

**APPLICATION FOR AUTHORISATION OF AN ACQUISITION OF NEW ZEALAND WOOL SERVICES LIMITED BY CAVALIER WOOL HOLDINGS LIMITED****Cavalier Wool Holdings' issues for consideration by the Commerce Commission**

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Cavalier Wool Holdings Limited (**CWH**) has reviewed interested parties' submissions on the Draft Determination. Nothing in those submissions causes CWH to change any of the views it has expressed to the Commission. Nor, in CWH's view, does any submission call into question the evidence put forward by CWH in support of its application for authorisation.

NERA has also reviewed the reports prepared by Castalia and Futures Consulting Limited (**Futures**). NERA have confirmed that nothing raised in those reports causes it to change its view that the public benefits arising from the acquisition can be expected to outweigh any anti-competitive detriments.

Many of the assertions made by interested parties are provided with no evidential support. Accordingly, CWH believes that the Commission should test the propositions put forward by interested parties and then seek comment from CWH.

The particular issues which CWH suggests the Commission should explore are set out below. The fact that CWH has not specifically listed a matter below does not mean that it accepts interested parties' views. CWH reiterates the arguments it has previously made in support of its application for authorisation particularly its submission on the Draft Determination.

**Potential price impacts**

1. No party has adequately identified how the removal of WSI – which is a weak constraint given its small share of commission scouring and its limited ability to grow given exporters' reluctance to use WSI as a commission scourer – gives rise to a change which will enable CWH to impose price increases of any level let alone to the scale alleged.

***Constraints from China***

2. CWH does not agree that China's scouring market is only capable of scouring fine wool. This is a very outdated view and is contrary to the up to date evidence CWH has presented to the Commission in respect of which no party has provided conflicting corroborative evidence.
3. CWH does not agree with the conclusions drawn at paragraphs 18 to 24 of the Futures report.
4. CWH does not agree that the constraint from China is confined only to wool destined for China:
  - (a) CWH cannot price discriminate based on destination today despite having almost all of New Zealand's commission scouring.
  - (b) No interested party has identified why the presence of WSI (given its clear limitations as a constraint) is the structural feature of the market which prevents this price discrimination today.

***New entry***

5. CWH disagrees with Futures' analysis of new entry costs. The assumptions used are uncorroborated, invalid and without any foundation. There are also errors in Futures' application of its own model:

- (a) There is no explanation of the process followed in estimating the different cost categories and why the different items differ by different amounts.
- (b) Futures' analysis includes costs which are not currently incurred by CWH (or alternatively which are incurred but treated differently in the CWH accounts) and their inclusion has a material impact on Futures' analysis. To illustrate, merely removing one of those items reduces the alleged price increase by 25% by itself. There is no evidentiary basis for the inclusion of such items.
- (c) Futures' analysis is based on an extremely high and outdated estimate of the cost of a new scour. This level of cost is contrary to the evidence before the Commission.
- (d) Futures have incorrectly applied their stated WACC parameter. This error by itself causes Futures to overstate the purported price increase by approximately 30%.
- (e) Correcting these errors and using more realistic assumptions shows Futures assessment of a 40% price increase is fundamentally flawed.

CWH requests that any discussion of the Futures analysis be held in a confidential session as it relates to information which is confidential to CWH.

***Impact of variable cost savings on price increases***

- 6. NERA has taken into account the reduction in variable costs in assessing the possible price increases. Futures has not accounted for this despite its acceptance that significant cost savings will arise.

**Vertical integration impacts**

- 7. CWH does not agree that the acquisition will result in detriment in downstream markets:
  - (a) The acquisition would not give CWH any greater ability to raise Godfrey Hirst's costs through non-price means than in the counterfactual for the reasons expressed in NERA's 10 March memorandum.
  - (b) The Commission was correct to have regards to the current shareholding of CWH in assessing the likely impact.
  - (c) As a matter of law, in a merger context, the analysis of anti-competitive detriments falls to be considered only in the markets in which competition is lessened by the transaction.

**Impacts on quality**

- 8. CWH disagrees that WSI will be able to achieve the improvements in base Y that CWH has achieved in the counterfactual.
- 9. CWH disagrees that there is no evidence CWH has achieved a base Y improvement at its Timaru scour line.
- 10. CWH disagrees that it will have an incentive to invest the required capital to make the modifications necessary to give rise to additional base Y benefits on its scour lines at Awatoto in the counterfactual.
- 11. CWH disagrees with the propositions put forward in Schedule 2 of Chapman Tripp's memorandum on behalf of Godfrey Hirst. Specifically:
  - (a) Godfrey Hirst present data showing "the base Y value for wool processed at Whakatu has decreased over the period covered by the results". CWH does not dispute that the base Y

of scoured wool being produced from Whakatu has declined. However, CWH does suggest the Commission seek clarification on the source of this data.

- (b) It is asserted, without any evidence, that this is decline in the base Y of scoured wool is “not due to scouring quality” and that that the base Y of scoured wool has declined for reasons other than scouring quality. It is asserted is that the base Y of the greasy wool scoured at Whakatu has also declined and this “is a reflection of wool types processed and a result of the business that WSI have done in markets that purchase poorer colour wool types such as India”:
- (i) What is the evidence that this trend has not been caused by a reduction in scouring quality?
- (A) CWH suggests that the Commission ask WSI to provide records or a chart of the greasy and scoured base Y values of the wool it processes on WSI’s own behalf (CWH does not have equivalent greasy wool data as CWH does not own wool and so does not have records of the base Y of the greasy wool it scours). This WSI wool accounts for the majority of wool scoured at WSI’s scours so will be representative.
- (B) CWH also suggests that WSI be asked for a chart graphing its peroxide usage and cost over the five year period.
- (C) If the reduction in WSI’s scoured wool base Y has been due to factors other than a reduction in scouring quality, this will be shown in this data as the trends for greasy and scoured base Y will be the same and peroxide use would be unchanged.
- (ii) CWH notes that there is no reference to Delta Y or dY, which a key indicator of scouring performance.
- (iii) What is the evidence for the assertion that the mix of wool types has changed?
- (iv) The assertion regarding India is contrary to CWH’s expert’s understanding of demand for wool in India – his experience is that India is demanding better quality wool than it has done in the past.
- (c) Godfrey Hirst then extrapolate from these two unsubstantiated propositions that “Awatoto must have processed better colour wools” and imply that this has caused the base Y improvements at Awatoto;
- (i) The trends reported are for scoured wool and hence are of no assistance in determining the status of greasy wool passing through Awatoto.
- (ii) Godfrey Hirst are wrong that there were only two scours in the North Island during the period. Until 2009 there were three scour operators in the North Island. Only when Godfrey Hirst itself sold its scouring assets was the number reduced to 2.
- (iii) There is no evidence to support the proposition that the quality of greasy wool scoured at Awatoto has been of increasing base Y quality over the same 5 year period. CWH says that is not the case and says that it does not own any of the wool and as a commission scourer it scours only greasy wool blends provided by merchants who endeavour to achieve the best base Y scoured quality from the least base Y greasy blend. Godfrey Hirst have presented no evidence to disprove this.
- (d) All the scoured wool base Y trend provides evidence for is that, despite the use of peroxide bleach by WSI, the base Y of WSI’s scoured wool output at Whakatu has declined over 5 years. That is prima facie evidence that WSI’s scouring performance has declined. There is no evidence to the contrary. This supports the view that post the proposed CWH

rationalisation the base Y outputs for greasy wool presently scoured at Whakatu will substantially improve.

- (e) Godfrey Hirst's assertion that the Y-Z trends of scoured wool it reports are evidence that merchants cannot decrease the base Y value of the greasy wool purchase is incorrect.
- (f) Even were the statement true, CWH does not agree that no benefit could arise. The benefit could arise from a higher scour wool price (rather than a lower greasy wool cost) or a cost saving in the form of reduced peroxide bleach use being required.

### **Cost savings**

- 12. CWH disagrees with the characterisation by Futures and Garry Forward of certain of the cost savings as being wealth transfers. These savings do not arise from input price reductions, but rather from using less inputs.
- 13. CWH disagrees with Garry Forward that CWH will not be able to achieve certain of the cost savings.

### **Potential Production disruption**

- 14. CWH disagrees that there would be disruption to production while the scours are reconfigured. CWH would have no incentive to allow this to occur. In any event, the existence of high season and low season shoulders as well as the availability of Clive enables the reconfiguration to be transitioned without material impact.

### **Land valuation**

- 15. CWH does not agree with Futures that the sale of the land and buildings will result in a social cost. CWH supports the Commission's proposed approach for the following reasons:
  - (a) There is no basis for the assumption that the land and buildings could only ever be used as a scour, indeed it is unlikely that a valuation would ever be carried out on the basis of the premises being sold to a competitor. Sales of other scour sites indicates that such land and buildings are not specialised and are often used for other purposes, e.g. storage facilities and often sold very quickly.
  - (b) The issues raised by Mr Reay are, at worst, merely issues of repair and maintenance and do not undermine the value of the land and buildings to the extent claimed by WSI.
  - (c) Futures' approach to an alleged restrictive covenant that might be required is inconsistent with the notion that the buildings should be valued on a vacant possession basis.
  - (d) It is unclear whether the issues raised by Mr Reay have been disclosed to the Receiver as part of the sale due diligence process to date.

### **Productive and dynamic efficiency losses**

- 16. CWH disagrees with the reasons put forward by Futures and Castalia as to why the Commission's estimates are wrong. These submissions overlook the evidence provided by CWH.
- 17. CWH disagrees that the removal of WSI will reduce Godfrey Hirst's incentives to innovate in the carpet market. Godfrey Hirst sold its scouring business to CWH with a contractual promise to scour all its wool through CWH scours. That suggests that innovation was not considered an issue at that time.

## **Miscellaneous**

18. CWH disagrees that it would ever have any incentive to withdraw WSI's wool demand from the market. Indeed, the whole profit maximising rationale is about encouraging greater greasy wool throughput through the CWH scours in order to gain efficiencies.

**2 May 2011**