CHAPMAN TRIPP

Memorandum

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To: The Chair and Members
Commerce Commission

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**SUBMISSION OF GODFREY HIRST ON DRAFT DETERMINATION:
CAVALIER WOOL HOLDINGS/NEW ZEALAND WOOL SERVICES INTERNATIONAL**

1 We act for Godfrey Hirst, the leading manufacturer of carpet in New Zealand and Australia.

Godfrey Hirst's interest

2 Godfrey Hirst is vitally interested in this matter. Already a leading manufacturer of woollen and synthetic carpet in Australia, Godfrey Hirst expanded its carpet manufacturing business to Auckland in 1986. It subsequently acquired its own yarn spinning plant in Christchurch. In 2007 Godfrey Hirst acquired the assets of Feltex New Zealand out of receivership. The restructured Godfrey Hirst group now has capacity to produce **[ ]** broadloom metres of wool annually from its state of the art plants, selling carpets under its two main brands in New Zealand, Feltex and Godfrey Hirst.

3 In order to produce those carpets Godfrey Hirst's plants consume approximately **[ ]** of greasy wool annually, of which approximately **[ ]** is processed in Godfrey Hirst's New Zealand plants. Those volumes represent approximately **[ ]** respectively of the total New Zealand wool clip, adding significant value in the process.

4 At present, New Zealand has two scourers for that portion of its strong wool clip destined for further processing in New Zealand or Australia – Cavalier Wool Holdings Limited (CWH) and New Zealand Wool Services International Limited (WSI) – which not only compete, but do so using different business models.

5 As the Commission is well aware, since Godfrey Hirst sold its own scouring capability to interests associated with CWH, much of the wool consumed by Godfrey Hirst in New Zealand is scoured in terms of a Scouring Agreement with CWH **[ ]**. Crucially, however, at present up to **[ ]** of Godfrey Hirst's scoured wool requirements may have been scoured from WSI if "commercial endeavours" have failed to obtain appropriate supply through merchants who scour with CWH.

6 Thus, WSI's existence as an alternative scourer not only incentivises CWH's continued performance, but provides another channel for scoured wool when the Scouring Agreement in fact does not deliver, for whatever reason.

7 In practice, WSI has assumed increasing importance as an alternative scourer for Godfrey Hirst, as WSI has for other local processors of strong wool. Certainly, Godfrey Hirst would not have relinquished its own scouring capability if it had envisaged its further processing plants being left captive to a monopolist scourer.

8 Accordingly, Godfrey Hirst is strongly opposed to CWH's proposal.

Acquisition substantially lessens competition

9 Godfrey Hirst agrees with the Commission's preliminary view in the Draft Determination that neither existing nor potential competitors would be likely to sufficiently constrain the merged entity. Thus, the Commission cannot be satisfied that the acquisition would not have, or would not be likely to have, the effect of substantially lessening competition.

Vertical integration means whole industry affected

10 Godfrey Hirst disagrees however with the Commission's view that the markets for wool scouring services and supply of wool grease are the only markets relevant to the proposal.

11 As is outlined in paragraph 44 below, that ignores the vertical integration impacts on the whole wool sector. Downstream processors like Godfrey Hirst, in particular, will be adversely affected.

12 There is no basis for ignoring these vertical integration effects. Certainly, the presence of two minority shareholders on CWH's register provides no assurance that they will provide an effective check on the major shareholder's downstream activities.

13 The Commission expressly recognises (at paragraph 31 of the Draft Determination) that scouring and associated pressing currently accounts for only about 5-6% of the current value chain for wool. Ignoring vertical integration effectively focuses attention solely on that relatively small part of the process. It is however an integral part of the process upon which onshore processors of wool are dependent.

Detailed comments on competition analysis

14 In addition to the above major points of principle, Godfrey Hirst has made detailed comments on particular aspects of the Commission's competition analysis as set out in the Draft Determination.

15 For ease of reference, these comments are set out in Schedule 1 adopting the same contents headings as are used in the Draft Determination.

Insufficient public benefit to authorise

16 Godfrey Hirst disagrees with the outcome of the Commission's analysis of public benefits and detriments.

17 Godfrey Hirst submits that the Commission cannot be satisfied, on the balance of probabilities, that the acquisition will result, or will be likely to result, in "such a benefit to the public that it should be permitted", as section 67(3)(b) of the Commerce Act 1986 requires.

18 That test necessarily invokes a high threshold. Unlike with a clearance, given under either section 66 or 66(3)(a), authorisation is not merely a ruling that the transaction does not invoke a statutory prohibition. Rather, it is an exemption from that statutory prohibition in the particular case, given on the basis that a broader public interest – measured primarily in terms of efficiency (as required by section 3A) – should prevail.

19 Further, authorisation of a business acquisition, unlike authorisation of a restrictive trade practice, once granted cannot be revoked or varied. The structural change it contemplates must be assumed to be permanent.

20 So, mere balancing of benefits and detriments and a finding of net benefit is not sufficient for authorisation of a business acquisition. The Commission must be satisfied that the public benefit will be such that it should be permitted. That is, the benefit is of such magnitude or kind that the exemption allowing for permanent structural change of the relevant industry, should be permitted.

21 Further, the requirement that the Commission must be satisfied as to that outcome or likely outcome means that any uncertainty must work against the Applicant. The Commissions view (in paragraph 242) that "comparatively greater weighting" be given to the benefits because of the potentially wider range of the detriments, cannot be correct in light of the Court of Appeals ruling in *Commerce Commission v Woolworths Ltd* (2008) 12 TCLR 194.

22 In *Woolworths*, the Court of Appeal concluded that there are three options under section 66. First, if the acquisition would not substantially lessen competition, grant the clearance. Second, if the acquisition will substantially lessen competition, decline the clearance. Third, if there is uncertainty as to whether or not granting the clearance would substantially lessen competition, decline the clearance. This approach of if there is uncertainty the application should be declined, must apply to the authorisation process as well.

23 Here, the Commission indicates (in paragraph 240) that the "net positive public benefit" volume is such that after applying that enhanced weighting as to enable the Commission to be satisfied that authorisation should be granted.

24 However, the quantum of that net positive public benefit in this case, on the Commission's own analysis, would be very modest. Taking the conservative view that previous Commission practice and commercial prudence requires, net benefit would be around $4 million at 5-year NPV.

25 Even that modest net public benefit (as assessed by the Commission) results from a combination of the Commission's substantial acceptance of CWH's own quantification of benefits and its adoption of a derisory figure for dynamic efficiency losses.

26 That figure for loss of dynamic efficiency the Commission produces by applying a factor of zero to 1 percent to industry revenues. That approach has two apparent shortcomings, namely:

(a) Why has the Commission adopted a factor that treats the wool scouring sector as 5 times more innovative than it regarded the dairy industry in a previous authorisation application?

(b) Why has the Commission ignored the impact of vertical integration on the rest of the wool industry and applied that factor to scouring revenues only?

27 Castalia Strategic Advisors has reviewed the Commission's benefits and detriments analysis and the further information provided by CWH to the Commission. Castalia's report is attached at Appendix D. It shows that:

i. the proposed merger would cause significant vertical impacts on downstream markets, including the manufacture of clean, coarse wool in carpet production;

ii. the proposed merger would result in less product innovation because the relevant innovation that will result in dynamic efficiencies in the New Zealand wool industry relate to product (such as blend qualities), rather than process innovation and competitive pressure from China will not motivate product innovation; and

iii. the benefits of the proposed merger are not certain and should be considered conservatively.

Process Disputed

28 Godfrey Hirst also disputes aspects of the process adopted by the Commission in its consideration of the application to date.

Confidentiality means lack of transparency

29 First, the extensive confidentiality claims the Commission has allowed the Applicant have resulted in a grave lack of transparency. That is especially stark, and damaging, in relation to the Commission's benefits and detriments analysis.

30 When the then Minister of Commerce Hon Lianne Dalziel reported to her Cabinet colleagues on a review of the efficiency and effectiveness of the merger clearance and authorisation systems of the Commerce Act in 2008 she noted, with regard to the analytical framework for assessing benefits and detriments:

> "Quantification used appropriately, ensures that the Commission's assessments are transparent and objective".

31 She duly reported that those processes work well.

32 In fact, the authorisation process for mergers is a road seldom travelled. The NZ Dairy Board and the participating dairy co-operatives tried in 1999 ("dairy merger proposal"); and Air New Zealand and Qantas in 2003 ("Air New Zealand/Qantas").

33 Both those attempts were unsuccessful; with the Commission's quantification of benefits and detriments on each occasion demonstrating – transparently and objectively – that the public benefits claimed for the proposed merger were not likely to outweigh the competitive detriments. Indeed, in each case, the Commission's own analysis demonstrated that the detriments would prevail over the claimed benefits by a considerable margin. In each case, this was readily apparent from the Commission's detailed quantification. How the respective figures for the three categories of detriments and individual items of claimed benefits were derived in each case is also readily apparent from the public versions of those determinations.

34 Attached as Appendix A are the detailed summaries of detriments and benefits from the public version of the Commission's draft determination on the dairy merger proposal.

35 Attached as Appendix B are the detailed summaries of detriments and benefits from the public version of the Commission's final determination on the Air New Zealand/Qantas proposal.

36 That same transparency of process has been radically departed from in the present case. Attached as Appendix C are the corresponding summaries of detriments and benefits from the Draft Determination on CWH's proposal. The only individual figures given are a wide range for allocative efficiency; and readily ascertainable sums for sale of land and expenditure on plant.

37 As a result, crucial elements of the Commission's quantification have been withheld from comment by interested parties on this occasion. Our requests that that information be made available for testing was declined on the basis that for benefits the Commission has adopted CWH's calculation, and for detriments making more detail available would disclose the merged entity's variable costs and total industry revenue.

38 That lack of transparency has seriously impeded persons with expert industry knowledge from commenting on the Commission's conclusions on matters such as the potential loss of industry innovation.

39 As is noted above, the Commission's initial estimate of a likely range of dynamic efficiency losses of "zero to 1 percent of total industry revenue" produces a derisory figure. While the Commission notes that comparable loss of innovation was measured in Air New Zealand/Qantas by multiplying total airline sales by factors of 0.5% to 1.5%, the dairy industry would seem to have far closer natural affinity to wool scouring than aviation. With the dairy merger proposal a range of 1% - 5% was used.

40 Getting the balance right with confidentiality is obviously problematic. But withholding the detail of the Commission's benefits and detriments analysis

effectively prevents proper comment by interested persons on whether the public benefit is such that the change to industry structure should be permitted.

Vertical integration concerns have been ignored

41 Second, the Commission acknowledges that the draft determination limits its consideration of the acquisition to the markets for wool scouring services and wool grease. It states (in paragraph 60) that “no other interested party has argued or submitted to the contrary”.

42 That statement is quite incorrect.

43 Our letter of 4 March to the Commission on behalf of Godfrey Hirst states plainly that the resulting vertical integration would have serious competition consequences for other markets at other levels. We said:

> *15 In addition to removing all existing competition and deterring potential new entry, the acquisition would have serious vertical integration consequences for those downstream markets for which strong wool is the primary input. Such markets include manufacturing of carpets and other textile products. New Zealand and Australian carpet and textile manufacturers currently further process up to 30% of the New Zealand wool clip, adding significant value (in excess of $1 billion to their respective economies).*
>
> *16 Those adverse vertical integration consequences are ignored totally by the application, which claims that the proposed acquisition “will, ultimately, reduce vertical integration.” That claim is patently misleading.*
>
> *17 First, as described above, CWH’s outright acquisition of Lanolin Trading creates a new barrier to entry to the scouring market. Second, and more seriously, all downstream processors of strong wool would become dependent on a single scourer, CWH, which itself is a rival processor.*
>
> *18 At present the New Zealand wool industry has 2 scourers of strong wool – CWH and NZWSI – which not only compete, but do so employing quite different business models. CWH, as well as scouring all the Cavalier Group’s own carpet wool requirements, also operates as a commission scourer, providing scouring services to a number of wool merchants, Godfrey Hirst and other further processors of wool.*
>
> *19 NZWSI operates primarily as a merchant scourer, which typically purchases, scours and ships the broad range of wool types required by its export customers for further processing. That different business model requires NZWSI to employ a more innovative approach to its operations as it has to modify its offering to meet the differing demands of its user clients.*
>
> *20 Importantly, however, NZWSI also provides merchant scouring services for New Zealand downstream processors, including* ***[***
>
> ***]****. The increasing importance of NZWSI as an alternative scourer, and the incentive and potential for NZWSI to increase its commission scouring operations, was stressed in CWH’s previous application.*

21 CWH, as a commission scourer, currently must "compete" with NZWSI for Godfrey Hirst's scouring requirements, to the extent that NZWSI itself will scour any wool that NZWSI supplies to Godfrey Hirst. If CWH were allowed to acquire NZWSI's scours and operations there would be both loss of NZWSI's present incentive to innovate, as well as potential for price increases and price discrimination by the merged entity.

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24 Importantly, Godfrey Hirst would not be the only firm so adversely affected. All downstream processors of strong wool would face increased costs and decreased levels of service from the merged entity. Those downstream processors would extend to Australian carpet manufacturers, including Godfrey Hirst, who are presently reliant on supply of strong wool from New Zealand wool merchants.

25 Even if the merged entity were not to take advantage of its market power to increase prices and/or reduce service levels, the rationalisation of New Zealand's scouring capacity onto one site each in the North Island and South Island would give risk to substantial additional risk of business interruption. Fire, earthquake and industrial action are all real risks.

26 The commercial rationale claimed in the application for the proposed acquisition is misleading. Reference is made to the report of Wool Taskforce and the sweeping claim made that the proposed transaction "reflects one step in maintaining and enhancing value … by adding value to greasy wool grown in New Zealand.".

27 In fact, the acquisition will do the opposite. Essentially, the Wool Taskforce report stresses the need to raise demand for products made from strong wool by developing "entirely new products, uses, and markets for strong wool". That is, wool is better treated as a core ingredient in further processing, than as a commodity.

28 That transformation will not happen if further processors become captive to a single supplier of scouring services.

29 The putative existence of scouring capacity in China will provide no relief to a New Zealand (or Australian) manufacturer of strong wool products, if it involves a **[ ]** increase in the cost of scouring. In any event, that Chinese scouring capacity – like the Australian scours – is configured to process the fine wool required by Chinese textile and apparel manufacturing industries.

30 New Zealand manufacturers of carpets and other strong wool products require on shore a competitive and innovative scouring service for the strong wool that New Zealand

produces. The New Zealand wool industry simply will not transform in the way the Wool Taskforce postulates if the Commission allows the creation of a bottleneck at scouring level.

44 Put simply, all downstream processors of strong wool operating within New Zealand will be adversely affected. That includes – but is not limited to – manufacturers of woollen carpets. The competition consequences for those downstream markets need also to be determined and quantified by the Commission.

45 It is important to note that Australian manufacturers of carpet and other woollen products are similarly dependent on supplies of scoured strong wool from New Zealand. Their requirements are currently relevant to the Commission's consideration of the impact on exports from New Zealand.

46 Further, given the Australian and New Zealand governments' joint commitment to a single economic market, with particular reference to firms facing consequences for anti-competitive conduct which impacts in both markets, the concerns of Australian manufacturers should also be seen as of direct relevance.

47 The significance of vertical integration was recognised previously by the Commission in both the dairy merger proposal and Air New Zealand/Qantas.

48 With the dairy merger proposal the Commission examined the potential impact on not only the raw milk market, but also the numerous downstream manufacturing markets for which milk is a core ingredient. Indeed, when the government subsequently passed the Dairy Industry Restructuring Act 2001 to enable the merger which the Commission had declined to authorise, that legislation included special protection for downstream processers reliant on access to raw milk.

49 In Air New Zealand/Qantas, the Commission was more express in its recognition of vertical integration concerns. It said:

> *877 Where an acquisition involves vertical integration such as that involved in the proposed Alliance, the Commission will consider not simply the ability to foreclose a market but also access concerns that it may create. At vertically integrated firm which has market power in an upstream market has the ability to discriminate in favour of its own affiliated activities in the downstream market.*
>
> *878 In the present situation the relevant issue is that the removal of competition at the upstream level may increase the incentive for the Applicants to give preferential rates in terms of discounted airfares to their vertically integrated downstream wholesalers. The refusal to sell tickets is not necessary for there to be a competition issue which arises from the Alliance placing travel wholesalers at a comparative disadvantage compared with Qantas Holidays, for instance.*

50 The Commission duly concluded, on the balance of probabilities, that the existing competition in the upstream aviation markets was likely to be insufficient to constrain the airlines with respect to the downstream markets.

Balance of probabilities required

51 Third, the Commission in Air New Zealand/Qantas, stressed in a number of places, that the onus of proof lies with the applicant to satisfy the Commission on the balance of probabilities of the various matters it is asserting. In particular, the Commission noted:

> *As with authorisations under section 67(3), the onus of proof lies with the applicant to satisfy the Commission that the proposed arrangement does not substantially lessen competition or that the arrangement results in such a benefit to the public that it ought to be permitted.*

52 That means, in the present case, that mere assertions about matters such as long-term competitive threat, constraints on detriments and significant benefits claimed to arise from the acquisition all must be proved. As the High Court observed approving the Commission's Air New Zealand/Qantas determination:

> *The test [for SLC] requires the Commission to consider whether a substantial lessening of competition is likely. The public benefit test also requires an examination of likely results. In this context, likely refers to probable outcomes rather than possible or speculative effects.*

53 The Commission would appear to have ignored that requirement for proof of matters asserted, especially in relation to its assessment of factors limiting loss of dynamic efficiency. In particular:

- the fact that incremental product and process improvements have occurred historically when an industry is competitive provide no indication as to how a monopolist might operate;

- it cannot be assumed that future innovations resulting from public sector R&D or private sector research will remain the exclusive preserve of CWH rather than be exploited off-shore;

- there is no evidence that CWH's minority shareholders, Direct Capital and ACC, have an interest or experience in pursuing ongoing innovation in the wool sector. Both those shareholders are recent investors in CWH and both have broad portfolios. The respective investment benchmarks for those two shareholders cannot be assumed to include a commitment to long-term innovation over more immediate return; and

- there is no factual basis for asserting that concentrated shareholdings produce high levels of oversight;

54 The requirement of proof of matters asserted applies equally with regard to public benefits resulting from the proposed acquisition that will not otherwise occur. As Castalia's report notes: "[such] efficiencies are easy to claim, but very difficult to prove" hence overseas competition authorities are particularly sceptical of benefits that result in a monopoly.

55 CWH's claim in respect of higher Y value demonstrates the wisdom of such scepticism. While the Commission correctly attaches no weight to that claim on the basis that the same enhancement would be achieved in the counterfactual, and much of that enhancement would be exported in any event, Godfrey Hirst submits that the claimed higher Y value – on close scrutiny – is more apparent than real.

56 Even if an improved scoured base Y result could be achieved, other contaminants and specifications would prevent the lower based Y wool achieving the suggested enhanced Y value. Where 'Y minus Z' is a measure of the yellowness of the wool, base Y values and 'Y minus Z' values essentially mirror each other. This is because the higher the Y value, the less yellow in the wool meaning Z will also be a high number, and consequently 'Y minus Z' is close to zero. However, when a low Y value wool is used, the wool will be very yellow thus the Z value will be much lower than the Y value and therefore 'Y minus Z' will produce a greater number. Detail on this analysis is attached at Schedule 2.

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APPENDIX A

DRAFT DETERMINATION ON THE DAIRY MERGER PROPOSAL

SUMMARY OF PRELIMINARY ESTIMATES OF ANNUAL DETRIMENTS ($M)

Category	***Status quo* counterfactual range**		**Deregulation counterfactual**	
Allocative inefficiency	2.4	10.0	2.5	10.0
Productive inefficiency	75.5	151.0	96.0	192.0
Dynamic inefficiency	66.0	300.0	65.0	325.0
TOTALS	137.9	461.0	163.4	527.0

SUMMARY OF THE PRELIMINARY ESTIMATES OF PUBLIC BENEFITS PER YEAR ($M)

Category	**Status quo Counterfactual**		**Deregulation counterfactual**	
	Claimed	**Accepted**	**Claimed**	**Accepted**
Promotion of industry change				
• cessation of pay-out bundling	20.0	0	0	0
• integration of marketing & processing stages	20.0	5.0-15.0	0	0
Promotion of processing & structural efficiencies				
• reduction of duplication in ancillary activities	113.6	21.0-41.0	123.2	35.5-60.5
• plant production flexibility and rationalisation	23.1	0	23.1	11
• deferral of capital expenditure	13.8*	0	13.8*	0
Preservation of single seller marketing	0	0	40.0	0-20.0
Industry development				
• best practice transfers across companies	N/Q	0	N/Q	0
• funding of "industry good" research	0	0	29.0	0
• overseas competitive advantages	N/A	0	N/A	0
TOTALS	190.5	26.0-56.0	229.1	46.5-91.5

APPENDIX B

FINAL DETERMINATION ON THE AIR NEW ZEALAND / QANTAS PROPOSAL

SUMMARY OF ANNUAL DETRIMENTS, YEAR 3 ($M)

Item	Detriments	
	Range	Most Likely
Allocative inefficiency and transfers	83 - 110	90
Productive inefficiency	18 - 91	55
Dynamic inefficiency	[ ]	50
Totals	[ ]	195

SUMMARY OF ANNUAL NET PUBLIC BENEFITS ($M) (YEAR 3)

Item	Range	Most likely
Detriments		
• allocative inefficiency and transfers	(110) — (83)	(90)
• productive inefficiency	(91) — (18)	(55)
• dynamic inefficiency*	([1) — ([1)	(50)
Sub-total	**([ ]) - ([ ])**	**(195)**
Benefits		
• tourism	(18) — (4)	(11)
• domestic spending by NZers deterred from overseas travel	5 — 20	13
• cost savings	30	30
• engineering & maintenance	5 — 10	8
• scheduling	0.5	0.5
• new freight services, direct flights, online benefits and miscellaneous	0	0
Sub-total	**22.5 – 56.5**	**40.5**
TOTAL NET BENEFITS / (DETRIMENTS)	**([ ]) - ([ ])**	**(154.5)**

* The Commission's estimate is an intermediate point in a range partly bound by an estimate derived from confidential information. Consequently, the range cannot be disclosed for the purposes of balancing public benefits and detriments.

CHAPMAN TRIPP

APPENDIX C

DRAFT DETERMINATION ON CWH'S PROPOSAL

SUMMARY OF DETRIMENTS

Category	**Evaluation**	**5-year NPV**
Allocative efficiency	$0.176 million to $3.752 million per year	$0.733 million - $15.645 million
Productive efficiency	[ ]	[ ]
Dynamic efficiency	[ ]	[ ]
Total of quantified detriments		**$1.439 million - $21.736 million**

SUMMARY OF BENEFITS

Category	**Evaluation**	**5-year NPV**
Reduction in Production and Administration Costs	[ ]	[ ]
Sale of land	One-off benefit	$8.792 million
Capital expenditure on land and buildings	One-off cost	[ ]
Capital expenditure on plant	[ ]	$0.880 million
One-off Rationalisation Costs	One-off cost	[ ]
Total of quantified benefits		**$25.870 million**
Removal of weak seller	No weight given at this time	
Wool super store	Not quantified, but benefit recognised.	
Quality benefits	No significant weight given at this time.	

Note: A 10% discount rate was used in these calculations. This was the factor applied by the Applicant.

APPENDIX D

CASTALIA'S ANALYSIS

SCHEDULE 1

COMMENTS ON SPECIFIC PARAGRAPHS OF THE DRAFT DETERMINATION
(All numbers refer to paragraph numbers of the Draft Determination)

Other Relevant Parties

This should include commission wool spinners (Summit, Christchurch Carpet Yarns and Wool Yarns).

Existing Competition

Constraint from WSI

75. CWH's board minutes record "explicit concern in relation to the competitive threat that WSI imposes", whereas the Application discounts WSI as a competitor.

Requirements for Entry

Production site with necessary consents

95. The problem is that Godfrey Hirst have looked at sites within the Awatoto, Whakatu and Tomoana industrial areas and can't find any suitable ones.

Scouring equipment

100. There are no second hand 2.4 metre scours available for sale that Godfrey Hirst is aware of so the only option would be to install new machinery. Further there is little available in the way of second hand blending, opening, pressing or grease recovery equipment and what there is, is owned by the Applicant and would not be available to any potential new entrant.

Detriments

Consideration of loss of allocative efficiency

138. The demand for wool scouring will not be affected by the price of wool scouring because wool scouring is essential to further processing and cannot be substituted or replaced. The only constraint to increased scouring tariffs is competition from another service provider.

142. The figures quoted in relation to wool revenue to growers do not reflect recent increases in the wool price. The situation now is quite unique with wool contributing significantly to farmers' incomes, substantially more than in recent years.

Experience from the previous acquisition

156. Wool exporters are concerned that if they provide pricing information to the Commission they may face retaliation from CWH, particularly in the factual if there is no alternative processor.

Loss of Productive Efficiencies

172. ACC and Direct Capital do not have any experience in the wool scouring industry. Therefore, they do not have the knowledge or experience to determine whether or not CWH is operating to optimum efficiency.

Both ACC and Direct Capital, as institutional investors, will be looking and pushing for the maximum return from their investment without any conscience with respect to downstream effects on the wider industry.

Possibly one of the biggest risks in the proposed acquisition is that CWH is 50% owned by institutional investors with no other interest or involvement in the wider wool industry, which could give rise to price gouging in a monopoly market.

Increased supply risk

177. CWH appear to understate the supply risk and the Commission seems to have accepted this.

The claim that, "post acquisition, Cavalier Wool's plants will not be operating at full capacity and the Clive plant will remain as back-up capacity" is misleading on several fronts.

- Firstly, CWH have stated that they may sell the Clive site so it may not be available at all.

- Secondly, unless there is enough capacity in each islands plant to process the others wool then there is significant risk, not only to further manufacturing in New Zealand but also the NZ scoured wool export business.

- The risk of industrial action stands to stop both islands production. Employees and Unions will be in a strong position to make unreasonable demands because there is no alternative and with one company operating all plants industrial action would likely affect all sites.

The fact that CWH has comprehensive insurance to cover freight between islands in the case of plant shutdown addresses only cost in the event this were to occur. Is there enough capacity in the transport industry to handle this? 10000 bales per week equals approximately 70 full truck and trailer loads per week, ferry crossings. This hasn't even been considered, let alone investigated. Further, this insurance cover is an additional cost to the industry that is not necessary under the counter factual.

Sending wool to China for processing is not a viable alternative, even in force majeure situations for the same reasons as already outlined. The additional cost, quality and loss of control remain barriers. Stockpiling wool is not an option as further processors (both NZ based and overseas) are relying on timely delivery as contracted.

Comprehensive risk management infrastructure and processes do not address natural and unforeseen events, even malicious damage or industrial action.

Put simply there is no acceptable alternative to the counterfactual regarding supply risk.

178. The Commission has failed to understand that the only acceptable mitigation to the risk of any event that causes medium or long-term loss of a scouring capacity in the factual is the counter factual. For CWH to say that any electrical failure could be repaired within 48 hours shows a lack of understanding in their own business. Godfrey Hirst waited longer than that for specialised electrical parts at both Clifton and Clive. Further, electrical failure is not our greatest concern. Fire, Earthquake, Industrial Action, Flood/Tsunami, Resource consent compliance all have the ability to

halt production for extended periods at any processing site and the only protection against this is the counterfactual.

179. Godfrey Hirst disagrees here. To say that "there is only a small increase in risk arising from the consolidation of scouring activities into a single location per Island" shows a lack of understanding of the risks and what is at stake. CSL is a good example of this – imagine the impact if Godfrey Hirst did not have its Dannevirke and Bell Road yarn plants.

Loss of Dynamic Efficiency

189. Both WSI and CWH have a history of being innovative. Therefore the claim that, in the counterfactual there is less competitive tension is wrong. There exists demonstrated competition tension present (refer to CWH Board minutes) and this will not change in the counterfactual (which is effectively the status quo).

190. The Chinese threat to wool scouring in NZ does not arise from Chinas ability to scour wool cheaper than can be done in NZ. Rather, scouring has endured in NZ because of the substantial localised further processing (spinning and carpet manufacturing) that exists. In all the examples quoted, particularly Australia it wasn't just the scouring industry that was relocated to China but all the downstream processing as well. So as long as there is a carpet and commission spinning industry in NZ there will be a demand for NZ based wool scouring also.

Benefits

Productive Efficiencies

193. CWH claim cost savings through reductions in wages, salaries, gas, coal and electricity. Reduced salaries and wages are a given but gas, coal and electricity are variable costs that are linked to kilograms processed. The only savings would be from the electrical fixed line charge that would be possible through a reduced number of sites. The amount of gas, electricity and coal used by CWH however would not be materially less than that used by CWH and WSI in the counterfactual, i.e. scouring 1kg of wool will use x units of electricity and heat, figures which will not change as a result of the proposed acquisition.

Capital expenditure

207. Godfrey Hirst fails to see how the capital expenditure associated with relocating WSI's plants is a benefit. Relocating these plants does nothing beneficial, it simply moves them. Granted, any improvements made could result in a benefit however the relocation cost is surely a detriment that should be netted off the benefit received from the sale of surplus land and buildings.

Removal of weak seller

213. The Wool Exporters quoted are clearly more motivated by the potential removal of their biggest rival than the creation of a wool scouring monopoly.

No one has considered the effect on the wool industry if NZWSI suddenly ceased trading. NZWSI trade up to 35% of the entire clip and it is doubtful that the balance of the wool export trade could handle the sudden increase in business as it's not as straight forward as simply selling wool. In particular the wool has to be financed and insured pending payment and exporters are already struggling with these two issues following the recent increase in wool prices. To assume that exporters will be able to double or triple their bank facilities and credit insurance limits is naïve at best.

214. There is an alternate view that the sudden removal of NZWSI as a wool trader could result in the wool price plummeting due to the sheer volume of additional business that the balance of the trade would be faced with and it is only through this depressed wool price that the remaining exporters will be able to trade the available clip within existing financial arrangements.

SCHEDULE 2

COMMENTS ON CWH'S CLAIMS ON Y BENEFITS

Attached is a chart detailing Whakatu Wool Scour Y and Y-Z values for all wool processed between December 2005 and October 2010. Also attached is a fact sheet that has been downloaded from the NZ Wool Testing Authority website that explains colour and colour measurement.

Base Y Value

The blue line on the chart details the scoured base Y result for all Whakatu scouring with the scale on the left side of the chart. This compares to the chart that CWH have provided on page 34 of the Application and also page 7 of the letter from Bell Gully dated 28 March. Godfrey Hirst notes that the base Y value for wool processed at Whakatu has decreased over the period covered by the results. This is the complete opposite of the trend recorded on the CWH chart.

The reason for the downward trend of base Y at Whakatu is not due to scouring quality. In fact, scouring quality has improved over the period covered by the results, particularly over the past two years. Rather, the downwards slope of the Whakatu base Y trend is a reflection of wool types processed and a result of the business that WSI have done in markets that purchase poorer colour wool types such as India. **[**

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With only two scourers in the north island it is logical that if wool types processed change at Whakatu then the wool types processed at Awatoto will change in an opposite way, i.e. Awatoto must have processed better colour wools if Whakatu is processing poorer colour wools and this explains the upwards slope on the CWH charts.

With respect to the NZWTA base Y colour as presented by CWH, Godfrey Hirst submit that this information represents a total base set that has not changed over the recorded period and this is why there is little change in the base Y trend. The wool processed by CWH and Whakatu however is not individually representative of this base set but when their individual results are combined we expect the base Y result for all wool scoured in the north island will follow the trend outlined on the NZWTA chart.

Y-Z Value

CWH have claimed that if they can produce a higher base Y scoured result then Merchants will be able to allocate cheaper less bright (lower base Y) wools to achieve the required scoured result. Godfrey Hirst have submitted that, even if CWH could produce an improved scoured base Y result, that other contaminants and specifications will make it difficult for Merchants to allocate lower base Y wools.

The red line on the Whakatu chart details Y minus Z value (Y-Z) for all Whakatu scouring with the scale on the right side of the chart. Y-Z is a measure of the yellowness of the wool with high values indicative of a less bright (Y value) and more yellow product. Thus, the higher the Y-Z value the less valuable the wool.

As can be noted from the Whakatu chart base Y values and Y-Z values mirror each other almost exactly. This is because the brighter the wool (higher base Y) the less yellow it will contain so the Z value will be closer to the Y value and Y-Z therefore closer to zero.

This confirms Godfrey Hirst's view with regard to the use of poorer base Y wools. As can be seen, if a merchant were to allocate wool to a scourment with a base Y value of one unit less (assuming CWH could produce an improved scoured base Y value) the Y-Z value would be higher and less likely to meet the specification.

Whakatu Wool Scour Y and Y-Z values for all wool processed between December 2005 and October 2010:

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FACT SHEET FROM NZ WOOL TESTING AUTHORITY WEBSITE EXPLAINING COLOUR AND COLOUR MEASUREMENT:

What We Do:

Colour & Measurement

Click here to download PDF document

Colour Measurement

When daylight strikes an object the light can either be wholly absorbed by the object, in which case it appears black, or totally reflected, in which case it appears white. If however, the object absorbs some portions of the spectrum then it will appear as the colour of the light which is not absorbed.

The visible light spectrum is made up of seven colours – red, orange, yellow, green, blue, indigo and violet. So, for example, if an object absorbs red, orange, green, blue, indigo and violet it will appear to the eye as yellow. However, if the light which shines on the object is not daylight but contains a predominance of one section of the spectrum, then the true colour of the object will be distorted. For this reason colour is measured using a standard light source which is specified by an international standard.

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By using filters it is possible to measure the amount of light reflected from an object over all sections of the spectrum. Whilst this would give us extremely accurate readings, the result (comprising seven different numbers) would be very cumbersome. To simplify this, the spectrum is divided into three zones made up of red/orange area (x), the green/yellow area (Y) and the blue/indigo/violet area (Z). These three measurements are called the Tristimulus Values and are measured by a Spectrophotometer.

The purpose of colour measurement is principally to assist the dyer when the wool is being processed. Dying is an additive process and it is therefore impossible to dye the wool lighter than its original colour. If a very light pastel colour is required the wool must be very white and bright. On the other hand, if dark colours are to be dyed, stained and dingy wool could successfully be used.

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Preparation of Results

What is the process:

Sub-samples are placed in a special holder with one face exposed to a light source. After the colour readings have been taken the specimen is turned over for a further set of readings. This process is repeated on another spectrophotometer all readings are averaged to give the certified result.

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Interpretation of Results

A Certificate will show all three tristimulus values. In practice the X and Y values are very similar in colour measurement and for practical purposes the X value can be ignored.

From a value point of view, two aspects of colour measurement are important. One is lightness (brightness) and the other is yellowness. In this context, Y is regarded as the level of brightness and Y-Z is an indicator of yellowness. If Y is numerically high the wool will be bright but if it is low they wool will appear dingy. Generally, if the value of Y-Z is numerically low the wool will be white, but if Y-Z is numerically high the wool will be yellow. Good colour wools are lighter (higher value of y) and less yellow (lower value for Y=Z). Two lots of wool may appear visibly different, but if their measured colour values are identical they will be indistinguishable in colour after processing.

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As a Guide:

BRIGHTNESS		
	D65/10	**C/2**
Very Bright	>70	>66
Bright	68-70	64-66
Average	64-68	60-64
Slightly Dingy	59-64	56-60
Dingy	<59	<56

YELLOWNESS		
	D65/10	**C/2**
Very White	<9	<-2
White	9-10.5	-2-0
Slightly Creamy	10.5-12.5	0-3
Creamy	12.5-14.5	3-6
Quite Yellow	14.5-16	6-8
Heavily Stained/Yellow	>16	>8