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Dear David and Hamish

Cavalier Wool Holdings / Wool Services International

Thank you for taking the time to meet with our client and us on 15 February and for visiting the Timaru site on 17 February.

Given the range of topics covered during those meetings, this letter sets out some of the information provided during those meetings. However, we thought it would be useful at the outset to set out again for the Commission the rationale for the transaction and how the quality benefits arise.

Current position

- There are currently three scouring plants and seven scouring lines in New Zealand
 - WSI plants are currently sub-optimally configured and cannot be expanded
 - CWH's Awatoto plant is sub-optimally configured – []
- The position today is that in an average year capacity utilisation is []
 - Includes the [] Clive plant which is utilised []
- It is accepted that the volume is the primary driver of scouring profitability

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Excess capacity and diseconomies of scale

Step 1: Obtain access to WSI volumes

- On acquisition, CWH will be in a position to contract to scour WSI volumes
- It does not currently have access to this volume or any ability to win it

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Greater pool of available demand for CWH's scouring services

Step 2: Closure of Kaputone and Whakatu sites

- On acquisition, CWH will close the Kaputone and Whakatu sites
- Removes []
- Enables avoidance of approximately [] in administration costs
- Enables the land to be sold
- The WSI greasy volumes will transfer to Awatoto and Timaru for scouring

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Increased economies of scale

»»

Land sale benefit – []

Leaves CWH with insufficient capacity

- []
- []

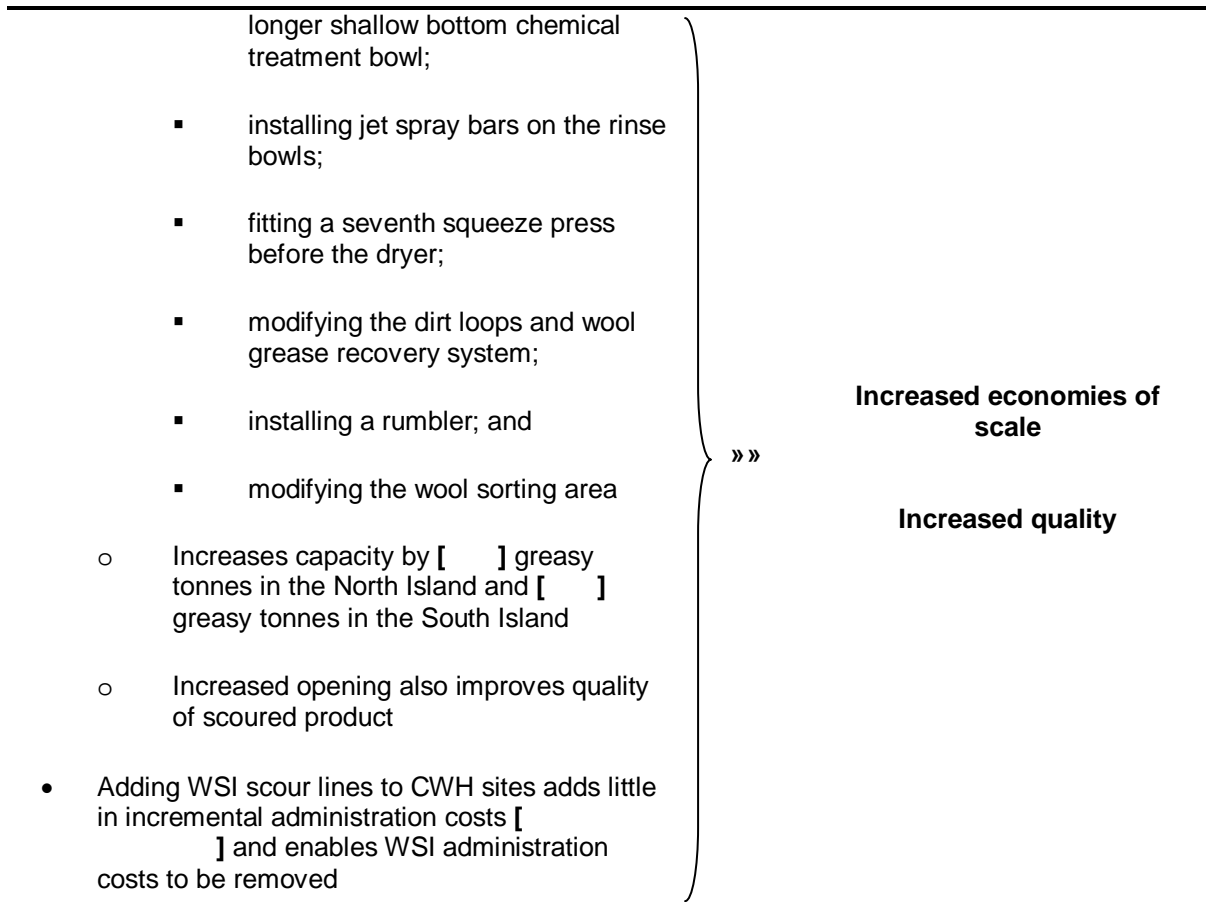
Step 3: relocate the WSI scour lines to Awatoto and Timaru and modify to improve throughput and opening and cleaning performance

- Just adding scour lines increases capacity by [] greasy tonnes
- Building modifications required to house lines at both Timaru and Awatoto
- Provides opportunity to straighten and expand former WSI scour lines to improve performance and capacity/throughput
 - The changes are set out in ¶5.43 of the Application and include:
 - reconfiguring the bowls to enhance the rinse capacity;
 - modifying bowl 6 to become a

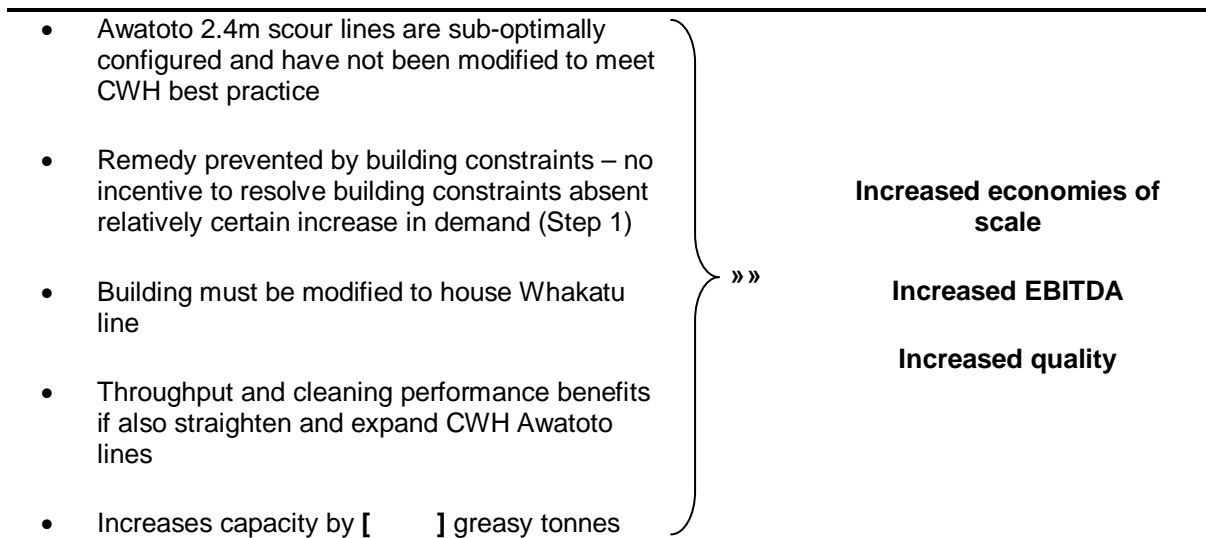
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Increased economies of scale

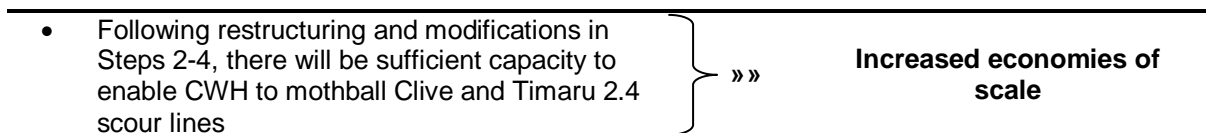
Increased quality



Step 4: modify the Awatoto 2.4 scour lines



Step 5: mothballing of Clive and Timaru 2.4 scour line



<ul style="list-style-type: none"> • Will be retained for emergencies – ongoing costs of mothballing included in cost/benefit model 	} » »	Emergency contingency
<hr/> Result <hr/>		
<ul style="list-style-type: none"> • Removal of duplication • Modified WSI plants have greater throughput • Modified CWH Awatoto lines have greater throughput • Capacity utilisation increases to [] 	} » »	Economies of scale/ Increased EBITDA for CWH
<ul style="list-style-type: none"> • As a result of the modifications, all the Awatoto scour lines (both existing CWH and former Whakatu WSI) will gain Y quality benefits as described in the Application • As a result of the modifications, the Kaputone scour line transferred to Timaru will achieve Y quality benefits as described in the Application 	} » »	Increased quality

1. The rationalisation is possible only if the transaction proceeds

1.1 Expansion of WSI scour lines only possible with the transaction

Post-acquisition CWH will relocate WSI’s Kaputone and Whakatu scour lines to CWH’s Timaru and Awatoto plants respectively.

Relocating the WSI scour lines will enable CWH to make modifications to these scour lines to increase their throughput (efficiency) and operational performance (see Step 2 above.) (The by-product of this will be an increase in the quality of the scouring service provided.)

These modifications are not possible in the counterfactual because the WSI scour lines are either physically or environmentally constrained:

- (a) CWH understands that the Kaputone site is subject to effluent restrictions which mean it is unable to increase capacity.

Accordingly, while it might be physically *possible* to modify the Kaputone scour line in the counterfactual there is no real chance or commercial likelihood this would occur as there is no incentive to increase throughput if there is no ability to increase overall capacity.

Indeed, CWH understands that Kaputone’s throughput per hour has declined over time as WSI has sought to reduce its capacity to manage its effluent discharge issues.

- (b) The Whakatu site is physically constrained and its buildings cannot be extended.

WSI has built on as much of the Whakatu site as is possible. No further building extensions are possible given the land is bordered by a river and a road and is surrounded by residential houses.

WSI has also fully used the space within the existing buildings. In fact, even having done so, WSI has already had to compromise the layout of its scour line by configuring it in a dog-leg formation so as to fit within the building. While the dog-leg configuration is sub-optimal, it cannot be corrected given the current building constraints. In turn those constraints cannot be remedied given the site constraints.

In contrast, CWH does not face any environmental or physical constraints at its Awatoto and Timaru sites, although building extensions will be required at each site to house the new scour lines.

1.2 ***Building extensions will only occur in the factual; not the counterfactual***

At Timaru, the building extensions will enable CWH to remove a small dog-leg at the end of its existing 3.0 metre scour line (between the end of the mixing bowls and the HD press).

At Awatoto, the current size of the building has meant that CWH's two 2.4 metre scour lines are (like Whakatu) sub-optimally configured in a dog-leg fashion. Furthermore, CWH has not made the modifications to these scours necessary (i.e., increasing the number of openers) to bring the 2.4 metre line up to the Timaru 3.0 metre standard, which represents CWH best practice.

Unless CWH extends the Awatoto building, it cannot:

- (a) straighten these lines post bowl number 6; or
- (b) add a longer chemical bowl; or
- (c) include the spare triple drum opener in the blending system,

(together the **Awatoto modifications**).

Extending the building to house the 3.0 metre scour line will enable CWH to simultaneously straighten the 2.4 metre scour lines and make the other modifications necessary to bring the scour line up to Timaru "best practice" specification.

CWH *could* make the investment necessary to extend the Awatoto building and the Awatoto modifications absent the transaction, however there is no real chance or commercial likelihood that this will occur.

The rationale for increasing throughput is to increase capacity and thereby decrease unit costs. In other words, the commercial rationale relies on an increase in volumes being available either by removing an existing bottleneck or by acquiring new volumes to fill the newly created capacity.

CWH is not capacity constrained at present and, given the trend in the wool clip, is highly unlikely to be so in the counterfactual. In an average year, CWH's capacity utilisation is [], although in the six months to December 2010, CWH's New Zealand capacity utilisation was [] (caused by New Zealand's wet winter and the volatility in the wool prices altering merchants' buying behaviour).

Nor, in the counterfactual, is it likely that there would be sufficiently certain incremental volumes available to justify the investment required to extend the buildings and increase volumes. This is particularly so given that CWH believes it already scours [] of the non-WSI volumes. Hence, the majority of the incremental volume available is either already being scoured offshore or is volume which is captive to WSI.

Hence, with the current over-capacity and little scope for increased demand for its services, there is little incentive for CWH to invest [] to make the Awatoto modifications to increase throughput. Doing so would simply result in an increase in surplus capacity with no certainty of any incremental revenue. The quality benefits which would flow from making the investment are largely a benefit to merchants and therefore, alone, do not provide an incentive.

1.3 **Post-restructuring capacity levels**

As set out in the Application, post-transaction CWH will retain around []

The Commission has previously recognised the commercial benefit of this. In Decision 666 CWH provided evidence to the Commission which showed that for HBWS, an increase from [] capacity utilisation would reduce costs (including depreciation but excluding interest) per kilogram of greasy wool processed by around [] cents per kilogram, which the Commission concluded were similar to figures expressed by other industry participants.

In CWH's financial modelling, it has forecast its total costs per greasy kg to reduce by [] cents in the North Island and [] cents per greasy kilogram in the South Island.

1.4 **HD freight cost savings**

During the site visit, the difference between the HD presses operated by NZWSI and CWH were explained. In summary, CWH operates two 600 ton Autefa High Density Wool Presses, which are designed to press up to 21,000 clean kilograms into a 20 foot container. In contrast, NZWSI operates two Gualchierani High Density Wool Presses, which can only reliably pack up to 19,500 clean kilograms into a container.

This has important implications in terms of freight costs as a merchant using CWH can lower its costs per clean kg exported. To illustrate:

- (a) The approximate cost of a 20 foot container from New Zealand to China is US\$1,000 meaning that a merchant can reduce its freight costs by US\$0.0037 cents per clean kg (NZ\$0.0048 cents per clean kg).
- (b) The cost of a container to the USA or Europe is approximately US\$2,500, meaning the saving is US\$0.0092 cents per clean kg (NZ\$0.0119 cents per clean kg).

2. **New entry**

2.1 **Availability of second hand plant**

There is less second hand plant available in Australia now than there was at the time of Decision 666. The reason is that the second hand plant then available has been sold to Chinese scour operators. The most recent example is the plant from Fletchers (owned by

Charguers) in Dubbo (Australia's most recent plant closure in October 2010), which has already been sold to a Chinese scour operator.

However, CWH understands that second-hand plant is available in [] []]

CWH also understands that second-hand plant remains available in []. This was available at the time of Decision 666.

2.2 **Cost of new plant is significantly reduced**

Balanced against there being less second hand plant available in Australia is the fact that the cost of new scouring equipment has significantly declined over the last two years. This is primarily due to the fact that Chinese manufacturers now produce scour lines which are very similar to those produced by scour manufacturers around the world, including Andar in New Zealand. CWH understands that scour lines from China are selling for US\$500,000 to US\$1 million.

CWH understands that new Chinese equipment can now be obtained for around the same price as the cost of second-hand plant at the time of Decision 666. CWH understands that there has been three new scours built and sold in China in the last 6 months.

2.3 **Sites available for new entry**

Empty sites for wool scouring operations with the necessary consents remain available. The empty scouring site directly opposite CWH's Hawkes Bay site discussed in the earlier application remains available, which still has its water tower intact and is also understood to still retain its water rights for scouring.

In addition, the recent closures of several meat freezing companies mean there are now more sites available than was the case at the time of Decision 666.

2.4 **Economies of scale**

CWH estimates that a commission scourer would need approximately [] bales ([] tonnes) to enter into the market successfully and sustainably. To put this in perspective, CWH's three largest customers (outside Cavalier Bremworth) are currently []

[] customers would have more than sufficient volume to enable an efficient scour line to develop. As CWH said at the meeting in Wellington, while the customers could enter the market, in fact they won't do so - the threat of entry (and accordingly of a permanent loss of material volumes) would be more than sufficient to constrain CWH pricing.

Exporters/merchants seeking to enter the scouring market to satisfy their own needs (rather than for commercial scouring) would be able to enter at a lower level given they would only need to cover their own costs. CWH understands that potential likely new entrants/re-entrants include [], either alone, or together with other merchants.

3. **Constraint from Chinese scourers**

While the constraint from Chinese scour operators is detailed in the Application, a few additional points are worth noting:

- (a) First, although most scours in China are relatively small compared to CWH, there are a number of large scourers that are starting to emerge.

The example given in the Application is of the recent opening of a new plant with three 3.0 metre scour lines which is more capacity than is available currently in the North Island.

- (b) Second, like New Zealand, China can scour fine wool (such as Merino exported from China) and coarse wool (carpet type wools of the type formerly scoured in the United Kingdom). In this respect, CWH is aware that there has been a shift in China towards scouring coarse wool as new carpet tufting plants are being installed.

- (c) Third, an example of the constraint imposed by China is the commercial strategy of []. [] is an example of an exporter/merchant which previously scoured with CWH but now exports nearly all its wool to overseas in greasy form.

Another example is [] who has informed CWH that if they are not satisfied with CWH's service offering, they will send all of their wool overseas greasy.

- (d) Fourth, as noted in the Application, it is becoming increasingly viable for customers to export greasy wool to China and then to re-export that wool in a processed/semi-processed form to a customer in another country.

A good example of this is Icebreaker, the New Zealand clothing company. Historically, its wools were scoured in New Zealand but now the wool is exported in greasy form to China where it is scoured and processed into yarn and then re-exported to Fiji for manufacturing. CWH understands this is also happening for coarse wool which is being re-exported as yarn to the United States.

- (e) Fifth, the reason that clean wool is not currently re-exported from China is primarily because Chinese scours do not currently have HD press technology. As with scour line technology, it is only a matter of time before Chinese scours invest in obtaining this technology. Once they have this, the prospect of re-exporting clean wool from China will become a real constraint. For this reason, CWH would not sell any HD press equipment to a Chinese scour operator.

4. **CWH's experience since Decision 666**

CWH's experience since Decision 666 (early 2009) is that it has not lost significant volumes of business to WSI.

As the Commission is aware, CWH [

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[

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This small increment is consistent with what CWH's export customers have been telling it. CWH is only aware of three customers, namely [

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(a) []

(b) [

]

5. Ability to price discriminate

CWH confirms that it has very limited visibility over the final destination of the wool it scours for its customers and, accordingly, cannot readily discriminate prices for wool destined for China versus wool destined for other markets.

[

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[

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6. Relevance of Australian and UK experience to New Zealand

In response to the question about the relevance of the Australian and UK experience to New Zealand, CWH says that the same principal drivers which caused the decay of those industries are present in the New Zealand market.

In respect of Australia, CWH acknowledges that the Australian market is made up primarily of merino wool. However, it is the location of final processing and now sourcing in China which has decimated its scouring industry. The primary reason why Australia has been more dramatically affected than New Zealand is the lack of steps taken in Australia to consolidate the industry as has happened in New Zealand.

The United Kingdom scouring industry is very similar to New Zealand. While it is not a large wool grower it acted as a hub for the scouring and then processing of both coarse and fine wools. Greasy wools from a number of countries were sent to the UK to be scoured and processed. The greasy wool that was scoured in the UK is now being exported directly to China where the majority of processing now takes place. As the UK scourers lost scale, they became increasingly uncompetitive.

7. Update on wool flows

Enclosed with this letter is an updated wool flows diagram which builds on the diagram displayed in Appendix 2 of Decision 666. The numbers are derived as follows:

- (a) [] The estimates are for the 12 months to 30 June 2010.
- (b) The quantities scoured by each of CWH and WSI in each of the North Island and South Island are derived from Lanolin Trading Company statistics for the 12 months to 30 June 2010.
- (c) The difference between total market size ((a)) and the quantity of greasy wool scoured in New Zealand ((b)) is assumed to be have been exported greasy from New Zealand. The amount of greasy wool implied in this method is 41,249 tonnes or 21.97% of New Zealand's wool clip. This 41,249 tonnes is almost identical (within 0.4%) to the greasy wool export volumes recorded by Meat NZ for the 12 months to 30 June 2010 (41,405 tonnes). The figures show that:
- (i) 18% of North Island wool was exported in greasy form with CWH scouring []; and
- (ii) 26% of South Island wool was exported in greasy form with CWH scouring [].
- (d) The volumes of greasy wool exports scoured by Chinese versus other scourers have been estimated using Meat NZ data which show that for the 12 months to 30 June 2010, 36,142 tonnes of the 41,405 greasy tonnes exported (87%) were exported to China, with the remaining 13% exported to other countries with Germany (4%) and Italy (3%) being the two next largest greasy wool destinations.
- (e) The volume CWH scoured for each of Godfrey Hirst and Cavalier Bremworth for the 12 months to 30 June 2010 is derived from CWH internal management data. The balance was scoured for merchants/exporters:
- (i) in the North Island, []; and
- (ii) in the South Island, [].

While Lanolin Trading Statistics provide an accurate assessment of the scouring conducted by WSI, because WSI is primarily an exporter/merchant, it is difficult for CWH to assess the extent to which WSI is operating its scour lines to scour for its own use versus the extent to which WSI is operating as a commission scour line (i.e., supplying its services to other merchants/exporters).

WSI's annual report for the 2010 financial year indicates that WSI's scouring segment earned \$24.839 million in revenue comprising \$17.998 million from "Inter-segment sales" and \$6.841 million from "external sales". The "Inter-segment sales" have come from the "Trading" segment which is defined as the group which "deals with the purchase of greasy wool from growers and the sale of both scoured and greasy wool to customers locally and worldwide".

The figures in the Annual Report imply 28% of WSI's business is true commission scouring, however CWH believes this is a material overstatement. CWH believes it captures [] of New Zealand's commission scouring with WSI having around [].

At the time of Decision 666, the Commission correctly concluded that WSI had a limited commission scouring presence. [

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CWH believes that the difference between WSI's reported "external sales" and its true commission scouring position is likely to derive from the way in which WSI accounts for scouring performed on volumes which are sourced from its wholly owned subsidiary Raymond Dale Wool Marketing Limited, its joint venture company Rural Wool Link and another related company owned by Jim Patterson.

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8. Other benefits

In addition to the benefits quantified in the Application itself, CWH submitted that a range of other benefits are likely to arise as a result of the acquisition which are not achievable in the counterfactual but which have not been quantified either because it is impractical to do so, or because quantification was not possible prior to the Application being submitted.

Such benefits should form part of the Commission's weighting of the benefits and detriments and a benefit should not be accorded less weight simply because it has not been quantified. The High Court has said that such an approach would be wrong.¹

8.1 *Retaining WSI assets in New Zealand*

Absent the acquisition, there is a very real prospect that WSI's scouring assets will be lost to New Zealand. WSI is the only remaining merchant scouring model in the world and the trend in other wool exporting countries is that scour lines have been closed and the plant relocated to China.

There seems to be no reason to believe that a new majority shareholder in WSI will persist with a merchant scouring model, when this model has proved to be unsuccessful. Nor does there seem to be any reason why a new major shareholder should wish to retain scouring assets in New Zealand when a ready market for them exists offshore.

8.2 *Enhancing New Zealand's scouring industry*

The acquisition will enhance the New Zealand scouring industry and enable CWH to more effectively compete for commission scouring work.

This benefit extends not only to New Zealand wools, but also enhances the potential for CWH to compete to scour Australian greasy wool. CWH's Timaru scour lines are capable of scouring merino wool and do so today. Given that nearly all of Australia's greasy wools are now exported greasy to China, the opportunity exists to capture some of the Australian volume for scouring in New Zealand.

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¹ *Air New Zealand v Commerce Commission*, CIV 2003 404 6590, 17 September 2004 (HC).

[

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By reducing CWH's unit cost position, the acquisition will enable CWH to make a more attractive offering to potential customers such as [].

While difficult to quantify, the benefits of winning such business will be material for New Zealand. Australia is the largest wool grower in the world and New Zealand is well positioned to secure some of its commission scouring business if it is able to offer a more cost competitive service.

8.3 ***Enhancing the value of New Zealand's wool exports***

To the best of CWH's knowledge, WSI is the only remaining merchant scourer in the world.

We understand that merchants have informed the Commission that the vertical integration between WSI's trading and scouring division results in the world price for New Zealand wool being reduced. CWH agrees that this is a likely outcome of such a model.

The reason it is a likely outcome is that scour lines operate most efficiently when they are continuously operating. Accordingly, WSI as a scour operator has an incentive to keep its scour lines operating continuously.

However, as the Commission is aware, merchant customers are reluctant to use WSI as a scour operator. The result is that WSI needs to procure sufficient wool to keep its scour lines operating, and in many instances it does not have buyers for this wool when it procures and scours this wool. This leaves it as a weak seller in the international market reducing the price which New Zealand wool sells for.

As CWH is not an exporter it does not have information that would enable it to quantify the price difference, although it understands that exporters would be able to provide this data to the Commission.²

The acquisition results in the removal of the vertical integration between the trading and scouring business and so would remove this weak seller problem. This can be expected to remove any price differential resulting from the weak seller position a merchant scourer inevitably finds itself in.

While CWH does not have the information to quantify this benefit, it agrees with the Commission that the benefit could be substantial. A 10 cent per kg price differential across New Zealand's wool exports of approximately 169,000 tonnes (excluding domestically processed wool products) implies a benefit to New Zealand of \$16.9 million per year.

² The recent press release by WSI (22 February 2011) appears to provide support for the view that WSI is a weak seller into international markets when it notes: "Many of our overseas customers have already been in contact expressing their concerns, and these will be brought to the attention of the Commission."

8.4 **Superstore**

The current supply chain for greasy wool from farm to wool scour is over complex, over capacity, wasteful and costly. There is a great deal of duplication of facilities and wasted freight expense.

A 'wool superstore' refers to the concept of centralised consolidation at purpose built independent greasy wool super stores sited adjacent to one or more wool scours. Wool sorting, classing, testing and storage would occur under one roof, which would lead to the elimination of the duplication of facilities, resources and infrastructure currently present in the wool industry. A wool superstore aims to streamline the process, and improve efficiency and productivity for greasy wool handling.

You have seen the site for the proposed wool superstore at Timaru. There is also sufficient land at Awatoto to also enable this to occur in the North Island. CWH would operate the wool store on a commission basis similar to the way it operates wool scours. As it is not a merchant/exporter, CWH is confident that merchants/exporters will support the concept and []

This benefit will only arise in the factual because CWH has no incentive to develop this model, or to undertake significant capital expenditure to create a superstore, absent this acquisition and the additional volume uplift it can obtain. This makes the investment worthwhile.

There is no real chance of a superstore model being developed in the counterfactual. CWH is the only readily identifiable independent party which could facilitate the model (not necessarily owning it) and the capital expenditure necessary outweighs the commercial benefit in the counterfactual.

Nor would a merchant/exporter led model be likely to work. Current political factions between industry participants mean that this concept is not workable absent a non-merchant/exporter developing the proposal.

The elimination of duplication and reduction in freight costs alone are material public benefits for New Zealand, although these are difficult to assess in the abstract.

Please let us know if you have any questions regarding the contents of this letter.

Yours sincerely

[Sgd: Phil Taylor / David Blacktop]

Phil Taylor / David Blacktop
Partner / Senior Associate

Enc.