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Commerce Commission

Attention Anthony Stewart

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Cavalier Wool Holdings - Response to issues raised at the Commerce Commission's Conference on 4 - 6 May 2011

Cavalier Wool Holdings Limited (**CWH**) believes that none of the opinions or views expressed by third parties during the conference held on 4 to 6 May 2011 should cause the Commerce Commission to change the preliminary view it expressed in the Draft Determination that the benefits to the public would be likely to outweigh the loss of competition arising from the acquisition.

Attached as an Annexure is CWH's response to issues raised by third parties at the conference (based on information on the record as at the end of the conference) and the further information requested by the Commission. A report from NERA providing the further analysis requested by the Commission is also **enclosed** with this letter.

1. **Little or no evidence provided to support assertions made**

   Many of the views and opinions expressed by third parties were backed with little or in many cases no supporting empirical evidence. Various theories were espoused with little reference to the actual facts of this case. New Zealand's courts have previously warned against "assuming inefficiencies on grounds of economic doctrine" or "relying on purely intuitive judgment".

   The Commission will look at the facts before it and determine whether, on the balance of probabilities, there is a real chance of public benefits arising from the acquisition.

2. **Evidence on the record demonstrates public benefits likely to result from the acquisition**

   The variation to the Application filed by CWH on 12 May 2011 conclusively removes any risk that the benefits claimed will not be realised.

   The evidence conclusively demonstrates that not only is there a "real chance" of public benefit resulting, but that there is in fact a high degree of certainty that such benefits will result.

   Indeed, with the exception of the quality benefits, there was little debate about whether benefits of the type claimed were in fact public benefits; the only real debate was to the extent of those benefits.

Moreover, the evidence presented (on balance) reinforces the appropriateness of the Commission's preliminary view. Specifically:

- There was agreement in principle that if the calculated cost savings represented a reduction in "inputs" to achieve the same "outputs" these were real cost savings for New Zealand. CWH confirmed in evidence that the cost savings arise from a reduction in units, and not a reduction in price.

- There was no dispute that the sale of land was a relevant benefit. Nothing presented by WSI should cause the Commission to revisit the value it assessed. If anything, CWH continues to believe the amount specified in the Draft Determination is conservative. The sale will be achieved in year 1.

- There was clear widespread support for the establishment of a wool superstore and the benefits it would create. There was also support for the view this would not happen absent the acquisition.

- There seemed no debate that if CWH had improved its base Y value by doing things WSI had not done and could not do, this would be a benefit of around 4 cents per kg. Third parties asserted that there was no evidence that WSI had not achieved these benefits but have to date declined to produce the independent test data which is within WSI's control to provide. WSI have agreed to procure this data; but, if they fail to do so or if the data is not based on independent test house (as was CWH's data), the Commission would be entitled to infer from that failure that the correct data does not support the assertions made.

- No evidence was presented that cast doubt on the Commission's assessment of competitive detriments. If anything, the evidence indicated that the detriments would be at the low end of the scale identified by the Commission. CWH submits that:

    - the evidence was clear that the primary drivers for CWH to achieve productive and dynamic efficiencies would remain if it acquired WSI; and

    - the evidence was also clear that price increases of the type advanced by third parties – now up to 40% over current prices – were simply unrealistic and unsupported by compelling empirical analysis. But one example was Futures Consulting Limited's new entry model which was shown to be highly sensitive to a few key assumptions for which there was simply no factual support. Indeed, tweaking 3 or 4 assumptions to reflect market place reality reduced Futures' implied price increase from 12.5 cents to **[ ]** cents.

3. **The position of WSI and the views expressed by its officers**

The example of Futures' new entry model illustrates the caution which, in CWH's submission, the Commission should exercise in placing weight on the views and opinions expressed by WSI's management and officers.

The WSI officers were openly and aggressively antagonistic to the transaction; their positions have consistently changed and CWH submits the views expressed have been informed more by their personal feelings rather than as officers cognisant of the interests of all WSI's shareholders. This has all manifested in an apparent strategy of seeking to confuse rather than assist the Commission.

CWH submits this caution extends equally to the four "independent expert" evidence WSI introduced. With the exception of Dr Layton, the other three experts stand to lose regular revenue if the transaction proceeds as, in each case, WSI appears to be a major client.

CWH is happy and able (at short notice) to provide any further information to the Commission on any of the matters raised in this submission.

Yours sincerely

[Sgd: Phil Taylor / David Blacktop]

Phil Taylor / David Blacktop
Partner / Senior Associate

Enc.

Annexure: detailed submissions

1. Relevant provisions of the Commerce Act

1.1 The authorisation sought

CWH has applied for an authorisation under section 67(1) for it or any interconnected body corporate to acquire all of NZWSI's wool scouring assets[1] and/or any interconnected body corporate of NZWSI that holds any of those wool scouring assets (the **Acquisition**).

Section 67 provides the statutory mechanism by which authorisation may be given to a person proposing to acquire the assets of a business or shares. Section 67(3) provides:

> ... the Commission shall—
>
> (a) If it is satisfied that the acquisition will not have, or would not be likely to have, the effect of substantially lessening competition in a market.... give a clearance for the acquisition; or
>
> (b) If it is satisfied that the acquisition will result, or will be likely to result, in such a benefit to the public that it should be permitted.....grant an authorisation for the acquisition; or
>
> (c) If it is not satisfied as to the matters referred to in paragraph (a) or paragraph (b) of this subsection.....decline to give a clearance or grant an authorisation for the acquisition.

Counsel for Godfrey Hirst made a submission that an authorisation is an "indulgence"[2]; this submission is incorrect and finds no support in the statutory scheme or the applicable case law. Authorisations simply embody Parliament's intention that maximising economic efficiency is the primary objective underlying the Commerce Act. Accordingly, the characterisation of an authorisation as an indulgence is legally misconceived and should be disregarded.

This was explained by Cooke P in *Telecom Corporation of New Zealand Ltd v Commerce Commission* [1992] 3 NZLR 429 (**AMPS-A**) at 438:

> By its long title the Commerce Act is an Act to promote competition in markets within New Zealand. That does not imply that unlimited competition is to be pursued at all costs, however wasteful of resources. If a reasonable amount of competition is being promoted, as it is in this field, the public detriment from excluding further competition may not be serious and may more readily be outweighed by the public benefit of economies of scale and other efficiencies.

1.2 Assessment of detriments

The structure of section 67(3) provides an analytical process for considering authorisation applications:

- Sub-section 67(3)(a) provides that the Commission must first consider whether it is satisfied that the proposed acquisition will not have, or would not be likely to have, the effect of substantially lessening competition in a market. If it is so satisfied, it must grant a **clearance**.

[1] Being the wool scouring assets and stock located at Whakatu and Kaputone and 50% of the shares in Lanolin Trading.

[2] Per Mr David, T 4 May, 74: 8 and T May 5, 87: 4.

- It is only if the Commission cannot be so satisfied, that the question of an authorisation arises.

- Sub-section 67(3)(b) provides that the Commission must consider whether, notwithstanding the finding of a substantial lessening of competition in a market (or the failure to exclude the real chance of that outcome occurring), the acquisition "will result, or will be likely to result, in such a benefit to the public that it should be permitted".

- If it is satisfied that it is likely that it will result in such a benefit, then it must grant authorisation; if it is not so satisfied it must decline authorisation.

The deliberate decision by Parliament to structure section 67(3) in this way has implications for the way in which detriments fall to be assessed.[3]

It is only those detriments which arise in the market in which the identified substantial lessening of competition occurs that are relevant in the public benefit calculus.

This is consistent with the clearance regime itself. To illustrate, where a transaction is found by the Commission not to substantially lessen competition in market A, clearance cannot be declined because of an impact in market B unless that impact in itself substantially lessens competition in market B.

The same fundamental approach applies in respect of authorisations. Detriments arising in the market where there is an identified substantial lessening of competition are weighed against public benefits.

This is the approach which has been consistently applied by the Commission and the Courts. See, for example:

- The Commission's decision in *Air New Zealand / Qantas* (at paragraph 897):

> [T]he authorisation procedures under ss 61(6) and 67(3)(b) are the same. Both require, as a result of the Commission's findings of a substantial lessening on competition for the Commission to identify and weigh the detriments likely to flow from the lessening of competition in the relevant markets, and to balance those against the identified and weighed public benefits likely to flow from the proposed Alliance as a whole. **It is important to note that the detriments may only be found in the market or markets where competition is lessened, whereas benefits may arise both in those and in any other markets**. Only where the Commission is satisfied that the benefits outweigh the detriments would it be able to grant an authorisation for the Acquisition and Arrangement proposals. (emphasis added)

  This was not overturned in the High Court which recorded that the tests for authorisation of a restrictive trade practice and a business acquisition were "substantially the same".[4]

[3] This structure is different from the authorisation process for business acquisitions and RTPs in Australia. Under the Competition and Consumer Act 2010, the Australian Competition Tribunal rather than the ACCC has jurisdiction to grant authorisations. The Tribunal has no ability to grant a clearance. Therefore, the sole test is whether there are benefits to the public and there is no threshold question as to whether there is a substantial lessening of competition. Prior to the introduction of a formal clearance process, authorisation applications were made directly to the ACCC.

[4] *Air New Zealand v Commerce Commission* (2004) TCLR 347, para 33.

- Justice Wilson's observation in *New Zealand Bus Ltd v Commerce Commission* [2008] 3 NZLR 433 (CA) at paragraph 271:

> ... As a counterpoint to the adoption of the low "substantial lessening of competition" test, the Act in s 67 permits the Commission to authorise an acquisition which is likely to have the effect of substantially lessening competition if the public benefits resulting from the acquisition outweigh the detriments caused by the substantial lessening of competition. **As the Commission correctly held** in *Re a Proposal by Goodman Fielder Ltd* (1987) 1 NZBLC (Com) 104,108, at p 104,147 and in *Re Air NZ Ltd & Qantas Airways Ltd* 23/10/03, Rebstock P, Chairman, Commerce Commission Decision No 511, at para 897, **all benefits must be taken into account whereas only detriments in a market where competition is lessened will be relevant.** (emphasis added)

- The Commission's Draft Decision in the *Dairy Co-op case* (paragraph 441):[5]

> It is important to note that because of the wording of the Act, the detriments may only be found in the market or markets where dominance is acquired or strengthened, whereas benefits may arise both in those and in any other markets.

- The Commission's decision in *Ruapehu Alpine Lifts* (paragraph 234):

> The authorisation procedure requires the Commission to identify and weigh the detriments likely to flow from the acquiring of a dominant position in the relevant markets, and to balance those against the identified and weighed public benefits likely to flow from the proposed acquisition as a whole. **It is important to note that the detriments may only be found in the market or markets where dominance is acquired or strengthened, whereas benefits may arise both in those and in any other markets**. Only where the benefits clearly outweigh the detriments can the Commission be satisfied that the proposed acquisition will result, or be likely to result, in such a benefit to the public that it should be permitted, and thus be able to grant an authorisation for the proposed acquisition.

- The decision of the High Court in *New Zealand Co-operative Dairy Co Ltd v Commerce Commission* [1992] 1 NZLR 601 at 631 (HC):

> That decision also held, correctly in our view, that by the introduction of the word detriment into the authorisation test it was intended that the Commission has a duty "to assess, as far as practicable, the degree of competitive detriment likely to flow from the acquisition or strengthening of a dominant position" and went on to say:
>
> > Similarly, with respect to mergers or takeovers, the Commission considers that it must comprehend the degree of detriment likely to be associated with the risks which, by definition, flow from dominance. Otherwise, the Commission could unfairly prejudice a proposal by, in effect, assuming that the risks, and hence possible adverse effects, were so open-ended as to be unlimited.
>
> This need not be the case. ... To infer that the risks of dominance were unlimited could unfairly prejudice a merger or takeover proposal (and any potential for net efficiency gain), since sufficient public benefit would always be impossible to find.
>
> We agree with the Commission's conclusion in that case that the application of the authorisation test should involve an assessment of "the likely degree of detriment, arising from the acquisition or strengthening of dominance". This involves an evaluation of the limits of that detriment.

[5] As Mr David correctly noted at the hearing, the Commission in assessing efficiency losses in that Draft Determination excluded "butter" from its estimates of revenue on the basis that it did not see the transaction as giving rise to dominance concerns in the butter market. This illustrates the correct principle.

That is not to say that vertical integration impacts are irrelevant to the Commission's assessment. However, those impacts are to be assessed at the initial stage in answering the question as to whether the acquisition is likely to result in a substantial lessening of competition in any market:

- If the vertical impacts do amount to a substantial lessening of competition in a market, then the detriments from that lessening of competition are relevant.

- If the vertical impacts do not result in a substantial lessening of competition in that market, then no detriment falls to be assessed.

Accordingly, section 67(3) requires the Commission to identify any market where it cannot be satisfied a substantial lessening of competition will not, or will not be likely to arise. Having done so it must assess the detriments associated with a substantial lessening of competition in those markets and only in those markets. It is against those detriments that the public benefits arising in any market must be measured.

In CWH's submission, the Acquisition does not give rise to a substantial lessening of competition in any market other than those identified by the Commission in the Draft Determination. As a result, the detriments to be considered in the balance in this Application are only the detriments arising in those identified relevant markets and in no others.

1.3 Public benefits

The principles applying to a calculation of public benefits are well settled and were stated most recently by the High Court in *Air New Zealand* at paragraph 319:

- Benefits include efficiency gains (s 3A of the Act) and anything of value to the community generally.

- Only net benefits are included. Any costs incurred in achieving efficiencies must be taken into account. Transfers of wealth which achieve no benefit to society as a whole should be disregarded.

- The benefits must result from the acquisition or arrangement. Benefits which would or would be likely to accrue whether or not the proposed acquisition proceeded should be disregarded.

- Benefits should be quantified if possible but benefits which, by their nature, are incapable of quantification should still be taken into account.

1.4 A fact based assessment

The assessment of benefits and most importantly detriments is a fact based assessment. Assumptions of inefficiency should not be made on the grounds of economic doctrine alone (see *AMPS-A*, per Cooke P "Parliament has expressly directed in s 3A that efficiencies are to be taken into account. In my view that direction should not be effectively (albeit unintentionally) circumvented by assuming inefficiencies on grounds of economic doctrine.").

1.5 The standard of proof and "likelihood"

Interested parties at various times referred during the conference to the need for the Commission to be "certain" or to have a "high degree of certainty" or even to be satisfied

"beyond reasonable doubt"[6] that the authorisation will result in a public benefit. These assertions are without foundation and misstate the statutory test for authorisation.

It is settled law that the standard of proof under section 67 is the civil standard of balance of probabilities.[7]

Section 67(3)(b) requires the Commission to be satisfied on the balance of probabilities that the acquisition "will result, or will be likely to result, in such a benefit to the public that it should be permitted".

The High Court in *Air New Zealand* referred to this test of "likely to result" as requiring the Commission to look to "probable outcomes rather than possible or speculative effects".

It is relevant that in section 67(3)(b) the "likely" outcome which the Commission is to look to is whether there are benefits to the public.

This is different to the merger clearance context in section 66 where the "likely" outcome is a substantial lessening of competition. Under the structure of section 66, the Commission is required to decline clearance if it cannot exclude the likelihood of a substantial lessening of competition.

This difference is illustrated by the judgment of Panckhurst J and Professor Lattimore in *Ravensdown Corporation Ltd v Commerce Commission* (High Court, Wellington, AP 168/96, 9 December 1996), a case concerning a merger authorisation (emphasis added):

> The Commission must be satisfied `that the acquisition will result, or will be likely to result, in such a benefit to the public that it should be permitted . . . '. **This means that the Commission must be satisfied of at least the likelihood of benefit to the public, resulting from the acquisition, before authorisation is appropriate. It is that end result which must be likely**. As to the meaning of likely see the review of the authorities undertaken by McGechan J in *Commerce Commission v Port Nelson* (pp 429 — 432), and the shorter Court of Appeal analysis by Gault J at the appeal stage in *Port Nelson v Commerce Commission* (p 226). What is required is that the Commission make a facts-based assessment of benefits and detriments, adopting a quantitative approach where possible, and **on the basis of that assessment decide if it is satisfied the acquisition is at least likely to result in such benefit to the public that it should be permitted. In short, the test of likelihood is to be applied at the end of the process**.

In other words, the Commission's role is to assess benefits and detriments and then assess whether it is likely that the benefits exceed the detriments.

It is clear from this passage that "likely" in terms of section 67 is not to be interpreted differently than it is in other contexts of the Commerce Act, i.e., an outcome is "likely" if there is a "real and substantial" chance that it will occur or that there must be a "real chance" that it will occur.

Accordingly, section 67(3) requires the Commission to determine, on the balance of probabilities, whether it is satisfied that it is more likely than not that there is a real chance that the acquisition will result in net public benefits. If it is so satisfied, it is directed to grant an authorisation. If it is in doubt as to whether there is a real chance the acquisition will create public benefit, it must decline.

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[6] **[ ]**

[7] *Commerce Commission v Southern Cross Medical Care Society* (2002) 10 TCLR 269 (CA), para 7; *Air New Zealand v Commerce Commission (No 6)* (2004) 11 TCLR 347.

2. WSI's position and the expert evidence called by WSI

2.1 Commission should be cautious in placing weight on opinions offered by WSI

The position of WSI and its Board and management throughout this process can be politely described as "fluid". For all the reasons outlined below CWH submits that the Commission should be cautious in placing weight on the evidence provided by these witnesses.

2.2 Unclear role of WSI's representatives

At the initial meeting between Mr Kirke, the Chairman and the Board, Mr Stock and Commission staff, Mr Kirke stated that:

> The Board of WSI does not want to take an advocacy position on the CWH bid because it has duties to the minority shareholders. **[**
>
> **]** the Board sees its role to ensure that accurate information is provided to the Commerce Commission.

This was reiterated in a letter from **[**

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This is an appropriate position for the company and its directors to take in relation to a potential acquisition.

WSI's representatives referred to themselves at the conference as officers of the company. For example, Mr Kirke as Chairman of the Board and Mr Deakins as Chief Financial Officer (he is also board secretary). These two gentlemen, together with some of the other officers appearing at the conference, are also shareholders in the company.

Rather than adopting the neutral "assisting stance", which Messers Kirke and Stock indicated the company would take, these representatives took an openly and aggressively antagonistic stance to the proposed acquisition. They appeared to be giving views in their personal capacity rather than cognisant of the views of all WSI's shareholders.

The position taken by representatives of WSI at the conference (and in the media subsequently[8]) is perhaps best summarised in Mr Stock's observation that:

> …it's a bit like the turkey at Christmas, isn't it Mr Chair, that they realise that their jobs will be lost if they vote for it, so I doubt whether they would; that's up to them to say that. But the indications given to date are that they would not vote for such a proposal.

This statement highlights the primary personal interests that the representatives of WSI were seeking to protect. Put simply, their behaviour demonstrated that they are opposed to the transaction. In determining what weight to give to their evidence, the Commission should make an assessment as to whether their evidence was neutral, balanced and objective. It is CWH's contention that it was not.

[8] As recently as 10 May 2011, Mr Dwyer (identifying himself as the Managing Director (our emphasis)) has reiterated that he and other shareholders would oppose the CWH offer. Of course, such an offer has not yet even been made.

While CWH does not deny that is a natural and rational personal reaction, it is a relevant consideration for the Commission when considering what weight to place on the opinions and views expressed, which were often in the nature of assertions without underlying evidence.

2.3 WSI's (ever) changing position

The inference that the WSI representatives' overriding objective was to do or say anything in an attempt to stop this acquisition at all costs, is confirmed by the fact that the positions and opinions expressed at the hearing are in contrast to other statements relating to the benefits and detriments made by WSI representatives at various times throughout the Commission's process, and **[**

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For example:

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- During the initial interview with Commission staff, WSI stated that its "commission scouring is increasing a little, but not as much as indicated by Cavalier" and that "WSI has done some work for exporters over the last 12 months...but not a lot". They stated their main customers were "[ ]". As discussed further in section 4 below, WSI now seem to be claiming their commission scouring volumes have increased significantly *since* this time. CWH does not believe this is correct. However, it acknowledges that WSI might be selling *scoured wool* to Godfrey Hirst, [ ] this is not commission volume.[9]

[9] [ ]

2.4 WSI's expert evidence

This caution should not be confined to the opinions and evidence offered by WSI's representatives. It extends equally to the "independent expert" evidence WSI introduced.

WSI's approach is equally evident in this evidence and for the reasons expressed below CWH submits that the Commission should be cautious in placing weight on the evidence provided by these witnesses. Their evidence did not satisfy the criteria required of a party giving expert evidence.

Indeed, with the exception of Dr Layton, the other three experts stand to lose regular revenue if the transaction proceeds as WSI appears to be a major client. They therefore lack independence. Furthermore, they had not made due inquiry to qualify themselves as informed experts. CWH makes the following specific comments:

Dr Carnaby's evidence	Dr Carnaby seemed to be at pains to stress his view that there was "no evidence" of WSI's quality performance so nothing could be concluded from the data presented by CWH. The information that Dr Carnaby refers to is in the hands of WSI[10]; Dr Carnaby as an independent expert has made no apparent effort to investigate what that data did say. Whether he has been instructed not to seek this data or not, the approach is consistent with WSI's general strategy. WSI has undertaken to provide the equivalent Y information as CWH also using test house results. If WSI does not do so or provides results which are not independently tested, then it is CWH's contention that the Commission is entitled to infer that the evidence did not support the arguments being advanced by WSI or Dr Carnaby. More generally, as CWH has previously highlighted, it does not accept that Dr Carnaby is an "independent" expert; CWH understands that Dr Carnaby is, and has been for some time, a contractor and consultant to WSI.[11] This role would be lost if the transaction proceeds. Furthermore, **[** **]**.
Dr Reay's	Issues of the sort raised in Dr Reay's reports have not been publicly disclosed previously and CWH submits that they are significantly overstated. For example, Dr Reay states that the roof at Whakatu is "materially affected by corrosion",

[10] Mr Dwyer confirmed at the Conference that "Practically everything we buy, every bale we buy, is tested" [T 4 May, 100: 16] and "And likewise, every bale we supply is tested again in the scoured state" [T 4 May, 100: 18].

[11] CWH submission, 28 March 2011, pg 5.

evidence

although Mr Caradus's from WSI[12] evidence confirmed that this was caused by titanium dioxide[13] and inferred this caused staining but not corrosion.[14]

Dr Reay admits at paragraph 4 of his letter that his company "has been an engineering consultant to [WSI] for a number of years and have carried out a number of consultancy roles". This relationship would be lost if the acquisition proceeds.

Furthermore, CWH notes that Dr Reay did not disclose in his "independent report" that he resides at the same address as a Barbara Kay Reay, who is the 13th largest shareholder in WSI. It is unclear whether Ms Reay is part of the group of minority shareholders that Mr Dwyer has publicly stated will oppose the CWH acquisition.

Dr Layton's evidence

Dr Layton was called by WSI to give his expert economic opinions. The views he expressed went far beyond his expertise as an economist and ranged into many areas in which Dr Layton felt qualified to give factual evidence. It is worth noting that these additional "insights" were at all times put forward in support of propositions and arguments being advanced by WSI.

As the Australian Competition Tribunal noted in *Re: Qantas*:[15]

> Generally, whether an expert's opinion is confined to his or her area of expertise and whether experts state the factual basis upon which they have formed their opinion, are useful considerations in determining at what point an expert witness ceases to be impartial and has moved beyond the bounds of legitimacy into advocating for a party.

As was highlighted, Dr Layton's analysis contained a number of material errors and some rather heroic assumptions. The comment that **[**

][16] reflects either a lack of understanding of how a stand-alone wool scour operates, or is an example of Dr Layton seeking to reverse engineer a justification for an assumption made.

Overall, CWH submits that Dr Layton's approach appeared to be that of an advocate rather than confining himself to his role as an economic expert. CWH submits that Dr Layton's evidence was not focussed on assisting the Commission to determine the issues before it, but rather was focussed on promoting the outcomes desired by his client.

Dr Savage's evidence

Dr Savage's evidence was in CWH's submission largely irrelevant. Consistent with the broader WSI strategy, he sought to create new issues, but which neither he nor WSI attempted to readily apply to the current application.

As with other experts identified, despite professing to be an "independent expert" Dr Savage is the Managing Director of Apex Environmental Limited, which lists under the projects on its website the wastewater treatment plant at Kaputone

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[12] Mr Caradus was described as "the General Manager who started both the new scours at Whakatu and Kaputone when they were installed" T 4 May, 23: 22-24.

[13] T 5 May, 29: 5-8.

[14] T 6 May, 59: 14-17.

[15] [2004] ACompT 9, para 221.

[16] **[ ]**

woolscour.

Again, this relationship would be lost if the acquisition proceeds.

In CWH's view, the Commission should have serious reservations about the independence of the views expressed.

3. Public benefits

It remains CWH's position that the acquisition will give rise to, or be likely to give rise to, substantial public benefits.

The variation to the Application filed by CWH on 12 May 2011 conclusively removes any risk that the benefits claimed will not be realised.

None of the opinions or evidence presented at the conference cause CWH to change this view.

CWH has not repeated the submissions it has made previously detailing the public benefits in this section; rather, this section responds only to those issues that arose out of the conference and should be read in conjunction with the submissions already made.

3.1 Cost savings

It remains CWH's position that industry cost savings of $**[ ]** over five years will result from the consolidation of the wool scours.

All parties appeared to agree in principle that there will be cost savings resulting from the acquisition.

There also seemed to be broad agreement that if the calculated cost savings represented a reduction in "inputs" to achieve the same "outputs" these were real cost savings for New Zealand.[17] CWH confirmed that the cost savings arise from a reduction in units, and not a reduction in price.[18] Further information on the energy cost savings is contained in confidential Schedule 1.

There is no reason to believe these cost savings will not be achieved. The variation to the Application filed by CWH on 12 May 2011 conclusively removes any risk that the benefits claimed will not be realised.

As the Commission is aware, **[**

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As the Commission is also aware, the cost model presented was used by CWH's shareholders in making the decision to pursue this transaction.

[17] T 5 May, 40: 7-8. In fact, in some instances there was support for the ability to realise cost savings, for example, in relation to electricity. See for example: T 5 May, 41: 10-11; T 5 May, 41: 17-19; T 5 May, 41: 25-26.

[18] T 5 May, 40: 12-18; T 6 May, 60: 3-6.

[19] CWH submission, 18 March 2011, pg 1.

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NERA have modelled the cost savings benefits on a "steady state" basis and hence attributed full value to them in year 1. This approach is consistent with attributing full value to the detriments in year 1.

In reality, there will be a transition period over which the cost savings and detriments scale up, although the cost savings are likely to be realised much more quickly than any detriments would crystallise.

This is because the cost savings represent a combination of savings from (a), putting the businesses together and removing some overhead structures/administration costs, and (b) putting the scour lines together.

The former cost savings can be achieved almost immediately on acquisition and arise from the removal of duplicated administrative costs as not all administrative functions would need to be separately provided at all sites (this accounts for a significant proportion of the administrative cost savings) and also via the ability for CWH to optimise production across all sites so as to minimise operating costs. The remaining savings will be achieved when the scour lines are consolidated, which is expected within 12 months of the acquisition.

3.2 Capital cost savings

It remains CWH's position that that the acquisition will reduce capital costs by $0.88 million over a five year period. Capital cost savings are not a large benefit claimed and were not debated to any extent at the conference.

However, the same principles apply; if the calculated capital cost savings represent a reduction in "inputs" to achieve the same "outputs" these are real cost savings for New Zealand. CWH has demonstrated that these savings do reflect reductions in inputs to achieve the same level of outputs and hence are public benefits. More information can be provided if required.

3.3 Land value

It remains CWH's position that the value of the land and buildings are $[ ] million. CWH believes the Commission's preliminary view that the lowest value that should be ascribed is $8.792 million is a conservative approach.

There was no apparent dispute among parties that the selling of the land and buildings at Whakatu and Kaputone is a benefit,[21] the issues were confined to the quantum of that benefit and when a sale would occur.

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[20] [ ]

[21] T 5 May, 21: 9-10.

(a) ***Value of the properties***

WSI's argument that the value of the buildings is much lower than is recorded in their financial statements and in the Receivers' IM and that the properties should be valued on a "vacant possession basis" should be rejected.

WSI's argument rests on the premise that the buildings should be valued on a "vacant possession basis" which they say in relation to Kaputone is much lower than the value recorded in WSI's accounts.

When a property has a significantly lower "vacant possession" value this implies that the property is specialised to its current use such that when the scouring equipment is removed (as it will be following the relocation of the scours) a replacement tenant could not easily be found or could only be installed with significant changes to the building. **[**

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WSI has submitted a report from Dr Alan Reay in which he expresses the opinion that "the buildings on the two sites have been purpose built for use as scours and associate wool stores and that their economic use for other industrial or commercial uses would be very limited".

CWH's concerns in relation to this report have been outlined but in any event it is not clear that Dr Reay has the expertise to discuss the potential usage of the buildings rather than their construction.

Dr Reay's opinion is contrary to CWH's experience with previous sales of wool scour sites, and its discussions with people with experience of the two sites.

In terms of its experience, CWH informed the conference that it or its officers have been involved in, or are aware of, the sale of eight wool scours over the last 15 years, the majority of which have been sold for uses outside of the wool industry.

The Commission asked for further information regarding these sales[22] and each of them is discussed below:

Clifton wool scour land and buildings (Godfrey Hirst transaction, 2009)	• Sold in the middle of the GFC for **[ ]** million which was $**[ ]** million above its "vacant possession" valuation of **[ ]** and within 5% of the going concern value.[23] • CWH had to fill the drains and ducting holes in the floor and repair a wall that was damaged getting out equipment. Total cost was under $100,000 which was more than covered by the sale of scrap and surplus equipment. • It is now used by a transport operator.
Winchester Wool Scour,	• Sold to and used by Paddon Direct, a supplier

[22] T 5 May, 34: 13-14.

[23] T 5 May, 27: 5-8.

Timaru (2006)	of farm machinery and equipment. The site is used for refurbishing imported farm equipment. • The site was sold for CWS's budgeted valuation.
Wanganui Wool Scour buildings (1996)	• Now used for furniture manufacturing. • CWH has no information on sales value.
E Lichtenstein Wool Scour (Onehunga) (2000)	• Now used for manufacturing. • This was sold within 12 months of the scour operation ceasing.
Seaview Wool Scour (2004)	• Now used for industrial warehousing. • CWH has no information on sales value.
Tomoana Wool Scour (1994)	• Now used by Heinz Watties for storage of cans. • CWH has no information on sales value.
Gisborne Wool Scour (2004)	• Now used as a woolstore for a private wool merchant. • CWH has no information on sales value.
Feltex Wool Scour (2007)	• Now used as a chicken processing factory and by an onion merchant. • CWH has no information on sales value.

Accordingly, there is ample experience which supports the view that scouring buildings are not highly specialised and there are a number of alternative economic uses. The "pits, coal bunkers, and other structures" that Dr Reay refers to as limiting the economic use of the scours are a common feature of wool scours and were certainly present at Clifton; these have not deterred previous prospective purchasers.

The Commission requested further information regarding what parties are likely to buy the properties[24] and the potential remedial costs for cleaning up the sites if the issues identified by Dr Reay are real issues.[25] CWH makes the following comments:

(i) *Re: Whakatu*

A potential user of the Whakatu site has already approached CWH expressing an interest in acquiring the site and the Commission has a note of its discussions with that user.

[24] T 5 May, 22: 21.

[25] T 5 May, 30: 1-6.

CWH has contacted four previous managers of Whakatu, one of these was the Manager through the building program in the 2004/2005 period and another was the Manager of the site up until approximately May 2009. All four managers have told CWH that the Whakatu building could be used for purposes other than wool scouring if the wool scour was relocated.

In his report Dr Reay stated that "the roof of the scour building at Whakatu is materially affected by corrosion due to the use of chemicals. It is likely that substantial sections of the roof of the building would need to be replaced due to corrosion taking a medium term view of the buildings".

The evidence from WSI at the Conference indicates this is incorrect; WSI representatives confirmed that the staining assumed to be corrosion was due to titanium dioxide being used.[26] While this left a brown stain on the roof, it did not actually corrode the roof as suggested by Dr Reay. WSI inferred this was correct.[27]

In any event, even if that section of the roof did need to be repaired, the cost would be negligible. CWH has measured the affected roof area by gaining the floor plans from the city council and by using aerial photographs of the site. CWH has had an indicative quote for what it would cost to repair this section of the roof (if it was needed) of **[ ]** plus GST.[28]

(ii) *Re: Kaputone*

While no party has yet made a proactive approach in relation to Kaputone as has happened in Whakatu, CWH does not consider it would have any difficulty in selling this property.

There remains a demand for buildings of the size of Kaputone in the industrial fringe of Christchurch. In response to the Commission's query regarding whether any approaches have been made for the Kaputone site,[29] there are a number of displaced operators in the transport, logistics, engineering and construction industries, who remain uncertain about their locations and many would consider Kaputone to be a potential option. These include:

- **[**

[26] T 5 May, 29: 5.

[27] T 6 May, 59: 14-17.

[28] T 5 May, 30: 17-18. This quote can be provided to the Commission if necessary.

[29] T 5 May, 24: 3-5.

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There are also a number of parties looking at industrial land and buildings as development land is becoming a tradable commodity as businesses displaced by the recent earthquakes look for suitable space and compete with other potential tenants. Large industrial sites historically have interest from this sector and there is no reason to believe that Kaputone will be an exception.

Mr Stock, as Counsel for WSI, gave evidence about the existence of the unrelated adjacent disused meat processing site but no informed expert view was given and in CWH's opinion no reliance can be placed on the views expressed. Certainly there was no evidence to show that the disused processing site had any relevance to a nearby current scouring site.

Specifically in relation to the issues raised by Dr Reay:

(A) Cobbled floors

Dr Reay has made the statement that the "new storage building at Kaputone does not have a concrete floor as would be required for most purposes and uses, and instead has a cobbled floor".

CWH does not dispute that there is some cobbled floor, but understands the affected area is restricted to one very small storage shed and another area where the wool grease plant and amenities are. CWH does not believe that these areas are large enough, or in a critically located part of the building, to devalue the building greatly.[30]

However, even if for any reason the cobbled floor did require replacing, CWH has received a quote for a "pre-stressed floor" for $125 per m^2.

Pre-stressed flooring is suitable for a site with an insufficient base structure and is the flooring used at CWH's own Awatoto scour line under which there is no hard base.

(B) Subsoil conditions

Dr Reay makes the statement that "the subsoil conditions at Kaputone... are such that the bearing capacity of the subsoil limits the design load capacity of the floors to pneumatic forklifts of limited capacity and low level bulk storage".

This statement is incongruous with the CWH's understanding that there is a substantial crane structure inside the Kaputone buildings. CWH understands this structure is used to transport fully laden containers. This would indicate that there is a substantial building structure in place at Kaputone and suggests the concerns about the load bearing capacity of the floors are overstated.[31]

[30] T 6 May, 58: 27-30.

[31] T 6 May, 58: 30-32.

Overall, CWH submits:

- there is no reason to believe that the vacant possession value of the land is lower than the going concern value of the land; and
- the Commission should be cautious in placing any weight on the opinions offered by Dr Reay as his report is clearly aimed at advancing the WSI's management interests rather than being an application of independent expertise as required by the High Court Rules.

(b) ***Timing of sale***

The land will be available for a completed sale within 12 months of the acquisition. The rationalisation timeline is discussed in section 5 below.

CWH will market the properties prior to that time and expects that it would have sales agreements finalised such that there would be no or minimal lag between the site becoming available and a sale being completed. This is consistent with the Clifton sale, which occurred simultaneously with settlement of the main transaction.

In any event, while CWH recognises that if a sale took longer than one year to complete it would be appropriate to discount the future value received to present day terms, it would also be necessary to consider the fact that land values are likely to appreciate over time.[32]

3.4 Superstore

It remains CWH's view that the acquisition will enable the superstore concept which will give rise to substantial benefits.

(a) ***Widespread support for the superstore benefit***

There was clear widespread support for the establishment of a wool superstore and the benefits it would create.[33] WSI acknowledged the superstore could generate "great benefit". **[**

[34]

][35]

[32] Submission on Draft Determination, page 10; T 5 May, 37: 30-33.

[33] See Mr Whiteman's and Mr Crone's comments at T 4 May, 82: 13-26.

[34] **[** **]**

[35] **[**

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While WSI representatives attempted to suggest that a superstore could arise in the counterfactual, the reality is it would not.[36] CWH would not pursue the superstore concept in the counterfactual. History indicates this is unlikely to be reversed in the counterfactual. However, with the acquisition as Mr Whiteman explained:

> Once it moves to two sites.....for me it's like a wart on the end of your nose to have a superstore attached to those two sites.[37]

(b) ***Quantification of the benefit***

The Commission's Draft Determination suggested the benefit (if realised) would be **[ ]** per year.

CWH have provided a copy of their analysis to the Commission on 14 March 2011 and based on that analysis NERA estimated the value of the benefit as being **[ ]** per year based on an allowance for capex of **[ ]**.

(c) ***Superstore is not "anti-competitive"***

The superstore is a third party logistics operation similar to those present in many other industries.[38]

The existing services offered by brokers, wool testing authorities, transport operators etc will be unaffected. All that will be provided is the opportunity for owners of other woolstores to "outsource" their warehousing needs and therefore remove costs from their business.

The submission that the superstore would raise competition issues before it could be implemented is erroneous. The submission was made with no evidence or even an example as to how a Commerce Act issue would arise.

Commerce Act issues are certainly not a barrier to this concept occurring. There would be no obligation on farmers etc to provide the wool directly to the superstore[39] and the concept would not, and would not be likely to, suppress or hinder competition between any participant in the wool distribution chain. For example:

- those seeking storage are not obliged to use the superstore;
- growers would still compete to sell wool as they do today;
- wool buyers (brokers/merchants/exporters) would still compete to buy wool as they do today;
- transport providers would still compete to provide transport services to wool buyers and wool customers as they do today; and

[36] See Mr Dwyer's comment at T 4 May, 81: 21-22: "Initial examination of the facts, though, are not too encouraging because the cost of building is very high...".

[37] T 4 May, 82: 24-26. Mr Crone agreed this was "essentially right".

[38] T 4 May, 77: 25-26.

[39] T 4 May, 83: 13-15.

- providers of wool testing services would still compete to wool testing services to wool buyers and wool customers as they do today.

3.5 **Quality**

CWH remains of the view that there are substantial Y value benefits arising from the transaction that would not be available absent the transaction. The conference was useful in narrowing the areas of debate even further:

- There is still no debate that 4 cents per kilogram is a good proxy for the value. Mr Whiteman and Mr Cowan were of the view this value flows back to farmer.[40]

- WSI representatives confirmed that base Y can be improved through equipment changes and liquor condition.[41]

- CWH have argued that if a scour can increase base Y through scouring, exporters/merchants can change their wool blends so as to save costs. WSI acknowledged that merchants will seek to use poorer quality wools in their blends if a scourer is able to improve the Y value.[42] Similar sentiments were expressed by merchants.[43]

The only real debate seems to be whether WSI have achieved a similar increase and whether CWH's base Y improvement could have been caused by a change in their wool mix. Dr Ranford and Mr Fookes are both of the opinion that changes in wool types are not a likely explanation.[44]

Godfrey Hirst and WSI argued that the base Y of the greasy wool scoured at WSI's Whakatu plant had declined over the last five years and therefore CWH's greasy base Y must have increased. From this they sought to draw the conclusion that CWH's scoured base Y improvement was due to wool mix.

However, neither WSI nor Godfrey Hirst presented data on WSI's greasy base Y despite Mr Dwyer confirming that practically every bale scoured by WSI is tested in both greasy and scoured form. Nor did WSI's independent expert obtain this data – he appeared content to sit back and simply say "there is no evidence".

CWH cannot provide data on the greasy wool processed only through its sites as that data is held by its customers not it. However, CWH has consistently stated its belief that the quality of the wool it is processing has decreased over time and CWH provided this evidence at the conference[45] (specifically, and the percentage of oddments (which tend to have a lower base Y) CWH is processing compared to its total processing has increased from 18.5% to 23% in the last five years.)

So, while WSI has data on its own greasy and scoured base Y values, its peroxide use etc, it has chosen not to supply this to this point to their own quality expert[46] or to the Commission.

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[40] T 4 May, 110: 8-12, 22-27.

[41] T 4 May, 94: 21-25.

[42] T 4 May, 96, 12-17.

[43] T 4 May, 110, 22-27.

[44] See attachments to CWH submission, 28 March 2011: Stephen Fookes, pgs 2 & 5; Steve Ranford, pg 3.

[45] T 4 May, 106: 26 – 107:3; T 4 May, 108: 1-4.

[46] T 4 May, 98: 6-13; T 4 May, 103: 10-12.

WSI finally, with some considerable prompting, has undertaken to provide the equivalent Y information as CWH is also using test house results. If WSI does not do so or provides results which are not independently tested, then it is CWH's contention that the Commission is entitled to infer that the evidence did not support the arguments being advanced by WSI or Dr Carnaby.

This is particularly the case because **[**

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3.6 Weak seller

For the reasons described in CWH's submission on the Draft Determination, CWH remains of the view that the evidence suggests that this "weak selling" is in fact occurring and hence removing this effect will result in a substantial benefit to New Zealand. The size of this benefit is material.

CWH's submission was that there is no single "world price",[47] but rather the commercial reality is that there are various frictions in the market which mean that the actual contract price struck between an exporter and a customer for each consignment will reflect a bargained outcome around the prevailing world benchmark price. WSI's evidence confirmed this was the case.[48]

CWH also expressed the view that WSI's bargaining position will be influenced by its practice of procuring greasy wool ahead of concluded sales.

WSI were also of the view that prices have been low over recent years and they blamed this on the exit of Lichtenstein.[49] It is clear from other evidence before the Commission that most of the rest of the industry believe that WSI's trading performance is a far more important contributing factor, a view which is corroborated by WSI's financial performance over time.

4. Competition analysis

4.1 Relevance of WSI as a competitive constraint

In section 2.2 of its submission in response to the Draft Determination CWH explained why in its view, at best, the WSI constraint, if it exists at all, is a weak, indirect, imperfect and uneven constraint which in CWH's view should not be given weight relative to the other constraints faced by CWH.

CWH explained that the much more significant and direct constraints for CWH are the risk of loss of greasy wool volumes to off-shore scouring facilities or the threatened loss to new entry, because each of those losses is likely to be permanent in nature and in practical terms unlikely to be capable of being regained.

[47] See CWH submission, 9 March 201, pg 3.

[48] T 4 May, 14: 20-22.

[49] T 5 May, 15 1-2; T 5 May, 17: 20-26.

None of the opinions or evidence proffered at the Conference cause CWH to change any of its views. WSI's primary focus appears to remain internal as it has always been.

(a) ***WSI's commission scouring volumes***

WSI representatives implied that its commission scouring volumes have increased significantly.

CWH does not believe the WSI volumes in fact reflect "commission scouring" but rather the sale of its own scoured wool to Godfrey Hirst and other local spinners. However, even if those numbers are correct, CWH estimates that WSI's share of the commission scouring market is **[ ]**% in the North Island and **[ ]**% in the South Island or **[ ]**% of the New Zealand market.

In any event, the suggestion that WSI's commission scouring has increased is in marked contrast to other statements made by WSI representatives during this process. During the initial interview with Commission staff, WSI stated that:

- its "commission scouring is increasing a little, but not as much as indicated by Cavalier" – in other words Cavalier had, in its authorisation application, overstated the competitive impact of WSI;
- "WSI has done some work for exporters over the last 12 months... but not a lot";
- their main customers were "**[ ]**".[50]

It is unclear what has changed since February that would cause such a marked change in WSI's commission scouring volumes. CWH has certainly not noticed any rapid change since it filed its application for clearance.

As intimated above, CWH does not believe WSI's commission scouring volumes have increased significantly, however acknowledges that WSI might be selling its own scoured wool to Godfrey Hirst, **[ ]** this is not commission volume.[51]

Accordingly, the most likely explanation for the increase is that WSI is counting sales of its own scoured wool to Godfrey Hirst as commission volumes. This is not true commission scouring, but rather the sale of scoured wool by the WSI trading division in the same manner as it sells wool to any other domestic or international customer. To illustrate, while CWH refers to Godfrey Hirst as its "customer", the actual wool that is being scoured is owned by merchants and exporters not Godfrey Hirst. It follows that the market shares implied by WSI's figures are materially overstated.

This view is reinforced by the fact that the volumes of commission scouring being claimed by WSI (which show an increase of some 30,000 bales between 2008/2009 and 2009/2010) are inconsistent with the scouring volumes WSI has asserted in discussions concerning the underwriting agreement (approximately **[ ]** bales).

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[50] **[ ]**

[51] **[ ]**

(b) ***Current prices to exporters not constrained by WSI***

Exporters have not attempted to leverage the WSI presence by actively splitting their scouring demand between CWH and WSI and most exporters remain strongly opposed to using WSI to scour their wool.

Despite this, and CWH's **[ ]**% share of commission scouring, CWH has not been able to increases prices to these customers; Mr Crone confirmed this.[52]

It is of course notable that only one of the other major exporters felt this acquisition was of sufficient importance to them to make a submission on the Draft Determination, let alone attend the public conference.

This confirms some other material constraint is in play that effectively limits CWH in a real way at all levels of potential price increases, and it is not clear how removing WSI from the market will affect this constraint.

4.2 New entry

New entry remains a real and relevant constraint for CWH. Any loss of volume caused by new entry is likely to be permanent (or at least semi-permanent) in nature; in practical terms, it is unlikely to be capable of being regained. It is the threat of such permanent loss that creates the threat and the constraint.

The evidence provided at the conference confirms that the precise pricing and/or service degradation tipping point at which entry will be prompted is very difficult for CWH to accurately assess.

(a) ***Location of a new scour line and consenting issues***

CWH accepts that there would be issues for a new entrant to navigate, but these are readily surmountable.

First, there are sites available which would support a new scouring operation.

As Mr George outlined at the Conference when Direct Capital invested in CWH, Direct Capital looked at the potential for new entry. Direct Capital visited the Oringi freezing works in Dannevirke[53] and obtained expert advice on the likelihood of buying land and resource consents for a new scour. That analysis contained a list of the industrial parks that could support a new scour and a list of the industrial parks that probably would not support a new scour site.

(i) *North Island*

In terms of location, CWH agrees that a new plant in the North Island would best be located in Napier or Hastings given its proximity to Napier port and also given the experienced workforce in the region.

CWH has already provided evidence to the Commission indicating that a new scouring operation could be located in the Awatoto or Whakatu/Tomoana

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[52] T 4 May, 15: 2-13.

[53] **[**

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industrial zoned areas in which case planning permissions and water/trade waste capacity restrictions would not create a substantive barrier to entry.

For clarity, based on the enquiries CWH has made, CWH has identified the following sites (three buildings and three land sites) as being currently available and able to support a new scour operation:

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(ii) *South Island*

In the South Island, the issue of location requires a balancing of proximity to wool sources (which would suggest Timaru as the obvious choice) versus proximity to Lyttleton (which would suggest Christchurch) and hence lower freight costs. Layered on top of that are the costs of installing the effluent treatment plant that would be necessary to operate in Christchurch, which are likely to be substantial.

Given CWH's location at Timaru, a new entrant is likely to also site itself in this area given the lower establishment costs and the fact that it will not be at a locational disadvantage.

As set out in a previous submission[54], the Timaru District Council has confirmed that a new wool scouring business could be established as a permitted activity in the Industrial H zone (provided it met all the parking, coverage, and other requirements). The Council has confirmed there is plenty of Industrial H land available at Washdyke as the Council purchased land for oxidation ponds and a generous buffer zone around them and this land is suitable for Industrial H activities.

[54] CWH submission, 14 March 2011.

(b) ***No need for a plant in both Islands***

CWH does not agree with Godfrey Hirst's comment that a new entrant would need a plant in both Islands.[55]

The question of entry should not be viewed in isolation from the question of who are the possible entrants and what would be the reason for entering. The most likely entrants are disgruntled customers of CWH of one form or another whether that is an exporter, a coalition of exporters or a domestic customer such as Godfrey Hirst.

In relation to Godfrey Hirst for example, it has now consolidated its operations to the North Island following the Christchurch earthquake so it is difficult to see why it would require scouring in both Islands.

More generally, however, entry in one Island makes the threat of entry in the other Island a far more real and tangible threat for CWH. Therefore entry in one of the Islands is likely to be sufficient to prevent CWH from pricing above competitive levels in the other market.

(c) ***Size of the plant and the need for customers***

The question of plant size and access to customers is largely informed by looking at what the entry scenario would be.

There is likely to be sufficient volumes in **[ ]** to underwrite a 2 metre or 2.4 metre scour line. Mr Whiteman confirmed that Masurel "turn over the volume of scoured wool today to run a 2.4-metre plant ourselves".[56]

The question of the size of the plant required is really a question of right-sizing. It is correct that the 3.0 metre plant if fully utilised is the most cost efficient operation. This is simply because is capable of processing upwards of **[ ]** greasy bales of North Island wool per year. This is a significant amount of capacity and this level of capacity is one of the reasons why there are only six 3 metre scourlines in the world.

In contrast, there are hundreds of 6 foot, 2.0 meter and 2.4 meter woolscours around the world which operate very successfully and very efficiently based on the wool volumes being processed.

(d) ***Cost of plant***

The cost of the plant will differ depending on whether a 3.0 metre, 2.4 metre or 2.0 metre plant is used and whether it is new or second hand. In response to WSI's estimations,[57] the following outlines CWH's information regarding the cost of plant.

(i) *New plant*

CWH believes a new turnkey 3.0 metre scour line in a leased building could be established for $**[ ]** million. This would include all necessary ancillary equipment and an HD press. CWH suggests the Commission confirm this cost with Andar.

[55] T 4 May, 21: 25-29.

[56] T 4 May, 26: 14-23.

[57] T 4 May, 25: 1, 10; T 4 May, 32, 30-32.

However, this would very much be the "Rolls Royce option".

Smaller plant would have a cheaper cost. CWH has already presented evidence to the Commission that it is possible to purchase a brand new 2.0 meter Andar style mini bowl woolscour from China for US$1 million (around NZ$1.4 million).[58] These plants are gaining in popularity and can be built in six months.

(ii) *Second hand equipment*

CWH's information is that second hand scouring equipment is readily available.[59] There is no particular problem with second hand equipment. Woolscours are very robust pieces of equipment and provided that they are maintained correctly they will run for many years.

Andar, for example, also sells second hand equipment and is currently marketing two, 2.0 meter second hand Top Masters for US$**[ ]** million (NZ$**[ ]** million) each. Again, Andar can confirm this.

CWH is aware of four other Top Master woolscours for sale around the world and numerous Chinese built woolscours that are also for sale. While the second hand Chinese plants lack the sophistication of the modern Andar plants, they can be modified and should not be overlooked as a cheap entry alternative. CWH estimates that a new entrant could purchase and land a second hand, 6 foot multi hopper Chinese woolscour into New Zealand for under NZ$**[ ]**.

(iii) *Other ancillary equipment*

It is easy to purchase new equipment such as triple drum openers, hoppers and post scour openers. The average cost is US$10,000 per item.

[ ]. These are readily available and it is possible to find them new and used.

While finding separation equipment has previously been problematic, it is now possible to purchase high quality equipment from China at a fraction of the former cost.

It is possible to purchase High Density Wool Presses second hand and there are High Density Wool Presses here in New Zealand for sale.

In conclusion contrary to the statements by WSI representatives:

- CWH believes that a new entrant could re-enter the New Zealand scouring market with a second hand plant (or new Chinese 2.0 meter wide scour) for approximately NZD $**[ ]** million (including land and buildings). This would give the entrant capacity to process around **[ ]** greasy bales per year or around **[ ]** Mt. This is the most likely entrant option.

[58] CWH response to Draft Determination, pg 8.

[59] CWH is aware of second hand plant available in **[ ]**.

- A full 3.0 metre entry would cost around NZ$**[ ]** million giving the entrant processing capacity of **[ ]** greasy bales per year or **[ ]** Mt per year. This option is possible for a scourer with a guarantee of volume.

(e) ***The likely entrants***

Evidence at the conference suggests that there are people who would enter given these costs and the benefits to them:

- Godfrey Hirst is one; Ms Pauling suggests entry would take 18 months to two years[60] and at worst, Godfrey Hirst have **[**

].

- Mr Whiteman from Masurel confirmed:

> ...we have the volume in New Zealand, we turn over the volume of scoured wool today to run a 2.4-metre plant ourselves, and we have the financial capital to build a plant ourselves. All that to say we don't want to, we have no desire to, but we have the capacity and volume capital and expertise to build a plant.[61]

- More generally, given the interest in this sale process, there appears to be people who are eager to be involved in the sector if the opportunity presents itself.

(f) ***The entry model***

It is certainly not the case that CWH could increase price by 40% without prompting either entry as Futures suggest.

This 40% figure was based on a Futures model which was sensitive to a few key and unsupported assumptions about operating and administration costs even putting aside the debate as to capital costs of new entry. This was explained by NERA at the conference and that discussion is summarised in the enclosed NERA report.

A good example of this was Dr Layton's assumed $800,000 of "Management Fees". This represents a second layer of management above what CWH has today and includes **[**

][62]

Following that discussion, Commissioner Gale asked NERA to prepare an entry model. NERA's response based on information provided by CWH is detailed in the enclosed report, and the approach and assumptions NERA used are not repeated here.

[60] T 5 May, 82: 22-23.

[61] T 4 May, 26: 14-23.

[62] **[ ]**

NERA's analysis illustrates that, based on the assumptions used new entry **[**

]. Combined with NERA's original critical loss analysis, the modelling illustrates that threat of entry is a material constraint on CWH.

The purpose of this modelling is not to precisely identify the tipping point for new entry, but simply to highlight the threat that entry imposes in the market.

4.3 China and other markets

The Chinese market is not focussed on fine wool and only scouring fine wool and importing greasy coarse wool. CWH has provided material which demonstrates this is not the case. China is a growing market for all wool types including coarse wool in both scoured and greasy form. Mr Dwyer seemed to confirm this when he said:

> What this gentleman is talking about is the carpet wool market, in carpet wools going to China. The majority of New Zealand wool going to China is scoured for the carpet industry in China. So I don't think there's much to be won back.[63]

However, the evidence at the conference indicated that the constraint from markets such as China is wider in two respects.

First, there are other emerging markets which have their own scouring capacity and which are likely to increase in importance. Mr Whiteman stated that "In India, there's scouring capacity, so you might be better to put India in the same basket as China".[64] Over 6,000 tonnes of scoured wool is currently exported to India.

Second, there is the more indirect constraint caused by downstream competition:

- Mr Heath of Wool Equities said that in his view contract spinners in New Zealand cannot sustain any price rises because their competition is "in fact India or China or Portugal".[65]

- Ms Pauling from Godfrey Hirst referred to the possibility of relocating to China.[66] The loss of such a significant customer (over **[ ]** tonnes per year) provides every incentive and impetus for CWH to keep prices down and service quality up so as to avoid that scenario.

In such a scenario a price increase by CWH would seem to be a self-defeating strategy. The impact of any strategy which led to such a loss would be devastating for CWH.

As Mr Pike stated, it is Godfrey Hirst's belief that "the sudden demise of wool scouring in Australia is more a result of the removal of the further processing industries in Australia to China which gave rise to the opportunity for the wool to be scoured in China".[67]

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[63] T 4 May, 42: 8-11.

[64] T 4 May, 56:14-15.

[65] T 4 May, 53: 32 – 54:11.

[66] T 4 May, 29: 24-29.

[67] T 4 May, 11: 15-22.

4.4 Price discrimination

The reality is that there is little in the way of price discrimination by destination today. If it was a profit maximising strategy, one would have expected CWH to have already adopted it given it is observed in other competitive markets (e.g., movie theatres).

The reason it does not occur today was explained by CWH at the conference. CWH has confirmed it has little knowledge of where wool is going to as its final destination, at least internationally, as most wool is hubbed through either Singapore or Hong Kong. What information CWH does have is the information that customers provide to it. If customers did not wish them to receive this level of information, they could take steps to withhold it from CWH.

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In relation to domestic users, **[**

]. However, even for other domestic users there would be opportunities for these customers to defeat any price discrimination by buying wool from exporters (in much the same way Godfrey Hirst does today) or through a wool exchange such as Abrahams Wool Exchange.

4.5 Vertical impacts in carpet market

The proposed acquisition will not result in incremental vertical integration effects that will result, or be likely to result in a substantial lessening of competition in the New Zealand carpet market.

(a) *Long term scouring contract*

CWH will have little ability to discriminate against Godfrey Hirst. **[**

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(b) *No incentive to discriminate against Godfrey Hirst*

Nor will CWH have the incentive to discriminate against Godfrey Hirst.

(i) *Importance of Godfrey Hirst as a customer*

As was emphasised at the Conference, Godfrey Hirst is one of CWH's most (if not the most) important customers and given the significance of its volume and throughput CWH has no incentive to act in a way which places this volume at risk of being lost either through new domestic entry or relocation offshore.

Indeed, Mr Ferrier, in the confidential session said of CWH **[ ]**[68] and later said **[ ]**.[69]

The general sensitivity of the merged entity to volume loss is confirmed by NERA's critical loss analysis.

In fact, CWH acquired the Godfrey Hirst assets to achieve economies of scale and the Commission has evidence that **[ ]**.

There is no reason to believe that CWH would now wish to forego those advantages by putting this volume at risk.

(ii) *Shareholding of CWH*

NERA has addressed the issue of whether CWH would have the incentive to raise Godfrey Hirst's costs. They have concluded CWH would not have an incentive to engage in input foreclosure as it would not be a profit maximizing strategy for ACC and Direct Capital.

The Commissioners requested submissions regarding the assertion by interested parties that the Commission was not entitled to consider the shareholding of CWH in assessing the impact of vertical integration.[70] That assertion is simply wrong and in direct contrast to section 47 of the Commerce Act.

Any change in the shareholders of CWH will itself amount to an acquisition of shares to which section 47 will apply and in respect of which the Commission is entitled to intervene if it were to give rise to a substantial lessening of competition.[71]

That is even if it could be said that a substantial lessening of competition in the carpet market would be caused, or be likely to be caused if Cavalier Bremworth held a controlling shareholding in CWH, the transaction that would be needed to enable Cavalier Bremworth to reach that position would fall to be assessed under section 47 at the time such an acquisition occurred and not before. Put simply, it could not proceed (without authorisation) if a substantial lessening of competition was likely.

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[68] **[ ]**
[69] **[ ]**
[70] T 4 May, 72: 9-10.
[71] Or alternatively, a contract, arrangement or understanding to which section 27 would attach.

It follows that the Commission is perfectly entitled (and indeed required) to take into account the constraint imposed by the current shareholding structure of CWH in assessing the competitive impacts of the proposed acquisition.

(iii) *Features of the carpet market which make input foreclosure unlikely*

There are various features of the New Zealand carpet market which make input foreclosure an unlikely strategy and which suggest that even if it were possible, no substantial lessening of competition would result.

The Commission most recently considered this market in 2006 when granting clearance for Godfrey Hirst to acquire Feltex Carpets Limited (Decision 587) and in 2007 when clearing, in effect, Cavalier to acquire Norman Ellison (Decision 628).

In both cases, the Commission defined the NZ carpet market to include a differentiated spectrum of products including synthetic, woollen and wool-blend carpets, as well as woven and tufted carpets. Godfrey Hirst is a manufacturer of both woollen *and* synthetic carpets.

The Commission granted clearance for both transactions on the basis of existing domestic competition, imports and specifically (in the case of Decision 587 and implicitly in the case of Decision 628) the countervailing power of retailers.

Imports played a significant part in the Commission's decisions. In Decision 628 the Commission concluded that imports already provided a constraining presence and that the presence of imports could be expanded and the constraint could easily be increased.

The Commission also highlighted the ability and incentive for retailers to be proactive in seeking out overseas supply if they sensed any misbehaviour by local manufacturers. It also noted the presence of excess capacity in global markets, particularly in the USA, which suggested entry into New Zealand could be an attractive option for a USA company should Cavalier seek to take advantage of any market power it may have.

These features of the NZ carpet market remain in place today and if anything the constraint provided by imported product and synthetics has increased. There is no suggestion that the NZ carpet market is not part of a broad global market.

Furthermore vertical integration in the industry already exists through Cavalier Bremworth's 50% non-controlling shareholding of CWH.

What this means is that even the benefits to Cavalier Bremworth of an input foreclosure strategy are unlikely to be sufficient to outweigh the damage caused to CWH by the strategy. This is because:

- Godfrey Hirst could and most likely would expand its production and marketing of synthetic carpets.

- Retailers could substitute woollen and synthetic and wool blend carpets from other producers – that is, a reduction in their purchases of Godfrey Hirst carpets would not necessarily lead to a proportionate increase in Cavalier Bremworth sales.

Accordingly, it is difficult to see how CWH's acquisition of WSI would substantially lessen competition in the NZ carpet market given the existence of the range of synthetics, and the availability of imported carpets.

5. Detriments

As outlined above, it is only those detriments which arise in the markets where competition is substantially lessened that are relevant to the assessment. These are detriments which arise in the markets for scouring in the North Island and the South Island.

5.1 No production disruptions likely

CWH does not believe there will be any production disruptions other than a very minor stoppage at the Awatoto plant (2 to 3 days).

Indeed, CWH has no incentive to allow the moving of scours to disrupt the flow of greasy wool as this will reduce income. As Mr Hales said at the conference "we will be doing everything that we can to ensure that every kilogram of wool that's available to us is scoured in a timely manner".[72]

The Commission asked CWH to outline its plan for moving the scour lines.[73]

As indicated to the Commission CWH will relocate WSI's plant during the low scouring season which is approximately May to December.

CWH's existing capacity will be sufficient to wash the volumes of wool that have traditionally been washed through these months of 5 million to 6 million greasy kgs in the North Island and 4.5 million to 6 million greasy kgs in the South Island. CWH currently has the capacity to scour in excess of 6 million greasy kilograms in the North Island and 4.8 million greasy kilograms in the South Island in any four week month.

CWH's plants will need to work at full capacity throughout the relocation period, but this is not unusual and CWH has a history of working at full production for a sustained period of time.

Furthermore, CWH has a good working relationship with its customers and it has worked with them constructively during previous rationalisations to ensure no disruptions.[74] Cavalier Corporation has already stated that it will work with CWH, if needed, to accommodate scouring planning.

CWH's proposed programme assuming a possession date of 30 September 2011 is as follows:

If authorisation is granted	CWH will immediately begin the consenting process and will get designs of the buildings at Awatoto and Timaru drafted. Tendering for building work will occur once the building plans are approved. CWH anticipates that the design of the buildings will take

[72] T 5 May, 2: 11-12.

[73] T 5 May, 11: 18-19.

[74] T 5 May, 3: 25-33 – 4: 2.

	approximately one month.
Acquisition finalised	CWH will begin building the new equipment required for the upgrades, including the bowls for Kaputone, the openers and part of the blending system.
October to December 2011	Changes made to the Awatoto site to enable the 3.0 metre plant to be relocated from Whakatu, including upgrading the electrical supply to the site.
November/December 2011 to March/April 2012	CWH expects building at Awatoto to start in November/December 2011 and be finished by March/April 2012 at the latest. Pre-planning for the installation of the 3.0m scour at Awatoto can be done in parallel with this work. Awatoto, Whakatu and Clive scouring will be fully operational at this time. The building work at Timaru is more complex than at Awatoto and thus the building process at Timaru will be started as soon as possible. This includes relocating the fire pumping system and one transformer, dismantling the existing office block, and fitting a new mains water line from the road to the fire pumping station (as a precautionary measure). There will be no disruption to processing while the buildings are extended at Timaru and production at Kaputone will remain available.
May to August 2012	Relocation of the scours will begin in May 2012. CWH anticipates it will take 4 months to relocate the equipment to Timaru and between three and four months for Awatoto. Awatoto and Clive will remain fully operational during this time as will Timaru.

Even if there were likely production disruptions (which is denied), NERA's analysis in the **attached** memorandum illustrates that Futures' estimate is overstated by between 10 and 30 times.

5.2 **Allocative efficiency losses**

CWH remains of the view that no price increases are likely as a result of the acquisition. Nothing presented at the conference causes CWH to change that view.

Certainly, price increases of 20% or 40% are simply unrealistic and these should be excluded from the analysis. Price increases of 10% are also extremely unlikely to be profit maximising in light of:

- the weak constraint provided by WSI;
- the constraints provided by the risk of loss of greasy wool volumes to off-shore scouring facilities or the threatened loss to new entry;

- the inability to price discriminate; and
- the fact that CWH already has **[ ]**% of the commission scouring volumes and that exporters have shown a reluctance to use WSI.

CWH remains of the view that a very "worst case scenario" would be a price increase of 5%, although it reiterates that it has not been able to achieve these from exporters to date despite their reticence to utilise WSI.

CWH also reiterates the point made in its submission on the Draft Determination that even if a price increase did occur, this would be a price increase from the lower factual price levels likely as a result of variable cost savings from the acquisition.

Accordingly, CWH believes that even on a worst case scenario any loss of allocative efficiency would be at the low end of ranges identified by the Commission.

5.3 Loss of productive efficiency and dynamic efficiency

In the submission in response to the Draft Determination CWH expressed the view that, if anything, the Commission's estimate of productive efficiency losses and dynamic efficiency losses were overstated.

The opinions and evidence offered at the Conference only serves to reinforce this view and it remains the case that there is no reason to consider that the Commission has understated likely losses in the Draft Determination.[75] The removal of WSI from the market will not remove the other and primary drivers to maintain low costs.

While it has been suggested that the Commission cannot assume that a small shareholder base creates greater oversight of costs, the reality of this company is that its shareholders, which include a major customer, do take an active interest in the operation of the business. This is a highly relevant matter for this particular transaction.

In relation to the issue of increased supply risk, as stated in CWH's submission on the Draft Determination **[**

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CWH has not placed a cost on holding this equipment because it considers it can store the plant on its current premises. While this decision would prevent it from selling these items, CWH has not budgeted for or claimed as a benefit the proceeds from selling this equipment.

[75] In fact Mr Dwyer's evidence suggested that dynamic efficiency may improve if the acquisition proceeds as he suggested that WSI was reluctant to implement innovations for a fear of being copied. See: T 5 May, 73: 22-29.

[76] **[**

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Confidential Schedule 1: Calculation of energy savings