
25 moving off season, which is obviously a logical thing to do; I take, therefore, that we
26 are now talking about the 2012 off season and not the 2011 off season.

27 The reason for saying that is clearly there are processes to be gone through
28 before the factual becomes the case and I would say that we are getting very close to
29 the start of the off season now, and by the time of these regulatory processes that have
30 to be worked through that we will be coming towards the end of the off season and
31 therefore we are now looking at the window of 2012.

32 I would then be wondering, because of further disruption to the market, what
33 the intention would be with the Wool Services trading operation given it is their

1 intention to sell or close. I just think those matters should be put on record.

2 **CHAIR:** Would Cavalier care to respond to that please?

3 **MR HALES:** Yes, Nigel Hales. Yes, we've carefully planned forward and we've taken into
4 consideration the peak processing period of time. We've also taken into consideration
5 what we think may need to be done to the Kaputone plant.

6 But what we would be doing is we would start off - and indeed I have already
7 submitted floor plans to the Commerce Commission in a previous document, of what
8 our intentions are. As soon as we get the tick, if you like - if that's the correct word to
9 use - we will start the consenting process and I'll be getting a building design done.

10 We expect the building programme to take about six months, and indeed we've
11 got a list of contractors already available and willing to do that. During that period of
12 time we will be building the physical modifications to the plant, I'm meaning the
13 mechanical modifications; and then it will take us, we believe, approximately three
14 and a half months for Whakatu to be installed and, correct Ian, at four months for
15 Kaputone. We think that we can do that in a very timely manner and our past
16 experience would say that it's very achievable.

17 **MR FERRIER:** David Ferrier, Cavalier. In respect to the trading division question, we have
18 every incentive because we believe that there is value in it to. We may well need to
19 maintain that trading division's operation in time to facilitate the sale of that trading
20 division. So we would hope to do that as seamlessly as is possible.

21 **COMMISSIONER BEGG:** Could I just clarify the timing then. You're saying that the
22 building will take six months, so the actual relocation of the plant will be the
23 following year, the 2012 season, is that right?

24 **MR HALES:** Yes, that is correct.

25 **COMMISSIONER BEGG:** Okay, thanks.

26 **COMMISSIONER PICKERING:** Just define for me again the season?

27 **MR HALES:** Okay. We could loosely describe the busy processing season from January
28 through to May and the off season from May through to December.

29 **COMMISSIONER PICKERING:** Okay, thank you.

30 **MR PIKE:** Kevin Pike. My comment is more of a question, and I'm more familiar with the
31 North Island machinery than the South Island machinery, so rather than talking about
32 Kaputone my question relates to Awatoto.

33 Given that you're intending to straighten your scour lines and the room that

1 you're creating from that is going to give you the space to put the Whakatu 3-metre
2 scour in place, it would therefore follow that there must be a period where both of your
3 2.4-metre scours are out of commission as well as the Whakatu 3-metre scour and your
4 only capacity in the North Island at that point is going to be the 2-metre scour at Clive.
5 And I just wonder how you're going to cope with the demand in that situation given
6 that you're going from such a large capacity down to such a small capacity.

7 And I also wonder whether the same situation exists in the South Island
8 whereby there will be a period where both your 3-metre scour and Kaputone's 3-metre
9 scour will be unavailable for processing at any time.

10 **MR HALES:** Nigel Hales. Yeah, good point Kevin. Yes, we've well thought about that.
11 During this off season we intend to do some work to the 2.4s to prepare them. In fact
12 we've got all of the bowls and that ready to go in. And we think that we'll need two
13 weeks to put the bowls in. Obviously we have to get the building done first.

14 But it won't be a big job actually to straighten out Awatoto. We will have to be
15 down for a period three to four days and we'll do this in advance during this off season
16 to change the transformer at Awatoto. The transformer's at its limit at the moment and
17 we have to upsize it, so that's a big consideration that we've planned for.

18 There'll be no disruption whatsoever at Canterbury, simply because where the
19 3-metre's going is completely away from the existing 3-metre. The only disruption
20 will be to the office because we're going to dismantle the office building and straighten
21 the back of the buildings up there. So no disruption and we've carefully carefully
22 thought about this.

23 **MR PIKE:** Can I ask what's the likely expected amount of time that the Awatoto site will be
24 completely unavailable for processing?

25 **MR HALES:** We don't think it's going to be at any stage, except the time that it's down for
26 the change in the transformer and then - you see this is the beauty of having two wool
27 scours. You never have both of them down together. You only ever have one at a
28 time down and our scours are completely separated right at the moment by electrics
29 and everything. So we're never going to have two down.

30 **MR PIKE:** Okay, so --

31 **MR TAYLOR:** Sorry, just to interrupt that, could you clarify for the Commission what you
32 mean by scour lines rather than scours?

33 **MR HALES:** Okay, sorry, Awatoto has two identical scour lines which is the physical bowls

1 that wash the wool, they're side by side, two separate scour lines, and they're
2 completely separated. So if one breaks down the other one can continue. And it's like
3 when we do our winter maintenance even now we never stop, we always just stop one
4 plant and keep the other one running and then switch back to the other one. That's
5 exactly what we would do through this rebuilding process. And, sorry, we would run
6 Clive as well.

7 **COMMISSIONER GALE:** In the South Island when you actually move the unit from
8 Kaputone, presumably that plant stops operating for a while, so that capacity's out of
9 commission for some period; what's that time with the preparations you make in the
10 building and so on? At some time you've got to uplift the hardware and move it, so do
11 you lose capacity during that period in the South Island?

12 **MR HALES:** Yes, we do, and we will lose capacity for four months.

13 **COMMISSIONER PICKERING:** That's all in your off season?

14 **MR HALES:** Yes, yes.

15 **COMMISSIONER PICKERING:** So all this will be completed by the beginning of the
16 2012 season then, all that you're talking about, is that right?

17 **MR HALES:** Effectively it will be from the time that we expect to get control of Wool
18 Services' assets, it will be in a timely manner of approximately 11 to 12 months.

19 **COMMISSIONER PICKERING:** So you would, in your planning, you're sort of
20 presuming you'll get control by the end of this calendar year?

21 **MR HALES:** Yes, we are.

22 **COMMISSIONER PICKERING:** So it will all be in effect then by the 2013 January
23 type --

24 **MR HALES:** Yes.

25 **COMMISSIONER PICKERING:** Okay, just trying to get into my head these timings.
26 Yeah, okay.

27 **MR HALES:** We're obviously hopeful it may be a little bit earlier than that.

28 **CHAIR:** Okay, are there any further questions or points parties want - I'll take this fellow
29 first and then James, I'll have you after that.

30 **MR COWAN:** Keith Cowan, Wool Equities. What I've just heard, I think, is that Cavalier
31 intend to be a wool exporter merchant for some considerable period of time. Did I
32 hear that correctly?

33 **MR FERRIER:** No, if you're referring to my comments, we will sell and we will maintain

1 the trading division until we do sell. Clearly to maximise value it would be better to
2 do that than to close it and then sell the shell.

3 So yes, you do hear it right, that there will be a period of time where - and
4 there seems to be a lot of enthusiasm for that particular asset, so we would not expect
5 it to be a long period of time that we may be operating the trading division.

6 **CHAIR:** Can we come back, this issue I'm going to address when we're talking about the
7 price of wool, so I think where you're heading we will get a chance to pick on this in a
8 moment. Can I take James Mellsop please.

9 **MR MELLOP:** Thanks Dr Berry. I'm not sure if you want to talk about this now, but the
10 other point Dr Layton made was that if there is a disruption he then said how everyone
11 should value that.

12 **CHAIR:** I was going to come to that.

13 **MR MELLOP:** Okay, sorry, I'm jumping the gun.

14 **CHAIR:** Can I just check to see that there's no other comments relating to this question of
15 the likelihood of disruption. And if there's not then I was going to move briefly to
16 Dr Layton's - Mr Dwyer.

17 **MR DWYER:** I think that the question of bedding down the operation or commissioning the
18 operation hasn't been addressed properly. You simply do not move a plant from A to
19 B and press the green button, it doesn't work like that. And Cavalier should know that
20 because they had a long period of disruption themselves when they installed their new
21 plant at Washdyke. Therefore, I think that to simply say that it will take four months
22 or something before it will be in running order I think is grossly exaggerating and I
23 don't believe is achievable.

24 **CHAIR:** Can I just go back, we had evidence just before from another - sorry, I've forgotten
25 your name, you're Ian?

26 **MR CARADUS:** Caradus.

27 **CHAIR:** As I understood you were satisfied with the combination of the 3 and 2.4-metre
28 scours, you agreed with Cavalier that --

29 **MR CARADUS:** Well, I did say that, but what I would be very interested to know would be
30 the actual figures and the scheduling that have been prepared to do this change.
31 Because I'm not sure whether one of the scours is going to come down, will you be
32 running the two of them full-time in the off season?

33 **MR HALES:** What needs to be remembered, through the recommissioning period we still

1 have the existing capacity available. We have the existing capacity of two 2.4-metre
2 wide scours at Awatoto, the 2-metre scour at Clive and a 3-metre scour coming on to
3 line. Then when the 3-metre scour is fully on-line the 2-metre scour at Whakatu then
4 gets shut off - at Clive sorry; and exactly the same scenario in the South Island.

5 So Michael's correct, we do not expect to turn that scour on in day one and it
6 running at 100 percent performance, although we have done that in the past. Brand
7 new scours are different to second-hand equipment. New scours you would expect to
8 have a longer run in period than you would on a second-hand plant.

9 So, you know, I think we've covered the timeframe quite well.

10 **MR DWYER:** I'm sorry, may I respond to that? I'm sorry, but I can't agree with you because
11 you talked about doing modifications to that plant and it's not just going to be a plant
12 that's run in if what you say the modifications are going to be. And therefore I think
13 that you're going to run into a period where you won't be just in the off season but
14 you'll have a plant that will not be functioning properly in the full season. And as a
15 result there'll be considerable disruption to the industry.

16 **MR CARADUS:** Mr Chairman, have you actually done the figures for the capacity at that
17 time? Do you have an indication of the demand on the process will be.

18 **MR HALES:** Yes, we have and I've looked at the history of the Lanolin Trading Company
19 and if you have a look at the flows in the last two seasons, and I'm including year to
20 date, are actually quite similar to, you know, year on year out. The previous season,
21 2008/2009 there was a complete drop off. So we have to allow for some seasonal
22 peaks and troughs as well.

23 If for any reason when we come to move this equipment, and we will be
24 prepared before the June/July period is upon us, if the wool peak is dropping we will
25 pull the programme forward, but if we're still in the height of peak, say in May, then
26 we would not attempt to do it until June.

27 **MR CARADUS:** I think it's fairly difficult for the people gathered here to understand some
28 of that logic. I'd be very interested if you could supply the Commission the figures
29 that you're working on, and Wool Services as well, yes.

30 **MR HALES:** Yeah, well obviously the figures that we've supplied have already gone to the
31 Commerce Commission and that includes our expected run rates, which is the key
32 critical point in that, so we wouldn't be supplying our run rates to Wool Services, but
33 the Commissioners do already have that information.

1 **MS PAULING:** It sounds to me like there's going to be some issues around capacity over
2 that time which you will hopefully manage. But I guess our concern is that how that
3 priority will be worked out and that leads into obviously the concern that presumably
4 your major shareholder will have priority potentially over the others in the industry.
5 And I guess that raises question marks. You can't answer that, but that is a concern for
6 us over that period.

7 **MR FERRIER:** David Ferrier, Cavalier Wool Scours. I can assure Godfrey Hirst they have
8 contractual protection for exactly that circumstance, so they have no need to fear that
9 the priority that will be given to them, because they're protected by contract.

10 **CHAIR:** I think we probably have exhausted the discussion on this topic. I'll take just one
11 more question.

12 **MR COWAN:** Just one thing from the wool growers' perspective. The patterns of shearing
13 in the last two years are probably not a good indicator to base your planning on as to
14 how wool is going to come in. I think with the increase in the price of wool farmers
15 are now prepared to shear more frequently than they did before and you'd be better to
16 go back to periods where there was more regular shearing than there has been in the
17 last two years for doing your planning for when the wool might be coming off.

18 **CHAIR:** Okay, if parties can make, particularly if Cavalier can take us through the full
19 articulation of their claims about no disruption in the submission for 13 May.

20 Okay, I'd like to turn now briefly to the question raised by Dr Layton about
21 production disruption if it was to occur. And Dr Layton accepts that there will be
22 delays in processing 10 to 30 million kilos of wool, that this will be for three months
23 on average and at an interest rate of 7 percent and an average price of wool of 5 kilos.
24 There is an interest cost of 0.88 and \$2.63 million on top of this for storage and this
25 translates to an economic cost of 1 to \$3 million.

26 I'd like to invite James Mellsop and then Alex Sundakov to respond to
27 Dr Layton's analysis please.

28 **MR MELLOP:** Thanks Dr Berry. I suppose my concern is I don't think the \$5 is the
29 correct figure to apply the interest rate to. I'm assuming that's some sort of price for
30 wool internationally, I don't think it's clear where it came from.

31 But a couple of points; one is that if there is disruption then society will also
32 avoid variable costs in the wool chain, so that has to be netted off. And I think also the
33 way we've analysed the rest of the costs and benefits of this transaction are in the

1 scouring market, the surplus changes in the scouring market. So that seems to me to
2 be the place where this should be valued.

3 So it's the difference between the scouring price and the variable costs of
4 scouring which is - I won't say the figure in this session, but it's clearly a lot less than
5 \$5. So I don't think the \$5 is the correct denominator to be using.

6 **MR COWAN:** We think it's too low. If you look at the strong wool indicator for last week it
7 should be 6.54.

8 **MR MELLSTOP:** My point is that it's not the price of wool that's actually relevant for society
9 in terms of the valuation.

10 **MR COWAN:** What is relevant?

11 **MR MELLSTOP:** Do you want me to repeat?

12 **MR COWAN:** This is about wool.

13 **CHAIR:** That's fine, perhaps if we can take Mr Sundakov.

14 **MR SUNDAKOV:** I strongly disagree with James. I mean obviously the price of wool
15 changes so whichever one is the right price to use it makes sense to use the latest
16 number, which potentially is a lot more than \$5.

17 **CHAIR:** We're having difficulty hearing you Alex.

18 **MR SUNDAKOV:** So what I was saying is that obviously the price of wool, we should use
19 the latest number and that changes, so it's now more than \$5 anyway. But the key
20 point of principle is what is it that we're measuring here. I think that to my mind the
21 fact that we're looking at the effects that are caused by changes in the market for
22 scouring services is slightly a red herring, because what we're really looking at is how
23 changes in the competitive conditions in the market for scouring services are affecting
24 society as a whole; and that effect isn't restricted to the specific cost of scouring, that
25 effect can be much wider.

26 So in that regard, to the extent that changes in the competitive conditions in the
27 market for scouring services are going to cause delays that incur greater societal cost,
28 whether the incidents of that falls on farmers or traders or anybody else, the incidents
29 is irrelevant; what is relevant is the extent of the damage.

30 **CHAIR:** Look I'll give you a chance to respond to that very briefly, Mr Mellstop. We will be
31 going through this fully with Dr Layton tomorrow, so I just was mindful that without
32 Mr Sundakov being here tomorrow I wanted to give him a chance to express his views
33 on the topic.

1 **MR SUNDAKOV:** Thanks very much, I didn't realise I was getting a second bite of the
2 cherry, because actually I will be able to be here tomorrow.

3 **CHAIR:** Right, okay.

4 **MR SUNDAKOV:** I've made arrangements to stay.

5 **CHAIR:** Well look, can we just park this one until tomorrow then sorry.

6 **MR DEAKINS:** Further on that particular subject in addition to the economists' views, I
7 think there are certainly some additional views that I'd like to begin the discussion on
8 at the present time. As we've just been discussing, Dr Layton's report on page 18
9 makes some very telling points on the disruption to the New Zealand wool market.

10 I think that disruption has the potential to be massive. I think we need to
11 identify and ask the question what does the selling of New Zealand Wool Services
12 International actually mean, because that is one of the two options that are being put
13 forward by Cavalier. The other is closure.

14 If it is not closure, though, what does the selling of WSI mean? It means that
15 the company name and its brands IP etc will be sold. It does not mean that the
16 ongoing business will be sold and will continue. It is highly unlikely that that would
17 be the case. It would require in excess of \$20 million worth of capital to be introduced
18 to allow that to happen. I've seen no evidence that that money would be available to
19 continue the trading operations of New Zealand Wool Services in its current form.

20 So what does that mean to the New Zealand wool market without Wool
21 Services having, at present, where it currently buys at every wool sale in excess of
22 30 percent of what is on offer and in addition to that in excess of 30 percent of all wool
23 that is traded outside the auction?

24 I put it to the Commission that when New Zealand Wool Services is withdrawn
25 from the market the price of wool on the following day will drop significantly and will
26 take a considerable amount of time to recover.

27 **COMMISSIONER GALE:** You mean the world price of wool or the price paid to farmers?

28 **MR DEAKINS:** The New Zealand price of wool.

29 **CHAIR:** This leads into the last topic we were talking about with this wool price drop there.
30 Can I just explore, I mean if you've got WSI, the first thing is initial disruption. I'm
31 assuming that there would be ongoing contractual obligations if the acquisition
32 happens. There are existing contractual obligations which would not be affected by
33 the fact that there's a share transfer of the register of WSI.

1 So in the intermediate medium term I assume that Cavalier would continue to
2 honour the existing contractual relationships with --

3 **MR DEAKINS:** Yes, I don't know whether that will have any effect on stopping the price of
4 New Zealand wool dropping immediately, because what you're saying is yes, I agree
5 that Cavalier would continue to honour and run out the book that is currently owned
6 by New Zealand Wool Services that exists for several months.

7 **CHAIR:** How long would that be for?

8 **MR DEAKINS:** Most probably the furthest sales in most traders' books would be in the
9 period of, at a maximum, six months, but on average around two to three months, so
10 you would say that that book would be run out over three to six months; because of the
11 way the trader operates and his positioning, that he will have that position effectively
12 covered at the present time and will already own a fair amount of that wool that he is
13 going to be supplying to the market. Hence there will be no need for Wool Services,
14 unless it continues to sell, to buy further wool.

15 **CHAIR:** In that three to six month period, if I'm a merchant, isn't that a golden opportunity
16 for me to grow my business? Where 30 percent of the market that was attributed to
17 WSI previously is there, you know, there's a big opportunity for --

18 **MR DEAKINS:** Yes, exactly, and I think over time that is exactly what will happen. The
19 business that Wool Services currently has will be distributed amongst the other players
20 in the industry. But they are going to struggle to finance, put in place, find the capital.
21 The banks make it very clear that a trading operation requires further capital, have
22 higher covenants than an operation like New Zealand Wool Services that owns hard
23 assets.

24 The other traders in New Zealand, many of them are small, many of them do
25 not have access to additional capital, they will not be able to take up the slack in the
26 short-term. They will not be in the market buying that wool on the following day.
27 The price of New Zealand wool will drop dramatically on the following day that
28 New Zealand Wool Services withdraws from the market.

29 **CHAIR:** Can I just ask one more question before I start inviting other parties. My
30 understanding is that the pattern of exit of merchants has not actually affected the price
31 of wool and the case in hand I think that we have reference to is the Lichtenstein exit
32 from the market. My understanding was that there was no price effect as a result of
33 that exit.

1 **MR DEAKINS:** That would not be my understanding, however I can't contradict it, but that
2 is not my understanding.

3 **CHAIR:** Would you differentiate that being a small player versus a large one?

4 **MR DEAKINS:** No, they were a large player, but of course that was a managed exit and
5 controlled over a particular period of time. This is not what will happen with
6 New Zealand Wool Services, it will be the following day.

7 **CHAIR:** But there is the three to six month period.

8 **MR DEAKINS:** No, no, the wool is already bought, so they'll be withdrawing from the
9 market the following day.

10 **CHAIR:** Okay, right. I'll invite now comments in response to that from Cavalier.

11 **MR CHUNG:** Wayne Chung, Cavalier. I'd just like to make a reference, Mr Chairman, that
12 in 2000 year, we - this is Cavalier Corporation - closed E. Lichtensteins. And it's a
13 similar situation as with WSI, we actually chose to actually close the trading
14 operation; whereas with WSI we probably certainly would like to see it sold as a going
15 concern. So this is a bit more drastic situation.

16 So E. Lichtensteins back in 2000 would have been a very very dominant
17 player, in fact would have been as dominant as WSI in the South Island as it is in the
18 North. So when we closed it I don't think we saw any disruption in terms of the ability
19 of wool being able to be moved to the other wool exporters. So there is ample other
20 players to take up slack if that needed to be.

21 But we certainly don't see, you know, as I said, Wool Services just closing the
22 first day we actually take it over. We've got every incentive to maximise the value of
23 Wool Services trading and therefore we believe sale as a going concern is the most
24 likely route that we would take.

25 **CHAIR:** Do you have a response to the suggestion that the competitor merchants wouldn't be
26 able to get the capital from the banks to grow their business?

27 **MR CHUNG:** Well, you know, we don't see that because, you know, the ability of banks to
28 fund a stock item which is a world commodity, and it's very liquid, I suspect the bank
29 funding would be a high percent of that wool. And secondly, if the wool is sold the
30 means of finance there is essentially to discount the bill with the banks.

31 So we believe the amount of working capital involved is probably minimal.
32 But perhaps some other wool exporters here could add comment to that.

33 **MR DEAKINS:** I think that is important because I think Mr Chung has never been involved

1 in the wool trading business and I don't really think that he has the ability to comment.

2 **COMMISSIONER GALE:** Before we leave Mr Chung, though, before we take your
3 comment; when you say sold as a going concern, do you mean the trading operation
4 sold with a contract for scouring?

5 **MR CHUNG:** Yes, yeah, I meant obviously to maximise the value; that would be the case,
6 yes.

7 **COMMISSIONER GALE:** We haven't discussed that in detail before.

8 **MR CHUNG:** So we would do what we can to actually do that.

9 **MR FERRIER:** Commissioners, if I can just make a couple of quick points, firstly the
10 comment that Mr Chung doesn't know about wool trading; I can't treat that as real
11 comment. He was the financial controller of a company turning over something
12 similar to Wool Services Trading Division for ten years prior to becoming Cavalier
13 Chief Executive.

14 The second comment is that we're aware of a wool exporter who hasn't been
15 represented here in the last two days who has been given a further \$10 million facility
16 in contemplation of this transaction proceeding, and specifically to meet the demands
17 that they expect they have been given a \$10 million injection. I could go to verify that
18 and give you that information, I'm not sure whether you'd be prepared to do that, but
19 that's been directly told to us.

20 Having said that, we're not so interested in that in the sense that - we are
21 interested in that. but we also, as a going concern, want to optimise the value that we
22 can get for selling the existing trading operation. There are a number of parties, some
23 of whom we're aware of, particularly well-funded, that are interested in the trading
24 operation specifically.

25 **CHAIR:** Are there any exporters or other parties who may have a view or information they
26 can share with us that would inform us?

27 **MR COWAN:** Just from Wool Equities' perspective, we are concerned about the price of
28 wool. It's been right in the doldrums and it's been falling for probably 100 years. It's
29 turned the corner and it's doubled in the last year and farmers now have reasonable
30 incomes from their wool. We've already seen, since this Draft Determination came
31 out, that the price of wool has fallen a little bit as exporters move to shorten their
32 positions in anticipation of this decision going to Cavalier and Wool Services Trading
33 withdrawing from the market. So I believe we're already starting to see some signs in

1 the last three weeks of movement in that.

2 With the price of wool rising, the only way to operate that sort of business is to
3 run a rolling stock position, and Mr Deakins has rightly said that the wool is bought
4 before you sell it in these rising price situations. If there's any chance of the price of
5 wool falling, which I think there's a high risk with this transaction, then certainly
6 there'll be a high risk if there is no well funded player to come in and take this Trading
7 Division over.

8 So unless the Commission can be absolutely satisfied that the trading hole that
9 Wool Services will leave immediately is filled, then this is going to affect the income
10 that New Zealand farmers and New Zealand itself gets for wool, and it will be
11 significant. We've estimated if it went for a year it would be in the magnitude of
12 \$200 million.

13 Now I know it will be filled over time, but how long that takes and how well
14 funded that player needs to be, \$10 million of capital isn't going to be enough. And all
15 the exporters are very short of capital at the moment, with the doubling of the price
16 they're all struggling to actually do the trading that they're doing right now.

17 **CHAIR:** I'll take Mr Dwyer and then give Cavalier a chance to respond.

18 **MR DWYER:** I'd just like to comment on Mr Ferrier's statement. He seems to be very
19 certain that he's going to own Wool Services and is telling the world all about it, which
20 I have to say we take exception to. But the facts are that when Lichtenstein was
21 withdrawn from the market we've had a period of nine years of low prices, nine years,
22 and it's only just recovered in the last 12 months.

23 **COMMISSIONER PICKERING:** Do you attribute that to Lichtensteins pulling out or not?

24 **MR DWYER:** It started the rot.

25 **COMMISSIONER PICKERING:** Sorry?

26 **MR DWYER:** It started the rot.

27 **MR J M TAYLOR:** R-O-T.

28 **COMMISSIONER PICKERING:** Yes, I got it. I heard it, I didn't get it.

29 **MR CHUNG:** I think it's a long bow to associate the recent drop in wool prices as quoted
30 earlier, and likewise to Lichtensteins to the wool trading of each of the operations. I
31 mean the fact is wool has lifted dramatically over the last six or eight months, and it
32 needs to sort of top itself out, so to speak, because it needs to find its floor. So there's
33 going to be movements up and down.

1 And there's so many factors that affect wool, it's just got absolutely nothing to
2 do with internal politics here; it's everything to do with what happens internationally,
3 what happens to the demand of wool etc etc. And the most important of the last few
4 days, or the last month, of why wool has been dropped has been essentially the strong
5 Kiwi dollar, which has a huge influence on wool. So to try and associate it back to
6 this situation is actually ludicrous.

7 The other aspect of Mr Dwyer that mentioned that Lichtenstein caused the
8 erosion or the rot of wool for nine years; I mean gee whizz. I didn't think wool traders
9 had that long of a memory but I might be wrong there.

10 **MR DWYER:** It just goes to show how little you know about the wool market Mr Chung.

11 **COMMISSIONER GALE:** No, excuse me, don't do that.

12 **CHAIR:** Look I'd prefer to have those kind of exchanges refrained from if you don't mind.

13 **COMMISSIONER GALE:** Can I ask Mr Cowan please to explain, I need to understand
14 better your proposition that the price that New Zealand earns for wool will now
15 decline. Are you saying that because there will no longer be a trader who will trade
16 ahead so far that in these long-term markets the prices will drop? That we could
17 influence the world price in Europe I take it you're talking about?

18 **MR COWAN:** You've got to look at the amount of working capital that's in the industry.
19 And if you added it all up, you know, and you take 30 percent of it away, of the capital
20 that's available in that industry, and you've still got the same pot of wool, taken
21 30 percent of the capital away to buy it, what's going to happen? The wool's still
22 going to be bought but for 30 percent less. That's the risk you have. How long it takes
23 people to come in with the extra capital to prop it up, it will be a while. \$10 million
24 won't cover it.

25 **COMMISSIONER GALE:** But a \$200 million loss to whom?

26 **MR COWAN:** To wool growers around the country. When the price of wool drops, the
27 price that they get paid for their wool drops, the export earnings from that wool drops.
28 Just in the last year we've seen wool income for New Zealand go from about \$650 odd
29 million to over \$1 billion worth of wool. That's all to do with the price increase, and
30 we've seen sheep farmers, which we represent, now having better incomes from wool
31 now wanting to shear more regularly, look after their sheep better and increase sheep
32 numbers because there's revenue there for them to do that.

33 **COMMISSIONER BEGG:** So are you saying that New Zealand wool will be sold below

- 1 the world price for a period?
- 2 **MR COWAN:** It's quite possible.
- 3 **COMMISSIONER GALE:** So it will be snapped up, it will be heavily competed for. I'm
4 just struggling to see how it can drop the world price. Maybe somebody can help me,
5 Mr Ferrier?
- 6 **MR COWAN:** New Zealand wool is a very big proportion of the world market for this type
7 of wool.
- 8 **COMMISSIONER BEGG:** But the customers are still there, you're just saying the
9 intermediaries aren't there. But I hear Cavalier saying they're not going to drop this
10 business as of the next day, they're going to have a transition. So you're saying you
11 don't believe that suggestion?
- 12 **MR COWAN:** Well, I'm not sure what they're saying. They're actually saying different
13 things at different times and they're writing different things in the submissions that
14 they're putting in. So I read that they have no intention of expanding their business to
15 become a wool exporter merchant.
- 16 **COMMISSIONER GALE:** I have to say, an economist's presumption is that they're not
17 going to flush value away if they've bought a business. If they've bought a business
18 the presumption must be that they will dispose of it in a way that minimises losses to
19 themselves, not in New Zealand's interests but to themselves.
- 20 **MR COWAN:** Yeah, to themselves they're not going to, but they don't really care about the
21 wool interests in terms of farmers. If the price of wool goes down they're still going to
22 get the same number of kilos going through. Sheep grows a kilometre of wool an
23 hour, if you add up all the ends of the fibres, and it's still going to keep doing that and
24 they're still going to get the processing revenue from that. And in fact it suits Cavalier
25 for the price of wool to drop, because if you look at them as a purchaser of wool, if the
26 price drops they will actually have a lower ingredient cost.
- 27 **COMMISSIONER BEGG:** So is Godfrey Hirst looking forward to this reduction in wool
28 prices?
- 29 **MS PAULING:** I couldn't possibly comment.
- 30 **MR PIKE:** I can answer that question. Godfrey Hirst buy in the market on the day and pay
31 the market price on the day. So whether the price goes up or down is not as relevant to
32 us as paying a fair price on the day for the fibre.
- 33 **MR FERRIER:** David Ferrier, Wool - not Wool Services. **[Laughter]** Excuse me, Cavalier

1 Wool Holdings. I do think I need to make the point very clearly, we have a
2 shareholder, a major shareholder that is a carpet maker.

3 Cavalier Wool Holdings, we have a very very different goal, the goal we
4 specifically have is to scour as much and process as much wool as we are able. We
5 are thrilled to pieces, unlike - I'm sure - our shareholder, that the elevation and the
6 value of the New Zealand clip, and contrary to the suggestion that has been made, the
7 more money the grower gets the better, the more sustainable, the more future we
8 perceive we have.

9 So I think it's worth making it clear, we're a company driven to process the
10 maximum volume we can, we achieve that, as we perceive it, better the higher the
11 price is, and moving forward into the future as well. We're mindful that Cavalier and
12 Godfrey Hirst, I'm sure, are uncomfortable with these higher input costs, but they're
13 not our concern. The higher the better as far as we're concerned.

14 **MS PAULING:** Can I just comment just generally. Obviously for us, and it will be the same
15 for Cavalier, we're competing in a global market; carpet is effectively a commodity.
16 As the wool price has gone up we believe it has a significant effect on our ability to be
17 price competitive, so it does affect us what happens with the wool price, and that will
18 affect the volume that we put through the scour. So if the wool price goes down and
19 we can be more competitive with our carpets we will be able to sell more which means
20 there's more volume through the scour, in general terms.

21 **CHAIR:** I think this probably can bring to an end the discussion on this issue. I think we've
22 canvassed all issues. Is there anything else?

23 **MR AINSWORTH:** I'd just like to ask, the business of the \$30 million that it would be
24 needed for Wool Services to carry on trading, has Cavalier made any provision for
25 that?

26 **COMMISSIONER GALE:** Is this Mr Deakins' comment?

27 **MR AINSWORTH:** Yes.

28 **COMMISSIONER GALE:** Is it 20 or \$30 million Mr Deakins?

29 **MR DEAKINS:** In peak season between 40 and \$50 million.

30 **MR GEORGE:** Yes, we are well advanced through our banking discussions with BNZ and
31 it's - yes, we have cash flow forecasts by month and it's provided for.

32 **CHAIR:** Okay, if we can bring this topic to an end and make a start on the next. We've
33 fallen a bit behind on the timetable, but we're scheduled to continue until 10.30, so we

1 still have another half hour to go. So in that time let's see if we can do the land
2 valuation topic and I'll hand to Gowan Pickering to lead the discussion on that.

4 LAND VALUATION

5
6 **COMMISSIONER PICKERING:** Okay. This topic is about the question of what is the
7 appropriate value for land that might be sold and hence affects significantly the benefit
8 statement.

9 I think the first thing it's generally accepted that the selling of Whakatu and the
10 Kaputone is a benefit, and does anybody have any dispute about that? **[No comments]**

11 Okay. And there is some question, which we'll come to later, about whether a
12 purchase price or some other way is the appropriate valuation method. But for the
13 time being, and in our draft consideration, we had a purchase price of about
14 \$8.7 million, which was the price that the receiver had put on the buildings.

15 The first question I want to understand is what was the basis for the receiver's
16 valuation and can somebody from WSI tell me that? Is it a going concern or is it a
17 vacant possession, what?

18 **MR DEAKINS:** No, the answer to that is quite simple. The valuation that was placed in the
19 receiver's report was simply what he's trying to do is sell shares in New Zealand Wool
20 Services as a going concern. So he has simply used the figures that New Zealand
21 Wool Services use in their reporting, which are on a going concern basis and as
22 required under international financial reporting standards.

23 **COMMISSIONER PICKERING:** Okay, so the number then that you use - and we won't
24 disclose that - in your report, which was different, was that a going concern still or --

25 **MR DEAKINS:** A valuation has been provided to the Commission which clearly states that
26 the vacant possession value is different to a going concern value. That is quite a
27 common position. I don't think there's anything at all unusual about it. And it is
28 simply a valuation prepared by independent valuers for people outside of New Zealand
29 Wool Services, so it is very independent; that says the value of these properties, if
30 there is not a going concern or a wool scouring business on it, is not this, it is that.
31 And therefore to me it is black and white that the valuation that must be used in a
32 vacant position situation is that, nothing else.

33 **COMMISSIONER PICKERING:** Okay. Now could I ask Cavalier, their valuation that

1 they put in their submission, what was that basis?

2 **MR GEORGE:** Ross George from Cavalier Wool Holdings. It was the basis of three things
3 really. One is, you're right, it was the statement given to the receivers and was in a
4 prospective sale document.

5 Secondly, we've analysed the financial statements of Wool Services and as a
6 listed entity there's obviously a requirement, an ongoing disclosure requirement if they
7 think the value of any of their assets are or could be below book value, and so we've
8 taken into account those three things.

9 The valuation in the accounts, which appears to drive a lot of these, is a
10 valuation from 07 that appears from the WSI accounts, and a profit update was issued
11 by the Chairman relatively recently which didn't appear to have any impairment
12 included in it. So we would say in those circumstances you can rely on the public
13 statements, and we do. And you can rely on the public statements of WSI and all
14 listed entities.

15 The valuations of industrial property are valuations of property, the property
16 itself is a going concern and the property itself doesn't change by nature. We would
17 also assert that the value of a property doesn't change because the tenant changes.
18 Would you like me to go wider or --

19 **COMMISSIONER PICKERING:** Well, in a sense I'm coming to that, because if you
20 secured these sites and then sold them, firstly would you put covenants on it, and I
21 guess secondly, who do you think will buy these?

22 **MR GEORGE:** Okay, the answer to your first question is yes, we would put covenants on
23 them. That's what's happened in the past. And secondly, referring to Nigel Hales'
24 statements earlier on, Cavalier Wool Holdings has been through this process many
25 times. It's always had excess land to sell and this situation, like in many other
26 situations, it's actually relocated the plant and equipment and there are some issues
27 with the building of what goes with the building and what goes with plant and
28 equipment. But as you know, in this situation all of the equipment and all of the
29 capacity is being relocated somewhere else.

30 So it is a real estate interest and effectively a shell. These buildings appear,
31 just from historical examples, appear not to be sole purpose buildings, they do appear
32 to be fit for other purposes, and there are eight examples of X wool scours over the last
33 11 years that have all been sold to other uses. The other uses have included storage,

1 they've included logistics, furniture, agricultural uses and machinery uses.

2 And the most recent example was less than 18 months ago with the Clifton
3 Wool Scour, which was sold almost immediately. There were two offers on the
4 building, one was from a transport operator and one was from a port, and so we would
5 say they are most - the examples would quite clearly show that they are not single
6 purpose buildings. In fact I'm aware through other involvements, they were quite
7 appropriate for storage in particular.

8 **COMMISSIONER PICKERING:** Do you have people who you think will buy now or do
9 you know people that will buy now? Because there is a timing issue associated with
10 this too.

11 **MR GEORGE:** Yes. Yes, and one of the issues around the publicity involved in this, and
12 this isn't normal in a sale and purchase situation, the Commerce Commission process
13 has made it quite public. Out of that we do have an unsolicited offer for Whakatu,
14 yes - sorry, an expression of interest. It has a price range.

15 We're aware of the potential uses of the building, which one of them - in fact
16 perhaps I could get on to that on the damages to the building - one of the suggested
17 uses from that party is a party more in the food industry than in the industrial industry.

18 **COMMISSIONER PICKERING:** So they could use the building?

19 **MR GEORGE:** Yes.

20 **COMMISSIONER PICKERING:** So you might realise a sale there in a reasonably short
21 time. Kaputone, is that a good site to sell?

22 **MR GEORGE:** Kaputone - Christchurch has clearly had some disruptions and we're all
23 aware of that. We have done quite a lot of work on Kaputone and we were interested
24 for disruption purposes to examine for our own scours, but also because we'd publicly
25 stated that we would relocate from Kaputone.

26 As I understand it Kaputone did come through - as I understand it production
27 could continue during the earthquake times, and Christchurch appears to have divided
28 into two; those buildings that have been damaged - those areas in which buildings are
29 damaged and areas in which they won't. And I must say our experience from other
30 involvements in logistics and industrial and residential areas just suggests an absolute
31 movement two ways in demand and value of property in Christchurch, and clearly the
32 damaged and the undamaged areas.

33 Out of the earthquake, which I presume you are referring to, there is an acute

1 shortage of storage space in Christchurch, both in businesses we're involved in, but in
2 general businesses.

3 **COMMISSIONER PICKERING:** Nobody's approached you in the last three weeks since
4 this came out and said --

5 **MR GEORGE:** No, nor have we made any approaches.

6 **COMMISSIONER PICKERING:** Okay. I think that probably covers that part of it. One
7 thing that I wanted to understand, is there any contamination, are there any consent
8 issues that would occur in a sale situation here?

9 **MR GEORGE:** Not in the past involvements, and we believe not in this situation. I will ask
10 Nigel to take a view on this. But there is always some make good as a landlord and in
11 fact as there was in the past eight examples.

12 **COMMISSIONER PICKERING:** But you haven't allowed anything for that in your
13 calculations?

14 **MR GEORGE:** Yes, we have, minimal transaction costs.

15 **COMMISSIONER PICKERING:** Minimal to me can mean different things at different
16 times. I'll leave that, yeah. Mr Ferrier.

17 **MR FERRIER:** David Ferrier. What I can confirm from a range of wool scour closures is
18 there's not a contamination issue that I'm aware of. One of the benefits of moving
19 from what's perceived as a pretty dirty smelly ugly industry to any of the new uses that
20 these areas are being put to, you're generally not having a problem with the change of
21 use. So consents have not as far as I'm aware been an issue.

22 And in terms of contaminations, sites that we thought might have an issue, and
23 I can comment, for example, on a family wool scour that's effluent thing just pushed it
24 out into fields and that sort of thing, stringent testing and examinations were done and
25 there has been no issue that I'm aware of. And I would imagine with Wool Services
26 facilities, if there were major contamination issues they would have been disclosed at
27 some point, and there are none that I'm aware of at either of their sites.

28 **COMMISSIONER PICKERING:** Thanks very much.

29 **DR SAVAGE:** Dr Matt Savage, independent environmental expert. There is one historical
30 site with the recent wool scour closure that required fairly extensive and massive land
31 rehabilitation afterwards. The closure of Ashburton Wool Scour resulted in a major
32 rehabilitation project of a large area of land. I cannot comment whether that will be
33 the case at either Kaputone or Whakatu.

- 1 **CHAIR:** Can you identify who you're acting for please?
- 2 **DR SAVAGE:** Independent environmental consultant and Wool Services.
- 3 **MR FERRIER:** Commissioners, if I can just confirm that Ashburton was one wool scour
4 we've had nothing to do with so --
- 5 **COMMISSIONER PICKERING:** I guess I have to ask the question, is it materially
6 different? Was it a very old site or what might have been different about this from
7 other sites?
- 8 **DR SAVAGE:** The key differences were they, as was mentioned with the other site, had land
9 application of their waste water, so that resulted in land contamination, and they had
10 large scale storage of waste water on site, which Kaputone also does but it's in a more
11 contained manner, a more securely contained manner.
- 12 **COMMISSIONER PICKERING:** Kaputone does?
- 13 **DR SAVAGE:** Kaputone does have large scale storage of waste water on site but it is more
14 contained, it is securely contained. This one was an earth dam.
- 15 **COMMISSIONER PICKERING:** Okay, thanks. Wool Services. Do you have some
16 further comments?
- 17 **MR DEAKINS:** Yes, I'd just like to respond first of all going back to the issue of valuation.
18 I heard nothing in the Cavalier submission or reply that would indicate that you would
19 go away from an expert's opinion on the value of land. I think it is also relevant that at
20 the Kaputone site there is considerable vacant land close to the Kaputone site, has
21 storage facilities on it which will be available. That land has been vacant for some
22 time, so I just make that point as well.
- 23 **COMMISSIONER PICKERING:** The conclusion is therefore it would be hard to sell?
- 24 **MR DEAKINS:** Well, I'm not expert in that area and I would make no comment. I just
25 make the point that --
- 26 **COMMISSIONER PICKERING:** That was the inference.
- 27 **MR DEAKINS:** Well, I certainly meant to infer that, but I can't say any more than that.
- 28 **COMMISSIONER PICKERING:** Okay, I just wanted to understand.
- 29 **CHAIR:** Is that observation applying to the post earthquake scenario in the Christchurch
30 market?
- 31 **MR DEAKINS:** Well, I'd just like to add to a further comment that was made about
32 Christchurch sites and earthquake damage and no earthquake damage. I think the
33 Commission should be aware that yes, Kaputone was fortunate that it suffered minor

1 damage, was able to continue. However, its direct neighbour, most probably within 50
2 metres, suffered severe damage; and I could be wrong but my understanding it is still
3 closed. So to market it as an earthquake free area I think is going to be very difficult
4 to do. There is significant damage in very close proximity to Kaputone wool scour in
5 a major processing plant.

6 **MR FERRIER:** Commissioners, just in some sort of response to that, the --

7 **MR DEAKINS:** Excuse me, I hadn't finished.

8 **COMMISSIONER PICKERING:** Sorry.

9 **MR DEAKINS:** Sorry, yeah, if you don't mind. In addition there has been expert opinion
10 submitted to the Commerce Commission from Dr Alan Reay, who is regarded as one
11 of New Zealand's better engineers, has been involved with and knows well the sites at
12 both Whakatu and Kaputone, and I think he makes some very significant points on the
13 actual properties themselves; the need for contamination clean up and also on the
14 matter of what those sites will be suitable for, and he makes it very clear that they will
15 not be suitable for certain activities that have been mentioned as a possible vehicle for
16 sale.

17 **COMMISSIONER PICKERING:** We did note that.

18 **MR DEAKINS:** I'd also add that Kaputone has been a wool scour on that site for in excess
19 of 100 years, many more, and, well, it is a very old site and has been one, so as to what
20 other use --

21 **COMMISSIONER PICKERING:** A lot of history there.

22 **MR DEAKINS:** Yes.

23 **COMMISSIONER PICKERING:** Can I just ask WSI again, are there any further points
24 you want to make before I come back to Cavalier? Mr Stock.

25 **MR STOCK:** Yes, David Stock. I think that to use the receiver's assessment of value in its
26 report would be inappropriate. The receiver's valuation was on the basis of the sale of
27 shares in the company, with the company continuing as a going concern, whereas the
28 proposition put forward by Cavalier is to close the site, remove the plant, place a
29 covenant on the site and then sell it as vacant property with a covenant on it. And that
30 will give a significantly different valuation result than a valuation based on a going
31 concern as per the receiver's report. I think that is the key issue.

32 **COMMISSIONER PICKERING:** Thank you. Mr Ferrier.

33 **MR FERRIER:** David Ferrier, Cavalier Wool Holdings. Just in response to that comment.

1 At the time when I acquired the Clifton Wool Scour business I think I acquired as a
2 going concern pursuant to going concern in book valuations I think of \$5.2 million. I
3 was scared as anything about my ability to recover that because it was smack in the
4 middle of the global meltdown and within two weeks of having the ability to sell it,
5 maybe three weeks, I had sold it for within 5 percent of that I think just over
6 \$5 million. So I sold at - the going concern valuation in those circumstances was very
7 similar to the value that I was able to get it, and there were multiple bidders in that
8 circumstance. It was sold immediately, it was sold the day I took possession of it.

9 Just a comment - excuse me - in terms of the site being a site that's over
10 100 years old, we have previously acquired sites that had been used for more than 100
11 years and have had no contamination concerns in that circumstance.

12 **COMMISSIONER PICKERING:** Thank you.

13 **MR KIRKE:** I'd just like to comment on Mr George's statement that there was no
14 impairment in the recent Chairman's announcement for Wool Services. That's quite
15 correct, and the reason for that we have no reason at this point in time to tell the world
16 that the Cavalier application will be successful. And we very deliberately, in our
17 public statements in terms of making our staff feel more secure and sending a signal to
18 our businesses around the world, it's very important that we continue to announce to
19 the world we consider that we're an ongoing running business.

20 **COMMISSIONER PICKERING:** Thank you.

21 **MR PIKE:** Kevin Pike. I'd just like to respond to Mr Ferrier's comments regarding Clifton.
22 Having owned and operated that site for a number of years, we had several interested
23 parties in that site for most of the period that we operated it, and there was a large
24 demand for industrial land in Invercargill, and I believe that that's why that particular
25 site sold so quickly and at such a good price. It doesn't necessarily transfer, though,
26 that other sites in different parts of the country would be so easy to sell.

27 **MR FERRIER:** Just a response to that, we have sold other sites and met expectations and
28 had sale prices similar, in my recollection, to the previous book values of those
29 properties. If I can just make a further comment on the issue of fit for purpose and the
30 uses of these scours, I hear the Wool Services expert's opinion, but we do have
31 statements from the four previous Wool Services Whakatu managers confirming that
32 in their opinion these scours are fit for a wide number of uses.

33 **CHAIR:** That was going to be something I was going to follow-up on. Is the Whakatu plant

- 1 that you have the expressions of interest for as I understand it?
- 2 **MR GEORGE:** That's correct.
- 3 **CHAIR:** And that is going to be to somebody who uses it for storage facilities?
- 4 **MR FERRIER:** Correct.
- 5 **CHAIR:** And there are no impediments in terms of --
- 6 **MR FERRIER:** Sorry to interrupt, there's a number of interests.
- 7 **CHAIR:** So there's a number of different potential uses.
- 8 **MR FERRIER:** Correct.
- 9 **CHAIR:** And there's no impediments in terms of contamination of the site, there's no issues
10 there pertaining to the --
- 11 **MR FERRIER:** That is our understanding at this point.
- 12 **MR DEAKINS:** I just make the point that Cavalier have not had access to that site and
13 neither have any potential people that have expressed interest. So I think that makes it
14 very clear that --
- 15 **CHAIR:** I was just going to raise, can I come to your expert; you expressed a view that that
16 plant had a contamination issue and I just want to know the basis for --
- 17 **DR SAVAGE:** No, that was not in relation to Whakatu Wool Scour.
- 18 **CHAIR:** Not Whakatu, okay.
- 19 **COMMISSIONER PICKERING:** You've had access to Mr Reay's report, haven't you?
- 20 **MR GEORGE:** Yes.
- 21 **COMMISSIONER PICKERING:** So did that change your mind at all? We have a view
22 here that says that that limits to some extent.
- 23 **MR FERRIER:** David Ferrier, we just didn't agree with a number of the conclusions.
- 24 **COMMISSIONER PICKERING:** Okay.
- 25 **MR HALES:** Yes, I'd just like to comment about Dr Reay's report. I understand that he's an
26 engineer not an expert in valuations. But having said that, we were very concerned
27 obviously when we read his report and we did some additional checking, and I think
28 the best example is actually to look at Whakatu from an aerial map, Google Earth
29 actually, and we very clearly could see the staining that he was talking about on the
30 section of roof.
- 31 So subsequently we've done some more checking and I guess the obvious
32 question for the Commission to put to Wool Services is, is the staining that's on that
33 roof a consequence of overuse of chemicals such as peroxide and acid or something

1 like titanium dioxide which actually doesn't rot the roof but stains it. It just seems to
2 be a little bit contradictory for us.

3 **COMMISSIONER PICKERING:** On that particular point have Wool Services got an
4 answer to that?

5 **MR CARADUS:** Yes, I could respond to that. Yes, you're correct, it was titanium dioxide
6 which was a process that we had some considerable demand for when we
7 commissioned the plant, but since that only lasted for about eight months and that
8 practice has ceased now.

9 But I'd also like to - I think it should be made aware, particularly at Kaputone,
10 apart from the store which was constructed in 1998, the total operational area is in
11 extremely bad condition simply because of the sulphides and the emissions from the
12 bowls. And I'd have to say from practical experience that, you know, as far as the
13 store goes, it would be a very costly business to refurbish that total area. Thank you.

14 **COMMISSIONER PICKERING:** Mr George, you want to say anything?

15 **MR GEORGE:** Yes, just two issues around the valuation parameters or instructions. Our
16 proposition is that this building, like all of the other buildings, is very tenatable. It's
17 tenatable for all of the uses that I'd mentioned before and the valuations that are
18 undertaken on a building always take into account whether - it doesn't take into
19 account any point in time, or a tenant in any point of time, it takes into account a
20 tenant and a yield and an actual yield or a potential yield.

21 The short-term uses for this particular site are quite good and this site also is
22 next to - it's next to a railway and it's next to a residential area, and I think you're right,
23 a lot of the land around this site is vacant land, and some of it's agricultural land and
24 there are long-term plans to move residential into it. And I don't know the changes
25 since the earthquake, but I am aware in an area on the north of Christchurch where a
26 very large residential development is being proposed and we're involved in that.

27 **COMMISSIONER PICKERING:** What's the zoning around this then?

28 **MR GEORGE:** It's a variety of zones actually. A lot of the area is actually the old Belfast
29 Freezing Works, so it's got that zoning. Immediately on the other side of the railway
30 line, which is about 50 metres or so, is residential, to the south is light industrial. But
31 it is an area that's being reconsidered for different uses now. So I guess it is --

32 **COMMISSIONER PICKING:** Coming back to this building then, who was it, was it
33 Mr Kirke who mentioned it? No Ian, yes, you mentioned; is the proposition then that

1 somebody just moves straight in in your thinking, or are you going to have to spend
2 some money as the landlord, well as the seller/vendor, to clean this up or what?
3 Because the value that we've got from you assumes that it will just be taken over and
4 somebody else will do all the cleaning up or use it in different ways. I'm trying to get
5 to the net number, whether the number you provided was the number we should use,
6 which we haven't, but which would take into consideration.

7 **MR FERRIER:** Commissioners - David Ferrier - if you don't mind me responding to that.

8 **COMMISSIONER PICKERING:** No, no please do.

9 **MR FERRIER:** Because I have had specific experience of it. It's remarkable what happens
10 with these wool scours, you've been into some of them. They don't look that great
11 when they're in there operating and they've got wool all over the place. Pull all the
12 wool out of it, pull the equipment out of it, which can happen very quickly, repair the
13 floors for the area, it can happen very quickly and they become very quickly in a fit for
14 leasing and/or sale state.

15 When got the Dr Reay report, for example, we were concerned, we did have
16 specific experience from people who will been through the scour and knew it well.
17 We have had a quote to repair the roof to the extent that it needs and requires repair,
18 and I think the quote is at \$40,000 if that is of some assistance.

19 **MR DEAKINS:** Can I just conclude by saying that we have independent valuation reports
20 which are black and white, we have an opinion on the sites from one of New Zealand's
21 leading engineers - he is not valuing the properties, he is talking about other
22 engineering matters - and we have Cavalier who have never been - who have not been
23 on site to make judgments, and I would have thought the conclusion is
24 straightforward.

25 **COMMISSIONER PICKERING:** Thank you.

26 **MR HALES:** That's not strictly correct, I have been on Whakatu site.

27 **MR DEAKINS:** I acknowledge that, but not for the purposes of doing this sort of work.

28 **MR FERRIER:** David Ferrier, Cavalier. The party that is particularly interested and has
29 approached us, or one of them certainly has been on site on a number of occasions.
30 The explanation for that is they have a diversity of interests; one of their interests is
31 involved in wool, other interests are involved in other activities.

32 **CHAIR:** Do we actually have information on this indicative bid? It seems to me very
33 important to know, if you're saying you've got a person who's interested in buying

1 Whakatu, that seems fairly relevant evidence to me to us in terms of working out, you
2 know, what the property is worth is it not?

3 **COMMISSIONER PICKERING:** Could that be provided to the Commission?

4 **MR FERRIER:** Yes, from my part it can be. The issue will be we're working out the value
5 proposition ourselves to further it with that party.

6 **COMMISSIONER PICKERING:** Could you as part of the next week's submissions if you
7 can do something.

8 **MR FERRIER:** Certainly.

9 **COMMISSIONER PICKERING:** Okay.

10 **COMMISSIONER GALE:** In the submissions from John Marshall they said in the
11 Kaputone area if that plant was closed it would require merchants to provide extra
12 storage. Did you read that submission? The closure of Kaputone means that
13 somebody would lose some storage facilities.

14 Does Kaputone provide storage to merchants? I wondered whether you'd made
15 provision for storage when the work is brought together in Timaru.

16 **MR GEORGE:** I don't know the answer to that.

17 **MR HALES:** Obviously we're not aware of what volume of wool is stored at Kaputone. But
18 I'd make the point that Timaru's an hour and a half down the road by car, probably two
19 hours by truck. We're going to have ample storage available to us in the Timaru
20 region to store wool, and we hadn't considered this, so --

21 **COMMISSIONER GALE:** Thank you.

22 **COMMISSIONER PICKERING:** Just one final - Mr George you want to --

23 **MR GEORGE:** No, please.

24 **COMMISSIONER PICKERING:** Just one final question from me. There was, I think by
25 Mr Layton, mention that we should have taken a different approach to the valuation, a
26 sort of five year rental type approach to the valuation. Anybody got any comment
27 about that, or should we discuss this tomorrow in the - just the economists really, it's a
28 question --

29 **MR MELLSON:** Do you want to do it now?

30 **COMMISSIONER PICKERING:** Yeah, if you have a quick answer to that.

31 **MR MELLSON:** Well, I guess all of these costs and benefits we're analysing there's
32 uncertainty. That's the world we're in. The thing about the land is that there's the
33 debate about the value, but there's actually relatively certain benefit. It's accepted it's

1 going to be sold, so the question is really just for how much. So in that sense it's a
2 very certain benefit. So I think the approach the Commission has taken and has taken
3 in the past in the Ruapehu decision is a reasonable one in the circumstances.

4 **COMMISSIONER PICKERING:** Fine.

5 **MS BRANSON:** The question was actually not about the certainty of the value of the land,
6 the question is more about for all your other costs and benefits you're looking at, what
7 are the costs and benefits over a five year timeframe. So the sale of the land, what are
8 the benefits from selling the land that you earn within that time year, five year
9 timeframe.

10 So a one-off sale every 20 years, 100 years, why would you include that lump
11 sum; surely you would spread that in terms of what is the benefit, what is the
12 equivalent benefit per year. So the rental value per year, so that you're comparing all
13 of your costs within a five year timeframe, all of your benefits within a five year
14 timeframe, equal basis.

15 **COMMISSIONER PICKERING:** For a non-economist, if you sell it within five years is
16 that all right?

17 **MS BRANSON:** But it's a capital investment, you're buying an asset that you're going to get
18 more than five years use from. So if you're looking at the benefit or the --

19 **COMMISSIONER PICKERING:** The money's in your hand.

20 **MS BRANSON:** -- the cost of buying it, it's what does it save you for five years, by buying
21 that for storage or whatever, you're saving having to pay five years renting storage
22 somewhere else.

23 **COMMISSIONER PICKERING:** I understand your point.

24 **MR SUNDAKOV:** I mean I think Brent makes a fair point, and in an a sense I think we kind
25 of often ignore that point in these kind of considerations that some of the benefits and
26 costs that we look at have a terminal value and some don't. And I think he does make
27 a fair point that we should probably be consistent.

28 **COMMISSIONER GALE:** Can I ask whether you would regard the market price of the
29 land as incorporating the certainty in its future value and its future opportunities for
30 use? I'm struggling to see why the market value wouldn't capture that uncertainty. I
31 mean the reason, as I understand it, that we stick to five years is we're uncertain about
32 longer term benefits. But so are the people who are buying the land, and that's
33 incorporated in people's willingness to pay for an asset.

1 **MS BRANSON:** That's correct that their uncertainty and their attitude to risk around the
2 business that they're going to operate on this land that they buy would be reflected in
3 the price they're willing to offer. But again, when they're willing to offer that, say they
4 were wanting to run a business there for 20 years, or expecting to run a business there
5 for 20 years, the amount they're willing to buy the land for is going to reflect that
6 they're looking at a 20 year timeframe for their business.

7 The rest of the cost and benefits in the assessments are only those costs and
8 benefits that are accruing over the first five years. So in that case you'd need to look at
9 the purchaser, what's the benefit to them for purchasing that land only for the first five
10 years.

11 **COMMISSIONER PICKERING:** I understand your theory.

12 **MR MELLOP:** Are you looking for a response from me?

13 **COMMISSIONER PICKERING:** No, no, sorry, Mr Heath there.

14 **MR HEATH:** Yes, Cliff Heath, Wool Equities. You asked the question about John Marshall
15 and the storage. Well, I'm not totally familiar with his situation, but I believe it was
16 probably for his Joma plant rather than - but certainly in terms of Christchurch Yarns,
17 who I am familiar with, what they will lose from this is the ability to go around the
18 corner effectively and pick up the wool, purchase the wool directly off Wool Services,
19 and put it straight into their spinning plant.

20 That will be lost. Because first of all they will then have to buy the wool in a
21 greasy state, get it scoured in Timaru and then bring it back. So he's got a storage
22 issue around that. At the moment he basically uses, as I understand it, Wool Services
23 to store his wool and picks it up as he requires it.

24 **COMMISSIONER PICKERING:** Okay, thank you. Mr Hales.

25 **MR HALES:** We also scour for the customer in question there, we fully know what they
26 expect, and it's just usual practise for us. They deal through an agent actually and he's
27 based in the Wairarapa, buys the wool for them and gets it processed independently
28 through whichever service, and we deliver it to Christchurch just as a truck would
29 come from I presume Belfast to his factory.

30 **MR COWAN:** I'm just interested in a comment that I heard from Cavalier that there's ample
31 storage in Timaru. When Clifton was closed there wasn't ample storage in Timaru and
32 I haven't seen any evidence of massive buildings of storage around that site at this
33 stage.

1 So I'm just wondering what happens when 50 percent more wool, or
2 100 percent more wool than you've got there now arrives into Timaru, what happens?

3 **COMMISSIONER PICKERING:** Somebody at the back.

4 **MR CUNNINGHAM:** Tony Cunningham for Cavalier. I'd just like to respond to that, being
5 based in Timaru myself. Yeah, a lot has happened in that economy. The port itself
6 being a large export port has substantially downsized within the last 18 months having
7 lost several major shipping lines, so that's opened up a lot of storage facilities around
8 the port area, which is only a couple of Ks away from the plant. We don't think there's
9 a storage issue in Timaru for wool.

10 **COMMISSIONER PICKERING:** Thank you. Can I just ask the staff there, are there any
11 further questions you want to raise at all?

12 **MR FORSYTH:** Just for Cavalier, you said there's eight examples of you selling wool
13 scours in the past 11 years. Do you have evidence on how many of those sales you
14 reached the going concern book value?

15 **MR GEORGE:** No, I don't.

16 **MR BLACKTOP:** We can check whether we've got that information. We haven't got it now
17 but we can check and respond next week.

18 **COMMISSIONER PICKERING:** There seems to be three hands here, who's best
19 positioned? You decide.

20 **MR FERRIER:** Just a quick response to that. Looking at our list of eight, when we say
21 they're actually not all ones that we ourselves have sold, they're some that have been
22 sold as a result of transactions we've been involved in, yes.

23 **MR TAYLOR:** I think we can have a look at it, Commissioners, and see if we can put
24 something in the final submission and cover it off.

25 **COMMISSIONER PICKERING:** All right.

26 **MR GEORGE:** Can I also stress, the reason I gave the examples of alternative uses and gave
27 the examples of industries that had short supply at the moment in Christchurch, was
28 simply because we don't call it going concern ourselves, but we would be selling a
29 building that's being used and hopefully we've given you a reasonable amount of
30 comfort that there are other types of people that would use the building. I think that
31 was the essence of our submission.

32 **COMMISSIONER PICKERING:** All right. I'll close this session unless anybody else has
33 anything more to add. If not I'll hand back to the Chairman.

1 **MR STOCK:** One thing for the Chair. David Goddard's proceedings in Auckland have been
2 adjourned due to an intervening death and he will be able to be here for the next
3 session Mr Chair.

4 **CHAIR:** Thank you. I'm just mindful of the timetable going forward. We've not quite kept
5 on schedule, but we'll come back after the break and do cost savings and then the other
6 topics which I expect mean that we will take up that 1.30 slot to finish this session off
7 today. So if in the next session between - actually it's now 10.40, so if we come back
8 at, say, close on 11 o'clock. Shall we make it 11 o'clock?

9 **COMMISSIONER PICKERING:** Yeah.

10 **CHAIR:** Perhaps if we wanted to do the session with Mr Goddard when he arrives at 11. We
11 can amend that, but I think if we can just adjust the sessions and we'll start at 11 again
12 and go through until 12.

13 **COMMISSIONER PICKERING:** Late news here.

14 **MR STOCK:** Yes, he can be present at 11.30 just particularly for that session Mr Chair.

15 **CHAIR:** That's fine, we can just work in the time around. So we'll come back at 11 and then
16 go through until 12.30 and then we'll come back at 1.30 to finish of what sessions we
17 need to do.

18

19 **Adjournment from 10.38 am to 11.01 am**

20

21 **CHAIR:** Thank you for returning promptly at 11 o'clock. We'll now move to the next
22 session on cost savings and Sue Begg will lead the discussion on this.

23

24 **COST SAVINGS**

25

26 **COMMISSIONER BEGG:** Thanks. We will have an opportunity to discuss the details in
27 tomorrow's session, but I think we can discuss in general terms a number of the issues
28 to do with cost savings, so I'd like to do that today.

29 The first thing I thought we should start with is the questions of the time that
30 might be taken to achieve the benefits and the suggestion that Cavalier's been
31 optimistic in the timing that is incorporated in its modelling for the benefits. And just
32 listening to this morning's session it sounds to me like it's going to take up to a year
33 before plant is moved for the completion of that process, which suggests to me that the

1 land wouldn't be available to sell until that had been completed, and some of the
2 rationalisation benefits would only begin to be realised at that point.

3 So I'll invite Cavalier just to respond as to what assumptions they've made
4 about the timing of the benefits and have they, in light of the submissions - I think
5 Dr Layton, for example, has raised this issue - have they changed their mind as to how
6 that should be incorporated?

7 **MR MELLISOP:** Yep, sure. I mean I think, Commissioner Begg, there are a couple of
8 people who probably want to speak on this. On the factual issues it will be one of
9 these other guys. The sort of reaction I had to the arguments made by Dr Layton are
10 that to a degree we need to be careful how technical we get about when all these things
11 are going to happen. Because one can also argue on the cost side as in the detriment
12 side that they're not going to happen on day one either, there will be some sort of lag.

13 So I guess that's the only sort of economic reaction I have, that it's probably not
14 correct to assume that detriments suddenly all occur from day one and benefits all
15 from day 364 or 374 or whatever. So I guess it's a caution about trying to be too
16 scientific about when everything - I mean we can go down that route, but to this point
17 we've sort of assumed it's a year by year thing. So that was the sort of framework
18 response, sorry, it's not a factual response.

19 **COMMISSIONER BEGG:** So the assumptions are that the benefits are achieved from year
20 one?

21 **MR MELLISOP:** In our original report that's correct, we've assumed benefits and costs start
22 in year one. We haven't thought which day in year one, it's simply been a slightly
23 more general analysis, which I think is the right way to do it.

24 **COMMISSIONER BEGG:** And your argument is that it's not that important because the
25 detriments, if benefits are relayed, detriments might also be delayed?

26 **MR MELLISOP:** Yeah, I'm not saying it's not important. If benefits weren't going to happen
27 until year three then clearly it would be important. My only comment is that we
28 probably also need to think about the detriment side if we're going to think about the
29 benefit side and actually when prices will start increasing, when the firm will become
30 less efficient. It's not going to happen on day one necessarily. So that's the economic
31 sort of reaction.

32 **MR TAYLOR:** Perhaps if I could add to that for Cavalier. I think one's got to be pragmatic
33 about this method of quantification. It's never going to be possible to achieve an

1 immediate, on day one, outcome. And naturally in all these cases of authorisation
2 benefits and detriments get spread over a period.

3 But certainly, as Mr Mellsop has said, dynamic detriments or inefficiencies that
4 arise don't happen on day one, they will occur over a number of years, but we classify
5 them for day one. Same with productive - slothful behaviour just gradually grows into
6 a business, it doesn't happen immediately, yet we quantify on day one. And the same
7 with benefits, most of these benefits that are hard wired benefits on removal of cost
8 will occur pretty fast, but almost immediate, but some of the rationalisation ones may
9 take a bit longer.

10 **COMMISSIONER BEGG:** One of the most critical assumptions I assume will be on the
11 timing of the sale of land given the significant value attached, depending on whether
12 we accept the suggestion that we should only look at the five years, but if we're
13 looking at the full life of the assets that's really important. I'll just ask James where
14 you think that justifies a different treatment than costs and benefits more generally.

15 **MR MELLSOP:** This is, I guess, kind of the point I was trying to make before. All of these
16 things there is uncertainty and there's different degrees of uncertainty, yet it's not
17 standard practise to try and assign probabilities to all the costs and benefits, just
18 because possibly it's false science.

19 It seems to me that with the sale of land in the scheme of uncertainty is a
20 relatively uncertain benefit. So that's why I think the approach the Commission has
21 taken in Ruapehu and so far in this case is a reasonable one for that reason. Is that
22 answering your question?

23 **COMMISSIONER BEGG:** Not entirely, in that I was - it seems to me it looks reasonably
24 clear that at best Cavalier will be able to sell the land a year after it starts the process,
25 and then obviously who knows after that that's where the uncertainty kicks in as to
26 whether there are buyers at that point. And the question is because that's such a
27 significant part of your benefits, the discounting of one year makes quite a difference.
28 I just wondered if that should be treated differently?

29 **MR MELLSOP:** I think if - I mean I can't comment on how long it would take to sell the
30 land, that's obviously a factual issue. But if you believe that it won't be sold until year
31 two then it would be appropriate to discount that benefit. Also, I guess the
32 complicating factor is that you may expect the price of land to increase over time, that
33 would offset that to some degree. Is that your question?

- 1 **COMMISSIONER BEGG:** Yes, thank you.
- 2 **MR TAYLOR:** If I could just comment on that. I think the evidence given by Mr Hales
3 earlier was that the removal of the existing scales out of Kaputone and Whakatu would
4 happen quite rapidly. It's the process of rebuilding that takes longer when they're
5 moved to the new sites.
- 6 **COMMISSIONER BEGG:** But the rebuilding of the building, I understand, has to happen
7 first, then the shifting of the scour can't happen until the off season. That takes you at
8 least six months and maybe longer before we have vacant land, vacant property to sell.
9 That's just what I was assuming there.
- 10 **COMMISSIONER PICKERING:** Can I just ask, in your plan when was Whakatu available
11 for sale, or possession?
- 12 **MR HALES:** Nigel Hales. Approximately nine months after the take-over.
- 13 **COMMISSIONER PICKERING:** Okay, so if we make an assumption, did you make an
14 assumption that that takeover would be at the end of this calendar year or what?
- 15 **MR HALES:** Between now and the end of the calendar year, yes.
- 16 **COMMISSIONER PICKERING:** Okay, nine months from there. What about Kaputone,
17 what dates did you use for that?
- 18 **MR HALES:** Exactly the same because we'd be dismantling the physical scour lines out of
19 those plants almost simultaneously.
- 20 **COMMISSIONER PICKERING:** Okay, thanks.
- 21 **COMMISSIONER BEGG:** Okay, did Cavalier finish there and I'll move on and ask other
22 parties about that? Wool Equities.
- 23 **MR HEATH:** Just a question to Nigel. On your last point, that on the issue of timing, that
24 basically you've got a seasonal issue here, which if it's nine months from possession
25 and possession is, we'll say, in a month's time, two month's time, then that doesn't
26 work with the seasonality. So you would have to bring the seasonality into it which
27 actually extends the whole thing by another year I would have thought. Perhaps I'm
28 off peat here, but that's my piece of arithmetic.
- 29 **COMMISSIONER BEGG:** Perhaps we'll get Cavalier to, in their submissions to us, they
30 could clarify their expected programming depending on when the deal is closed and
31 that would be helpful.
- 32 **COMMISSIONER PICKERING:** Could I just go back to --
- 33 **COMMISSIONER BEGG:** Yeah.

1 **COMMISSIONER PICKERING:** It was nine months from the time of the closure of the
2 deal.

3 **COMMISSIONER BEGG:** But it depends on the seasonality I think is --

4 **COMMISSIONER PICKERING:** No, no, so if it was, say, if the deal was closed in July
5 then you'd be right in the middle of the season. If the deal was closed at the end of
6 the year you're into your off season. I'm just getting quite clear in my mind what was
7 being said. Is that right?

8 **MR HALES:** Yes, that's what I'm assuming.

9 **COMMISSIONER PICKERING:** We don't know the start date, that's the only problem.
10 Yeah, okay, that's fine. Thanks.

11 **COMMISSIONER BEGG:** Godfrey Hirst.

12 **MR SUNDAKOV:** Perhaps if I can comment. I agree with James that I think we should be
13 very careful to avoid the full science here. I think the approach to quantification has to
14 be very much targeted to the needs of the decision. What that means, though, is that
15 the degree of quantification and the detail that we get into has to be related to how
16 robust the decision is to particular assumptions. When we look at the Draft
17 Determination what that really shows is that very small variations in assumptions flip
18 the decision from net detriments to net benefits. I think if you're in that set of
19 circumstances, I think it becomes really important to start drilling down to a level of
20 detail that gives you the robustness of the decision.

21 So, for example, if the decision was entirely robust, it was irrelevant whether
22 the benefits kick in a year later or two years later, it didn't make any difference to the
23 net direction, then you would say why bother getting into that kind of detail. But
24 when you are sitting right on the cusp and these things make such a huge difference, I
25 think it would be very dangerous not to look into that level of detail.

26 **COMMISSIONER BEGG:** Thank you. Wool Services, any comment?

27 **MS BRANSON:** It depends how critical is the balance between your total benefits and total
28 costs, and if they are finely balanced then whether you have large costs up-front and
29 then have some delay or some weight until you get your benefits, or some weight or
30 some delay until you get other detriments, that can be a critical factor as to whether the
31 total benefits are larger or smaller than your total costs.

32 **COMMISSIONER BEGG:** Thank you. Just turning now to some details on the cost
33 savings. An issue's been raised by Garry Forward, who was the accounting expert for

1 Wool Services, about the treatment of energy savings that have been calculated, and
2 this is for electricity and for coal. He points out that the savings that have been
3 included in Cavalier's calculations, some of them appear to result from a lower price
4 per unit of electricity being achieved and/or a reduction in fixed line charges and he
5 suggests that these are not real savings in resource costs which would be relevant for
6 cost benefit analysis.

7 There's a third possibility of savings which are a real reduction in the actual use
8 of energy. I think no-one would have any debate that that was a saving. But I just
9 wanted to check with Cavalier what their response was to this proposition that some of
10 the savings that have been accounted are actually wealth transfers from one party to
11 another.

12 **MR DRAKE:** Yes, Jim Drake. I can assure you that the modelling is a reduction in units and
13 not a reduction in price.

14 **COMMISSIONER BEGG:** So obviously, not obviously, but perhaps line charges, you'd
15 have fewer fixed line charges, any change to that that's not been taken into account?

16 **MR DRAKE:** That's correct.

17 **COMMISSIONER BEGG:** So these are all efficiency savings through reducing the amount
18 of energy used?

19 **MR DRAKE:** Yes.

20 **COMMISSIONER BEGG:** I wonder if you can just - it would be interesting to hear how
21 you're going to achieve those savings.

22 **MR DRAKE:** So the savings specific --

23 **COMMISSIONER BEGG:** The actual real savings, the reduction in energy use, how does
24 that come about, given you're scouring the same quantities presumably as before?

25 **MR DRAKE:** Well, the majority of the unit cost savings are coming by either reduction in
26 overheads or by higher run rates would give us a lower cent per kilo cost.

27 **COMMISSIONER BEGG:** So you have a higher run rate, you're saying that's achieved
28 using less electricity or coal per unit?

29 **MR DRAKE:** The higher run rates are actually achieved by using similar units. With a
30 scour you're effectively running or you're not. So if you can achieve higher run rates
31 per a day the actual units themselves do not vary with your run rates.

32 **COMMISSIONER BEGG:** So you're getting more throughput for the same amount of
33 energy?

1 **MR DRAKE:** For the same amount of units, correct, yes.

2 **COMMISSIONER BEGG:** Okay, and that is arising because of the reshaping of your plant
3 and the use of the wider scour, is that a more efficient --

4 **MR DRAKE:** What we're going to do to our own scouring equipment at Awatoto plus the
5 modifications that we are going to make to the two 3-metre scours.

6 **COMMISSIONER BEGG:** Any other comments from Cavalier on how these efficiency
7 achievements are going to be realised? **[No comments]**

8 Okay, I wonder if Wool Services would concur.

9 **MR DONNELLY:** Adrian Donnelly, Whakatu Wool Scour. I'd just like to comment on the
10 energy requirements in processing and in terms of electricity. Yes, there could be
11 some savings, but in terms of gas, increasing your run rate will also increase your gas
12 usage, or coal usage, for drying because you've increased the amount of wool that you
13 have to dry. And it is proportionate, the more wool you dry the more energy you will
14 use. So I don't believe there'll be the savings that have been promoted.

15 **COMMISSIONER PICKERING:** What's the proportion of electricity and gas in the
16 normal scour situation?

17 **MR DONNELLY:** In terms of electricity you operate your opening machinery, your scour, it
18 runs 24/7 pretty much the same electricity consumption, unless you've got heaters and
19 things that are electrically.

20 But in terms of scour processing, you've got to remember when wool is
21 scoured it has a large proportion of moisture left in it which has to be dried. So
22 increasing a few scoured wool at 3 tonne an hour or 4 tonne an hour greasy then the
23 clean rate would be proportional to its yield and the drying demands, or the gas
24 consumption, would be quite different for both those processes.

25 **COMMISSIONER BEGG:** So your view is that the savings in electricity costs might be
26 realised through the restructuring, but the coal and gas is used for the drying process
27 and that's what you're questioning the efficiencies from that?

28 **MR DONNELLY:** Well, the plant, if a 3-metre plant is relocated from one position to the
29 other then it will require the same energy to run the same motors. So potentially --

30 **COMMISSIONER BEGG:** I presume Cavalier are suggesting that they can run that scour
31 more efficiently, is that the argument?

32 **MR HALES:** Yes, we accept what Adrian's saying about the dryer. Energy usage in a dryer
33 is variable as your production rates go up, but a large part of your plant's not. Like

1 your bowls, for instance, which consume, from memory, about a third of your gas
2 consumption. And in the case of the North Island scours that's fixed, it's when you get
3 your bowls to a temperature there's very little extra energy required. And lanolin is
4 another example. But if you run - say you change your run rates from 4 tonne an hour
5 to 5 tonne an hour then that's where you get your savings in those fixed areas. And,
6 sorry, and that's what we're intending doing.

7 **COMMISSIONER BEGG:** Right, so some of the coal's used for heating in the scouring as
8 well as drying, and for heating the water that's used to wash the wool you're seeing a
9 saving there?

10 **MR HALES:** Yes.

11 **COMMISSIONER BEGG:** Okay.

12 **MR STOCK:** I'd just like to address the question of the fact that the Cavalier figures, of
13 course, have not been made available to our clients for their consideration, they are
14 confidential, and the savings which they are claiming are a very substantial part of the
15 efficiency gains. And it's a question of whether the Commission would accept the
16 Cavalier figures, or whether these should be subject to other external scrutiny to
17 determine whether or not they are accurate.

18 I think it would be very - one would need to take great care in determining
19 whether or not to accept the figures, because obviously the expert we employed to
20 look at them has not got a great deal of involvement in the scouring industry, he
21 doesn't know how it operates and he's merely had to go by a sort of inquisition method
22 of trying to determine the probity of the costs put forward by Cavalier, and therefore it
23 has been very difficult for him to come to a final conclusion.

24 And therefore I think that the costs put forward need to be subject to some
25 form of external scrutiny by an expert to determine whether or not they are properly
26 proposed as per the Cavalier figures.

27 **MR DAVID:** I'd concur with Mr Stock. We heard from NERA, from Cavalier, that some of
28 these energy savings are going to result from changes to their own equipment. Now
29 changes to their own equipment are not a public benefit unless those changes would
30 not occur but for the proposed acquisition.

31 **COMMISSIONER BEGG:** It is their claim because the straightening of the scour would
32 only take place, I understand it, if the transaction goes ahead.

33 **MR DAVID:** Now that requires scrutiny by industry experts, whereas Mr Sundakov and I

1 have had access to their material. We're not in a position to comment on the detail and
2 the accuracy of that claim. That's the kind of information that only people with
3 industry expertise can do and the Godfrey Hirst experts have not had that opportunity.

4 **COMMISSIONER BEGG:** I take your point, but I think that we can get a reasonable
5 amount of response in terms of in principle whether these sorts of savings could be
6 achieved, which goes at least some way towards answering the question for us. But in
7 terms of the specific number, so I think that we'll think about that issue.

8 **MR DAVID:** That's exactly my point, Commissioner Begg. Without the opportunity for
9 independent scrutiny by other parties there is a significant degree of uncertainty as to
10 the quantum of the benefit, if there is in fact any benefit.

11 **MR KIRKE:** If I could just add to the comments that Mr Stock made just from the
12 perspective of the board of Wool Services, it has been extremely frustrating from our
13 perspective to not even be able to see the figures that Cavalier have used for our
14 business. And we found that enormously frustrating, that we can't even scrutinise the
15 figures they've used for our company because they've all been redacted in the
16 information that we've received.

17 **COMMISSIONER BEGG:** Okay. We've heard those comments, and of course
18 confidentiality is always a difficult issue in these situations, but you understand the
19 reasons why it is required, but we'll give further thought to that.

20 **MR SUNDAKOV:** Could I make one specific point in relation to the reduction in the
21 number of units. My understanding was that the reduction in the number of units
22 included the reduction in the number of units of fixed lines. Is that correct?

23 **MR DRAKE:** Sorry, the number of?

24 **MR SUNDAKOV:** Of inputs included the reduction in the number of the units of fixed lines,
25 line connections if you like. Because part of the saving is the avoidance of - fewer
26 sites, therefore fewer fixed line charges, and that's a reduction in the number of units I
27 think as you described it.

28 **MR DRAKE:** Sorry, I'm a bit confused whether you're talking about less units as in less
29 kilowatt hours, or less physical fixed line charges.

30 **MR SUNDAKOV:** Well, I think my reading of the numbers was that there was both less
31 units of energy but also less units of fixed lines, in other words lower fixed line
32 charges.

33 **MR DRAKE:** Yes, that's correct.

1 **MR SUNDAKOV:** I just wanted to make the point that the reduction in the number of fixed
2 lines is not a resource saving from a national point of view to the extent that another
3 user of the building will require exactly the same fixed line as before.

4 **MR DRAKE:** If the new user of the building was using it for that specific purpose.

5 **MR SUNDAKOV:** Well, you'd have to imagine that a new user of the building didn't have
6 any electricity for them not to require a fixed line connection.

7 **MR DRAKE:** But the fixed line charges are based in part on your peak demand and we don't
8 know what the peak demand will be of anyone else going into the building.

9 **MR SUNDAKOV:** That's exactly right and that's a financial element of it. But the resource
10 saving would be avoidance of usage of a resource, such as not having any need for a
11 fixed line. To the extent that the amount of investment that's required to manage the
12 network remains unchanged and it seems - I mean you can imagine where change in
13 one usage of one building could change the overall network configuration. But to the
14 extent that that's fairly unlikely, it's hard to see how there could be any resource saving
15 from the fixed line element of it.

16 **MR DRAKE:** Are we getting into an economic argument here? Because if we are I'm
17 probably not the best person to be talking about it.

18 **COMMISSIONER BEGG:** We'll have James Mellso, but we can of course continue this
19 tomorrow. When I asked the question about fixed charges I thought you said that you
20 hadn't taken into account the reduction in fixed charges, because that was the debate
21 that was raised by Garry Forward as to whether that should be counted as a benefit.

22 **MR DRAKE:** Certainly if we take an example in electricity we are taking a reduction in
23 fixed charges because we will no longer have the Whakatu and Kaputone sites.

24 **COMMISSIONER BEGG:** So your argument would be that's a saving in real resource
25 costs, not just a price to you. But perhaps James Mellso, because it's an economic
26 issue, might --

27 **MR MELLSON:** Yeah, thank you. Two things; first of all just to clarify the model. My
28 understanding is that what Jim and the Cavalier team have done is not assume any
29 price decreases from input suppliers, it's simply using less inputs. So just to clarify, I
30 think it's the same case --

31 **COMMISSIONER BEGG:** So in the variable charges there's no reduction in price benefit
32 calculation. Okay, that's good, yeah.

33 **MR MELLSON:** There's less use of resources, that's correct.

1 **COMMISSIONER BEGG:** Okay.

2 **MR MELLSOP:** And secondly, just picking up Alex's point, I don't think I agree with that,
3 because I think the same argument could be made for buildings or anything else. The
4 way I think about this is moving forwards the same quantity of wool will be scoured in
5 New Zealand using less inputs. So the surplus in the market increases, and I don't see
6 why we would treat a fixed line any differently to a building or some other asset that's
7 no longer used by scouring.

8 **COMMISSIONER BEGG:** Assuming the fixed line charge reflects the assets that are used
9 to supply that entity I suppose, that there is a link between the price for the fixed line
10 charge and the resources used to provide that fixed, which may or may not be the case.

11 **MR MELLSOP:** Yeah, I'm not sure. I mean I see this as a productive efficiency gain for the
12 industry. The same scouring quantity is done for less costs, so that to me is the
13 definition of productive efficiency gain.

14 **COMMISSIONER BEGG:** Right, so you wouldn't look beyond the numbers to see what the
15 effects in the economy are in terms of the costs of supplying that electricity and the
16 costs of the lines, which I think is what Alex might have been suggesting.

17 **MR MELLSOP:** I'm not sure if that's what he means or not, but that's not the sort of
18 approach we traditionally take in these processes. We're looking at the surplus in the
19 scouring market.

20 **COMMISSIONER BEGG:** Okay, thanks for that.

21 **MR PIKE:** Kevin Pike. I understand the fixed line component and the reduction in costs that
22 will flow because you're not supplying energy to as many sites. What I'm struggling to
23 get to grips with is the variable cost which is the actual units of energy used to process
24 a given quantity of wool.

25 And, to explain it, if we have an amount of wool that has to be physically
26 moved from one point to another, such as over a hopper brattice, it requires a certain
27 amount of energy to do it, and if a machine is running at, for instance, 1,000 kilos an
28 hour, also going to use X amount of energy to lift the wool over the top of that
29 brattice. To increase the run rate requires that machine to lift more wool, which uses
30 more energy.

31 Now Cavalier are also making modifications to the scours that we don't fully
32 understand because we haven't been told what they are. But if we're doing things like
33 increasing bowl capacities, so there's more liquor in the scouring bowl that needs to be

1 heated, that again is going to use more energy than what's presently being used by
2 Wool Services to process that amount of wool.

3 In addition to that, wool travelling through the scour needs to be heated. It
4 comes into the scour at ambient temperature and it's heated up to 60, 70 degrees. It
5 takes more energy to heat, or it takes more energy to heat - it takes a given amount of
6 energy to raise the temperature of that wool and it's all relative to the run rate.

7 So I suggest that in terms of the variable costs and the amount of energy units
8 used, there won't be as much benefit as is being claimed.

9 **COMMISSIONER BEGG:** I'll get Cavalier to respond.

10 **MR HALES:** Yes, I'd like to respond to that. We've got good history on the changes that
11 we've made to our plants, and indeed we have the evidence of lifting the Awatoto site
12 by 60 percent in run rate over the period of time. So we've been able to benchmark
13 ourselves against what happens clearly in a wool scour when you increase
14 throughputs. So on the basis of that data we're very confident in the figures that we've
15 provided to the Commission.

16 **COMMISSIONER BEGG:** So you've improved the run rate and you've done that without
17 increasing energy use strictly in proportion, so you've achieved an efficiency?

18 **MR HALES:** Yes.

19 **COMMISSIONER BEGG:** That's the evidence you suggest you have, and we've got, okay.
20 Okay, I think we've probably, as I say, we can pick this up again tomorrow in terms of
21 more detailed discussion of numbers, unless anyone else has a question?

22 **COMMISSIONER GALE:** Can I just raise a question to see if it clarifies it for me. I think
23 what you're saying is there are sort of standing losses in heat from equipment,
24 irrespective of the volume going through it. You heat up the bowls, as I now discover,
25 and they're going cool down in the air irrespective of how much is flowing through
26 them. So there will be sort of a fixed cost of heating and running the plant.

27 And then if you get a higher run rate that's obviously an efficiency if you're
28 using it to a higher utilisation. But is that sort of - because I think of these things in
29 terms of fixed and variable costs, and I entirely buy this argument that wool - it takes a
30 certain amount of energy to heat something a certain amount. But it does seem likely
31 that there are standing losses and other more fixed elements to the energy use. But I
32 wonder how big they are in the total scheme of things.

33 A question that went back before, the electricity use relative to the heat use,

- 1 just in budgetary terms, what are the rough proportions?
- 2 **MR DRAKE:** I'm sorry, we haven't got them here but we --
- 3 **COMMISSIONER GALE:** How much you spend on electricity and how much you spend
4 on heat.
- 5 **MR DRAKE:** Sorry in total?
- 6 **COMMISSIONER GALE:** Yeah.
- 7 **MR DRAKE:** In the counterfactual?
- 8 **COMMISSIONER GALE:** In the scouring plant. I mean is it half, is it a quarter? I mean
9 roughly speaking.
- 10 **MR DRAKE:** [Makes calculation].
- 11 **COMMISSIONER GALE:** Let's do it off-line if it's --
- 12 **MR FERRIER:** David Ferrier, Cavalier, just while Jim's coming obviously to a slight more
13 accurate answer with respect to Awatoto specifically, each of the scours we've either
14 acquired, closed down, and our own scours all have slightly different energy
15 components. And the division of costs are dependent on what access to what types of
16 fuels they have.
- 17 So there's no - you might think it's one of those things, it's 60 percent gas and
18 33 percent thing; it's so different in each circumstance that it's worth --
- 19 **COMMISSIONER GALE:** Okay, I'll let it drop then.
- 20 **MR FERRIER:** -- giving you a slightly accurate response anyway.
- 21 **MR DRAKE:** If I just take as an example Awatoto 2.4 metres, the split is approximately 75
22 percent gas and 25 percent electricity including line charges.
- 23 **COMMISSIONER GALE:** Right, thank you.
- 24 **MR HALES:** Excuse me, could I add one more point. The bowl extensions that we intend to
25 do at Awatoto were actually cold bowls as well. They won't require heating, it's just
26 cold water.
- 27 **COMMISSIONER BEGG:** Okay, just moving on then to the suggested labour cost savings.
28 I just wonder if you could give us an overview of where those cost savings are going
29 to come from if that wasn't confidential.
- 30 **MR DRAKE:** The cost savings from labour is really coming from the duplication of our
31 overheads in the sites. We still will require scouring staff to man the scour lines and
32 we will also, you know, require ongoing support to those, for example, you know,
33 storeman and the likes. So the savings from labour are really where we are duplicated

1 at the sites.

2 **COMMISSIONER BEGG:** So given that you're consolidating sites, would you need fewer
3 staff to run the machines, even though you've got the same volumes going through, but
4 if you have them all on one site, does that achieve efficiencies there, say in scouring
5 staff or plant managers etc?

6 **MR DRAKE:** Yes, there are efficiencies, plus we also have the 3-metre scour at Canterbury,
7 which we can draw on as well for our data.

8 **COMMISSIONER BEGG:** Okay. I wondered if anyone had any comments on whether
9 significant labour cost savings could be achieved through this rationalisation. Again
10 bearing in mind the confidentiality, I guess you haven't seen the actual numbers.
11 **[No comments].**

12 Okay, I'd just like to turn to the final question on the capital savings, the capital
13 cost savings. This is the suggestion that one of the benefits is that the annual
14 maintenance and capital expenditure will be lower following the transaction. There's a
15 suggested investment, an up-front investment to move the scour lines, and then
16 following that there's a suggested savings per year.

17 I just wanted to check first of all what the up-front investment was. I presume
18 that's the cost of moving the scour lines and reconfiguring them. And I heard also
19 today that a transformer needs upsizing, so I guess that's part of those costs.

20 So could I just ask what the capital expenditure is that you're going to do that's
21 going to result in these ongoing savings. Cavalier?

22 **MR HALES:** Sorry, a lot of that information is confidential, but I could say that there will be
23 capital investment going into the plant before and as it's being installed.

24 **COMMISSIONER BEGG:** So it's not just the shifting and the straightening, it's these
25 processes that you have that you think achieve the higher benefits?

26 **MR HALES:** Yes.

27 **COMMISSIONER BEGG:** And in terms of the savings in maintenance costs going
28 forward, is that largely arising because you're mothballing a plant, one of the scour
29 lines in Timaru and also the Clive, or is it just that because you've got these scour lines
30 consolidated into the two sites that you can economise on, I don't know, maintenance
31 staff, you can use them more efficiently etc?

32 **MR HALES:** I think I could answer that and say that it's a bit of both.

33 **COMMISSIONER BEGG:** The plant that you have at Clive and the 2.4-metre line in

1 Timaru, they're going to be maintained in place, is that right, and so there will be
2 ongoing maintenance to make sure they don't deteriorate I presume, but much less
3 because you're not using them?

4 **MR HALES:** Yes, that is correct. Both scour lines will be maintained in full working order,
5 but really that's more about giving them a start up once a month, putting some water
6 over the rollers and giving them a good grease. There'd be nothing wearing out.
7 Maybe the odd electrical input or something like that, but really nothing substantial.

8 **COMMISSIONER BEGG:** Okay. Has anyone got any comments they'd like to make on
9 those issues? **[No comments]**. Okay, tomorrow we can perhaps get into some of the
10 numbers and discuss in more detail, but that brings to a close my questions on that.

11 12 **ABILITY TO ACHIEVE CLAIMED BENEFITS**

13
14 **CHAIR:** All right, shall we move now to the session on the ability to achieve the claimed
15 benefits, and perhaps if Mr Goddard could join us at the front table here. I'd just like
16 to begin by exploring one issue raised in Mr Stock's letter of 27 April. He's drawing
17 here two points. One is that there are issues around the compulsory acquisition
18 abilities, a question whether the applicant would ever be able to achieve 90 percent.

19 And then the second issue raised is whether the applicant would in any event
20 be able to secure 75 percent of a special resolution to achieve the rationalisation
21 benefits. You state here, Mr Stock, that the key employees and directors of WSI who
22 hold approximately 10 percent of the total voting shares are going to play a significant
23 part in this.

24 Given that we have seen opposition of directors and senior management to
25 whom you refer, and you say it's approximately 10 percent, are you saying that there
26 are more than 10 percent who would frustrate either a compulsory acquisition or a
27 special resolution?

28 **MR STOCK:** Mr Chair, the staff and directors hold between them over 10 percent, and there
29 are also a significant number of what we call 'gone no address' shareholders who must
30 be included in the numbers but whom cannot be contacted which takes it up to a
31 significantly higher number.

32 **CHAIR:** Your position would be that a loan on the basis of the directors and senior
33 management that you're aware of, that they would not ever vote for this rationalisation

1 proposal?

2 **MR STOCK:** Well, it's a bit like the turkey at Christmas, isn't it Mr Chair, that they realise
3 that their jobs will be lost if they vote for it, so I doubt whether they would; that's up to
4 them to say that. But the indications given to date are that they would not vote for
5 such a proposal.

6 **CHAIR:** Could I turn next to a submission made by Mr Goddard in his submission also
7 dated 27 April, and you conclude, Mr Goddard, that it seems that any authorisation
8 must be made conditional on Cavalier either doing one of those things. Can I just
9 explore with you what you think to be the jurisdictional basis for us to impose
10 conditions to a merger authorisation?

11 **MR GODDARD:** That's a good question, and let me just check that. If the conditions can't
12 be imposed then I think it would follow that authorisation could not safely be granted
13 because of the risk that all the competitive detriments, identified by the Commission in
14 its Draft Determination, would materialise but there could be no confidence that the
15 benefits would, and yet, the acquirer would be left with the assets which it had
16 lawfully acquired.

17 So if there isn't jurisdiction to impose those conditions, and you're right, sir, I
18 can't think --

19 **CHAIR:** You're not arguing there's some kind of inherent power to impose conditions?

20 **MR GODDARD:** I had assumed when I wrote my note that it would be possible to say an
21 acquisition is authorised if these factual circumstances obtain, but not otherwise. In
22 other words if the world is in state X then you are authorised to proceed. And I
23 certainly don't think there's any jurisdiction to grant an authorisation subject to
24 conditions which, if they were not met, would require a subsequent divestment. That
25 jurisdiction doesn't exist.

26 I had assumed that if something could be authorised absolutely then it could
27 also be authorised subject to certain preconditions being present; but it was an
28 assumption, I didn't actually do any research or analysis on that. If I'm wrong in
29 assuming that then, as I said earlier, I think it would be extremely difficult to see how
30 this could be authorised.

31 **CHAIR:** Can I turn to what's now been proffered as an undertaking which, as I read it,
32 would, if we gave authorisation, and if either of those two matters you raise as
33 conditions were not satisfied, Cavalier is now saying that they would divest within

1 four months of the acquisition date. I assume that undertaking's largely proffered in
2 line or around the notion that you've raised in your submission. Would you see that
3 having parallel satisfaction to the conditions that you've raised in your submission?

4 **MR GODDARD:** No, I think there are some real issues around that. Actually I have, in the
5 very limited time available since the undertaking materialised, been asked to prepare a
6 short note on that. If I could perhaps provide that, that might be helpful. I am not sure
7 what --

8 **CHAIR:** That's fine.

9 **MR GODDARD:** And I'll talk to it very briefly.

10 **CHAIR:** Sure, that would be helpful. And there is the opportunity up to 13 May for all
11 parties to provide further submissions. So I anticipate that there will be full
12 submission opportunities for this issue.

13 **MR GODDARD:** That's very helpful, because that is the first point, in fact, that more time is
14 needed to make a considered submission on this. I have simply identified some
15 preliminary issues, essentially legal issues.

16 But of course to think through the commercial implications of Cavalier
17 acquiring the stake and holding it for four months and then seeking a purchaser is
18 something that requires, I think, a bit of reflection. Pausing on that and saying but
19 here are some preliminary comments, I think we can move over paragraphs 1 and 2;
20 move to 3.

21 The first comment was that I was a little bit surprised by this use of
22 Section 69A which of course normally involves an undertaking to divest part of the
23 assets acquired. It's drafted in very general terms and all it says is that the
24 Commission may accept a written undertaking to dispose of assets or shares specified
25 in the undertaking.

26 So there's no restriction on the face of Section 69A on an undertaking to divest
27 everything that's acquired. But the normal use, of course, is to say well competition
28 will not be harmed or the benefits will outweigh the detriments if we acquire this
29 component of the business but divest these other components, which will ensure that
30 there are still some material competitive constraints in the market sufficient to satisfy
31 any concerns.

32 Here what's effectively being said is we would like to acquire the assets and
33 then if it turns out at a later stage that that was a bad idea and that competition is going

1 to be harmed but the public benefits that justify that harm cannot be obtained, we'll
2 reverse what's been done. And I'm not aware, although again I haven't had time to do
3 any extensive research on it, of a similar use of Section 69A before.

4 So it's a surprising use of the provision, I wonder whether it's really within its
5 intention. I think the reason for that becomes apparent if we move on. It's helpful, I
6 think, to think through the scenario where the undertaking is operative. What would
7 the result be if the acquisition proceeds, the conditions aren't met, and as a result the
8 undertaking has to be acted on?

9 That would mean that for a period of four months Cavalier has had majority
10 control of its only competitor in New Zealand. It will have had the opportunity to
11 appoint directors, including potentially its own people to the board. It will have the
12 ability to obtain access to confidential information about customers, about prices. It
13 will have less of an incentive across that period to compete vigorously itself with WSI,
14 which it has the majority stake in, and to the extent that there's any change in the
15 management of WSI one would expect that management also to soft pedal on
16 competition during that period because why would you try to take volumes off an
17 essentially, well, a closely related company.

18 There's also the disruption to the business in terms of loss of customer
19 confidence in the ongoing future of the business, the anxiety that it may not be there in
20 a few months time if the approvals are obtained, and the real risk, I think, of steps
21 being taken to manage that risk.

22 Key employees will need to think through very carefully where their future
23 lies, and if, of course, there's a solid block of opposition certain to defeat the
24 approvals, the employees may not leave, but then we can also be sure the benefits
25 won't be obtained. If that's looking more marginal then the risk of loss of key people
26 and thus key ongoing competitive capability becomes a real issue.

27 So it seems to me, as my paragraph 4, that inevitably there's going to be some
28 harm to competition in the short-term as a result of common ownership and control of
29 the two companies. That will also create a very substantial risk of significant harm to
30 competition in the longer term. Some of those changes; loss of customers, loss of
31 market share, loss of key personnel, access to confidential information, will have
32 ongoing impacts that cannot be reversed simply by divestment four months on. They
33 can be expected eventually to work their way out of the system to some extent

1 perhaps. But if market share tips over critical thresholds, if key people and know-how
2 are lost, I don't think one can assume that.

3 And what we also know in the event that the undertaking is triggered is my 4.3,
4 that the claimed benefits won't have occurred. So I think what that tells us that in the
5 event that the undertaking is triggered, the acquisition will have harmed competition
6 and there'll be no off-setting benefits. None of the benefits will have been achieved,
7 which means the acquisition shouldn't have been authorised in the first place. And the
8 real risk of that scenario means, I think, that the Commission can't be satisfied even
9 with this undertaking in place that the benefits from the acquisition outweigh the
10 detriments.

11 There are a couple of other reasons I think to be concerned about this
12 undertaking. It doesn't satisfy the usual criteria for a divestment remedy as outlined in
13 the June 2010 guidelines issued by the Commission. Of the three types of risk
14 identified by the Commission in that publication; composition risk, asset risk and
15 purchaser risk, the composition risk isn't present because you'd be divesting a whole
16 functional business, subject to the asset risks. But those other two risks are very acute.

17 The asset risk, the risk that competitive capability will be lost in the process of
18 acquisition and then divestment I think is very live, really for the reasons I ran through
19 a moment ago; loss of customers, loss of market share, loss of key personnel and
20 associated capability. I think there's a real risk of a permanent weakening of WSI as a
21 competitor as a result of a window of control by its only competitor in New Zealand
22 followed by a divestment.

23 And when we talk about a four month window, I think the undertaking was
24 that time would start running from the point at which the acquisition went
25 unconditional. So to the extent that there's a period before it becomes unconditional
26 where it hangs over the company and influences customer behaviour and personnel
27 behaviour, that period could be longer still.

28 The purchaser risk issue; the difficulty of finding a purchaser with an
29 appropriate commitment to the ongoing operation of the business is also very acute.
30 There's an obvious attraction in selling it to someone who doesn't intend to trade on
31 but, for example, to realise assets and perhaps sell odd bits of equipment later to CWH
32 pursuant to a separate application.

33 But there's an additional risk even in relation to finding a purchaser of the

1 shares here, which is if anyone else were to acquire these shares they'd also trigger the
2 Takeovers Code requirements and they wouldn't be able just to acquire this block of
3 shares, they'd have to make a full offer. So to find a purchaser within four months
4 would require someone else who was willing not only to acquire this block but to
5 make a full offer for the company. And whether there's someone like that out there I
6 think is a question that can reasonably be asked.

7 And it's this sort of uncertainty, uncertainty about whether an appropriate
8 purchaser that doesn't themselves raise competition concerns - that's not so acute here
9 because there's no-one who would trade it on who has any market power in this market
10 except for the two players before in this transaction. But the risk of someone who
11 wouldn't trade it on, who would want to break it up, is real. And the risk of just not
12 finding someone, so it's left in some sort of limbo under the control of CWH, seems to
13 me a real concern.

14 That's why the Commission usually requires - I've said in 9 that divestments to
15 occur before any merger proceeds, but perhaps I should also have said or at least
16 contracts to be in place before that proceeds to ensure that asset risk and purchaser risk
17 don't materialise and that competition is not harmed in the very manner that the
18 undertaking's designed to prevent. In this case where the undertaking relates to the
19 whole of the assets to be acquired, I doubt very much that that's feasible, and it does
20 seem to me that if it's possible an authorisation that is conditional on a certain state of
21 affairs existing is as far as the Commission could properly go.

22 If the Commission's not ultimately moved by those concerns and considers that
23 it should contemplate accepting an undertaking to acquire and then divest the whole
24 thing, then it seems to me that certainly an undertaking that's much more far-reaching
25 and that provides much more comfort about the enduring competitive capability of
26 WSI would be needed. And there are some helpful models, I think, in the sort of
27 terms, for example, in relation to asset shares being held by trustees out of the control
28 of a purchaser that can be found in previous decisions of the Commission and of the
29 ACCC.

30 So in my paragraph 10 I suggest that any undertaking would need to be much
31 more carefully structured than this. It would need to ensure the competitive capability
32 is maintained and that the divestment does occur so far as that can be assured, and
33 some possible terms which would go some way to delivering that are then listed.

1 First of all that the shares should go to an independent trustee, not to Cavalier,
2 pending satisfaction of the conditions; so you don't have that co-ownership which
3 weakens competitive incentives and creates various risks during the interregnum, and
4 obviously Cavalier not able to give directions to the trustee, it wouldn't be a bare
5 trusteeship with effective control through the trustee.

6 Second, the trustee's obligations under the terms of the trust would be to
7 maintain the status quo and not to exercise voting rights or other powers attached to
8 the shares, including but not limited to the power to appoint or remove directors.

9 Third, there's reference in the undertaking to a possible acquisition of assets in
10 the interim, at least that's touched on in passing where there's an undertaking to
11 procure divestiture of all the shares in WSI and any assets acquired from WSI. It
12 seems to me the possibility of assets being acquired in the interim as a result of
13 decisions made by a sympathetic board is certainly one that causes concern in terms of
14 ongoing competitive capability.

15 So there should be no asset acquisitions by that kind by Cavalier pending
16 satisfaction of the conditions. There should be clear quarantining of commercially
17 sensitive information about the business of WSI pending satisfaction, and it should be
18 the trustee that conducts the sale process not Cavalier. You wouldn't want them to be
19 seeking out a friendly acquirer whose principal commercial driver was to sell the
20 assets, buy the shares at a low price, procure a resolution to wind up and go out of
21 business.

22 So it seems to me that the trustee should hold the shares and should be
23 required, if the conditions aren't met within three months, to commence a sale process
24 and to sell the shares for the best price obtainable within one month after that date.

25 I think an undertaking structured along those sort of lines would go much
26 further than the undertaking that's been proffered to manage the risks associated with
27 this sort of interim control in circumstances where competition would be otherwise
28 materially lessened and the benefits not achieved at all.

29 It still seems to me that the level of risk to competition applying the sort of, I
30 hesitate to use the words 'precautionary principle' because it's a bit trendy these days,
31 but really the approach, for example, that the Commission adopted in The Warehouse
32 decision saying well there may not necessarily be much of a constraint but it's the best
33 potential constraint on the supermarkets that's on offer, and we'd be particularly

1 concerned to lose whatever is out there in circumstances where there are just two
2 players. The argument that was adopted by the Commission and then upheld by the
3 Court of Appeal, after a brief interregnum where I managed to persuade the High
4 Court otherwise but not enduringly so; and that concern about the risks to competition
5 seems to me to be live here, even with the undertaking.

6 Those are just some very preliminary thoughts on about 36 hours notice. If I
7 can clarify anything I'd be happy to do so.

8 **CHAIR:** I think the way that I'll handle this, this is something that's become part of the
9 record at the very, you know, last minute before the hearing and I think it is very
10 helpful to begin to canvass views here.

11 What I intend to do is ask Mr David next to express his views and then
12 Mr Taylor to give his views and then if Mr Dunning had anything further to add that
13 might be of assistance. At least we can begin to canvass the arguments, then it gives
14 parties the opportunity to go away with the benefit of this discussion and frame up full
15 and considered submissions for the 13th of May.

16 So I think, in the circumstances, that's the best way that's available to us to
17 handle this. So if we're happy to proceed on that basis, Mr David, have you got any
18 additional comments that you would like to add?

19 **MR DAVID:** Thank you, Mr Chair. Firstly on the broader question of whether authorisation
20 of a business acquisition can be given subject to conditions, the short answer from the
21 Act is that an authorisation of a business acquisition, unlike an acquisition of restricted
22 trade practice, can't be given subject to conditions, it can be given subject to
23 undertakings.

24 You do get clever counsel, like Mr Taylor, from time to time wrapping
25 together applications for authorisations for restrictive trade practises with applications
26 for authorisation of business acquisitions and making the one conditional upon the
27 other and thereby effectively giving rise to a condition in that circumstance. But that's
28 unusual and it's not relevant to the case here.

29 On the broader issue that Mr Goddard --

30 **CHAIR:** Sorry, I don't actually follow that last point. What was that again?

31 **MR DAVID:** Well, you don't have a double authorisation application here, it's simply an
32 application for a business acquisition. So there is no scope for trying to fold in
33 conditions that might be appropriate to an authorisation or a restricted trade practice.

1 **MR GODDARD:** If I could help, I think that's probably a reference back to
2 Air New Zealand/Qantas where Mr Taylor very cunningly applied for authorisations
3 both of an acquisition and of certain agreements and said that the acquisition of the
4 assets was part of a package with the contracts in question and that the authorisation of
5 the contracts should be conditional on certain matters. And the result of that, if they
6 were treated as a package, would have been that effectively the acquisition of assets
7 became conditional on the trade practises conditions.

8 **CHAIR:** Obviously this has no relevance here.

9 **MR GODDARD:** No, it didn't fly.

10 **CHAIR:** I prefer comments to irrelevant matters to be limited please.

11 **MR DAVID:** Certainly. On the broader question of whether the Commission can give
12 authorisation or grant authorisation only on the basis that a particular set of
13 circumstances prevail, then as far as I'm aware there is no jurisdiction for that
14 proposition. The Commission, in considering an application for an authorisation, must
15 have regard to all possible factual circumstances that might prevail. That requires
16 obviously the Commission to have a high degree of certainty that the structural change
17 that it's going to approve will have such a benefit that it will override the damage to
18 competition that will result from it.

19 On the question of the divestment undertaking, the divestment undertaking
20 came as a surprise to me on Tuesday. I endeavoured to discover what the basis of it
21 was, what the intention was behind it, to no avail. I do note that, as Mr Goddard's
22 already indicated, it is a very late stage for a divestment undertaking to be made. And
23 if I refer to the Commission's own guidelines they say;

24 "If divestments are offered as part of an application for authorisation this
25 enables the Commission to assess the effects of the business acquisition taking into
26 account divestments from the start" - and I'd emphasise the words *from the start*. "If
27 divestments were offered near the end of the Commission's assessment the
28 Commission may need to request an extension to consider the situation in the light of
29 the proposed divestments. This could significantly extend the timeframe for the
30 Commission's assessment of the application".

31 And I'd submit, Mr Chair, that that is the situation here, that expecting us to
32 make a detailed submission by 13 May on some divestment proposal which we don't
33 understand the basis of is quite unreasonable. It will take longer than that for us to

1 make a proper submission on that.

2 There is also the issue of whether the offering of the divestment itself gives rise
3 to a further concern on the part of the Commission, that is whether the Commission
4 ought now exercise its jurisdiction under Section 68(2) of the Commerce Act and
5 proceed to decline to give authorisation on the basis of uncertainty, that is the
6 uncertainty that the proposed acquisition will go ahead for a reason other than a
7 provision of the Act.

8 There's a higher degree of possibility now in the event that the requisite 90
9 percent is not achieved or the 75 percent approval is not given, that the acquisition
10 won't proceed not being for a reason in the Act itself, and on that basis I'd submit that
11 the Commission ought to exercise its discretion now to consider whether or not to
12 decline the application.

13 So far as the divestment itself, to the extent that I do understand its purpose, it
14 seems to me that it indicates two things. One, an uncertainty on the part of the
15 applicant as to whether or not the benefits can be achieved; but secondly in relation to
16 the detriments, both the competitive detriments and the inefficiencies that potentially
17 will result from the acquisition, as Mr Goddard indicates, it does give rise to the
18 possibility that they will occur and will occur from the outset. You can do a lot of
19 harm to a company in four months.

20 There is also the residual uncertainty as to whether or not divestment can be
21 achieved in a four month period. The Commission's past practice, so far as I'm aware,
22 is to allow up to a 12 month period for divestment, and I know from circumstances
23 that in some cases that's been difficult to achieve and extensions have been sought.

24 So for all those reasons, if the divestment undertaking is going to stand, we
25 need a lot longer to consider it, and the Commission should also consider whether or
26 not it gives rise to a need to exercise its discretion to decline on the basis of
27 uncertainty now.

28 **CHAIR:** Thank you. Mr Taylor.

29 **MR TAYLOR:** I've got a lot to answer. I'll start off. I think first and foremost this whole
30 discussion makes a number of assumptions about the bid process which I think needs
31 to be considered before we can even think about the issues arising from the
32 undertaking.

33 Mr Stock and Mr Goddard, and now Mr David, assume a process which can

1 only follow the path that's been described in Mr Goddard and Mr Stock's opinions.
2 This is an application to acquire the shares or the assets of the business of WSI in the
3 sense that either the shares of WSI could be acquired or the assets of the scours could
4 be acquired within a 12 month period following the authorisation being granted.

5 Now none of us know how this bid process is going to play out, least of all the
6 applicants, and certainly not WSI. But one possibility might be that somebody buys it
7 who has no desire to operate a scouring business and simply acquires the shares, takes
8 the trading business, and offers to sell the scours to my client. In that case there would
9 be absolutely no uncertainty at all about a scale process or about the rationalisation
10 following. And I only give this, I'm not suggesting that that necessarily will be a path
11 that's followed, but it's an example of how certainty could be achieved, other than by
12 the process that Mr Stock and Mr Goddard have advanced.

13 So we need to keep firmly in mind that there are a number of ways to skin this
14 cat and a number of ways in which the outcome can be completed. But I frankly can't
15 go into the bid process arguments in front of the assembled multitude because if
16 they're bidders themselves then we'd be passing them confidential information. So just
17 bear that in mind, that there is a process that's being followed that might have a
18 different outcome and which requires authorisation to be granted, but might not be
19 limited by the process outlined.

20 Secondly, I think there are assumptions being made about whether or not the
21 benefits would be achieved and that assumes that the Commission reaches a
22 conclusion that without the rationalisation benefits there are insufficient benefits to be
23 had. And that's something that the Commission's got to consider and reach a
24 conclusion on. But it may not be that the rationalisation benefits of putting the two
25 scours finally together at this point is a necessary outcome in order to achieve the
26 desired result.

27 Turning to the form of undertaking, the Act is quite clear, unambiguous, and
28 unlimiting in what it provides in Section 69A. As Mr Goddard has said, the statement
29 is in giving a clearance, or granting an authorisation under Section 66 or Section 67 -
30 which is effective in this case - the Commission may accept a written undertaking
31 given by or on behalf of the person who gave the notice - in other words CWH - to
32 dispose of assets or shares specified in the undertaking.

33 It doesn't say that it has to be that way in order to avoid a substantial lessening

1 of competition, it just gives the Commission a broad authority to accept an
2 undertaking, to divest assets. The undertaking as given does just that; it's an
3 undertaking to divest shares or assets. No more, no less. To try and suggest that
4 there's some limitation around it because of past practice is, I think, stretching the
5 argument.

6 So it seems to me very clear that there is an undertaking that can be offered and
7 can be accepted if it does what's required in this occasion - which is to give the
8 Commission the added comfort of an assurance already given by the company that it
9 will only proceed with the acquisition if it can be assured it can get the scours - is to
10 give the Commission that added comfort that that will in fact happen, that that
11 assurance will not be overlooked.

12 Moving on to the question of detriment that might arise in the intervening
13 period. The acquisition would be of a 64 percent shareholding, or slightly less than
14 that, that is being offered by the receiver. That 64 percent shareholding will require a
15 process, if you follow Mr Stock's and Mr Goddard's methodology, seeking a special
16 resolution, if that is indeed required, and that will take up some of the time in the three
17 months that's referred to in the undertaking as presented.

18 I think it's fair to say that there will be only a very limited period following that
19 during which any degree of detriment could be said might be achieved. And one's got
20 to put this into perspective. This is an acquisition by what would then be the highest
21 bidder paying the highest price for 64 percent of a company which in four months time
22 might be asked to divest or have to divest if it couldn't achieve the conditions.

23 And to suggest that Cavalier, a public listed company, is one shareholder, the
24 Accident Compensation Corporation is the other shareholder, Direct Capital is another
25 shareholder, all of whom have profit maximising incentives, would deliberately set out
26 on some path to cause detriment to the target which they may want to get the best price
27 for in a divestment undertaking is again stretching the limits.

28 So I would argue that it's most unlikely that any detriment will occur in that
29 period for the very reason that having paid the top price, if the divestment's to follow,
30 they're going to want to try and acquire the top price from the purchaser.

31 On the question of asset risk, I think the same argument exists. There is
32 unlikely to be any asset risk to a company, the buyers of which are going to want to
33 get the best price. From a purchaser risk there will be a number of bidders as part of

1 this process who have already done due diligence, completed and sought to acquire the
2 assets, the 64 percent shareholding.

3 So I don't think it's feasible to look at this and suggest that there might be either
4 asset risk or purchaser risk. Nevertheless, I'm attracted by the suggestion made by
5 Mr Goddard that there be some conditions surrounding the undertaking, and I did
6 suggest to the Commission that that might be available also, but in the interests of
7 simplicity at this stage we didn't gather those conditions around this undertaking for
8 discussion.

9 So I haven't had time to look at Mr Goddard's conditions, but I'm sure they go
10 far beyond what's necessary. But certainly conditions of an undertaking to divest has
11 certainly been accepted by the Commission in the past and would certainly be of little
12 problem to our client who has no intention of interfering with the business while it
13 seeks to satisfy the ownership for rationalisation.

14 **CHAIR:** Can I just clarify one matter. I think it's fair to say we can only rule on the
15 undertaking that you put before us. We have to rule on that, we can't start playing
16 around with your undertaking. So am I taking it from you that you may produce a
17 further varied undertaking to this one which would accommodate Mr Goddard's
18 suggested conditions?

19 **MR TAYLOR:** Maybe not accommodate all of his suggestions, but certainly might
20 accommodate some of his suggestions. I think it's quite helpful what he's suggesting.

21 **CHAIR:** We would certainly need action on that very fast in terms of - I'm just very mindful
22 of rights of natural justice and the like. If you do propose to amend the undertaking,
23 time is very much of the essence.

24 **MR TAYLOR:** Understand that. And bear in mind that this has arisen altogether because of
25 the submissions from Mr Stock and Mr Goddard that we only received a matter of a
26 few days ago and have been moving to resolve.

27 Turning to Mr David's comments, I agree there's no room for a condition on a
28 merger acquisition, and I agree that this is not an Air New Zealand/Qantas situation.

29 I don't believe that this undertaking is difficult to understand. The reasons for
30 it are not difficult to understand and the effect of it is not difficult to understand. It's
31 not like an undertaking to divest assets to somebody in order to achieve a third party
32 competitor where all the elements of whether the business would be sufficient to
33 constrain need to be taken into account. So I don't agree that there's a need for any

1 extension or that it will take a long time to consider.

2 On the Section 68 issue, as I said, there are a number of alternative ways this
3 transaction could play out. None of us know who the bidders are, other than the
4 receiver, none of us know what they might have as their intentions in respect to the
5 business, none of us know who will be successful.

6 So to suggest that the Commission should cease to investigate this
7 authorisation is I think drawing rather a long bow. Other than that I think at this stage
8 we might be better if we all reserved our positions, made submissions, we'll look at the
9 question of the form of the undertaking and proceed from there.

10 **MR GODDARD:** I think that's right, I think we all need a chance to reflect on this. And if
11 there is going to be a revised undertaking then I think it's important that that actually
12 be provided and a reasonable time allowed after that to comment on the particular
13 form and effect of that undertaking. So I would ask that thought be given to how that
14 can be accommodated, consistent with natural justice requirements that you mentioned
15 a moment ago, sir.

16 A couple of short points, two short points arising out of the substance of what
17 what's been said, which I think is very helpful in terms of clarifying the issues. First
18 of all, I've worked out why I had a sense of unease about use of Section 69A in this
19 way. And that really ties into the point on which Mr Taylor and Mr David are in
20 agreement, which is that the Act does not permit the Commission to impose conditions
21 on authorisations that have to be met after the event in order for the authorisation to
22 remain valid in the acquisition context as opposed to the trade practice context. In the
23 trade practice context it's explicitly authorised, Section 61(2).

24 There's no similar provision in relation to acquisitions. That's not an accident,
25 that's because the Act proceeds on the basis that an authorisation, once granted, is
26 granted and can't be clawed back after the event. But if it were possible to give an
27 undertaking to divest an asset after acquiring it if certain circumstances occur, then
28 that's just a back door way of granting an authorisation subject to conditions which is
29 exactly what the Act doesn't permit.

30 So I think, having listened to this very helpful discussion, that I would firm up
31 the submission I was making in my paragraph 3 and say that it would be inconsistent
32 with the scheme of the Act to use Section 69A in a way which effectively rendered an
33 entire authorisation, an entire authorised acquisition conditional on certain post

1 authorisation matters. In my submission that's not permitted by the Act, it's
2 inconsistent with the scheme of it.

3 And the second point is that I understood Mr Taylor to be saying that one of
4 the reasons the Commission shouldn't be concerned about asset risk in particular was
5 the identity of shareholders. I think that ties into the broader question of whether who
6 owns a company is relevant to the assessment of lessening of competition or of
7 achievement of benefits.

8 And I would just reiterate the submission I made earlier, that that is, I think,
9 inconsistent with the scheme of the Act which is focused on market structure. As the
10 courts have said on a number of occasions; Air New Zealand/Qantas, New Zealand
11 Bus, substantial lessening of competition is the same thing as a material increase in
12 market power or a material reduction in competitive constraints. It's an analysis of the
13 external features of the market to the company in question. And who owns a company
14 has no bearing on the extent to which it has market power or the extent to which it's
15 subject to competitive constraints.

16 At most it could provide some sort of comfort on the extent to which that
17 market power might be exercised. But that's not something which can properly be
18 considered in the context of the SLC test, nor I think in relation to assessing asset risk
19 here.

20 **MR TAYLOR:** Mr Chairman, I think we could go back to the words on this and I don't think
21 that's going to be helpful to you. Suffice to say that there is a specific provision in the
22 Act allowing for you to accept undertakings, and I don't think you can remove from
23 that by some sort of sleight of hand the right to accept undertakings by saying it's
24 imposing a condition when it's clearly not.

25 **CHAIR:** I think we can take further written submissions on that, I think that's in the territory
26 of it.

27 **MR DAVID:** Mr Chairman, I would like the time not just to make a submission on the form
28 of the undertaking itself, when that's finalised; I also think it's important in this
29 instance for us to have the opportunity to make submissions on the Commission's own
30 provisional view as to the effect of the undertaking, in particular in relation to the
31 greater or lesser degree of certainty it gives rise to in relation to the benefits and
32 detriments, because that's key to this proposal.

33 The undertaking forms part of the authorisation, so I would ask that consistent

1 with the process that the Commission has followed to date and consistent with the
2 process the Commission has indicated that it would follow in this matter, that we get
3 the Commission's own preliminary view as to the effect of the undertaking.

4 **CHAIR:** Thank you. Can I invite Mr Dunning if he's got any views he may wish to add or
5 share with us so that people have the benefit of thinking that through before
6 committing to submissions.

7 **MR DUNNING:** Hopefully, and I'm non-partisan, just to elucidate some of the issues to
8 ensure the submissions may touch on them. I'm sure Mr Goddard and Mr David will
9 be thinking of these things.

10 I suppose one point is to what extent does Cavalier believe that there is
11 sufficient on the record - and it may be that we need to do this in a confidential
12 session - in terms of this bid process and why there is a degree of confidence that the
13 Commission can have sufficient for the tests about these benefits being achieved.

14 The second point really is, in terms of the extra conditions suggested by
15 Mr Goddard, to what extent the Commission could accept those, or are they
16 behavioural in some aspect, are they conditions which the Commission can properly
17 consider.

18 The third point is if the Act does allow the sort of swallow and disgorge type of
19 approach to undertakings, does that then place a greater emphasis on ameliorating
20 aspects of potential anti-competitive harm caused in the meantime.

21 And the final point is, I assume from what Mr Taylor was saying that the
22 confidence about the timing is that there's effectively a month, I think, proposed for a
23 sale. And as I understood what he was saying the asset and purchaser risk would be
24 satisfied under the Commission's guidelines by a degree of confidence about other
25 bidders in the process who fail to achieve the asset the first time around, or other
26 reasons, and it may be that some comment could be made about that.

27 That's all Mr Chairman.

28 **CHAIR:** Thank you. Well look I think that very usefully begins the assessment of those
29 issues. I would strongly urge Cavalier to consider any - if you are looking to amend
30 the authorisation application we need to know that very soon and then we will take
31 into account process issues once we have that information.

32 I think we can draw this session to a close and it's now convenient to have our
33 lunch adjournment. We have had some slippage on the timetable today, but given the

1 availability of time this afternoon there's no problem with that.

2 So if we can come back at 1.30 we'll then do productive and dynamic
3 efficiency losses, and you'll see we've got a time allocation of 30 minutes, 45 minutes
4 for each of those and then we'll do the confidential session after that. So I think we'll
5 just have one session after lunch and finish hopefully on or before 3.30.

6 So, actually just one other announcement, the transcript of yesterday's session
7 is now on the website in draft form, so the transcripts of the hearing are now starting to
8 be produced.

9 Okay, well if we can come back 1.30 and start off then that would be great.
10 Thank you.

11
12 **Lunch Adjournment from 12.31 pm to 1.30 pm**

13
14 **CHAIR:** Okay, shall we make a start for this afternoon's session. We'll begin initially with
15 Productive Efficiency Losses followed by the Dynamic Efficiency Losses, and at the
16 end of that we'll then go into a confidential session which will include the respective
17 Cavalier and Godfrey Hirst parties to talk about the contract.

18 So I'll hand over to Stephen Gale now to lead off the session on Productive and
19 Dynamic Efficiency Losses.

20
21 **PRODUCTIVE AND DYNAMIC EFFICIENCY LOSSES**

22
23 **COMMISSIONER GALE:** Thank you.

24 Yesterday, we discussed price competition between WSI and Cavalier, and I
25 think that that idea of competitive pressure between the businesses carries over into
26 not only a pressure on prices but a pressure on costs, on running costs. But given the
27 discussion that's already under the bridge that we've had yesterday, I wonder if WSI
28 has anything else to add about the way in which competition between you and
29 Cavalier plays out in the market.

30 It seems to me that the way it's going to appear is that at the auction, you're
31 going to have a view about what you can afford to pay for wool and you're going to
32 discover whether or not you're being out-bid by the other side or not and that's going to
33 tell you whether your costs or deals are better, but I wonder if there is any other
34 intelligence within the industry that sharpens up that competition, that would ever let

1 you know, well, I need to get some feature of my production process running better.

2 **MR DWYER:** Good afternoon. WSI is engaged currently in a number of quite major
3 initiatives in the scouring field which we believe that it will give us a reasonable
4 strategic advantage and that's what we're looking for in a very highly competitive
5 industry.

6 Obviously, if there were a monopoly, we would have to stop these projects.
7 We haven't got Board approval for a lot of them, but I believe that by the time we have
8 got through the R&D stage, the final outcome will be that it will give us quite a
9 quantum leap in both our processing and the product that we produce.

10 For sensitivity reasons, I can't really go into too much detail because these are
11 projects that we are only just starting on, and not alone will it be a good thing for Wool
12 Services, but long-term, it will be a very good series of achievements for the industry
13 as a whole.

14 We look at wool itself in this and what we can do to improve our product and
15 include such items as the downstream processing results that will result from these
16 initiatives. We're working on certain aspects of effluent disposal, waste disposal;
17 we're looking at further aspects of grease recovery and I think on the effluent side of it,
18 I'd just like to say that we have an expert here to just give us a little bit of background
19 on that side of it, Dr Mark Savage.

20 **DR SAVAGE:** Dr Matt Savage, effluent expert. One thing we've looked at a lot today is the
21 economic benefits obviously of the takeover merger. We're talking about public good
22 and Kaputone Wool Scour in particular has had a very long-standing and progressive
23 innovation programme with regards to improving the environmental performance of
24 their systems.

25 As Mr Steve Weinstein pointed out yesterday, scouring in New Zealand, one of
26 the benefits and appeals of this, is the environmental image of scouring in
27 New Zealand. Unfortunately, the truth is that a wool scour produces raw effluent, the
28 same loading as a small city, and most wool scours in New Zealand don't treat that. It
29 just gets discharged to ocean with very minimal additional treatment.

30 Kaputone, over a very long time has established very strict treatment and
31 control of their effluent discharges as an ongoing innovation. Just recently, they've put
32 in place systems to reduce their entire water use by up to 80 percent, and as has been
33 alluded to, there is a significant ongoing innovation programme that will lead to - the

1 intention and goal of it is to lead to Kaputone Wool Scour being the cleanest wool
2 scour in the world, or on par with, in the next 12 months.

3 **COMMISSIONER GALE:** Would it be fair to say, then, that the inducement for these
4 improvements comes from the company's action as a merchant, so in its final markets,
5 it wants to be able to portray itself as a clean green processor. So I'm wondering
6 whether, in the company's work with commission scourers, does the company dream
7 up improvements, or do merchants come to the company and say, you know, as we
8 heard yesterday, "It would really help our business if you could clean up your act
9 because we'd be able to sell a product that had better features". I'm wondering what
10 part the merchants play in this innovation process?

11 **MR DWYER:** Well, the merchants, in our view, play a very minor role. This has been
12 driven by WSI itself and its desire and its aim and image to portray itself as the leading
13 and very best wool scourer and processor and supplier of raw material. And that's our
14 aim, is to build our image in the marketplace. And yes --

15 **COMMISSIONER GALE:** Excuse me, that's you in the marketplace, not you as a scourer?
16 It's you as a merchant, you as a seller of processed wool, is that right?

17 **MR DWYER:** No, no. We are a vertical organisation taking the wool direct from farmers
18 right through to the finished product, or delivering it to the next stage which is
19 manufacturing. But we have the dual role of being a supplier of raw wool and a
20 processor, and it's our aim to be the very best in that field.

21 **COMMISSIONER GALE:** Okay. Thank you.

22 **MR CHUNG:** I fully agree with that comment, that we really think the sort of green
23 environment, or the special conditions, are essentially dictated by what we call our
24 customers in scouring, which is the wool exporter. And I think it would be also fair to
25 say that in all cases, all the requirements that have been put on us have been met.

26 So we have no outstanding requests that we've yet to come up with. So would
27 that be right, Nigel? You'd be able to comment on that, from an operational point of
28 view.

29 **MR HALES:** Yes, I'd like to add a little bit more too. That the other wool scours that are
30 operating in Napier/Hastings district and Timaru district have outfalls going out to sea,
31 whereas the property that Matt's described has previously discharged into the
32 Waimakariri. So it's not like for like.

33 **COMMISSIONER GALE:** I guess the interest in this session is really how much sort of

1 competitive pressure there is between the two companies to perform. And we're
2 talking about all cost savings, not just sort of product improvements. It seemed more
3 likely to me that where we focus on waste disposal, part of it will just be cost because
4 you have to meet environmental laws, at least cost.

5 But from the discussion that we've had, it sounds like a major feature in the
6 innovation story, is that somewhere down the chain at the consumer end someone
7 wants to say here's a product that's clean and green; it would seem less credible to me
8 that that's an interest that the scourer has primarily of their own accord, it seems to me
9 more likely that the merchant is going to say, "I can sell this for a higher value if it can
10 be certified as coming from a scour that has, you know, acceptable effluent". So I'm
11 prepared to be disabused of that, but is that --

12 **MR SUNDAKOV:** Could I just add to that, because I think it's a very important topic about
13 competition that occurs not just as a result of having two separate entities, but also
14 having separate entities with quite different business models. I think, as we've sort of
15 heard over the last couple of days, one of the key features of this industry is that there
16 are various kinds of vertical integration elements here and there all over the place that
17 really matter.

18 It seems to me that the merchant scour model, where it's your own wool
19 therefore you capture all the benefits of branding and change in production process
20 that results in that versus a commission model where those benefits are smeared across
21 everybody, is going to generate quite different type of competition, different sort of
22 behaviour.

23 **DR SAVAGE:** If I could just talk to Nigel's comment about comparing like for like as well.
24 New Zealand is very diverse in its environmental regulations from region to region. In
25 an instance, say the Kaputone Wool Scour was to discharge to the local sewer like the
26 ones in the Hawkes Bay and Timaru do, they would actually need to make their
27 effluent cleaner by regulation to go into the sewer than it does need to be to go into the
28 river. Were that plant to be shifted to Timaru, there would be no environmental
29 regulations for any form of treatment that is currently being done. So the level of
30 treatment could within regulations, and meeting all obligations, be dropped.

31 **COMMISSIONER GALE:** Thank you. We've had a discussion, we've touched on it in the
32 last couple of days, about the shareholder monitoring or management, and there have
33 been various views expressed about whether the existence of a concentrated and

1 well-informed shareholder base would make a difference to the possible loss of
2 productive efficiency, you know, the general idea that if you move from two
3 companies to one, then maybe the management of the firm relax a little bit, don't make
4 so much effort, but if you've got a concentrated shareholding, then there's still some
5 pressure there.

6 I think the proposition's been made, well, you can't count on the shareholders
7 in future and arguments in the other direction about, well, who's going pay most for
8 the company, the people who can get the most value or what?

9 I just wonder whether anyone has views that they want to say they haven't
10 already said in their submissions about how we should treat the pressure from - we
11 know at the moment there's a concentrated shareholder in Cavalier; can we count on
12 that to go on exerting pressure on management to go on saving as much money as
13 possible.

14 **MR CHUNG:** Certainly, can address it from Cavalier's point of view. We are a listed
15 company and we pride ourselves in creating shareholder value. So we have every
16 incentive to make sure that that happens and a record, if you look back, would
17 continually talk about return on funds employed etc.

18 So we're all about, you know, reducing costs and maximising profits. And I
19 assume the other shareholders, which is Direct Capital and ACC, they likewise would
20 be very rational investors with a similar sort of interest.

21 **COMMISSIONER GALE:** Thank you. Mr Ross(*sic*), do you have a comment?

22 **MR GEORGE:** Yes, we are, but we're no different, I guess, to any other listed company or
23 investment group. I mean, there are a variety of ways to create value, and we've heard
24 a number of them here. I mean, we are happy to embrace them all and just on the
25 topic that has been raised on effluent, I suppose we don't have an unbridled ability,
26 speaking from Direct Capital's point of view, to maximise shareholder value at the cost
27 of other things because we're a signatory to the United Nations Principles of
28 Responsible Investment, and to get things approved at our level and to get capital
29 approved at company level, we need to have ensured that we've sort of taken into
30 account the sorts of things that Matt's talking about.

31 But I don't see any difference in ownership changes. I just see all up, all the
32 people that I can think of that would like to buy WSI will have a profit component to
33 them, and it's just a matter of how you allocate those wishes within the company. But

1 profit maximisation is going to be something that the current shareholders have got,
2 and the new shareholders will have.

3 **COMMISSIONER GALE:** Okay, thank you. WSI or Godfrey Hirst?

4 **MR DAVID:** Just a comment, Commissioner Gale. I don't think that you can make an
5 assumption that, really, a concentrated shareholder base gives a greater degree of
6 scrutiny. One of the more broadly-held companies is a cooperative company,
7 particularly in a primary sector where you've got supplier shareholders and that kind of
8 company has a very, very high level of shareholder scrutiny. That principle has been
9 accepted by the Commission on a number of occasions.

10 It seems to me that WSI, with their shareholder base, are probably quite akin to
11 a cooperative company. A number of their shareholders are also suppliers and
12 employees. So I don't think you can make the assumption that there is going to be a
13 continuation of scrutiny by the concentrated shareholding that outweighs the present
14 situation.

15 **COMMISSIONER GALE:** Going back to the theme I was starting on a little while ago
16 about the merchants, I wonder how much we can rely on the fact you've got quite a
17 concentrated customer base, in respect of the commission scouring part of the
18 business.

19 It would seem to me that this is a different circumstance to a supermarket or
20 other structure. Here, we have a handful of customers who have a very intense interest
21 in the market value of their product, and I'm wondering what comments the two sides
22 have about how much pressure they're actually getting from merchants to do the job
23 better as opposed to improvements that the company volunteers.

24 So I suppose what I'm asking is, do merchants actually know quite a lot about
25 scouring and do merchants actually know quite a lot about what the potential is for
26 improvements in the product that are of interest to customers, or are merchants a sort
27 of a passive lot that just take what they get?

28 **MR HALES:** Nigel Hales. Most definitely, we've got a very wide and diverse customer
29 base, I think it would be fair to say, that are sending wool to just about every
30 wool-using country in the world. While I wouldn't describe our customers as experts
31 in scouring, they do know the difference between what they need to do to make a
32 blend of greasy wool work for the final processor.

33 So yes, they're working with their customer overseas, developing their blends,

1 and through us, we're developing products for them for their mills. We're regularly
2 asked to do trials and we're doing that all the time. Our most recent trials have been
3 through a Malaysian mill, actually, with New Zealand wool and English wool.

4 So I wouldn't say it's an everyday occurrence, but it's at least monthly that we
5 would be doing some sort of trial work for our existing customer base.

6 **MR FERRIER:** David Ferrier, Cavalier. If I could just add to what Nigel said, and may be
7 slightly in conflict with it. Most of our customers, and I'm just running through a
8 quick list, either have now or have had wool scour ownership in the past, and in a
9 number of those circumstances, they've actually, rather than being shareholders,
10 they've actually been the creators and the builders and the developers of those scouring
11 facilities.

12 **MR DWYER:** Michael Dwyer. Just on that, if I may, just to add, I would say that most of
13 the merchants don't really care about anything that is going on too much because
14 they're straight-out traders. We have a vested interest in what we do because, as I tell
15 all our clients, we must deliver the very best wool and give you the best service
16 because we have a great deal of capital at stake.

17 So much so, in comparison to most in the wool trade, we have a lot more
18 capital and a lot more money at stake obviously with our plant and equipment, as
19 against a straight trader who has minimal capital, and really, the only thing they're
20 interested in is turning over wool and making a twist on it along the way, but from our
21 point of view, we've got everything on the line with what we do. Consequently, we're
22 a lot more conscientious in what we do and what we deliver.

23 **COMMISSIONER PICKERING:** With due respect, Michael, surely a trader or merchant
24 has to sell certain quality? So he or she must be defining quality and demanding
25 quality of a scourer?

26 **MR DWYER:** That is true, absolutely true, in fact, but there is less onus on them to - there's
27 less onus on them to deliver the right product all the time. I'm not saying that every
28 exporter is not up to our standard; in fact, a lot of them are equally as good and as
29 conscientious. But there's quite a fringe element there that aren't and has denigrated
30 the wool industry over the past decade or two decades, or for as long as you like, but
31 there is always that fringe element in the business. And it's really those like that that
32 I'm referring to.

33 But there are a lot of traders who really do not have a long-term interest, and

1 do not have the interests of the wool grower or the industry at heart so long as they can
2 make a buck.

3 **COMMISSIONER PICKERING:** Okay, thanks.

4 **COMMISSIONER GALE:** That's helpful, because it does go to the issue of whether there's
5 a serious amount of competition at present between the two scouring businesses in
6 respect of quality dimensions in the commissioned scouring business.

7 The next topic is whether the fact that we start out with a cost base that
8 everybody knows now will be a constraint in future, that if the merged entity moved to
9 put up prices, does the fact that with two companies, everybody knows what the
10 scouring prices traditionally have been for quite some time now, does that act as an
11 impediment to Cavalier to put prices up? **[No comments]**.

12 No? Okay. Actually, we'll go back one step to where the innovations happen
13 and where the cost savings happen. Yesterday, Ms Pauling, you said that scouring
14 isn't rocket science and that rang a bell with me because it seems it's been described as
15 a cleaning exercise. So I'm wondering where the rocket science is; is it actually in the
16 sort of carding, the processes, the treatment of the clean wool, is it in the process of
17 blending, choosing which wools to put together that will ultimately have the physical
18 and colour performance?

19 Because a huge part of the discussion for this afternoon and for our sort of
20 detriments analysis, is the proposition that the industry's going to decline because the
21 scouring part will no longer be so intensely competitive. But it's not clear to me yet
22 whether the scouring part is all that important in the ultimate quality mix.

23 It seems there are a lot of movable things, and just washing the wool might not
24 be where it's all at. So I'd be very grateful for some guidance on where the gains in the
25 sector which may or may not save the wool industry are happening.

26 **MS PAULING:** Well, I guess from our point of view, I mean, for scouring we have to have
27 that process done to our wool before we can add value, particularly at the yarn plant
28 level, because that's the most complex part of our business. The wool scouring,
29 obviously, a lot of it is in the buying of the wool, from our point of view, and getting
30 the specifications right and that comes down to the blends.

31 Obviously, if the scouring's not done properly, that can affect the end product.
32 So we're not talking about saying they can't do the scouring well, all we're sort of
33 saying is it's not a complex process, but it is absolutely crucial in order to go to the

1 more complex stages.

2 I mean, just putting it simply, I mean, if we're making yarn and there's VM - or
3 vegetable matter - in it, I mean, we can't effectively use the wool. So although it's not
4 complex, it still needs to be done well. And it's adding that value. I mean, the basic
5 principle is if we can add value to New Zealand wool in New Zealand, that's good for
6 all of us, and that's what we feel we've been doing, and want to be able to continue to
7 do it, and the scour is a crucial part of that process.

8 **COMMISSIONER GALE:** But would it be fair to say you're not so concerned that a
9 movement from two scourers to one, two companies to one, would jeopardise your
10 ability to have the scouring done adequately?

11 **MS PAULING:** No, we are concerned about that. We're concerned that once we go down
12 from two scours, or a one provider, that there won't be the same impetus on them to
13 provide the service at the level that it has been at, so they can potentially dumb down
14 the service that they're providing.

15 And we're also concerned, as we said, around risk management issues in terms
16 of the plant, if there's any damage to the plants or one gets taken out by flooding or by
17 an earthquake, where that leaves us. And we are concerned that - I mean, as has been
18 discussed previously, whether there will be impetus on them to keep up the standards
19 if they can save a dollar by doing something a little bit less adequately, but still
20 charging, you know, whatever it is that the charge becomes.

21 **COMMISSIONER GALE:** Okay. Thank you.

22 **MR DWYER:** Could I just say, currently, and I've said this already, we're taking initiatives
23 to develop added value products in scouring, and that, under a monopoly situation, we
24 would not take those initiatives because there'd be no advantage in it, and why?
25 Because there'd be no confidentiality about it, and all our efforts would have been
26 wasted and that's the one big problem we've faced in this industry, is that anybody who
27 has done anything gets copied very quickly, and the key from our point of view is to
28 be able to develop new products and be able to hold on to the IP of those
29 developments.

30 **COMMISSIONER GALE:** But if you were the monopoly, Mr Dwyer, why would it not be
31 possible for you to capture the benefits, and why would you do a project now that
32 wouldn't be worth doing if you were the monopoly, where you'd be selling a higher
33 value product in your end markets?

1 **MR DWYER:** I don't consider the possibility of myself being a monopoly.

2 **COMMISSIONER GALE:** Yeah, that's not really answered the question. What you're
3 saying is you are now contemplating quality improvements that wouldn't - where there
4 is a possibility at the moment that someone will find out what you're doing in Cavalier,
5 you're now considering these investments, but you wouldn't do it if the risk was
6 completely removed of you losing the intellectual property.

7 **MR DWYER:** Well, we would do it in our own scours where we can do it confidentially.

8 **COMMISSIONER GALE:** To whose benefit?

9 **MR DWYER:** Obviously to our own.

10 **COMMISSIONER GALE:** But is this cost saving or is this adding to the value of the
11 product?

12 **MR DWYER:** It would be a bit of both probably.

13 **COMMISSIONER GALE:** Cavalier, would you like to help me with this?

14 **MR HALES:** Yes. My first thought is, is that when the scours are merged, we would be
15 obviously trying to bring some of the management structure from Wool Services over
16 to our sites and there there'd be a natural progression of that knowledge coming with
17 them. So we'd have that for a kick-off.

18 But we're also, Cavalier, like any responsible company, is investing in R&D,
19 and our board has already given me approval, and indeed, we're working on it now for
20 a number of projects and in a number of areas, mainly around waste streams. One
21 such example is blending our dry matter with coal dust to make a nugget to get a
22 cheaper -

23 **COMMISSIONER GALE:** These are cost reductions or effective cost reductions?

24 **MR HALES:** Yes. It will do two things. It will give us a cheaper fuel source, and it will
25 also help our waste stream; that's just one example. I think we've got a five-year plan
26 that's identifying something around \$60 million worth of benefit to flow through, as
27 we progressively bring it through.

28 **COMMISSIONER GALE:** Okay, thank you. Back to Mr Dwyer. I appreciate that you
29 don't want to say out loud sort of what the process improvements are, but can you tell
30 us what dimensions of the product you're aiming to improve with these initiatives?

31 **MR DWYER:** Yes. We think it will add, to the bottom line for us, 2 million a year.

32 **COMMISSIONER GALE:** But I mean, are you adding to Y value or are you adding to fibre
33 strength preservation? I'm really out of my depth here. What is it that you are doing

1 that's making the product more worthwhile?

2 **MR DWYER:** Well, I think if I tell you too much, I've disclosed our plan. But in actual fact,
3 it will assist the Y value, yes, indeed.

4 **COMMISSIONER GALE:** Okay, thank you.

5 **MR FERRIER:** David Ferrier, Cavalier Wool Holdings. It's probably implicit, but it
6 warrants clarification. In China, as an example, they don't lack the ability to innovate,
7 and in fact, they are of course continually innovating. The suggestion, that having got
8 to where we might get to in the future, we would do anything other than drive
9 innovation to combat and in fact stay ahead of that game, is a proposition I find really
10 difficult to accept.

11 **COMMISSIONER GALE:** Thank you. Okay, so the last part of this on the productive
12 efficiencies, these things overlap obviously, but amongst the economists, the
13 discussion is often, all right, well, if productive efficiencies decline, then the way we
14 scale those is to think, well, what are the variable costs in this industry, what are the
15 operating costs, as being the primary place where you would experience a loss of
16 efficiency, productive efficiency.

17 But I wonder, really, about whether that's entirely true, because there are other
18 - there are sort of fixed costs of maintaining, you know, things that occur to me are
19 like the time-based costs of maintaining equipment. I wonder whether we should
20 apply these effects to fixed costs as well, and wonder what guidance I can get from the
21 economists present. Mr Mellsop, do you want to have a shot?

22 **MR MELLSOP:** Thank you. This is actually an issue that I addressed in a memo dated 16
23 March. Just to clarify, the initial report that we did for this application basically took
24 the Commission's previous approaches and applied it to this industry, and then, as I
25 understand it, Commission staff said, well, what if we were starting without that
26 framework, how would we approach these things?

27 So I drafted that particular memo and in there, I state that when we're looking
28 at a five-year timeframe, I think it is appropriate to include fixed costs as well as
29 variable. And we did that. We also drew on particularly the TFP literature to try and
30 work out, rather than simply take the 1, 5 and 10 percent that the Commission's
31 previously used, what does the literature say we should use, and it's actually lower
32 than the scale the Commission has used.

33 So we applied what we learned from the literature to the fixed and variable

1 costs and actually get a number, which I won't say in public here, but very similar to
2 the Draft Determination annual productive inefficiency number.

3 Sorry, one more comment, Dr Gale. If we were doing just a single year
4 analysis, then I think you wouldn't include fixed costs, but because this is longer, one
5 would. But also I think that the impact on fixed costs would only occur in the longer
6 term and therefore, should actually be discounted in a present value sense, because it's
7 happening further out into the future.

8 **COMMISSIONER GALE:** Yes, and sort of following on from the conversation this
9 morning, this process, if there is one, of easing up and relaxing as a sort of progressive
10 thing over time, not day one type --

11 **MR MELLISOP:** It would affect different costs at different types.

12 **COMMISSIONER GALE:** Yes. Mr Sundakov?

13 **MR SUNDAKOV:** I think I agree in principle, I just draw some different conclusions and
14 numbers out of it. I think that you definitely want to look at both the variable and the
15 fixed costs, but I think - I mean, the nature of fixed costs is they're not incurred
16 continuously, they tend to come in spurts, and the impact of productive inefficiencies
17 therefore is going to be concentrated around the periods when there are significant
18 changes to the way that the capital is utilised, and the way capital is structured.

19 I think that a key feature of this particular transaction is that as a result of the
20 transaction, there's really a massive reallocation of capital and re-use of capital, so that
21 that's the things that - the potential risks, I guess, to productive efficiency that may, in
22 other circumstances, accrue slowly over long periods of time because capital continues
23 to be used in the same way with relatively minor additions, under normal
24 circumstances.

25 Here, there's actually quite a step change in the way capital is utilised. So I
26 think that that definitely needs to be taken into account.

27 **COMMISSIONER GALE:** You mean, the disruption or --

28 **MR SUNDAKOV:** The disruption and then the consequence of bringing that back
29 on-stream. So for example, what is the - to the extent that there is, say, a reduction in
30 incentive that we're discussing here, when you go through the disruption process,
31 bringing the plant on-stream, the difference between a very competitive environment
32 where you go all out to bring it on-stream and back up to full production within a
33 couple of months, versus a slightly more relaxed environment where it takes you three

1 or four months, can be quite significant, so I think that needs to be taken into account.

2 I think also I just want to highlight, and I don't want to repeat what's already in
3 the report, but I think I also want to highlight that there are two ways, I think, of
4 looking at productive inefficiencies. One is, if you like, the sort of conceptual way of
5 estimating what happens to costs as a result of changes to incentives.

6 But I think we also, in our report, highlight the fact that actually, there is a
7 significant change to some important input arrangements as a result of this transaction,
8 and in particular, the nature of industrial relations for a monopolist is very different to
9 the nature of industrial relations for competing firms.

10 There's significantly more ability for trade unions to extract; in fact, that's a
11 very good reason why trade unions like monopolies, is that there's significantly more
12 ability to extract surplus which then the monopolist gets to pass on to the consumer.

13 **COMMISSIONER GALE:** Any comment? That's a slightly new topic, so it would be
14 worth having --

15 **MR MELLISOP:** Well, I recall that statement in the Castalia report, but generally in terms of
16 labour, I mean, I don't like the term 'monopoly' here because I think it's not - we've got
17 constraints from overseas, but if we use that term loosely, we're creating a
18 monopsonist in respect of labour, and typically, that would push down labour costs,
19 whereas I understand the argument from Alex to be actually that labour costs would go
20 up. So I couldn't work it out.

21 **MR SUNDAKOV:** Think a very simple model of labour relations. If you're a trade union
22 contemplating going on strike, and you are representing workers working in a
23 company that competes with another company, if you go on strike, the consequences
24 to your business can be very significant because the business then flows to your
25 competitor.

26 So there is a very significant disincentive in a competitive environment to go
27 on strikes, because the benefit from going on strike very quickly gets eaten away by
28 competition. That's precisely why, when we look around, we observe a lot fewer
29 strikes in competitive industries.

30 On the other hand, if there's sole employer and a sole processor of this kind of
31 New Zealand and you go on strike, there is a very real opportunity for you as a union
32 get the benefits from that strike because the business isn't going to flow anywhere else,
33 and so your employer is going to be willing to - you know, first of all, the employer is

1 able to settle with you, they've got the surplus to produce, but secondly, you're in this
2 bilateral monopoly situation, and I mean, I'm just trying to think of all the examples,
3 but you may recall that when there was a sole ferry going across the Cook Strait, they
4 went on strike all the time; when there were two, strikes largely disappeared.

5 When there was only Air New Zealand flying in New Zealand, they went on
6 strike all the time. Once there were competitors, strikes largely disappeared. Lots of
7 examples like that.

8 **MR MELLISOP:** I guess labour relation laws have changed a lot since some of those
9 examples. I'm thinking of the classic monopsony description in the text books about
10 the single mill in a town. I'm not sure if we want to go any further, but that's the
11 difficulty I have.

12 **COMMISSIONER GALE:** If we have some time tomorrow, we might discuss this, and we
13 might discover whether the people working in the mill enriching themselves at the
14 expense of farmers is a transfer or a loss of efficiency in the economy.

15 I think the boundary between what we have been saying and the rest of this
16 discussion on dynamic efficiency effects is blurred. You know, the productive
17 efficiency is sort of a short-term version of that, the dynamic efficiency effects are
18 those that involve investment as well.

19 I wonder whether anyone has an impression of the rate at which innovation's
20 been happening in this sector, because we've heard a lot about sort of incremental
21 improvements, and we wonder whether this actually levelling out or whether science is
22 advancing at such a rate that this is a trend that we can expect to go on, you know, at a
23 fantastic rate.

24 Presumably, in the past, there have been some sort of step changes, that people
25 have discovered new sort of chemical opportunities and technological opportunities,
26 but what's the industry's expectation of future opportunities?

27 Cavalier, do you want to - talking about your research and development
28 programme, do you see a future where scouring costs can go down by 20 percent over
29 the next 10 years, you know, as a result of incremental improvements, or is it very,
30 very much fine-tuning now?

31 **MR HALES:** Yes, Nigel Hales. It's hard to mirror, to look into the future, to see what
32 scouring costs might look like in 10 years' time.

33 **COMMISSIONER GALE:** I should ask you actually, really rather than forecasting, just has

1 the process sort of slowed down in the last few years relative to the previous years?
2 Do you sort of have the feeling that it's levelling out, or do you have a feeling that, no,
3 you're discovering new things all the time that --

4 **MR HALES:** Most definitely. In fact, if anything, it's accelerating. Our biggest issue at the
5 moment is keeping up with all of the new technology that's available and the
6 innovation that's available to us. To be quite frank, we just don't know which one to
7 do next, and you know, how to prioritise which one's better than the other.

8 **COMMISSIONER GALE:** Okay. So this is an important topic. Anything to add to that?

9 **MR FERRIER:** If I could just add to that, it's interesting that's Nigel's perspective, and he's
10 really a guy who loves wool scouring. Any independent observation of it would have
11 it as being not quite so exciting, and certainly, the things that are on the table and
12 what's been on the table for the last 30 or 40 years, a lot of the base equipment is the
13 same.

14 Certainly, Nigel's experience has enabled him to become involved in very key
15 developments, but in terms of a pace of change, I think you'd have to question that,
16 and I think it's pretty likely we'll be doing the similar things. For us, the drive with
17 this has been - and why we've been able to hold the position we have over the period
18 of years is we have become more efficient and I've got no doubt we will continue to
19 become more efficient, but we typically offset that to pass on to our customers the
20 advantages to maintain international competitiveness.

21 But it's interesting. I mean, we've got a number of initiatives there, and they
22 might seem big to Nigel, but for any layperson looking at it externally, I think they'd
23 think they're relatively - we're not close to turning our bale of wool into a silk purse.

24 **COMMISSIONER GALE:** Can I ask Godfrey Hirst the same question. We've talked about
25 whether scouring is done adequately for your purposes, but in terms of improving your
26 product, and improving its prospects in the market, are the things that you see
27 yourselves as constantly on the scourer's case, what specifically are the things you'd
28 really love to have do better, and that you expect to have done better in the future?

29 **MR PIKE:** We probably see the most opportunity for those improvements through the
30 further manufacturing stage.

31 **COMMISSIONER GALE:** Yes. Thank you.

32 **DR SAVAGE:** Dr Matt Savage. Just as I used to be the R&D manager of the largest
33 manufacturer of wool scours in the world, the focus on R&D and wool scouring for a

1 very long time was bigger, better, faster, more wool through a machine and that led to
2 the 3-metre machines we're talking about now.

3 Obviously, with the state of the global wool industry, that came to its inevitable
4 end. A lot of the focus is now on improving the qualities of the fibre, and the
5 environmental. A huge proportion of the current research being done is in the
6 environmental field because it's something that is lacking in the global industry and
7 there is a lot of scope for improvement.

8 Sorry, just as an example for that, there's been a lot of talk about these small
9 changes made to the wool scour to improve energy efficiency and throughput. The
10 changes in effluent we're talking about resulting in recycling of wastewater because
11 we're not putting hot water down the drain, we're recycling it back into the system,
12 we're making massive energy savings. That's sort of a comparative thing that's come
13 just as part of the competitive environment has progressively improved. And water
14 use, of course, as I mentioned before, just reducing - what we've done recently,
15 reducing the usage of water by up to 80 percent of the scour.

16 **COMMISSIONER GALE:** Okay. Thank you. Final question, probably, to the economists.

17 Setting aside the sabotage issue, setting aside the messing around with your competitor
18 proposition for which we've asked for some supplementary submissions, chapter and
19 verse on how that works and what the incentives are to do it, while all the technical
20 experts are here, I wonder whether it's possible to discuss the sorts of things could be
21 done, that Cavalier could do to disadvantage Godfrey Hirst, just to test some of those
22 views amongst the sort of practitioners as opposed amongst the economists.

23 So I think, Mr Sundakov, you had a bit of a list of things like inventory impost
24 and delays. Can you summarise those, please, and we'll just allow Cavalier to
25 respond.

26 **MR SUNDAKOV:** So this is really going to now looking at the vertical effects --

27 **COMMISSIONER GALE:** Yeah.

28 **MR SUNDAKOV:** -- rather than the dynamic efficiencies in the wool scouring market, just
29 confirming that.

30 **COMMISSIONER GALE:** Yes, thank you.

31 **MR SUNDAKOV:** Yes, I think that there's obviously very substantial economic literature as
32 well as, I think, observations of practice about the way that an upstream monopolist
33 who is itself involved in the downstream business could raise the costs of its

1 downstream competitors in ways that do not relate to pricing, but relate to various
2 business practices.

3 And these relate to various steps that can be taken to make life for the
4 competitor more difficult. You know, there's delays in delivery, there is the
5 scheduling production to benefit your own timing rather than the other parties' timing,
6 and this is obviously, you know, not accusing anybody of bad intent, but just simply
7 looking at the sorts of things that one can do in principle.

8 And often these things are kind of aggregations of very small steps where each
9 individual step may be very difficult to either detect or in any way to counteract
10 because there is always a good reason why something is delayed or there's always a
11 good reason why scheduling works one way rather than another way.

12 So it relates to those kind of features of the production process, where
13 convenience and timing may be quite important to the competitors, and by reducing
14 convenience and making timing less attractive, you're effectively forcing the
15 competitor to hold greater stocks or do whatever it is that's required to deal with those
16 consequences, and that imposes costs on them.

17 The other major category of steps that can be taken is that to the extent that you
18 derive information from what the competitor is doing, so for example, once there is a
19 single scourer in New Zealand, the competitor who wants to test some innovative
20 techniques now has no option but to test it through you, there's no opportunity to go
21 somewhere else to do something that they'd like to keep from you, that also changes
22 the competitive environment.

23 Knowing what kind of wool is being processed and when can give you useful
24 intelligence on what's happening on the marketing side in downstream manufacturing
25 and that can also be used for competitive advantage. So that's, if you like, just a very
26 high level list of the kinds of things that, well, at the very least if I was doing it, I can
27 imagine, trying to utilise.

28 **COMMISSIONER GALE:** Thank you. Maybe Godfrey Hirst would like to sort of flesh
29 that out. What are the things, given that you probably have medium term contracts
30 with the provider, or sort of agreements over some period, I know you do at the
31 moment, and presumably you will in future, which of those things can you not protect
32 yourself against?

33 **MS PAULING:** I mean, our concern is we can't actually protect ourselves against any of

1 them because if they breach the contract, we have no option to go anywhere else. And
2 you know, we have a good working relationship with the scour, but we just don't know
3 what's going to happen post any merger.

4 I mean, it will affect every level of our production if suddenly there's
5 inadvertent or actual sabotage of the product that's coming through. If the scouring
6 standard drops, that will affect our ability to make anything, let alone make first
7 quality product. The delays around if, for example, our product is scoured and there's
8 a problem with it and it has to be re-processed, those delays in our production can
9 mean that all of those sales go to really our only viable competitor in New Zealand,
10 Cavalier.

11 There's issues around logistics, getting product in and out. Again, you know,
12 in a normal situation, if we were told by the scourer there was a truck breakdown, you
13 would probably believe them, but you know, there's level of scepticism which will
14 seep in if, you know, we are beholden to them.

15 I mean, we're concerned about the information, as Alex has said, of our
16 production levels because they will have access to all of our wool that we're
17 processing, so all of our wool carpets for both Australia and New Zealand, they will
18 have access to. So it affects not just our New Zealand business, but the Australian
19 business.

20 They basically will have a snapshot of our entire business, and have the ability,
21 if they choose to, to make our live incredibly difficult, if not impossible. The only
22 options we have are to open another scour ourselves, which could take 18 months to
23 two years, or to look at going to China, which again, is not something you can just turn
24 on and off. It's a year or longer. So they will know that.

25 So if they want to be difficult, you know, we will be held basically with a gun
26 to our head with no other options; we can't go to Wool Services, we can't go to China,
27 we can't start our own within any kind of reasonable timeframe.

28 **COMMISSIONER GALE:** Tomorrow, we intend to talk about this amongst the economists
29 in theory, but I think in this session, it's really interesting to understand in a market
30 that seems to be quite competitive with imported carpets and both companies
31 exporting carpets, what's in it for Cavalier to mess you around, what is it that they gain
32 commercially by messing you around?

33 **MS PAULING:** Everything; market share.

1 **COMMISSIONER GALE:** So domestic market share, or --

2 **MS PAULING:** Domestic and in Australia. Because we compete directly with Cavalier in
3 Australia, with our wool carpets, and ultimately off-shore because we sell quite a lot in
4 America. Cavalier's looking at extending their export programme into America and
5 around the world.

6 There's been articles in the newspaper where Cavalier's looked at increasing
7 their exporting. I mean, we're already there, and it is predominantly wool carpet that's
8 at risk. They have the potential, in a practical basis, to cause a lot of problems for us.

9 **COMMISSIONER GALE:** Thank you.

10 **MR FERRIER:** David Ferrier, Cavalier. If I can - I'm not sure if this is an economic
11 argument or whether this is helpful, but certainly at the point two years ago when
12 Godfrey Hirst made the decision to exit their New Zealand scouring facilities, they
13 were well aware Wool Services have, from time to time in their past, been full for nine
14 months of the year. I gather at the moment they're full for six months of the year.

15 So at the point that decision was made by Godfrey Hirst in particular, they
16 were fully aware that there were very large tracts of the year where their business
17 would not be welcomed because Godfrey Hirst - Wool Services International simply
18 would not have been available to them.

19 So I hear what they say now, but I'm imagining they got themselves
20 comfortable with those thresholds some time ago. They'll say, yeah, but they could
21 push and shove, but in fact, there would be a number of people around this room who
22 would agree that Wool Services aren't easy to push and shove to do exactly what you
23 want them to do. I mean that as a compliment.

24 **MS PAULING:** If I could just answer that. We wouldn't be betting Wool Services to do any
25 commission scouring from us. We would be buying scoured wool from them, so we
26 would be part of their nine month capacity, and that we would be buying the finished
27 product for them, so that wasn't an issue for us, and it hasn't been.

28 **MR CHUNG:** I'd just like to remind the panel that whilst we talk about Cavalier, really, it's
29 Cavalier Wool Holdings, and Cavalier Corporation is the competitor Godfrey Hirst.
30 Cavalier Corporation does not have control of the board, and therefore, no control of
31 management. So management is independent.

32 The other point that I would like to put to the competitors who scour with our
33 scouring, if they really believe that some of this innovation would be passed down to

1 Cavalier, then I'm pretty sure the management of Cavalier Wool Holdings would be
2 more than happy to undertake a confidential arrangement where it's withheld from
3 Cavalier.

4 The other point I'd like to also mention is that, you know, there are lots of
5 Chinese walls within CWH. As I said, that Cavalier don't really have management
6 control, is not really aware of the day-to-day goings on with Nigel and Godfrey Hirst,
7 nor does it want to know.

8 If we do know the total volume of Godfrey Hirst, I don't think that serves us
9 any knowledge at all in terms of market information. Because it's a world market and,
10 you know, we don't know how much they sell in Australia, how much they sell in
11 New Zealand. You know, we just can't sort of determine that. So it's really of no use.

12 I'd also like to make the other point that I think Ms Pauling mentioned that if
13 we did mess them around, they would be the best party to actually be a new entrant.
14 So the management of CWH have no desires to mess them around. They want to
15 provide the maximum customer service they can. So that threat of it, we would take
16 very, very seriously and to make sure it doesn't happen.

17 **COMMISSIONER GALE:** Thank you. Okay, the final question to the economists, because
18 the number of parties have said to the Commission in response to the Draft
19 Determination, what's wrong with your previous 1, 2, 3 percent dynamic efficiency
20 habit. And I'm wondering, going back to the dynamic efficiencies in the abstract, what
21 reasons the parties have for adopting the particular ranges they've ventured.

22 It seems to us that they've sort of taken - to some degree they've said, well, how
23 different is this industry from other industries that the Commission has looked at
24 before. There's been lots of previous proceedings like this where people have said
25 where on earth does 2 or 3 percent come from, and Dr Layton said in his paper there's
26 no economic foundation for 1, 2 or 3 percent.

27 So I wonder whether, in forming those judgments, Godfrey Hirst,
28 Mr Sundakov, can sort of give us some background as to treating this thing in the
29 abstract and not - and sort of recognising the economists' discomfort with just saying,
30 well, it's a number like 2 percent of something, what guidance you can give us as to
31 how we really ought to do this.

32 **MR SUNDAKOV:** I think what you just described is absolutely right. I think that it's an art
33 rather than a science. I guess my thinking in this regard is, I don't think any of us

1 really have a sufficiently empirical way of calculating exactly what's right.

2 So, really, my thinking is driven probably more by good regulatory practice
3 rather than by any sort of new insights into how to calculate the numbers. It seems to
4 me good regulatory practice does matter here. You know, when you really have to
5 apply an art rather than a science, you have to have good reasons for departing from
6 what's become customary and accepted practice.

7 There may be good reasons for it, but we haven't seen any and it's kind of very
8 difficult to discuss them.

9 **MR MELLOP:** In that memo I referred to before, there's another issue I did look at. The
10 Commission has used two approaches in the past to dynamic detriments; one is to take
11 a percentage of revenue and the other is a demand shift type approach, which I think is
12 the more rigorous one. And the question then becomes how far does the demand
13 curve shift or how much less does it shift outwards due to lost innovation incentives.

14 I think my take on the discussion over the past hour has been that in fact there's
15 not a lot of shift in that demand curve for scouring. In fact, the innovations are being
16 driven by customer demands by Godfrey Hirst, that's where the innovations are
17 coming in wool.

18 What I did in that memo was, first of all, describe the Jerry Hausman approach
19 to quantifying dynamic efficiency, and that's in the mobile telco space, so clearly quite
20 a different industry, but asked what empirical data do we have here. And so what I did
21 there was say, well, we know that CWH has improved the value of Y by one unit over
22 the last 10 years. We can turn that into an implicit shift in the demand curve using my
23 approach, and that - I don't think there'd be any reason not to mention the figures here,
24 these are percentages.

25 That implied each year a demand shift of between 0.13 and 1.18 percent. So
26 it's not a big shift each year. Obviously, there'll be other innovations that have been
27 made, I'm not claiming that's the only one, but it seemed to me of the - well, there's not
28 much information out there, so it seems to me to be the best way to try to calibrate
29 things here. When you take that into account, then the Commission's previous range
30 of 0.5 to 1.5 percent for the reduced demand shift, the 1.5 seemed like quite a large
31 one to assume.

32 So it seemed to me that you should assume the lower end of that range. I'm
33 conscious that's a fairly quick description, I'm happy to elaborate, but it's in the

1 document. I thought it was just useful to summarise it and to see whether it got any
2 reaction or --

3 **COMMISSIONER GALE:** Thank you for that.

4 **MR DAVID:** Commissioner Gale, from a legal perspective, what we are looking for is a
5 reasonable degree of consistency of approach by the Commission, and we would say
6 that the approach that you've take here is in fact a radical departure from what the
7 Commission's done previously. You've measured loss of innovation by applying
8 factors of 0.5 to 1.5 percent of scouring sales and say that that's conservative, having
9 regard to what you did in relation to Qantas/Air New Zealand.

10 But Qantas/Air New Zealand is probably not the best, or closest comparison.
11 Probably the dairy industry rationalisation of 10 or 12 years ago is a better comparator
12 there.

13 There, the Commission said that the dairy processing industry as a whole could
14 perhaps be characterised as a moderately dynamic industry in terms of product and
15 innovation.

16 There, the Commission applied factors of 1 to 5 percent across total industry
17 processing, not just the processing of the raw milk, the processing of the downstream
18 products with the exclusion of butter.

19 Now, we would say that's a closer comparator to the approach the Commission
20 should be taking here. There's no basis in terms of the information you've had over the
21 last couple of days to treating the wool industry as significantly less dynamic than the
22 milk processing industry was 10 or 12 years ago. In fact, all we've heard about the
23 innovation that both Wool Services and Cavalier have brought about over the last
24 10-year period is an indicator of the contrary.

25 **CHAIR:** Can I just follow that up with a comment and a question.

26 In terms of the dairy merger so-called decision, it was never actually in fact a
27 decision, it was only ever a Draft Decision. And for that reason, it seems to me to
28 have no status of the kind that is being made in the submissions.

29 The other point I'd just like to raise with Mr David is that, inevitably, you do
30 get change of composition of a body like this, and this is largely a matter of the views
31 and the persuasion of economists who sit on the Commission. Are you suggesting that
32 economists such as Sue Begg and Stephen Gale should have no liberty to rethink the
33 matter and are bound by previous economists on the Commission?

1 **MR DAVID:** No, Mr Chair, but what I'm saying is that if there is a significant departure, a
2 radical departure from the approach the Commission has taken previously, there ought
3 to be a reasonably explained basis for that supported by evidence, and given that this
4 is, as I've said previously, a request for an indulgence to give effect to a permanent
5 structural change that can't be reversed, there needs to be a high degree of certainty on
6 the part of the Commission that it should take that approach.

7 I think that the Court of Appeal's decision in the Warehouse case, where the
8 Commission now has their middle way, if it's not satisfied on a matter, to decline, in
9 that case a clearance, here an authorisation, gives validity to the notion that any
10 uncertainty should go against the applicant not against the parties that are disputing the
11 proposal.

12 **MR SUNDAKOV:** Perhaps if I can come back to the economics for a second and just
13 respond to what Mr Mellsop said. I mean, I think that Professor Hausman's approach
14 is as much an art, no more scientific than any other approach because at the end of the
15 day it all really comes together on the basis of lots of assumptions and lots of
16 judgments about how markets work.

17 But to the extent that one wanted to use that, that's perfectly fine. If you were
18 to use that, then I think it's just simply restricting the shift in the demand curve to the
19 effects associated with the change in the Y value is not sufficient, because that's only
20 one of the drivers. There are other things that are happening in the industry as well, so
21 you'd have to accumulate all of them.

22 And secondly, you'd have to look at the - not just at the annual changes but at
23 the present value of future changes that may be foregone.

24 **MS BRANSON:** Whilst we're on the economics, there is actually a third possible
25 methodological approach. It is, again, rough and ready, given as the Commissioners
26 recognise, the difficulties in measuring precisely dynamic efficiency, but it's one that
27 Dr Layton alluded to in his paper which is established in empirical fact, that dynamic
28 efficiency can be considered in terms of how many multiples is it of, or how many
29 times larger is it than productive and allocative efficiency.

30 That's obviously going to vary by sector and vary by the type of change that
31 you're making to that sector. But there have been a number of studies over many years
32 and in fact, a previous paper by Mr Mellsop and his colleagues at NERA provided a
33 brief summary of the academic literature on by how much do dynamic efficiency

1 losses outweigh productive and allocative efficiency losses, and indeed, that was in the
2 context of specifically how much does moving from competition to monopoly, what
3 risk does that pose to dynamic efficiency.

4 Obviously, there's a very wide range of sectors and a very wide range of
5 changes, but the general principle from the empirical evidence is that dynamic
6 efficiency benefits swamp static efficiency benefits, or losses in the case of moving
7 from competition to monopoly.

8 But also, it's actually to get some feel for the numbers, the magnitudes, there's
9 obviously very wide range in the literature, but from a number of examples, dynamic
10 efficiency losses range from between two to three times the allocative efficiency losses
11 to as much as 20 times the allocative efficiency losses.

12 That would obviously make a very big difference to the cost benefit analysis in
13 this particular case, and there is the question about, well, what are the specific
14 characteristics of this industry and are those sorts of magnitudes applicable or not. But
15 it does at least take us a little step further in terms of some empirical basis to the
16 relative magnitudes.

17 **MR MELLISOP:** Can I just respond, given it's my report. Two things; that's the Jerry
18 Hausman-type approach, so the new product creates a whole new surplus. That
19 particular report, I'm assuming is the kiwifruit one you're referring to, where Zespri
20 introduced the gold kiwifruit, and we valued the benefits of that.

21 So my point here is that I think this is a different industry, and the discussion
22 we had before was that those sorts of innovations are happening driven by the market
23 not by the scour, which seems to me to be a much less dynamic industry than telco or
24 kiwifruit where you've got brand new markets, in effect, being created.

25 And the only other comment is that that's a monopoly to competition and as I
26 said before, I don't think that's what we're looking - I don't like the word 'monopoly'
27 for the merged entity here, because in my view, it will be subject to competition. So
28 it's not like Zespri in that case which is a statutory monopoly.

29 **MR SUNDAKOV:** I'm going to have to jump in at this point. I think it's exactly like Zespri
30 because your point that we'll be subject to competition from obviously it's competitors.
31 Zespri is essentially a monopoly in New Zealand, but it competes with kiwifruit
32 growers in other countries. So in that regard, it's exactly the same setting.

33 **MR MELLISOP:** No, the difference is - that report was looking at the incentives for

1 New Zealand players to innovate. The difficulty with Zespri is that - sorry, this is I
2 guess off topic, but is a single desk to exporting so it's very hard to commercialise new
3 products for anybody else.

4 **MS BRANSON:** With respect, although the paper, the context of the paper was the kiwifruit
5 sector, the entire section that deals with the academic literature and the empirical
6 evidence from previous studies is not specific to kiwifruit and does cover not just
7 product improvement, but process improvements, including regulatory improvements,
8 changes to taxes, changes to tariffs. So there was a very wide range of examples to
9 support the strength of dynamic efficiency benefits or potentially losses.

10 **MR MELLISOP:** All the literature, it's a question of degree. The literature is about –
11 Jerry Hausman is the extreme example; new cell phone, \$50 billion. What I'm saying
12 here is we take the same methodology, but the shift in demand curve is minor. So it's,
13 I think, completely different to those. All those articles there are actually about brand
14 new products being created or the taxes in respect of broadband, so it's a brand new
15 product being created.

16 So it's a question of degree. What I've done in that memo is said that if we
17 look at the history of innovations in this particular scouring industry, they are far
18 smaller than we see in the telco industry, which is the sort of pioneering article in that
19 literature.

20 **COMMISSIONER GALE:** I think we have that covered now in the submissions and in
21 Dr Layton's paper, and Mr Sundakov's view. Thank you. Thank you to the
22 non-economists for bearing with us during that session, which is now closed.

23 **CHAIR:** Right, thank you. This brings to an end the public session of the conference. I'll
24 just make a few standard comments we make at the end of these sessions.

25 First of all, thank you very much to all of the participants who have appeared
26 before us. We realise many have come from out of town and we do value the time and
27 effort you've put into coming here to assist us in the process.

28 Just a reminder that final submissions are due on Friday, 13 May, but I do urge
29 once again, as I did before, that matters are confined to all matters that are on the
30 record before the Commission at the close of this hearing.

31 Transcripts of these public sessions will be available on the website
32 progressively over today, tomorrow, and I would imagine by Friday we'll have the
33 final version of the public transcripts available at the end of that.

