Cavalier Wool Holdings Limited and New Zealand Wool Services International Limited

Application for Authorisation

Date of hearing: 10 June 2015

The Commission: Dr Mark Berry
Dr Stephen Gale
Anna Rawlings

[Amended 26 June 2015 to remove confidential information on pages 27 and 28]

(9.34 am)

(Health and safety briefing from venue staff member)

CHAIR: Good morning everybody. I'd like to welcome you to the Commerce Commission conference on Cavalier Holdings Application for Authorisation to acquire the shares and/or wool scouring assets of New Zealand Wool Services International.

I am Mark Berry, Chair of the Commerce Commission and with me are the members of the Commission who are making this decision, to my right Dr Stephen Gale and to my left Anna Rawlings.

Commission staff will also be assisting us during the conference and they're located on this bench here, together with Matthew Dunning QC, our barrister.

The conference notification and agenda were provided to interested parties on the 15th of May and just by way of background briefly, under section 67 a person who

proposes to acquire assets or shares of a business may give notice to the Commission seeking authorisation for the acquisition.

The Act requires the Commission to give clearance for the proposal if it is satisfied the acquisition would not have the effect of substantially lessening competition in a market. If the competition is not satisfied, then clearance must be declined. Although we may still grant an authorisation if we are satisfied that the acquisition will result in such a benefit to the public that it should be permitted.

If we are not so satisfied, then of course the authorisation must be declined.

Public benefits include efficiency gains and anything of value to the community generally. The focus is on economies of scale and scope; better utilisation of capacity and cost savings.

Only net benefits are included; any cost incurred in achieving efficiencies must be taken into account.

Generally transfers of wealth which achieve no benefit to society as a whole are to be disregarded.

However, if these transfers are between New Zealanders and non-New Zealanders, as is the case here, additional factors will need to be considered.

As you will all know, we released a Draft Determination giving a preliminary view for authorisation on 26 March.

Some parties have made written submissions on the Draft Determination.

Public versions of the submissions have been posted on our website.

Independent economic experts and legal counsel who have provided the Commission with confidentiality undertakings have received access to all confidential

versions of submissions. This is on the basis that they do not reveal confidential material to their clients or anyone else.

Turning to the procedures for the conference today, the Commission's primary contact person is Mya Nguyen and Mya is over there (indicates), so if you have any questions about today, Mya is your first point of contact.

The Commission has carefully read all submissions that we have received.

The Commission intends to focus the conference on issues it wishes to explore further and to test these issues, so as to deepen our understanding of what we see to be key issues.

There is an outstanding matter in relation to the details of land valuations for the three sites: Kaputone, Whakatu and Clive. This topic is not on today's agenda.

Following this conference, subject to their confidentiality undertakings, the relevant parties will be provided with the Commission's confidential independent land valuations and will be given the opportunity to submit on these valuations.

The standard rules that apply to this conference, as you'll be aware from the previous proceeding, that we've had. The conference is not an opportunity for parties to question the Commission. However, in saying that I hope that as matters progress there will be opportunity for dialogue between Commissioners and interested parties such that informality is advanced to the fullest extent.

This conference will, in accordance with our previous conferences, be issues-based rather than parties-based. That means the Commission will deal with one issue at a time as outlined in the agenda and will question all relevant parties on specific issues before

moving on.

The conference is not adversarial and no party will have the right to ask questions of any other party during the proceedings unless requested to do so by the Commission.

While the conference is focused on particular issues we wish to explore further, the fact an issue is not on the agenda does not mean the Commission has reached a final decision on all matters.

That said, we request that the parties do not deviate from the agenda topics unless specifically requested to do so.

The Commission does not intend to request opening statements from the parties and nor closing statements. Rather, the Commission may request a final round of written submissions should they be required or if answers to questions are not able to be provided at the end of the conference.

So we'll do a mop up it at the end of the day and just work out where we go to from here in terms of further submissions.

It goes without saying that the Commission members are approaching all matters relating to Cavalier Wool's Application for Authorisation with an open and independent mind and I do stress our views will continue to evolve up to the point that we make our final decision.

My understanding is that all independent experts have formally confirmed that they have read the Code of Conduct for Expert Witnesses and the High Court Rules and agree to abide by these when speaking at this conference.

The Commission has scheduled a confidential session for the end of the day; as confidential issues and questions arise I will park them for consideration in

this later session which is only open to attendance for those parties who have signed the confidentiality undertakings. But we will endeavour to do as much as we can in open forum. But we will hit points today where there will be a need to park things for confidentiality.

As you will see, the conference proceedings will be recorded. Microphones are available at the table for speakers. Please identify yourself and speak slowly into the microphone so that the stenographer does not have difficulty keeping up or hearing you. The Commission expects to be able to provide interested parties with this transcript of today's proceeding shortly.

Only experts and legal advisors who have signed confidentiality undertakings will receive the transcript of the confidential session.

I assume you've all got the agenda which provides for breaks throughout the day. These times are indicative; we will aim to keep to them as best we can, but we will have some movement potentially dependent on how the day plays out.

Finally, Commissioners will not be available for access during the breaks. This room will remain open during breaks, so secure any confidential information that you have.

Tea and coffee for all parties is available all day in the conference area, although the conference is not catered.

Copies of the Draft Determination and agenda are available for those who don't already have it, and contact Mya if you need a copy of that.

Any new documents provided to the Commission for the first time in the course of today's proceeding will also need to be put on our public website, so we need to get that to Mya in PDF form as well.

Before we commence the first session, and in order to help the stenographer, it may be an idea to go round the table so that each of the participants can identify themselves by name and organisation so it's on the record to help our stenographer identifying you when you start off. So perhaps if we start with Professor Guthrie?

PROF GUTHRIE: I'm Graeme Guthrie from Victoria University of Wellington.

MR DAVID: I'm Grant David from Chapman Tripp for Godfrey Hirst.

MR DIXON: I'm John Dixon, Counsel to Godfrey Hirst.

MS PAULING: Tanya Pauling, Godfrey Hirst.

MR HALES: Nigel Hales, CEO of Cavalier Wool Scourers.

MR MELLSOP: James Mellsop, from NERA Economic Consulting.

MR LONERGAN: Gavin Lonergan, Direct Capital on behalf of Cavalier Wool Holdings.

MR TAYLOR: Phil Taylor, Bell Gully, Counsel to Cavalier Wool Holdings.

MS PASLEY: Penny Pasley, Bell Gully.

MS HARRIS: Emma Harris, Bell Gully.

MR DEAKINS: Geoff Deakins, New Zealand Wool Services.

MR MCKENNA: Tony McKenna, Lempriere Capital Partners.

MR DAVIS: Michael Davis, Lempriere Australia.

MR DAWSON: John Dawson, New Zealand Wool Services.

CHAIR: I'd like to start out with a session on productive and dynamic efficiency issues.

And the first question we would wish to pose is to Professor Guthrie.

Our Draft Determination places some weight on the impact of the potential for increased demand for the export of greasy wool and also notes the continuing decline in wool clip volumes and we identified these as relevant factors in assessing the likelihood of productive and dynamic inefficiencies.

We note Professor Guthrie that you make no reference to these factors in your expert report and we'd like to know what your views are, do you think that these are or are not relevant considerations informing us as to the likelihood of productive and dynamic inefficiencies.

PROF GUTHRIE: Sorry, could you repeat the start of that please?

CHAIR: In the course of formulating our Draft Determination views we attached some weight to the increased exports of greasy wool to China and the declining wool clip, and we've identified these as relevant considerations in reaching a view as to the likelihood of, or not, productive and dynamic inefficiencies and we just wonder what your views are on these market dynamics on this subject?

PROF GUTHRIE: I think that productive efficiency and dynamic efficiency relate to what happens after the merger takes place. So the idea is that firms are going to merge, competitive pressure disappears and then firms get lazy and their costs start to inflate. So that is the idea behind the losses of both forms of efficiency.

Now, if there is a greater threat from China, that affects the level of the costs that the merged firm can run, but it doesn't necessarily effect the rate at which they can relax after the merger. So that if the threat from China is greater, then at the time of the merger they're going to have to get costs down further in order to compete. But once that's happened, you've still got looking forward you've got the same, the same situation as you would have had four years ago; that is China is out there, it's more competitive than it was four years ago, but you've got your costs down further than they were four years ago. So from that point on you can still get a little bit lazy and your costs can push up, but

they're starting from a lower base.

So I don't think that any increase in pressure from China is necessarily going to change the rate at which costs come back up again after the merger.

CHAIR: But presumably there's a point at which if you're, you know, becoming organisationally slack and prices are going up and so on, you know, in two, three, four years' time surely you're going to be mindful of the threat of people in response to that looking to export greasy wool?

PROF GUTHRIE: But I think you would have been four years ago as well. The point is -- the idea is that you know you've got this pressure from overseas, so when you merge the two firms from a competitive starting point you get costs down to the point where you can compete with China. Now, if there's a greater threat from China you will have to get them down further in the first instance. But the buffer that you'll build in will be the same. So if China is not much of a threat you don't need to get costs down far to start with, and then they'll just drift up over time because of the lack of competition internally.

If, on the other hand, China is a much bigger threat, you're going to having to start by getting costs down so much further than previously, but you'll still have that buffer that will allow you to increase the costs later on.

So I think you could argue that a greater threat from China would lead to costs being lower in the first instance, but not necessarily have any effect on the losses that would occur after the merger takes place.

CHAIR: What about the declining volume of wool clip, assume that that decline continues? Do you see that doing anything or not in relation to keeping the merged entity productively and dynamically efficient?

PROF GUTHRIE: I think if the clip is declining so that the

industry is changing in any way, dynamic efficiency is going to be more important than it was previously. If the industry was stable and demand was constant, then there's not going to be as much need to change the way that the firm's operate in response to changing market conditions. But if you've got demand falling, or rising for that matter, then there is going to have to be a series of decisions that the firm is going to have to make after the merger takes place, in which case the potential for dynamic efficiency losses is going to be greater. If the industry was stable, you set it up, you leave it, it's fine. But if demand is declining and you're having to rationalise, then that's the situation where dynamic efficiency can be important.

So I think it doesn't necessarily follow that a declining demand is going to make those losses smaller.

CHAIR: Would you like to respond to any of those points Mr Mellsop?

MR MELLSOP: Sure, thank you.

So two questions I think were there. So, Professor Guthrie's response on the first question to me almost assumes that China stops and stands still, China, Malaysia, wherever the pressure is coming from, whereas to me if it's an ongoing competitor, then there will be ongoing pressure. So I have a different view on the productive efficiency aspect.

On the declining wool clip, I've already expressed my view that I think it will, if it continues to decline, will get more and more pressure on what is a fixed cost business.

And I think, I've got to be careful what I say here, but in our report after the Draft Determination we had some analysis of CWH's historical prices, and I won't say in this session what that finds, but I think it's

indicative of partly the threat from overseas, but also I think the declining wool clip is consistent with that having putting pressure on these firms and that the predictions are that will continue.

CHAIR: Can I ask somebody from Cavalier to express an industry view on the questions I have posed and indicate to me, you're running a business post-merger, what kind of pressures/threats are you seeing the export of greasy wool, the lower clip, imposing on you? Why are we to think that there would be no particular risk if productive or dynamic inefficiencies as you respond to those kind of threats?

MR HALES: I think when you look at the costs it covers a wide range of areas, and to remain competitive with China we have to continually innovate. We spend quite a lot of time researching the markets overseas, including China. So we make regular trips to China to assess what level their scouring -- the competition's at; what changes they're making and what new developments.

We're continually having to adjust our operation modes to keep abreast of what's happening in China through innovation and technology, here. And if I could use the example of Hawke's Bay Wool Scourers. In this past year we've managed to improve the average run rate by 200 kilograms per plant and improved the quality of the wool by colour, by basically making a new formula of detergent. I can't see for any reason why we would stop doing that. It just doesn't make any sense. If we're unable to keep abreast of what's happening overseas, and I'd include Malaysia and other countries in that, then simply wool is going to go greasy. The tipping point is so fine.

So I hope that answers your question.

CHAIR: Okay, look I'll just see if there is any follow up

questions from staff, but we'll just do this issue-by-issue.

MS CSORGO: It's Lilla Csorgo from the Commerce Commission. I had one follow up question for Cavalier: You talked about the sort of ongoing work and research that you're doing to keep production efficient, has that changed since the last time we were here?

MR HALES: No not at all. We've made step changes every year, and we plan to make changes every year going forward. It's just if we don't we'll be left behind.

CHAIR: Look, my next question is fairly much information gathering. We just want to get some feel on the record for the existing information data and reporting systems in terms of what they are and what impact they're having in terms of monitoring productivity at Cavalier both on an ex post and real time basis.

Is this something that can be answered in open session or would you prefer to do it in confidential?

MR TAYLOR: We can deal with it.

CHAIR: Okay.

MR HALES: Okay, with monitoring, I break that into two categories: an internal monitoring system and an external monitoring system.

Internally the factory is monitored minute-by-minute and every part of the factory is assessed by different levels of authority right down to the minute. That formulates into daily production reporting, and I'm meaning every part of the factory. Then it goes into weekly reporting, formal weekly reporting, through to formal monthly reporting which is into a -- and then taken through to a board pack type report, which is then put in front of the Board for questioning.

All KPIs are measured right throughout the whole factory minute-by-minute and we benchmark ourselves

against previous years, previous performances, trends in wool type et cetera, et cetera.

External monitoring includes trips to other countries, including China on a regular basis to monitor what's happening over there.

The trends that we're seeing in China, pricing, what our competitors around the world are pricing their services at and any other information that we can. And most particularly about wool grease as well, what the trends are there.

CHAIR: Look, I'd like to turn to some of the other more contentious issues based on the submissions.

The first one is the question around shareholder constraints.

And again, in our Draft Decision we've expressed the view that the fewness of the shareholders in this case provides a basis for monitoring the productivity of the wool scour.

And I'll turn my questions predominantly to Professor Guthrie in this session and that your main argument, as I understand it, is that this reasoning is suspect because of the unexercised option between Lempriere and ACC and Direct Capital. And as I read your brief, you suggest that this may lead Lempriere to pursue high risk strategies.

And if I can begin first by trying to understand and explore the nature of what these strategies might be and how they would lead us to a conclusion of likely productive inefficiencies. It seems to me that there's two potential options we could think about; some of these higher risk strategies might be in technology, enhancement, other areas and achievement of those could in fact be you know pro-competitive and also result in productive and dynamic efficiency. Other high risk

strategies like you know, deferral of maintenance and so on may have the opposite affect over time.

And so I just want to understand if you can just particularise further what you're saying the risks are and why it should conclusively sit in the basket of equating to a productive or dynamic inefficiency conclusion that we should draw.

MR GUTHRIE: I think you've sort of described them the way that I would. And one of them is sort of a strategic decision making and then the other is the nuts and bolts of running the business as it stands. And just from what we've heard, this threat from China and the need to innovate and all that stuff, there's your opportunity for investment, how aggressively to you try to innovate? Do you try to get ahead of what's happening in China? Or is it a risky strategy to actually wait and see what happens?

Anything that a firm does where it's uncertain about the outcome in the future is going to be a source of risk and that's potentially going to affect the different parties in different ways.

If there was no option and you just had four large shareholders, then -- there's always going to be things happening outside the business, but it would be reasonable to say you've got four large shareholders; they each own a large chunk of the firm; they're going to want to maximise the share price.

But with that option you have a situation where if there's some sort of innovation taking place, like the ones that you described; if that's very successful, the party that has the option is going to get the benefit. Once the value of the firm goes above the strike price of that option all of the benefit going to one party. So -- whereas the others their benefit was capped once it hit

the strike price and the option was going to be exercised. Whereas if things don't work out --

CHAIR: So there is no detriment in that situation?

PROF GUTHRIE: Could I come back to that? I'll do the down side, then I'll come back.

CHAIR: Okay.

PROF GUTHRIE: The issue with this investment not working as well as people expected is that you're then into the realm of down side risk, where the party that owns the option is protected by the fact that the option can just not be exercised. So if things work out really badly, you've still got your shares, but you don't have the down side of the option to go with the up side.

So the party that has the option likes high risk projects and whether it's high risk strategic projects or whether it's high risk operating strategies, it would be the same.

On the other hand, the parties that have given this option, they have the opposite situation in that they're fully exposed to the down side risk, but they're having too -- well they're not getting the up side risk beyond a certain point. So that high risk for them is bad.

And what it means is that the Commission can't assume the way that it has done, that these four shareholders just want to maximise the value of the firm, or in the language that the Commission is using: "want to maximise profits".

And the argument that you make is that well they want to maximise profits; a necessary condition for maximising profits is that you minimise cost. And so you're getting pressure to maintain productive efficiency because you want to minimise costs because you want to maximise profits because you want to maximise the value of the firm.

And likewise, with the sort of investments that might lead to dynamic efficiency, to some extent those are going to be relating to investments that reduce costs in the future. If you can reduce your future costs you'll protect your market share or boost it and so on.

So, all of those decisions are tying back to productive efficiency and dynamic efficiency.

And it works in the Draft Determination because everybody wants to maximise profits which means that everybody -- all the shareholders want to minimise costs. But once you take away that profit maximisation objective thanks to the option, then it doesn't follow that they necessarily want to -- it doesn't follow that they want to minimise costs. And so any sort of investment that you might think would lead to greater dynamic efficiency is being compromised because the different parties don't want to maximise profit.

And so your argument about these things minimising costs relies on parties wanting to maximise profits. And that means balancing the up side and the down side. Once you take that away, the objective function has changed and the whole argument collapses.

The other issue relates to both productive and dynamic efficiency is that when you've got that conflict within the ownership group, putting aside the fact that they'll want different things and that will change the decisions that they want to make, it just generates conflict within that organisation. And so that instead of focusing on whatever objective function you want them to have, they're focusing on this conflict within the parties. And so instead of having their eye on the ball of cost minimisation, or whatever, they've got their eye on this conflict that's going around.

So there is a direct affect in that it alters the

parties' objective functions. And there's an indirect affect that it just creates disagreement within that decision making group which is going to affect everything from now on.

CHAIR: If we can just come back to my question, I mean what I'm struggling with is that one of the story lines is actually a productive efficiency story if taking high risk strategy actually ends up with everybody winning, with a successful outcome. You know, to me it's not actually pointing to a productive inefficiency problem. In the real world that's how it could actually play out. And so I'm just struggling to understand how we would factor that into our conclusion?

If we accept what you're saying, you're saying that the incentives around this non-exercised option is going to count as a detriment. But if you play through that high risk strategy in the real world it may end up actually as the opposite.

PROF GUTHRIE: I think -- but you have to make your decision now before we know what those outcomes are going to be. And so your assessment of whether the decisions that are going to follow this are good or bad has to be done on an ex ante basis. And sure, it may well be that this high risk strategy turns out to benefit everybody, but you're not going to be able to wait to find out before you've got to make your decision. So you also need to allow for the fact that it may turn out to be bad for everybody. So you're in a situation where you have to evaluate the effective of this not knowing whether there's going to be an up side outcome or a down side outcome.

And my argument is that the costs of this are in the decisions and you measure the costs before you know what the outcome is going to be.

DR GALE: Can I ask a question?

I wonder if you can give us an idea as to how we would estimate the scale of this affect? Do you have some empirical material that you can draw on, that we can draw on, you know the idea may have a logic to it, but it's a question of how material it is. And we sort of need some guidance as to making it significant or not.

PROF GUTHRIE: I think that it's going to be difficult to quantify it. I could imagine a lot of people could try and they'd come up with a lot of different approaches and you'd get a lot of different numbers and at the end of it I'm not sure that you'd actually be any the wiser.

I think the point I've tried to make is that one thing we can say is that it's not going to be better than it was four years ago. So whatever level of productive and dynamic efficiency losses you thought you were going to have then, they're going to be bigger now as a consequence of that conflict. Bigger or unchanged. But they're not going to be smaller. When you introduce this conflict of interest within the organisation you are not going to make the situation better. It will either be worse, or it will be unchanged.

And I think -- I can tell you the affect is positive not negative. I can't tell you how big a positive number it is.

CHAIR: Can I invite Mr Mellsop and also Cavalier to respond to Professor Guthrie's views on this point?

MR MELLSOP: I suppose I'd like to make two points addressing the two questions.

The first is the more I've actually thought about Professor Guthrie's paper the more I think you don't need to worry about it, and I'll explain why that is. It's because I think, and I'm sure Professor Guthrie will tell me if I've got this wrong, but I'm pretty sure that his argument assumes that the strike price of the option is

fixed. Whereas, in fact, once again I potentially need to be careful about what I say in open, but I think it's okay to say that the strike price actually reflects the future value of the firm. So if to use Professor Guthrie's phrase there's a Hail Mary strategy implemented, and the value of the firm goes up a lot, my understanding of the exercise price, there are four parts to it --

CHAIR: I just wonder, I actually had that -- I've got three questions on this and that's my third one, so if you can just confine the comments just at the moment to the question about these different strategies -- the high risk strategies and how they would be likely to play out with an unexercised option?

MR MELLSOP: Okay, maybe I'll come back then to -- I don't think there's a conflict of interest is what I'm saying.

CHAIR: Okay.

MR MELLSOP: That's why I don't think you need to worry about it. But if I can come back to that then?

CHAIR: I'll just move to my next question and then it might be a chance to come back in.

Because at 45% what can Lempriere actually do to initiate these high risk strategies? Because this conversation has assumed that this unexercised option is conferring on Lempriere the ability to influence the way that the target company would do business. And so I just wouldn't mind getting a feeling for the views on that particular topic and then if we can start with Godfrey Hirst and then I'll invite Mr Mellsop and Cavalier to take us through the dynamics of how these factors about the strategies we've spoken about so far and what a 45% shareholding means in that context.

PROF GUTHRIE: It's a flippant answer, but 45% is bigger than 27 and a half and that does give them -- you know they

are the largest shareholder, it gives them -- you don't need to get much more support to get above 50%.

The other thing is that the point of the conflict --

CHAIR: But if you've got Lempriere going out on a high risk strategy why would all the other parties come in behind that?

PROF GUTHRIE: They may not. But that gets back to my second point about this ongoing conflict within the organisation. That you've got one group of shareholders who want high risk because they've got this call option; you've got another group of shareholders who own 27 and a half percent who prefer low risk because they've given up this call option and then you've got a third group of shareholders who aren't involved in that option at all but have these drag along rights that they've got to deal with.

So you've got three groups of shareholders; none of whom have got a majority, but all of whom have got a different objective function. And you know what a committee's like when you've got three different groups, no-one's in control and they all want different things.

And that's my second point about the problems that can cause.

And ultimately, when it comes to decisions about deferred maintenance or about investment, a decision is going to have to be made. And you can't assume that just because everybody has a different objective function, that they're going magically settle on the one that maximises market value or maximises profit.

CHAIR: Is there anything we need to know about decisions which may need more than a majority vote? Are there any class of actions or business decisions that a 45% shareholder could frustrate that supports your argument?

PROF GUTHRIE: I think I'd need to know how the company works

before I could answer that.

MR DAVID: Mr Chairman, the answer to that maybe that if there's an extraordinary resolution required then a 45% shareholder can have a negative control over the company, and that's clearly spelled out in the Commission's own guidelines. There is a range of different points at which control of various kinds can be affected. And certainly a 45% shareholder, particularly in collusion or in cahoots with other parties that have a community of interest in relation to the same option being exercised or not being exercised, have got an ability to exert considerable control. The Commission's own guidelines indicate that 45% is in many instances a significant degree of control. For example, sufficient to trigger association with other parties.

CHAIR: Okay. Can I pass it over to Cavalier and its experts now to respond to the ability of the 45% shareholder to substantially influence decisions, and also that the likelihood of high risk strategies actually playing out in light of the unexercised option.

MR LONERGAN: Sure, and then we'll come back to James on the --

CHAIR: Yeah, and then I'll lead questions on the strike rate of the option.

MR LONERGAN: I'd make three points really. Firstly we've got a shareholders' agreement which manages behaviours amongst the shareholders and that's a standard agreement between the parties.

I suppose the second point I'd make is in our example, Direct Capital, we're a private equity investor. In our 20 years we've never owned a business one hundred percent. You know, we've always done that in partnership with other parties; managing the conflicts that Professor Guthrie is talking about is just our daily, you know,

daily jobs really. It's just not an issue.

I suppose the third point, just touching on the negative control, in my mind that prevents high risk strategy, I mean that's exactly the point of it. You can't promote a high risk strategy off a minority shareholding.

So, look, I just don't accept that when you've got multiple shareholders that that necessarily drives to an inferior behaviour. Twenty years in private equity would tell us otherwise.

MR TAYLOR: Perhaps to add to that, the shareholders agreement provides for directors to act in the best interests of the company, not in respect of their shareholding companies. So that they're driven to do what's best for the company, not for themselves.

CHAIR: Can we move on to the question that's already been touched on, and just for the sake of example and so as not to enter into confidential information zones, if you make an assumption the current value of the shares of a company is $5 and the strike price of the option value is say $10. In these circumstances would the holder of that call option promote a high risk strategy that was going to harm productive or dynamic efficiency goals?

It just seemed to me when faced with that kind of call option scenario, it's one that's not likely to have a productive or dynamic inefficiency outcome as something that would be in their interest to promote or likely. And also, what does it tell us about the expectations of the parties where the strike price may be substantially higher, it's telling us that both the holder of the call option and also the vendors are thinking that something, you know, positive in terms of these factors is going to happen in relation to that market?

So can I just get your response to that and then

that will lead into the ability for James to respond.

PROF GUTHRIE: You talked about the example where the share price is $5 and the strike price of the option is 10.

That's not -- I mean, it seems like a big difference and you might think that option is so far out of the money that it's really not worth much. But there's a couple of things there, three things actually.

A typical merger premium can be of the order of 40 or 50 or 60%. So that when firms acquire another one they'll often -- in fact on average they'll pay 50 or 60% more than the share price prior to that merger becoming known. So big differences between the current value of the assets and a price that's going to be paid for them by another party to get control. 5 to 10 isn't necessarily a huge number. That's the first thing.

The second thing is that by all accounts this is a risky sort of business and if the challenge from China and Malaysia is as strong as we're hearing then the value of those underlying assets can potentially be very very volatile. And so again, 5 to 10 isn't a huge difference in that context. It would be if it was a safe regulated firm, the share price isn't going to go from a 5 to 10. But something like this it could happen, it's not an unrealistic difference.

The third part of it, is that the terms of that option will have been negotiated as part of a wider package when the merger was being put together. So you've got factors like the strike price of the option; you've got the length of time that the option is going to last; you've got the possibility of adjusting the strike price of that option over time, and you've also got the percentage of the firm that one of the parties is going to end up owning, maybe it's 45% with a strike price of this. They could have changed the strike price and had a

different ownership stake.

So it's -- that strike price has got all sorts of things going on that don't just relate to the potential value of the underlying asset, if the option is going to be exercised.

So it's just -- we've got to be really careful about how we interpret that option.

And I don't think that a strike price that's twice the value of the current assets in this situation is especially large. It's a risky business. A 60% premium isn't big anyway. I think it's quite feasible that the value of the firm could change without adopting ridiculously risky strategies in order to put that option in the money.

CHAIR: Thank you. Mr Mellsop?

MR MELLSOP: Sorry, I'm just figuring out what's confidential and what's not.

So there's three or four questions I think floating around which I would like to address. And I think if I could start with what I started on before, because I think the subsequent questions related to it as well. And that is how does the strike price work? Because it's not fixed, it's not static. And even the base price, which I believe is confidential, that was what Phil was just telling me now. I think even that actually goes up each year by a rate which I don't know if I can say or not? By 15%. So even the fixed price is going up by 15%.

Then there are three other clauses which to an economist, and others can correct me if I'm wrong on this, but to me say that the strike price basically reflects the value -- if the value of the company goes up a lot due to a Hail Mary strategy, then the strike price reflects that because it's based, for example, on a

multiple of EBITDA, or EBIT, it's one of them, I've forgotten which one, EBITDA. So therefore, those who are selling the shares to Lempriere benefit from the up side in the company. So this is why I don't think there is actually a conflict of interest. I have a different view to Graeme on whether this thing exists.

So that's the first point I wanted to make.

And I think that also segues into the subsequent question about the 5 versus 10.

Two comments there, so the 10 using that number which is made up, isn't static, that changes.

Secondly, one of Professor Guthrie's responses was that the takeover premium point, which I agree that there often are takeover premiums, but I think that makes the 5 to 10 even more extreme, because it kind of assumes that the actual value of the company now is more like 3, for example.

CHAIR: What sort of takeover premium would you accept as being realistic?

MR MELLSOP: I can't quite recall what the literature says, I've no reason to dispute what Professor Guthrie is saying; I am sure these guys will have a comment, so I don't have a different -- I can't -- I don't know off the top of my head.

MR LONERGAN: There is no magical number, what I would say is the premium that Professor talks to is presumably in a listed market with a widespread shareholding where you need a big premium in order to attract the 90% threshold. You know, this is a private company with four shareholders. So there's just not the tension in that to require a significant premium for theoretical control.

MR MELLSOP: I only had one other comment which is actually going back to Dr Gale's earlier question about quantifying this, is that okay if I quickly address that?

And, I mean, I'm not quite sure how one would do it either. So my argument is you don't need to worry, as I've already set out.

But I think it's relevant just to remember that -- I mean I don't want to downplay the importance of dynamic efficiency in any industry, but we're talking here about cleaning wool and I was reading an economist's article the other day about Bombardier, so the Canadian aeroplane maker, and the article is just saying that it's basically betting the company on building an aircraft to compete with 737s. Now that is obviously a Hail Mary strategy. I just think it's important to remember here we're talking about the innovation we see in this industry is more along the lines of adding another bowl, getting it cleaner, increasing run rates. So I think that goes to the materiality if we did try to quantify this.

But, as I say, I actually don't think we need to.

CHAIR: Can I take any questions from staff on this subject of the unexercised option?

MR LONERGAN: Sorry Mr Chairman, maybe could I make just one more comment on the option?

We Direct Capital and ACC applied no value to that option at the time that it was negotiated, so yeah, in our view it's actually not quite sure why we're even having the discussion. But you know, there is simply no value ascribed to it.

CHAIR: I will give Godfrey Hirst a chance to respond and then we might end this part of the session.

MR DAVID: Mr Chairman, the option clearly gives rise to a high degree of uncertainty, we've seen that just in terms of the discussion here.

The High Court which looked at your decision last time Cavalier sought authorisation said that where there is uncertainty, particularly surrounding quantitative

analysis, the proper approach for the Commission to take is not to fix on a particular point, but take account a range that allows for that uncertainty. And we'd submit that that clearly is what needs to be done here to account for the various uncertainties that arise as a result of the Lempriere option and potentially the exercise of the drag along right.

MR TAYLOR: Mr Chairman, just on that point, the High Court didn't say that. The High Court said the Commission needed to pay attention to giving reasons for its decisions in taking a point on a range. Not saying it has to be a range.

CHAIR: We have fully considered the range point arguments in terms of our analysis and so, you know, we're not looking to see that as a topic we need to go through today. We've fully taken into account the High Court decision on that.

Just looking at our timetable things have already fallen apart a little bit, but we have ample time allocation. I mean, we don't want to rush these things and potentially we're looking for the day to go through this and we're making much slower progress than I expected on this one.

Can we break now, it's close on 10.30; if we can get back here at quarter to 11.

And you'll see eventually as the day goes quite a lot of push out in terms of the agenda. I mean, just realistically the confidential session may well be starting in that 2.45 slot. So we'll just play the day out as we have to to accommodate all of the subjects.

So we'll see you back here at quarter to 11.

(Adjourned between 10.30 and 10.47 am)

CHAIR: Let's reconvene the session on productive dynamic inefficiency topics.

The next item I had for conversation was the issue of about incentive based remuneration schemes for employees and you'll see in our Draft Determination that we've indicated that this is another relevant factor on this issue of the likelihood or otherwise of productive and dynamic inefficiency.

Can I start out with Cavalier on this and to the extent possible in open session, can you share with us first of all the nature of the current schemes in place and what is proposed post-merger?

And it would also be helpful if you could point to any evidence you believe you have about productivity gains through this scheme that your company operates. Do you have any evidence that could substantiate that your schemes are in fact translating into productive efficiencies?

If there's problems with this we can park it for the confidential session, but I would like to try and explore it at high level as best we can at public session.

MR HALES: Cavalier runs a standard bonus remuneration scheme right across the two sites. They're an absolute mirror image in the North Island to the South Island. And the bonus remuneration for the productive staff, I'm talking productive staff here, can make up to 45% of their weekly wage. And it's a mix of a bonus based around taking responsibility through a tier of structures such as leading hand, shift supervisor et cetera, et cetera.

It's also based around the actual productivity of the scours and it has a kick-in rate around a budget level for throughput, and levels above budget rate are paid in increments to the highest possible level, which I don't mind saying here is $6.

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So it's fair to say that our staff are highly motivated to earn their hundred percent maximum bonuses on a daily basis, which they do.

And we can provide evidence that shows that the upper levels of the bonus system are generally met on a weekly basis.

Obviously we're checking on KPIs, which are hourly and daily, and all of that is visible for the staff. So at any point in time they know exactly where they are as far as their bonus system goes and the particular levels that they're earning either weekly or daily, actually.

On the management side, we have bonus schemes in place based on profitability. So, as senior management we're incentivised to ensure that the profitability of the business is maximised. And, like any bonus scheme, it's a true incentive to ensure that that happens.

And it's to reward performance above a budget level.

So I hope that answers your question.

CHAIR: Can I turn to Professor Guthrie on this, in your report you referred to incentive problems and you also called ratchet affect arising.

From what you've just heard about the structure of the remuneration scheme operating at Cavalier does that pose you still problems in terms of ratchet affects? And if you can just articulate your views on whether this scheme should or should not give us comfort that organisational slack is unlikely to creep in?

PROF GUTHRIE: The first thing I'll say is that these schemes have been around for decades and the potential to have them was around in 2011, so whatever level of discipline they provide was there in 2011. So I don't think the

Commission can use it as an excuse to tighten the --

CHAIR: This is another question, when I was reading your report it seemed that you were working off some kind of an assumption of counterfactual analysis when we assess detriments, and I was going to invite legal submissions on that today. And that it seems to me that when we actually get to make an assessment as to whether or not there is likely to be a detriment it doesn't require us to do counterfactual analysis. But can I -- I'll come back to that for legal submissions, if I just forewarn that I'll invite submissions on that.

Please continue.

PROF GUTHRIE: So I think the first thing is that there's no reason to think that the discipline will be greater this time than it was last time.

The second thing is that --

CHAIR: The question is whether the discipline would be there for the merged entity?

PROF GUTHRIE: I think there'll be some discipline -- I mean, people respond to incentives, there's no doubt about that. But incentives can sometimes be a little bit more complicated than you think when you design it. So, for example, the compensation schemes based on output by a team are subject to a free rider problem. If you're talking about the output of a team on that particular day or that particular shift, if you're one member of that team, if you cut back in your effort you're still going to get the benefit from what everybody else is doing. And if you work hard to boost your bonus, you're sharing it with other people. So that because of that free rider problem, yes people will work harder, but they're not going to work as hard as they would if there wasn't a free rider problem.

So there'll be benefits, but it's not going to solve

the problem of shirking, it shifts it a bit.

In terms of the ratchet affect. The targets that are going to be set will change over time in the light of experience. And if I was a self-interested worker and I was thinking well I'm going to work really hard this work to boost my pay -- perhaps I'm going to work really hard this month to boost my pay. At the back of my mind is an awareness that once the managers work out what we're capable of they're going to reset the target. So I will get a short term high bonus as a result of that work, but then the rules are going to change and I'm going to have to perform at that level repeatedly because the managers have found out what I'm capable of. And it doesn't mean that I don't respond to that incentive, but it does mean that it's weaker than it might appear.

So I think to answer your question directly, yes it will help. But I don't think it helps perhaps as much as the Commission thinks that it helps.

The other issue is that when you tie pay to one particular aspect of the job that you want people to do, they respond to that incentive to maximise their pay; they maximise the performance of that particular task because it can be measured. And all of those other things that can't be measured people are not going to put effort into it. If I've got so much effort that I can put into a job, do I put it into health and safety issues, for example, where that can't really be measured, or do I cut corners in order to increase output this period? Do I take short cuts? That'll boost my pay in the short term. It's not going to do wonders for productive efficiency in the long term.

So when I hear stories about a really sort of aggressively targeted performance based pay scheme I worry about the ratchet affect, because I think well if

they're monitoring performance that closely and I'm a worker then I am not going to show them what I'm really capable of.

And secondly, I'm going to put my effort into the things that are being rewarded and I'll take it away from other things.

And if the scheme can reward everything that matters for productive efficiency, at the efficient level, then it will work fine. But that's not necessarily going to be the case.

CHAIR: I just wonder, I'm just trying to frame what is a simple question in that you're heading in your conversation towards a world of ultimate productive efficiency development and I'm just trying to think through what is the question that we have to consider here and that if we're looking at the situation today and then in the post-merger situation we're looking to see if there's likely to be any deterioration in productive efficiency. And so the argument would be that by having an effective remuneration scheme that incentivises good performance, that that should be enough for us to get comfort that we're not going to go into reverse gear and have organisational slack happening that isn't happening today.

Is that a fair way to characterise the way -- perhaps if I can get the lawyers to come in and then I'll come back to the economists. I mean, the way that I've just tried to portray it is that a fair way to describe the kind of legal test that we are having to address in this scenario? Is it that kind of simple question about no going backwards in terms of productive efficiency?

MR DAVID: I think the simple test Dr Berry is no going backwards in terms of the approach that was mandated by the Court last time in relation to loss of productive

efficiency where the Court said unless there is a particular reason, you adopt a range of 1 to 5% and to deviate from that mandated approach the Commission needs to look for specific reasons. And one of the specific reasons that the Commission has given is the incentive based schemes.

The question must be what has changed? Is there sufficient comfort on the part of the Commission that these incentive based schemes bring controls on potential loss of productive efficiency that weren't present last time? Is there an incremental increase in control over that loss? That must be the question.

MR TAYLOR: I suppose from my perspective, the view of what might happen post-merger is a matter of assessing with historical reference to what has happened in the past; what's the likely factual output that will occur?

So, in this case, there is already a remuneration programme in place. Will it continue? Well, that depends on what the drivers are and that's a factual question of what the drivers are, to put it in place now and whether those drivers will still stay in place.

I think in this case the evidence is that China is what drives this to happen and China will still exist.

It's certainly not a comparison from counterfactual and factual, it's just determining what's likely. So it's just that probability -- the balance of probabilities test that the Commission has to weigh up. And so they look at it and give a decision.

Last time round the Court said, as I mentioned earlier, that there was a need to provide evidence. I think their only comment was that in the decision there wasn't any evidence provided for why the Commission took the stance. The fact is the Commission may well have reached the same conclusions as reached in the Draft

Determination but didn't express it in the decision itself on the record.

So that I don't think it's a matter of what's changed, I think it's a matter of whether those outcomes are still likely.

CHAIR: Can I just ask a question about what is the likely post-merger position for this remuneration scheme? You know, in a world where you can get under more pressure from exports of greasy wool and so on. I mean, would you see -- this question to Cavalier, would you see the need to accelerate and make more generous your employee remuneration scheme? Is that one strategy that would be a likely competitive response?

MR LONERGAN: I'm not sure what the answer is.

We've got the scheme in place. It's effective. Do we need to continue -- you know, does that need to change in response to ongoing competitive threats from China, Malaysia, other parts of the world? Of course, in the areas that we can control.

We've got an effective scheme in place today and that will continue post-merger, so I'm a bit nonplussed that any change is actually required.

CHAIR: Can I invite Mr Mellsop, do you have any response to Professor Guthrie's submissions on ratchet affect and free riding?

MR MELLSOP: Yeah, thank you.

Once again there are probably a couple of questions, including your one floating around in there.

And I suppose the way I look at this is that economists see there is a principal agent problem in a company. The shareholders and the managers. Managers are the agents, the shareholder are the principals. Concern about divergence of interests. So one way to handle that is to design contracts that incentivise

behaviour by management, and further down to staff.

So a couple of points there, one is that I think it's -- going specifically to your question Dr Berry, if you lose a competitor then you lose a benchmark. So we would expect that to have an impact. So I think that addresses your question here; I think Nigel has already talked about his visits to China, so we still have the benchmarks out there. And that's why I think when we're talking about the detriments here, we're looking at the bottom end of the range.

In terms of Professor Guthrie's specific critiques of incentive contracts, you know, as a matter of theory they all make sense to me.

My main comment, which I've made before, is that I think we need to assume that CWH only uses these things if it thinks they work. They may not be perfect. But CWH wouldn't invest the time and the costs in implementing these things if it didn't think they worked.

And I mean I'd be interested to hear what Nigel says about measurement over long periods of time, because that would be the true test in terms of the ratchet effect. You know, do we see productivity stop as a result, or do we see it continuing to increase?

I think they cover my responses unless there are further --

CHAIR: Would Nigel like to comment on that please?

MR HALES: Yeah sure, thank you.

We introduced the incentive scheme that we have in place now many years ago, so I can call on experience of a great deal of time.

When we first took over the scouring operation in 2000 the run rate was 1800 kilograms per hour. In 2014 the run rate was 2900 kilograms per hour, or a 61% increase.

The staff have shared in that increment of run rate going up by way of productivity bonuses which have been continually adjusted upwards, not downwards. So today they're on the highest level of bonus. And we just don't reach a level, say 2.7 tonne an hour and then say that's enough, keep going. We actually lift it as we're going. So there's always an incentive for the staff to do better and participate in the rewards of that.

So I believe that the bonus system has worked extremely well for the company and it's worked extremely well for our staff.

And we'd continue that; unless there is something better in the future, I cannot see that we would change a system that works very well.

CHAIR: I will just see if staff have got any questions on this.

MR IRVINE: Reuben Irvine for the Commission. I have a factual question for Cavalier around the timing of these various monitoring or bonus pay schemes. So as I understand you've just answered that the performance pay scheme has been in place for a number of years. I was wondering if you can talk a bit more, if you are able to in this session, just provide a bit more detail about when some of your other monitoring processes have been introduced or implemented or changed materially, in particular whether over the past four years there have been many changes?

MR HALES: Thank you Reuben. Yes, that's a good point.

Monitoring has evolved over a period of time and it's fair to say that we're becoming more sophisticated in every area as new instruments and tools become available to us, and it's continually evolving.

I can't say particularly the improvements between say 2010 and 2014, other than I know that it's evolved to

a very, you know, comprehensive reporting structure right at this moment.

CHAIR: Okay can I just test to see if Godfrey Hirst has anything they want to add on this subject before we move on?

PROF GUTHRIE: There is a couple of things that I've noted here. One is that, going back to what we talked about before the break, that incentive based pay is another issue that can be a source of conflict between the shareholders in the firms. One high risk strategy, if you like, is to give senior managers very highly incentivised pay schemes. And a low risk strategy would be to do the opposite.

So, one source of conflict that we're talking about could be the choice of how you're going to compensate your senior managers. It could also be how aggressively you target the pay for your workers. So that's just another example of a conflict.

The other one is, given that this scheme has been in place since 2000, it just gets back to this point that what has changed since four years ago? It may be, may be, the monitoring is so much better now that the productivity -- the potential for productivity losses is less. But, I haven't -- it's a possibility. I haven't seen any evidence that that's the case. The scheme was in place then, it's going to be in place now. The extent to which it’s changing over time just reinforces the possibility that as a worker you would be aware of this ratchet effect. If you'd been there for ten years and you've seen this scheme changing over time you're going to anticipate it changing in the future and potentially you're going to use that -- you're going to use that to your advantage.

MR DAVID: I think there's a further point Mr Chairman, that

the Commission needs to be confident as to the nature of the incentive schemes going forward.

Bear in mind that these schemes were brought in at the time that Cavalier Wool Holdings is dominated, for want of a better word, by Cavalier Bremworth as its 50% shareholder. Going forward, if this merger is authorised by the Commission, there will be a new not dominant shareholder, but certainly a very large shareholder from day one who may have a different view in relation to incentive schemes, bonus incentive schemes, and certainly upon exercise of the Lempriere option there can be no certainty that the present situation that was brought in under the regime of Cavalier Bremworth is going to continue.

MR TAYLOR: I just wonder whether Lempriere would like to comment on that?

MR MCKENNA: Not particularly, I mean I think we'd just look at whatever is best for the operations of the business as to the decision that we'd made in consultation with the guys running the operation.

MR DAVIS: The only thing I'd say from our limited experience around, that's Lempriere as opposed to WSI's, is incentive systems are very difficult to implement and be successful and changing them radically doesn't work either.

So if there is a system in place that CWA has and works well, we are very cognisant of the fact that to change a lot of things could be very much a disincentive to the business, so we would take it on board and our natural position would be to go with the existing position.

CHAIR: Just while you're there can I just ask you, you've heard the conversation this morning so far about what your incentives may be as a shareholder within the

organisation and how this may lead to you adopting high risk strategies that could have adverse outcomes. What would you say is your likely approach as shareholder in this new entity?

MR MCKENNA: I think our approach will be to maximise the value of our investment. And to talk about high risk, if you're looking at damaging the value of the 45% that we retain, which is not insignificant for us and in the business, I think it sort of underestimates the importance of the block of the business that we've got, and the investment that we've got in there.

MR DAVIS: From my perspective, I suppose I'm a little bit with James Mellsop in terms of the consequence of the option, and I find it quite impractical that we could see through the structure of the option and the business that the outcomes that people are talking about could occur.

We're a minority shareholder, we're not the majority shareholder. The option is effectively not fixed. And so I think that's a very important aspect.

So if you're talking about high risk strategies either Lempriere has to take it on and pay a huge premium to achieve it and then invest all that money at the high risk, or the parties around the table will agree to do so. That's natural business.

CHAIR: Thank you. I will move to the next topic I had on this.

Professor Guthrie, in your report you come to a view that the loss of productive efficiency will be greater this time than it was in Decision 725. And it seems to me that in light of that High Court decision we do need to become focused more on what we see to be the maximum potential detriment.

But can you tell us what number you have in mind, if it's greater than Decision 725, what would your view be

in terms of how you would quantify it, what the number would be or what your justification for it would be?

PROF GUTHRIE: I would go back to the range that you had in Decision 725, and I know you don't want to talk the range, but that's how I think about things. And I wouldn't pick a number.

I think what's interesting when I go through the Draft Determination and I look at one of those later tables where you break out the allocative efficiency and the dynamic efficiency and so on. With productive and dynamic efficiency there's really no formal economic analysis to support the numbers, and I can understand that because if I thought there was a better way I would have done it in the submissions, so you've got to do that. You do have to choose numbers without a lot of supporting economic analysis. But that should mean that your -- you should be least confident about those numbers. And I'm really surprised that in the case where you have to make decisions without any supporting analysis, you actually pick a number. We've got a range for allocative inefficiency; we've got a range for the plus or minus 10% for the land values, and all of this sort of thing you've got a range. But then the two cases where you've had to pick a number, you seem to have sort of supreme confidence in what you're doing.

And I would have thought, when I go down that table, that the productive and dynamic efficiency would have been the one that had the biggest proportional range?

So I can't give you a number. I wouldn't, because I don't think a number is relevant. I would go back to the range that you had in Decision 725.

CHAIR: Okay, I'll just park that; I'm going to come back to some of the themes you've introduced there with my last question actually.

But I think I can move on to my next question about dynamic efficiency and I'll put a proposition to Cavalier for reaction.

It just seems to me that this isn't really what you would describe as a particularly dynamic market and that much of the innovation seems to have come from third party such as machinery, manufacturers over the years. So we're not looking at an industry that's got a lot of dynamic efficiency gain potential sitting there.

I mean, would you agree with that proposition or not? And if you don't, if you can tell us exactly how you see dynamic efficiency having impacted on your business over say the last decade?

MR HALES: I don't necessarily agree with that statement.

To differentiate ourselves from the rest of the pack we've had to come up with innovations ourselves which we haven't necessarily shared around the industry. We're quite different in the way we approach the scouring process. We're different in a way that's undocumented beyond Rex Stewart's findings and the people before us had at Wool Research & Co. So, for argument's sake, we take out a large percentage of the dirt in the greasy end rather than trying to wash it out. That's an innovative process that belongs to Cavalier Wool Holdings and it hasn't been repeated anywhere around world the at this stage. The downstream benefits for our customers are that they can use a differentiated type of blend or wool product and we can get a much more repeatable product.

Also around wool grease, innovations there, we're continually innovating there. And we see that there's a lot of opportunity for that direction in the future. So we're well advanced there as well.

CHAIR: So I mean how much of your time do you commit to R&D and how would that play forward post-merger? Is there

going to be any change which is adverse, any incentives not to be doing R&D to the extent you might be now?

MR HALES: No, I believe that it will be more rather than less. A large percentage of my time is spent on R&D matters now.

CHAIR: So why are you going to spend more time on R&D post-merger, what's driving that?

MR HALES: Continual innovation; opportunities that we've seen already, particularly in waste streams. So there is a whole raft of opportunities there that need to be followed through on.

The actual scouring process, we're continually improving that and we've got recordable evidence of the gains that we've made there. You can look at a scour line and think yes that's a simple old scour line, but when you actually really understand what has been changed about that scour line to increase the wool grease recovery and things like that, or improve the cleanliness of the wool. It's not often, you know, unless you're a specialist you can't see it from the outside.

MR TAYLOR: I suppose the question might be is it a particularly dynamic business in the sense of compared with other businesses, such as airlines or whatever? Or is it incremental?

MR HALES: I guess you'd have to say it's incremental. But depending on, you know, if you're looking from the outside, or you're actually working in the industry.

CHAIR: I mean, what's driving your innovation is it the fact you've got a competitor sitting there at the moment? How would you see your approach to R&D compared with your competitor?

MR HALES: Most definitely. There's competitors all around us, all round the world, not only China and Malaysia. So yes, we're continually looking at doing that. But also

we wouldn't be doing our jobs if we didn't maximise our profit; no need for my position.

MR LONERGAN: You might want to talk about differentiating the end profits that come out of that and the requirement that that's a New Zealand product, not a Cavalier product as a whole.

MR HALES: Okay, just speaking specifically then on wool grease, in let's say the last four years and more particularly in the last two years, we've begun to understand more about wool grease and the properties that it has. Previously we've only ever sold a drum of wool grease. Now we actually understand what's in that wool grease and we're finding out that there are properties such as cholesterol which is made into vitamin D3; New Zealand wool grease is very high in cholesterol, so we have a marketing advantage there that we're pursuing.

So it's an ongoing evolution of understanding about the products particularly in the waste stream.

CHAIR: Thank you for that.

Can I come back to Professor Guthrie again, and I expect your answer is going to be the same, you haven't quantified a maximum detriment for the potential dynamic inefficiencies that may flow, but I assume your position is the same, that you prefer not to actually take a number?

PROF GUTHRIE: Yeah I think that's right. I mean, I suspect the Commission's underestimated the importance of dynamic efficiency. When I look at that 1% upper limit it sort of looks low, but I can't quantify it.

But I would say, in terms of this being a boring industry where dynamic efficiency doesn't matter, well clearly it does there. So, at the level of particular firm it matters, but then it's not just investment that's relevant, it's also disinvestment. If you have got a

market where the throughput is falling over time then dynamic efficiency can involve the optimal time of scaling back capacity, not just expanding it. You look at the change in the industry over the last few years that's evidence that it's a dynamic environment. It's not as though there have been a set number of firms with a set amount of capacity and nothing has changed for a very long time. It's just that it's investing downwards not upwards.

CHAIR: Do you think there is going to be a loss in dynamic efficiency post-merger, you know, because part of these answers I've been hearing talk about what's happening internationally, I mean these companies are benchmarking themselves internationally on that answer. Is there still something there that's driving the need to continue with dynamic efficiency such that there may be no expected loss?

PROF GUTHRIE: I don't think it's changed since last time, which goes right back to the first question you had about the role of China. That I think perhaps if the pressure from overseas changed its reset the starting point but it hasn't reset the rate at which people will relax afterwards. So I think that the loss of competition within New Zealand is going to have a negative effect and I don't think that the changing competition -- because that's a result of the merger taking place, that competition disappears. It doesn't have any effect on the competition from China it just means that you're starting at a lower point. But after that it carries on.

CHAIR: I'll dedicate another five minutes to this session, but if I can just follow up from some your comments so far.

When the calculation is done to do productive dynamic inefficiencies, in the case of the first this is

calculated on a percentage against pre-merger variable costs and the second one is calculated on a percentage of total revenue.

Is that something as an economist you have confidence in as being a formula to give a number that is reliable for adjudication purposes?

PROF GUTHRIE: I don't have a better suggestion. That's as positive as I can be.

You need to come up with a number; it seems reasonable. But it's another reason to have a range.

It's not as -- allocative efficiency, you've got models you can put numbers in, you can calculate the dead weight loss. Here you have to do things like take a percentage of some variable. You've got to choose which variable you're going to use. There's uncertainty about whether that's the right one. You've got to choose the percentage, that's more of uncertainty.

CHAIR: So there's a lot of uncertainty in terms of mapping out quantitative analysis when we do productive dynamic inefficiency calculations.

PROF GUTHRIE: I think so.

CHAIR: Have you got a different view, Mr Mellsop, on that?

MR MELLSOP: I think if we think about productive and dynamic separately. On productive, I'm trying to rack my brain and I can't recall the numbers off the top of my head but I can send through some literature later if that's helpful. But there is a literature which we've looked at before for this very purpose looking at productivity of firms that have been monopolies, and Government owned monopolies and have become deregulated and the improvement in productivity as a result. So here we're kind of going the other way, although I think the crucial difference is we're not going to a monopoly because of the overseas scours.

What I can't recall off the top of my head, but I have looked at it in the past, is that literature comes up with a percentage range. So we have that to base the productive efficiency calculations on.

I did look at this in the last round of this transaction, but I just can't recall what it says. But happy to follow up on that.

And so that's looking at monopolied competition. In my view, we're not going from competition to monopoly here, we are losing one competitor but there are still some remaining so we don't go the full hog back and therefore, we go for the bottom end of the range that that literature talks about.

CHAIR: Yeah, but just how comfortable are we with the numbers? That's even going back another step further than that.

And I'll put the final question I have to the lawyers. You know, I mean just how far does Justice Richardson take us in the need to do quantitative analysis?

Sitting here look at these numbers, how confident can we be as decision makers that we actually have quantitative analysis that is reliable? Or is it more appropriate that we give greater weight to an overall qualitative assessment?

I don't know of any other jurisdiction where decision makers are doing this kind of quantification. Most would have a very strong view that it just is not reliable enough to make decisions; that you must place weight on qualitative judgment calls looking at these kind of factual matrices. So just how safe is it to be playing around with these numbers in the round?

MR TAYLOR: My inclination is that the quantitative process that Justice Richardson referred to is intended to assist

the Commission in reaching its decision on what's likely in the course of the evidence provided. So that in this case, as James has said, there is a continuing competitive pressure coming from overseas that says this is what the company looks to for reasons -- that motivates it for a profit maximising; that motivates it for maintaining the volumes of greasy wool in domestic New Zealand for scouring. And so it comes back to that factual basis rather than the how you get to a range or how -- what the quality of the range or the figure is, is how comfortable the Commission gets that competition is going to continue to constrain and then it can say well, we think it's likely that X is the result.

CHAIR: Can I put a question to Mr Dixon I'll just try this one off you John, I mean would we be wrong to say look we've done our best to try and quantify this; we've done the ultimate in terms of thinking about the methodologies, we've applied them, we've turned our minds to the evidence, but, you know, at the end of the day it's informative to a point, but we're just not that confident that we can place so much weight on this quantitative analysis, it is just too uncertain and so ultimately it is a qualitative judgment call that we need to come down and make.

MR DIXON: I think the point of the quantitative analysis that Justice Richardson was talking about was to avoid speculation. It's not going to be an intuitive feel, it has to be as informed as it can be.

A quantitative analysis, in this instance we're looking at productive and dynamic efficiency, is a means to endeavour to put some science around it and to put some parameters around it.

We have now a relatively accepted methodology, it was accepted last time by the High Court, it’s been

accepted in other cases; so it's sensible to apply that. And to apply it again, I think we'd say as a range rather than picking a point, although you may narrow the range to a certain extent if you can get a degree of confidence when you apply that sense check at the end.

So I guess my answer is avoid intuitive feel, use the quantitative analysis as a guide to put you into the ballpark and then refine that based upon the factors that you take into account, the things that you are thinking about, as where it may be in that range. But I think it's dangerous when you're doing that to pick a particular point and the High Court said last time that when you do that you give an artificial precision to something that is inherently difficult to do.

MR TAYLOR: But the process is exactly what the Commission set out in its Draft Determination is the summary or the outcome of following that process.

CHAIR: Can I turn to staff to see if they have any questions before we finish this session?

MR IRVINE: Notwithstanding what was accepted by the High Court last time and what we've used in the previous decision or in the Draft Determination, in terms of the methodology for estimating productive efficiency loss, potential productive efficiency loss, do either of the two economic experts have a view on whether this percentage of efficiency loss should be applied to a pre-merger variable cost or a post-merger variable cost?

MR MELLSOP: I think it's pre-merger, because --

MR IRVINE: Do date it has been.

MR MELLSOP: To date it has been indeed. And I think that's the correct answer, because we want to know what happens to resources, what affect the transaction will have, both in terms of reducing costs but also through this dynamic we're talking about increasing costs, so I think it's the

pre-merger costs would be my response.

MR IRVINE: That pre-merger variable cost would be the most appropriate benchmark to then apply?

MR MELLSOP: More appropriate than post-merger costs which I -- was that your question?

MR IRVINE: Yes.

MR MELLSOP: Yes, indeed.

CHAIR: Professor Guthrie do you --

PROF GUTHRIE: Yeah, I'd agree with that. I mean, if nothing else at least you've have got a more precise idea of what the pre-merger costs are than what some hypothetical post-merger costs would be, so that's another reason to keep as much as uncertainty out of this process as possible.

CHAIR: Okay, if there is no further questions on that we'll finish that part of the session today and move to the next subject of allocative efficiency losses and Dr Gale is going to lead the discussion on this.

DR GALE: So this session is about the possible scale of the losses to the farmers and merchants through scouring not done in New Zealand if the prices go up.

The difference between this and the previous analysis was that in the past case we focused more on entry as a limit to the cost increase, and now Cavalier is arguing that the more relevant limitation on the way that price may be able to move is the threat of scouring in China and elsewhere.

We've had quite a lot of contradictory views from merchants on how much wool that is currently exported in clean form could be exported in greasy form instead. Firstly to China because there's a substantial amount that goes clean to China and then there's a comparable amount that goes clean to Europe.

So in one case a merchant said it was clear we could

send greasy wool to Malaysia, get it scoured there and re-export it. Another merchant said that China has a very strong preference for scoured wool, but that it would take quite a hike in prices to get them to switch to greasy. So these are questions that are quite wide open.

One thing that we've wrestled with is a way to form a feeling for the flexibility that New Zealand players may have, would be to understand the size of the Chinese wool industry both importing both greasy and clean product and turning it into garments and to carpets and upholstery. Our impression, and it would be helpful if people could set us right on this in the course of the discussion, is that in very round numbers we export about 40,000 tonnes of greasy wool to China and about the same amount of clean wool to China. We export about the same amount of clean wool to Europe all in round numbers, something in the order of 40,000 tonnes. Our understanding, and we are open to be corrected on this, is that the total use of wool for in China is about 500,000 tonnes, and so this sort of goes to the question of how much New Zealand is a sort of a marginal player or a huge feature of the Chinese market.

It would be helpful for us to get clarification on that in the course of this discussion.

So I want to direct the first of these questions to Cavalier sort of as a general -- to make some general remarks about how scoured wool that's destined for China or for other places, what is the constraint? How would you summarise the constraint that greasy exports impose on prices in New Zealand? How immediate is this threat? And remember for all of us we're thinking of coarse wool, decades ago -- I mean, Australia had a scouring industry and now has no scouring industry so we're interested in

the same sort of potential dynamic here, how close are we to that tipping point?

So just to help in answering the question, if I just trace through a few of threads to this topic, rather than asking you to make general comments.

What could you tell us about recent trends in Chinese demand, or any other country that has scouring capacity, for both greasy and scoured wool? Particularly of the sort of wool that's relevant here and has this been changing over time?

Another thread would be are there any impediments to China or other countries that have lots of scouring capacity from absorbing the greasy wool -- in greasy wool form the wool that we currently send clean to other destinations like Europe? So that's the 40,000 that goes clean to Europe; what is the capacity of China to absorb that in greasy form, either do the manufacturing itself or on-sell?

And then we'll come to some questions about the difference in margins that the merchants may earn in these two parts of the market, greasy and clean. Do we have any merchants here, merchant operators? I thought I recognised you. Because we would be grateful if we can direct some questions to you later in the process about the margin, the state between greasy and clean exports and how much that various between submarkets.

So Cavalier can I ask you to start on that process?

MR HALES: Sorry, I just need to refer to my notes here before I start.

It's generally accepted that China is now the power house of world textiles and that over 50% of the world's wool ends up in China in some state or form, either greasy or scoured. It's no different for New Zealand, fractionally over 50% of the New Zealand wool clip now

ends up in China. Some in greasy form and some in scoured form.

If we look at most recent statistics, and accumulating with the commissioning of the two Chinese-built scours in Malaysia we see a massive increase of 830% of volume going to Malaysia in greasy form from New Zealand, albeit in low numbers. We also see that there's a significant trend at the moment to Italy for greasy wool, and a growing trend of wool going into the Czechoslovakia for combing. The Czech plant is substantially a tops mill, or a combing mill, but it's now adjusting its production to include New Zealand cross-bred wools and combing them. And both of those scours that are in the Czech Republic, one was former Temona(ph) in Hawke's Bay and the other one was ex-Wanganui Wool Processes, so both -- they've got the capacity to wash a large volume of New Zealand wool.

We also see a new trend emerging in China and I'm sure John is way better qualified to speak on China than I am, but we see an emerging trend of combing medium to coarse cross-breds in China and even a new plant being put in at Tianyu to specifically handle cross-breds, mainly New Zealand wool.

So the trends are still up. Greasy production, or greasy export, year to date April is up 5.9% on last year. Scoureds are only marginally up. So, it's quite a trend still of greasy exports increasing. Sorry, I'll probably hand-over to John now.

CHAIR: Could you begin by identifying your name and organisation for the record please?

MR DAWSON: Yeah, John Dawson, New Zealand Wool Services.

I'll give you a wee bit of background, I made my first trip to China in 1979 and so from that you can imagine the number of times I've actually been there and

the changes that I've actually seen over that time span. And those changes continue, like all industry dynamic, everybody has to adapt to change.

But the reality today is that the greasy price being exported from New Zealand is determining the scoured price that we can trade at.

And the reality as far as we see as a major exporter to China is that the Chinese will only pay a maximum of 10 to 15 US cents a kilo more than the greasy price. And that is just the way it is in the market place today.

What has changed and made it more difficult for scoured wool exporters out of New Zealand is that the demand for greasy wool, or the specification on the greasy wool type has become a lot more easy to trade and the reason I say that is in the last two years we've seen the actual clientele in China change. And what I mean by that is increasingly the greasy exporter is actually selling his wool to the actual end user, rather through an intermediary which has in the past been a trader. Now the trader will set specifications which are usually more difficult to meet to protect himself, and that has been the way it has been in China until I would say the last 18 months to two years.

And what that's meant as far as scoured trading is concerned is that the relaxation of specification for greasy wool has meant that in fact the exporter from New Zealand is actually exporting a scourment rather than a more difficult to make type in the future, which in fact has meant that it's become harder for the New Zealand scoured exporter to compete in China. And that is exactly the reality of what's happened in the last two years.

So, I suppose what I'm saying is the fundamental point is that in China today there's only a maximum

increment that the client will pay for scoured wool.

DR GALE: In your view is it like a step-change, that there's a price of scouring here and there's a comparable price for scouring in China, and so that's the only margin that's available here, so that that demand would disappear very smartly with a price increase. Or is it sort of graded, is it likely that there's a graded response from amongst merchants and the targets at the far end for sort of subtly different forms of scoured product?

MR DAWSON: I don't think it's a graded response, it's just the market deciding in China that that's the differential given the circumstances that prevail at the moment that they'll pay. And of course that takes into account the scouring rate they pay in China, the conditions, you know, the overall market competitive conditions in China. It's a very competitive market place and that's the maximum increment that they'll pay.

DR GALE: So what portion of the Chinese market is New Zealand product, just going back to our sort of digging around about total scale?

MR DAWSON: China takes, as my colleague here said, just over 50% of the New Zealand wool clip goes to China and of that 50% it's roughly split between greasy and scoured, yeah.

DR GALE: But how much would our wool be in the Chinese market? I mean, they're getting wool from other places.

MR DAWSON: Well they take half the wool in the world don't they? So, as a percentage -- actually I think we should come back to you on that, because there's certain type categories.

DR GALE: Okay, that would be helpful.

MR DAWSON: If you put a volume number over the total import of China of wool from the world we wouldn't be a huge

percentage. But it's a bit more technical than that, it comes back to actually specific types from specific countries and what New Zealand is competing with.

DR GALE: Okay thank you.

MR HALES : Just to clarify that point, 58,000 tonne exported year ending 2014 from New Zealand to China.

DR GALE: 58,000 tonnes of both greasy and clean?

MR HALES: Both clean and greasy converted back to a greasy weight. That's total.

MR DAWSON: And I would think you'll find that the total import of China from wool world-wide would be in the order of hundreds, I mean it could be half a million clean tonnes per annum.

DR GALE: Mr Mellsop, I just wondered your perspective on that, you impression as to the nature of this costing New Zealand versus costing China of doing the scouring?

Later on we'll get on to the expressing this as a demand curve. But wondering what your impressions are of the -- of what's this basic dynamic value, you can scour it here and you can scour it there, and there must be sort of to some extent the costs will be -- they have the same technology. How would you expect the response -- the price response to be? How immediate would you expect the price response to be if New Zealand's costs were elevated or the merged entity raised prices?

MR MELLSOP: Okay, thank you. Probably a couple of comments.

I suppose I interpret what John has just said about the 10 to 15 US cents premium for clean over greasy in China. So I interpret that to mean that if now the merged entity raises price here, then those wanting to export clean to China are in trouble. That's how I interpret what he's saying.

And I suppose the other comment I would make in respect of your question is that it's quite striking to

me that already a quarter of the New Zealand wool clip is scoured in China, and you know, we talk about is the price increase we should assume 15 or 20%. The evidence is that China is already constraining, it's already competing. And I guess this comes to your question about gradation versus step-change. But it's already in there, and I actually think you could argue that the price increase we should assume should be lower because of that.

Is that addressing your question?

DR GALE: Yes, I just wanted to get that -- a first impression.

Can I pass the question over to Godfrey Hirst, your sort of impressions of the constraint, your awareness of this market?

MS PAULING: Well I might get Kevin Pike to talk about it, but it's just been interesting listening to those numbers, and these need to be verified, but from what Nigel is saying about the tonnage that's going to China, was 58,000 tonne. And our usage, just Godfrey Hirst, is around 7,000 tonne. So you look at our relatively to China, it's not that great, plus Cavalier Bremworth.

So talking about China and the volumes out of China is kind of creating this illusion that it's this massive big thing, when relative to the usage here by us and Cavalier Bremworth it's relatively insignificant really, when you look at what China does use versus what they're getting from New Zealand. So I think that probably gives some perspective around why we are here and how crucial this is to our business.

So I think Kevin Pike -- I think the other issue is there's all this discussion around China and sending greasy and clean to China; our understanding, and I'll get Kevin to probably clarify, there's not a lot of

scouring capacity up there for New Zealand coarse wool. So you know, I don't know what John's information is based on, and I'll get Kevin to sort of talk to it, but we're uncomfortable that we could easily get our wool scoured in China.

Kevin do you want to have a little talk?

DR GALE: While Kevin is coming to the table, did I understand your submission to be that if prices increased much you'd take the whole operation to China, that you wouldn't traffic the wool to and fro?

MS PAULING: We can't traffic the wool to and fro to China.

DR GALE: Does that mean that you're confident that you could find a scouring facility to enable you to manufacture in China?

MS PAULING: Not at this stage.

But the situation in Australia, you mentioned Australia and the fact that wool scouring has closed down there. Effectively the wool scouring closed because the yarn plants moved. We're in the position where wool carpet sales are difficult. We are coming up with new products; trying to increase wool sales, partly because they've been hurt by the imports of synthetic carpet that was supported by warranties that promised all sorts of things that didn't deliver, and the move to hard flooring.

So, as an end user of the wool, we are trying everything we can to increase sales of wool carpet. But, we're in the position where we're fighting in a really really cost competitive market which is now global. So we're competing with all of the massive massive American manufacturers that have huge scale and efficiencies, and we're down in here in New Zealand trying to sell a niche product that the US and offshore countries really don't have any interest in.

So it is incredibly price sensitive for us at every aspect of the process.

So, we're in the position where if we cannot get our wool scoured in New Zealand our yarn plants can't stay here.

And I would argue that the same would probably apply for Cavalier.

If the yarn plants go, half of my production -- I do -- we do all of the production of New Zealand wool carpet for our entire group, so that's half of my production is going offshore. That jeopardises the viability of our tufting plant. So it's not just a simple matter of, you know, we can send it up to China. It is just logistically impossible for us.

So, if the scouring becomes uncompetitive because we see tariffs double, for example, which I don't think is beyond the realms of possibility, all of that is going to put massive price pressure on our wool and yarn, which is struggling to compete with the synthetics and the hard flooring.

So, you know, that's what we are grappling with.

DR GALE: Okay thank you. I checked your flow about getting Mr Pike to answer the question about volumes.

So the question really just to refresh is that we want to know what the capacity would be in China to absorb some of the -- what your experience is of the scouring capacity in China that could take both the wool that goes clean now, but also maybe more importantly the wool that goes elsewhere to Europe.

CHAIR: Could you identify yourself for the record?

MR PIKE: Kevin Pike from Godfrey Hirst.

I'd just start by talking about the volumes of wool that are going greasy to China and I'd like to make the point that my understanding is that the percentages are

changing, but the volume of wool being exported in greasy form to China is only increasing slightly and my point here is that China is not aggressively competing to take more and more greasy wool in competition with the scours in New Zealand. They are simply taking the same amount to process in much the same way that they have for many years, or several years.

If we go back a decade or so and look at the greasy wool exports from New Zealand, China is in fact taking significantly less wool now than they have in the past.

We've also been to China and Malaysia and looked at the scouring options that are over there. We don't believe that they offer a viable alternative for us logistically and practically. And we think that this extends to wool that is exported in scoured form to Europe as well. The scours that we've seen over there, some of them are very nice scours and have the potential, but they're not there at the moment because they don't have adequate wool preparation machinery, which is the post-scour -- sorry the pre-scour wool preparation that Nigel Hales referred to earlier at his plants in New Zealand.

They're also very restricted in the shipping weights, the weights of scoured wool that they can export post-scouring which again, has -- adds a lot of cost to that -- to the overall cost of the wool once it's at the end users' premises.

DR GALE: Is that more so than shipping clean wool from New Zealand, what's the constraint?

MR PIKE: Well, to give you an example, the scours in New Zealand will pack approximately 20,000 kilos of clean wool into a container. Whereas the more common benchmark in China and Malaysia is around 12 clean tonnes per 20 foot container.

DR GALE: Because we have better packing technology or?

MR PIKE: Because we have -- yes, much more substantial wool pressing machinery. Largely as a result of us being located in New Zealand and the need to ship wool efficiently overseas to an end user.

Whereas, my view is that China is more interested in processing wool internally for use within China, rather than exporting it elsewhere.

DR GALE: Can I come back to the margin question? Mr Dawson, you say it was 10 to 15 cents, how does that compare to the total scouring cost?

MR DAWSON: In New Zealand?

DR GALE: Yeah.

MR DAWSON: It's approximately half.

DR GALE: So why isn't the margin the same? Does that mean that their costs of scouring are half ours?

MR DAWSON: I think one thing with Mr Pike's discussion is that I think it would pay to realise that the freight cost for a 20 foot container from New Zealand to China is something in the order of a thousand US dollars. So even though it sounds 12 tonnes to 20 tonnes, or whatever, it's not quite the cost that it sounds when you relate it to the cost of a 20 foot container on freight.

DR GALE: Your comment about the margin surprised me, given if the total cost of scouring is about 30 cents, of that order, how come we can only command a premium of 15 cents?

MR DAWSON: I think you should ask the Chinese, Dr Gale, on that one, yeah.

MR HALES: I'm sorry, Dr Gale, I've misled you with a figure, I rushed my answer and I'm sorry about that.

DR GALE: This is the totals was it?

MR HALES: Yes, it was. The total that I gave you was actually greasy exports and we should add to that 28,890

tonnes of scoured wool as well; I'm terribly sorry about that.

DR GALE: 28,890. So it's about 28, 29 clean you say and about what?

MR HALES: 38,801 greasy.

DR GALE: So we had about 39.

MR IRVINE: Sorry, just checking there Nigel, that figure that you have for scoured tonnes exported to China that's not greasy equivalent, that's the actual scoured weight.

MR HALES: Yeah, it's still in --

MR IRVINE: That's the actual scoured weight.

MR GALE: Okay.

MR IRVINE: So if it were -- just for rough figures if you converted that clean wool export figure to greasy equivalent, that 28,890 would come out at around just under 40,000 greasy tonnes, as I understand it?

MR HALES: Yes it's 76%.

MR IRVINE: That ratio clean is about 75% or so?

MR HALES: Yes, 75's okay.

MR IRVINE: So if you do it in all greasy tonne equivalent, we're exporting about 39,000 greasy tonnes to China; we're exporting in greasy equivalent tonnes about 39,000 clean to China and then 38,000 to the EU and then about 34,000 clean to the rest of the world. That's our understanding of the figures. All put into greasy equivalent tonnes?

MR TAYLOR: Could you just update those figures you've got there?

MS PAULING: So that's 78 tonne total to China, is that right?

MR HALES: I just have to work that one clean, but I'll give you that shortly.

Okay, each month Beef and Lamb produce a set of export statistics based on a particular export code for wool. And if we look at the other major users of

New Zealand wool we make it based on year-to-date European Union accounted for 11% of New Zealand greasy export wools and 34% of scoured wool exports.

Top five destinations for New Zealand scoured wool: China, Great Britain, Italy, India, Germany.

Also five important New Zealand greasy wool capacity -- sorry, I got that wrong -- 14% of greasy wool go to Italy and Germany, as we discussed before. China accounts for 54% of all New Zealand wool exports year-to-date April; 46% of which are in a greasy form. And 83% of all New Zealand greasy wool exports. Greasy wool exports to China have increased on last year.

DR GALE: Just while you talk about that, you've mentioned that before the greasy exports to China have gone up recently. But I think Mr Pike made the comment that they're a lot less than they were in the past?

MR HALES: No that's not correct.

DR GALE: Can we fix that later or something, can you provide us some figures?

MR HALES: Yes by a careful analysis of the Meat and Lamb figures you will see it's had not a large increase over the last five years but it's gone from roughly 250,000 odd bales and we think it will settle around 280 this year, in the grease.

If you don't mind, I'd like to just mention too the development of the Chinese wool scours. We're aware that there are five brand new scours on order for China through James Irvine's efforts. These are new builds.

DR GALE: For our sort of wool, for these cross-bred coarser wools?

MR HALES: A mix actually. Yes, there's one that's going into Red Sun, which is a top maker, but there's a couple that are going up into Hebei Provence and one going to in Mongolia which are definitely coarse wool.

CHAIR: Do we have evidence of this on the record, or is this new information?

MR HALES: This is new information, those five scours are new.

And also we recently did a survey of 35 scours in China all cross-bred scours, not to be confused with top makers or fine wool scourers. Only two of them wouldn't provide commissioned wool scouring services. But the combined total of their capacity or available capacity was 876,000 bales.

So if we're producing a little over 900 in New Zealand there is certainly some capacity up there for cross-bred scouring.

DR GALE: So where are they sourcing their wool for that?

MR HALES: Worldwide. China has actually the largest population of sheep in the world, and a substantial internal capacity of wool, obviously Australia, not only merinos but cross-beds from Australia going up there. The UK is huge. French. Sardinian. All of those countries through there that are wool producing countries. Pakistan.

And we should not forget that there's substantial new capacity been added in Malaysia, two 2.5 metre scours which would easily have the capacity of -- the equivalent of 260,000 odd bales New Zealand.

DR GALE: We'll probably break for lunch very soon, but just one final question on this potential for other markets to absorb the greasy wool.

How much does our exchange rate affect this? Does the exchange rate move the substitutability around? How should we think through New Zealand's strong dollar; the strengthening of it recently, has that changed these patterns?

MR DAWSON: It's a moving feast. You'll find that given price spikes that we certainly have seen in the wool market if

you go back five years. I don't think you can relate them to -- all to exchange rate. I think it purely comes back to supply and demand issues. And what you find -- what we find with our client base offshore is that they'll substitute -- when New Zealand wool gets to a certain level they'll substitute out of it and use alternative origins of wool. In a lot of cases they're not happy about that, but business conditions, or margin, or whatever, absolutely determine that. And of course at the end of the day they have to survive, so that's what happens.

DR GALE: Okay, shall we break now?

CHAIR: Okay, let's break for lunch.

I assume we can safely come back at 1 o'clock and still get through everything today.

I'm just looking at the timetable, if we come back at 1 o'clock and we'll keep on moving through until 2.30 and then we'll start again at 2.45 and continue then until the end of the day's session.

So we'll see you back at 1 o'clock thank you.

(Adjourned between 12.09 and 1 pm)

DR GALE: Okay, shall we start again?

I'd just like to spend a little bit more time before we move on, on the topic of the capacity in China to take the wool that currently goes to Europe and elsewhere. I think there were clearly mixed views a bit earlier about how much capacity there might be in China to take that wool, but interested in what the margin differences might be. Is Mr Pike still here?

MS PAULING: He's coming back.

DR GALE: He can answer as a follow-up, I'd ask either Cavalier or Lempriere really, if you have a view; perhaps Mr Dawson as well, a view as to the price differential that is commanded by the European market, the sort of

margin that merchants and farmers can get in the European market? Presumably it's a limited market to some extent or we'd send everything there. Just wonder if you can explain the dynamics and what you think the capacity would be that if prices for scouring went up what would be the point at which it became more profitable to sell the wool greasy into China than to sell to Europe?

So this probably is a question directed mostly at merchants rather than -- or people with merchant experience rather than scouring experience. Does Lempriere have a view?

MR DAWSON: Dr Gale, just my initial reaction to that would be that the market would sort that out. In other words, what I said prior to lunch is that clients will substitute out of New Zealand wool if they see it becoming too expensive in relation to other similar fibres that they can use to make the end product that they are, invariably carpet yarn to carpet or rugs. That's actually what happens in the marketplace.

DR GALE: So do you have in mind a sort of a tolerance to a price increase before that switching out started to happen.

MR DAWSON: It varies. No, I don't. But I can assure you it happens.

DR GALE: Okay. It's just that we're sort of searching for anchors for this discussion, you know, clearly there is a demand affect, but we're trying to put a scale on it.

MR TAYLOR: Dr Gale, there is some additional information that Mr Hales has in relation to scouring capacity in Europe and scours that have been upgraded and developed dealing with cross-bred wool -- making, for example, Czechoslovakia I think is 50/50 greasy and scoured wool that they're taking.

DR GALE: Okay. But only a very small amount of greasy wool

going to Europe at present, is that right? Our figures are about 5,000 tonnes.

MR HALES: Yes Dr Berry, I can confirm that year-to-date if you look at the European Union as a total there's 5,233 tonne been exported greasy there this year, so far.

DR GALE: So is it your view that there is a big up side potential there? That if prices went up that a large amount of the 38 no,-- the 60, 70,000 tonnes that's going to Europe and the rest of the world now, you could make a significant dent on that through scouring in Europe.

MR HALES: I think for the reasons that John explained it's hard to quantify that. But what we can see at the moment is there's this shift in a particular wool type that they're able to process and they're focusing on. So it's a new clothing type basically.

DR GALE: Okay. A question that was touched on in the last decision some time ago was the ability of the merged entity to price discriminate by destination. I wondered on just how visible it is to everybody involved in terms of the specifications for the particular scouring task that sort of happens. What your views are about whether it would be possible to keep prices down to the scoured wool that's going to China, if that's the more sensitive portion, but ramp it up for the wool that's going elsewhere?

Does Cavalier have a view about how that -- the extent to which that's feasible?

Because clearly the merged business doesn't want to lose any more business than possible, than necessary.

If there was no visibility then it would just shoot in the dark and find the profit maximising price; in the process sacrificing some market. But if it could preserve the Chinese market by rebates or something like that, what's the visibility through the network and the

ability to price by destination?

MR HALES: Of the scourments that we receive at the moment, the percentage of destination is not that great, it's not a hundred percent. So for an exporter who may think that we're gaming them over a particular region, it would be very easy for them to just simply not give us the shipping instructions until post we've scoured the wool. So it's really a non-point. We have exporters now that won't give us any details about the scourment, weight destination or anything anyhow. So that they, you know, don't make the yield in that visible. So very easy actually.

DR GALE: I see, so they have a commercial incentive not to tell you too much if they're rival merchants.

MR HALES: No. And it's actually, at this very moment it's not interesting to us either. We know the particular types for some mills, but if you've got like a standard carpet blend which might -- we would use the terminology a 128, 4 to 6, say a three colour for a carpet; that could be used in Turkey, England, China, New Zealand, Australia or wherever or America actually. So we can't even discriminate by the particular type, because it's just so universal.

DR GALE: Okay, thank you.

Godfrey Hirst, Ms Pauling, do you have a view about the dynamics of the market? I know your experience with trading is less.

MS PAULING: Kevin Pike probably is better to answer that question. But just in terms of their ability to identify product destined for us, we have quite specific specifications. So I think Nigel would agree it's pretty easy for them to identify when it's our wool. So if they can do that for our wool I don't know why they wouldn't also be able to do that for other end users wool. And I

would imagine they would be well aware of where the wool is going if they have to ship it. So to say that they would be told after the scourment happened I think is slightly impractical, but Kevin can probably could answer that better than me.

DR GALE: Okay. You are back. Hello Mr Pike.

MR PIKE: Tanya is correct in what she's just said. And I'd add that even if the monopoly scour wasn't aware of the destination, because they're a monopoly, if they found out afterwards they could still take action against the merchant because there's no alternative for that merchant to process with anyone else in the future.

DR GALE: Okay, Mr Dawson?

MR DAWSON: The only point I'd like to make Dr Gale is that if you're talking about price discrimination with certain markets against others from the merged entity. In the wool industry today we have an auction system that some people would say there's pluses and minuses, but one thing it does do is make greasy price transparent to the whole world, to all our markets. So I would say to you that if some of this price discrimination was happening from the merged entity it would be very readily exposed in the marketplace, in the world marketplace.

DR GALE: Well it's not so much that people would resist, it's just that the beneficiary would be the person who was exporting to China, rather than lose the business the scourer might say well we'll give you a rebate afterwards or do something to make it still attractive to you to scour here, so as not to lose that business and that profit, but at the same time maybe the higher prices can be commanded in the European for the product that's going further afield, Europe and elsewhere, why wouldn't that work?

MR DAWSON: In my experience, the exporting -- the New Zealand

exporting industry is a very competitive one, we have something like 34 players in the industry, and from where I sit that just -- it just doesn't happen like that.

DR GALE: Okay. Mr Hales?

MR HALES: As a processor we would not run that risk simply because our customers could switch very quickly and easily to greasy exports and we wouldn't know. You know, we don't know what decisions they're making, so it's a risk that's hanging over our heads every day. So there would be -- there's never been any thought of that and I would doubt that there's likely to be in the future.

DR GALE: Okay. Thank you.

Just turning now to how we've tried to form a view about the price -- plausible price increases. In the Draft Determination we did some modelling to provide a sense check to how high the price increase might be, the maximum potential price increase. This is based on the restraint -- the idea of the restraint from greasy exports. In that modelling we took into account the reduced variable costs that the merger is supposed to achieve. And as a result still predicted price increase of the order of 18 or 19%.

In NERA's submission, Mr Mellsop, you've said that you think the limit that we ought to accept would be closer to 15%. I wondered if you can take us through the reasoning? Our approach has been to say well in New Zealand the market is defined in New Zealand, there are a couple of scouring parties, they've merged and we're treating the competitor pressure from overseas and the elasticity that the merged entity would face. Is that not the most sensible way to proceed to find the profit maximising price increase that we should expect?

MR MELLSOP: The first question I have is actually what is the demand curve that you're referring to, is it a residual

one facing the remaining New Zealand -- so the merged entity or is it a world one? It's actually a question I've got around in circles on a bit, but I think it's relevant to your question about whether it already incorporates the elasticity.

The other point I think is that -- I thought the idea of doing a sensitivity or a sense check was a good one and I think our critique was that it missed a couple of bits and you mentioned the variable cost thing, I didn't pick that up actually. One of the attractions of the Cournot approach to that sanity check is that it actually also provides a sense check on the elasticity of the demand curve. Based on the model's assumptions, so it's assuming a Cournot behaviour with all the limitations or the caveats that go with that.

And, in fact, I think that came out with different elasticities than have actually been used, I'll have to just go back and check what the results were, but they're in that report of course.

So that was one of the attractions to me of -- otherwise I think last process, this process, we've kind of been making numbers up about what the elasticity is. And I know the Commission this time around took out the point 05 on the basis that, as I understand it, that China is now actually a greater constraint, that's how I interpret what the Commission has done.

But that's why I thought if we do a Cournot model, warts and all, it gives another estimate or piece of data on what the elasticity is.

DR GALE: Yes my understanding from the team was that exploring your Cournot idea we were reasonably comfortable with our elasticity estimates, you know, of the order of 1.

But I wonder can I ask Professor Guthrie whether, I

know your contribution to this was to reflect on the entry barrier, but you will have seen the debate that's going on about profit maximising behaviour and linear demand curves and so on and just whether you've formed a view about how one ought to proceed in trying to find out what the maximum price rise should be assumed to be as a basis for these allocative losses? Push the button.

PROF GUTHRIE: I can talk about the sense check and the Cournot one in particular because any of these models -- James has mentioned the warts, and they're there, any of these models are making a lot of unrealistic assumptions. Now, to some extent if the Commission didn't -- if the Commission disregarded any analysis that made unrealistic assumptions, there wouldn't much left. Everything that we're producing somewhere along the lines will have assumptions that really don't stack up. And the Cournot is fine, and there's assumptions that we make there, that basically it's static, there is no uncertainty, there is no frictions.

And I was interested to hear before lunch the talk about the changes that are going on in China and how rapidly things are changing there. That immediately creates an inertia in decision making here. If you're not quite sure what's going to happen in China in the next year or two you're not necessarily going to switch from exporting one way to exporting it another. You'll wait and see how that resolves.

Now issues like that are important when there's that much volatility in China. They're important when the industry in New Zealand is changing. And they just -- that create real issues about what sort of insights something like a Cournot model can produce.

So there's question marks about the assumptions.

But in some -- you've got to live with that, to some

extent. But what you then have to look at is the quality of the predictions that the model makes. Because if the predictions are good and the assumption are lousy, well maybe the model is still going to be useful. But if the predictions are lousy and the assumptions are then really it's not much use.

And my problem with the Cournot story is that it doesn't do a good job of even explaining what we see at the moment.

Cournot is a tricky sort of form of competition to motivate. And the way that it's usually done is you have sort of a two-staged process where firms start by building their factories, setting capacity, and then after that they compete on price. The issue is you've got to somehow commit to having a fixed level of capacity.

And as a consequence of that second stage of price competition, and NERA said it in its report, it said -

MR DAVID: I can't find what it said --

PROF GUTHRIE: It said that they compete on price in order to sell capacity.

So one of the predictions of that Cournot approach is that there's no excess capacity, the price will drop so that every bit of capacity is being used.

Well, the whole motivation for this merger is that there's excess capacity that needs to be taken out of the system.

So the problem I have with Cournot is that its predictions are actually at odds with what we see in the market now.

DR GALE: Or its description of the market dynamic is different from what we see now.

PROF GUTHRIE: Yeah. And my point is that in order to use it as a sense check you're using it to predict the future.

Well why would you use a model to predict the future if it can't even explain what's happening in the present?

DR GALE: So in the alternative what we've done is used a simpler, even more static model, really just to say well there is a residual demand curve for scourers here what might the elasticity be, how might the price be? And in your submission you've used that model to say well you think the price rise; the barriers are higher -- I mean, the entry level is higher than the allocative losses.

So do you have a view about whether the sense check of a profit maximising monopoly in New Zealand facing that external demand curve for -- that the wool would go out not scoured? Do you have any comments about whether that's an unreasonable way to proceed to get us to an order of magnitude? It may be that there's a higher or lower cap imposed by entry, I mean that's a point we'll come to.

PROF GUTHRIE: I think the monopoly case is preferable to the Cournot. Although it makes -- it's more assumptions -- well it's questionable whether it does actually -- although it makes its own set of pretty strong assumptions, I think the predictions that it makes are actually a better fit. I don't like the idea of over-engineering models, because the more structure you put on them the more you're likely to move away from reality.

So the approach that the Commission has done, if it's going to do a sense check I think that's a reasonable thing to do. But you do have to think about the statics, the lack of uncertainty. It's another number to put into the mix. It's not one that you should hang your hat on, so to speak.

DR GALE: Thank you.

The last point in this topic of just how you model

price affects is that the merchants have commented about the potential for there being step changes in, you know, demand, if there's an absolute limit to what the Chinese will pay by way of a margin, then you'd imagine there were sort of increments in demand that would disappear if the price went over some trigger level.

So in principle, and this came up in our last deliberations, you can imagine the demand for the New Zealand scouring as sort of being stepped. But the closer we got to that nobody new how to draw the steps, nobody knew exactly where they would be or how high and so we ended up using a linear demand curve as being a sort of consensus view. Would anyone like to revisit that topic or offer us -- draw on the back wall a stepped demand curve or -- Mr Mellsop?

MR MELLSOP: I won't draw a stepped demand curve, because we don't know.

I mean, the question about what price increase should we assume and what evidence do we have when making that assumption, I mentioned before that -- and this is why I disagree with Graeme about what the Commission has done being the best sense check. I don't see this is creating a monopoly. So we can't forget that already a quarter of the wool clip goes greasy to China. So it's already in the market and that's my sort of fundamental concern with the Commission's sense check.

I mean, I've listed in my reports various factors which I think point to a smaller rather than greater assumption. But I think a really compelling one is this thing that I probably can't mention, but I have mentioned already today, and just refer the Commission back to it, the analysis of CWH's real prices over the past whatever years it was we've looked at, despite the fact we've had rationalisations. And, to me that, if you look at that

and then you say actually we're assuming a 20% price increase because of this one, they're so different. That, to me, the 20% is implausible.

So sorry, Dr Gale, that's not answering your question specifically because I don't think we can draw that demand curve.

DR GALE: No but it would be useful in the confidential session to come back to the discussion about real price affects.

MR MELLSOP: Sure. Yes.

DR GALE: Okay, shall we do that?

MR MELLSOP: Yes.

DR GALE: So I appreciate it's sort of curtailed in this session.

MR MELLSOP: Can I also just add one other thing. It's interesting, if we did assume a step demand curve I don't know what that would do to the detriments, because you've got two impacts, you might have lower allocative inefficiency but higher wealth transfers potentially. So it's also not quite clear to me where that would take us beyond where we're at anyway.

DR GALE: It would be a pity if it was pivotal, wouldn't it?

MR MELLSOP: Yeah it would be.

DR GALE: In the case that it wasn't the constraint from greasy exports that was going to keep prices -- Professor Guthrie you sort of revisited the entry analysis that we had more reliance on last time, and NERA in the analysis had suggested a 15% cost of capital, and I think you'd said it would be substantially higher, closer to 20%. Fair enough.

I don't know if this is an unfair question or sort of difficult to answer here Mr Dawson, but if merchants were sort of clubbing together, if merchants got fed up with the local scouring business, the offering that they

were getting, and thought well why don't we club together and sponsor a scour collectively so that we do have a reliable price and we know we're not at anybody's mercy, you could do it -- if you're sponsoring it you can set the price, you know, it's just cost recovery for that contracted party.

Do you have any benchmarks for how risky you would view that as a venture? If the merchants clubbed together it would be like a joint buying exercise. It seemed to me it might be a lot less risky than the market in the broad.

MR DAWSON: Dr Gale, my honest answer to that would be I just don't think it would happen. I just don't think that would happen in the market that the export sector operates in today, in the New Zealand wool industry. I just don't think that would happen.

DR GALE: Okay, all right, no thanks. I appreciate that was sort of tricky to get in and nail.

MR LONERGAN: Can I maybe address that point?

You know, because we really get into discussion over Professor Guthrie's paper about the hurdle rate that would really be required to drive that decision. And I suppose, you know, really a couple of observations of that paper really. The first one was it assumes that this universe of investors, or in this case potential entrants are pretty homogenous, that they all have the same sort of hurdle rate. You know, and that's simply not the case. You can have a financial investor such as a private equity firm, Direct Capital, or you can, as you've pointed out, have a merchant or a club of merchants pooling their volume together and establishing a new scour. The way that we would look at risk is very different to the way that the merchants would look at risk. So as a financial investor you'd be looking at

adding capacity to a market that's already got excess capacity and you're having to compete for volume, compared to the group of merchants who have their own volume and in many ways are driven by protecting their business or the threat of supplier behaviour. So where the risk lies really reduces quite considerably between those two parties.

I suppose the second point is we've got the benefit of data points. Professor Guthrie came to a conclusion that 20% was the right hurdle rate to get to. We've got the benefit of specific data points in this transaction. So, for example, just to run through those. When ACC acquired its shares in CWH from David Ferrier in 2009 its investment paper applied a post-tax whack of 10%. In 2010 when Direct Capital acquired its shares in CWH from Mr Ferrier it applied a post-tax whack of 13.84%.

Also at the time that ACC acquired its shareholding it also secured an undertaking from Mr Ferrier around the transfer of his residual 25% in the event that it gave rise to a change of control. And in that event ACC would tag that sale at a return rate of 15% per annum.

And then coming back to the option agreement, once again, you know while theoretical in nature and you know, the purpose of which we've previously responded to, that includes an annual escalation of 15%.

So, you know, there are four data points.

And I suppose I'd add to that, you know, these are all data points from the most recent one, the option agreement, but substantially back 2009, 2010. We're in a fundamentally lower interest rate environment. So we would argue that as a financial investor our hurdle rate will be the highest out of any new entrant coming into this market.

For merchants clubbing together, particularly around

protecting their interest, their incumbent business, their hurdle rate would be significantly below what a financial investor would have.

So we just found that the 20% was unsupportable.

DR GALE: Professor Guthrie, as I understood it your proposition started from sort of textbook theories of option pricing and waiting to invest and such like, is that right? Your own textbook. And the one by Dixon and Pindyck and people. Is that right? So you were sort of saying that there's an investment hurdle and it can go up, the investment hurdle can be raised substantially by uncertainty.

PROF GUTHRIE: Yes and no. If you go back to my report, I started with a discussion of the theory, so in that sense it's right.

But I don't think that's an accurate description of the basis for what I'm claiming.

DR GALE: So is there more of the empirical material --

PROF GUTHRIE: It's empirical. I mean, there's a whole lot of theory out there as to why firms should set hurdle rates in excess of their cost of capital.

Now, academics are interested in theory so a lot of the research is about - sorry interested in understanding why firms do what they do. But the evidence that I've cited in my report is empirical. I don't care why firms set hurdle rates. I do in my day job as an academic, but the Commission --

DR GALE: So how do you relate it to the commercial setting that's been explained by the club of merchants. Of course this isn't going to happen, the question is how much can the monopolists push their luck before the threat of it stops it going any further?

PROF GUTHRIE: Can I give you a selection of answers to the various things that we've talked about just in the last

few minutes?

DR GALE: Okay.

PROF GUTHRIE: The three examples that we just had, it's not clear the extent to which the hurdle rates and the extent to which they are cost of capital that are used for the purpose of valuation. In particular the third one sounded -- the 15% sounded very much like a cost of capital, not a rate of return that you would have to earn in order to make an investment. So I'm sort of nervous about taking those numbers at face value because they may not be talking about what we're talk about, which is the rate of return that a firm needs to make in order to invest.

There's that issue.

The one about merchants clubbing together to enter and having a much slower hurdle rate I think is just wrong. You go right back to your very first finance class at a university, the risks associated with -- the hurdle rate you should use is based on the risk of the investment and if these group of people invest in that project they are facing the same sorts of risks as a different group of people investing in the same project. And it's really easy to look at the situation with merchants clubbing together and say oh well they're their own customers, so they don't have any risk of losing customers in the future, and therefore the risk is lower. But it just doesn't work that way. The risk doesn't disappear, it's transferred to other parties.

Now if you're a financial investor that builds a scour and then goes out and gets your own customers, the asset that you're talking about is that scouring operation and the risk associated with it. If you're a group of merchants that pool together to build your own scour and then use it for your own -- your own customers

effectively, the risk hasn't gone away, it's just been reallocated in your business. You've got a group of merchants that now have a scouring division and then they've got their existing merchant business. Now the scouring division is low risk because it's got guaranteed customers. But what's happened is that the merchant business has taken on the risk of the scouring operation. And so if these merchants know what they're doing, they will factor in the risk -- they will factor in the overall increase in risk to their business, just like a financial investor will. So that the risk -- the hurdle rate -- there may be reasons why different investors have different hurdled rates, but just being your own customer isn't going to do it.

And so if financial investors are going to have high hurdle rates because they see this as a risky investment then merchants will as well.

DR GALE: Thank you.

Any comment?

MR MCKENNA: I know from Lempriere's perspective if faced with this sort of situation we would definitely have a lower hurdle rate.

When you can control your destiny I think it makes a big difference towards your attitude towards your business and what it means, because if it's under threat you have to take action to protect its existence.

So from our perspective, I can just say that we would definitely be flexible on hurdle rate if it was to do with our expertise and that we could provide volume to that activity.

DR GALE: Thank you. Any other comment, NERA?

MR LONERGAN: I disagree.

MR MELLSOP: I won't comment so much on the hurdle rates for merchants versus financial investors, but more just on

the -- as Graeme notes, he's looked at the empirical literature here, and I would -- my team has taken a look at the articles a bit more carefully over the last few days that Graeme cited and we've actually got a little note here I can hand up from one of my team members.

The main thing I wanted to suggest is that, and it may it have already been done, that the Commission economists take a peak. Because I think Professor Guthrie he's carefully said that a 20% is a plausible hurdle rate, I think that's basically the phrase, and I think the literature says that. But what the literature says is that that is at the high end of the range. So it's at the high end of the empirical data. The average figure on our reading is not 20% and in this note we've set that out a bit more. So I just wanted to make that comment based on our readings of the document and just suggest that, as I say the Commission team may have already read it, but it would be worth having a read of.

DR GALE: Okay. Thank you. That brings us to the end of --

Questions from staff to pursue some of those matters?

MS CSORGO: This is going back to that topic of price constraints and the sources of those price constraints, and part of it just that, maybe everyone else in the room as clarity on this, but I didn't have clarity on it and I'd be most interested in what Mr Dawson had to say about it.

If I could just understand what are the sources of price constraint on wool scouring in New Zealand versus exporting greasy by a group of customer? So customers that are located in China, Asia, Europe and elsewhere, and domestically.

And if the strength of those alternatives differ, then how we may or may not still have a sort of equal

price constraint on all three of those different groups of customers?

MR DAWSON: Thank you, madame. From my perspective as an exporter of wool to the world, if you like, sitting in my desk we get enquiry every day from China, Europe, all over the world, and obviously we make decisions on the day based on what we can trade the wool at profitably and that, of course, then comes back to what you can buy it at, source it at within New Zealand, your different sources et cetera, et cetera.

If you're referring to the 10 to 15 US cents in China, that is the market premium set by the Chinese market. In other words, we sell to probably 20 to 30 different end users in China, scoured wool, the major ones, and the maximum we can achieve, I can tell you now we try and get more, but the maximum we can achieve are 15 US cents a kilo for the scoured product versus greasy. That's what the marketplace is telling us. And at the end of the day we're the supplier, they're the customer. So that's the rule we follow.

And as far as other countries are concerned, as I said before, we have an options system in New Zealand, which is highly transparent worldwide. If we try and have different prices for different markets, that is very easily will come back and cause us problems in our business as far as selling is concerned.

MS CSORGO: So if I understand it, that the constraint on you for exports that are destined to Asia is that -- they can just switch to buying greasy and scouring in their own markets. But for elsewhere they would look at what the price premium is for Asia and also look at your auction price for wool --

MR DAWSON: That's for New Zealand wool. That’s for New Zealand wool. But please remember that New Zealand wool

competes with UK for the same end use. New Zealand wool is hardly ever owned -- hardly ever used in a hundred percent entirety on its own, it's blended. So the customer, for whatever reason, if he sees it's against him by paying a certain price for New Zealand wool, when he can source UK, Irish, all other origins, he'll do that.

MS CSORGO: So is there consequently the equivalent of that 10 to 15% for wool destined to other locations other than China?

MR DAWSON: We'd never -- it just doesn't come like that in other markets. And because of the volumes of greasy to China and the volumes of scoured to China, that differential is the most readily visible.

I can't answer you as far as the other markets are concerned in the world. All I can say is that they can pay a certain price for New Zealand scoured wool. If you're asking them to pay more, they'll substitute out and go into other fibres.

MS CSORGO: So is that suggesting, or are you suggesting that there would be no scope for a price increase on clean wool coming from New Zealand as a result of an increase in scouring price here?

MR DAWSON: Very price competitive -- New Zealand wool has to be very price competitive, because it can be substituted. They would prefer to have New Zealand wool but, at the end of the day, if New Zealand wool becomes uncompetitive they'll substitute out of it and use something else. And of course I haven't even gone to manmade fibres which have taken a lot of market share out of the New Zealand wool industry.

MS CSORGO: So are you suggesting that there is no scope for a price increase at all?

MR DAWSON: Very marginal, because it's so competitive, the

world demand is so competitive, the demand situation.

MR IRVINE: Just to follow-up and clarify that, so the, say European buyers or elsewhere in the world who are purchasing clean wool from New Zealand and they're competing against clean wool imports from other countries such as the UK you mentioned, so that's wool that is grown in the UK, scoured in the UK itself and then exported?

MR DAWSON: Correct.

MR IRVINE: So the countries we're competing against when we sell wool to Europe all have their own domestic scouring sectors?

MR DAWSON: A lot do. Like in the UK they are a very large carpet manufacturer, for example, and they use a lot of New Zealand wool and they blend that with a lot of their own origins. All I'm saying -- the point I'm trying to make is that if New Zealand wool becomes uncompetitive as far as price is concerned, they'll use something else. So we have to be very careful in New Zealand not to price our wool out of the foreign market.

MS CSORGO: And what about domestic users?

MR DAWSON: You should ask Godfrey Hirst and Cavalier about that, yeah, they're the two major domestic users.

MS CSORGO: But from your perspective do they too benefit from some sort of competition from sources other than New Zealand?

MR DAWSON: There's an amount of foreign wool that comes into New Zealand, it's quite small, but I think it's a very competitive marketplace. Again, what I'm saying I think stands in the local -- in the Australasian market as well.

MS CSORGO: Did anyone else have any comment on my questions?

MR CALLON: My name's Ross Callon; I'm Executive Chairman of NZ Yarn and I have a few comments in regard to some of

the earlier issues in regard to return hurdle rates and more recent questions.

NZ Yarn was acquired out of receivership by a joint venture company primarily; 1200 farmer wool growers, and an agritech company from Ashburton, principally.

Their perspective on hurdle rate is quite different I suggest to a financial investor, and the perspective on an industry can be quite different.

I think we're looking at each step in the supply chain here instead of looking at the broader industry dynamics where business models can be changed and links in the chain can be removed.

So there's a lot of issues that I think have not been considered here and in terms of how an industry can be made more competitive. We've seen it in the airline industry, and a lot of other industries where we get changed business models and the use of technology.

So some factors that need to be brought into consideration, I believe.

I think the position of the merchant is quite different to the downstream manufacturer. And the issues of capacity utilisation are absolutely fundamental.

We spoke earlier about efficiencies of the firm. I think what has been overlooked is this broader industry has had a significant decline in quality which has led in part to the demise of wool as an industry. And we see a lot of contaminants coming through from the wool scours into downstream manufacturing which gives rise to major financial claims on the business.

DR GALE: So why is that happening? Why is the quality declining?

MR CALLON: I think because there's a lack of profitability in the industry and the lack of returns that can be achieved. So there has been disinvestment.

DR GALE: You mean that the yarns business can't afford to buy the quality of scouring that --

MR CALLON: They can't afford to buy the quality; they haven't been able to get a return on reinvestment, and so there's been continual disinvestment. You've only got to look at the demise of Summit in Oamaru owned by Sumitomo Corporation running at large losses for quite a number of years and has been acquired by Godfrey Hirst at a deep discount to asset backing, and compared with what that company received as an insurance payout on a replacement value basis for their plant in Christchurch would be a multiple of ten times.

DR GALE: So if the merged entity -- if the merger proceeded and there was a line of business selling scoured -- you know, specialised scoured wool to the yarns sector, why would it be suit the merged entity to harm that line of business? Wouldn't it just be carved out as a business that was --

MR CALLON: Well the downstream entities have got to look to find new markets. The issue of synthetics was mentioned before, in America the carpet industry's about a 20 billion dollar turnover industry of which around 2% is wool, or slightly less. So that's an indication of over a 40 year period why we've seen the demise of wool. And, in particular, many years ago in the 70s and 80s we saw the demise of the garment wool industry. And now we're seeing the challenges faced by the cross-bred wool industry going into the carpet industry, spun yarns and carpet tufting.

DR GALE: So do you see - it's not clear to me whether you see this merger as a threat to the yarn business or helping?

MR CALLON: Well, I think it could be quite a threat because we'd be faced with the supply chain going back into Asia and to bring the wools back, but that could also be a

positive, it depends how well you can integrate the supply change.

Some of the things that are yet to be determined through some of the financial modelling that was referred to before. That many other -- much of the textiles industry in New Zealand, we saw the demise of that in the 80s and the 90s. Freight is one thing that protects carpet. Because of the volumetric nature of the tufted carpet compared with the yarn.

DR GALE: Okay thank you.

After Lilla's question there is still a mystery to me about the numbers you mentioned, the 10 to 15 cents limit in the Chinese market, but we're exporting 40,000 tonnes greasy equivalent to China, it costs a lot more than 15 cents US to scour it here, why do you persist? Why is the business still happening? Why is that channel still happening if the scouring price in New Zealand is almost twice the margin you can command in China on the scoured wool?

MR DAWSON: I think one of the answers to that question Dr Gale is the ability of the New Zealand exporter to buy wool at the right time, and to blend wool, wools of the right type, to make a certain product. And I'm saying that --

DR GALE: Okay. So you can make up the difference through --

MR DAWSON: You can make up the difference. I'm not saying -- it's a very very competitive business.

But, in saying that, I'm not at all making a quality aspersion on New Zealand scoured wool because it's highly specified, we have to meet -- a max -- link all the criteria; the most that we've ever had to meet today.

But it comes back to the exporter having the ability to actually cover most of that difference within New Zealand and the skills that they've acquired over the

years and the ability to make a certain product at a certain price.

DR GALE: Okay thank you.

Actually that takes us into a topic which is the relationship of the merchants and the farmers, and you made the comment that the auction system is transparent and competitive.

But is there an element of -- the relationship -- the extent to which increases in scouring prices can be passed back upstream to farmers in terms of lower prices at the auction?

Does that make a difference to this discipline from the greasy export option?

MR DAWSON: I think the fundamental question here is supply and demand, at the time.

To be quite honest, in certain market situations differentials or price signals are ignored when there's a strong demand for wool. And we've certainly seen that occur at many times in my experience.

But, I think the fundamentals are, in the New Zealand industry at the moment, if you look through -- I've got a little green book here that you're most welcome to have as a reference, I know it's yellow, but I've got a green one, it's a bit later than this one. But the reality is in the New Zealand industry today there is 34 active exporters, 19 brokers, four wool scourers, ten textile processors, 61 private merchants, and nine meat companies all competing for wool. And, of course, in the background you've got a clip that's in decline as well. I've heard the number 28, 29 million sheep left in this country. In my humble view no-one has a real handle on what that actual number is, today. But it's certainly coming back.

So I think my view is that given the industry

dynamic today, the farmer will certainly not suffer the price diminution that has been suggested in some literature that I've read previously from this Commission.

DR GALE: Well, this might be a good point to work on that a little bit.

If the export market is extremely price sensitive and can't tolerate price movements. And the merchant level market is hotly competitive and there are 60 independent merchants competing at auction. If the price of scouring goes up where else is it going to go than to the farmer in reduced earnings?

MR MELLSOP: I missed the last part of the question, sorry.

DR GALE: The hypothesis is that the export market's incredibly price sensitive and won't tolerate increased scouring prices; can't be passed through to Chinese manufacturers. And the merchant level function, I thought it was a matter of sort of agreement in the last deliberations that the merchant level is hotly competitive and has option auctions, and farmers will get the best price for their wool.

So doesn't any scouring price have to just go back upstream to farmers?

MR MELLSOP: I suppose the first question is could there be a scouring price increase given those dynamics?

And if there is, what I've said is that -- I think in reality we'd see it spread -- somehow. But, I mean I think we see the same in dairy, ultimately the growers have the most inelastic supply curve.

DR GALE: Particularly for wool is it not? That wool is a residual product off another product.

MR MELLSOP: Although we are seeing a decline in clip, so presuming there's some elasticity in there that would suggest.

I think what John is saying, if I put that in economic speak, it's that if there's a price increase by the merged entity it's not universal across merchants. It's only those who want to scour, that face it -- so it's not like suddenly the Government says we'll put a 5% tax on all scours. Then you can see how that would go through to the growers.

Whereas, if there is this asymmetry because some merchants are buying and want to sell greasy, so they now have a marginal cost advantage compared to those who don't, then it just gets harder and slower to pass through.

Because if you go to the farmers and say I'm going to pay you less because the evil scourer's cranked up its price. The farmer says well that's okay, I'm going to go to merchant X who doesn't face that and therefore sell overseas.

So I think that that's the kind of point I've tried to make around this, which I think is similar to what John is saying, but in my economic sort of terms.

DR GALE: Okay.

MR MELLSOP: Does that make sense.

DR GALE: So it's to do with the merchants having -- different merchants selling both greasy and clean wool, is that the --

MR MELLSOP: I think that's an important factor, that this is not a universal impost, so to me that alters the dynamics of pass through.

DR GALE: But does it mean that the merchants end up carrying some of it, or does it mean that it's just averaged out for a particular farmer?

MR MELLSOP: Well I think it means that those merchants who want to persist in selling clean are going to struggle to buy the same volumes they would've otherwise. Whereas

those who are happy to sell greasy can pick it up, subject to the capacity issue overseas that you've been asking questions about.

DR GALE: Have Godfrey Hirst and advisors mulled over this, exactly who is going to carry any such price increase?

PROF GUTHRIE: I didn't understand anything that James said then.

I think your story is right. The world price is already set.

The merchants are so competitive that they don't have any scope. Where is that price increase going to go? It has to go to farmers. I just don't see how it can disappear. As long as scouring prices up, that increase isn't going to go offshore. There is no scope for it to hit merchants. It's got to go to farmers. I don't see an alternative to that.

DR GALE: Thank you.

MR DAVIS: I think the explanation of John and maybe James' position, or from mine anyway, is that there's no doubt there's huge amounts of demand and supply going on and they're never equal, and so you're aware of commodity and it's being traded and it's going up and it's going down. And the cycles and positions of different people and the stock they have, all -- there's a number of factors that have an influence.

What we're talking about here is an efficient supply chain and a cost structure within that supply chain.

So at points in time demand far exceeds supply. And so no -- effectively, it's not the grower receiving less, it's what the price of the raw commodity plus the additions that a merchant may wish to seek from a customer. So the customer would wear it in that instance.

So there is always a combination of situations that

are occurring at any point in time.

Over the longer term there is no doubt that as part of the cost structure, be it a broker's charge or a scouring charge or a transport cost, they are part of a supply chain that I think the industry would want to have as efficient as possible.

So, in terms of the position, growers at a point in time when the demand is very low, you would think that this is the price I can get, this is the cost of transition or transformation, and so the grower receives less.

So it's not a linear line. It definitely isn't instant. There'd be positions in place that may take three to six months to work their way through even at this point in time.

So, there are a lot of factors and in effect the merchant can also wear, because his position at this point he would have a forward position in sales or he'd have a stock position he may have, and whatever that is, he may in fact be the one who gets squeezed. So there's any combination that can occur where that price would actually be distributed. Over time though, I think everyone would acknowledge, it's part of whatever the supply chain cost is, absolutely.

DR GALE: Mr Hales?

MR HALES: Another alternative which I hope will make things a bit clearer. The fundamental purpose of a wool scour is actually to clean the wool and actually blend wool, different types from different regions in different percentages. So if you have a particular wool type and an exporter is under pressure, he's only got 15 cents margin in that particular wool to get to China, how does he make it work? He's got 61 other people banging on the door at the farmers, so he can't pay the farmer less, so

what he does is he has to rely on his scourer to perform a duty on particular other lower value wools which you know, might be what we call a style difference, like a BC as opposed to a B style which might be 10 cents difference.

We used in 725 a term called dumbing down the blend. If the exporter dumbs down the blend he can lower his cost price and if he has the confidence in his wool scourer to produce the same product at the other end that meets all of the specifications that's where he can make his margin, if you like. And that's why we're still competitive. We're very very good at tidying up dumbed down blends, if you like.

DR GALE: One little factual question that's in the list here that we might need to pass to the confidential section which is the wool grease prices that we should use as a benchmark for the analysis. Is that something you're happy enough to talk about in open session?

We want a lower bound for wool grease prices for the analysis. Should we discuss that?

MR HALES: Yes it's public knowledge, wool grease prices around the world. It's a world market.

For the modelling for a new entrant was $3.75 -- $3.50, I’m sorry. And we expected the price to increase over a three year period.

Wool grease prices have been cyclical and have reached a low in the last 18 months due to a disease in the Asian fish farms called Early Mortality Syndrome that had a devastating effect on the shrimp farms and of course cholesterol levels dropped, those two markets cholesterol and lanolin.

Currently the market is on the recovery and today we're selling at around $4.50 and we're expecting the market to go to over 5.

There's a lot of optimism in the market and in fact the largest refiner of cholesterol in the world is a company in China called Biogarden Technologies. They've got the capacity to handle two thirds of the world's wool grease production. They're currently not working, but expected to come back into the market in July.

So there is some upside. We see no down side at the moment. And the word's just craving for vitamin D3, so we think that market's very solid.

DR GALE: Any follow up on that?

MS CSORGO: I had a quick follow up on something that Mr Dawson had indicated and that was when you're looking from your green book you had indicated that there are all sorts of buyers of the wool clip at auction. So -- and you'd that there were 61 wool merchants participating in those auctions, so what percentage of the total --

MR DAWSON: No, there's 34 exporters who -- the majority of those would operate at the auction only, and then around the auction system there's 61 wool merchants that operate in the industry as well.

MS CSORGO: So what percentage of the total wool clip is purchased by wool merchants?

MR DAWSON: The auction percentage I think is around 50%. 50%, so it's 50% of the New Zealand wool is channelled through auction. The rest of the wool is channelled through wool merchants and the other parties that I mentioned.

MS CSORGO: So that doesn't quite answer my question in terms of including those who do and don't buy at auction, what percentage of the total clip would be bought by wool merchants?

MR DAWSON: 50%, or nearly 50%.

MS CSORGO: Okay. Thank you.

DR GALE: One other quick factual question please to Cavalier.

I think in our Draft Determination we had modelled the time it would take to get a new plant going at six months. And Godfrey Hirst specialists are saying it would take three times that long. Can you fill us in about what's the basis for your six month presumption that an entrant could get a plant together in six months, buy the equipment, find a site. This is still to do with the entry barrier, you know, the barrier to price rises, if that was the relevant constraint.

MR HALES: Sorry Dr Gale we said it was 12 months for entry, it would take 12 months, yes, and we still stand by that.

We dispute the fact that it would take longer simply to get consents. We have expert opinion on that. And we also are aware of a new wool scour that's just been made in China. It was made -- from the time it was ordered and the time that it's been delivered to Unilan in Argentina was actually three months, it's a new James Irvine scour. So that's all public knowledge.

DR GALE: Okay.

So Godfrey Hirst, a six month discount for the price that might be the cap, we might be gilding the lily here given the uncertainty on that price itself, but do you have a strong reason why in New Zealand you just don't think it could be achievable within 12 months?

MS PAULING: Probably Kevin's better to answer this, but I think the issue for us is finding suitable land and the effluent discharges consents are what's difficult. And you've still got to get the plant here, assembled, functioning. So it's not an easy thing to do, setting up a manufacturing plant.

Kevin do you have anything to add.

MR PIKE: I think the first issue is finding a suitable site and there's an amount of time that would be required to find a suitable site after which you may or may not have

to erect buildings. While those buildings are being constructed the plant can be purchased simultaneously, yes, I acknowledge that. But I think that if you considered that you could find a site that didn't require too much in the way of alteration; had buildings in place and it was in an area that was sympathetic to industrial discharges that made the consents relatively straightforward to achieve also, then yes, you might be able to get a plant commissioned, or you might be able to get a plant working within 12 months.

But, our position -- or my position, is that, you know, that is making quite a few assumptions. If you do have to complete significant building works; if you do have to convince authorities to grant your consents; if you do have to design a lot more in terms of, you know, effluent treatment plants and what have you, then it's going to take longer.

And the second, and a very important part of getting any plant working is also the time that it takes to commission the plant. There's been a bit of discussion about James Irvine's new plants that are being installed around the world, and yes I've seen a couple of them and I can tell you that I haven't seen any examples that haven't taken at least three months to actually get running properly -- commissioned and running properly after they've been got into work.

So I think if you add all the things that are going to combine to -- or have to combine to result in a plant that is running efficiently, then it is simply a lot longer than 12 months.

DR GALE: Thank you.

Question to Godfrey Hirst: if it were possible for the merged entity to put up prices, are we right in thinking that you don't have any downstream flexibility?

Your product's in a competitive market; you can't raise carpet prices, so would the -- so rather than lose your volume, would you expect that the merged entity would just price to keep you in business? There would be no particular advantage in ejecting you from the carpet market, because everyone is facing such intense competition from synthetics and other sources.

Can you take us through where you see the hazard?

MS PAULING: I guess the hazard for us is that we're relying on a monopoly post-merger. We have no alternative to get our product sourced from anyone else. So, it does come down to our survival.

So if they decide that they're going to increase, for example, our tariff by 50% or a hundred percent because they can, they're going to proceed on the basis that oh well wool may be a smaller percentage of our volume, so therefore they can get away with more.

But what that actually means is that we will no longer be able to produce wool carpet in a way that is financially viable. So it will effectively signal a further move away from wool. And I agree that that will end up potentially being a negative for them, but you don't know how -- you know, it's going to play out.

I guess we just feel incredibly vulnerable that the -- from what's been said, is that the only people that are going to get the price increase is us. They're not going to pass it onto China; they're not going to pass it on to Europe. We're going to wear all of that price increase.

DR GALE: But not to the point of -- would there be any point in them pricing it to the point where you couldn't operate?

MS PAULING: Who knows.

DR GALE: Because they would lose a stream of scouring revenue.

MS PAULING: Quite possibly. But, you know, they've still got Cavalier in there, so they could price ours at a higher level than Cavalier's, because Cavalier is a shareholder in the entity. We don't know. I'm not suggesting for a minute -- but we can't afford, we have a huge investment in the New Zealand wool industry here. We've got two yarn plants, we've got a tufting mill which is essentially making wool carpet. I can't afford to rely on the goodwill of our scourers to ensure our ongoing financial viability. And that's kind of the position we will be in after this, in terms of our wool production. And all of the New Zealand business is essentially wool production. We have two yarn plants and we have a tufting plant that makes wool carpet for the entire world wide group. This potentially puts all of this at jeopardy and I can't afford to be in that position.

We're not going to buy New Zealand wool; send it offshore greasy to get it scoured and sent back here to feed our yarn plants. It's not going to happen.

DR GALE: And your own scourers are not at scale, is that the reason why the fallback option of scouring your own?

MS PAULING: Yeah, we don't have the volume, because the wool carpet sales have dropped off because of competition from everywhere else and we're fighting to keep it going. We've got a new product we're bringing out which we hope will have some impact, and we're saying to the retailers look you need to support wool. So we are supporting wool, but at the moment we're kind of on our own. And if we have to rely on the goodwill of a scourer to not only not put up our pricing, but to then prioritise our work and to continue doing it to the standard that had been pre-merger, there is a lot of variables and ifs and buts

for us there for a huge chunk of our business in terms of the New Zealand entity.

And from what I'm hearing, the only people who are going to get a price increase is us.

Oh and you (indicates), yeah.

DR GALE: Who do we need to know about as well?

MS PAULING: They're a yarn manufacturer in Christchurch.

DR GALE: Did the team want to pursue that further?

MS CSORGO: I did have a follow-up question for Godfrey Hirst. So are you indicating that there is absolutely no scope for a price increase, so that there would be some sort of change in your costs of production that wouldn't put you over the edge and essentially put you out of the wool carpet business?

MS PAULING: No no that's no what we're saying. All we're concerned about is unreasonable increases. And what we're saying is we've been told that our prices will only increase by 15%, but you know, we've had other indications from the merged entity saying that, you know, we better be very careful because there will be significantly more increases. And I guess those threats that have been out there are a concern for us.

We're in business too and we accept that prices go up and down and we negotiate and we're not expecting -- we don't expect to have no increase, but we don't want to be in a situation where we are completely dictated to because we have no other option, other than closing down our plants.

The wool carpet market is highly competitive and is price sensitive. That doesn't mean we can't have any increase, it just means we can't have one that's unreasonable.

MR DEAKINS: Can I just come in here?

I'm struggling with the argument that Godfrey Hirst

are putting up here.

My understanding is when Godfrey Hirst buys wool for their plants they are buying it off New Zealand wool exporters and they are not going to the wool scour directly, is that correct?

MS PAULING: In the past we have always had a contract directly with the wool scour. So we have a tariff that's set for our wool up until 16th of April this year, we've had a set contract price. So from that time forward our pricing has been determined by the merchants. But whereas before we've been always able to negotiate a price, because we've had a big volume that option now is clearly not available to us.

MR DEAKINS: But you've always bought through the New Zealand -- a New Zealand wool exporter?

MS PAULING: Yes, that's right. They pay for their scouring at our tariff.

MR DEAKINS: I think I've got a solution for you that I think therefore you haven't got a problem and I would guess that Cavalier Wool Scour has contracts with most of its exporter clients that are mostly probably in place for the next several years at a price - a fixed price. So I would suggest that you get on the phone to John Dawson and he's got a price for scouring that's not going to change and buy your wool off him and you won't face any increase.

MS PAULING: And so at that point is he going to charge me more for the wool because he knows that I have no choice to go anywhere else?

MR DEAKINS: Well he will charge you the price for the wool that the world market dictates.

MS PAULING: So again, he can only get --

DR GALE: We'd better not negotiate it on the spot.

I appreciate that there are sort of product

speciality features. The deal that the merchant would do would be very bespoke for your carpet; it's not the same as the stuff that's going to China.

MR DAWSON: It wouldn't only be us. They could come to us, but as I said, they have plenty of choice in New Zealand today. So the idea that this company could take advantage and be singled out is not correct.

MS PAULING: Except that it goes back to the initial point that the scourer is fully aware of what is ours, our wool that's being scoured and there were no options. As I say, we've always negotiated our scouring rate. That opportunity is now lost to us.

MR DAVID: It also goes back to the conclusion that the Commission has reached in its Draft Determination, Dr Gale, that the type of cost disadvantage that we're talking about here as a result of a scouring cost for Godfrey Hirst, and to quote the Commission's words:

*"... could render it a less effective competitor, or either reduce its market share or drive it from the market completely."*

Now that's a succinct statement of potentially what could happen.

DR GALE: Yes, what I was exploring was really whether why would the -- even assuming a way this sort of invisibility and free trading at the world prices, whether it would logically suit the merged entity's interest to drive a customer who is prepared to do 7,000 tonnes, whatever it is, of business.

I haven't seen a rationale for driving that firm from the market?

MR DAVID: Well that's going to depend on the business case for the Cavalier Wool Holdings going forward in the guise of its new ownership and you know, potentially with the exercise of the Lempriere option. We don't know what the

intentions are of those parties. That hasn't been expressed in the application. It certainly hasn't been explored here.

MS PAULING: I think the other thing too, it's been made clear that as the merged entity comes together we are a less relevant client. So we are dropping in importance all the way through this process.

So them losing our volume going forward is probably not that big a deal to them; where it is a huge deal to us.

They will be able to substitute, like they say, from offshore potentially.

MR LONERGAN: Can I just respond to a couple of comments there?

The decision to discontinue the contract that Godfrey Hirst had with Cavalier Wool Holdings was their decision, it was not Cavalier Wool Holdings.

Secondly, 7 million kilograms of volume is 7 million kilograms of volume in an industry where we've got declining volume, that's critical for us. There is zero interest from Cavalier Wool Holdings' shareholders to lose that volume and there's zero interest to subsidise Cavalier Bremworth.

MR MCKENNA: From the Lempriere point of view, it's the same. That we've got no interest in losing that volume, and had offered Kim McKendrick that we'd continue to scour on the same terms as the agreement that we understand that he terminated.

MS PAULING: Just to be clear about the termination, we had had a six year scouring contract. If we didn't terminate at that time we were potentially committed for 10 years. So we gave notice; said we wanted to enter into negotiations. The parties told us they would rollover the existing contract, on the same terms, but they

wouldn't negotiate. And that's where things have been left.

DR GALE: Okay, shall we leave it there?

MR MCKENNA: Just for the record, we didn't say we wouldn't negotiate.

DR GALE: Okay.

We've got five minutes left.

We touched a little bit earlier on the pass through between farmers and merchants, and Mr Mellsop explained his view, do we want to pursue that further, do the team have follow-up questions on that topic?

So the next topic is this issue of wealth transfers between parties and the role of having foreign parties and I feel we need a break before embarking on that, because it will be cleaner to sort of do it as a piece than have a five minute nibble at it at the start.

So can we reconvene in quarter of an hour, at 20 to please?

(Adjourned between 2.25 and 2.42 pm)

DR GALE: Welcome back. The next topic is on wealth transfers and how we should handle the partial foreign ownership of the merged entity.

Godfrey Hirst, through Professor Guthrie's submission, has argued that the benefits of the transaction that flow proportionately to the foreign shareholders shouldn't be included as public benefits. So I wonder if you -- I'll ask you about this and then I'll ask NERA.

Are you saying then the cost rationalisation is not always beneficial, or should not always be regarded as beneficial to New Zealand?

PROF GUTHRIE: Yes, to the extent that some of the benefits go overseas, then I don't think they should.

In my two reports I've got an example of exactly

that situation where as a result of a merger the merged firm is going to reduce its use of natural gas, it's one of the benefits that are listed in the Draft Determination. And what I've done there is I've gone through and tracked exactly where those benefits flow and some of them do stay in New Zealand but others go overseas. And having gone through your guidelines, it seems pretty clear to me that they shouldn't be counted.

DR GALE: Yes our guidelines draw a distinction between functionless and functional rents. And so I wondered if their cost savings and savings of assets, so the foreign ordinary can sell assets that are no longer required in New Zealand like the land and buildings, do you regard those as functionless in the same way that the excess profits are regarded as functionless?

PROF GUTHRIE: I have to say that I don't, having read those guidelines and the Draft Determination, I don't really understand what the Commission means by functionless rents. And I don't understand why you think that counting these benefits is going to create an incentive for overseas shareholders to invest in New Zealand in a way that benefits New Zealand.

I mean even in the list of questions here:

*"It's all about providing efficient signals to beneficial in-bound foreign investments ..."* and so on.

It sounds very good, but I spent some time last week trying to actually write down the detail of how that is going to work, and it may just be that I'm not very good, but I put quite a bit of time into it. And I can't see how your decision to allow or disallow -- or how your decision to allow increased profits that flow overseas to count as benefits to New Zealand and to feed into your decision; I don't see how those can alter the incentive for overseas firms to invest.

And what would be really helpful for me, and I think for other people looking at this, would be if the Commission staff could actually do that exercise that I tried to do last week and couldn't.

And all I'm really asking is for somebody to tell us exactly what the sort of investment is that you're trying to incentivise. And then to demonstrate how your decision affects firms -- overseas firms' incentives to undertake those investments.

Now I tried to do it, and I think it's the way that your staff were trying to do it as well, is that you say well, there's four different scenarios that you've got to consider and it's two times two. The first thing is these overseas shareholders they either decide to invest in whatever this investment is, or they don't. And the Commission is either going to make its decision including the increased profits from overseas investors or it's going to make its decision not including those amongst the benefits. So there's two decision rules that you can take. There's two decisions that the overseas investors can make. That gives four different combinations. And all you've got to do is in each of those four combinations write down what the pay-off is to the overseas investors and then you can see whether -- and then what's the overseas investor going to do? Well they're going to do whatever gives them the higher pay off. And when I did this last --

DR GALE: The case study that popped out for me thinking of this along the same lines was that if the New Zealand firm is allowed to rationalise -- so a foreign firm is considering investing here; it knows that if New Zealand based firms rationalise even with the prospect of some price increase, they may be allowed to do it if they can front up with enough gains from the rationalisation. But

under your decision rule if there was any prospect of a price increase at all, the foreign firms would know they would never be allowed to rationalise because there'd be no offsetting benefit recognised.

So the question is, that's going to act as a deterrent to the foreign investor, other things being equal.

PROF GUTHRIE: That's what I was doing last -- that's exactly the case that I was looking at last week.

And so I think what you're trying -- what you want to get out of this is an incentive for that overseas firm to invest where the investment isn't a part of that merger, but it's pre-investment, it's pre-merger; that's the investment that you want to encourage.

Now, somewhere in those guidelines it makes the point that overseas investment by itself is not a benefit to New Zealand. Capital comes into New Zealand but dividends and interest and so on leaves. So that you don't -- or you say that you don't actually count overseas investment as a benefit. It's only, I think technology transfer is one of the things that you mention, there's a few things like that that are sort of externalities, I guess, that are as a result of that investment.

And so it seems that --

DR GALE: Yes, which is a way of saying that it's not the gross amount of the investment that it's a benefit, there are other benefits associated with it, the gross quantity be the measure.

PROF GUTHRIE: And if that's the sort of investment that you want to incentivise, and I'm not suggesting that you should try to do this in practice, but continuing with this experiment, you would count the benefits that go to New Zealanders as part of the merger and you'd want to

count the benefits that go to New Zealanders from the overseas investment that took place leading up to the merger. Those are actually the benefits that you care about I think. They're only benefits to New Zealanders. You don't care about benefits to foreigners except to the extent that they generate additional benefits to New Zealanders.

And so what you're wanting to measure is the pre-merger benefits to New Zealand, plus the post-merger benefits to New Zealand. But what you're proposing to do is to take the post-merger benefits to New Zealand, which should be in there, and then you're going to add to that the post-merger profits that go overseas.

DR GALE: The post-merger profits that go overseas at the present we're regarding as a cost.

PROF GUTHRIE: As a benefit -- ah no.

DR GALE: So the excess profits from the price rise -- the profits from the price rise we're regarding as a cost -- a transfer out of the counter.

PROF GUTHRIE: At the moment you're counting the increased profits that go overseas as a benefit.

MR IRVINE: So the increased profits from a price increase from the exploitation of market power are seen as a transfer of wealth away to foreigners. That's separate from an increase in profits from cost reductions arising from rationalisation.

PROF GUTHRIE: You're wrong on that. Because when you go through that gas example you count a hundred percent of the cost savings from reduced gas usage. Now some of those cost savings go to the New Zealand Government, you count those, and I think you should; some of them go to New Zealand shareholders in the forms of increased profit and you count those and I think you should; but you also count whatever is left over, which is about 33% of that

total, you count that as a benefit. And I'm saying that that's actually a transfer that's going overseas in the form of increased profit.

MS CSORGO: Just to be a hundred percent clear, anything that is a productive efficiency savings, we are currently regardless of who owns the facility, is counted as a benefit.

PROF GUTHRIE: I realise that that's what you're doing --

MS CSORGO: No no no, I understand what you're saying, that that portion of that shouldn't be, but just so that we're a hundred percent clear, that is what we currently do.

PROF GUTHRIE: Yeah, okay. But you're counting it and the justification that we get is that you want to count it, because that will improve overseas firms’ investment incentives.

And from what I worked out last week, the only way that that can be true is if the increased profits that are going overseas, that I think we agree you're currently counting, it's only going to improve investment incentives if that is equal to the pre-investment benefits to New Zealanders of this transaction. And I mean, it might but there is absolutely --

DR GALE: Those bits are very -- it's too late to observe the pre-investment gain --

PROF GUTHRIE: That's right.

DR GALE: -- the firms are in the country.

PROF GUTHRIE: But it seems from what you're saying that the investment that you're trying to incentivise by counting those post-merger increased overseas profits is the investment that took place leading up to the --

DR GALE: So it's a signal to firms in general that if kiwi firms are allowed to rationalise despite some price increases, because the rationalisation gains -- we don't want -- as the starting point we don't want foreign firms

to conclude if I invest in New Zealand and the time comes that I want to merge with somebody else, those rationalisation gains, I won't be able to make that merger and so then I will be in an inferior position relative to the New Zealand parties who are able to make rationalisation gains.

That's the affect we're trying to capture.

PROF GUTHRIE: Yes, and I don't think you are.

It would only really capture that if benefits to New Zealanders, separate from the merger, but from the investment that you're trying to encourage, equalled the interest profits that go overseas as a result of the merger.

DR GALE: Yes, it's whether it's -- the question is whether it's a practicable rule --

PROF GUTHRIE: Yeah, and I just --

DR GALE: -- or whether you can modify it?

PROF GUTHRIE: I can't think of any reason why, and I go back to that -- and I've said it before, but I'd like to say it again, that those investment benefits we're talking about, you say in the guidelines that overseas investment is not a benefit to New Zealand, the dividends go out to compensate, it's the zero MPV thing. The only benefits that you're really trying to incentivise are the technology transfers and so on. And why would that be equal to the increased profits as a result of this merger that are going overseas?

DR GALE: I don't think it's a mathematical equation, they're sort of offsetting concerns.

PROF GUTHRIE: But ultimately the maths are involved.

DR GALE: What I want to do is test the -- because the way it's expressed at the moment it is a sort of a bright line rule isn't it, you either count it or you don't count it. So I'd just appreciate Mr Mellsop's comment,

because you're making the opposite argument that we should fully count the benefits irrespective of the fact they all flow to overseas parties.

MR MELLSOP: Yep.

DR GALE: And what confidence can we have that that's the right way of paying attention to this overseas investment concern that's sort of sitting behind this?

MR MELLSOP: This discussion has been very interesting because I think the incentives on foreign investment are relevant, but they're secondary.

And, in fact, something Professor Guthrie, the way he stated it, really brought it home to me, there was something like we -- actually I haven't written this down properly, but to me that's not why we're interested in treating the surplus increases as benefits for this transaction. It's actually quite a separate reason, which I'll run through. And I think perhaps if we use Professor Guthrie's exemplar of a unit of gas. I think we're agreed that post-merger the way we're conceptualising this is that the merged entity can scour the same quantity using less gas. So, a unit of gas is now residual or redundant to scouring of wool. So it's adding zero value to the economy.

Now to me the key thing here, and this is where I differ from Professor Guthrie's analysis in his two papers, the key thing is that that unit of gas can now be used for something else in New Zealand, and that is the benefit. And that's what the High Court described the benefit as too, we're freeing up this unit of gas or this piece of land or this employee to do something else in New Zealand. So what we actually are trying to quantify is what is the value that that unit of gas adds in its new use? That will be some combination of producer and consumer surplus. We actually have no idea what it will

be, or whether the consumers or the procedures will be Kiwis or not, you know, we don't know. But that's actually what we're trying to quantify here. That is the benefit that a real resource is now freed up and is used for something else in New Zealand and it's the value it's adding over the zero value in scouring that's of interest to us.

And now look, leave this to the lawyers, but that's my reading of paragraph 281 of the High Court as well, that that's exactly what Justice Mallon was saying.

So what we're using, and I think what the High Court said was appropriate, to use as a proxy for that new value is the sales price -- the expected sales price.

So the unit of gas, whatever the market price is of that, the value of land. That's what we're choosing to use as the value this thing will create in its new use.

Now because of this whole discussion of incentivising foreign investment, you know, I think it's relevant from a policy perspective, but I don't think it's actually the core of what we're trying to do from an economics' perspective.

I do think that going to the incentives, I've made the point, and Graeme has disagreed in his second paper, but to me there's another scenario that his first paper didn't include which is that we might have a transaction which frees up in an efficient way resources in New Zealand that gets disallowed by the Commission because some of the cash might flow offshore.

So we're missing out on freeing up these resources for other uses. And to me that's the incentive problem, that's the public policy problem.

But I think the major point is that what we're trying to value is the alternative use. And that I think is where I differ from Professor Guthrie's analysis.

Does that make sense?

DR GALE: The part of it that seems to me, or that still need to think about further, is the foreign owned firm was buying 101 units of gas and paying for 101 units of gas and that money was coming into the county. Now they buy one unit less, so they buy one unit less and that's released for use. But seeing they were paying its market value, the fact that they were buying it before and aren't now, just balances out, doesn't it?

MR MELLSOP: And this is the piece that I think is missing. So okay, that's correct, but what about the surplus that's created when that unit of gas gets used to, I don't know, something else in the economy, that's actually what we're interested in, is freeing up the resources to be used to add value. They're adding zero value now in wool scouring, they're redundant; now it can add value somewhere else, and that to me is the missing surplus that actually is the key thing here.

And, as I say, we actually don't know what that value will be, we don't know if it's going to be small or big or what it will be. All we can use as a proxy is the sales price. And that's my reading of what Justice Mallon said as well. I will obviously leave that to legal minds to confirm or not.

MR TAYLOR: Justice Mallon I think made it clear that the scouring that was carried out on a site that was now going to be sold because it was no longer required. That scouring was still being carried out, but on lesser sites freeing up the other ones for another use, and at 281 she said:

"*The benefit lies in the release of surplus resources for other economic uses and the best evidence of the value of those alternative uses is the price that is likely to be paid for the surplus.*"

And I think that paragraph 281 encapsulates the whole of Professor Guthrie's argument and James and explains the differences.

DR GALE: All right, no appreciate that; I think we're clear on the two positions.

PROF GUTHRIE: Can I just clarify? Because that statement there about the benefit of this, there's two sorts of benefits the Commission talks about, there's net benefits and there's gross benefits and when James is talking about the value of this gas and its alternative use, he's talking about the gross benefit. There's a cost to this. And you mentioned it yourself, and it goes back to this statement that I've used previously, and I shouldn't have, that these cost savings free up the resources. They're not free. There is a cost to New Zealand and it's -- if you look at that hundred dollars' worth of gas that's -- I agree, once the merger occurs that gas was not being used productively. The merger takes place, that gas is available to use somewhere else; we benefit to the tune of a hundred dollars, possibly a little bit less, but I'm happy to go with a hundred dollars. But -- and where is that hundred dollars coming from? Well, there's a hundred extra dollars that the firm is going to make in pre-tax profit. 28 of that goes to the New Zealand Government in tax. Now that is just a transfer, so we don't count it. 55% of the remaining 72 dollars, that goes to New Zealand shareholders, that's just a transfer, we don't worry about that. But there's the remaining 45% of the 72 dollars that is going offshore. And if we're counting the resource that's being freed up as a benefit to New Zealand because it's going to be used in New Zealand, then surely we have to count the $33 that's going overseas where it can't be of benefit to New Zealand?

And NERA wants to include the benefit of the gas, but it doesn't want to include the cost of making that available.

And I think we all -- I've made the same mistake myself in my first report. We talk about this as "freeing" up the resource. And it's not free. There's a cost. And the Commission is really clear when it talks in its guidelines about its net benefits that matter, it's not gross benefits. And if you're going to follow that, the net benefit recognised the cost, and the cost is that 32% of that hundred dollars is going offshore.

And I agree with James, that the investment incentives I think -- I don't think they would support -- I don't think you could defend them, if you go through the maths and actually try to look at it, I think they don't have the investment incentives. I think it's a red herring in many ways. It's a simpler case of making sure that the Commission measures the net benefits of these transactions and not the gross benefits. I think it's as simple as that.

DR GALE: Have you got a new thing to add Mr Mellsop? I think we understand the two positions.

MR MELLSOP: Well just to -- I don't -- I mean, this use of the term "freeing up", releasing, whatever, I'm not arguing there's a free lunch. What I'm arguing is that if the value of the unit of gas in scouring is -- if the value added by that unit of gas in scouring is zero, okay? And let's just make up some numbers. If the value add by the unit of gas in another market is 500 or 5, whichever. It's the 500, it's the 5, it's the additional value it's adding to the economy, that is the benefit. And to me it's the net benefit.

So if in fact we said in wool scouring there is some little benefit to this unit of gas, but there's a higher

benefit elsewhere, so in fact it adds $5 of value to the economy in wool scouring, but 500 in something else then the benefit is 495, it's the net. So I don't think I'm talking gross versus net.

What I think we should be doing is saying this merger, what extra value out of that unit of gas is created for the New Zealand economy? To me that's the question. And where cashflows -- I don't think it's important, it's the real resource; how can we get it into the most valuable use? What is the incremental value add which I think of as net.

So I really just wanted to clarify that's how I'm seeing it.

DR GALE: And it is what we wanted to clarify, get the two positions clear and obviously not try to reach a conclusion right now.

Do you want to pursue that anything further?

Okay. The last part on this list before we get to benefits is about the change in the shareholding post-transaction and I wonder if this is part of the -- needs to be part of the confidential session?

This was to do the with I think it was your proposition again Professor Guthrie, that the fact of the option later, depending on how it came out, would change the net cashflows in a way that's sort of not already written into the deal. If we're going to explore this in detail is it better that we do that in a confidential session or is it an open matter?

MR DAVID: It is certainly not confidential to us.

MR TAYLOR: I'm not aware.

DR GALE: The way the option works and the way the value and the flows to overseas parties. I mean, you will have read Professor Guthrie's submission on the topic.

MR TAYLOR: No, I don't think it's likely to be confidential.

MR DAVID: The only potentially confidential part I think is the trigger point.

MR TAYLOR: It is, yeah.

DR GALE: So I think the proposition in general is that this question about how much goes to -- of the wealth transfers to foreign parties that we ought to count is tied up with the option. And to date what we've assumed is that the shares that are traded in this transaction reflect the future value of that option. And so we don't see how any subsequent change in the shareholding between the parties would shift the value of the transfers to foreign parties and wonder if you can elaborate?

PROF GUTHRIE: I think if the price for that transaction was set at the time that it occurred, then I'd agree with the Commission, that the benefits are going to say.

The problem is that transaction, whenever it occurs, is going to be at a price that has been -- that's not fully determined at the time and I'm not suggesting that there's a constant strike price that's been set now because I know that the details of that option have some twists to them. But there is still a pricing rule that's been set and that -- it's got some inputs that will be adjusted at the time, but the rule itself has been set today and that -- I mean, I wouldn't say that if that option took ownership from this percentage to that percentage, that the full amount of those benefits would flow overseas, because clearly they won't. There's an element of the transaction price that's been set at the time, because there are inputs into that pricing formula that will occur at the time.

But they're only inputs into that formula.

And I think we mentioned before lunch that one of them is a fixed multiple of an accounting measure of firm performance. Well if you look at the level of that

multiple in financial market data, they change all the time. And so it's not -- you know, there will be times when that transaction price calculated using that formula looks quite attractive, and there will be times when it looks quite unattractive. And that's the feature of an option that provides a separation between the value of what's changing hands and the price that the firm is going to have to pay. And after all, one party is not going to exercise that option if it's getting less than it has to pay in terms of the strike price.

So straight away there's going to be a premium, because they'll be getting more than they're paying for it.

DR GALE: So how does this unfold, if we're counting up the benefits that flow offshore as part of this analysis, how do we allow for the presence of the option? I mean, do we assume it's exercised or assume it's not? Or do we assume that -- because all that we can know is what the transaction is at the moment.

PROF GUTHRIE: So you said if we are counting the benefits that go overseas --

DR GALE: Yeah --

PROF GUTHRIE: -- or if we aren't?

DR GALE: -- I think that was your proposition, that the cost of this transaction that we ought to account for in the form of profits to overseas shareholders will depend on the option.

PROF GUTHRIE: Okay. So if we're not counting the benefits; if they're excluding them for the calculation.

DR GALE: How would we do it?

PROF GUTHRIE: You would start with the percentage that's -- the overseas ownership with the option not being exercised, that's going to give you a lower bound on what goes overseas. An upper bound would be the percentage of

ownership after that option is exercised.

And the answer will be somewhere within that range.

DR GALE: I see.

PROF GUTHRIE: Please don't ask me where.

DR GALE: The probability weighting that it's exercised, okay.

PROF GUTHRIE: Yeah, but also this issue that the price isn't being set at the time of the transaction. So already there's going to be some variation.

So if the option took ownership from X percent to Y percent, the proportion of profits that are going to flow overseas will be bigger than X less than Y. It gives you a range; that's probably as good as you can do.

DR GALE: Anything on this further?

James do you have a response to this about how it would be allowed for in a -- allowing for all futures, some of which include the option being taken and some don't?

MR MELLSOP: I think I've got the same view as Graeme, but possibly different interpretation of how the strike price works but that is a factual question for you guys.

If we assume that effectively the strike price reflects the forward looking value of the firm at the time. So if we assume that's the case. Then I don't think it makes any difference at all, you'd be going for the 45%. Because ACC and Direct Capital are getting paid for the increased value and as New Zealand companies they're getting that value. Which I think is the same thing Graeme is saying, the question is, is the strike price going to reflect the current or the expected value of the firm or not? Whereas if there's some degree to which it doesn't, as I understand what Graeme's saying then you might start moving above the 45% somewhere along that spectrum. Does that make sense?

DR GALE: Yes. Okay any more questions on the option feature?

MR LONERGAN: There are two components to establishing that price and the working of the option is that it's the highest of the multiple of earnings, or the share price escalating it at 15% per annum which is the hurdle rate that we apply. So to James' point, I mean it's almost silly for financial investors to be sitting here saying that we'll contemplate a pricing mechanism that gives away value. You know, we're simply not going to do that. So the mechanism we've got, in our view, captures all of that value. So to James' point, you know, if it was to be exercised which is a completely different topic, but if it was to be exercised that value is retained by New Zealand shareholders.

DR GALE: Okay, I think that's all we need to pursue. I think we've got the story straight.

And that's the end of those two sessions on allocative efficiency effects and the wealth transfer puzzle.

So the next session is about the benefits and it's a question of whether it's entirely in confidential session or open session first?

MS RAWLING: Yeah, I think we can probably start and see how we go.

But the questions really that we want to get to here relate to the claimed benefits including the sale of land and plant and the magnitude of those benefits which have been disputed by Godfrey Hirst.

So the questions relate to the release of land from the plant closures and the time taken to do that and to sell the plant itself and then the time related issues for cost savings to the extent that we don't cover that in discussions.

So if we need to discuss values themselves we can

tide that over to the confidential session. But otherwise I think we probably can make a start and see how we go.

So just to reiterate also the valuations relating to the land itself, as you know, we'll deal with separately to this conference. We're not, in either confidential or this session, going to go get into the question of valuation itself.

But what I first wanted to start with were just questions around the timing factor, I guess, which you've raised Professor Guthrie primarily. And so to date the Commission has considered that assets that are no longer needed for scouring purposes as a result of the transaction will give rise to a benefit as soon as they become available for their alternative use, and this relates in part to the quote that Mr Tailor read out from the High Court decision too. So that's an approach that the Commission took in Decision 725 and it's an approach that was endorsed by the High Court there where there was no disruption to the values ascribed to those benefits.

So my first question really I think, Professor Guthrie, in first instance is what is there to have changed? And we've heard quite a bit of harking back to the previous circumstances, what is there that you say has changed between that position then and the position now that we should take into account to alter that approach this time round?

PROF GUTHRIE: I wasn't involved four years ago, so I'm sort of struggling to answer that.

So, I mean, I've approached it from a standing start and I must admit in my first report I think I probably got it wrong as well. There I was talking about how long is it going to take before this land is sold? And that's not actually the issue.

What's relevant is when once this land becomes available, when is it going to start generating economic activity that benefits New Zealand? And that's not the same thing as the land being sold. And it's not even necessarily the same as the land being sold and then being used to generate economic activity. Because, from somewhere in the guidelines, it's clear that relocating economic activity from one part of New Zealand to another is not a net benefit to New Zealand. So the question is not how long is it going to take for this bit of land to be sold; it's not a question of how long is it going to take before this land starts supporting economic activity. The question is how long is it until New Zealand's total economic activity increases as a result of this unit of land being available? And that seems to me to be -- it's much harder to justify that there's going to be no delay.

If it was the case of the land being available for sale, well okay it could be available for sale I don't think on day one of the merger, but perhaps after one year it could be available for sale.

But that's not the issue. It's making that land available will eventually lead to New Zealand's economic activity increasing.

And the delay that you've got to put into your calculations has got to reflect the length of time until New Zealand's economic activity increases as a result of that land being made available.

I think that's -- I can't accept that that's going to go happen straight away.

MS RAWLING: So does that, Mr David, raise a question for us about the interpretation of the decision of the High Court and particularly the aspect that Mr Tailor read aloud?

MR DAVID: I think what Professor Guthrie has just said is entirely consistent with what Justice Mallon said in the High Court where she said:

*"The benefit lies in the release of the surplus resources for other economic uses, and the best evidence of the value of those alternative uses is the price that is likely to be paid for the surplus resources."*

Now both of those factors are future looking. They don't relate to the moment that it becomes available for sale, it comes to the release of those surplus assets for those alternative uses. Now that is a factor that may take some time.

Similarly, in terms of the price that's likely to be paid as I'm sure we're going to find out when the valuer comes back with his or her valuation that time is a function that needs to be factored into that assessment as well.

So I think that Professor Guthrie's answer is not inconsistent with what Justice Mallon is saying here.

MS RAWLING: Do you agree with that? Is that the approach --

PROF GUTHRIE: I'm not a lawyer.

MS RAWLING: No I'm not asking you -- and I'm not asking for the legal interpretation, I just understood your analysis to take a slightly different approach.

PROF GUTHRIE: I think the -- if we want to estimate the present value of the benefits generated by a piece of land, that a piece of land can support, I think the market value of that is the best estimate you've got. Which I think is partly what's being referred to there. So if you need to estimate the value of that piece of land being available, I think the market price or the market value is the appropriate estimate. But it's just a question of when that land becomes available.

If I can give you an example, suppose that the

scourers is shut down, that lands becomes available and then another party buys that land, transfers their activity from this piece of land to the new one. What is the benefit to that of New Zealand? I would say it's the difference in the value of the land, because this one is now generating activity that was previously supported by this piece of land here. And so the net gain to New Zealand is the economic activity there, minus the economic activity that's not taking place there.

So I think the issue about how do you value the economic activity? The market price of the land is the best estimate. But how you implement that to actually get the value to New Zealand of making that first piece of land available for other uses is a bit more complicated than just taking the current market value of that piece of land.

MS RAWLING: Mr Mellsop?

MR MELLSOP: Thank you. Two or three comments.

I mean, I agree with what Graeme is saying that what matters is when is this thing going to add more value to the economy? And that's consistent with my argument about the foreign ownership discussion we just had.

I guess just to pull that apart slightly, just a nuance, is I guess the potential delay, if there is one, and that's a factual question for the sellers selling it. And then potentially delay of the buyers using it for something else. I think the latter would be picked up in the purchase price. So you know, if a property developer ends up buying it they'll probably take into account how long it's going to take them to turn it into apartments. So I think that part will be picked up in the value, but maybe not the first part, I think.

But probably my broader point here really is that we've had this discussion in the last process and the

difficulty with going down this route is that we then have to look at when will allocative inefficiencies start; when will productive inefficiency start, when will dynamic inefficiency start? Certainly productive and dynamic will not start on day 1. And so I think where the Commission got to last time, and certainly where we got to when we wrote our first report in this process is that it's kind of abstract away from this, because otherwise we're going to be here for four years trying to figure out when everything starts and then doing present valuing it all. So there's a tractable practical way of doing things let's just do it from day one, unless there is some clear reason that you'd, you know, you do treat it differently. But if we go down this route then we do need look at the detriments timing as well to be consistent.

MS RAWLING: If we just come back to the sale of land itself and Professor Guthrie, if we were to look at a longer period for sale what is -- so in your reports you talk about a one year rationalisation period and a lesser benefit from two years or from subsequent years. What do you say would be an appropriate kind of a period for us to be guided by if we were to take that sort of approach?

PROF GUTHRIE: I chose two years. Is there support for that? No. It's not zero. It's not negative. There's going to be a delay.

And the analysis I saw I think from NERA, or maybe it was the Draft Determination, it had a one year period in which the transformation took place. So clearly the land's not going to be available for new economic activity during that first year.

So my -- you certainly can't start it straight away. It seems to me that the earliest it could happen would be after a year.

So even if you think there are going to be no delays in terms of after the land becomes available, the earliest you can take it is at the end of that first year.

And so I added a year to reflect the possibility that there will be delays.

And again, it's not just the delay in that land, it's if economic activity is being transferred to that and from somewhere else, then the issue is how long is it going to take for the somewhere else to start generating activity? And if actually when that's sold it's only economic activity being transferred from a third site, then the question is how long is it going to start for that site to start generating new economic activity?

And I don't think the process is sufficiently frictionless for there not to be delays.

Because the test is that it's new economic activity, and that's a harder test than simply new economic activity in that particular location.

MS RAWLING: So if we take the sale price of the land in question, what's your comment to Mr Mellsop's point that the value of that will already take into account the likely future use or delay in that, or transfer of use?

PROF GUTHRIE: I agree with him. But it's -- when you buy the land you're getting the flow of services that it's going to generate in the future whenever they will start. So I think that land value will incorporate that delay. But again, it's -- the test is that it's new economic activity, not that it's new economic activity in that particular location. Which isn't going to be picked up by the land value.

MS RAWLING: Perhaps if I ask Cavalier then in relation to the release of land in these particular cases, what is your view on how long it might reasonably take to have those

properties ready for sale in each case, if it differs or not?

MR LONERGAN: I might answer that in two ways. One operational, from Nigel's perspective and then secondly from a balance sheet perspective.

MR HALES: I've been involved in eight rationalisations now in the wool scouring industry. The most recent ones that I can remember we had buildings for sale. The list was Clifton, Clive, Winchester, Seaview and Lichtenstein's in Auckland. In all of those cases on day one there was a new activity started in those buildings.

I can only quote on our experience in that, and that ranged from wool storage to transport operators; dry storage facilities and the Paddon's have got the Winchester one.

In fact the Clifton site we had three buyers on it all stacked up and if the first one fell over the second one was there; if the second one fell over the third one was there.

So, our experience is that in the past surplus wool scouring buildings have been keenly contested.

MR TAYLOR: Perhaps if I could just add to that. In a letter that we provided to the Commission in the previous application dated 18th May 2011 we ran through a list of other uses; so there's nothing dramatic about what these buildings and sites are used for that requires long term preparation. The Winchester wool scour was used for refurbishing imported farm equipment. The Wanganui wool scour was used for furniture manufacturing. The Lichtenstein wool scour was used for manufacturing. The Seaview wool scour was used for industrial warehousing. The Tomoana wool scour was used for storage of cans. The Gisborne wool scour was used by a private wool merchant. And the Feltex wool scour was used by a chicken

processing factory and an onion merchant.

It's not the high tech uses, so it doesn't take long to bring into action.

DR GALE: Can I check Professor Guthrie, are you asking us to go behind the sale price and go to some lower figure to reflect the time it would take for economic activity to fire up on it?

PROF GUTHRIE: Yeah, I mean, that's how I would implement it. But I mean you can think of it as a discount on the market value, but really it's just saying this land is not going to be leading to new economic activity in New Zealand for some period. And the way that you can operationalise that is effective -- I've got a formula in my first report that effectively it's just take the market value and discount it back a couple of years. That's how I'd implement it.

DR GALE: It seemed to be me very hard to operationalise if the Court has said the best measure is what you can sell it for on the day, then why doesn't that capture -- because the person who buys it on the day has to internalise the fact that it's going to take time to start generating the money.

PROF GUTHRIE: I think that's the best estimate of the value of the economic activity that that unit of land can support. But the point is that that's not the same thing as the present value of the new economic activity somewhere in New Zealand as a result of that land becoming available.

So if the chicken processer, was actually processing chickens somewhere else and then he moves into this site, that's not a benefit to New Zealand it's just moving the benefit from one region to another.

DR GALE: But it must be captured by the competitive process to buy the land, must it not? If there was such a small

difference between where the chicken farm was and someone who has a higher new use will outbid them for the --

PROF GUTHRIE: What happens to the land where the chicken processer was? It gets back to this idea of net benefits and gross benefits.

If it's just moving that activity from somewhere else, that's not a benefit. The benefits only start when new economic activity begins somewhere in New Zealand as a result of that site becoming available.

DR GALE: I must say I'm surprised because I would have thought the conventional view in this sort of analysis was that the market prices reveal the economic value. And I'm not aware of any proceedings in which we've said well yes you could buy this piece of equipment as part of the capital investment in this process and that's what it would cost, but actually the economic cost of creating it is a lot less than that because the plant had its own costs. We would never be asked to go behind market prices for measuring economic gains.

PROF GUTHRIE: I'm not asking you to go beyond economic price. I'm asking you to calculate the full cost.

It's only new economic activity in New Zealand that counts as a benefit. It's not new economic activity on that unit of land. And the market price of the land is the value of the economic activity that that piece of land will support.

And if it's just a case of somebody moving their factory across town and that other land is left idol for 20 years, then there's no benefit to New Zealand.

DR GALE: So you think a notional delay of a year or two will capture all those possibilities?

PROF GUTHRIE: Yeah, well it's better than a notional delay of zero, which is to say that somewhere in New Zealand new economic activity will begin the moment that this merger

takes place because this piece of land is available.

CHAIR: Doesn't your theory potentially significantly reduce the concept of public benefit in that if we have to start enquiring on a trickle-through theory as to when a new activity is introduced to the economy, you know the chicken farmer moves to this wool store and another entity moves into the old chicken farm and then you've got to start having another inquiry as to where that person came from. You know, you could end up having ten different transactions before you actually discover your public benefit. I mean, how pragmatically can we implement those kind of rules and are you actually really wilting back the whole concept of public benefit with that flow-through theory?

PROF GUTHRIE: There's three things there.

One is I'm not suggesting that that's what you do. I'm suggesting you just apply a two year delay to the present -- two year discount to the present value calculation.

But, the second thing is that the process that you describe is the generation of public benefits to New Zealand. If it's just a case of everybody takes one step to the right, then the economic benefit occurs when that last person that moves vacates land that generates new economic activity.

And I think -- I mean there is a wider point that when you run through the list of benefits that the Commission is counting, I don't think you're being sceptical enough about what some of those benefits are. You're assuming that this unit of land is going to generate economic activity that is new to New Zealand on day one and I don't think that's -- I think that's overly optimistic. And I'm not suggesting you go down that process of ten hearings, but I do think you should allow

for realistic delays in New Zealand's economic activity increasing as a result of that land becoming available.

CHAIR: I don't know whether your on record on it, but just picking up on Mr Mellsop's point about it, you know, the factor is if you accept or take that approach of delay on public benefits would you accept also that you do the same for detriments?

PROF GUTHRIE: I think the difference is that the detriments come from things that the firm can control. It decides when it's going to put up prices; it effectively decides when it's going to get lazy and let costs go up. Whereas in this case the firm -- has control over when its land becomes available. But it's then reliant on other parties to start generating this new activity. And I think that's -- I'm sympathetic to what James is saying, and in principal I'd go along with it, but I do think there's a difference. And it's if you control what's happening it's going to happen faster than if you control part of what's happening and then you're relying on other people playing their part.

MR TAYLOR: Certainly at 282 Justice Mallon went on and discussed that point and said:

*"...to disregard or discount any benefit from the release of land on the basis of productivity performance in the factual would be to double count any productivity detriment."*

So his approach is that it's not necessary to calculate the productivity performance of the asset that's being released, it's enough to take the value of the asset and treat that as how the market views its productivity.

MS RAWLING: Just to bring that back to Mr Dixon, Mr David perhaps again, it seems to me a different -- taking into account the aspect that Mr Taylor's identified it seems

to me a different proposition to take then the price that's likely to be paid for that land at the time that it would be paid, which in Decision 725 the Commission concluded was likely to be soon after the proposed acquisition, but then to add to that another factor which is the time before it comes into productive use after that sale.

So, I guess my question to you is are we being invited to depart, I guess as a matter of law when you take into account what Mr Taylor's said, from that finding in the High Court at that time?

MR DIXON: Well I think fundamentally from my point of view, I disagree with Mr Taylor's interpretation of what the High Court said and what's missing from it is a lack of emphasis in his interpretation are the words "that the release of surplus resources for other economic uses". And as I understand what Professor Guthrie is saying the "for other economic uses" point is the critical one there. And that's a timing issue.

MS RAWLING: Then how do we interpret Justice Mallon when she says immediately following that:

*"... the best evidence of the value ..."* which is really what we're trying to arrive at, *"... of those alternative uses is the price that is likely to be paid."*

And I think that goes to the point that was made previously that -- or the question doesn't the price of the land itself already factor in these matters of when it might come into use, or the delay or the productivity of that use and other matters?

MR DIXON: No, because I think the price is forward looking. And as Professor Guthrie said, I think the price is a reflection of that future value, but the timing of when that future value will kick in is the critical point.

So I don't consider that comment to be inconsistent

with what we're putting forward.

Graeme have I captured what you said correctly?

PROF GUTHRIE: I think the point is that the market value is the estimate of the value of the economic activity that that land will support. But that's not the same thing as -- that doesn't mean that it's the value of the new economic activity that will occur somewhere in New Zealand as a result of that. The market value is the value of the economic activity that that land will support, which isn't necessarily the economic activity that is going to be added to New Zealand as a result of that land being made available. It's the chicken processor moving across town.

MR DIXON: Otherwise don't you lose the importance of the concept of a net benefit?

MS RAWLING: Just so that I'm clear on what you're advocating, do you say then we take the market price, whatever these valuations come up with; then we apply another factor, a delay of two years, to account for the fact that despite that's the market price and despite the sale might take place reasonably promptly, there will be a delay in it being put into productive use? Is that the approach that we're invited to --

PROF GUTHRIE: I agree with everything apart from about the last half dozen words. And the discount that I'm suggesting you apply isn't because of the delay in that land generating new economic activity, it's because of the delay in additional economic activities in New Zealand. So that land may start generating -- supporting economic activity straight away, but that's not enough. It's got to be when does the new economic activity in New Zealand occur as a result.

So I agree with everything up until that last part. And it's not the delay until that land generates

activity, it's the delay until New Zealand sees a benefit somewhere across the country.

MS RAWLINGS: I might just hand it back to Cavalier, if there's any other comment to make on that particular point? If there's not, that's fine too.

MR TAYLOR: We haven't really any further comment to make.

MS RAWLING: Anything from staff on those issues before we move on?

DR GALE: So somebody -- this is a dog at a bone I'm afraid, somebody some less gas in the example that we talked about; the gas stays in the reservoir. Other people go about using the same amount of gas and in 20 years' time when the reservoir runs out one person gets the use of that gas; that's when it comes into the economy. You're saying that the price paid for that entitlement today isn't right somehow; the market price today of the gas doesn't do the job?

PROF GUTHRIE: I'm saying that -- the market value of gas reflects the value of having one extra unit of gas available for use. But gas is more homogeneous than land. I think that's the point. So that if you had different classes of gas and having that extra unit in the reservoir increased the quantity in that class but not another, then it would be a different issue. But gas is homogeneous, and so there is a clear substitution. If you have one extra unit of gas today you won't run out until a little bit later in the future. But the land is different. That chicken processor moved across town for a reason because the new land was better than the old lands. What's the value of that to the economy? Well it's the difference in the market values of the land. He's given up using rubbish land and he's using better land. So the benefit is the difference between the two. That doesn't apply in the gas example, because one unit

of gas is like any other.

DR GALE: In the previous portions of land say the chicken farmer moves from the other land and sells that, so the cascade goes all the way back and realises the full value of the market.

MR MELLSOP: That was actually the thought I was going to articulate exactly. I've been sitting here trying to -- I've been silent because I've been trying to -- it's been whirring.

I think that is the difficulty so the chicken farmer has sold the land that she was on to someone else and that presumably is now going to a higher value use than it was in. The person who bought that was using it for something else. It becomes very intractable.

I mean, I think I've already said that the sale price is a proxy for the value we're actually interested in. I just think as a practicality we need to accept that it's a proxy because it's probably impossible -- and it could even be possible that in fact there'd be no netting off at all once all these transactions occur. I haven't quite worked through that yet.

PROF GUTHRIE: Can I make one comment to that?

That would be true if all of these transactions were lined up so that you moved from one bit of land to another and it's seamless. But if it's actually going to be the case that A guess to B; B goes to C; C goes to D and somewhere down the line that new economic activity is increased, then every time that the land is changing a use there's going to be a period where it's not available to be generating economic activity. That's why it's important that we talk about when the new economic activity is being -- when New Zealand's economic activity increases, because you have to allow for those sequences of transactions and there's always a delay. You don't

move your chicken processor across town and put the chickens in the back of a truck and move them across and kill them somewhere else. There's lags and that's what I think you need to capture.

MS RAWLING: Okay, so I think might just leave that at that point just -- and I'll just circle back to the discussion about the time it might take to release the land itself.

Just one more point on that for Cavalier, if you can from an operational perspective, if you did have a time lag between the acquisition and the availability of alternative use of that land, what are the kinds of costs, and it sounds like you haven't really experienced this, but the kinds of cost that you might incur in holding that land while you wait that release? It would just be interesting perhaps to add that to the record.

MR LONERGAN: Conceptual I suppose it's the interest rate on the otherwise debt that we would incur holding that land and not freeing up that resource.

Which kind of leads to the point I was going to raise about the balance sheet perspective to this. We are completely incentivised to release that land as soon as we can. That either reduces debt or it creates a dividend cashflow to investors and which directly leads to creating shareholder value.

So, the concept that we would willingly sit around for one year, two years, without any motivation to very quickly realise the value in that land is -- I mean it just doesn't make sense.

MS RAWLING: What I might do first is just see if anyone else has anything to add from Cavalier's perspective just on that overall question just in relation to any other costs that we should be taking into account.

And if not, perhaps then yes it would be interesting to hear from Godfrey Hirst who has some experience in

decommissioning I think, a plant about the sort of costs that you might consider would be incurred.

Nothing else from Cavalier?

CHAIR: What were the actual time periods Mr Taylor? Those examples you gave, you've indicated that happened quickly, but that was over a matter of months was it? We've got real world-evidence here on that issue.

MR TAYLOR: I'm not sure we actually have the time periods for that, although some of them were passed on.

MR HALES: Yes I'll use the example of Clifton, I think we allowed Richardsons Transport who were the eventual operators to unload a boat load of palm kernel even before the paperwork was signed off. So it happened very quickly in that case.

CHAIR: Roughly say three to six months for all of those examples would be your prediction?

MR HALES: No less.

CHAIR: Less than that?

MR HALES: Way less.

We had the plant out in two weeks.

Clifton was definitely, I'll call it day one. Winchester, Paddon's were in there again with containers loads of farm equipment coming from offshore even before we'd vacated.

Clive was obviously transferred and has long term leases going on there, so even during the sale process of that land and buildings there will be rental income coming in.

Seaview was on day one, and I don't remember how long it took the transport company to set up in that one. And Lichtenstein's again, it was a day one transfer, but I don't know the -- I can't remember the exact time that they scaled up to get to a hundred percent.

MR TAYLOR: And I think from memory from the last run, there

were buyers on standby for certainly Whakatu there were a couple of buyers for that already during the conference period and I think another buyer was lined up, or at least looking and kicking the tyres of Kaputone.

So the evidence would suggest that there's not a history of delay on these things.

MS RAWLINGS: You did have some comment?

MS PAULING: Yeah I think Anna your question was what would be the holding costs if it isn't sold, and there was mention of the financing. But having got a property in Foxton that I've been holding for seven years we've been unable to hold, we've got massive maintenance costs because if it's not fully utilised you're having to maintain old industrial buildings; you've got rates; we've had to have security; then you've still got to have the services providing to the site even if you are sub-leasing so there's those costs as well if you are having to hold beyond a straight sale. Kevin.

MR PIKE: I could add that the Kakariki site which was the Feltex site that we sold, which was a scour site took -- there was a delay of six months after acquiring Feltex that we sold the site. There was a further delay of several months before the chicken processer got in there with his rendering plant and got going. So there was a reasonable delay in that case too.

MS RAWLING: Was that a delay in that case between the offer for sale and actually being able to dispose of the property or?

MR PIKE: The delay was initially caused by us in that we had a site that was full of wool scouring machinery that we had to remove, dismantle -- sell, dismantle and remove before the site was available for sale, and then following that, the removal of the plant, it took a month or two for the sale to go through.

MS RAWLING: That leads really to the next time in question which is in relation to the availability of plant and the time it might take to decommission plant.

It wasn't quite clear from the Cavalier responses whether that was built into that release of the land? How long could you reasonably expect it to take to actually decommission and remove plant from those premises?

MR HALES: Okay, I'll use Clifton again as an example because it's one of the most recent ones.

That was a large site, included greasy wool dumps and two scour lines, with high density press. We were on site on day one and we had the majority of the plant equipment out within two weeks and distributed around. It took us I think a further week to get the dump out, and we had the buildings and everything put right within a month. So it was a pretty quick process.

Winchester was much the same.

You have a big team of engineers there, often contractors that you have to bring it from outside areas, specialist contractors, and that you don't want them being around for six months. They generally get into it and get the job done.

MS RAWLING: And given the state of the market for secondhand scouring lines, equipment, what do you reasonably expect it might take in terms of time for you to sell on the plant that you take out of these three?

MR HALES: It's a difficult question to know. Again, in previous cases we've sold quite quickly actually.

If we use the example of -- and I'm really annoyed to know that there's been other equipment sold and -- while we're waiting for this process, there's been some opportunity for a joint venture sale of our equipment gone by; we are looking -- actively looking at a couple

of others. As you know, we'd rather place our equipment into a joint venture situation rather than straight sale.

MS RAWLING: So have you got a sense of time that it might take, or based on past experience?

MR HALES: Past experience we haven't tried to do a joint venture with our equipment. But it's generally been very quick in the past and we would certainly be disappointed if it took any more than a year.

MS RAWLING: And what sort of holding costs do you incur if you can't dispose of it?

MR HALES: Very little actually. Wool scouring equipment is very very robust and as long as you protect the electrics it can actually sit outside, apart from the wool dryer. Generally it's stainless steel. So we've got surplus equipment outside right at this moment.

MS RAWLINGS: And Godfrey Hirst have you got a sense of either of those? The time it might take to dispose of plant and costs that might be incurred in holding it if it had to be held?

MS PAULING: Probably Kevin's got a better idea, but I understood that there wasn't any intention to sell the equipment out of this transaction, it was just going to be retained by Cavalier?

MS RAWLING: Or move it to alternative use, I guess.

MS PAULING: But Kevin you've got a better idea of how long it takes to sell scouring equipment.

MR PIKE: It really depends on the equipment that's for sale and the state of the market which goes up and down all the time.

At the moment you know, I could -- I wouldn't really be able to say whether it would sell quickly or not. I suspect there would be people out there to buy. Foreign investors who would buy scouring equipment relatively quickly.

MS RAWLING: Thank you.

The other issue that really comes back to Professor Guthrie I think, around disposal of plant related to its value; I'm not sure if the values are confidential or not, but in any event it seems that the parties and the draft were reasonably aligned in relation to the ultimate value. But that that might be affected by the need you'd posited, Professor Guthrie, to all the costs associated with decommissioning and removing it.

And on the other hand Cavalier has indicated that any sale and removal would be on as is where is basis and that again it's a return a little to the discussion we were having before potentially, in relation to land, but that therefore the value that had been ascribed to that was on an as is where is basis.

Do you have any comment on that additional information?

PROF GUTHRIE: No I think you need to be careful that everybody is valuing the same thing. Potentially people have come up with the same numbers, but they may be -- one may be on as is where a basis and the other may not be. That's all.

MS RAWLING: That is the purpose of my question, to get at that particular issue. And again, I guess just to put the question a different way. If Cavalier is putting that value on an as is where is basis and say that a purchaser would take responsibility for decommissioning, they may pay them I assume that's a possibility or pay specialists to come and take it out, or come and take it out themselves because they prefer to do that. Would you expect for that to be reflected in that price, or do you have a different view about the reasonableness of the price if they now say it's on an as is where is basis, or clarify that.

PROF GUTHRIE: I think if it's on as is where is basis you wouldn't allow for the same decommissioning costs. You may reduce it all the way to zero.

MS RAWLING: So you would expect the price to be reduced to take into account the purchaser's expenditure of labour or whatever.

PROF GUTHRIE: Yes. But also, I mean you don't know what you're buying. It could be a secondhand car, it's the same thing, the price will reflect it.

MS RAWLING: Is there Cavalier comment on that? It might help in this regard to talk about these particular values so we can get agreement on them, but I don't know if those prices are confidential or not? They are. So maybe we tide that over and come back to it.

MR WILCOCK: May I just say something?

MS RAWLINGS: Sure.

MR WILCOCK: Sorry, I've got a plane to catch, that's all.

I'm Glenn Wilcock; I run a company called NZ Yarns. I've been working in this industry probably all my working life. We rely on the local scouring. We haven't got any options, as Tanya has mentioned as well, we have to buy from the local scourers. Which is very important for us, and it's probably even more important for the company that I run because we are just a woollen mill. We actually have no other options, we can't manufacture synthetic through tufting and we can't do anything else. So we are actually a wool mill.

It's been a tough four or five years actually for the trade. If we went back probably five or six years, I reckon the local manufacturing took about 25% of the clip, and that's a guess I'm not going to be held to that. And we're now down probably, I don't know, 7 or 8% of the clip, and from sheep numbers from 40 million down to 28. So it's been a tough time and New Zealand wool

generally has had a tough time. There is also on the back of this, there's a bigger issue as well. There's what jobs are involved further after the scour, for the post-scour and Tanya touched on that and Cavalier will have the same problem as well. If we don't get the scouring right, and we don't have gouged prices -- so if we have gouged prices for the local manufacturers or we have to subsidise China, which has been suggested here, then our industry is going to fail even more. Now I reckon there's probably with the few jobs we've got in Christchurch, what's happened with GH and what's happening with Cavalier, there's probably 500 manufacturing jobs post-scourer that are dependent on the wool trade.

So that's where we are.

All this talk over the last four or five years with the scour, it hasn't done the wool trade any good. And I'm not saying the merger shouldn't go ahead, I'm not saying that at all. Because the other side of that, we need a strong scouring industry to support the manufacturers. But it hasn't done the trade any good. I mean just the thought of New Zealand wool as far, as my work's concerned exporting yarn around the world, just that question mark on the sustainability and what's happening with the scourers, it's not helping things.

So we sort of need to get to the bottom of this, which I know you guys are, which is fine. I'd say if the scours do go ahead, and this is if they go ahead, and I can see pros and cons for both, okay? Then I'd like to see at lease some safeguards where the local manufacturers are at least safeguarded. Because it's a big thing. Once these jobs are gone they won't be coming back again.

Thank you.

MS RAWLING: Thanks for your comments.

Before I think the last topic we need to cover in relation to benefits just cost savings, but before we do that I will just make sure there is no questions about plant from Commission staff at all?

And really the cost savings question is the same, just in a different category of benefit I guess and that is that Godfrey Hirst has raised a concern that the cost savings that have been identified will not be realised from day one of the merger and I just wanted to give Cavalier an opportunity to comment on that and perhaps give an indication of how long it could reasonably take for estimated capex opex savings to be realised?

MR HALES: I'll ask Mr Jim Drake to help me here if you don't mind please.

Once a merger is effected we intend to immediately enact parts of the merger while we're waiting for equipment to be moved and we would -- the intention is to fully utilise the Awatoto site in its current configuration and also the Timaru site while the upgrades are being done. So, we will get not full benefits on day one, but we will get progressive benefits coming through from day one through to when we actually effect the moving of the equipment and get that up and running, which we are still estimating to be a six month timeframe from the time that the merger -- that we're actually allowed to effect the merger and by the time we get everything done as far as moving the equipment goes.

So I'll get Jim to just go into a bit more detail if that's okay?

MR DRAKE: Jim Drake, financial controller Cavalier Wool Holdings.

We anticipate that in the South Island most of the overhead synergies will be achieved very early on. In

the case of the North Island it will take a little longer because we will be operating two scouring sites and therefore there will be some sort of lag with getting all of those overheads.

And I guess that would also relate to the likes of the release of fixed charges on the electricity transformers and the likes of that as well.

MS RAWLING: Godfrey Hirst the opportunity to provide any further comment on that, in addition to the submission that's been made?

MR DAVID: No comment.

MS RAWLING: Any other questions from staff on cost savings?

That's it on benefits. So we'll just come back to that confidential issue.

CHAIR: This I think brings to an end the public session for today.

Could I just check with staff, we did have a follow-up information request of some sort earlier on? I expect the way forward is if the Commission staff can frame a question to that person and that evidence will then become available on our website as part of the public record.

The other thing, as I mentioned at the start of today, was the production of the transcript as soon as that's available that will also be available for these public sessions on our website as well.

So look, for all of those who aren't parties to the confidentiality undertakings, thank you very much for taking time to be here today; for the industry participant we're about to lose thank you very much for your participation and for the insights that you've been able to give us today into this merger.

Okay, if we can clear the room of all individuals except for those who have signed confidentiality

undertakings we can then proceed to the mechanics for the confidential sessions.

I assume that the space on level 25 is available for break out for those who are leaving now. You've got use of the 25th floor until the counsel and experts finish here and can join you at the end of that.

MR TAYLOR: Mr Chairman, I think the confidential is around confidential information of CWH and Lempriere. So presumably they can remain, because they may be needed to answer questions.

CHAIR: Yes that's right, I mean if they are the source of the information they can remain.

(Hearing room closed except for those who have signed confidentiality undertakings)

(4.10 pm)