Memorandum

Date: 15 October 2015

To: The Chairman and Members
Commerce Commission

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CAVALIER WOOL HOLDINGS AND NEW ZEALAND WOOL SERVICES INTERNATIONAL - GODFREY HIRST SUBMISSION ON SECOND DRAFT DETERMINATION

1 This submission has been prepared on behalf of Godfrey Hirst New Zealand Limited (**Godfrey Hirst**) by John Dixon, counsel, and Chapman Tripp.

2 We have been assisted again by expert economic advice from Professor Graeme Guthrie of the School of Economics and Finance, Victoria University of Wellington. His Economist's Report is attached as Appendix A to this submission. We have also had further assistance from expert valuer C W Nyberg of Darroch, in relation to the valuations of the Whakatu, Kaputone and Clive scour sites.

The Process has been Hard for Everyone

3 We have previously expressed our concern at the limits that have been placed on the input and instructions we have been able to obtain from Godfrey Hirst owing to the extensive confidentiality which the Commission has imposed in terms of our confidentiality undertakings.

4 While we appreciate that the sharing of commercially sensitive information poses real difficulties, we have noted that there has been unusually stark information asymmetry here. What particularly stands out as unfair is that the Commission appears to have allowed Cavalier and Lempriere/NZWSI to share information with each other that ordinarily would be restricted from each other, as competitors, while keeping that same information from Godfrey Hirst. That has meant that the Commission has missed out on our client providing input to properly test the assertions made by the applicant's counsel.

5 So saying, we recognise that the investigation and process relating to this Application has been protracted and arduous for the Commission and especially its staff. Their efforts are appreciated. We stress that our criticisms are not directed at individuals, but the Commission's processes.

6 We recognise, too that the Commission's prolonged investigation will have been frustrating for the Applicant and its shareholders, both current and intended. Their Application proceeded originally on the basis that the substance provided in the course of the previous authorisation process which resulted in Decision 725 (and endorsed in part by the High Court) "remains largely unchanged" apart from further reduction in available wool clip and "a slight increase in the volume of greasy wool exported to China".

7 In fact, as we have shown over the subsequent 12 months, much had changed from that previous application and continues to do so. In particular, the shareholder composition of CWH post-acquisition, and the level of foreign ownership that would result, necessitates significant departure this time from the Commission's previous analysis. As a result, the Commission's original Draft Determination produced a net benefit figure of the slenderest of margins, (being $2.51 million).

8 That net benefit figure would have [ ] by the revised valuations for the Clive, Whakatu and Kaputone sites provided by the independent valuers engaged by the Commission itself. Even allowing for additional benefits in the form of increased Capex savings and reduced redundancy costs subsequently identified by the Applicant and accepted by the Commission in its Second Draft Determination, the resulting overall net impact would have continued to result in a small net detriment figure if the Commission had retained its previous findings as to the constraints on the merged entity's ability to raise prices and resulting allocative efficiency loss.

9 As is described in detail below, that outcome (consistent with the Commission's approach in the original Draft Determination) was only avoided by the Commission's adoption in the Second Draft Determination of separate markets for the supply of wool scouring services that segregate between international wool users and domestic wool users and picking a lower level of price increase of 15% at which wool destined for overseas users faces constraint provided by greasy exports. It is only that segregated market definition and the resulting reduced allocative efficiency detriment that allows for the Commission's ultimate finding of a small net benefit figure in the Second Draft Determination.

10 That closeness of margin at every stage of the process no doubt contributes to the strongly held views of the Applicant and its current shareholders and NZWSI on the one hand that the merger will have positive benefit for the New Zealand wool industry; and the equally strongly held view by Godfrey Hirst that it will result in substantial and irreparable harm to that industry.

11 It is the Commission's unenviable task to determine on which side of the line the overall net impact properly lies, on the balance of probabilities.

12 Importantly, the Commission has a particular responsibility where the margin is so narrow to ensure that its own final determination is made on the basis of conclusions from established facts or reasonable estimates, sound economic analysis, and consistent legal principle.

This Submission

13 In our submission, there are some key respects in which the Second Draft Determination falls short of this standard. Most materially, we consider that the Commission has erred in the following respects:

13.1 **Benefits flowing offshore**: The Commission's approach of equating the direct and immediate benefits from rationalisation that flow to foreign shareholders with the indirect and long-term benefits that may feed-back to New Zealand in other ways and in other markets is incorrect as a matter of economics and of law. The two benefits are simply not related.

13.2 **Loss of Allocative efficiency**: The Commission's conclusion that the price increase that will follow the acquisition is unlikely to be more than 15% for customers other than Godfrey Hirst is based on an inadequate review of the record (which simply does not support the conclusions drawn). Further, the Commission has made other errors in its analysis, such that the end result is that allocative efficiency losses will be substantially higher than the Commission estimates.

13.3 **Loss of Productive and Dynamic efficiency**: The Commission has erred in not applying the same customer-specific differential that it applied to allocative efficiency losses to productive and dynamic efficiency losses. Further, the Commission has underestimated these losses in any event, and we provide further evidence to support that submission.

13.4 **The Counterfactual**: The Commission's discussion of the counterfactual whereby Cavalier must inevitably sell the Clive scour was, we appreciate, written before the further information was provided by the Applicant [ ]. Nevertheless, the Commission's conclusion is flawed – and the new information proves this to be the case.

13.5 **Other benefits**: The Commission has erred in its approach to certain claims of avoided expenditure [ ]. While we do not repeat our earlier submissions in detail, there are two particular respects in which we submit that the Commission's analysis should be revised.

14 **Framework for Analysis**: This submission also addresses the Appropriate Framework for Analysis of a merger authorisation application. Contrary to Bell Gully's submission dated 10 August 2015 (Part C thereof), we submit that, in circumstances where the Commission's net benefit range estimate includes both positive and negative values, the Commission should decline authorisation unless it can exclude a real chance that the detriments outweigh the benefits. This is consistent with the relevant case law and with the policy objectives and purpose of the Commerce Act.

Benefits Flowing Offshore

Commission has erred in its approach to benefits that flow to foreign shareholders

15 In response to the original Draft Determination, Godfrey Hirst submitted that to the extent that the benefits of the proposed acquisition flow to the foreign shareholders they should not be counted as a benefit to New Zealand. The Commission appears to have accepted the merits of this argument, in principle, by concluding that Professor Guthrie's approach "may provide an accurate estimate of the immediate, direct benefits that arise within the market of interest", but the Commission nevertheless rejected the approach because it "may ignore any other longer-term or wider public benefits."[1]

16 Put another way, the Commission found that all of the productivity enhancements in terms of asset realisations and cost reductions should be included in public benefits, despite some of those gains going directly to foreign shareholders, because the acquisition may have significant flow-on or feed-back benefits to New Zealand.

17 Godfrey Hirst submits that the Commission has made several errors in its approach, which is inconsistent with the approach it has adopted in other cases (and which has been approved by the Court). Godfrey Hirst further submits that the Commission's proposed approach is faulty in that it masks the true value (if they can be calculated) of these benefits or their true nature (if the reality is that they are unquantifiable).

18 The consequence of these errors is manifest. The effect is to include over $10 million of benefits, which should not have been included – or, at the very least, should have only been included as unquantified benefits. That difference alone is more than enough to tip the balance firmly against authorisation.

Claimed "flow-on benefits" to New Zealand

19 The errors can be demonstrated by a review of the mooted "flow-on benefits" to New Zealand.

20 At paragraph 388, the Commission advances the notion that over the longer term the benefit of cost reductions could be passed on to merchants and over the even more longer term it might eventually be passed on to farmers. This prospect is said to result from competition in the scouring markets from overseas scours, particularly in Asia.

21 This notion has several flaws. The first, and most obvious, is that it is at odds with the Commission's view that the acquisition is likely to result in a substantial lessening of competition (**SLC**) in the scouring market. If the Commission accepts that there is a real chance of an immediate price rise of up to 15% for wool for export, as it does, then that is a complete answer to this point.

22 If what the Commission is really saying is that, *as an alternative* to a SLC, there is also a prospect that prices would go down, then – while Godfrey Hirst rejects that alternative claim – that is, in any event, merely that: an alternative. The

[1] Commerce Commission. Second Draft Determination at paragraph 380.

Commission must consider what may occur under different scenarios, including most relevantly, the scenario where there is a SLC and a substantial price rise. In that scenario, this idea of a flow-on benefit does not arise.

23 Second, as the Commission appears to indicate in footnote 233, this prospect would relate only to reductions in variable costs; it would not apply to the proceeds from the sale of land and plant, which could be immediately repatriated overseas. So it would only be of partial effect. Further, it would not apply at all in the market for scouring for domestic wool use, which is not subject to international competition, so there would be a further dilution of claimed effect.

24 Third, it depends on a full-pass through of the savings by merchants (many of whom – like NZWSI - are foreign-owned) to New Zealand farmers. The premise of this is that because price increases would be passed on to growers (whose supply is inelastic), so too would cost reductions. But that is a fallacy. Just because price increases may be passed through to wool growers does not mean that cost savings will be. More likely they would be passed on to the merchants' overseas customers, who (as the Commission notes) have supply alternatives.

25 Moreover, the Commission itself seems to struggle to accept its own argument, as demonstrated by the wholly tentative nature of its assertion at paragraph 384:

> *Furthermore, competitive pressure generated by offshore scours* ***could*** *lead to* ***some*** *proportion of these cost reductions being passed onto merchants in the form of lower prices, if not immediately then* ***possibly*** *in the future. Given the structure of the wool sector,* ***much*** *of any such price increase* ***may*** *ultimately be passed onto farmers in the form of higher farm gate wool prices. (Emphasis added.)*

26 Assertion based on assumption as to possible future partial conduct is not a proper basis on which the Commission may confidently count millions of dollars of benefits that will immediately be passed offshore, as a benefit to the public of New Zealand.

27 Finally, even if the Commission believes the scouring prices will revert to competitive levels in its possible (undefined) future – in other words, even if the Commission thinks that the SLC will be short term, which it has not suggested *anywhere* in either the original or Second Draft Determination – that does not account for the benefits of the price rises that accrue to the foreign owners in the shorter term period. Given that the longer term period must be at least 5 to 10 years, with a 15% price increase from current levels (notwithstanding claimed cost decreases) the foreign shareholders will extract substantial rents, with no corresponding benefit. That should not be counted.

28 In summary, this whole notion is at odds with the Commission's conclusion that a SLC is likely; and as such, should be dismissed. Even if advanced as an alternative proposition, it is plainly not a full answer and the Commission cannot allocate all of the benefits in the way it has indicated it intends to.

Acquisition might save the local scouring market, which has benefits to New Zealand

29 At paragraph 391, the Commission suggests that the acquisition may improve the competitive effectiveness of the local scouring market *vis a vis* international scours, and consequently make it less likely that the domestic scouring market will collapse, and so it thereby retains the benefit to New Zealand of having this market here.

30 Godfrey Hirst rebuts this suggestion on two main grounds. First, as set out more fully in Professor Guthrie's report, this approach effectively equates the benefit to foreign shareholders (which is principally a function of their shareholding and will, therefore, change depending on the level of such shareholding) with an amorphous benefit to New Zealand from having a domestic scouring industry. But the two bear no relation to each other.

31 To equate them may be superficially attractive – but only because it avoids the Commission having to do the more difficult task of quantifying this benefit. And that is the problem with this approach. It masks what the true benefits are – which may be more or less than the amount of the benefit flowing to foreign shareholders.

32 That is contrary to the approach that the Courts have consistently mandated – namely, the Commission must seek to quantify benefits where possible and not rely on intuition. If the Commission does believe that there are benefits from an increased prospect that the local scouring industry will survive (and it is only the incremental increase in *chance* of survival that is to be valued, not the benefits of the industry itself), the Commission should specify a discrete value for that – and explain how it has reached that value. Failing that, the Commission should accept that such benefit is not quantifiable and acknowledge this. That unquantified benefit can then be dealt with at the appropriate stage of the enquiry, which is after all the quantifiable benefits and detriments have been identified and balanced.

33 Indeed, it is most likely the case that the benefits posited here would be unquantifiable. But even if they were not, as Professor Guthrie notes, this highlights a further problem with the Commission's approach. Not only does it equate two numbers that simply cannot be the same, but in so doing it attributes unnatural precision to the second figure. Because, assuming for the moment that the flow-on benefits that the Commission suggests might arise in the long-term were quantifiable, they are certainly not quantifiable with any degree of precision. It must be the case that there would be a range for them. This is obscured by the Commission's proposed approach.

34 The second argument is that, in any event, any perceived benefit from retaining the scouring industry must be counterbalanced by other possible outcomes, including detriments that attach to such outcomes.

34.1 By way of example, there is the real possibility that CWH will increase prices to domestic users to the extent that Godfrey Hirst is forced to exit the domestic carpet industry, leaving Cavalier Bremworth constrained only by imports. This would involve the loss of over 400 jobs and cause competitive harm to the domestic carpet industry. The retention of the scouring industry, and the benefits it brings, must be counterbalanced by the loss of a key part of the domestic carpet industry, and the benefits that brings.

34.2 Another example, is the potential for Lempriere to shut down the domestic scouring industry altogether – given its ultimate Chinese ownership, and claimed "comprehensive global footprint in all sectors of the wool market" Lempriere could exercise its option, take control of the merged entity, and shut down the industry, ending the benefits the Commission has posited, and moving all funds offshore. Alternatively, [ ].

Helps ensure continued efficient inbound foreign investment, which benefits New Zealand generally

35 At paragraph 392 (and paragraph 383), the Commission advances a policy argument: that the benefits that foreign investors extract from the acquisition and take offshore should be counted as a benefit to New Zealand – notwithstanding that they depart the country – because doing so will incentivise other foreign owners to continue to invest capital in New Zealand and such investments are generally good for New Zealand.

36 It is not clear whether the Commission is saying that the benefits that flow offshore from this merger can serve as a proxy for the benefits that New Zealand may derive from the additional investment in other industries that will be incentivised by this approach[2] or whether the Commission is disregarding the actual amounts involved and just making a policy choice.

37 But, either way, the flaw in this approach is – again – that there is *zero* relationship between the variable amount that flows offshore (based as it is on the level of foreign ownership) and the static amount of this perceived benefit, whatever that amount may be.

38 So, again, the proper approach is for the Commission not to sidestep this calculation by deeming it within the benefits from rationalisation, but to make a specific and defensible calculation of it, or to say that it is unquantifiable and to deal with it elsewhere.

39 In any event, however, as Professor Guthrie's report makes clear, when properly understood, the incentives align. There is no need for this additional incentive to ensure proper outcomes for New Zealand.

There may be incremental gains from the freed up resources

40 At paragraph 393, the Commission argues that an additional net surplus may be generated by use of the freed up resources, for example, that land that is no longer needed can be used by someone else and return more money to New Zealand.

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[2] Remembering, of course, that the value that matters here is only the value of any investments that would not otherwise have been made, but for this policy of including the benefits that flow out of New Zealand as being benefits that occur in New Zealand. The Commission would not be valuing investment in New Zealand generally.

41 But this proposition is contrary to the Commission's customary approach and, indeed, is contradicted by what the Commission says at paragraph 378 – and in particular footnote 232, where the Commission says: "the current value of an asset will reflect any potential future gains, even if those gains are yet to be realised."

42 But, even were one to accept that there might be some incremental gain, the Commission faces the same problem as noted above: it is attaching a false value to this benefit by equating it with the amount that goes to the foreign owners (which is, itself, subject to variation depending on the level of that ownership). The two bear no relation whatsoever to each other. Instead, the Commission needs to be transparent about what it is doing and either assign a value to this incremental gain – and show how it has calculated that value – or agree that it is unquantifiable benefit, and deal with it as such.

Gains already paid to previous shareholders

43 At paragraph 394, the Commission puts forward another untenable argument to support its approach. It says that it may be that some element of the cost savings might have been factored into the price that Lempriere paid to acquire the scours in 2011 – because both parties knew that a sale to CWH was possible – and so as that went to New Zealand persons it has already been captured by previous New Zealand shareholders.

44 Leaving aside that that is a very long bow to draw, this theory runs into some hard facts, which make it implausible. First, Lempriere told the OIO that it had no intention of disposing of NZWSI's scouring assets to CWH, notwithstanding its awareness of the previous conditional agreement. Given that, it is hard to see how Lempriere would agree to an increased price incorporating a value that it expressly stated it was not interested in.

45 Second, at the time of the Lempriere acquisition, NZWSI's conditional agreement with Cavalier had already fallen through – notwithstanding that the acquisition was authorised. So, there was plainly something about that original transaction that made it not a viable option for NZWSI. Thus, from its point of view, it is hard to see how it would attempt to agree a price incorporating a value that it was not seeking to obtain elsewhere.

Case law favours separate quantification

46 In addition to its policy arguments in favour of equating the direct benefits that flow out of New Zealand with the indirect benefits that may flow back to New Zealand, the Commission also suggests that the *AMPS-A* decision supports this approach.

47 Godfrey Hirst accepts that the High Court in the *AMPS-A* case rejected the proposition that "profits earned by overseas investment in this country are necessarily to be regarded as a drain on New Zealand."[3] It also accepts that the High Court went on to conclude that "improvements in international efficiency create gains from trade and investment which, from a long-run perspective, benefit the

[3] *Telecom v Commerce Commission* [1991] 4 TCLR 473 at 84. Note that the excerpt cited above is from the High Court decision, not the Court of Appeal, as the Commission's footnote 235 suggests. The Court of Appeal granted the appeal, but did not address this point specifically.

New Zealand public," and, for that reason, the Court rejected the Commission's approach of not counting the benefits to foreign shareholders.[4]

48 Where we respectfully differ from the High Court – and the Commission should too – is in its unstated assumption that the long run benefits from the gains in trade and investment it envisaged occurring can be equated with the amount of the benefit that flows off-shore, either as a matter of fact or as a matter of policy.

49 As set out above, the problem with this approach is that there is simply no relationship between the two figures. As Professor Guthrie says, they are both numbers and they are both positive, but that is about it.

50 The *AMPS-A* approach of assuming or deeming these figures to be the same has been implicitly overruled in numerous cases since then, including, most importantly, on appeal in the *AMPS-A* case itself, where Richardson J stated:[5]

> *[T]here is in my view a responsibility on a regulatory body to attempt so far as possible to quantify detriments and benefits rather than rely on a purely intuitive judgment to justify a conclusion that detriments in fact exceed quantified benefits.*

51 Essentially, in using the amount of the direct and immediate benefits from rationalisation that flow offshore as a proxy for the indirect and long-term benefits that may flow back to New Zealand, the Commission is avoiding its responsibility to attempt to quantify those indirect, long-term benefits.

52 The better approach is that adopted by the Commission and endorsed by the Court in the Air New Zealand/Qantas merger case.[6] There, the Commission was asked to consider the benefits that might flow from Air New Zealand's enhanced "global competitiveness". That is essentially the same type of benefit as the AMPS-A's court's "improvements in international efficiency". And, it is the same type of benefit as the Commission is positing here, namely "increased competitive effectiveness [. . . enabling] a merged firm to better compete against international rivals".

53 But rather than dealing with it in the manner that it proposes here, in the Air NZ/Qantas case, the Commission analysed that benefit separately, concluding that it was an unquantifiable benefit. This approach was accepted by the High Court.[7]

54 Indeed, as the Court went on to say:

> *Benefits should be quantified if possible but benefits which, by their nature, are incapable of quantification should still be taken into account.*

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[4] Ibid.

[5] *Telecom v Commerce Commission* [1992] 3 NZLR 429, at 447. See also, for example, *Godfrey Hirst v Commerce Commission* [2011] 9 NZBLC 103,369, at [53]

[6] *Air New Zealand v Commerce Commission (No. 6)* [2004] 11 TCLR 347.

[7] Ibid, at [411].

55 And that is precisely the point. The Commission must attempt to quantify these benefits. If it cannot, it can still consider them elsewhere. But what the Commission cannot do is gloss over its responsibility to attempt to quantify them by deeming or assuming that the amount going to foreign shareholders from rationalisation can be equated with these benefits. The case law is clear on that, and the Commission can, therefore, accept the principle of the AMPS-A case – that long-term flow-on benefits should be weighed in the overall balance – without following the flawed reasoning that they must be equated with a different kind of benefit altogether, which is out of step with compelling authority since then.

The extent of the wealth transfer

56 As noted above, and discussed in Professor Guthrie's report, one of the reasons why it is a mistake to equate the direct and immediate wealth transfer to foreign shareholders with the indirect and uncertain long-term flow-on effects, is because the percentage of ownership of the merged entity by foreign shareholders can change.

57 That point is particularly applicable here because of the Lempriere option. Although the effect of the Lempriere option is not discussed at all in the Second Draft Determination, Godfrey Hirst is aware that the Commission's view is that the option should be disregarded as it is conditional upon Commission clearance and thus does not give rise to an equitable interest.

58 Godfrey Hirst has already expressed its concerns about the manner in which the Commission engaged in the renegotiation of the option. It maintains that view, but does not repeat it here.

59 Godfrey Hirst has also previously expressed its view as to why the Commission should take into account the Lempriere option. That does bear re-iteration here, because of its relevance to the wealth transfer point. In short, Godfrey Hirst maintains that the "equitable interest" approach is irrelevant. What is important is whether there is a likelihood that the option will be exercised and clearance granted.

60 Plainly, the parties have negotiated a right for Lempriere to exercise the option. There must, therefore, be a likelihood it will be exercised. Although Lempriere has stated that
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61 In any event, as has been demonstrated by the fact that Lempriere is now looking to sell its scours despite telling the OIO that it had no intention of doing so, it is plainly the case that commercial circumstances can change in a relatively short time. They might well do so here.

62 Further, the Commission must accept that there is a realistic prospect of it giving clearance for the exercise of the option. An application seeking clearance to do so would be made in a factual where the Commission has *already* acquiesced in the acquisition of a 45% stake. In that case, to go from 45% to 72.5% would not ordinarily change the competition landscape to such an extent that clearance would

be declined. Certainly, the Commission cannot now say there is no real chance that it would approve the exercise of the Lempriere option.

63 All of that points to a realistic possibility – a real likelihood – that Lempriere will, shortly after the Acquisition is completed, extend its ownership [ ] and potentially exercise the Drag-along right. So, the Commission must consider those alternative factuals in its current analysis.

Loss of Allocative Efficiency

64 The most significant change in the Second Draft Determination is the Commission's assessment of much lower allocative efficiency loss – i.e. $2.19 to $15.03 million – as compared to $4.58 to $20.03 million in the original Draft Determination. The seeming reduction of loss by exactly $5 million at the "high detriment" end of the spectrum is what produces the Commission's estimated net benefit of $4.5 million. How that allocative efficiency figure reduces by $2.39 at the low end to $5 million at the high end thus requires the closest scrutiny.

Commission previously estimated a 20% price increase.

65 In the original Draft Determination the Commission considered that the constraints on price increases from threat of entry were similar but not as strong as in Decision 725. Consequently the Commission estimated allocative efficiency losses based on "a higher range of potential price increases of 10-20%" That use of the higher range of potential price increases was based on several factors. They were:

65.1 Segard Masurel (being the most likely new entrant) considered entry to be unlikely at a price increase below 10%;

65.2 Total wool clip and volume of wool scoured might continue to decrease making potential entry more difficult;

65.3 Growing substitution of wool products for synthetics, particularly by domestic carpet manufacturers would also be a greater deterrent to entry;

65.4 Threat of increased greasy exports or entry into wool scouring are likely to provide a constraint on CWH increasing prices by more than 20%;

65.5 Modelling provided by NERA as adjusted by the Commission suggested that entry would be profitable with a price increase of 20%;

65.6 James Irvine suggested that a 20% price increase would be sufficient to make entry profitable; and

65.7 A price increase of more than 20% was unlikely because at this level price merchants could switch to exporting more greasy wool.

66 The Commission noted that it also "estimated" the profit maximising prices for the various demand elasticities ranging from -0.05 to -1. This was undertaken to provide a "sense check" of the Commission's presumed 10 to 20% price increase in the factual. Those factors all showed profit maximising prices would be in the region of 20%.

67 Under the sub-heading *Price Discrimination* the Commission noted that CWH may be able to raise the effective price for scouring wool for "captive wool" to be considerably more than 20% whilst leaving the scouring price for wool to be exported to China, for example, relatively unchanged. The Commission opined that "this could materially impact the magnitude of allocative efficiency losses".

68 At paragraph 277 (of the original Draft Determination) the Commission stated as follows:

> *The Commission's preliminary view is that CWH would face constraints on its pricing that are likely to limit its ability to raise prices above 20%. These include the ability of merchants to export a greater amount of wool in greasy form and the possibility of new entry.*

69 The Commission then proceeded to estimate allocative efficiency losses for a range of demand elasticities. Its Table 4 showed estimated allocative efficiency losses for scouring with price increases of 10%, 15% and 20% respectively.

70 Godfrey Hirst in its submission of 21 April 2015 on the original Draft Determination submitted that confining the prospect of a price increase to 20% was "too modest", being based on speculation that at this level (i.e. 20%) merchants could switch to exporting more greasy wool. Godfrey Hirst suggested that a range up to 25% was at least as plausible.

The customer dimension

71 The Commission departs radically from its previous position in the Second Draft Determination. Significantly, the Commission introduces a "customer dimension" to its market definition, differentiating between international wool users (who are located offshore and comprise the majority of downstream wool buyers) and domestic wool users who are located within New Zealand. The Commission reasons that international buyers are able to source suitable quality clean wool or greasy wool from a number of countries outside of New Zealand and thus domestic wool merchants are constrained in their ability to raise prices to these buyers "above an export parity price level".

72 The Commission regards the ability of merchants to switch towards greater exports of greasy wool as the primary constraint, as CWH would be able to increase prices by up to 20% before threat of entry is likely to provide a competitive restraint.

73 Unlike international wool users, domestic wool users would incur material additional costs if they had to import clean wool into New Zealand. Importing clean wool would also raise concerns about quality control as well as reliability of supply and timeliness of deliveries. Thus, the Commission reasons that, to the extent that wool scouring costs are passed on by wool merchants to downstream wool users, a monopolist domestic wool scour would likely be able to charge higher scouring charges for wool destined for domestic use than wool destined for export.

74 The Commission concludes that there are separate markets for wool scouring services for wool destined for export and for wool scouring services for wool

destined for domestic use. At paragraph 290 the Commission considers that CWH would have the ability to discriminate against domestic wool users.

75 That introduction of a customer dimension focussing on the merged entity's ability to discriminate against domestic wool users seems prima facie consistent with the approach described in paragraph 3.40 of the Commission's *Mergers and Acquisition's Guidelines*, where the Commission explains that it will examine the ability of suppliers to discriminate between customers because their competitive alternatives vary. Here, domestic users cannot have recourse to greasy exports, being the primary constraint which the Commission perceives operating CWH.

76 Godfrey Hirst submits, however, that the Commission has erred in separating these two markets in at least the following respects:

76.1 It has misconstrued the evidence regarding possible price increases and so has limited them to 15% when in fact they could be much more.

76.2 It has failed to properly consider the position of domestic users other than Godfrey Hirst.

Price increases are not limited to 15%

77 The principal basis for the Commission's conclusion that it should cap possible price rises at 15% (rather than 20% as in the original Draft Determination) is interviews it has conducted with merchants about their views of what price rises the merged entity might contemplate and what they and their competitors might do in response.

78 The first point to acknowledge is, of course, that these are mere predictions of market participants, guessing at what a supplier might do, without any clear understanding of the future cost structure of that supplier, its ownership (which could change), or how it might seek to run its business. And guessing at what their competitors might do, again without true insight into their underlying costs and incentives. There must, therefore, be a considerable degree of uncertainty in these predictions, which should be addressed by the adoption of a relatively conservative approach, and the possible application of ranges.

79 A further consideration is that there is no basis on which to believe that one prediction is better than another, simply because one merchant has a slightly larger market share than another. Thus, to the extent that the Commission appears to favour the guesstimates of one or two larger merchants over those of slightly less large merchants, it would need to justify that preference on some more tangible basis.

80 The second point is that the Commission appears to have misunderstood, and thus mischaracterised, what the merchants actually said to it. And this has led it into error. We explain this in detail below.

81 As well as NZSWI, the Commission spoke with 12 other buyers of scouring services in New Zealand. It discussed the position with respect to the [ ]to [ ] largest in the Second Draft Determination, as well as some smaller merchants.

82 [ ], the [ ] reportedly said in its interview of [ ]. Although the Second Draft Determination recites that [ ] of [ ] was unwilling to speculate as to the likely magnitude of any increase in prices, it does record that he expected any price rise would be more likely to be a gradual series of incremental adjustments over time.

83 But what the Revised Draft Determination omits to take into account on this point is that [ ] said on the several other occasions [ ] was interviewed by the Commission. In his interview of [ ] said that [ ].

84 In [ ] subsequent interview of [ ] does not recant from [ ] previous view that a [ ]

85 [ ]

86 The [ ] largest buyer of scouring services, [ ], is reported in the Second Draft Determination to have said that a price increase of 15% would be unlikely because merchants would likely switch to more greasy imports. More specifically, [ ] is reported at paragraph 262 to have said:

> *[ ]*

87 But nowhere in either of the two file notes of the interviews with [ ] does [ ].

88 In the file note of [ ] first interview of [ ] states at paragraph 9:

"[ ]"

89 In the following paragraph he indicates that [ ]. The Commission omits this important evidence from its discussion entirely.

90 Then in the file note of his subsequent interview on [ ]. Neither of those amounts fits under a 15% cap.

91 [ ] went on to say at paragraph 14 that:

"[ ]"

92 [ ].

93 In relation to the [ ] largest user of scouring services, [ ], the Commission records that [ ] of that company did not think that CWH could increase prices by more than 15%, because of the threat of a move to greasy exports. We take that statement at face value, noting that we have not been provided with any additional information regarding that interview.

94 In relation to the [ ] largest user of scouring services, [ ], the Draft Determination does not contain a report of this merchant's views on the size of any potential price increase. All that it reports is that this merchant currently has a [ ] part of its business with China and that if CWH were to increase prices, they would consider other scouring options such as scouring more wool in China or Malaysia, [ ].

95 In fact, scrutiny of the file note of interview with [ ] reveals that their major concern is not [ ] The file note says at paragraph 5 that:

"[ ]"

96 In relation to [ ], the [ ] largest wool merchant, the Commission records [ ] of that company as saying that the threat of greasy exports or entry would limit any price increase to 10% at the highest. [ ].

97 Plainly, those figures cannot be reconciled. While one could argue that the specific example, based off real figures, is the more reliable, the point is that this is another case where the Commission has omitted to note relevant information, which paints a different – indeed, contrary – position to that it has taken on the 15% price cap.

98 In relation to [ ], the [ ] largest wool merchant, the Commission records [ ] of that company stating that if scouring prices were increased by 20% only a small proportion of scouring would be lost. Again, we take that at face value, not having any further information on which to review it.

99 Finally, in relation to [ ], the [ ] largest wool merchant, the draft determination shows that [ ] said that he thought he could "deal with about a 25% rise before he would start to pull his operations back".

100 In passing, we note that the Revised Draft Determination summarises [ ] and [ ] as opining that the threat of greasy exports "would not necessarily constrain price increases to less than 15%". That is an odd way of wording it, when both those merchants were clear that it would take more than 20% before any effects would be felt.

101 In summary, therefore, the true position of the merchants appears to be as follows:

Merchant	**Position**
[ ]	Not clear view, [ ]
[ ]	[ ]
[ ]	Not more than 15%.
[ ]	Not stated.
[ ]	[ ]
[ ]	Even if prices went up by 20%, only a small proportion of scouring would be lost.
[ ]	It could probably deal with a 25% increase before it started to reduce reliance on domestic scouring.

102 What is apparent from this discussion and this summary table is that there is no certain position on price increases across the merchants. [ ]

103 What is certain is that the Commission needs to take this doubt into account in assessing the appropriate range of possible price increases. It should do that, Godfrey Hirst submits, by applying a range to these estimates. Godfrey Hirst says that range should go higher than that originally contemplated by the Commission (10-20%), but at the very least, the range must go at least up to 20%. That is what the evidence demonstrates.

104 It is also what Professor Guthrie concludes. In his Economist's Report he also scrutinises the merchants' interviews so far available to Godfrey Hirst's advisers. His conclusion is that any careful, objective analysis of those interviews is that the Commission's view that [ ]

105 Their evidence is entirely consistent with Godfrey Hirst's submission on the original Draft Determination.

Cavalier Bremworth is not protected from increases

106 In addition to understating the likely price increase sustained by those customers it considers fall within the export market, the Commission also understates the number of customers who would experience the much larger price increases it accepts would arise in its newly defined domestic user market.

107 First, the Commission dismisses the prospect of price discrimination against the other large domestic wool user, Cavalier Bremworth. It does so by introducing a new constraint on the merged entity, namely contractual constraint.

108 While the Commission recognises that Cavalier Bremworth [ ] the Commission (at paragraph 291) "considers it unlikely that Cavalier would proceed with the merger if its related downstream carpet manufacturing business, Cavalier Bremworth, was at any risk of substantial increases in scouring prices that were in excess of any general price increase to merchants (i.e. more than 15%)".

109 Superficially attractive as it may be to make, the assumption that Cavalier Bremworth will be protected by a [ ] with the merged entity is wholly without foundation, [ ]. Further, the suggestion that any increase for Cavalier Bremworth would somehow be linked to the increase for international wool users is mere speculation.

110 The Commission assumes that Cavalier could insist on a scouring agreement that would protect Cavalier Bremworth despite the fact that [ ]"

111 But the reality is that such an arrangement would be [ ].

112 Further, the lack of provision [ ].

113 [ ].

114 [ ].

115 [ ].

116 Further, were there to be such a scouring agreement which favoured Cavalier Bremworth with a much lower rate than that available to all other domestic users agreed by CWH to protect it's "related downstream carpet manufactory business" as the Commission suggests, such an arrangement – and the parties to it – would be at serious risk of legal challenge under section 27 and 36 of the Commerce Act. The Commission would no doubt look very carefully at any pricing intended to impose a downstream price squeeze on a rival – or pricing which has that effect.

117 The only other domestic user of wool, [ ], is seen by the Commission as unlikely to face increases of more than 15% too, because of its own vulnerable financial position. The Commission sees CWH as supposedly incentivised to preserve a [ ] customer rather than increase scouring prices and losing that customer altogether.

118 Again, that assumption is without a foundation
[
]

119 Thus, the Commission's conclusion that the prospect of price discrimination for scouring of wool for domestic use applies only to Godfrey Hirst – which no longer has the protection of its own scouring agreement – and only to Godfrey Hirst's current reduced volume of [ ] tonnes per year – is not valid.

120 The Commission recognises that Godfrey Hirst could face a price increase of as much as 25% over current levels. But so too, would Cavalier Bremworth, [ ] and any other current or future domestic wool user who
[ ].

[ ]

121 The merchants' other concern - [ ]
[ ].

122 [
].

123 [
]

124 [
]

125 [
]:

125.1 [

125.2

125.3

125.4

]

126 [

]

127 That contrast

[

].

Loss of Productive Efficiency

128 The Commission's approach to segregate scouring services for wool destined for export from wool destined for domestic use has substantial consequences in its estimating allocative efficiency loss. Put simply, wool for export is seen as being protected from price increases above 15% (i.e. by threat of increased greasy exports) while wool for the major domestic user unprotected by contract (being Godfrey Hirst) is subject to price increases of 25%. Thus, the merged entity is less constrained in its pricing to Godfrey Hirst by the reduced threat of losing that custom.

129 To be consistent, the Commission should also apply that same segregated approach to its assessment of loss of productive efficiency. In the Second Draft Determination the Commission records that it has "obtained extensive information from Cavalier regarding the comprehensive coverage of incentive schemes and detailed performance and environmental monitoring". While there is also acceptance by the Commission that "a firm's management, without the day-to-day pressures from a close competitor and the competitive benchmark against which the firm's management can be measured, may become less productively efficient", the Commission nevertheless considers any loss of productive efficiency "to be minimal". Its resulting range for productive efficiency losses is unchanged from the original Draft Determination.

130 But, if Cavalier is able to be less cautious with regard to its pricing of scouring services to domestic users, it can be equally casual with regard to the quality of the service it provides to domestic users. There is no reason that CWH's management or indeed shareholders, who face no local competitor, would strive to maintain quality performance for domestic users who have no alternative. That compromise of quality of service to domestic users will be especially manifest at times when there are competing demands for the scour's capacity. The fact that the largest domestic user of its services is also a downstream competitor of a related company, Cavalier Bremworth, will do nothing to drive productive efficiency. Productive slackness is more likely to be tolerated where the burden of that slackness falls on a downstream rival.

131 Put simply, to be consistent with its treatment of allocative efficiency loss, the Commission must have regard to the potential for greater productivity loss in relation to domestic users.

Loss of Dynamic Efficiency

Separate consideration for different customers

132 Just as the Commission has estimated differing consequences for loss of allocative efficiency based on its segregation of wool destined for export and wool used domestically, the Commission must apply separate consideration to the potential loss of dynamic efficiency. If CWH can discriminate against domestic users on price, then it follows that it has less incentive to undertake technological or process gains that will benefit such users; instead any gains it did seek to develop would be directed at the export users.

133 Although it would be tempting simply to assume that any innovations for one group of customers must inure to the benefit of all customers – so loss of innovation will be equally borne - this is not the case. The current major category of domestic scoured wool users, being carpet manufacturers, have very particular specifications for their scouring requirements. Those specifications may lend themselves to particular process improvements that will be irrelevant to other customers. Similarly, other users and potential users of wool are likely to have their own unique scouring requirements. That is particularly so, for new end products currently being developed.

134 There is, therefore, an increased likelihood of dynamic efficiency loss because of the ability of the merged entity to ignore the needs of certain customers.

New wool products will require scouring innovation

135 In the Second Draft Determination the Commission persists with its belief that dynamic efficiency losses are likely to be limited. That belief in part is based on its premise that "most of the innovation [in relation to wool scouring] tends to relate to improvements on existing processes, rather than radically new products and processes. Given the relatively mature state of the technologies involved in wool scouring, any such innovations are likely to be incremental in nature".

136 That may be true in relation to wool being scoured for export. But, the Commission cannot assume that the same is – or will be – true for wool destined for domestic use. Contrary to the Commission's view that the market for wool destined for domestic use is limited to Godfrey Hirst, Cavalier Bremworth [ ], there are potentially a number of new domestic users of wool who will manufacture products other than yarn and carpets. According to Wool Industry Research Limited, much work is currently being done to develop and encourage investment in new and dynamic solutions for unutilised coarse wool that will "get wool off the floor".

137 Those new products will require a similarly innovative approach to scouring that goes beyond tinkering with existing processes. Radical new products to be made from coarse wool will require equally radical change in scouring processes.

138 We spoke with Ian Cuthbertson, Manager of Wool Industry Research Limited, which is a subsidiary of Wool Research Organisation of NZ Inc. (WRONZ). Wool Industry Research Limited was formed as a research consortium. The Wool Industry Research Consortium is involved with funding research to the benefit of the wool industry in the long term.

139 The WRONZ board is focusing on new and dynamic solutions for underutilised coarse wool. In 2011, Wool Research Limited contracted New York-based, Fahrenheit 212 to investigate new market uses for wool. Fahrenheit 212 matched coarse wool research products with potential market applications, and came up with the following four areas of application:

139.1 Beauty care/cosmetic;

139.2 Active apparel;

139.3 Bedding; and

139.4 Infant care.

A brief report from Fahrenheit's website on its work on New Zealand wool is attached as Appendix B to this submission.

140 Mr Cuthbertson was unable to specify details of these potential applications due to the highly confidential nature of the projects. However, he could confirm that two of the applications, cosmetic and bedding applications, were due for completion soon.

141 Although the other two applications were yet to be picked up by developers Mr Cuthbertson was especially confident regarding the infant care application. The natural properties of wool mean that it is a natural flame retardant and is extremely breathable.

142 The ingredients will be new intermediate products – these could be fibre or non-fibre. It may be used in a non-woven form and put into a foam, film or powder. The key, Mr Cuthbertson said, is to get past the staple length and break the fibre down and use it in another way. He talked about putting it into a composite plastic where it could be used for its flame retardant properties. There are thousands of proteins in wool which can be grouped for their uses into a small number of broad types. The keratin protein is the same protein humans have in skin, hair and fingernails, making it a material that is ideally suited for product development in the high-value cosmetic uses.

143 Mr Cuthbertson believes that the resulting end products could eventually encompass all of the current wool clip. He provided the following paragraphs of the WRONZ Annual Report, which highlight the work that is being carried out to develop innovative products using New Zealand coarse wool.

Company Specific Projects

A contracted condition of the company specific projects is that the detail and nature of the investments are held confidential by all parties until there is agreement from the Project Sponsor that it can be made public.

Hence in this Annual Report, it is not possible to divulge detail on all of the projects worked on within this financial year. A high level summary of the areas of work follows:

Apparel

Projects co-funded by industry relevant to the apparel area specifically generally have fallen into the area where the health and wellness of wool containing products is optimised and objectively determined thereby creating materials for the related marketing functions to use in their marketing collateral development. This supplements the more generic industry good work already completed around the environmental performance of wool products. In addition support has been provided towards the successful development of new yarn styles and fabrics targeting the high end for wool apparel.

Interior Textiles

Projects co-funded by industry span new and novel opportunities in bedding and floor coverings. The focus is on developing functionality in the products which will meet the current consumer product performance preferences. These projects are supported also by the development of technology for the production of new bright white and coloured shades, as well as more generic industry good work in carpets addressing the long term challenges around photo stability, colourfastness and abrasion resistance.

New Uses

The main focus for funding over the period has been in the support of novel products for wool for use in high value non-traditional uses for wool. Highly functioning wool based filtration media are being successfully developed for a range of high yielding new applications for wool. Promising research into ways of using wool fibre in composites has been undertaken with promising results to date. Significant investment has also been made into researching ways of utilising crossbred wool in high value, large volume value chains where its negative characteristics - particularly harsh handle due to coarse diameter - are not an issue.

144 The WRONZ website has a summary of projects funded by Wool Research, these include ongoing research into:

144.1 Niche Applications – Foot Covering & Foot Health;

144.2 Heat & Moisture Transport in Lofty Bedding Products;

144.3 Defining Wool's Air Cleaning Abilities; and

144.4 Understanding Wool Protein Crosslinking Networks.

145 Texus Fibre was formed in 2011 to create a new generation of functional materials manufactured from wool. Wool Industry Research Limited has been a research partner and funder for Texus since 2012. Since then Texus has embarked on a focused development program resulting in the production of natural, compostable air filter materials, now being exported to the world. Further, the Texus Fibre website states that "the research and development program continues to develop new ingredient branded materials made from wool, which will be used by manufacturers globally in applications as diverse as footwear, insulation, filtration and medical products."

146 In summary, it is clear that innovative new products for coarse wool will be increasingly available to domestic users of that wool. They will require equally innovative scouring services; the loss of which needs to be separately estimated by the Commission.

Counterfactual

147 The Second Draft Determination records Godfrey Hirst's previous submission (as mostly set out in detail in the section headed "Counterfactual" in Godfrey Hirst's submission of 10 August 2015) that, in the scenario without the Acquisition, Cavalier would be likely to discontinue its scouring operations at the Clive site. It reports Godfrey Hirst's previous estimation that Clive is presently scouring around [ ]% of wool currently processed in the North Island, and consequent assertion that closing Clive would have a negligible effect on the total amount of wool scoured in the North Island by Cavalier.

148 In fact, Godfrey Hirst's previous estimation of Clive's output was based on the number of days Clive was said in the Application to have operated annually. [Subsequent information recently provided on behalf of the Applicant shows [ ].

149 The Commission also refers to the [ ] from [ ] recording discussion of the [

].

150 [

].

151 But none of that attempted explanation by Cavalier is consistent with more recent events. The first point to note here is that the directors of Cavalier Corporation itself have changed and, changed substantially, in the two years that have passed since the time of that [ ]. Further, Cavalier Corporation's own financial performance has substantially deteriorated, as is outlined in detail in Godfrey Hirst's submission of 10 August 2015. Specifically, Deloitte had been brought in to prepare "an updated strategy and business plan" for Cavalier's survival. That new strategy has already resulted in substantial downsizing to "decrease debt levels" and "streamline the business". In particular, the sale of other major assets of Cavalier Corporation already has been announced.

152 So, any claim as to the [ ], must be treated with caution.

153 The Commission's own view, supposedly based on information provided by Cavalier, is that "absent the merger Cavalier would retain its scouring plant in Clive and continue to run it in peak periods. Furthermore, even if Cavalier's North Island volumes were to fall to a point where Clive was no longer required for peak periods, retaining it would still provide an option of value to Cavalier. This is because of the potential for usage, either because of planned maintenance or emergency outages at Awatoto or if scouring volumes were to recover."

154 To take the last point first, the Commission has nowhere else in the Second Draft Determination contemplated that scouring volumes are likely "to recover". On the contrary, the Commission's own analysis in the section of the Second Draft Determination entitled "Reduction in the total wool clip and volumes of wool scoured" (being paragraphs 66 to 72 inclusive) demonstrates the decreasing wool clip and reducing volumes of wool scoured, particularly in the North Island. Nowhere in that analysis is it suggested that scouring volumes are likely to increase.

155 More generally, however, the Commission in preparing the Second Draft Determination was yet to consider the additional information relating to Clive provided to the Commission by Bell Gully on 29 September 2015. That new information shows that Clive [ ].

156 [ ].

157 But, that claim is made without any substantiation. More seriously that claim is directly contradicted by the [ ].

158 [ ]

159 [ ], the next best indicator of Clive's likely future use is its recent past use. [ ].

160 That is a lot of money for a company that is in Cavalier's dire situation to retain the nebulous "option of value" which the Commission perceives. That is especially so when measured against the $[ ] that the Commission has accepted could be recovered from the sale of the Clive site, together with additional return from the sale of the surplus plant at Clive.

161 Turning now to the claimed need to retain Clive for [ ] equivalent [ ] provision is deemed necessary by CWH in respect of its South Island operations; or indeed by NZSWI in respect of either its North Island or South Island operations. Presumably, CWH manages to make alternative arrangements for any maintenance required at Timaru; and has a contingency plan for any emergency outage there. Why CWH could not make similar provision for Awatoto is not explained.

162 [ ].

163 Presumably too, CWH has the same need for "[ ]" at Timaru as it does for Awatoto; with merchants who scour at Timaru being as prone to disappointment as their North Island counterparts if their scouring is delayed.

164 If there really is a compelling need to [ ], that could be achieved by expanding the facility, as [ ]. Presumably the redundant scour line for Clive could be more easily relocated there than the larger scour line proposed in the factual to be relocated from Whakatu.

165 In short, the notion that a company in Cavalier's situation would retain a very expensive "option" which in fact produces negative value, for a very remote contingency, when there is a cheaper alternative and it makes no equivalent provision for its South Island operations, defies both logic and commercial common sense.

166 The Commission's *Mergers and Acquisition Guidelines* state that in assessing what is likely to occur without the merger the Commission makes "a pragmatic and commercial assessment of what is likely to occur". The G*uidelines* also state that

"as a practical matter, the Commission usually focusses analysis on the likely merger scenario we consider the most competitive". Further, the *Guidelines* refer to the Court's determination that a counterfactual scenario can be likely even when the chances of it occurring are less than 50% and, thus there may be multiple scenarios.

167 On the basis of its own *Guidelines*, the Commission cannot dismiss the real possibility that Clive would be closed by CWH (or, more accurately, remain closed to scouring) if the merger with NZSWI does not proceed. Even two years ago [ ]. Nothing has happened since then to make the decision to close Clive *less* likely. Indeed, the things that have changed – in particular, Cavalier Corporation's deteriorating financial position and its need to reduce debt (not addressed by the Commission in the Second Draft Determination) coupled with the declining wool clip – make the decision to close Clive *more* likely.

168 For the Commission to divine that Cavalier would rationally retain Clive as an "option of value" in the face of the updated information the Commission now has, would be to ignore the commercial realities relating to Clive and the pragmatic need for Cavalier urgently to get its financial house in a better order.

169 Professor Guthrie has updated his previous analysis of closing Clive and Kaputone, having regard to the valuations accepted by the Commission in the Second Draft Determination and the information relating to Clive provided on 29 August by Bell Gully. His updated calculation shows that total claimed benefits of $[ ] are attributed to closure of Clive and resulting sales and savings. In the counterfactual scenario that Clive would close without the merger, the Commission's net benefit figure must reduce by that amount.

Other Benefits

[ ]

170 Godfrey Hirst repeats the submissions it has made regarding the need for and the expenditure on the [ ].

171 While the Commission has largely rejected those submissions in its analysis in the Second Draft Determination, what is missing from that analysis is any basis for the Commission's acceptance of the claim that [ ]. (Nor is there any basis for the claim in the scant materials that NZWSI has supplied.)

172 Some context may assist: this proposed $[ ] of expenditure was not included in the Application, nor was it brought to light until six months after the Application was filed. It has not been supported by any contemporaneous documentation other than [ ] [ ]. Certainly, the Commission has not been provided with:

172.1 Board reports discussing the issue;

172.2 Additional [ ] reports outlining options;

172.3 Quotations from competing suppliers; and

172.4 Contemporaneous budget forecasts providing for the expenditure.

173 In these circumstances, a degree of real scepticism is called for.

174 But even if – after applying that real scepticism – the Commission were minded to accept the need for [ ], it still must satisfy itself [ ] is required.

175 Because, as set out in Godfrey Hirst's Post-Conference Submission, there are (or, at least very recently were) [ ] Given that capital expenditure at [ ] is apparently [ ], the Commission really does need to satisfy itself that the *only* course available to Lempriere is to [ ], to service an industry that it has itself been at pains to say is subject to a reducing wool clip.

176 Put another way, can the Commission truly be satisfied that there is no real prospect of Lempriere taking [ ] [ ]

177 Godfrey Hirst says that at the very least, the Commission should apply a range to this expenditure, to acknowledge what it says is the real possibility that [ ] would be acquired.

[ ]

178 Godfrey Hirst repeats its previous submissions (as set out in its Post-Conference Submission and elsewhere) about the [ ]. While the Commission has largely disregarded those submissions in its analysis in the Second Draft Determination, there is one point that requires further examination – namely, the price for the [ ].

179 This issue arose from the report of the Commission's independent experts, [ ]. In particular, the file note of discussions between the Lempriere executives and [ ] personnel [ ].

180 [ ].

181 [ ] [ ].

182 Nevertheless, at paragraph 466 of the Second Draft Determination, the Commission states:

> *[*
>
> *].*

183 But this is incorrect.
[

].

184 Thus, if the Commission determines to make an allowance for the [ ] expenditure on the [ ], it should discount the estimate price by at least [

]

Appropriate Framework for Analysis

185 If the Commission accepts Godfrey Hirst's submissions on some only of the key points made above, it is plausible to contemplate an outcome where the Commission's assessment of the balance of benefits and detriments could result in a range of possible values that spans both negative and positive values.

186 In our view, in that situation, the Commission should decline to grant authorisation.

187 Bell Gully have, however, submitted otherwise. In Part C of Bell Gully's submission dated 10 August 2015, Bell Gully argued that, in this situation, the Commission should grant authorisation if at least 50% of the range is distributed to the positive (i.e. if the midpoint of the range is a value greater than zero).

188 In support of that submission, Bell Gully says:

188.1 in the absence of any evidence to the contrary, the Commission should assume that the probability of any point estimate in the range being the actual net benefit is uniformly distributed across the range;

188.2 judicial interpretation of the term "likely" as it is used in section 66 of the Commerce Act (clearances) means that the Commission need be satisfied only that the greater part of the range reflects positive values; and

188.3 that this approach is in line with public policy.

189 Bell Gully illustrates their approach with an "extreme" example in which the lower bound of the range estimate is at -$2 million and the upper bound at $20 million. In those circumstances Bell Gully says the Commission should authorise the acquisition

because the probability that the actual net benefit is positive exceeds the probability that it is negative.

190 In our view, Bell Gully's proposed approach to decision-making in conditions of uncertainty:

190.1 does not follow from existing judicial interpretation of the Commerce Act; and

190.2 is inconsistent with the policy underpinning the Commerce Act.

Judicial interpretation of the Commerce Act

191 Bell Gully principally relies on the Court of Appeal's approach to the section 66 clearance test in *Commerce Commission v Woolworths*.[8] There, the Court referred to the 1991 changes in the language of section 66 and concluded from that that the High Court had erred when it concluded that the clearance assessment was a binary one. The Court of Appeal held that the Commission is entitled to conclude, on an application for clearance, that it is "in doubt" as to whether or not the acquisition will have the proscribed effect, and therefore decline the application. The Court said further that the existence of "doubt" corresponds to a failure to exclude a "real chance" of the proscribed effect occurring.

192 Bell Gully notes that no equivalent change was made to the statutory language of section 67, and from that it concludes that this "higher threshold" was not intended to apply in the authorisation context.

193 However, Bell Gully has overstated the implications of the Court of Appeal's conclusions. All that the Court ultimately held in *Woolworths* was that the High Court's "binary approach" implied that if the Commission was *not satisfied* that a proscribed effect was *likely* then the Commission would necessarily be *satisfied* that a proscribed effect was *not likely*.[9] That approach was not consistent with the statutory wording, and also left no room for what the Court of Appeal in *Southern Cross* characterised as the third possibility: "doubt as to whether the acquisition would result in a proscribed effect".[10] The Court of Appeal confirmed that in cases of doubt, the Commission could not be "satisfied" and would therefore have to decline clearance.[11]

194 This 'third possibility' of doubt, which the Court of Appeal affirmed in *Woolworth*, is derived from the need for the Commission to be "satisfied" as to the likelihood of the proscribed effect not occurring. Equally in section 67, the Commission must be "satisfied" that the acquisition will result, or be likely to result, in such a benefit to the public that it should be permitted. There is no difference in the statutory wording between section 66 and 67 in relation to the key requirement for the Commission to be, in either case, "satisfied" before it reaches its decision.

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[8] [2008] NZCA 276.

[9] At paragraphs [103] to [106].

[10] *Commerce Commission v Southern Cross Medical Care Society* [2001] 10 TCLR 269 at paragraph [65]. Affirmed in *Brambles New Zealand Limited v Commerce Commission* [2003] 10 TCLR 868 at paragraph [55].

[11] At paragraph [98].

Accordingly, in the context of the section 67 authorisation assessment, the Commission must:

194.1 grant authorisation if it is satisfied that the benefits of the acquisition will exceed its detriments; or

194.2 decline authorisation if it is in doubt as to whether the benefits of the acquisition will exceed its detriments, where "doubt" corresponds to a failure to exclude a real chance of the detriments exceeding the benefits.

195 In the case where the range estimate derived by the Commission from its assessment of the relevant variables spans both negative and positive values, the question therefore is whether the Commission can be satisfied that the actual net benefit falls on the positive side of the range, which in turn means the Commission must exclude a real chance that the actual net benefit falls on the negative side of the range.

196 Bell Gully has sought to characterise this issue in terms of the High Court's discussion in *Woolworths* of the term "likely". Bell Gully suggests that the fact that the High Court defined "likely" in the clearance context as reflecting a "real chance" or a "real and substantial risk" but lower than "more probable than not" means that all the Commission need do in the authorisation context is satisfy itself that there is a real chance that the benefits of the acquisition outweigh the detriments.

197 Perhaps recognising the absurdity, from a policy perspective, of suggesting that authorisation is available in circumstances where the Commission has found that it is *more likely than not* that the acquisition will result in net public *detriment*, Bell Gully has suggested that instead the Commission should read "likely" in the authorisation context as referring to a 50% probability. However, there is no reason to conclude that the High Court's reading of the word "likely" in the clearance context as referring to a "real chance" means that the same word should be read as "more likely than not" in the authorisation context. The more natural conclusion is that there is no direct read-across from the use of the word "likely" in section 66 to its use in section 67. Albeit the same word is used, as Justice Mallon noted in *Godfrey Hirst*, "it is not necessary to rationalise why the legislature has used slightly different wording in the authorisation provisions".[12]

Policy underpinnings of the Commerce Act

198 Instead, the Commission should focus on the policy rationale that underpins the New Zealand merger control regime, and the reasons why a conservative approach should apply to the grant of both clearances and authorisations.

199 Because the assessment of mergers is necessarily forward-looking, the Commission is always required to make decisions under conditions of uncertainty. As a result, when assessing whether clearance or authorisation is appropriate, there is an inevitable risk of:

[12] At paragraph [90].

199.1 false positives (granting clearance in circumstances where the acquisition will lessen competition, or granting authorisation when in fact the detriments outweigh the benefits); and

199.2 false negatives (declining clearance in circumstances where the acquisition will *not* lessen competition, or declining authorisation when in fact the benefits outweigh the detriments).

200 The problem of uncertainty in decision-making is particularly acute if the risks associated with false positives and false negatives are symmetric – i.e. if a false negative give rise to the same level of disutility as a false positive. Where the risks of error are symmetric, the decision-maker cannot 'err on the side of caution' by favouring one type of error over the other. Bell Gully's argument regarding the public policy implications of their preferred approach[13] essentially rests on the premise that the risks of error in the authorisation context are symmetric.

201 However, the merger control regime in the Commerce Act does *not* treat the risk of false positives and false negatives as symmetric. Rather, the Commerce Act demonstrates a clear preference for false negatives by requiring the Commission, before it grants clearance, to exclude a real and substantial chance that the acquisition will substantially lessen competition. Essentially, the Commerce Act expresses a policy preference for un-concentrated markets with higher levels of competition, and is prepared to sacrifice potentially efficiency-enhancing mergers if the risk that they will substantially lessen competition is "real and substantial" even though not more likely than not.

202 There is no reason to think that a different approach would apply in the authorisation context. On the contrary, the Commission should be more cautious in granting authorisation because, if authorisation is in issue, by definition the acquisition lessens competition and therefore has already been found to contravene the central policy objective of the Commerce Act. Conversely, there is no reason to think the Parliament intended the Commission to proceed cautiously when granting clearances, but throw caution to the wind when granting authorisations.

203 The requirement to exclude a real chance of a proscribed effect, mandated by the Commerce Act, is sound policy because, while a decision to decline clearance or authorisation can always be revisited at a later date at relatively low cost, a decision to allow an acquisition to proceed cannot subsequently be undone. Accordingly, if a decision to decline is later shown to have been incorrect, the costs to society of rectifying that error are much lower than the costs of rectifying an erroneous decision to allow the merger to proceed. For that reason, the socially optimal policy in relation to authorisations is to require applicants to exclude a real chance that the detriments outweigh the benefits.

204 The dangers of Bell Gully's proposed approach can be demonstrated by exploring its consequences for variations of the 'extreme' case that it poses in its submissions.[14] Bell Gully argues that, in its example in which the lower bound of the range estimate

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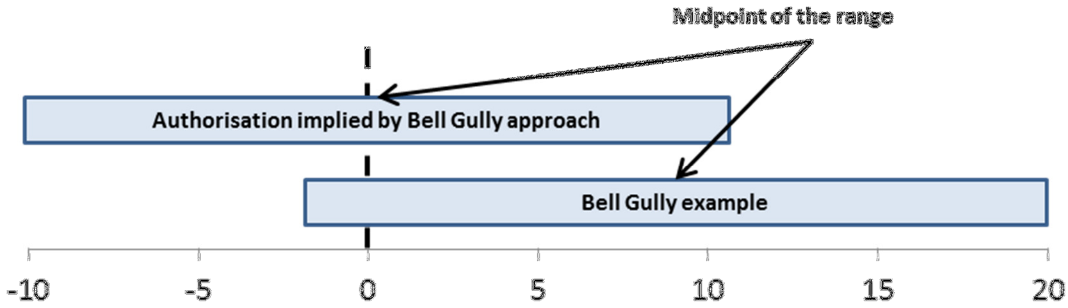
[13] At paragraph 15.

[14] At paragraph 3.9 and 16.2.

is at -$2 million and the upper bound at $20 million, the Commission should authorise the acquisition because the probability that the actual net benefit is positive exceeds the probability that it is negative (in other words, that the midpoint of the range is a value greater than zero). However, it is important to bear in mind that it follows equally from Bell Gully's submission that the Commission would be required to authorise an acquisition where the range estimate went from $-10 million to $11 million, as shown in the figure below. In both cases, the midpoint of the range is a value greater than zero and therefore, says Bell Gully, authorisation is required.



205 Accordingly, it follows from Bell Gully's submission that, in circumstances where the uncertainty in the estimation of the relevant variables produces a range of over $20 million, and the probability distribution of the range is uniform (i.e. any point on the range is as likely as any other), the Commission should authorise the transaction because the midpoint of the range is a positive value (of $500,000), even though:

205.1 it is equally likely that the net benefit of the acquisition is -$10 million; and

205.2 there is overall an almost 48% chance that the net benefit of the acquisition is negative.

206 Under those circumstances, it would be very surprising if the Commission were comfortable concluding that it was "satisfied" that the acquisition should be authorised on the grounds of public benefit.

Summary

207 If the Commission accepts Godfrey Hirst's submissions on all or even most of the key points above, the previous discussion on the Appropriate Framework should be moot in the present case. In summary:

207.1 The effect of erroneous treatment in the Second Draft Determination of benefits that flow to foreign shareholders is to overstate the public benefits figure by over $10 million;

207.2 The conclusion that price increases are unlikely to be more than 15% for customers other than Godfrey Hirst understates the loss of allocative efficiency by $5 million at the "high detriment" end;

207.3 Loss of productive and dynamic efficiencies are also understated to the extent that the customer dimension and enhanced vulnerability of domestic users to such loss has been ignored;

207.4 Benefits of $[ ] attributed to the closure of Clive are not valid in a counterfactual that sees Cavalier likely to sell Clive in any event.

208 Godfrey Hirst submits that, on correct analysis, detriments that would flow from the merger proposed by the Application would outweigh any resulting benefits to the public of New Zealand; and would do so by a substantial margin.

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APPENDIX A – ECONOMIST'S REPORT

APPENDIX B - REPORT FROM FAHRENHEIT'S WEBSITE