WOOL EQUITIES LTD

Submission to the Commerce Commission
On the Draft Determination ISSN No 0114-2720
In regard to the Cavalier Wool Holdings Ltd
Acquisition of 100% of the shares in NZWSI Ltd

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These notes are submitted from the position of an interest party, an interested party with some 7800 wool grower shareholders with an overall conceptual and critical interest in the full process of taking wool the fibre, through its various paths, from the sheep's back to scouring, and then conversion of that fibre into product that is ultimately purchased by the consumer.

Wool Growers Overriding Concern

The first critical concern for the Commission to consider is that Cavalier Group Companies are actively engaged in each of the activities in the statement above, either directly through a fully or partially owned subsidiary.

Thus in all activities (with the exception of Exporting) Cavalier Corporation is a direct competitor with all other participants in the wool sector. With the scour monopoly as proposed, Cavalier Wool Holdings Ltd, a subsidiary of Cavalier Corporation is effectively put in the position of “gate keeper” of the entire strong wool sector under this Draft Determination.

With that 'gate keeper' role comes the potential to decide at will who survives and who fails on both sides of the scour. That is the Wool Handlers, Brokers, and Merchants pre the scour, plus yarn spinners and carpet tufters in particular, post the scour.

Arbitrary actions by Cavalier in peripheral activities, associated with scouring such as favorable or unfavorable scheduling of processing, lack of care at blending, delays in container loading for shipping, delays caused by lack of storage space for incoming wool, processing of wool to substandard levels, and increasing costs around actual scouring are all potential collateral effects of this monopoly should the Draft Determination become the ultimate Determination of the Commission.

It is these “Collateral Effects” that we ask the Commission to seriously consider. We urge the Commission to work with the wool trade to establish answers to these questions from Cavalier and should they still be determined to uphold this Draft Determination, to put in place parameters for the Cavalier Group of Companies outside which they agree prior to the Final Determination not to deviate or operate.

While we accept that the application is in the name of “the child” Cavalier Wool Holdings Ltd it is the motives of the “parent” Cavalier Corporation that should be the focus of the Commission's attention.

A second critical concern is the effect this Draft Determination, and any affirmation of this decision in a Final Determination, will have on the price obtained for NZ wool. The Draft Determination has already had a negative effect on NZ wool prices. Cavalier Corporation, as a purchaser of wool as an ingredient, is desirous of lower ingredient costs. Cavalier proposes to “divest, or close down WSI’s national and international wool trading operation”. A new owner wishing to run this divested operation would require approximately $45 million of working capital to cover the trading of around $200 million of wool at a stock turn of five times. No existing wool exporters, or amalgam of wool exporters can raise this additional working capital, nor will any new purchaser for these assets be apparent. Without the asset value in the scours, this sales operation is unsalable.

So what we will see instead is the balance of the exporters trying to trade this additional volume of wool without the working capital. This will have the immediate effect of reducing the value of NZ’s export wool clip by around $200 million pa. Over 5 years, loss of earnings to NZ wool growers and the NZ economy will be over $1 billion.

Example
The NZ wool clip earns $1 billion pa now

Today						
	Capital	**Working Cap Borrowings**	**Total Funding**	**Tonnage Sold**	**Sales Value**	**Price/KG**
NZWSI	$10M	$35M	$45M	25,000	$215M	
Other Wool Exporters	$40M	$140M	$180M	91,000	$785M	
	$50M	**$175M**	**$225M**	**116,000**	**$1 Billion**	**$8.62**
Without NZWSI						
Other Wool Exporters	$40M	$140M	$180M	116,000	**$800M**	**$6.90**

Without NZWSI trading operation buying in the market, all wool continues to be traded but wool growers receive $1.72 less per kg and the NZ economy is $200 million per annum worse off. This alone is sufficient reason to reverse the Draft Determination. If

Cavalier Corporation purchase say 4,000 tonnes of wool per annum for their carpet making, they will save $6.88 million per annum in reduced wool ingredient prices for their operation alone. Another good reason for Cavalier Corporation to fight for a monopoly and close the NZWSI trading operation.

A third critical issue is the absence of wool exporters, the people who buy and sell all NZ wool, from the submissions to the commission. Why are they not making submissions? They are going to be facing the impact of this change - reductions in scouring flexibility, and likely increased and additional charges to pass on to their clients. They are not present because they are already too frightened to complain and have "black marks" stuck by their names in the Cavalier Corporation should this Draft Determination not be reversed.

Wool Growers Specific Concerns in regard to the Submission

Media Release
"Our preliminary view is that the proposed acquisition would substantially lessen competition in the North and South Island wool scouring markets. Cavalier Wool Holdings would essentially have a monopoly on the supply of wool scouring services post acquisition. However, at this preliminary stage, the Commission expects that there would be benefits to the public that would outweigh the loss of competition,"

1. What are the specific benefits to the public that the Commission perceives will be delivered by this determination? We are struggling to identify these.
2. There does not appear to be any immediate material benefit or cost saving to the public if there are 2 4 6 or 8 scours. Scouring is but a single process in a complex industry chain which is far removed from the public or consumers. The conversion of wool fibre from the sheep's back into say wool carpet products for consumers.
3. In the longer term however it is possible that choice of product and price of product may be effected by the determination as Cavalier Corporation uses it's "gate keeper" role at the scour to advantage itself and materially affect the ability of its direct competitors, to compete on an equal footing in the retail arena
4. Scouring capacity and flexibility is a key issue for wool sellers. Over the recession, delivery lead times worldwide have reduced putting NZ in a disadvantageous position. Cavalier has overplayed considerably the scouring overcapacity in the NZ industry. With four wool scours operating, we see the NZWSI scours running 24 X 7 for the majority of the year and Cavaliers own two wool scours also running at peak capacity for a minimum 3 to 4 months of the year. Wool has seasonal production and seasonal demand and scour overcapacity is a requirement for NZ's wool.

Draft Determination Reference Point 164

The Commission notes, however, that the Applicant's lack of knowledge of the scoured wool's destination may restrict its ability to price discriminate over the long-term

1. This is not in fact correct. In most cases, the client for whom the goods are being scoured would be known to Cavalier Wool Holdings Ltd. There is ample knowledge

to allow destination based price discrimination.

2. This argument on price discrimination can also be extended to where scouring for one wool product manufacturing destination, a competitor of Cavalier Corporation, could be discriminated against on a price and quality basis. This has already been performed over the past 5 years by Cavalier with Mohawk USA.
3. The result would be less choice of wool product and at higher prices for the consumer.

Media Release

"The Commission considers there is the potential for Cavalier Wool Holdings to raise prices after the acquisition because of the loss of the constraining influence of NZ Wool Services International. However, we expect that the level of the detriment resulting from the acquisition is likely to be limited by the ongoing, long-term competitive threat of the Chinese wool scouring industry and the potential for new entry into the New Zealand wool scouring industry,"

1. The ability for a monopoly to raise prices is a given and inevitable. Look no further than provincial air fares in this country where there is a sole provider of service.
2. When the wool scours of Godfrey Hirst were purchased by Cavalier Wool Holding Ltd some five years ago, the overall costs to scour wool increased by way of new incremental PH adjustment treatments, freight to scour and storage pre and post scour charges added to overall processing costs.
3. A further key issue here is to what extent New Zealand wants to control the value it achieves from its wool industry? Does New Zealand want to increase the added value to wool, something that Cavalier Corporation does very well for the greater good of New Zealand? Ie. the conversion of low value wool to high value carpet and in more than just Cavalier Corporation.
4. Or are we happy as a nation to see low value raw wool exported in increased volumes to China? Be quite clear once wool is exported to China for scouring it will not return to New Zealand for processing. That is simply not a financially viable option, nor does experience with Sunrise bedding wools confirm that it would be uncontaminated NZ wool returning.

Draft Determination Reference Point 52

"The Commission accepts that it is not economic to transfer wool across Cook Straight for scouring"

1. If the commission accepts that cross Cook Strait wool movement is uneconomic, then how can it be considered that shipping wool to China for scouring is an option?
2. The fact that shipping and scouring in China has been presented as a competitive alternative option is perhaps an indication of the intent of Cavalier Corporation in regards to its market competitors.
3. Cavalier are in fact quite happy to see wool scoured in China knowing full well that once it is in China that wool is then removed from the local production and as a consequence from the Australasian retail market place where their real competition

lies.

4. With fewer scouring plants, lead times for delivery will also increase. If competitive scouring can only be achieved overseas, then the competitiveness of NZ to achieve timely deliveries will cease.

Draft Determination Reference Point 85 – 86

The Commission accepts that a large New Zealand scouring price increase would be needed before scouring wool in China for resale elsewhere could be viable.

The ability for exporters to divert more greasy wool to China for scouring is unlikely in its self to sufficiently constrain the combined identity

From this statement coupled with the determination to proceed amounts to giving Cavalier Wool Holdings the right to test the limit of that scouring price increase as a right. Hence the determination acknowledges, accepts and confirms price rises for scouring are the inevitable outcome of the determination.

The only issues not quantified are the magnitude of the increases and who will be paying the increase in scouring.

Draft Determination Reference Point 141

The Commission concludes that higher scouring prices are not likely to be either absorbed or passed on. Instead they are likely to translate into lower margins for growers

It is difficult by any measure to see how price increases passed back as lower margins to wool growers is an acceptable outcome for the NZ economy, except for the increased margins available to Cavalier Wool Holdings. For this reason alone, this Draft Determination should be reversed.

Draft Determination Reference Points 99 – 101

The ability for a new entrant to build a new scour with in New Zealand on first appearance is a valid alternative, it terms of capital, operational cost analysis and viability,

1. When this determination is overlaid onto the requirements of the Resource Management Act, this becomes a virtual impossibility in any preferred location within New Zealand.
2. The uncertainty as to the cost of application in the first instance and uncertainty of permission being granted with affordable conditions in the second and with the timeline through to that permission being up to three years if contested in the third render this alternative as a non-starter for any potential competitor.

Media

"On the other hand, the Commission considers that there would be considerable benefits to the public arising from the rationalisation of the wool scouring industry that Cavalier Wool proposes to carry out. The rationalisation is likely to lead to lower production and

administration costs, the freeing up of industrial sites, and lower ongoing capital expenditure requirements in the future.”

1. Just how does the public receive measurable and quantifiable benefits from this rationalisation?
2. It is exceedingly difficult to discern any measurable long term public benefit from this determination, the contrary however is far easier to perceive. We would like the basis of ascertaining this finding and the measurement of it explained?
3. There is no dispute that the rationalisation may well lead to lower production and administration costs, but surely these will be captured by Cavalier Wool Holdings in the first instance and the shareholders of that company in the second. Normal commercial behavior would not see the direct financial benefits passed on to any other sector and certainly not to the public as a right.
4. Indeed the Commission has accepted that growers will receive lower margins as a result of this determination

   Draft Determination Reference Point 141

   The Commission concludes that higher scouring prices are not likely to be either absorbed or passed on. Instead they are likely to translate into lower margins for growers
5. Now is it the Commissions contention that as the Accident Compensation Commission is a significant shareholder in Cavalier Wool Holdings that this increased dividend to ACC constitutes the “considerable benefit” to NZ?

Draft Determination Reference Points 200 – 205

Sale of surplus land and buildings

1. It is difficult to see how the freeing up of two small industrial sites is deemed to be significant, or in the Public interest.
2. The Commission has considered the value of these sites as operating, (this may well be $8.792m as stated in point 205) however it is their value as abandoned specialist production facilities that ought to be value used for this test of benefit. Value will be destroyed on closure of the scours.
3. The cost of demolition and the potential of ongoing land care liabilities under the Resource Management Act demanding site restoration and after care may well in fact render these sites close to worthless. The country is currently littered with such contaminated closed residential sites. Is derelict dairy factories, meatworks, timber treatment plants and wool scours etc.
4. Both the proposed only Awatoto and Washdyke wool scour sites are coastal, running the risk of natural disaster from tsunami. Having weathered the Christchurch earthquake, we wonder at the wisdom of relocation of all scouring to a single site in each of New Zealand’s islands in the event of a natural disaster.

Draft Determination Reference Points 206 - -208

Capital expenditure

1. On the determination that the rationalisation will result in lower ongoing capital expenditure requirements in the future, that is a correct statement, in respect to Cavalier Wool Holdings, but it is not a true statement in respect to the balance of sector should Cavalier Corporation chose to use it's “gate keeper” position to manipulate its competitors.
2. The balance of the sector could in fact be faced with significant new capital cost to either build a new scour if at all possible, or alternatively shift scouring and consequentially post scour production of product to China. This will likely cause the closure of New Zealand spinning plants in particular, and in fact result in the wastage of capital rather than the freeing of capital.
3. A saving of $0.88m over 5 years can hardly be deemed significant, the cost to other parties effected by the closure of Kaputone in particular requiring new storage to be obtained will far exceed that saving. Yes there is a capital saving for Cavalier Wool Holdings but there will be increased capital requirement by the balance of the industry.

Draft Determination Reference Points 216-223

Wool Super Stores

1. On examination of the savings of costs to the sector presented and accepted as good cause to support the application of Cavalier Wools Holdings is the supposition that “super store” savings can only be achieved alongside and through scour rationalisation.
2. This is not true. The fact is that the prime driver of these cost savings will only be achieved after significant expenditure of new capital to build the 'super stores” and the supporting infrastructure.
3. This proposition as presented is flawed in its premise. It would also be a fairer statement that these savings in costs are in fact independent of whether there is a scour rationalisation or not, that is to say that these savings could be achieved just by building the “super store” and that scour rationalisation is not a prerequisite for these savings to be delivered.

Draft Determination Reference Point 224 – 239

Quality benefits

1. A totally subjective argument in itself, but critical in the determination
2. There is a basic premise in business “The customer is always right, even when they are wrong” that is to say that whatever the customer wants the customer should receive provided they pay the price.
3. Quality ought to be dictated by customer specifications and wool scoured to those specifications. If those specifications are not met, then there is the potential for claims against the exporter. This happened when the Cavalier scour was initially enlarged at Washdyke and Cavalier negated every exporters request for compensation despite having full knowledge as to the quality defects regularly occurring.

4. Perhaps in its consideration the Commission could consider the contrary effect on quality? That is that if there is a monopoly, with the removal of an alternative provider the incentive to maintain let alone improve quality has gone.
5. Competition ensures that quality is maintained and enhanced, and is a key marketing tool when attracting custom to competing scours.
6. This reason alone should be sufficient for the Commission to reverse its Draft Determination

In Regard to the "Public Benefit Test" specific points in the Draft Determination Public Benefit Test Section 40

1. Efficiency gains and anything of value to the community generally

There will be undoubtedly be efficiency gains for Cavalier Wool Scours, and in turn, Cavalier Corporation in its carpet tufting operation.

However that must be balanced with the resulting efficiency losses borne for direct competitors of Cavalier Corporation, should they be forced to scour in China.

2. Only include net benefits

The net effect for the country will likely be an efficiency loss to the wool sector as a whole when all of the collateral effects of the rationalisation are considered, the scours being in fact a minor but critical component in a complex industry of interconnecting parts.

The net potential loss to the value of the export value of NZ wool must also be deducted from any benefits.

3. The benefits must accrue from the acquisition

The principle benefits that will result from the rationalisation will be from the transfer of wealth, from wool growers to the shareholders of Cavalier Wool Holdings, any benefit to society is subjective

The benefits must result from the acquisition, in this case the bulk of benefits portrayed are in fact from the result of the building of "super stores" and rationalisation of the wool supply structure from farm to scour, which is quite independent of any scour rationalisation (they could be achieved through several different ways, not just by building the super store) and as such should be disregarded.

4. Benefits should be quantified where possible

Where the NZWSI assets valued at 31 December at $12 million are purchased for many times that value, then the question of recovery of that surplus cost must be deducted from any perceived financial benefits.

Conclusion

The reality for the public from this rationalisation will likely be:

Less employment in the sector

Less choice at retail for wool product

Lower wool grower incomes

Lower scoured wool quality

Less downstream wool processing within NZ

Less competitive NZ wool prices when compared to wools from other countries

NZ's wool exporting industry finally controlled by overseas owned and controlled wool exporters

This reality will be permitted by allowing a Cavalier to become a monopoly "gate keeper" in all aspects of wool starting with a scour but extending as a consequence across every facet of the NZ wool sector under the ownership of a single carpet manufacturer, Cavalier Corporation.

This is a more predictable outcome that any perceived benefit for the public presented in the Draft Determination of the Commission

From these facts, it is difficult to discern any measurable direct public benefit, and as a consequence the Draft Determination on allowing Cavalier Wool to purchase 100% of the shares in NZWSI should be reversed.

27th April 2011