FURTHER SUBMISSIONS FROM NEW ZEALAND WOOL SERVICES INTERNATIONAL LIMITED (WSI) ON APPLICATION BY CAVALIER WOOL HOLDINGS LIMITED (*CAVALIER*) FOR AN AUTHORISATION TO ENABLE CAVALIER TO ACQUIRE ALL OF THE SCOURING ASSETS OF WSI

1 **Proposal by Cavalier**:

1.1 On 9 February 2011 Cavalier made application to the Commerce Commission (*the Commission*) for an authorisation to enable Cavalier to acquire all scouring assets of WSI or 100% of the shares in WSI. The latter application has subsequently been withdrawn.

1.2 During the course of the Conference Cavalier clarified to the Commission that:

(a) Cavalier would only proceed with the share purchase if it acquired 100% of the shares in WSI to enable it to implement its proposals and obtain the efficiency benefits set out in its application;

(b) if Cavalier acquired the assets it would acquire all of the assets of WSI including the wool trading assets;

(c) Cavalier intended to close the two scours known as Kaputone and Whakatu, transfer the scouring assets to other Cavalier sites at Awatoto and near Timaru and then to sell the wool trading business operated by WSI.

1.3 On 12 May 2011 Cavalier notified the Commission that it had amended its application by withdrawing the application to purchase the shares in WSI and seeking authorisation for Cavalier or any interconnected body corporate of Cavalier to:

'*acquire all of the NZWSI's wool scouring assets (being the wool scouring assets and stock at Whakatu and Kaputone and 50% of the shares in Lanolin Trading) and/or any interconnected body corporate of NZWSI that holds those scouring assets.*'

1.4 The above will require the shareholders of WSI to pass a special resolution under section 129 of the Companies Act 1993 to approve any such sale. To achieve this it requires 75% of the number of shares voting on that resolution to approve it.

1.5 This will require the holder of the shares, the receiver of Plum Duff Limited (in receivership), and Woolpak Holdings Limited (in receivership) to vote in favour of the resolution together with a further 11.4% of the votes held by other shareholders. There is no certainty that support at that level can be obtained for a special resolution. Any support may be dependent on the price paid for the scouring assets and the distribution that could be available in respect of each share.

2 Ability of Cavalier to Implement Proposal

2.1 For WSI to sell the scouring assets it must obtain shareholder approval. The transaction would be a major transaction requiring 75% shareholder support.

2.2 Cavalier has a high degree of risk that it may not be able to:

(a) acquire those assets from WSI; or

(b) obtain WSI shareholder approval to that transaction.

2.3 WSI submits that it would be very difficult for Cavalier to purchase the assets without entering into a voting or other arrangement or undertaking with the holder of the 64% of the shares currently held by the receivers of Plum Duff Limited and Woolpak Holdings Limited. Otherwise the commercial risks to Cavalier would be too high.

2.4 The existence of any arrangements, agreements or understandings raises serious issues and barriers that would need to be considered in the context of:

(a) Parts III and IV of the Commerce Act;

(b) The Securities Markets Act 1988;

(c) The NZAX Listing Rules; and

(d) The Takeovers Code,

each of which carefully consider any control or voting arrangements.

2.5 WSI has submitted to the Commission that the above factual position means that Cavalier may not be able to carry out the rationalisation, or proceed with the transactions, for which it seeks authorisation, and therefore the benefits put forward by Cavalier may not be achievable.

2.6 A separate legal submission will be made on these matters.

3 The Factual and Counter Factual

3.1 Cavalier has put forward a number of benefits which Cavalier considers will arise in the factual. WSI submits that many of the benefits which Cavalier put forward as arising under the factual also arise under the counter factual.

3.2 The Commission's initial view on the application is that the factual will give rise to a substantial lessening of competition in the markets as identified by the Commission because:

(a) in the factual there will be no competition for scouring in New Zealand;

(b) little likelihood that there will be a new entrant who would be prepared to establish new scouring facilities in New Zealand because of the risks involved in making such an investment;

(c) the threat of scouring in China is limited.

3.3 Accordingly the Cavalier proposals will require an authorisation in order to proceed. WSI submits that this is the correct approach to the application. In the factual a monopoly will be created, there will be no competition for scouring in New Zealand and very little likelihood that there will be a new entrant who would be prepared to establish new scouring facilities in New Zealand because of the risks involved in making such an investment.

3.4 To determine whether an authorisation should be permitted under the factual the Commission needs to determine:

(a) the amount of detriment that would arise from a monopoly being created; and

(b) the likely benefits that would flow from the authorisation; and

(c) whether such benefits when netted against the detriments will create such net benefits or detriments to the public that the authorisation should be granted or declined.

3.5 If the Commission is not satisfied as to the matters contained in section 67(3) of the Commerce Act 1986 it must decline to give a clearance or grant an authorisation for the proposed acquisition.

4 Market Definition

4.1 The Commission determined in its draft determination the markets which are relevant to the application. WSI submits that the identification of the markets by the Commission is correct subject to further consideration of upstream and downstream markets.

4.2 There was such a significant body of evidence from the suppliers of wool, and the users of wool for manufacturing in New Zealand that both the upstream and downstream markets should be considered in detail by the Commission.

4.3 As a vertically integrated monopoly supplier of wool scouring services to those who seek to use its scouring services Cavalier would have the ability to disrupt and affect the businesses of others in the wool industry both upstream and downstream.

4.4 A number of upstream and downstream participants in the industry have made submissions against the Cavalier proposal including the persons set out below:

Upstream	**Downstream**
FibreTech NZ Limited	Rinanui Farms Limited
Godfrey Hirst	Wool Equities
Latitude National Wool Insulation	David McKitterick (Merchant)
Christchurch Yarns	Federated Farmers
John Marshall	Mark Hassall
	Mike Davis
	Timbercombe
	Woolrite (Merchant)
	Keratec

5 Trends in Wool Production

5.1 Cavalier stated (5.5 to 5.11 of its application) that there were declining sheep numbers and wool production which would continue.

5.2 WSI considers this statement is incorrect and submits that sheep numbers have now stabilised and wool volumes will not decrease. In support of this WSI have provided:

(a) A statement from Derek Kirke;

(b) An independent expert report from Nicky Hyslop (Appendix I).

(c) A newspaper report dated 9 May 2011 quoting Mr Rob Davidson of Meat and Wool (Appendix II).

5.3 WSI submits that the trend to convert land suitable for dairying from sheep farming has now stopped, or at the very least slowed to a trickle, and is unlikely to be revived in the near future. Land that is suitable for economic conversion to dairying is now scarce and the supply is unlikely to materially increase unless and until the irrigation schemes in Canterbury and South

Waikato currently being considered are consented and developed. This is very likely to be well beyond the five year horizon of the Commission's assessment period. Moreover the South Waikato proposals will reduce forestry areas and not wool production land. There are still substantial areas of farm land in New Zealand suitable only for beef and sheep and therefore wool will continue to play a major part in the New Zealand economy. With the combination of wool and meat prices at present levels, incentives to convert have materially reduced. The wool industry is no longer in a distressed state.

6 New Entrant into the Market

6.1 Cavalier submitted that any new entrant to the market would install a 2.4 m scour and the costs in carrying out this new investment for a new entrant would be approximately $XXXXXXXXXX. The model provided by Cavalier has been accepted for the purposes of considering the economic impacts. However because of the efficiencies gained by installing a 3 metre scour as against a 2.4 m scour it would be more likely that a new entrant would install a 3 m scour[1] and that the total cost of obtaining consents, acquiring land, constructing buildings, and obtaining all of the plant and equipment needed to operate a scour would be approximately $21 million [see evidence from Ian Caradus][2]. It was also submitted that to obtain the consents and acquire the land, plant and equipment to enable a new scour to be opened would take at least two years. There was further evidence from Godfrey Hirst that it would be difficult to locate suitable zoned land with the required attributes. There was evidence that with a new scour the bedding in process takes six to 12 months due to initial teething problems.

6.2 It was also put forward that any new entrant would need to build two scours, one in the South Island and another in the North Island, to give the appropriate coverage to those seeking commission scouring. It would also allow greasy wool from both Islands to be handled. If this is the correct economic structure to prevent differential scouring prices from Cavalier then the investment doubles and it becomes even more difficult to justify[3].

6.3 Any new entrant into the market would be likely to be a present user or exporter of scoured wool as only those persons would have the volumes necessary to support the creation of a new scour. Unless the new scour could build up very quickly to a volume of 18,000[4] tonnes per annum (being approximately 12% of the total wool scoured in New Zealand) then the economies of scale and efficiency to justify the building of a new plant would not be present. If there were two new scours in the North and South Island 36,000 tonnes of wool would be needed.

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[1] Mr Pike p 21 lines 30-35, 4 May 2011
[2] Mr Caradus p 32 lines 31-32, 4 May 2011
[3] Mr Pike p 22 lines 2-6, 4 May 2011
[4] This is a 3 m scour operating at 50% of capacity or a 2.4 m scour at 90% capacity;

6.4 Any new entrant would have to continue up to three years scouring wool with Cavalier while undertaking the construction of a new plant and getting it commissioned and fully functional and this would create material difficulties in the relationship for scouring wool between that party and Cavalier. This would almost certainly affect the business of the new entrant and thus be another barrier to entry.

6.5 Dr Brent Layton in his submissions has stated that because the owner of a plant would need to obtain a return over 25 years, and there are high risks in achieving the volumes to keep the plant full, the investor would need a return on investment of 15% after tax or approximately 21% pre tax (at a tax rate of 28%) to give the requisite returns. He noted that the return required is not comparable to that which the Commission may consider acceptable to a regulated monopoly.

6.6 What is relevant in this case is the return a potential new entrant would need as a hurdle rate before being able to finance and invest in a new scour to take on an established monopoly in an industry with significant economies of scale and relatively high fixed costs using very specialised assets. There is a considerable body of literature showing that hurdle rates used by firms are typically at a very significant premium to the firm's weighted average cost of capital.[5] The premiums are high and hurdle rate multiples of WACC are commonly observed.

6.7 Contrary to the claims of Cavalier at the Conference, both commercial practice and the literature support the required rate of return of at least 15% post-tax for an investor to tackle Cavalier's monopoly position by establishing a new entrant scour.

6.8 It is submitted that it would be exceedingly difficult for a new party to enter the market and it is highly likely that the risks involved in building a new plant, and keeping that plant operating efficiently, would result in very few persons (if any) contemplating that sort of investment when there are other far more reliable investments available in the market. WSI submits that the appropriate rate of return, based on the published materials and Dr Layton's submission is at least 15% after tax or 21% pre tax.

7 Benefits and Detriments – Y Factor

7.1 The Y Factor is a very minor factor taken into account when scouring wool. The key indicator for the wool industry is Y-Z as most wool purchases are based on this test and not the Y test. For the scouring of wool the

[5] For a summary of this literature see Glenn Boyle, *Corporate Investment Policy: What is the Cost of Capital?*, pp. 8-9. This report is available on the Commerce Commission's website. The link to the webpage is: http://www.comcom.govt.nz/search-results/&q=telecomlecgreportcorporateinvestmentpolicycostofcapital&q-all=&q-any=&q-exclude=&section=0&order=mostrecent&pagesize=20&mode=normal

improvement in the colour of the wool is dependent on the requirements of the customer. For many customers in India and China their requirement is to have a Y-Z above a minimum figure. This gives those customers wool of the right parameters for their uses. WSI purchases wool to meet this requirement and although it may purchase and scour wool with lower Y-Z values than Cavalier this is to meet market demand and requirements. WSI submitted (Mr M Dwyer) that WSI's scours provide a scoured product that is the same or better quality than that provided by Cavalier. This is demonstrated by WSI's growing demand and materially increased commission scouring. (See Appendix III attached),

7.2 The Y Factor is the increase in the whiteness and brightness in wool between the wool introduced into the scour for scouring and the scoured wool as the output of that scouring process. To measure the benefits arising out of the Y Factor the Commission needs evidence on the Y Factor applying to the greasy wool introduced into the scour and the Y Factor in respect of that same wool when it is scoured and the financial uplift in value from that rise in the Y factor. WSI has tried to investigate this matter within its own scours and has a great deal of difficulty in providing any results because:

(a) when wool is introduced into the scour the greasy wool comes from a number of allotments in different volumes (there can be up to 20 blends of wool introduced) and to identify the Y Factor of all of those blends and the weightings to be applied to them would be very time consuming and difficult[6]. One container of wool may have a variety of blends of wool requiring extensive testing of over 80 different Y factors.;

(b) Although the Y Factor is measured through the scour this is for the purpose of achieving an output that is measured by Y-Z to meet this measurement for the buyer of that wool. It is the Y-Z that is critical for most buyers (Appendix IV).

(c) Cavalier have not demonstrated the Y Factor of the greasy wool introduced into the scour and how this has been made up from different blends but has only taken an overall view of the Y Factor of the scoured wool that has been produced and the increase over time in the Y Factor of all scoured wool. This can arise from weather conditions during each year as can be demonstrated from the figures produced by the Wool Testing Authority on the brightness of wool over a ten year period where the statistics show up marked differences in the Y Factor for wool over each wool season. Variances also arise from shearing patterns, the time of shearing, different breeds of sheep and other factors.

(d) WSI's customers request details on the Y-Z indicators but only a small number of customers by volume contract a Y factor. The auction system

[6] Page 95 Lines 18-31, 4 May 2011

relies on wool being purchased based on the Y-Z factors which are highlighted in catalogues for wool sales. This method of assessing wool has been used in the industry for many years.

7.3 Cavalier contends that in achieving a lower Y value it can:

(a) blend lower grade wool (with a lower Y-Z) to give a better Y factor after scouring;

(b) increase the throughput and reduce scouring costs[7];

(c) receive a premium from merchants scouring wool for the premium attached to whiter wools.[8]

7.4 The evidence presented by Cavalier to the Commission fails to take into account or provide statistics on a number of key factors:

(a) to measure the Y-Z factor (which includes Y) both the inputs of greasy wool and the output relating to that greasy wool must be measured. Most scoured wool specifications require a blend of different greasy wools to be inputted into the scour; the weighted average Y and Y-Z of these greasy wools must be measured against the Y and Y-Z for the scoured wool otherwise the comparable Y-Z factors cannot be measured[9].

(b) Cavalier states it employs pickers to pick out the '*yellow*' (lower Y factor) wool. This can occur both after scouring and by sorting wool before scouring; the Y-Z of the wool picked out or sorted out and its downgraded price (because it is of lower value) must also be measured.

(c) No supporting evidence has been provided in the reduction of cost; Cavalier states it improves the run rate and reduces costs. However to dry wool the same energy must be used to dry the same weight. A claim that energy costs are reduced for the same volume is very difficult to sustain[10].

7.5 All the discussions have been on the Y Factor. It is the Y-Z factor that is relevant not the Y in isolation. No evidence has been put forward by Cavalier on this.

7.6 Cavalier submitted that it improves the Y Factor by employing persons who pick or sort out the yellow wool as part of the process**.** This process removes a percentage of the very low Y factor wools and would contribute significantly to the stated gains. It is more cost effective to purchase wools that do not require

[7] See 18.61 of Cavalier Application

[8] See 18.71 of Cavalier Application;

[9] See Mr Ranford, lines 23-26 p.101, 4 May 2011. Also Mr Pike, lines 11-17, p. 106, 4 May 2011;

[10] Mr Pike lines 3-8, p.46, 5 May 2011;

"picking". WSI accepts that it does not employ pickers as it considers that the significant cost in employing more staff to pick out the yellower wool does not result in scoured wool that has any higher economic value than the wool that is produced without the use of pickers.

7.7 When pickers are employed the wool picked out is of a lesser quality and the amount taken out can be between 2% and 4% of the total weight. This '*picked*' wool is then materially written down in value. When the loss on the wool picked out is combined with the costs of the pickers WSI submits there is no net benefit. WSI considers the selection of the proper blend into the scour is the most cost effective process to follow.

7.8 WSI's view is that many overseas buyers of scoured wool do not place any value on the improvement in the Y Factor and accordingly there is an economic detriment in employing more staff to pick out certain wools as it creates a higher operating cost without any compensating benefit being received by way of a higher value for the scoured wool. The customers of WSI are more concerned that the Y-Z meets the manufacturing requirement and that the wool inputted into the scour has the correct specifications as an output. This is supported by the evidence of Peter Crone of John Marshall[11]. (see Appendix V attached).

7.9 Cavalier states that merchants will pay more for the improvement in Y. The evidence from the purchasers of wool and Godfrey Hirst was that:

(a) No additional payment would be paid for this perceived improvement in Y[12];

(b) It is difficult to see by visual examination the improvement[13];

(c) The improvement in Y value does not exist because all that has changed is that the Y value of the inputs of greasy wool by Cavalier into its scour have improved so affecting the Y value of the outputs[14] .

7.10 XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX XXXXXXXXXXXXXXXXXXXXXXXXX:

(a) XXXXXXXXXXXXXXXXXXXX;

(b) XXXXXXXXXXXXXXXXXXXXXXXXX;

[11] Page 110 4 May 2011;
[12] See Peter Crone lines 15 & 18-21, page 109, 4 May 2011;
[13] See Dr Carnaby lines 18-22 page 98, 4 May 2011;
[14] Mr Pike page 105, lines 17-23, 4 May 2011;

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XXXXXXXXXXXXXXXXXXXXXXXXX.

7.11 For a number of years all of the auction catalogues, and sales information, has emphasised the Y-Z factor and this is the main technical information that is used by buyers of wool in determining the brightness and whiteness of the wool being purchased. The wool is normally sold in greasy form and no value could be attributed to the Y Factor that may be improved (if indeed that can be shown) by Cavalier in the scouring process. Cavalier is only a scourer of wools and by its own admission does not trade in wool and accordingly as a commission scourer cannot show that the scouring process will change the views of the exporters on price who purchase wool and then request that wool to be commission scoured by Cavalier;

7.12 WSI submits that the Commission should prefer the evidence of Dr Garth Carnaby who is New Zealand's leading wool research scientist on wool and who submitted that:

> '*It is my opinion that no relevant information has been provided in the application to support the contention that the Cavalier scours can achieve a base colour result, Y, different from that achieved with the NZWSI scours as they are presently configured. I consider that there are sound scientific grounds for doubting that this is the case.*'
>
> '*There is in fact still no evidence whatsoever presented by CWH, or before the Commission, as to whether or not the same lot of wool scoured in an NZWSI plant would have a lower, equal, or higher Y result than might be achieved by CWH in any of their plants.*'[15]

7.13 In respect of the matters raised by all parties at the conference Dr Carnaby has stated as follows:

'In my first submission I cautioned against inferring causality from the data available. I specifically referred to the risk that the claimed Base Y improvement, if real, could be just due to selection of a whiter subset of NI wools by Cavalier. The new information in my opinion strengthens the need for caution and strongly mitigates against drawing the conclusion that the changes in scouring practice described by Cavalier have had any material affect on Base Y outcomes.

It remains my opinion that no evidence has been presented to support the claim that either of the Cavalier scours would produce a higher Base Y value than either of the NZWSI scours as they are currently configured, should the same parcel of wool be divided and processed separately on each.

[15] Page 98 Lines 6-13, 4 May 2011

Accordingly it remains my opinion, now supported by this new evidence, that there is no evidence before the Commission to support the claim that reconfiguration of the NZWSI scours in the manner suggested would result in any Base Y improvements.'

See Appendix VII attached.

It is submitted that this should be accepted by the Commission.

8 **Super Store Concept**

8.1 Cavalier proposed that it would erect two new super stores for the storage of wool with one store being in the North Island and one store in the South Island. Ross George in his evidence stated that the stores would be constructed in modular form as it is not expected that the benefit from a super store would flow immediately[16]. He stated that the expectation was that it would commence with smaller volumes and build up to larger volumes over a period of time. He could not identify that period of time.

8.2 WSI submitted that it would be very difficult to establish a super store in the North Island and another in the South Island and to persuade all of those involved in the wool industry to utilise those super stores. Mr Dwyer pointed out that there is a multitude of wool traders who have their own stores, and who gain storage fees from storing wool, and that because they are the intermediary between the farmer and the scourer, or the wool exporter, they will be very reluctant to give up their facilities or storage fee income in the medium term.

8.3 WSI submits that it has considered the development of more extensive storage facilities for wool at both its Whakatu and Kaputone plants. It accepts that this would have the potential of creating benefits by way of lower handling charges if the store is immediately adjacent to a scour. WSI submits that it carried out extensive analysis, after reaching an initial view, on the likely benefits arising from a new wool store and that the economic benefits were not as substantial as first thought for the following reasons:

(a) The cost of building a new super store is substantial and there would need to be a return on this investment;

(b) There would need to be dedicated staff to operate a super store and this would negate part of the rationalisation savings in reducing handling charges;

(c) Insurers are very reluctant to provide insurance cover for wool where the bulk of the clip could be located in one store. They would prefer this risk to be spread over a number of wool stores;

[16] Page 85 Lines 24-25, 4 May 2011

8.4 In any event it is open to WSI to construct new wool stores at its sites at Kaputone and Whakatu and accordingly, whilst WSI is sceptical of the claimed benefits, if the Commission accepts that some or all of such benefits will accrue WSI submits many of the benefits claimed for the factual will also occur in the counterfactual. Only a small percentage of additional benefits would be separately available to Cavalier based on the factual arguments. In assessing the overall costs and benefits of the proposed transaction it is only the incremental benefit (and costs) that should be assessed and not the entire efficiency gains from the move to two superstores.

8.5 Cavalier put forward the position that only if volumes are aggregated is there justification for a superstore. WSI states that benefits can be achieved from consolidating smaller volumes at a number of medium size stores and the industry could move to this over time. However because of the need for consolidating wool from a number of smaller farmer providers, and the use of local storage, this can only occur over the medium term.

8.6 Under the factual there will be only one superstore in each island, and the South island superstore will be at Timaru. PrimePort Timaru's volumes are approximately 10% of Lyttelton's so that even under the factual it is very likely that the export of wool would be largely through Lyttelton to take advantage of the wider range and more frequent services and more competitive market for shipping rates available at that port compared with PrimePort Timaru. So, under the factual, there would be an additional element of road transport costs compared with under the counter factual because wools from mid-Canterbury and north would have to be carted to South Canterbury and then carted back again to Lyttelton. This is a detriment of the factual compared with the counter factual that needs to be offset against any incremental benefits the Commission believes should be counted.

8.7 Both WSI and Cavalier have given evidence that the superstore concept is likely to evolve over time. WSI considers it is unlikely that any material benefits will be achieved within the five year time frame of the Commission's analysis, but if the Commission considers that some will be then these need to be discounted for both the lag in their achievement and for the uncertainty surrounding their realisation.

9 The China Threat

9.1 Cavalier submitted that there was a significant competitive risk from the scours operating in China which would restrain and contain prices which Cavalier could charge for scouring in New Zealand based on the factual. WSI submitted that the threat from Chinese scours is limited to the modest quantities of wool currently scoured in New Zealand for further processing in China and currently New Zealand is more than holding its own for scouring this wool so the threat from China is not real and should be materially discounted. In support of this submission WSI states:

(a) that in the annual periods from 2007/8 to 2009/10 the tonnage of wool exported to China from New Zealand has risen from 37,245 tonnes to 46,282 tonnes. In respect of each annual period the amount of that wool which has been scoured and exported in scoured form has risen from 13,587 tonnes (36% of the wool scoured) to 18,288 tonnes in 2009/10 (which is 39.5% of the total tonnes scoured).

(b) this shows an increasing trend to scour wool for export to China in New Zealand (see Appendix I).

(c) for the 2010 year to date (1 July 2010 to 31 December 2010) the percentage of wool scoured has risen to 44.3% (see Appendix VIII). This trend line negates the argument that the Chinese scours are a real threat to scouring coarse wools in New Zealand.

[(Source of chart: Meat and Wool Economic Service (Beef and Lamb)]

9.2 In addition Chinese buyers of New Zealand wool prefer in many cases to have it scoured in New Zealand for the following reasons:

(a) The consistency and quality of scouring by WSI in New Zealand;

(b) The reliability of the branding that is attached to New Zealand scoured wool from WSI;

These are all performance issues which arise from high performance standards within the WSI plants which demonstrate that value can be gained in New Zealand by carrying out this further process in New Zealand.

9.3 WSI also differentiated between the scouring of fine wools and coarse wools. The WSI scours at Kaputone and Whakatu only handle coarse wools and do not scour fine wools. This creates economies of scale and efficiencies within the plant because the plants do not have to be altered to handle different types of wool. WSI accepts that there are a number of scours in China which scour fine wool and which are competitive with New Zealand scours in the fine wool area. However WSI has submitted that it is and can remain competitive in the scouring of coarse wool with Chinese scours which will not provide a price constraint for the New Zealand scouring market. The price (charge out rate) of scouring in New Zealand has reduced over the last 25 years due to efficiencies and innovation driven by competition.

9.4 A number of parties making submissions to the Commission agreed that it would be impractical and inefficient for wool to be exported from New Zealand to China for scouring and then re-exported to other countries. The red tape in achieving an import of wool into China and then a re-export, together with the additional freight costs, make this proposal very remote and is unlikely to occur in real economic terms. Evidence has been placed before the Commission of the likely costs that would be incurred for having wool contract scoured in China for re-export with further evidence that the buyers of scoured wool from China would also raise issues as to the quality and integrity of the wool being supplied. It is submitted that the supposed constraint from China for coarse wool is not a matter that should be taken into account.

9.5 The Australian market should not be used as a proxy for the New Zealand market. The largest proportion of the Australian clip is fine wool and the manufacturing of fine wool garments shifted offshore with scouring following. The large percentage of lanolin extracted from fine wool (6 to 7 percent against 2 percent) created the economies to permit this to occur. Fine wool scouring is much slower and requires a higher labour input which enables China to compete in the fine wool scouring market.

9.6 The existence of scours in China is:

(a) not an option for those who wish to export scoured wool to countries other than China. The cost and benefit of contract scouring in China for re-export are not there;

(b) as shown from increased levels of scouring New Zealand coarse wool for export to China the threat of scouring that wool in China is not apparent or shown;

(c) the scouring of wool in New Zealand is not highly sensitive to price; notwithstanding the New Zealand scourers have shown an ability to reduce prices and improve quality so as to remain highly competitive.

9.7 It is submitted that scouring New Zealand coarse wool in China is not a real threat to the New Zealand scouring industry.

10 Land and Buildings

10.1 WSI agrees that Whakatu could be realised more readily than the site at Kaputone. However in respect of both sites the realisation price for those sites would take into account:

(a) the need to carry out repairs and maintenance on the buildings to correct defects which have arisen due to the processes carried out within those buildings;

(b) the terms of any covenant which Cavalier placed on the site. Cavalier confirmed it would covenant the site to prevent wool scouring activities[17]. WSI submits that it is very likely that Cavalier would also prevent by covenant the sites for all wool related activities to prevent those sites being used as a base from which to compete against its concept of a super store for wool storage ;

(c) the time it would take to shift the scours from those sites and make those sites ready for sale.

10.2 There was some disagreement by Cavalier on the timetable for removing the scours, and having to carry this out in the off season, and as a result the timetable for offering the properties for sale. Any time delays will affect the certainty of the realisation of values for the properties.

10.3 A practical timetable would be:

(a) conclude acquisition by 30 November 2011;

(b) carry out building extensions by 31 May 2012;

(c) shift plant and equipment June – November 2012;

(d) ready land for sale; November 2012 to February 2013.

10.4 This would create a two year gap before the land could be realised and so any realisation would be subject to market uncertainties. In respect of the Kaputone site it is submitted that this would be a far more difficult site to sell for the following reasons:

(a) The age and quality of some of the buildings on that site;

(b) The oversupply of industrial buildings in the greater Christchurch area;

(c) A lack of investment interest due to the major earthquakes in Christchurch and the risk of liquefaction particularly as an adjacent site has suffered heavily from land displacement and liquefaction;

(d) The clean-up costs in respect of this site.

Reference is made to the report Dr Alan Reay in respect of the land and buildings at both the Kaputone and Whakatu sites.

10.5 WSI submits that it would be completely inappropriate for the value placed on the land and buildings by the receivers of its major shareholders to be

[17] See Ross George line 22, p.22, 5 May 2011

accepted by the Commission. Those values were based on a going concern and accordingly a continuity of the scouring operations on the two sites. To use those values would be, in WSI's view quite incorrect.

10.6 Cavalier has stated that it would close the operations on both sites and therefore those sites would be sold as vacant sites and will have a different valuation from a going concern valuation. WSI has submitted valuations which show the vacant land values, which valuations were carried out prior to the 22 February earthquake, and since then most valuations of properties in the Christchurch area have been significantly reduced and discounted due to the effect of the earthquake. This can be seen from public reports and announcements made by leading property investors in Christchurch including the Goodman Property Trust, the AMP Office Trust, The National Property Trust and the Kiwi Income Property Trust.

10.7 WSI considers the valuation approach taken by it of valuing a closed site with covenants attached is the correct approach. This is supported in paragraphs 6 to 9 of the statement by Mr G J Horsley (attached as Appendix IX and Mr D Preston (Appendix X). These persons are independent experts giving their view on the correct approach which is not correct in the draft determination.

10.8 WSI submits that a valuation based on a vacant property with a restrictive covenant attached to it is the only basis for valuing the properties. Any other valuation approach would be erroneous and misleading. The suggested approach by Cavalier is incorrect and WSI reserves its right to challenge any decision that arrives at a different view.

11 Disruption to the Market

11.1 The proposal before the Commission is that Cavalier or any interconnected body corporate of Cavalier be authorised to:

'*acquire all of the NZWSI's wool scouring assets (being the wool scouring assets and stock at Whakatu and Kaputone and 50% of the shares in Lanolin Trading) and/or any interconnected body corporate of NZWSI that holds those scouring assets.*'

11.2 For Cavalier to achieve this transaction will require a special resolution of 75 percent of the shareholders of WSI to vote in favour of it. If Cavalier reached any prior agreement in relation to the transaction with the receiver of Plum Duff and Woolpak, he would become a related party to the transaction and so not be able to vote, and the WSI shares held by Directors and Senior managers could defeat a special resolution.

11.3 The only practicable way Cavalier can purchase the scouring assets of WSI without acquiring all its shares is if a resolution to sell all the scouring assets to Cavalier is put to the shareholders and the receiver of Plum Duff and Woolpak (along with a modest number of other shareholders) vote in favour of it. For the receiver to be able to vote there would need to be no prior agreement in relation to the transaction between the receiver and Cavalier.

11.4 Provided the offer from Cavalier is better than any other actual or prospective offer, the receiver, and at least the required proportion of minority holders of WSI shares, are likely to vote in favour of such a special resolution.

11.5 The receiver will almost certainly insist that the proceeds from any sale of the wool scouring assets to Cavalier are distributed to the shareholders as soon as practicable, and since he controls WSI he can and will ensure his wishes are met.

11.6 Given the legal obligations upon him, the receiver will not wish to leave the proceeds of the asset disposal in WSI to fund wool purchases to support its merchant trading activities any more than is absolutely necessary, or for a longer time than is the minimum required, for the company to meet its existing wool trading obligations. The receiver will not leave himself open to the risk that the price of wool drops reducing the amount he can return to creditors of Plum Duff and Woolpak.

11.7 In fact, the receiver is unlikely to vote in favour of a resolution to sell the scouring assets to Cavalier unless the proposal is that Cavalier assumes all WSI's forward obligations to deliver scoured wool and to scour the wool held or purchased by WSI to deliver against those orders. This is because after the sale WSI will not be able to scour wool itself and so the receiver will not want the liability of meeting commitments which require it to pay Cavalier's "price" or default. Nor would the receiver want to have to dispose of the wool stocks held by WSI to fulfil these orders. Cavalier will be aware of this and, even without any explicit agreement with the receiver, the proposal put to a special resolution vote will cover off this point. Since WSI only deals in scoured wool there will be no on-going obligations to be funded and so the entire proceeds of the sale will be distributed as soon as practicable, together with any other resources WSI's remaining activities do not require.

11.8 The corollary is that under the revised proposal for which Cavalier now seeks authorisation, WSI will have to stop being a purchaser of wool on its own account as soon as the special resolution necessary to give effect to the transaction is passed. WSI will be out of the wool market as a buyer for as long as it takes for it to find new shareholders, be recapitalised and arrange lines of credit. It is unlikely it will quickly return to its current level of participation in the market (buying about 30% of the offerings at auction) for a considerable period of time, if ever.

11.9 WSI considered that under Cavalier's original proposals significant short-term disruption to the wool market was a possibility which the Commission must consider. Under Cavalier's revised proposal, because of the role and motives of the receiver under this proposal, WSI is of the opinion that very significant disruption to the wool market is almost certain to occur and must be taken into account by the Commission.

11.10 WSI submitted that it needs facilities of up to $60 million to cope with its present trading activities and the bank will only provide that funding because WSI can also offer hard assets in the form of land, buildings and plants to support its financial facilities. Accordingly other merchants and exporters would have difficulties in arranging these suitable financial and banking facilities to take up the volumes at present exported by WSI. During this period there would be material disruption to the market and it is likely that there would be a temporary reduction in wool prices which would have a flow on effect to the economy by reducing the amount received by farmers for wool.

11.11 Details of that economic impact were referred to in the evidence from Geoff Deakins and have been set out in more detail in Dr Layton's report. WSI submits that this is a real threat to the wool markets on a temporary basis during the period from the shift from the counter factual to the factual. The market does not have sufficient confidence in Cavalier continuing to operate this market because Cavalier has closed down its main wool trading activities through E Lichtenstein some years ago and has given strong indications to the market that it is not interested in continuing the trading activities of WSI. WSI submits that the period of disruption would be in the range of three to six months and that the cost to the New Zealand economy could be very much higher than estimated by Dr Layton and be $30m to $100m.

11.12 Cavalier stated at the conference that when it ceased wool trading operations through E Lichtenstein and Company Ltd (Lichtenstein) in early 2001 there was minimal disruption to the wool market. The suggestion was that this experience was a reliable guide to what would happen in the wool market if WSI withdrew.

11.13 WSI accepts that there was no noticeable disruption to wool prices at the time of Lichtenstein's withdrawal but submits that, for the following reasons, this experience is a poor guide to the likely disruption from the current proposal before the Commission:

(a) The wind-down of the trading activities of Lichtenstein was spread out over nearly a year. It started in July 2000 and by February 2001 between 20 and 25 percent of Lichtenstein's forward transactions outstanding at the time closure was announced were still to be fulfilled;

(b) Lichtenstein was not Cavalier's only wool buying entity in 2000-01[18]. It also owned Elco Direct. This entity had hitherto specialised in direct purchases from farmers but according to its website "with the closure of the [Lichtenstein] merchant wool scouring business in 2000, Elco Direct now services the [Cavalier] corporation's broadloom carpet business and New Zealand's wool exporters at large." In short, the changes relating to Lichtenstein in 2000-01 were to some degree a re-organisation within the Cavalier group and not a withdrawal of buying power from the wool market. It was to facilitate an orderly transition in the market.

12 Dynamic Efficiencies

12.1 During the course of discussions at the Conference WSI stated that the drive to be innovative would be lost in the factual. WSI submitted that the industry has remained innovative and competitive on a world-wide basis because there is strong competition in the counter factual and this has lead to both parties having a significant investment and creating innovative solutions which reduce costs and improve efficiencies within the scouring industry. WSI states that Kaputone has been the leader in innovative changes within the industry since it purchased and installed a 3 m scour in 1996/1997. Prior to ordering a 3 m scour WSI carried out a world-wide investigation and found that there was one 3 m scour operating in Uruguay. WSI then determined whether this could improve efficiencies and throughputs for the scouring industry in New Zealand. It then contracted Andar Limited to build a 3 m scour and this was the first scour of that size constructed and installed in New Zealand. It has then become the benchmark for efficiency within the scouring industry.

12.2 In addition Kaputone has carried out a number of further innovations including:

(a) the development of a new type of platen dryer which was an evolvement from dryers used in the grain industry and replaced the old drums that were used for drying wool and which created major problems of matting and other issues;

(b) installed new equipment at Kaputone so that major efficiencies in the use of water can be achieved with a reduction in usage of approximately 80% at Kaputone;

(c) being a major innovator in the development of new types of wools working with various research institutes and this has resulted in the commercial development of "*Glacial TM*" wool which has set a benchmark for the whiteness and brightness of wool in the New Zealand wool industry. This technology has been utilised successfully in the USA to produce pastel shades of carpet which were not previously available to the market.

[18] Wayne Chung, lines 11-24, p.15, 5 May 2011

12.3 WSI provides under confidentiality future initiatives which it has for its plants and which were mentioned by Mr Dwyer at the Conference. WSI submits that it can further improve the economics and efficiency of its two scouring plants to continue to ensure it has a competitive advantage and benefit over scour plants operating in other parts of the world. It is also working on initiatives for the extraction of further wool grease from the scouring process in conjunction with Cavalier.

12.4 WSI submits that without the competitive element within the scouring industry in New Zealand this innovative drive will materially reduce to the detriment of the New Zealand economy.

13 Efficiency Benefits

13.1 Cavalier has provided a model setting out its projection on the financial impact continuing with the status quo in the North and South Island (the counter factual) and then, for each Island, the position if the authorisation was approved (the factual). WSI has not been able to obtain any details from Cavalier on how these figures have been prepared and its advisers have significant doubts about many of the reductions in operating and administrative expenses after enquiry on the actual costs of WSI.

13.2 WSI has particular concerns on the following items:

(a) whether the bleach and other additives have been correctly calculated;

(b) whether the significant savings in energy costs can be achieved;

(c) how the savings in repairs and maintenance can materially change if all scours continue to be maintained to a high level and operated efficiently;

(d) whether all wages and salaries have been correctly stated particularly as Cavalier plants employ more people than WSI's;

(e) how there can be such a material saving in high dense packs if export volumes are to be maintained. It is noted that the revenue for high dense packing has no material variation;

(f) the basis for determining revenues from the press department and the scouring department.

(g) many of the key figures relate to revenue and not to price or volume changes without any explanation being provided.

13.3 Without the ability to examine and understand the projections provided, despite repeated requests for access to this information, WSI has been unable to provide useful comment. WSI submits that the Commission should not rely on the Cavalier projections and should seek independent verification of the key figures from an industry specialist who understands the wool and wool scouring industries.

13.4 The evaluation and projection prepared by Cavalier is a business case analysis. It is not an evaluation of the benefits and costs to New Zealand of the acquisition. It is submitted that the Commission must separate out and take into account the public benefits and costs and disregard the private benefits and costs.

13.5 If a public benefit test is applied then:

(a) based on the factual the new operation will be a commission scour with no trading operation. Discontinuing WSI's merchant scouring will not be a public benefit because the activities now carried out by WSI such as visiting overseas customers will have to be carried out by other parties in New Zealand. These are not savings to New Zealand as a whole but to the merged entity;

(b) the ability of the new entity to negotiate better prices due to its market strength are wealth transfers. Only lower costs of supply should be taken into account;

(c) Rates and taxes are transfer payments so savings in these must be excluded;

(d) cost savings due to productivity increases must be demonstrated to be dependent on the merger to be realised. Otherwise they are available on both the factual and counter factual. Cavalier has to demonstrate why WSI or another owner could not obtain those productivity improvements.

13.6 Cavalier has not produced any details on the productivity increases, how these have been calculated, and the benefits to the New Zealand economy. The financial projection put forward must be submitted to a test of verification before any of the figures can be accepted. To date Cavalier has denied WSI access to those projections so it cannot analyse and comment on them.

13.7 Dr Brent Layton has analysed the various costs and expenses and prepared a list of items that need careful consideration. This is attached as Appendix XI. It is self explanatory.

14 Production Disruption

14.1 Cavalier has claimed that there would be no disruption to production arising from the closing of the scours at Kaputone and Whakatu and shifting these to Awatoto and Timaru. Cavalier claimed to have carried out extensive planning on the shift.

14.2 Attached as Appendix XII is the plant utilisation for Kaputone and Whakatu. The lowest point is in October in each year and even in that month there is 60% utilisation at Whakatu and 80% at Kaputone. Utilisation in the four month low season from July to October averages over 80% at Kaputone and 60% at Whakatu.

14.3 Unless the Cavalier scours have significant capacity it is evident there will be a capacity problem in scouring for the industry for a period of four to six months while the scours are closed and shifted. With requirements for refurbishing parts of the scours and teething problems in restarting the scours the delays could occur over a period of up to 12 months.

14.4 It is evident that there is little spare capacity at the two main Cavalier scours so unless Clive is operated there will be under capacity in the industry for a period of four to six months. If Clive is operated there will be the additional costs of it doing so. Either way this cost of disruption to wool scour processing has to be included as a detriment as part of the factual which will be avoided under the counterfactual.

APPENDIX XII

ANALYSIS OF COST SAVINGS

1 CWH have claimed to the Commission that none of its productive cost savings represent merely changes in prices that are wealth transfers. I have been through CWH's spread sheet and calculated the percentage differences between their estimates for expenses under the Status Quo and the Merged scenarios. The "suspicious" numbers which suggest to me transfers or other reasons for them to be discounted, at least in part, are:

2 Scour - electricity unit charges – [XXXXXXXXXXXXXXXXXXX]. Although the amount of wool to be scoured is almost unchanged. This cost reduction cannot be due to production economies of scale as the same scours will be used (neglecting the minor impact of Clive). If it is due to lower prices, it is most likely a wealth transfer. If it is due to productive efficiencies, the question is why WSI will not achieve these under the counterfactual.

3 Scour – electricity fixed – [XXXXXXXXXXXXXXXXXXX]. Although the number of connections will be reduced, the cost to society to provide capacity for industrial facilities is typically more closely related to peak capacity than the number of connections and the peak capacity required at the three sites (including Clive) is likely to be greater under the merger configuration. Not obvious there will be a big saving, or any saving to society.

4 Scour - Gas/Coal – [XXXXXXXXXXXXXXXXXXX]. Again, the wool to be scoured will be the same and the equipment will be essentially the same so why the big reduction in energy input is unclear. If due to lower prices, it is most likely only a wealth transfer. If due to productive efficiency, the question is why WSI will not achieve these under the counterfactual.

5 Scour – Rubbish/Waste disposal – [XXXXXXXXXXXXXXXXXXX]. Again, the volume of wool being processed is roughly the same so why there should be a reduction in rubbish/waste is unclear. If due to lower prices, it is most likely only a wealth transfer. If due to productive efficiency, the question is why WSI will not achieve these under the counterfactual.

6 Press – electricity unit charges – [XXXXXXXXXXXXXXXXXXX]. See comments above relating to Scouring - electricity unit charges.

7 Press- electricity line charges – [XXXXXXXXXXXXXXXXXXX]. See comments above relating to Scouring - electricity fixed.

8 Administration – bank fees – [XXXXXXXXXXXXXXXXXXX]. This is probably due to the change in model from NZWSI being a merchant wool scourer exporting directly and funding its stocks to being a commission scourer. This is not a saving to NZ as a whole however as the forex and holding costs will still be incurred, but by other parties. This is almost certainly a transfer and, if so, should be excluded.

9 Administration – communications – [XXXXXXXXXXXXXXXXXXX]. This is probably largely due to the change in model from NZWSI being a merchant wool scourer exporting directly and so incurring considerable communication costs in the process. This is not a saving to NZ as a whole,

however, as the communication between NZ sellers and offshore buyers will still be necessary, but will be incurred by other parties. This is almost certainly a transfer and, if so, should be excluded.

10 Administration – FBT – [XXXXXXXXXXXXXXXXXXX]. FBT = fringe benefit tax. Taxation is a transfer payment and "savings" in transfers should be excluded.

11 Administration – insurance – [XXXXXXXXXXXXXXXXXXX]. The number of properties will decrease and this should lower insurance costs, but against this the scouring business (to which this overhead should relate) will be more concentrated increasing risk and hence charges for insurances such as business continuity and profit maintenance. I doubt there will be any real saving when insurance is judged on a like for like basis.

12 Administration – office expenses – [XXXXXXXXXXXXXXXXXXX]. The percentage appears unrealistically high even though the site numbers will be down. If some of the reduction reflects the abandonment of NZWSI's merchant scourer business model, it is likely to only reflect transfers of costs to other parties that should be excluded.

13 Administration – printing and stationery – [XXXXXXXXXXXXXXXXXXX]. Again, If some of the reduction reflects the abandonment of NZWSI's business model, it is likely to reflect transfers of costs to other parties that should be excluded.

14 Administration – rates – [XXXXXXXXXXXXXXXXXXX]. Industrial rates do not reflect the services provided by local councils as these are provided almost entirely on a user pays basis to this sector. They are a transfer payment and "savings" in transfers should be excluded.

15 Administration - travel – [XXXXXXXXXXXXXXXXXXX]. This is probably largely due to the change in model from NZWSI being a merchant wool scourer exporting directly and so incurring considerable costs travelling to maintain client relations. This is not a saving to NZ as a whole, however, as the travel for NZ sellers to meet offshore buyers will still be necessary, but will be incurred by other parties. This is almost certainly a transfer and, if so, should be excluded.

16 In total, [XXXXXXXX] of expense savings claimed by CWH are questionable. This is approximately [XXXXXXXXXX] of the total. The fundamental problem is that what is a private saving is not always a saving to New Zealand as a whole and for evaluating the factual and counterfactual it is benefits and costs to New Zealand which have to be assessed not CWH's calculations of savings from a merger.