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Decision No. 725

Determination pursuant to the Commerce Act 1986 in the matter of an application for authorisation of a business acquisition involving

CAVALIER WOOL HOLDINGS LIMITED

and

NEW ZEALAND WOOL SERVICES INTERNATIONAL LIMITED

The Commission: Dr Mark Berry, Chair
Sue Begg
Gowan Pickering
Dr Stephen Gale

Summary of Application: Cavalier Wool Holdings Limited, or any interconnected body corporate, has applied for authorisation to acquire all of New Zealand Wool Services International Limited's wool scouring assets (being the wool scouring assets and stock located at Whakatu and Kaputone and 50% of the shares in Lanolin Trading Company Limited) and/or any interconnected body corporate of New Zealand Wool Services International Limited that holds any of those wool scouring assets (the Acquisition).

Determination: The Commerce Commission determines that it is not satisfied that the Acquisition will not have, or would not be likely to have, the effect of substantially lessening competition in a market, but that 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. Therefore, the Commerce Commission determines to grant an authorisation for the Acquisition pursuant to section 67(3)(b) of the Commerce Act 1986.

Date: 9 June 2011

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EXECUTIVE SUMMARY

- E1. On 9 February 2011, the Commission registered an Application from Cavalier Wool Holdings Limited (Cavalier Wool – the Applicant), seeking authorisation under s 67 of the Commerce Act 1986 (the Act) to give effect to a transaction that would involve Cavalier Wool (or any interconnected body corporate) acquiring control over New Zealand Wool Services International Ltd's (WSI) wool scouring business (the Application). Accordingly, Cavalier Wool sought authorisation to acquire up to 100% of:
- WSI's wool scouring assets (being the wool scouring assets and stock located at Whakatu and Kaputone and 50% of the shares of the Lanolin Trading Co Limited (LTC)) or any interconnected body corporate of WSI; and/or
 - the shares in WSI.
- E2. On 12 May 2011, Cavalier Wool advised the Commission by notice in writing that it is sufficient for its commercial purposes if it is authorised to acquire from WSI and/or any interconnected body corporate of WSI, the wool scouring assets. Accordingly, Cavalier Wool applied to the Commission to vary its application. As a result, the Application no longer seeks authorisation to acquire up to 100% of the shares in WSI. It also made a minor change to the wording of its Application for authorisation to acquire WSI's wool scouring assets.
- E3. The Commission has determined to grant an authorisation for the Acquisition pursuant to s 67(3)(b) of the Commerce Act 1986. The Commission considered that likely benefits from the Acquisition would outweigh any potential detriments.
- E4. In reaching this determination, the Commission received numerous submissions from interested parties and obtained information from a wide range of sources. The Commission issued a Draft Determination giving its preliminary views on the issues and held a public conference at which those matters were discussed.
- E5. Cavalier Wool is 50% owned by Cavalier Bremworth Limited and 25% owned by each of the Accident Compensation Corporation and Direct Capital Ltd. WSI is a publicly owned company listed on the New Zealand Exchange's Alternative Market (NZAX). Its major shareholders are Plum Duff Limited and Woolpak Holdings Limited which are both in receivership. A receiver has been appointed to sell those shareholdings.
- E6. Cavalier Wool and WSI supply wool scouring services and are now the only two such operators remaining in New Zealand following a long period of rationalisation in the industry. Both operate in the North and South Islands. While the Acquisition affects a number of different markets, including those concerning wool grease and carpets, the Commission has focused its assessment on wool scouring services namely:
- the North Island market for the supply of wool scouring services (the North Island scouring market); and
 - the South Island market for the supply of wool scouring services (the South Island scouring market).
- E7. As part of the Acquisition, Cavalier Wool intends to rationalise its operations with those of WSI. This would include:
- closing WSI's scours at Kaputone and Whakatu and selling the land and buildings;

- relocating WSI’s scour lines at Kaputone and Whakatu to Cavalier Wool’s existing scouring sites at Timaru and Awatoto respectively;
 - mothballing Cavalier Wool’s Clive and Timaru plants; and
 - divesting WSI’s wool trading operations.
- E8. In making its assessment, the Commission compares the situation above (the factual) with what would occur absent the Acquisition (the counterfactual). The Commission understands that a number of parties are interested in purchasing the WSI assets, in addition to Cavalier Wool. The Commission considers that the relevant counterfactual is likely to be the status quo with Cavalier Wool and WSI operating independently.
- E9. The Acquisition would remove Cavalier Wool’s nearest existing competitor – WSI. In addition, the Commission considers that the ability for wool exporters to switch to greasy exports to China would provide only a moderate constraint on Cavalier Wool in the factual. Further, the potential for new entry into the scouring markets would provide only a moderate constraint on Cavalier Wool.
- E10. Therefore, the Commission is not satisfied that the acquisition will not have, or would not be likely to have, the effect of substantially lessening competition in both the North and South Island markets for the supply of wool scouring services. In these circumstances, the Commission declines to give a clearance for the Acquisition.
- E11. However, that is not the end of the matter. The authorisation procedure in the Commerce Act requires the Commission to identify the detriments arising from the loss of competition and to balance those against the public benefits that arise from the acquisition as a whole.

Public Benefit and Detriments

- E12. A public benefit is any gain, and a detriment is any loss, to the public of New Zealand, with an emphasis on gains and losses being measured in terms of economic efficiency. In contrast, changes in the distribution of income, where one group gains while another simultaneously loses, are regarded as mere “transfers” and are generally not included in the balancing process, because a change in efficiency is not involved.
- E13. The Commission assessed the detriments of the Acquisition in the following categories: loss of allocative efficiency, loss of productive efficiency and loss of dynamic efficiency.
- E14. In terms of allocative efficiency loss, if Cavalier Wool were to increase scouring prices post-Acquisition, the Commission considers that there would be an upper bound for the allocative losses from such price increases. This is because post-Acquisition:
- entry could occur at price levels below a 15% price increase and as such Cavalier Wool would be constrained as to the level of any price increase it could impose; and
 - Cavalier Wool would also be constrained by the potential for wool merchants to switch certain volumes of exports of wool to China from clean to greasy in the face of a price increase by Cavalier Wool. China has a strong scouring industry with many plants and generally lower scouring costs than the New Zealand industry. Loss of greasy wool volumes to China would likely be permanent and could undermine the economies of scale benefits from the proposed acquisition.
- E15. In terms of productive efficiency loss, the Commission considers that productive efficiency losses are unlikely to be large because of the on-going competitive threat

from the Chinese scouring industry and the profit maximising incentives of Cavalier Wool shareholders.

- E16. Dynamic efficiency losses are more difficult to estimate with any confidence. However, the Commission's view is that the long-term competitive threat of the Chinese scouring industry will reduce potential dynamic efficiency losses. The Chinese threat is likely to be a major spur for ongoing innovation as there is a real risk that if the Chinese scouring industry innovates more rapidly than that of New Zealand, then most wool scouring would move offshore, as has happened in Australia. Should sufficient wool volumes be lost in the future to China, the advantages gained from the Acquisition would soon be undone. The Commission is of the view that any loss of dynamic efficiency in this instance is likely to be small.
- E17. In terms of benefits, the Commission considers that the production cost reductions that Cavalier Wool anticipates in the factual are within the range that might be expected from a reduction in the number of scouring plants from five to two (whilst maintaining similar levels of scouring production). In order for these reductions to occur there must be consolidation and rationalisation of scour lines onto two sites as proposed in the Application. This will not occur in the counterfactual.
- E18. Additional benefits would arise from the sale of land and buildings, reduction of annual capital expenditure and the implementation of a wool superstore development which would reduce the cost of wool storage and transport in New Zealand.
- E19. The Commission's determination involves a balancing of the public benefits and detriments which will result, or will be likely to result, from the Acquisition. Only when there is a net positive public benefit can the Commission be satisfied that the Acquisition should be permitted, and that it should grant an authorisation for the Acquisition
- E20. The Commission concluded that total benefits of about \$31.6 million would arise from the Acquisition to be weighed against total detriments of about \$18.1 million.

Commission's Determination

- E21. Having regard to all the circumstances, the Commission's view is that it is satisfied that the benefits to the public would outweigh the detriments arising from the loss of competition. Therefore, the Commission 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.
- E22. Therefore, the Commission determines to decline to give clearance but determines to grant an authorisation for the Acquisition pursuant to section 67(3)(b) of the Commerce Act 1986.

THE APPLICATION

1. On 9 February 2011, the Commission registered an Application from Cavalier Wool Holdings Limited (Cavalier Wool – the Applicant), seeking authorisation under s 67 of the Commerce Act 1986 (the Act) to give effect to a transaction that would involve Cavalier Wool (or any interconnected body corporate) acquiring control over New Zealand Wool Services International Ltd's (WSI) wool scouring business (the Application). Accordingly, Cavalier Wool sought authorisation to acquire up to 100% of:
 - WSI's wool scouring assets (being the wool scouring assets and stock located at Whakatu and Kaputone and 50% of the shares of the Lanolin Trading Co Limited (LTC)) or any interconnected body corporate of WSI; and/or
 - the shares in WSI.
2. A question was raised by Godfrey Hirst New Zealand Ltd (Godfrey Hirst) and WSI as to the likelihood of the benefits from rationalisation being achieved if (as was likely, in their view) Cavalier Wool was unable to obtain sufficient votes of WSI's shareholders in favour of that rationalisation, following any authorisation of the transaction that the Commission might grant.
3. On 12 May 2011, Cavalier Wool advised the Commission by notice in writing that it is sufficient for its commercial purposes if it is authorised to acquire from WSI and/or any interconnected body corporate of WSI, the wool scouring assets. Accordingly, Cavalier Wool applied to the Commission to vary its application. As a result, the Application no longer seeks authorisation to acquire up to 100% of the shares in WSI. It also made a minor change to the wording of its Application for authorisation to acquire WSI's wool scouring assets.
4. By virtue of its variation, Cavalier Wool, or any interconnected body corporate of Cavalier Wool seeks authorisation to acquire all of WSI's wool scouring assets (being the wool scouring assets and stock located at Whakatu and Kaputone and 50% of the shares in Lanolin Trading Company) and/or any interconnected body corporate of WSI that holds any of those wool scouring assets (the Acquisition).
5. Cavalier Wool stated that the variation removes any doubt or uncertainty that the benefits claimed will be available at the same time as any detriments might be said to arise. Godfrey Hirst submitted that the Commission has no express power to receive or allow such a variation and even if the Commission does have an implied power to accept it, there would need to be full opportunity for interested parties to comment on the new matter for which authorisation is now being sought.
6. The request for variation was accepted pro tem by the Commission and publicised on the Commission website. Parties were invited to make submissions on it by 20 May 2011.
7. Having considered those submissions, the Commission has determined that it can consider and determine the Application before it, as varied. The practical ramifications that would follow if that was not the case seem to the Commission to be absurd. Godfrey Hirst submitted that the Applicant should be required to start all over again.¹ The original Application sought authorisation for an acquisition of the assets in the same terms (for all intents and purposes) as the variation. While there is no express

¹ See paragraph 7 of Chapman Tripp letter to the Commerce Commission of 20 May 2011.

reference to varying an application in Part 5 of the Act, the variation here was not a change in substance but a reduction in transactional ambit: in effect, an abandonment of the second part of the original two part application (that is, to acquire the shares of WSI).

8. In this instance, the Commission has concluded that the variation does not change the nature of the competition analysis, which all parties have had full opportunity to comment on as well as whether the variation fundamentally altered the nature of the analysis. The same substantive competitive issue arises and the competitive detriments and the public benefits remain the same.
9. Although it does not rely on it, the Commission notes that s 68(4) of the Act allows an applicant to advise the Commission that it does not wish the Commission to give a clearance or grant an authorisation and the Commission shall accordingly not give a clearance or grant an authorisation in respect of that acquisition. There would seem to be nothing in principle to prevent abandonment, also, of part of an application if no substantive change is wrought and subject to appropriate comment being allowed.
10. As to whether the reduced scope of the application, as varied, removes the doubts raised by Godfrey Hirst and WSI as to the likelihood of the benefits of rationalisation being achieved, that is discussed below.

BACKGROUND

11. Following the Acquisition, Cavalier Wool intends to rationalise the wool scouring operations of WSI and Cavalier Wool by:
 - ceasing wool scouring operations at WSI's sites at Kaputone and Whakatu and selling the land and buildings at those sites;
 - relocating WSI's wool scouring equipment from Kaputone and Whakatu to Cavalier Wool's existing wool scouring sites at Timaru and Awatoto respectively;²
 - modifying Cavalier Wool's 2.4 metre wide wool scour lines at Awatoto and the 3.0 metre line relocated from Whakatu, to improve their productivity; and
 - mothballing wool scour lines at Cavalier Wool's Clive and Timaru plants.
12. Appendix 1 gives more detail of the proposed rationalisation.
13. On 24 May 2011, Cavalier Wool made an offer to the Directors of WSI to acquire the entire business, assets and liabilities of WSI as a going concern at a price of \$40 million. Cavalier Wool advised the Commission that the Acquisition will include all assets including contracts for acquisition of wool and contracts for supply to buyers. The offer was made subject to the Commission authorising the Acquisition of WSI's wool scouring assets. The Directors of WSI stated that they would consider the offer.
14. Cavalier Wool has informed the Commission³ that it intends to on-sell the WSI wool trading business for the best price it can achieve, as soon as practicable. It stated that prior to the sale Cavalier Wool is incentivised to maintain the wool trading business as a going concern:
 - to realise the best price it can for the business;

² Kaputone is near Belfast which is north of Christchurch, while Whakatu and Awatoto are between Napier and Hastings.

³ Bell Gully letter of 27 May 2011.

- because the business will become a key customer of Cavalier Wool's enlarged scouring business; and
 - to maintain the value in WSI's greasy and scoured wool stocks, brands and customer relationships and contracts.
15. Cavalier Wool advised that several parties have expressed an interest in acquiring the wool trading business and it has commenced preliminary discussions with some of them.
16. Cavalier Bremworth, which the Commission considers to be associated with Cavalier Wool,⁴ owns Elco Direct Ltd, a wool broker which acquires wool for Cavalier Bremworth and also for wool merchants. If Cavalier Wool did continue as a wool trader post-acquisition, there would be aggregation of market share in the market for the acquisition of greasy wool. Cavalier Wool has submitted⁵ that its market share in wool purchasing would increase from [] in the counterfactual to [] in the factual but that would be within the Commission's safe harbours. The amended Application is for authorisation of the acquisition of scouring assets only. Moreover, no interested party raised concerns over concentration in this market during the Commission's submission and conference process. Therefore, the Commission does not consider this market further.⁶

STATUTORY FRAMEWORK

17. Any person who proposes to acquire assets of a business or shares and considers that the acquisition may breach s 47 can make an application for an authorisation under s 67 of the Act.
18. Section 67(3)(a) of the Act requires the Commission to give clearance for a proposed acquisition if 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 the Commission is not so satisfied, clearance must be declined, although it may still grant an authorisation under s 67(3)(b) of the Act if the Commission 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."
19. If the Commission is not satisfied that the acquisition will result, or will be likely to result, in such a benefit to the public that it should be permitted, or the Commission is in doubt as to whether there is a real chance the acquisition will create public benefit, it must decline an authorisation under s 67(3)(c).
20. The burden of proof lies with the Applicant to satisfy the Commission on the balance of probabilities that the acquisition is not likely to substantially lessen competition and if it is likely to do so, that the public benefit is such that the Commission should authorise it.⁷
21. Section 67(3) of the Act requires the Commission to issue a decision within 60 working days after the date of registration of the notice, or such other longer period agreed to by the Commission and the Applicant. The agreed extension of time in this case is until 10 June 2011.

⁴ See discussion in the Association Section.

⁵ Cavalier Wool's Authorisation Application, Page 16, 8 February 2011.

⁶ If the Commission did have concerns about competition in this market in the factual and if there was no Application for clearance or authorisation of WSI's wool trading assets by Cavalier Wool, the Commission would be likely to commence an investigation under Part 3 of the Act.

⁷ *Commerce Commission v Southern Cross Medical Care Society* (2001) 10 TCLR 269 (CA) at para {7}.

COMMISSION PROCEDURES

22. This Decision provides the Commission's reasons for its Determination on the Application.⁸ In preparing this Determination, the Commission has received submissions and obtained information from a wide range of sources. In the course of this process, the Commission has amongst other actions:
- reviewed the information and analysis in the Application, including the economic report submitted by the Applicant's economic experts;
 - posted a public version of the Application and initial submissions from interested parties on the Commission website;
 - sought further information and clarification from the Applicant on a range of subjects;
 - sought information from parties making submissions and from other sources at all levels in the wool industry;
 - interviewed the Applicant and other interested parties;
 - considered submissions from interested parties including economic and other expert evidence;
 - made relevant documents and reports available to the Applicant and interested parties, where necessary under expert and solicitor confidentiality undertakings;
 - published a Draft Determination on 13 April 2011 stating its preliminary view that it was not satisfied that the acquisition would not have the effect of substantially lessening competition in relevant markets but that it considered the acquisition would have such a benefit to the public that it should be permitted;
 - held a conference with interested parties on 4, 5 and 6 May 2011;
 - sought and received post conference submissions on matters raised at the conference; and
 - received an amended Application from Cavalier Wool in which it withdrew that part of its Application that related to shares in WSI. It now only seeks clearance or authorisation for the acquisition of the wool scouring assets of WSI.

Confidentiality

23. During the course of the Commission's investigation, confidential information was released to counsel and independent experts who signed confidentiality undertakings. WSI and Godfrey Hirst counsel have submitted that the process by which confidential information has been excluded from the public "...hindered the ability of interested parties to provide analyses by people in the industry."⁹
24. In particular WSI claimed that it was unable to make comment on the financial model provided by Cavalier Wool which showed the financial impact of the proposed rationalisation, as WSI counsel and experts were unable to discuss the figures in the model with WSI.¹⁰

⁸ As required by section 67(5) of the Act.

⁹ Post conference Response of Godfrey Hirst, 20 May 2011, p 13.

¹⁰ Post conference response of WSI, 18 May 2011, paragraph 3.

25. In the Commission's view, it would be inappropriate and commercially prejudicial to the Applicant to disclose the Applicant's commercially sensitive information to WSI and Godfrey Hirst. Disclosure of such information would provide the Applicant's competitors with an unfair advantage and the same could be said in reverse. As part of the Commission's processes it has attempted to balance, on the one hand, the interests of the Applicant and interested parties in safe guarding their confidential information in a competitive market. On the other hand the Commission wishes to test information in the interests of coming to the best informed decision on the Application.
26. Notwithstanding the claims of WSI and Godfrey Hirst, the Commission received a wide range of submissions from interested parties on the issues that were of assistance to the Commission in testing the evidence.

THE PARTIES

Cavalier Wool

27. Cavalier Wool is 50% owned by Cavalier Bremworth Limited, which in turn is a wholly owned subsidiary of the publicly listed Cavalier Corporation Limited (together the Cavalier Group) . The remaining 50% of the shares in Cavalier Wool are owned in equal parts by the Accident Compensation Corporation (ACC) and Direct Capital Investments Limited.
28. The Cavalier Group is involved in the manufacture of woollen and wool-blend carpets (through its subsidiaries Cavalier Bremworth and Norman Ellison Carpets Limited), and a wool procurement business through its ultimate 100% ownership of Elco Direct Limited.
29. Cavalier Wool owns and operates wool scours at Awatoto and Timaru. Cavalier Wool's plants provide commission wool scouring services for Cavalier Bremworth (and its subsidiary Elco Direct), independent wool exporters and local manufacturers of mostly yarn and carpets. Commission wool scouring is the term used to describe the contract scouring and pressing into bales, of wool owned by other parties. Cavalier Wool does not itself, take ownership of wool in the process.
30. Cavalier Wool owns 50% of the shares in the Lanolin Trading Company (LTC), with the other 50% being owned by WSI. The LTC is involved as agent for its shareholders in the purchase and marketing of wool grease, a valuable by-product of wool scouring. The company sells wool grease predominantly to overseas customers, and also to a small number of New Zealand firms, for use as an input in a wide range of intermediate and final products (for example lanolin and lanolin derivatives such as cosmetics, and cholesterol and cholesterol derivatives such as vitamin D and shrimp feed additive).

WSI

31. WSI is a publicly owned company listed on the New Zealand Exchange's Alternative Market (NZAX). Its major shareholders, Plum Duff Limited and Woolpak Holdings Limited (both in receivership) together own 63.8% of WSI.¹¹ Plum Duff is ultimately owned by South Canterbury Finance Limited, which is also in receivership. Woolpak Holdings Limited is owned by Mr Raymond Lund.

¹¹ On 16 December 2010, the receivers of South Canterbury Finance Limited (in receivership) appointed Messrs Maurice Noone and Malcolm Hollis, partners from PricewaterhouseCoopers, as joint receivers of Plum Duff and Woolpak Holdings.

32. WSI is a vertically integrated merchant wool scourer and commission wool scourer. Its wool merchant business involves the purchase of wool in New Zealand for sale to purchasers both in New Zealand and overseas. WSI currently purchases and trades about 30% of New Zealand's total wool clip and is New Zealand's largest wool trader.
33. WSI also owns and operates wool scours at Whakatu and Kaputone. Between 85% and 90% of WSI's wool scouring activities relate to the wool that it purchases itself as a wool merchant. The term used to describe wool scouring of this nature is merchant scouring. The balance of the production from WSI's scours is wool scoured on a commission basis for various independent wool exporters and other local end users.

OTHER RELEVANT PARTIES

Godfrey Hirst NZ Limited (Godfrey Hirst)

34. Godfrey Hirst is a manufacturer of woollen and synthetic carpets in New Zealand. The company is a large user of New Zealand wool, processing about [] tonnes of New Zealand wool per year, or about [] of the New Zealand wool clip. Godfrey Hirst currently purchases about [] of its wool directly from WSI¹² and the remaining [] from wool merchants, who utilise Cavalier Wool for their scouring operations.
35. Godfrey Hirst previously owned and operated wool scouring plants at Clive (near Napier) and Clifton (near Invercargill), but these were purchased by interests associated with Cavalier Wool following the implementation of the transactions that were subject to the clearance granted by the Commission in its Decision 666 (see below). The Clifton plant has been dismantled and the land sold, and the Clive plant is now operated by Cavalier Wool for only a few weeks each year at the peak of the shearing season.
36. As part of the transactions under which Cavalier Wool acquired Godfrey Hirst's wool scouring plants, the two parties entered into a "Scouring Agreement."
[]¹³
[]
[]¹⁴
[]¹⁵

Wool Merchants

37. There are a number of merchants that are involved in the purchase of wool by auction, direct from growers, and in the case of slipe wool¹⁶ from meat processors, for sale as either greasy or clean wool, to local and overseas customers. These merchants include Segard Masurel (NZ) Ltd (Segard Masurel); J S Brooksbank & Co (Australasia) Ltd (JSB); H Dawson Sons & Co Wool NZ Limited (H Dawson); and Fuhrmann NZ (1983) Ltd (Fuhrmann). Wool merchants are the major customers of commission wool scourers.

¹² []

¹³ []

¹⁴ []

¹⁵ []

[]

¹⁶ The process of slaughtering sheep for their meat requires each carcass to have the skin removed. This skin offers two by-products - the pelt for leather and the residual wool, known as slipe wool.

INDUSTRY BACKGROUND

Overview of the Wool Industry

38. Wool produced in New Zealand is sold either at auction or by farmers direct to wool buyers (brokers) by private treaty.¹⁷ New Zealand wool may be:
 - scoured and used in New Zealand for the manufacture of carpet, yarn or apparel (22% of the wool clip); or
 - scoured and exported as clean wool (56% of the wool clip); or
 - exported as unscoured greasy wool (22% of wool clip).
39. China is the largest volume destination accounting for around 32% of New Zealand wool exports in 2009/10. Approximately 57% of the wool exported to China was in its greasy form.
40. On the basis of the Beef and Lamb Industry Organisation statistics for the 12 months to 30 June 2010, around 74% of the total New Zealand wool exports were in scoured form.
41. Figure 1 shows the different functional levels in the movement of wool. Figure 2 outlines the anticipated 2011 volumes of wool flows in New Zealand.¹⁸

¹⁷ Wool buyers or brokers buy wool on behalf of Cavalier Bremworth and wool merchants, who then respectively process wool or aggregate, blend, arrange scouring and on-sell to national and international customers.

¹⁸ This flow sheet is based on information provided to the Commission by Cavalier Wool and Godfrey Hirst.

Figure 1: Flow diagram of the New Zealand wool industry

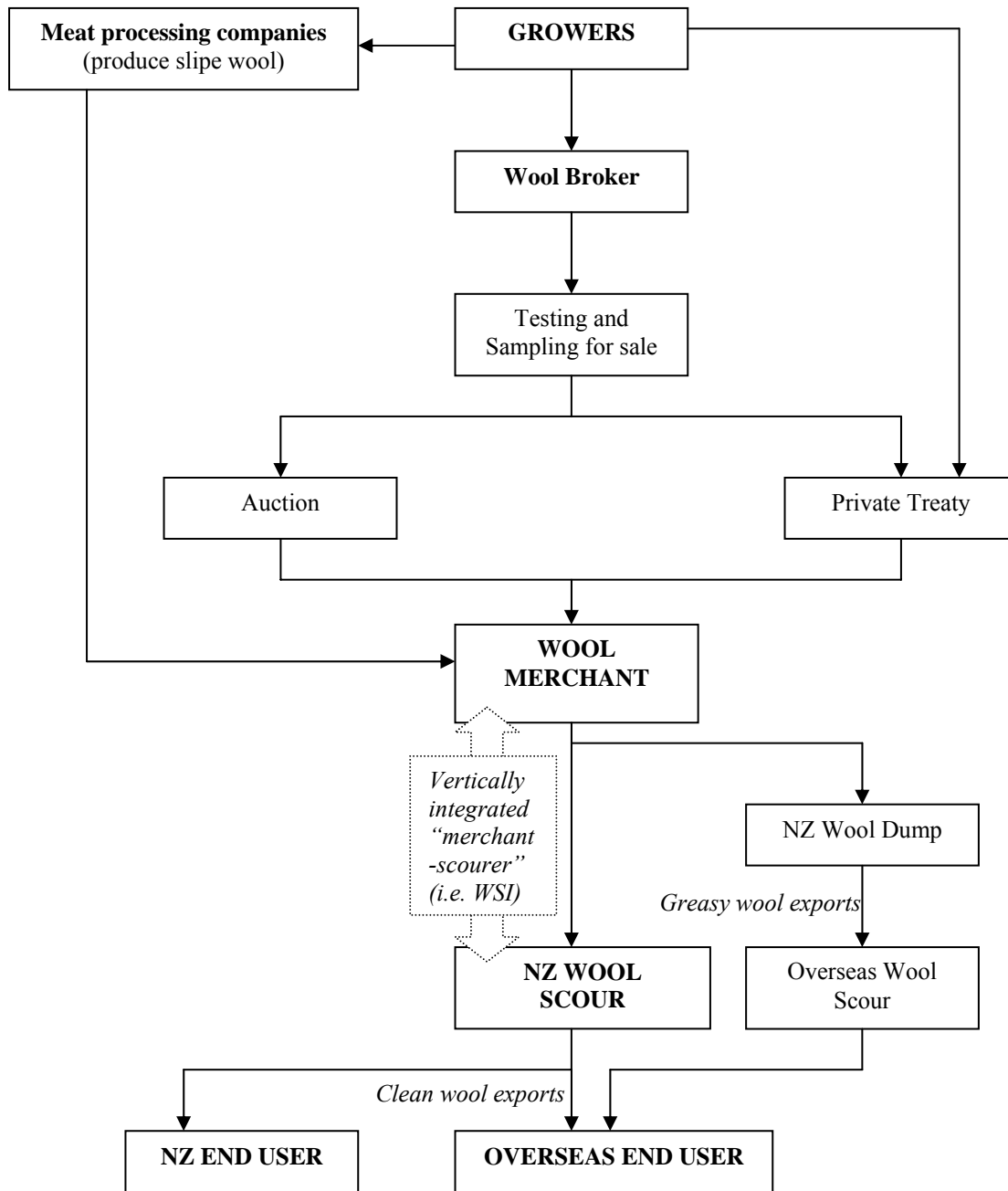
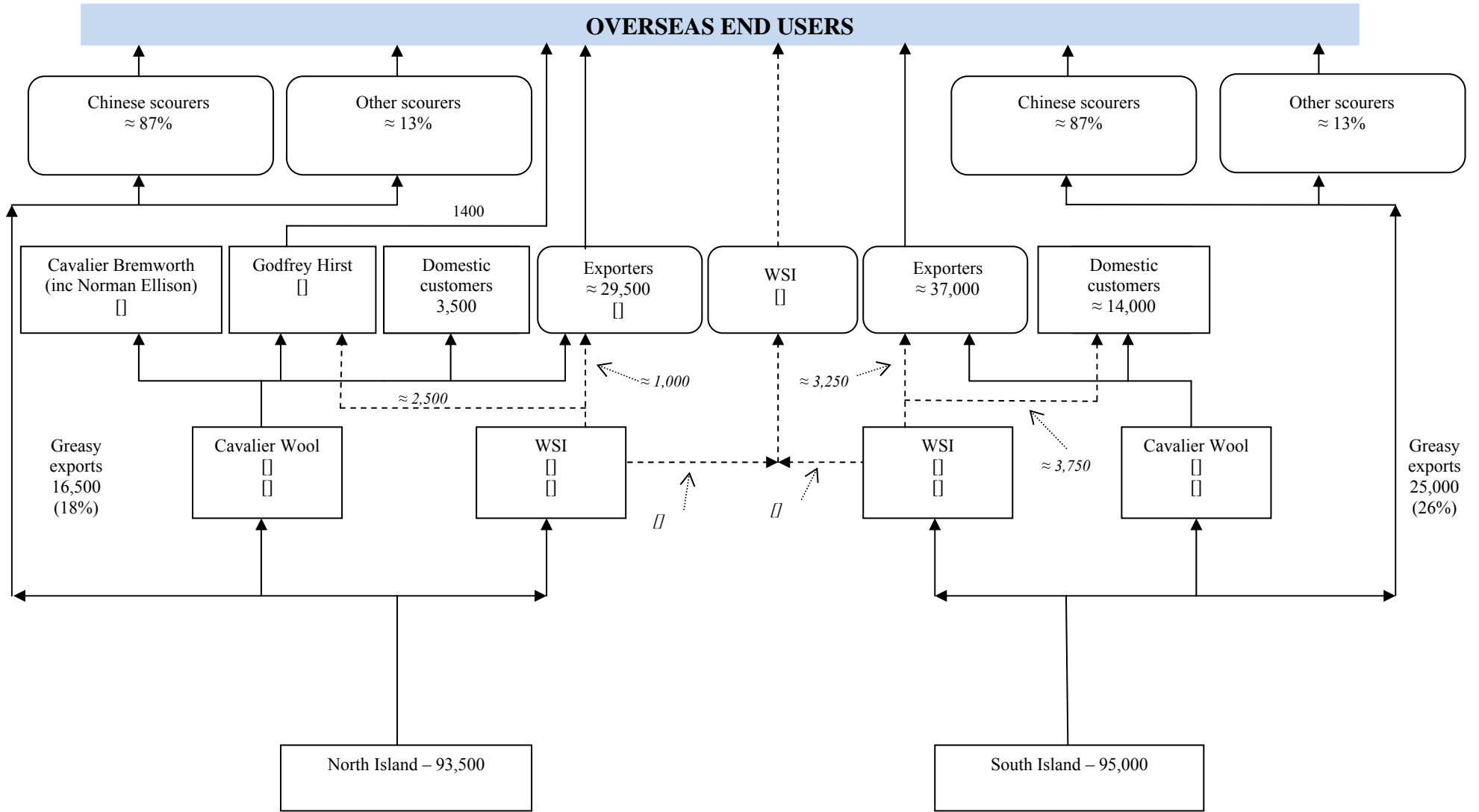


Figure 2: Estimated Wool Volumes (in tonnes)



Wool Scouring

42. In essence, wool scouring involves:
- receiving from wool merchants batches of greasy wool that are of a suitable mix of wool types to meet their customers' quality specifications – (quality means fibre strength, length and diameter, colour, brightness and cleanliness) and storing the batches prior to scouring;
 - opening of the blended wool fibres by a mechanical flail process to allow full contact between fibres and washing liquid;
 - washing (and sometimes bleaching) the wool in various numbers of bowls of hot water and detergent;
 - extraction of wool grease for sale by the LTC;
 - drying the wool;
 - high density pressing packing into bales; and
 - testing of each bale for correct wool specification.
43. The scouring and high density pressing processes currently account for only about 5-6% of the current value chain of scoured and packed wool.¹⁹
44. Historically, the size of the wool scouring industry has been closely aligned to sheep numbers and the available wool clip. For instance, when the New Zealand sheep flock reached its peak of 70 million in 1982-3, there were about 20 separate wool scouring operations. However, the decline in sheep numbers to around 33 million at present has been accompanied by a significant reduction in the wool clip and this, along with the development of higher capacity modern scouring plants and presses, has resulted in a reduction in the number and total capacity of wool scours in New Zealand. Currently there are five wool scouring plants, three in the North Island and two in the South Island.²⁰ If the Acquisition proceeds all five existing wool scours will be owned by Cavalier Wool which intends to centralise wool scouring at one site in each island (if the to be mothballed Clive site is ignored).

PREVIOUS DECISIONS

45. The Commission has previously considered wool scouring in:
- *Decision No 587: Godfrey Hirst NZ Limited/Feltex Carpets Limited*, 31 August 2006. This acquisition gave rise to horizontal aggregation in the market for the supply of wool scouring services in the North Island. This was a four to three market participant merger with Godfrey Hirst's market share at that time rising from [] to []; and
 - *Decision No 666: David Ferrier and/or New Zealand Woolscourers Limited/Cavalier Wool Holdings Ltd/Godfrey Hirst NZ Limited*, 6 March 2009. This acquisition resulted in the aggregation of market share in the market for the supply of wool scouring services in the North and South Islands. This was a three

¹⁹ There has recently been a steep rise in the price of greasy New Zealand wools, not matched by any increase in scouring/pressing costs. Therefore up until about one year ago, scouring and pressing was a larger proportion of the wool value chain.

²⁰ Although as stated, one North Island plant at Clive only operates for a few weeks a year at the peak of the shearing season.

to two market participant merger with Cavalier Wool's market share rising from [] at that time.

FRAMEWORK FOR ANALYSIS

Substantial Lessening of Competition

46. If 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, the Commission must give a clearance for the proposed acquisition. Section 3(1) of the Act states that competition means workable or effective competition.
47. To assess whether or not the effect will, or would be likely to lead to, a lessening of competition in a market, a counterfactual analysis is undertaken. This exercise requires a comparison of the likely state of competition if the acquisition proceeds ('the factual') against the likely state of competition if it does not ('the counterfactual').²¹
48. The High Court in *Air New Zealand v Commerce Commission (No.6)*²² accepted that an absence of market power would suggest there had been no substantial lessening of competition in a market but did not see this as a reason to forsake an analysis of the counterfactual as well as the factual. Justice Rodney Hansen stated that "...a comparative judgment is implied by the statutory test which now focuses on a possible change along the spectrum of market power rather than on whether or not a particular position on that spectrum, that is, dominance has been attained."
49. The Court of Appeal in *Port Nelson v Commerce Commission*²³ noted that for something to be "likely" it must be "above the mere possibility but not so high as more likely than not and is best expressed as a real and substantial risk that the stated consequence will happen."
50. The High Court in *Woolworths & Ors v Commerce Commission* observed that "...a substantial lessening of competition is one that is "real or of substance" as distinct from ephemeral or nominal. Accordingly a substantial lessening of competition occurs if it is likely that there will be a reduction in competition that is real or of substance."²⁴
51. If the Commission cannot be satisfied, it must then determine under s 67(3)(b) whether, nonetheless it can 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 requires the Commission to determine whether the detriments flowing from the lessening of competition are outweighed by the public benefits that result, or would be likely to result from the acquisition.
52. WSI made submissions to the effect that in an authorisation context there is an "extra component" to the test and it is at some level of magnitude higher for an applicant in this context. WSI submitted that "there must be clear and convincing evidence" of benefits outweighing detriments, that "an authorisation cannot be granted where there is some doubt" in this regard and that merely proving on the balance of probabilities is insufficient.
53. Godfrey Hirst put it that s 67(3)(b) "requires a high test...not satisfied by a bare positive margin", that the Commission must be more cautious and where there is uncertainty

²¹ *Commerce Commission v Woolworths Limited* (2008) 12 TCLR 194 (CA).

²² *Air New Zealand v Commerce Commission (No.6)* (2004) 11 TCLR 347.

²³ (1996) 5 NZBLC 104, 150; (1996) 3 NZLR 562-563.

²⁴ *Woolworths & Ors v Commerce Commission* (2008) 8 NZBLC 102,128 (HC).

surrounding the purported public benefit, the application must be declined (but accepts, however, that the balance of probabilities is the relevant standard).

54. The Commission acknowledges that the wording is different between s 61(6), relating to authorisations of restrictive trade practices, and s 67(3)(b) relating to business acquisitions. The former clearly refers to whether benefits outweigh detriments, whereas the latter refers only to the result being such a benefit to the public that an authorisation should be granted.
55. The High Court in *Air New Zealand/Qantas*²⁵ said that the tests were substantially the same, insofar as both require an assessment of likelihood of lessening of competition and of public benefit. The Court further noted, however, that “the way in which public benefit is required to be weighed is subtly different, but the practice of the Commission, sanctioned by the Court, is that there is no material difference between the tests mandated by the two sections.”
56. First, it is clear that the standard is the balance of probabilities and the Commission does not agree with WSI’s submissions insofar as it appears to suggest a standard of “beyond reasonable doubt”. The Commission agrees with Godfrey Hirst’s comments about the difference in wording and that it must apply the test as laid down in s 67(3)(b), but notes that:
- It is difficult to see what process could be used other than using the best evidence possible, assessing detriments and benefits and making a comparison between the results to determine where the likely outcome lies.
 - The test has been applied by the Commission using that process, and sanctioned by the Courts, on a number of occasions.
 - It is not clear on what basis the Commission could justify declining an authorisation if there was a positive margin in favour of benefits (that is, there were net public benefits). The Applicant would likely have legitimate grounds of complaint in that case, and it would potentially make the outcomes of authorisation applications variable insofar as they would be dependent on the unspecified subjective views of different Commissioners from time to time.
57. Secondly, to the extent that the Commission must be satisfied on the balance of probabilities on the basis of evidence put before it, it agrees that such evidence should be as “clear and convincing” as the circumstances allow.

The Public Benefit Test

58. Any assessment of detriment and benefit will be fact specific but a number of principles have emerged from the Courts’ decisions. The High Court in *Air New Zealand v Commerce Commission (No 6)*²⁶ noted the following:
- Benefits include efficiency gains (s 3A of the Act) and anything of value to the community generally: *Telecom v Commerce Commission* (1991) 4 TCLR 473,530.
 - 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.

²⁵ *Air New Zealand v Commerce Commission (No.6)* (2004) 11 TCLR 347

²⁶ Above n25 at {319}.

- The benefits must result from the acquisition. Benefits which would or would be likely to accrue whether or not the acquisition proceeds should be disregarded.
- Benefits should be quantified where possible but benefits, which by their nature, are incapable of quantification, should still be taken into account. The Court acknowledged that quantification of dynamic efficiencies and dynamic gains is particularly difficult.

Ability of Cavalier to Implement Proposal

59. Both WSI and Godfrey Hirst submitted at the conference that there was doubt about the ability of Cavalier Wool to implement its proposed rationalisation (and, thereby, achieve the claimed benefits), because:
- WSI is a listed issuer and subject to the NZAX Listing Rules, as well as being a Code Company under the Takeovers Code. As a result, in offering to acquire the Receiver's 64% shareholding, the same offer would have to be made to the remaining shareholders, who do not have to accept unless Cavalier obtained 90% and could compulsorily acquire the balance.
 - Any shareholding less than total control would mean that a decision to rationalise the scours would be a major transaction in terms of s 129 of the Companies Act 1993. Therefore, it would need approval by way of special resolution, namely, 75% of the shares voting, and Cavalier could not vote its shares in respect of any such resolution because it would be a related party.
 - The management and board members hold a sufficient number of shares which they would vote to defeat any resolution (as was stated at the conference).
 - Accordingly, an authorisation for Cavalier Wool to acquire the shares in WSI would lead to all the competitive detriments identified as arising from that ownership, but none of the benefits.
60. Cavalier Wool explained why this scenario would not occur, in confidence at that stage because of sensitivity about disclosing its bid details to the other parties, some of whom were likely to be competing bidders. It has since made an offer to WSI to acquire all its scouring assets in terms of the Application for authorisation, which itself has been varied to clear any doubts on this issue, so the earlier explanation and confidentiality no longer apply. For completeness, however, the Commission notes that the arguments by WSI and Godfrey Hirst proceeded on the assumption that the 64% shareholding held by the receiver and sought to be acquired, could not be voted in favour of a special resolution. As Cavalier Wool explained, however, that assumed a share purchase followed by a special resolution, whereas Cavalier Wool proposed to make an offer conditional on a special resolution being passed to enable the rationalisation to occur. If the Receiver wanted to accept the offer (if he did not, then no competition issues would arise in any event), he would be motivated to vote his shares to pass the special resolution which, in the absence of any arrangement with Cavalier Wool, he could do so. As Mr Stock accepted in submissions on behalf of WSI dated 20 May 2011, "there are ways that Cavalier Wool may utilise to make its intentions known to the market to purchase the Scour Assets which may not create legal difficulties."

61. [

] Cavalier Wool varied its Application on 12 May 2011 so as to abandon that part

relating to a share acquisition. As a result of its current offer to WSI, and in terms of its Application for authorisation, Cavalier Wool seeks only to acquire the wool scouring assets. As a result, it cannot be said that if that transaction is authorised, rationalisation of the wool scouring assets would be unlikely to occur, because:

- what is authorised to occur is the very transaction which will be implemented and enable control of rationalisation; and
- it cannot credibly be said there is no assurance that, having gained control of the assets, Cavalier Wool will not carry through with rationalisation, since:
 - that could be said of any proposed acquisition which comes before the Commission; and
 - as with any proposed acquisition, the value offered depends on the outcomes identified (i.e., the commercial and economic imperatives drive the proposed outcomes).

62. Accordingly, the Commission is of the view that no diminution of likelihood arises by virtue of issues raised as to the ability of Cavalier to implement the proposal. As a final point, it should also be apparent that a related submission made by Godfrey Hirst at the conference under s 68(2) of the Act (repeated subsequently by way of written submissions on 20 May) is not accepted by the Commission. In short, it was submitted that “{g}iven WSI’s intransigent opposition as expressed at the conference, the Commission must have real doubts that any sale of WSI’s scours to CWH is likely to proceed”²⁷ and under s 68(2) the Commission should, therefore, decline to grant an authorisation.
63. For a number of reasons that submission appears to the Commission to be misconceived. First, s 68(2) appears to the Commission to be directed to the (rare) circumstances where, for reasons as a matter of fact, an authorisation would be moot because it is unlikely that the Acquisition will proceed (such as, for instance, the acquirer going into receivership or liquidation, or the target being acquired by someone else before authorisation is granted). Secondly, even if Godfrey Hirst’s arguments were accepted about the claimed benefits being unlikely due to alleged doubts over an ability to implement the transaction, that does not mean the converse applies (namely, that “for reasons other than arising from the application of any provision of this Act”, the proposed Acquisition is unlikely to be proceeded with), since that would mean that in every case where, in the context of determining an application, the Commission did not accept claimed benefits were likely, it should exercise a power under s 68(2) rather than decline the authorisation in the normal course by way of Final Determination. The words in s 68(2) describing the applicable circumstances as being “for reasons other than arising from the application of any provision of this Act” reinforce the Commission’s view of the operation of s 68(2) in this regard. Thirdly, it is noted that this submission followed originally from the doubts raised about the transaction structure initially proposed (acquisition of assets and/or shares), and the ability to obtain a special resolution. Since the same doubts are not present in regard to the reduced transactional scope of the Application (acquisition of assets), the Commission has no reason to believe that the proposed Acquisition will not be proceeded with, if at all, in terms of the authorisation. As evidence of this is the fact that an offer has been made by Cavalier Wool to WSI to acquire its wool scouring assets.²⁸

²⁷ Submissions by Chapman Tripp on behalf of Godfrey Hirst of 20 May 2011.

²⁸ Letter from Cavalier Wool to The Directors of WSI of 24 May 2011.

64. Finally (Godfrey Hirst’s position appearing to come down to an assertion that due to management opposition, any offer for the assets would not be accepted), the Commission notes that in any “bid” situation it is not competent to assess the chances of success or otherwise. It is not uncommon for two or more bidders for an asset to seek clearance from the Commission (for example, Central North Island Forests), but only one can be successful. Despite the apparent opposition by senior management expressed at the conference, the Commission is still not in a position to pre-judge possible commercial outcomes. Any applicant is entitled under the Act to come to the Commission for the necessary statutory pre-condition which it requires to be able to make a bid, and the competition policies of the Act are met either way: if a bid within the terms of an authorisation is successful, then that is what the authorisation contemplated, and if it is not successful, then no issues arise under the Act.

Association

65. A preliminary question the Commission must determine is whether the Applicant is associated with any other parties in the relevant market(s). s 47(1) of the Act refers to an acquisition by a person. Person is defined as including two or more persons that are interconnected or associated under s 47(2) of the Act.
66. Sections 47(3) and (4) of the Act set out when two or more persons are associated. Two corporate entities are associated if one, either directly or indirectly, is able to exert a “substantial degree of influence” over the activities of the other. The Commission is of the view that, in this context, a substantial degree of influence means being able to bring real pressure to bear on the decision making process of the other, even if that pressure falls short of control.²⁹
67. In determining whether parties are associated, each case must be considered in light of its particular facts. Typically, the Commission takes into account the:
- nature and extent of ownership links between the companies;
 - presence of overlapping directorships;
 - rights of one company to appoint directors of another; and
 - nature of other shareholder agreements and links between the companies concerned.
68. Cavalier Wool is 50% owned by Cavalier Bremworth, which in turn is a wholly-owned subsidiary of Cavalier Corporation Limited. The Shareholders’ Agreement in relation to Cavalier Wool (the Shareholders’ Agreement) sets out that Cavalier Bremworth’s 50% shareholding in Cavalier Wool entitles it to appoint two directors to Cavalier Wool’s board. In total, there are four directors on Cavalier Wool’s board, with the other two shareholders, ACC and Direct Capital Investments Limited being entitled to appoint one director each.
69. In addition, clause 4.2 provides that the Board will delegate management of Cavalier Wool’s day to day operations to Cavalier Bremworth.
70. In light of these facts, the Commission considers it likely that Cavalier Bremworth can exert a substantial degree of influence over the activities of Cavalier Wool at both the board and management levels. Accordingly, for the purposes of the present analysis, the Commission will proceed on the basis that Cavalier Bremworth and Cavalier Wool are associated and should be considered as one head in the relevant market(s).

²⁹ Commerce Commission, *Decision No.278: Air New Zealand/Ansett Holdings Ltd/Bodas Pty Ltd*, 3 April 1996.

MARKET DEFINITION

Introduction

71. The Act defines a market as:

“... a market in New Zealand for goods or services as well as other goods or services that, as a matter of fact and commercial common sense, are substitutable for them.”³⁰

72. For the purpose of competition analysis, the internationally accepted approach is to assume the relevant market is the smallest space within which a hypothetical, profit maximising, sole supplier of a good or service, not constrained by the threat of entry would be able to impose at least a small yet significant and non-transitory increase in price, assuming all other terms of sale remain constant (the SSNIP test). The smallest space in which such market power may be exercised is defined in terms of the dimensions of the market discussed below. The Commission generally considers a SSNIP to involve a five to ten percent increase in price that is sustained for a period of one year.

73. The Commission defines relevant markets in terms of five characteristics or dimensions which are:

- the goods or services supplied and purchased (the product dimension);
- the level in the production or distribution chain (the functional level);
- the geographic area from which the goods or services are obtained, or within which the goods or services are supplied (the geographic extent);
- the temporal dimension of the market, if relevant (the timeframe); and
- the customer dimension of the market.

Product/Functional Market Dimension

74. The greater the extent to which one good or service is substitutable for another, on either the demand-side or supply-side, the greater the likelihood that they are bought and supplied in the same market. The degree of demand-side substitutability is influenced by the extent of product differentiation.

Wool scouring

75. The proposed Acquisition would give rise to horizontal aggregation in respect of wool scouring services³¹ in the North and South Islands.

76. Wool pressing (into bales containing the clean wool end product of a wool scouring plant) is an integral and necessary part of wool scouring plants. Therefore, in these reasons (for brevity) the Commission has included wool pressing as part of its definition of wool scouring services.

77. Wool scouring is a specific service required to clean wool in advance of further processing. There is no demand-side substitutability for the service and similarly there is no supply-side substitutability in the provision of such services. As such, the Commission considers that it is appropriate to define a discrete market for wool scouring services.

³⁰ Section 3(1A) of the Commerce Act 1986.

³¹ “Wool scouring services” include within their scope, the operation of high density pressing into bales at the end of the production processes.

78. Wool scouring services are typically provided on a commission basis. Ownership of the wool is retained by the end user, who pays a fee for the wool to be scoured and in some cases delivered to the next destination. In the case of WSI, which is a vertically integrated merchant scourer, the ownership of the wool is retained by the trading division throughout the scouring process. The Commission therefore considers that the appropriate functional dimension of the wool scouring market is the supply of wool scouring services.

Wool grease

79. In addition, the Acquisition would result in an increase to 100% of the shareholding of the merged entity in the LTC, which purchases and markets wool grease, a by-product of the wool scouring process.
80. As the purchase and supply of wool grease is a distinct step related to the production of clean wool and for which there is no substitute, the Commission considers that it forms a distinct market in both the product and functional dimensions.

Manufacture, import and wholesale supply of wool and synthetic carpets

81. During the Commission's submissions and conference process, representations were made, particularly by Godfrey Hirst, that competition concerns would arise in downstream carpet markets. Godfrey Hirst was concerned that Cavalier Wool could use either price or non-price behaviour to disadvantage Godfrey Hirst relative to Cavalier Bremworth.
82. As discussed above, the Commission considers that Cavalier Bremworth is associated with the Applicant which competes with Godfrey Hirst in markets for the manufacture, import and wholesale supply of wool and synthetic carpets. The Commission accepts Godfrey Hirst's submission that a relevant market is the national market for the manufacture, import and wholesale supply of carpet in New Zealand. This is consistent with the market definitions reached in Decision No 628, *Cavalier Corporation Limited and Norman Ellison Holdings Limited*, 14 November 2007.

Geographic Dimension

83. The Commission defines the geographic dimension of a market to include all of the relevant, spatially dispersed sources of supply to which buyers would turn should the prices of local sources of supply be raised.

Wool scouring

84. Industry participants advised the Commission that only small volumes of wool are currently transported across the Cook Strait and that freight costs make movement of wool between the Islands largely uneconomic. Andrew Campbell, Managing Director of JS Brooksbank, exporters of wool, informed the Commission that some wool does move between the Islands, depending on the type of wool and export requirements. However, Mr Campbell said that this was an exception and the vast majority of wool sourced from the North Island was scoured in the North Island and similarly for the South Island.³²
85. In the North Island, all existing wool scouring plants are located in close proximity to each other in the Hawke's Bay. While Hawke's Bay itself produces large volumes of wool, wool is transported from all wool producing regions of the North Island to be scoured in Hawke's Bay.

³² Commission interview with Andrew Campbell, 22 February 2011.

86. In the South Island, both scours are located in Canterbury, with Kaputone being near Christchurch and Canterbury Wool Scours being near Timaru. Similar to the North Island, wool is transported from all wool producing regions of the South Island to be scoured at either of these two sites.
87. Accordingly, for the purposes of considering the proposed acquisition, the relevant geographic markets are the North and South Islands.

Wool grease

88. Wool grease is a high value, low volume product and is, therefore, capable of being transported economically over large distances. For that reason, the Commission considers that for the purposes of this Application, it is appropriate to define a national geographic market for the purchase and supply of wool grease.

Market Definitions in Previous Relevant Decisions

89. In Decision 587,³³ the Commission concluded that a relevant market for the purposes of assessing that acquisition was the North Island market for the supply of wool scouring services (the North Island scouring market).
90. In Decision 666,³⁴ the Commission concluded that for the purposes of assessing that acquisition, the relevant markets in respect of wool scouring services were:
- the North Island market for the supply of wool scouring services (the North Island scouring market);
 - the South Island market for the supply of wool scouring services (the South Island scouring market); and
 - the national market for the purchase and supply of wool grease (the national wool grease market).
91. In Decision 628,³⁵ the Commission considered that for the purpose of assessing that application, the relevant market was a differentiated national market for the manufacture/import and wholesale supply of carpet.³⁶

Conclusion

92. Accordingly, for the reasons above the Commission proposes to adopt the following markets when considering the Application:
- the North Island market for the supply of wool scouring services (the North Island scouring market);
 - the South Island market for the supply of wool scouring services (the South Island scouring market);
 - the national market for the purchase and supply of wool grease (the national wool grease market); and
 - the national market for the manufacture, import and wholesale supply of wool and synthetic carpets.

³³ *Godfrey Hirst NZ Ltd/Feltex Carpets Ltd*, 31 August 2006.

³⁴ *David Ferrier and or New Zealand Woolscourers Ltd/Cavalier Wool Holdings/Godfrey Hirst NZ Ltd*, 6 March 2009.

³⁵ *Cavalier Corporation Ltd/Norman Ellison Holdings Ltd*, 14 November 2007.

³⁶ In Decision 628, the Commission considered that the relevant product market was differentiated due to the vast number of carpet options available in the market. This meant consumers faced overlapping product bands.

FACTUAL/COUNTERFACTUAL

93. In reaching a conclusion about whether an acquisition is likely to lead to a substantial lessening of competition, the Commission makes a with, and without, comparison rather than a before and after comparison. The comparison is between two hypothetical future situations, one with the Acquisition (the factual) and one without (the counterfactual).³⁷ The difference in competition between these two scenarios is then able to be attributed to the impact of the acquisition.

Factual

94. As noted above, the Applicant proposes in the factual to:
- close WSI's scours at Kaputone and Whakatu and sell the land and buildings;
 - relocate WSI's scour lines at Kaputone and Whakatu to Cavalier Wool's existing scouring sites at Timaru and Awatoto respectively;³⁸
 - modify Cavalier Wool's 2.4 scour lines at Awatoto to improve their productivity;
 - mothball scour lines at Cavalier Wool's Clive and Timaru plants; and
 - divest WSI's national and international wool trading operations.

Counterfactual

95. The counterfactual is the Commission's view of what would be likely to occur if the Acquisition being considered were not to proceed. It is the benchmark against which any changes arising from the proposed Acquisition is assessed. When making this assessment, the Commission recognises that future scenarios may include either the existing owners continuing to control the target entity, or other parties that are interested in purchasing the target entity if the Applicant's proposed Acquisition were not to proceed and the sale to continue.
96. The Applicant has presented its analysis on the basis that the relevant counterfactual is the status quo.
97. The Receiver for Woolpak Holdings and Plum Duff advised that a number of parties have expressed interest in being involved in the sale process and are expected to complete the confidentiality undertakings and receive the Receiver's fact sheets.
98. Industry participants have expressed concerns that WSI could be purchased by an international entity and the wool scouring assets could be sent offshore. They are concerned that this could lead to a permanent reduction in the scouring capacity in New Zealand. However, such an outcome seems unlikely as a purchaser wishing to purchase WSI, or its scouring operations, as a going concern would be likely to pay more than a purchaser that was only interested in the residual value of the scouring assets. The Commission notes that the current market capitalisation of WSI is about \$37 million (at the present 54 cents per share price) and that Cavalier Wool's offer for the business of WSI was \$40 million.
99. Given that Cavalier Wool and WSI are the only New Zealand-based parties currently operating in the relevant scouring markets, there would be no aggregation of market shares if WSI was purchased by any interested party, other than Cavalier Wool.

³⁷ *Air New Zealand v Commerce Commission* (No.6) (2004) 11 TCLR 347 at {42}.

³⁸ Kaputone is near Belfast which is north of Christchurch, while Whakatu and Awatoto are between Napier and Hastings.

Therefore, in view of these factors, the Commission's considers that the relevant counterfactual is likely to be the status quo.

COMPETITION ANALYSIS

100. This section assesses whether the Acquisition is likely to result in a substantial lessening of competition in the factual. The paragraphs that follow discuss the competitive constraints provided by WSI, Chinese scourers, and the prospect of entry into scouring in New Zealand.
101. The Commission is satisfied that there is no substantial lessening of competition in the national wool grease market. As a result, the Commission does not consider the national wool grease market in detail in this Determination.

NORTH AND SOUTH ISLAND WOOL SCOURING MARKETS

102. As discussed above, the Commission considers that transporting wool between the North and South Island for the purpose of scouring would not normally be economic. Therefore, there would be separate North and South Island geographic dimensions of the scouring market. However, the Commission considers that the competition issues in respect of the supply of wool scouring services are generic to both the North and South Island geographic markets. In both Islands there would be a reduction from two wool scourers to one. The Commission has, therefore, treated them together for the purpose of the competition analysis.

Existing Competition

Constraint from WSI

103. Post acquisition WSI would be removed as an independent supplier of wool scouring services in each of the affected wool scouring markets leaving Cavalier Wool as the only provider.
104. The Applicant discounts WSI as a competitor and considers that the more significant risk for Cavalier Wool is the loss of greasy wool volumes to off-shore scouring facilities or the threat of new entry.
105. Cavalier Wool has argued that the best estimate of WSI's market share is its [] share of commission scouring.³⁹ Cavalier Wool has also argued that most exporters are strongly opposed to using WSI to scour their wool and, thus, Cavalier Wool's prices to these exporters are not constrained by WSI's presence.
106. However, the minutes of Cavalier Wool's Board of Directors' meetings show an explicit concern in relation to the competitive threat that WSI imposes. The minutes include:

- []
 - []
- []

] ⁴⁰

³⁹ These figures were broadly corroborated by WSI at the conference. Mr Dwyer stated that WSI's 2010/11 commission work was 13.3% of its scouring at Whakatu and 25% of its scouring at Kaputone. This amounts to approximately 6.3% and 12.8% shares of North and South Island commission scouring respectively.

⁴⁰ Extract from minutes of a meeting of Cavalier Wool's Board of Directors, April 2010.

[
]⁴¹
 ▪ []

Figure 3: North Island Scouring Market Share⁴²

1

107. While the Commission notes that the Board minutes also discuss concerns in relation to the impact of increasing amounts of greasy wool exports, the Commission does not consider that this discounts the threat of WSI.
108. Moreover, the Commission considers that WSI's merchant scouring business places an indirect, but real, constraint on Cavalier Wool. That is, should Cavalier Wool increase its scouring prices to merchants, those merchants will become less competitive compared to WSI's trading arm. WSI would then be able to pay a higher price for farmers' wool relative to merchants facing higher scouring charges and/or offer lower prices to end consumers for scoured wool, therefore increasing its market share in scouring markets compared to that of Cavalier Wool.
109. WSI's ability to capture volumes from Cavalier Wool is limited in the short-term by its scouring capacity. While WSI advised that it does run at maximum capacity at times in the peak season, it does generally have some excess capacity which would allow it to increase its market share.⁴³

⁴¹ Extract from minutes of a meeting of Cavalier Wool's Board of Directors, May 2010.

⁴² Extract from minutes of a meeting of Cavalier Wool's Board of Directors, February 2011.

⁴³ Commission interview with WSI, 16 February 2011.

110. The Commission remains of the view expressed in Decision 666 that WSI is a significant competitive constraint on Cavalier Wool and that when the factual is compared to the counterfactual, that constraint will be lost.

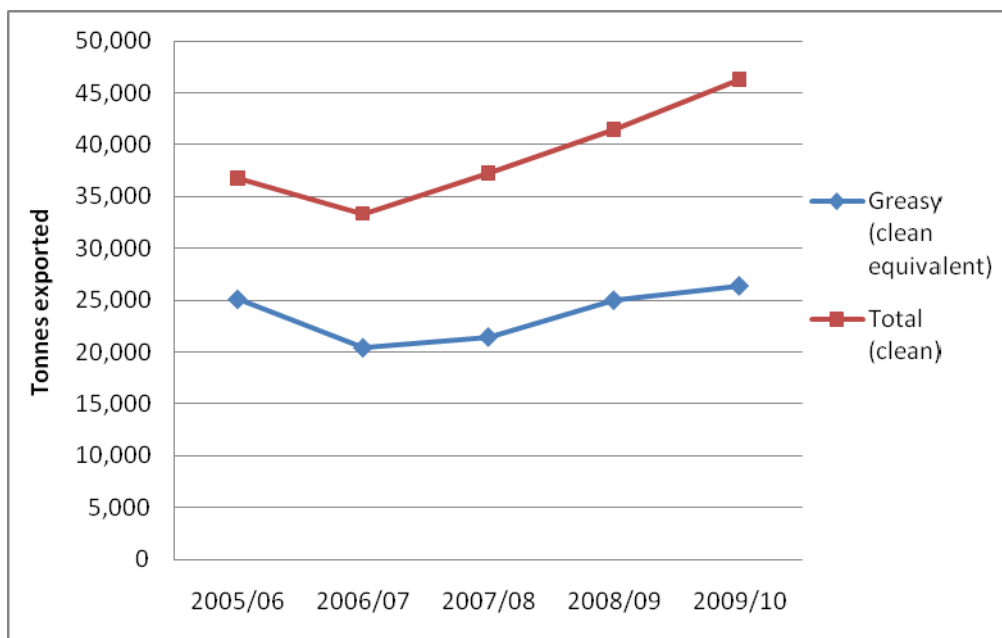
Constraint from Wool Scours in China

111. The Applicant asserts that the combined entity would continue to be constrained in the factual by the existing competition provided by overseas wool scourers, particularly in China.
112. The Applicant argues that existing competition in the form of greasy wool exports to China (where the wool would be scoured prior to downstream manufacturing operations) would be sufficient to constrain the combined entity. The Applicant states that should it seek to increase prices post-acquisition, exporters could readily switch to exporting greater proportions of greasy, rather than clean scoured, wool to China. The combined entity could lose profitable scouring business.

China's wool scouring capacity

113. China is currently the largest export market for New Zealand wool. In the year ending June 2010, about 32% of New Zealand's wool clip was exported to China. About 57% of those exports were in greasy form which implies that 18% of New Zealand's wool clip is scoured in China at present, and 14% of the wool clip is scoured in New Zealand and exported to China. Figure 4 shows that both scoured and greasy exports to China have been increasing over recent years. Discussions with industry players indicate that the boundary between greasy and scoured exports to China may be quite fluid. Some industry parties indicated that wool that has switched from clean to greasy exports to China is lost permanently, while others commented that at least some scoured volumes could be won back to New Zealand.

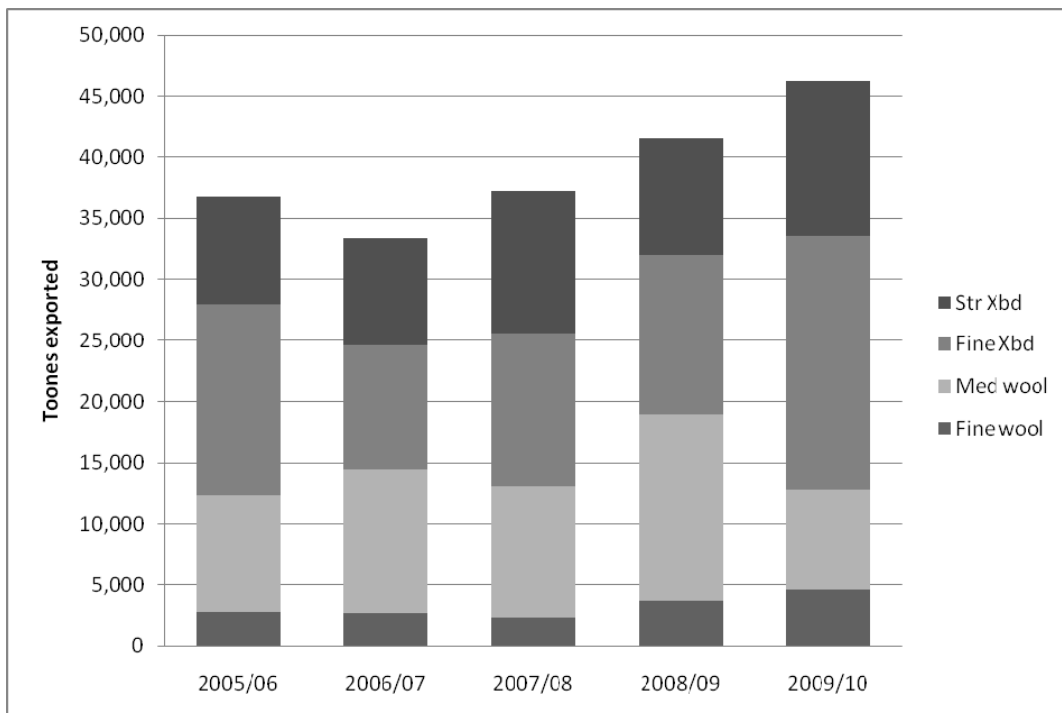
Figure 4: New Zealand Wool Exports to China over the Past Five Years⁴⁴



⁴⁴ This figure uses clean wool weights exported. One kilogram of greasy wool is equivalent to about 0.75 kilograms of clean wool. From Beef and Lamb Economic Service statistics.

114. The Chinese wool industry uses all types of wool, not just fine wools. This is illustrated in Figure 5, which shows that the amount of coarse wool being exported from New Zealand to China has been increasing over time.⁴⁵

Figure 5: Types of wool exported from New Zealand to China⁴⁶



115. Because 83% of greasy wool exports are to China, Cavalier Wool argues that these figures show that China is not merely a consumer of only fine wool.
116. As noted above, Cavalier Wool argues that the risk of exporters diverting a proportion of their present scouring volumes to China as greasy wool will act as a constraint on Cavalier Wool's pricing in the factual. Any such diversion of volumes would cost Cavalier Wool's currently profitable scouring business.⁴⁷ The Commission notes in this respect, that Cavalier Wool has taken action,
- [

]

117. There is some independent support for Cavalier Wool's view on "China."
 [(a merchant operating in New Zealand), advised that his company is now exporting more greasy wool than clean wool.⁴⁸ [] also advised that he has received several approaches from Chinese scourers with excess capacity who want to scour New Zealand wool.⁴⁹
118. Merchants advised they would be reluctant to abandon other (for example, European) profitable export customers for scoured wool, to sell greasy wool to China, even if there

⁴⁵ Note that coarse wool includes both fine and strong crossbred wool.

⁴⁶ From Beef and Lamb Economic Service statistics.

⁴⁷ In material obtained by the Commission from WSI under a section 98 notice,

[

]

⁴⁸ Commission interview []

⁴⁹ Commission interview []

were increased scouring charges in New Zealand. For example,

[], advised that for sales of some speciality wools, particularly ultrafine wools, a margin of 10%⁵⁰ can be achieved.⁵¹ However, for the bulk of export sales a margin of 2% is the rule of thumb. It would appear from these comments that there are some sales to customers that net back more to exporters than sales to China. Sellers to such customers may endure a larger increase in scouring prices before switching to simply exporting greasy wool to China (for the China market).

119. Indeed, some market participants expressed the view that some scouring price increases could be passed on to customers overseas. [] said that an increase of New Zealand scouring tariffs of up to NZ\$0.10 for example, (equivalent to a 25% increase on current prices) would not trouble international purchasers of New Zealand wool if passed on to them.⁵² He said that the major concerns of international manufacturers of wool-based products at present, is to ensure reliable long-term supply of clean New Zealand wool in the face of reduced production here. [], also stated to the Commission that a 5 to 10 cent increase in the scouring tariff would be irrelevant to the operation of international wool markets.⁵³ Further support for this view was provided by []⁵⁴
120. While the Commission notes that price increases may be able to be passed on to some customers in the short term, the Commission's view is that increased prices would most likely translate into lower margins for growers, because scoured New Zealand wool competes in international markets against wool from other countries and against other close substitutes such as cotton and nylon. If scouring prices were to rise in New Zealand post-acquisition, it is unlikely that merchants would be able to pass these price increases on to international customers to any significant degree, due to the competitive nature of wool export markets.
121. The wool export industry almost unanimously dismissed the idea of commission scouring of New Zealand wool in China, for re-export to other markets, most importantly due to a loss of control over the wool and the wool scouring process. Mr Peter Whiteman, Managing Director of Segard Masurel, advised that it has trialled scouring wool in China for re-export but now prefers to have it scoured in New Zealand for greater control and logistical reasons. Mr John Henderson of Fuhrmann stated he would not commission scour in China because that would require thorough supervision of unloading at the relevant port, delivery to the scour, and processing through the scour, and delivery back to the export port. Delay in delivery to the ultimate end use customer would also be unacceptable. The Commission interprets these views as meaning that a large New Zealand scouring price increase would be needed before scouring wool in China for resale elsewhere could be viable.
122. Futures Consultant's (Futures) submission on behalf of WSI on the Draft Determination argues that the Commission has overstated the constraint that increased greasy wool exports to China would place on the merged entity. Futures stated that the export of New Zealand greasy wool to China for scouring there is 6.6% more expensive than the

⁵⁰ Gross margin on top of the total of the exporters' wool purchase, packing, shipping, testing, agency and other costs.

⁵¹ Commission interview with []

⁵² Commission interview with []

⁵³ Commission interview with []

⁵⁴ Commission interview with []

scouring of wool in New Zealand for export to China as clean wool. If correct, this may indicate an effective constraint on the combined entity's ability to increase prices by more than this amount.

123. Futures' submission on the Draft Determination made further arguments on behalf of WSI in this respect:
- "China primarily processes fine wool rather than coarse wool."
 - "It would be profitable for the merged entity to entirely forgo scouring wool for China, if it could raise prices sufficiently for non-China volumes."
 - "The merged entity could increase its profits further if it was able to price discriminate and charge lower prices for wool destined for China."
124. As assessed above, the Commission considers that the first listed statement is incorrect. That view is based on industry organisation statistics presented above in graphical form. The evidence presented to the Commission makes it clear that China has sufficient capability and capacity to scour significant amounts of New Zealand coarse wool, and currently does so.
125. The second listed statement by Futures appears essentially correct except that it depends on what is "sufficiently". In that respect, in the section of these reasons which discusses potential allocative efficiency losses, the Commission finds that with the maximum likely price rise post-acquisition, it would not be profitable for Cavalier Wool to forgo all the volumes currently exported as greasy wool to China.
126. As discussed elsewhere, the Commission considers that moderate price discrimination in favour of Chinese sales could be possible. In the Commission's view, such price discrimination would have the likely effect of lowering potential allocative losses. This point is again discussed below and was accepted by Futures at the conference.

Conclusion on the "China" Constraint

127. On balance, the Commission's view is that the ability of exporters to divert more greasy wool to China for scouring, is unlikely in itself to sufficiently constrain the combined entity to avoid the effect of a substantial lessening of competition in the relevant wool scouring markets. The competitive pressure from China, as evidenced by [], may constrain price increases for sales to China, especially as it appears possible to price discriminate in favour of Chinese sales at least to some extent. Prices to other parties exporting to Australia or Europe, or for domestic production, could increase. However, such price increases would be capped by the possibility of entry and the ability for merchants to switch at least some of their sales from other markets to greasy wool exports to China. Alternatively, if price discrimination is not possible in the longer-term, it may be profitable for the combined entity to forgo a proportion of the wool currently scoured for China, in order to increase prices to exporters who have no real alternative to scouring in New Zealand. Again, price increases would be capped by the possibility of entry and the ability for merchants to switch at least some of their sales from other markets to greasy wool exports to China.

The Australian Experience

128. Nevertheless, the Commission does recognise that the Chinese scouring industry poses a significant long term competitive threat to the domestic industry in New Zealand.

129. The size of the Australian wool scouring industry has been severely reduced by competition from Chinese wool scours:

It has become increasingly apparent that as China, Australia's biggest wool trading partner increases its market dominance, their continued reluctance to purchase processed wool has resulted in wool processing in Australia diminishing each year. The processing of scoured wool in Australia has declined every year for the last 8 years which has resulted in a significant over capacity of wool scouring equipment in Australia. This ... has made our scouring business in Western Australia unsustainable and as a result has forced us to take this unfortunate decision (to close Jandakot's wool scouring operations in Western Australia).⁵⁵

130. The suddenness of the decline in the Australian industry mentioned by Jandakot is illustrated as follows:
- In 1995 there were 25 wool scouring sites in Australia scouring about 600,000 greasy tonnes per annum (of total Australian wool production of 730,000 tonnes per annum).
 - In 2009 there were three commercial wool scouring sites in Australia processing about 54,000 greasy tonnes per annum (of total Australian wool production of about 400,000 tonnes per annum).
131. Cavalier Wool stated that because the New Zealand scouring industry has rationalised itself by progressively removing overcapacity (unlike the situation that prevailed in Australia), it has so far survived the rise of the low cost Chinese wool scouring industry. It illustrates this by stating that at present average scouring prices in, what remains of the Australian scouring industry, are A\$0.45 per greasy kilogram. The equivalent New Zealand price for scouring comparable fine wools is NZ\$0.32.⁵⁶
132. The Commission notes that Godfrey Hirst stated that it has considered the possibility of moving its carpet manufacture (particularly its more expensive plant) to China.⁵⁷ Were scouring prices to increase too far in New Zealand, Godfrey Hirst appears to be saying there is a real risk that manufacturing may move offshore, causing an irreversible loss of volumes for New Zealand wool scourers.

Potential Entry

133. The Applicant asserts that the potential for entry would be sufficient in itself to constrain the combined entity.
134. An acquisition is unlikely to result in a substantial lessening of competition in a market if the businesses in that market continue to be subject to real constraints from the threat of market entry. The Commission's focus is on whether businesses would be able to enter the market and thereafter expand should they be given an inducement to do so, and the extent of any impediments they might encounter should they try.
135. This section examines the requirements for entry and uses the Commission's "LET" test to assess whether entry would be sufficiently likely, extensive and timely to constrain the combined entity.

Requirements for Entry

136. The likely effectiveness of the threat of new entry in preventing a substantial lessening of competition in a market following an acquisition is determined by the nature and

⁵⁵ Statement by Mr Lindsey Mitchell, Managing Director, Jandakot Wool Washing Pty Limited, January 2009.

⁵⁶ The Commission has also been informed that the scouring industry in the United Kingdom has been severely reduced in size. Currently scouring prices there are about £0.25 per kilogram.

⁵⁷ Cavalier Wool conference transcript, 4 May 2011, page 29.

effect of market conditions that impede entry. Various entry conditions are now discussed.

Production site with necessary consents

137. A key requirement for entry would be the acquisition of an appropriate site for a new scouring plant. It would necessarily need to be located at the centre of gravity of wool production in each island and be proximate to an export port (most likely Hawke's Bay in the North Island and Canterbury in the South Island). An appropriate site would require the necessary resource consents, including water supply and effluent discharge.
138. Godfrey Hirst advised the Commission that a 'green fields' site would likely have to meet higher, and therefore, more costly environmental standards than were imposed on existing wool scourers.⁵⁸ These new standards could place a new entrant at a competitive disadvantage to the incumbent merged entity.
139. Godfrey Hirst, advised that, as a result of the Acquisition it has investigated potential sites in Hawke's Bay that would allow it to re-enter wool scouring markets but it has not been able to identify a suitable site that would be large enough for a new wool scour.⁵⁹ Another prime site requirement, according to Godfrey Hirst, would be low cost access to the Hastings City Council marine sewage outfall which would provide the site with low cost effluent disposal.
140. However, in respect of potential sites in the North Island, Cavalier Wool provided the Commission with information from Mr Stephen Daysh, Director of Napier-based Environmental Management Services Ltd. Mr Daysh who has had 15 years planning experience in Hawke's Bay advised that any proposed new wool scouring operation in the region could be sited within either the Awatoto or Whakatu/Tomoana industrial areas.⁶⁰ In such a case, there would be no planning provisions or water/trade waste capacity restrictions that would create any substantive barrier to establishing such an operation in Hawke's Bay.
141. It has been suggested that it would be possible for an entrant to acquire a former meat processing site or even the site of a closed down scouring operation which would already have the relevant consents.⁶¹ The Applicant has advised there are a number of possible sites where a new entrant could locate a wool scour, including former wool scouring sites that retain the necessary consents.
142. Cavalier Wool has suggested that Oringi, the former Silver Fern Farms processing site, near Dannevirke is a possible scour site.
[
] Godfrey Hirst advised that its location makes this an unsuitable site as it is too far from the Port of Napier and effluent discharge would be problematic and treatment expensive.
143. Cavalier Wool has also identified the following sites in Hawke's Bay as being currently available and able to meet the environmental requirements to support a new scour operation:
- [].

⁵⁸ Commission interview with Godfrey Hirst, 24 February 2011.

⁵⁹ Commission interview with Godfrey Hirst, 24 February 2011.

⁶⁰ Letter to Cavalier Wool from Stephen Daysh, 28 March 2011.

⁶¹ For example, Cavalier Wool letter to the Commission, 22 February 2011.

- [].
- []

- []
- []

- []
- []

144. In the South Island, where Canterbury would be the preferred location for an entrant, Cavalier Wool advised the following:

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.⁶²

145. The Commission considers that a new entry is unlikely to face significant difficulties finding a suitable site for a scouring operation in the South Island. However, a new entrant may incur modest difficulty in locating a suitable site in the North Island, but the Commission does not consider this to be a significantly high barrier.

Scouring equipment

146. Entry into the wool scouring industry would require amongst other things, the availability of specialised plant and equipment. This equipment can be purchased new from Timaru based engineering company, ANDAR Holdings Limited and Chinese manufacturers, or potentially second-hand from overseas.
147. In the Draft Determination, the Commission noted that it had been advised that the installation of a new 3 metre wide scour line, with all associated equipment, such as a high density press, may cost about \$12-15 million. However, the evidence presented by industry parties suggested that entry could be easier, with a second-hand 2.4 metre wide line for considerably less.
148. Since then, the Commission has received the following widely disparate submissions on the costs of setting up a scour which generally appear to reflect the parties' individual interest in the outcome of the authorisation application:
- Cavalier Wool advised a new 3.0 metre scour on a leased site could be established for around \$10 million.⁶³

⁶² Cavalier Wool post-conference submission, page 26, 18 May 2011.

⁶³ Cavalier Wool post-conference submission, page 28, 18 May 2011.

- Cavalier Wool advised a second hand plant (or new Chinese 2.0 metre wide scour) with associated equipment land and buildings would cost around \$6 million.⁶⁴
 - Futures, on behalf of WSI, advised that a new 2.4 m scour operation would cost \$16.5 million.⁶⁵
 - Futures, advised that a new 3.0 metre scour operation would cost in the order of \$30 million.⁶⁶
 - Ian Caradus, on behalf of WSI, advised at the conference that a new 3.0 metre scour, with associated equipment and land would cost in the order of \$21 million.⁶⁷
 - Godfrey Hirst advised that a new 3.0 metre scour operation, with associated equipment, land and buildings would cost around \$18.8 million.⁶⁸
 - Godfrey Hirst advised that a second hand 2.4 m scour purchase, with associated equipment, land and buildings would cost around \$9.9 million.⁶⁹
149. The range of estimates given for a 3.0 metre scour operation is \$10 to \$30 million, although the Commission notes the lower figure is for an operation on a leased, rather than owned, site. Godfrey Hirst has provided the most detailed breakdown of entry costs. Its estimate is also near the midpoint (\$20 million) of the other estimates.
150. For smaller width scouring plant, the range is \$6 million to \$16.5 million. Again, Godfrey Hirst has provided the most detailed cost breakdown and its estimate of \$9.9 million is fairly close to the midpoint of the range.
151. The Commission notes that while capital costs are not generally considered a barrier to entry by economists, an understanding of entry capital costs is necessary to determine likely limits to price increases.
152. The Commission therefore considers the most likely entry costs to be approximately \$10 million for a second-hand 2.4 metre line and approximately \$20 million for a new 3 metre line.

Access to sufficient quantities of wool

153. A potential obstacle for a new entrant would be securing sufficient quantities of wool to ensure the necessary capacity utilisation for an economic wool scouring operation. It is conceivable that a new entrant could be a wool exporter, or group of exporters, perhaps combined with a downstream user such as Godfrey Hirst, such that the entrant could secure enough wool for an economic scouring operation through its own wool trading and/or wool purchasing arms. However, when this suggestion was put to wool merchants most expressed a general reluctance to enter or re-enter the scouring

⁶⁴ Cavalier Wool post-conference submission, page 28, 18 May 2011.

⁶⁵ Plant, land, buildings and resource consents for a 1 x 2.4 metre scouring operating would be \$12 million, \$1 million, \$2 million and \$1.5 million, respectively. Futures submission, page 9, 27 April 2011.

⁶⁶ Futures submission, page 9, 27 April 2011.

⁶⁷ Cavalier Authorisation conference transcript, 4 May 2011, page 32.

⁶⁸ Godfrey Hirst post-conference submission, page 33-34.

⁶⁹ Godfrey Hirst post-conference submission, page 33-34.

industry.⁷⁰ Of course this wariness could vanish should Cavalier Wool increase its scouring prices. Mr Whiteman stated:

Today, we {Segard Masurel} 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.⁷²

154. When questioned how much provocation Segard Masurel would require before it entered, Mr Whiteman responded “not much”.⁷³
155. As mentioned, other potential entrants could be a large domestic consumer of scoured wool (or a joint venture of several such consumers), who could choose to enter in order to ensure reliable supply of its input product at a competitive price. As discussed Godfrey Hirst, driven by its concerns over the acquisition, has investigated the possibility of re-entering the scouring market. Godfrey Hirst’s own demand of around [] tonnes per year in the North Island could be sufficient to allow a 2.4 metre wide scour line to operate at a capacity utilisation of up to 70%. Alternatively, there is the possibility that Godfrey Hirst could sponsor entry by guaranteeing its volumes for a certain period of time to another party.
156. Godfrey Hirst expects that it would take a minimum of 18 months for it to establish a new wool scour operation. In the meantime Godfrey Hirst has concerns that despite its contract Cavalier Wool, part owned and operated by Godfrey Hirst’s major New Zealand competitor in carpet markets, could make it very difficult for it, or any other customer who was a potential entrant, to obtain its required amounts of scoured wool in a timely manner.
157. Godfrey Hirst is also concerned that Cavalier Wool could potentially enter into long term scouring contracts with its customers during that entry period, in order to ensure they could not switch to a new entrant for at least some years (although the same strategy would be available to Godfrey Hirst as entrant). However, the Commission notes that while such long term contracts would be a barrier to Godfrey Hirst’s potential entry, the contracts could lessen any allocative inefficiency arising from the Acquisition if Cavalier Wool was required to offer lower prices in order to induce long-term commitments from merchants.

Significant economies of scale

158. The Applicant has stated that the Acquisition would result in significant economies gained by the rationalisation of the number of wool scour lines and operational sites to achieve better capacity utilisation and lower fixed and variable costs. Cavalier Wool’s lower average unit cost arising from the rationalisation would give it the ability to act strategically and lower prices in response to entry. An entrant could face the significant risk of the under utilisation of its assets.
159. Cavalier Wool in its Application states that its combined administration and scour operating expenses would be reduced by [] in the North Island and [] in the

⁷⁰ Until relatively recently the Timaru wool scour was 25% owned by each of the wool exporters Fuhrmann and G Modiano who, in 2007, sold their shares to Cavalier Wool which now owns 100% of that plant. It was reported to the Commission that this exit by wool merchants was at the expense of capital losses.

⁷¹ For example, Commission interview with

[].

⁷² Cavalier Authorisation conference transcript, 4 May 2011, page 26.

⁷³ Cavalier Wool authorisation conference transcript, 4 May 2011, page 20.

South Island after the acquisition. Therefore, it is likely that, post acquisition, Cavalier Wool's costs would be significantly lower than the present industry cost structure. Even if an entrant was able to enter on the same scale as a current industry competitor, it would initially face a significant cost disadvantage in doing so.

Entry in both islands

160. Godfrey Hirst has argued that simultaneous entry would be required in both islands. An entrant in one island could expect to find its customers discriminated against by Cavalier Wool in the other island.
161. In response, Cavalier Wool submitted that the question of entry should not be considered in isolation from the likely entrants and their scouring needs. For instance, the most likely potential entrant, Godfrey Hirst has recently consolidated its operations in the North Island and would only need to enter in the North Island.
162. In the Commission's view, there is no particular reason why an entrant would have to enter both islands simultaneously, if at all. Wool scouring operations are run as standalone units and there do not appear to be any large efficiency gains that would be available to a two island operation.
163. Moreover, given one of the main requirements for entry is the availability of sufficient wool to ensure economic capacity utilisation of the scouring plant, it is likely that entry by merchants or downstream customers would be more likely to occur in the particular island where the largest part of their wool business was located. If Cavalier Wool did discriminate against customers of the new entrant, this would likely spur further entry. In the Commission's view such discrimination would not be a profit maximising strategy for Cavalier Wool.

The LET Test

164. In order for market entry to be a sufficient constraint, entry of new participants in response to a price increase or other manifestation of market power must be:
- likely in commercial terms;
 - sufficient in extent to cause market participants to react in a significant manner; and
 - timely, that is, feasible within two years from the point at which market power is first exercised.

Likelihood

165. In order to be a constraint on market participants, entry must be likely in commercial terms. An economically rational firm will be unlikely to enter a market unless it has a reasonable prospect of achieving a satisfactory return on investment, including an allowance for any risks involved.
166. The Commission notes that there is now a long history of exit and rationalisation in the wool scouring industry. Moreover, sheep numbers have declined substantially in recent years although there are recent indications, as submitted by WSI, that the size of the flock may have stabilised or, indeed, be increasing.⁷⁴
167. Wool merchants, as potential entrants, did not generally express a desire to enter or re-enter wool scouring markets. The reasons given were the decline in the wool clip

⁷⁴ WSI post-conference submission, Appendix 1, 10 May 2011.

available, the high capital costs, and the fact that wool scouring no longer formed a core business for many merchants and in the past had required exit by them with capital loss.

168. However, as noted, Segard Masurel indicated that there was the potential for it to enter should Cavalier Wool sufficiently provoke it to do so.⁷⁵ The Commission also has been informed that []. Also, Wool Equities Ltd has publicly announced its interest in acquiring WSI should the opportunity arise.⁷⁶ More generally, Cavalier Wool has argued that given the considerable interest in WSI's sale, there appears to be a number of parties that are "eager to be involved in the sector if the opportunity presents itself".⁷⁷
169. The Commission considers that a potential entrant in the North Island would be Godfrey Hirst which has experience in wool scouring and has strong concerns about the Acquisition and the potential effect on its downstream carpet business. However, Godfrey Hirst has contracted with Cavalier Wool to be its preferred supplier for wool scouring services for all wool acquired by it in New Zealand [].
[] Godfrey Hirst also has concerns about non-price discrimination by Cavalier Wool []. Thus, the contract provides protection to Godfrey Hirst against its concerns, which appears to lessen the attractiveness of entry to Godfrey Hirst.
170. When assessing the likelihood of entry, an important factor is whether an entrant could achieve a sufficient return on capital, assuming it was able to secure the requisite wool volumes. As discussed above, a new entrant would be competing against the incumbent's economies of scale, and even with a potential scouring price rise may find it difficult to achieve a sufficient return on capital to prompt entry.
171. Futures, in its submission on the Draft Determination, provided an entry model for a 2.4 metre scour operation. It estimates that a 40% price increase would be required before entry was profitable, assuming a required rate of return of 15% post-tax.
172. In response, Cavalier Wool has addressed a number of concerns it has with Futures entry model, namely:
- Management fees: Futures included an extra layer of management and governance costs, which Cavalier Wool argues it has already accounted for. For WSI, Futures has suggested that the Chief Executive of an entrant would be required, in addition to a General Manager, as the former would spend most of his or her time overseas seeing clients. Cavalier Wool does not consider that would be the case for an entrant commission scour business, whose major customers would of course be New Zealand-based merchants and processors.
 - Wages and salaries: Futures assumed higher salaries in its model than did Cavalier Wool. However, Cavalier Wool stated that it has used the actual salaries and wages it pays currently its staff and multiplied this by the number of position required to give the most accurate amount.

⁷⁵ Cavalier Wool authorisation conference transcript, 4 May 2011, page 26.

⁷⁶ NZ Farmers Weekly, 23 May 2011.

⁷⁷ Cavalier Wool post-conference submission, para 4.2(e).

- Return on capital: Cavalier Wool does not consider the post-tax return of 15% that was suggested by Futures to be appropriate because, in Cavalier Wool's view, entry would of necessity be backed by commitments of wool volumes. Nevertheless, NERA on Cavalier Wool's behalf has used this figure in its entry model in order to take a conservative stance.
 - Plant costs: As noted above, Cavalier Wool considers a 2.4 metre scouring plant and buildings could be established for \$7 million as opposed to Futures' suggestion of \$16.5 million.
 - Detergent and gas/coal costs: Unlike Futures which has estimated these costs, Cavalier Wool has calculated the amount by using its own current figures for detergent and coal/gas costs.
173. NERA, on behalf of Cavalier Wool, used these adjusted amounts in its entry model which showed that an entrant could profitably enter without any price increase.
174. Godfrey Hirst has raised a number of additional issues in respect of entry:⁷⁸
- Godfrey Hirst has been unable to locate any second hand wool scours that would enable a new entrant to cheaply enter the New Zealand wool scouring market.⁷⁹
 - A cheap 2.0 metre Chinese built plant is not a viable alternative due to inferior efficiency and reliability.
 - The cost difference between new 3.0 metre and 2.4 metre wide scours manufactured by ANDAR Holdings Ltd, has been estimated at around 15% so it is unlikely any new entrant would elect to install a 2.4 metre plant when the more efficient 3.0 metre version is so close in price.
 - For a 3.0 metre scour greater committed volumes would be necessary to stimulate entry.
175. The Commission considers Godfrey Hirst's estimate of \$9.9 million for entry with a 2.4 metre scour line to be the most robust in this instance (although we note its concerns in relation to availability). Based on its extensive experience in the industry, Godfrey Hirst has made detailed line-by-line cost estimates, including costs of associated equipment, infrastructure and installation. Godfrey Hirst's estimate is higher than Cavalier Wool's estimate of \$6 million, but lower than WSI's estimate of \$16.5 million.
176. As noted, NERA has modelled profitable entry without any price increase in the factual. The Commission has considered NERA's model, and while it is satisfied that the operating and administration costs are representative of what an entrant's might be, it examined a scenario with the upfront capital costs significantly higher.
177. The Commission has adjusted NERA's model to include a range of entry costs between \$9.9 and \$16.5 million. The Commission considers that if an entrant achieved the requisite wool volumes an initial conclusion from the adjusted model would be that entry could be profitable with a price increase of between 2% and 15%.
178. The Commission also notes that currently WSI is able to compete and make a profit with its single 3.0 metre scour lines in each island. Cavalier Wool⁸⁰ advised that WSI's

⁷⁸ Godfrey Hirst post-conference submission.

⁷⁹ While Godfrey Hirst has not been able to locate a suitable second hand plant, it has provided estimates, based on recent sales, of the cost of entry with a second had 2.4 metre scour. As mentioned above this cost is \$9.9 million.

scouring division made a profit over both islands of \$4 million in the 2009 financial year and \$8 million in the 2010 financial year. This suggests that a new entrant could be profitable if it had sufficient wool volumes, similar cost structures, and could achieve the current market price.

179. Nevertheless, as a result of the difficulties faced by an entrant as discussed above, the Commission considers that entry is unlikely without an increase in price. As the adjusted NERA model indicates, an entry-supporting price increase would likely be between 2% and 15%, the Commission is not satisfied that, within this range, entry would not occur before prices increased by at least 5%.
180. However, as discussed below, the threat of entry provides a cap on the levels of detriment that would arise in the factual.

Extent

181. If it is to constrain market participants, then the threat of entry must be at a level and spread of sales that are likely to cause market participants to react in a significant manner.
182. A likely minimum commercial scale of entry would be one 2.4 metre wide scour line, which would likely be sufficient to cause the incumbent to react in terms of reducing or capping its prices so other parties do not have the incentive to enter. Illustrative of such a potential effect are Cavalier Wool's two Hawke's Bay 2.4 metre wide scour lines *each* of which process approximately [] tonnes of greasy wool per annum, or about [] of the North Island clip.

Timely

183. To effectively constrain the exercise of market power, entry must also be timely. If it is to alleviate concerns about a substantial lessening of competition, entry must be feasible within a reasonably short timeframe, which the Commission typically considers to be two years, from the point in which market power is exercised.
184. While the Commission notes the issues surrounding resource consents, it is likely that if entry occurred it would be within the relevant two year timeframe.

Conclusion on "LET" test

185. The Commission considers that entry fails the LET test as the Commission is not satisfied that entry would occur without at least a 5-10% increase in scouring prices.

Conclusion on Potential Competition

186. The Commission is of the view that potential competition is unlikely to occur within a two year timeframe to an extent that would be sufficient to constrain the combined entity and prevent the effect of a substantial lessening of competition in the relevant markets.

Conclusion on North and South Island Wool Scouring Markets

187. As noted above:
- the proposed Acquisition would remove Cavalier Wool's nearest existing competitor – WSI;

⁸⁰ The Commission had to rely on Cavalier Wool's profit estimation in the absence of information provided by WSI.

[].

- the ability for exporters to switch to greasy exports to China provides only a moderate constraint on Cavalier Wool in the factual; and
- the potential for new entry into the scouring market provides only a moderate constraint on Cavalier Wool in the factual in that entry would only be likely to occur with a price increase of at least 5-10%.

188. Therefore, the Commission's conclusion is that it is not satisfied that the Acquisition will not have, or would not be likely to have, the effect of substantially lessening competition in both the North and South Island markets for the supply of wool scouring services.

EFFECTS OF THE ACQUISITION IN THE WOOL GREASE MARKET

189. The proposed Acquisition would involve horizontal aggregation of market shares in the North and South Island wool scouring markets. Additionally, in the factual the Applicant would increase its shareholding in the LTC from 50% to 100%.

190. While there has been a submission by Godfrey Hirst⁸¹ that Cavalier Wool's 100% ownership of the LTC in the factual would be a barrier to entry,⁸² the Commission has been informed by Cavalier Wool (which has been confirmed by most parties interviewed by the Commission including WSI⁸³) that there is strong international demand for wool grease from New Zealand. The Commission has noted the recent statement of Dishman Veenendaal:⁸⁴

Due to a significant increase in wool grease prices, we are being forced to increase our Cholesterol prices significantly to the market.

Wool grease is the major raw material ingredient which is used in the manufacture of Cholesterol and thus very heavily determines the cost. There has been a significant increase in the price of wool grease over the past year and this factor has impacted the profitability of our Cholesterol business. Therefore, we are being forced to increase our prices significantly to the market.

There are a number of reasons for the sharp fall in the amount of wool grease which is available to the market and which has resulted in a significant increase in raw materials prices. The decreasing usage of wool in the clothing industry which has been replaced by cotton has resulted in less wool grease being made for the market. Furthermore, the substantial ...demand for wool grease for the manufacture of Cholesterol for use in the production of Vitamins is another reason for the decrease in availability. The number of sheep has also decreased and this is another contributory factor.

191. Therefore, the Commission considers that an entrant into scouring markets would have no difficulty selling its wool grease by-product at favourable prices by supplying the international demand mentioned above, and, as such, any exclusion from the LTC's expertise and intellectual property would not be an onerous condition that would adversely affect the potential entrant's ability to enter the relevant wool scouring markets.

192. In addition, Cavalier Wool, in response to Godfrey Hirst, submitted that it would not exclude an entrant from membership of the LTC cooperative because an excluded party would provide competition to the LTC in international wool grease markets. Therefore, the Commission does not consider that any increase in market power arising from the aggregation of market share in the relevant wool grease market would have the effect or

⁸¹ Letter from Chapman Tripp dated 4 March 2011, paragraph 9.

⁸² Given, LTC's years of experience in wool grease trading and extensive intellectual property.

⁸³ For example, file note of Commission Kaputone site visit, 16 February 2011.

⁸⁴ Dishman Veenendaal is a Netherlands-based group of companies offering services to the pharmaceutical industry.

likely effect of substantially lessening competition in that market. As a result the Commission does not propose to consider the national wool grease market further in this determination.

193. Futures on behalf of WSI, noted the low barriers to enter the wool grease market that would be faced by any potential entrant. Futures also noted that the LTC would be unlikely to discriminate against a new supplier of wool grease as it would undermine the LTC's single desk seller advantage. Futures concluded that there was unlikely to be a substantial lessening of competition in the national market for the purchase and supply of wool grease.

Conclusion on National Wool Grease Market

194. The Commission is satisfied that this is the case and notes that no party other than Godfrey Hirst has raised competition concerns about this market. Therefore, the Commission is satisfied that the Acquisition will not have, or would not be likely to have, the effect of substantially lessening competition in the national wool grease market.

EFFECTS OF THE ACQUISITION IN DOWNSTREAM CARPET MARKETS

195. In the Draft Determination, the Commission only analysed competition in markets for the supply of wool scouring services in the North and South Islands. The Commission received submissions on the Draft Determination and at its conference that the Commission should also consider competition effects in other markets in which Cavalier Bremworth, a 50% shareholder of Cavalier Wool, is a participant. Cavalier Bremworth is a wool spinner and wool and synthetic carpet maker and is associated with Cavalier Wool.⁸⁵ Cavalier Bremworth competes with Godfrey Hirst and other carpet makers in wholesale carpet markets in New Zealand and offshore.

Submissions on Downstream Carpet Markets

196. Godfrey Hirst submitted as follows:
- By virtue of being vertically integrated and associated with Cavalier Bremworth, Cavalier Wool would be able to leverage its market power in relation to wool scouring services into downstream markets, especially those for the manufacturing of carpets.
 - There is no evidence that the presence of Cavalier Wool's two minority shareholders would provide an effective check on its ability to foreclose downstream carpet markets. These two shareholders could exit as readily as they have entered. Moreover, the shareholders' representatives on the Board of Cavalier Wool may not be able to identify such behaviour by its Management. The two shareholders do not have a history of operating scours and would be unlikely to take an interest in the technical aspects of scour operation.
 - The impact of the Acquisition in Australia is also relevant. Although the Act defines a "market" as a "market in New Zealand", s 36A of the Commerce Act does recognise that behaviour constraints on the exercise of trans-Tasman market power are a relevant consideration. In effect, this Acquisition is tantamount to an exercise of such market power. In addition, both the Australian and New Zealand Governments have made a commitment to harmonising competition law in each country.

⁸⁵ See analysis in the Association Section.

- The Scouring Agreement between Cavalier Wool and Godfrey Hirst, which has the potential to protect Godfrey Hirst from sabotage by Cavalier Wool on behalf of Cavalier Bremworth, []].
- Such sabotage could involve Cavalier Wool increasing the costs of Cavalier Bremworth's downstream competitors, reducing their operating efficiencies and reducing the quality of the product offered to downstream competitors through:
 - [];
 - []]; and
 - []].
- Competition in the downstream markets and wool substitutes do not reduce Cavalier Wool's incentives to sabotage. While Cavalier Wool may have no ability to increase downstream carpet prices without causing a shift in demand to other products, it could increase the profits of Cavalier Bremworth by allowing it to gain market share through sabotage. This would not encourage downstream customers to switch to imported woollen and synthetic carpets.

197. Cavalier Wool submitted as follows:

- Cavalier Wool's [] scouring contract with Godfrey Hirst removes its ability to discriminate against Godfrey Hirst. This contract specifies:
 - []]; and
 - []].
- Cavalier Wool has no incentive to discriminate against Godfrey Hirst which is one of its most high volume customers.⁸⁶ Cavalier Wool is sensitive to potential volume loss as is shown by NERA's critical loss analysis. Cavalier Wool paid a substantial sum to acquire Godfrey Hirst's scours in order to achieve economies of scale, which resulted in significant benefits. There is no reason to believe that Cavalier Wool would put that volume at risk in the factual.
- Foreclosure by Cavalier Wool on behalf of Cavalier Bremworth would lead to a trade-off between higher profit for Cavalier Bremworth and lower profit for Cavalier Wool. The present minority shareholders in Cavalier Wool would have no incentive to agree to Cavalier Wool penalising Godfrey Hirst or other carpet makers in downstream markets. ACC and Direct Capital would only share the losses of such a strategy and none of the profits. Cavalier Wool submitted that if the two wished to exit their shareholding, any competition issues would be able to be addressed under s 47 of the Act at that time.

⁸⁶ The Commission notes that wool destined for Godfrey Hirst comprises about [] of Cavalier Wool's scoured wool throughput.

- There are certain features of carpet markets which make input foreclosure unlikely. These include existing domestic competition from synthetic and wool carpets, imports and the countervailing power of retailers. If Cavalier Wool did adopt a strategy to damage Godfrey Hirst on behalf of Cavalier Bremworth, Godfrey Hirst could expand production of synthetic carpets and retailers could substitute to non-Cavalier Bremworth products.
- It is incorrect that Cavalier Wool could harm Godfrey Hirst without reducing Godfrey Hirst's demand for Cavalier Wool's services. In such a case, the implicit degree of sabotage would be so small as to be irrelevant – if the sabotage would not affect Godfrey Hirst's demand for Cavalier Wool's scouring services, then it could not have a material effect on Godfrey Hirst's business. Similarly, this also means there would not be a material diversion of sales from Godfrey Hirst to Cavalier Bremworth.

The Commission's Analysis

Preliminary matters

198. The Commission does not consider that there would be vertical effects in wool spinning markets in New Zealand. While Cavalier Bremworth does carry out wool spinning operations, these are only for its own carpet production purposes. Godfrey Hirst also produces its own carpet yarn and, following the closure of its earthquake affected Christchurch plant, purchases some yarn from other suppliers, for example, Summit Wool Spinners Limited (Summit). Summit, when approached on the matter by the Commission, stated that it had no concerns over price and non price behaviour by Cavalier Wool in the factual in scouring markets affecting competition in yarn markets. It stated it did not compete for the sale of yarn with Cavalier Bremworth.

[

]. The Commission has therefore assessed vertical effects in the carpet market below.

199. Nor does the Commission consider there is any merit in the suggestion that the Commission should take account of vertical effects in Australian carpet markets. The Commission has previously held that "...detriments may only be found in the market or markets where competition is lessened..."⁸⁷ Section 3(1A) of the Act makes it clear that references to markets are references to a market in New Zealand.⁸⁸ The courts have extended the coverage of the Act to conduct outside of New Zealand to the extent that it affects a market in New Zealand. If vertical impacts do amount to a substantial lessening of competition in the New Zealand carpet market, only the detriments from that lessening of competition are relevant.
200. Vertical acquisitions are those that involve the merger of businesses operating at different functional market levels in the production of a particular good or service. To the extent that Cavalier Wool (operating in scouring markets) and Cavalier Bremworth (operating in downstream carpet markets) are associated parties, the proposed scouring

⁸⁷ Decision No 511, *Air New Zealand Limited and Qantas Airways Limited*, 23 October 2003 at {897} This was confirmed by Justice Wilson in *New Zealand Bus Ltd v Commerce Commission* {2008} 3 NZLR 433 (CA) at {271}... "As the Commission correctly held...all benefits must be taken into account whereas only detriments in a market where competition is lessened will be relevant."

⁸⁸ The High Court recently re-affirmed such an approach in *Commerce Commission v Visy Board (NZ) Limited & Ors*, 20 April 2011, Heath J, HC Auckland, CIV-2007-404-7237; {40} to {48}.

merger could raise the potential for adverse vertical effects in the downstream carpet markets.

201. As discussed previously, the Commission considers that Cavalier Bremworth is associated with the Applicant. The Commission also notes that Cavalier Bremworth operates Cavalier Wool's scouring operation. The Commission therefore cannot be satisfied with NERA's submission that the presence of Direct Capital and ACC as shareholders in Cavalier Wool could prevent foreclosure when it is profitable for Cavalier Bremworth but not in Direct Capital or ACC's best interests. For the analysis in this section the Commission therefore assumes that Cavalier Wool is controlled by Cavalier Bremworth.
202. As discussed below, Godfrey Hirst is party to a scouring agreement with Cavalier Wool. Although there was some dispute during the conference as to the terms of the contract, it is clear that prices between the parties are determined for at least []. The Commission therefore considers that during this [] period the contract provides Godfrey Hirst with protection against:
- [];
 - []; and
 - [].
203. The Commission therefore considers this contract would limit the ability of Cavalier Wool to use blatant price discrimination (price increases) and/or non price discrimination (low quality, delays in scouring etc) to foreclose its rival Godfrey Hirst for a period of [].
204. However, the Commission also notes that Godfrey Hirst has raised concerns that the contract may not provide adequate protection against non price discrimination for the remaining contractual period of [] and that price and/or non price discrimination will be possible after the contract has expired. The Commission therefore also considers these possibilities.
205. The Commission considers that non-price discrimination by Cavalier Wool would have the potential to have a significantly greater impact on Godfrey Hirst (for example, delays in delivery affecting production) than a simple increase in the price of scouring, which is a relatively small component of the cost of producing carpet. That is, non-price effects could be higher than those of any conceivable scouring price increases.
206. The Commission's view is that any attempt to raise Godfrey Hirst's costs either by non-price or price discrimination will be limited by entry or the threat of entry. If discrimination was attempted, Godfrey Hirst could threaten to either enter or sponsor entry into the scouring market. As outlined in the allocative efficiency section, the Commission considers that the maximum likely cost increase that Cavalier Wool could impose on Godfrey Hirst without triggering entry would be about 15%. Such an increase would only translate to [] of the carpet final carpet price.⁸⁹ Therefore, such an increase in Godfrey Hirst's scouring costs through price or non-price discrimination would be unlikely to have any significant impact on its ability to compete with Cavalier Bremworth in the carpet market. Competition in the downstream market for the supply of carpet in New Zealand with or without attempted foreclosure is therefore likely to be the same as in the counterfactual.

⁸⁹ One kilogram of wool produces about [] worth of carpet. Commission interview with Godfrey Hirst, 24 February 2011.

207. The Commission is also of the view that if entry to the scouring market did occur it would be costly to Cavalier Wool as it would lead to:
- a decrease in scouring volumes (both from the loss of Godfrey Hirst's volumes and from merchants switching to the entrant);
 - a decrease in margins through the loss of economies of scale; and
 - the potential for a decrease in scouring prices (from the increase in competition).
208. The Commission also notes that even if Cavalier Wool could be successful in foreclosing Godfrey Hirst, it is unlikely this would cause a significant lessening of competition in the market for the supply of carpet in New Zealand due to the competitiveness of this market. Along with Godfrey Hirst, a major competitor, there are also fringe market participants. In addition imports are significant as is competition from synthetic carpets. Cavalier Wool estimates the volume of the New Zealand carpet market to be about 2.2 million broadloom metres per annum. In this market, sales figures provided to the Commission by both Cavalier Bremworth and Godfrey Hirst indicate the two firms have approximately equal market shares.⁹⁰ Imports, according to Statistics New Zealand were 0.6 million broadloom metres per annum and have been increasing in volume in recent years.
209. This is supported by the Commission's findings in Decision 628:

Whilst entry through establishing a manufacturing plant is unlikely, the Commission considers that barriers to de novo entry by an importer are low. Supply is readily available and adaptations to colour, if needed, are readily achieved. Requirements such as stock and warehousing are also readily available and the sunk costs involved in entry are minimal. Accordingly, the Commission concludes that barriers to entry by importation are low and that further entry is likely...

The Commission is satisfied that the barriers to entering the carpet market are low and that the threat of entry by importers would likely impose a significant degree of competitive pressure on the combined entity.⁹¹

Conclusion on Downstream Carpet Markets

210. The Commission is satisfied that the Acquisition will not have, or would not be likely to have, the effect of substantially lessening competition in downstream carpet markets due to the following reasons:
- The scouring agreement with Cavalier Wool protects Godfrey Hirst from both price and non price discrimination for [] years.
 - Godfrey Hirst would likely enter the scouring market before non-price discrimination reached such an extent that competition in the market for the supply of carpet in New Zealand was affected. Therefore, the Commission is satisfied that Cavalier Bremworth would be constrained from raising carpet prices significantly in the factual. The corollary of this is that Cavalier Wool would lack a strong profit incentive to discriminate against Godfrey Hirst as such discrimination would not allow a significant increase in carpet prices.

⁹⁰ Godfrey Hirst and Cavalier Bremworth both advised the Commission that their carpet sales in New Zealand were about [] per annum.

⁹¹ Commerce Commission Decision 628, paragraph 86 and 87.

- The competitive nature of the carpet market due to the availability of imports would not allow Cavalier Bremworth to raise carpet prices significantly in the event foreclosure was successful.

PUBLIC BENEFITS AND DETRIMENTS

211. As the Commission has concluded that it is not satisfied at this stage in terms of s 67(3)(a) of the Act, it must now consider whether it can be satisfied that the proposed Acquisition will result or be likely to result in such a benefit to the public that it should be authorised in terms of s 67(3)(b) of the Act.
212. The authorisation procedures require the Commission to identify and weigh the detriments likely to flow from the Acquisition and to balance those against the identified public benefits likely to flow from the acquisition as a whole. The Commission considers that within the relevant markets, a public benefit is any gain, and a detriment is any loss, to the public of New Zealand, with an emphasis on gains and losses being measured in terms of economic efficiency. In contrast, changes in the distribution of income, where one group gains while another simultaneously loses, are generally not included because a change in efficiency is not involved.
213. As noted in *Ravensdown Corporation Limited v Commerce Commission*,⁹² “the test of likelihood is to be applied at the end of the process.” Only likely detriments and likely benefits can be taken into account by the Commission in this assessment. It was faintly suggested by Castalia Strategic Advisors (Castalia)⁹³ that there are two possible methods of calculating benefits and detriments; a binary assessment of likelihood that makes no adjustment for probability, and “an expected value approach”. The former is the statutory “more likely than not” approach, whereby only those detriments and benefits which overcome that hurdle are considered further in the assessment. The latter reflects “an economic or mathematical approximation”, whereby every detriment or benefit would be assessed, but with values reflecting both the probability of their occurring and the impact if they do.
214. The latter would more easily accord with the definition of “effects” in the Resource Management Act 1991, but is not, however, the test of “likely” impacts under the Commerce Act (a fact Castalia appear to accept insofar as it acknowledges it would be a “switch” and that the former describes “the legal test as currently applied”).

Quantification

215. The Commission is also mindful of the observations of Richardson J in *Telecom Corporation of New Zealand Ltd v Commerce Commission*,⁹⁴ on the Commission’s responsibility to attempt to quantify benefits and detriments to the extent that it is feasible, rather than rely on purely intuitive judgement. This is not to say that only those gains and losses which can be measured in dollar terms are to be included in the assessment; those of an intangible nature, which are not readily measured in monetary terms, must also be assessed.
216. The Commission is cognisant of the fact, however, that quantification is simply a tool that enhances the Commission’s final qualitative judgement. The estimates provided below are by their very nature only approximations of the implied public detriments and

⁹² High Court Wellington, AP 168/96, 9 December 1996.

⁹³ Castalia submission, page 27, 18 May 2011.

⁹⁴ {1992} 3 NZLR 429.

benefits. The Commission does not rely on a rigid balancing of the quantified detriments and benefits without applying a wider qualitative analysis.

217. Cavalier Wool's Application used a five year time period and a 10% discount rate to estimate the net present value (NPV) detriments and benefits. This approach is broadly consistent with approaches previously taken by the Commission. Other submitters have not challenged this framework for a quantified assessment in this instance.
218. The use of the five year time period and the 10% discount rate recognises the fact that most detriments and benefits become increasingly less certain over time. Beyond five years it is very difficult to forecast the effects of the proposed acquisition. While the Commission considers this framework to be the most pragmatic and appropriate in this case, there are two specific issues in respect of quantification that this approach may not address:
- Detriments and benefits beyond five years: As noted, the Commission considers that prediction of merger effects beyond five years is particularly troublesome. However, the uncertainty is unlikely to be so stark that detriments and benefits reduce to zero after five years. Of course, if merger effects do continue beyond five years, the proportion of detriments to benefits is likely to stay roughly the same. Therefore, the five year timeframe can be seen as a representative snapshot of the lifetime merger effects. However, this representation may be skewed if: (a) some benefits take place upfront, rather than over an extended period, and thus get excessive weighting in a five year period; or (b) some benefits do not take place for a number of years and thus get insufficient weighting in a five year period. To address this, the Commission has also undertaken a 20 year timeframe analysis of the detriments and benefits, using a 10% discount rate, as a cross check on its five year analysis (Appendix 2). These results did not alter the Commission's final determination in this case.
 - Possible inconsistencies in the time periods used: In the Commission's analysis below, the estimated values of the sales of the Kaputone and Whakatu scour sites are included as benefits as they would occur within the five year period, even though the sale price is the market estimation of the life time value of those sites. This contrasts with other benefits and detriments where the Commission has explicitly only looked at five years. The Commission considers the benefit from the sale of land and the costs of upfront capital expenditure to differ from some of the other estimates as once these transactions take place that benefit or detriment is certain. That is, it is not dependent on the ongoing success or otherwise of the proposed acquisition. Nevertheless, for completeness, the Commission has undertaken an additional analysis which includes an annual rental return on the sites, rather than their sale prices (Appendix 3). These results did not alter the Commission's final determination.

DETRIMENTS

219. The Applicant has stated that, given the constraints imposed by the continued growth of the Chinese wool scouring industry, it believes that the proposed Acquisition would result in little if any detriment.⁹⁵ However, it has assessed the level of detriment which "could be said to arise if the loss of WSI as a competitive constraint was considered to be significant by the Commission."

⁹⁵ At paragraph 19.1 of the Application.

220. In undertaking this assessment the Applicant has used the categories normally used for this purpose by the Commission – loss of allocative efficiency, loss of productive efficiency and loss of dynamic efficiency.

Loss of Allocative Efficiency

221. In general, when the price of a product increases (for instance, because of a loss of competition as a result of a merger), demand for that product will fall as some consumers switch to alternative products which meet their requirements in a less satisfactory way or are more costly to produce than the product they replace. In effect the country's resources are allocated less efficiently. The size of the loss of allocative efficiency depends primarily on the ability and incentive (that is, it is profit maximising) of the firm to increase prices post-acquisition. That ability and incentive depends on the extent that demand for the product declines with an increase in price (the elasticity of demand).

222. The Commission received the estimates shown in the Table below, of loss of allocative efficiencies that would arise from the acquisition. These were submitted by:

- NERA on behalf of the Applicant;
- Castalia on behalf of Godfrey Hirst; and
- Futures on behalf of WSI.

Table 1: Summary of Submissions on Allocative Efficiency⁹⁶

	NERA		Castalia	Futures	
Demand elasticity range	-0.5	-1.0	-1.1	-0.05	-1.0
Price increase range	1% to 10%	1% to 10%	20%	10% to 20%	10% to 20%
5-year net present value	\$0.70 to \$7.41 million	\$1.39 to \$14.82 million	\$31.29 million	[]	[]

223. In the Draft Determination, the Commission modelled allocative efficiency losses across a price increase range of 5% to 20% and demand elasticity between -0.05 to -1.0. In submissions up to the Draft Determination, no opponent had suggested price increase greater than 20%.

224. The Commission also posited a stepped demand curve that would alter the composition of allocative efficiency losses. For example, volumes of scoured wool to China could switch to greasy exports in the face of a relatively small price increase (because China has a scouring industry), but prices in other export markets could increase significantly

⁹⁶ The submissions make different assumptions about the quantity of wool scoured. Therefore there may be differences in the deadweight losses even when both the demand elasticity and price increase are similar across submissions.

without greatly affecting the volumes sold (because there was no local scouring industry in those markets).

Applicant's response

225. NERA, on behalf of Cavalier Wool have responded with the following points:

- A 20% price increase would be implausible because the “China constraint” means that it would be profitable for merchants to switch from clean to greasy wool exports to China at much lower price increases. NERA’s critical loss analysis showed that a 10% price rise would not be profitable if the merged entity lost sale volumes of more than [] million kilograms in the North Island or [] million kilograms in the South Island. In 2009/10, approximately 18,300 tonnes of wool were exported to China in scoured form. If a 10% price increase led to the loss of those volumes it would not be profitable.
- WSI only accounts for a small share of the contestable commission scouring volumes and is therefore a weak constraint. Its removal from the market will not significantly alter Cavalier Wool’s ability to increase prices.
- Cavalier Wool’s prices in real terms, have fallen since at least 2006/07, during a time when significant industry rationalisation and consolidation of market share has occurred. NERA argues it is therefore implausible that the removal of WSI would allow Cavalier Wool to increase its prices by 10-20%, when in fact prices in real terms have been decreasing even during periods of rationalisation.
- Cavalier Wool’s variable costs would likely be reduced in the factual and this effect would be likely to reduce the extent of post-merger price increases. NERA have calculated that with a 50% pass-through of variable cost reductions, proposed post-merger price increases of 10% would be reduced to 8% in the North Island and 6% in the South Island, once variable cost reductions are netted off.
- Declining sheep numbers in the future will reduce the demand for scouring, thereby moderating any price increases in the factual. As is noted elsewhere, however, the future levels of sheep number in New Zealand are indeterminate.⁹⁷

Response of opponents to the merger

226. In its post-conference submission, Castalia, on behalf of Godfrey Hirst argued the following:

In my view, different demand elasticities are largely irrelevant to the calculation of the likely allocative detriment—i.e. the size of the welfare triangle lost due to the movement along the demand curve—because a plausible reduction in quantity demanded is likely to come solely from scouring of wool destined for China.⁹⁸

227. Castalia recognises that different customer groups (clean wool for domestic processing, clean wool exported to China and clean wool exported to other export markets which do not have a local scouring industry) are likely to respond differently to price increases. Clean wool destined for China is likely to be most sensitive to price increases because scouring in China, rather than in New Zealand, is a realistic possibility. Using a demand elasticity of -1.1 for wool destined to China, Castalia estimates that Cavalier

⁹⁷ The Commission considers an assumption of flat wool production levels in New Zealand over the next five years to be the most appropriate in this instance.

⁹⁸ Godfrey Hirst post-conference submission 20 May 2011.

Wool could profitably increase prices by 20%, even taking into account a reduction in New Zealand scouring of about 27,000 tonnes per year.

228. Castalia concludes:

On the basis of this calculation, the total allocative inefficiency arising from the acquisition would be \$31.29 million. This is the same estimate presented in Castalia's first submission to the Commission (dated 4 March 2011) in response to the Application. In other words, taking into account different demand elasticities of different customer groups makes no difference to the analysis.⁹⁹

229. As previously noted, Futures, on behalf of WSI, has argued that Cavalier Wool could increase prices by 40% in the factual, without realistically risking new entry or the diversion of more than about 27,000 tonnes per annum to greasy wool exports to China. Using:

- that 40% suggested potential price increase;
- a price elasticity of demand of -0.35;
- an assumption that 75% of the wool clip is scoured in New Zealand; and
- an assumption that of the 75%, 15% is subject to long term fixed contracts and is not susceptible to any price increase over five years,

Futures estimates that the allocative efficiency losses would be between [] NPV, over five years.

230. Futures acknowledges that Cavalier Wool would be able to price discriminate to some degree, which would ameliorate allocative efficiency losses, but submits that any price differential increases the incentive for customers to arbitrage, making price discrimination more difficult.

Consideration of loss of allocative efficiency

231. In order to determine the most appropriate estimate for the potential loss of allocative efficiency in the factual, the Commission must make assumptions about the elasticity of demand for wool scouring in New Zealand. However, as is often the case, there appear to be no studies which show the extent to which the demand for scouring services in New Zealand rises or falls as scouring charges increase or decrease.

232. The Commission first considered whether a post-acquisition increase in scouring prices would be absorbed by merchants or passed on to their customers. In either case, this would mean that there would be limited allocative efficiency loss as volumes scoured in New Zealand would not decrease significantly (that is, demand would be inelastic).

233. However, it is the Commission's view that higher post-acquisition scouring prices would not be simply absorbed or passed on as described. Instead, increased prices would be likely to translate into lower margins for growers. The reasons are as follows:

- Scoured New Zealand wool competes in international markets against wool from other countries and against other close substitutes such as cotton and nylon. If scouring prices were to rise in New Zealand post-acquisition, it is unlikely that merchants would be able to pass these price increases onto international customers to any significant degree, due to the competitive nature of wool export markets.

⁹⁹ The Commission notes that this calculation includes scoured volumes of wool destined for Cavalier Bremworth and Godfrey Hirst.

- Peter Whiteman, Managing Director of Segard Masurel (NZ) advised the Commission that while some customers must have New Zealand wool as part of their wool blends, if New Zealand prices became too high those customers would remove the product from their ranges, or move to equivalent synthetic-based products.¹⁰⁰ Andrew Campbell of J S Brooksbank similarly advised that wool is sold in a global market and that New Zealand cannot dictate the price.¹⁰¹
 - It also appears unlikely that, if scouring prices were to rise in New Zealand post-acquisition, price rises could be absorbed by merchants. The Commission understands that merchants currently work in an extremely competitive environment and within tight margins of, on average, NZ\$0.15 – 0.20 per kg of greasy wool sold.
234. The Commission notes that wool supply is a function of the size of New Zealand's sheep flock. In turn, flock size is influenced, not only by wool prices but also by sheep meat prices and the prices of production obtainable from alternative use of farm land such as beef, dairying or forestry. Wool revenue as a proportion of total on-farm revenue for sheep and beef farmers has averaged about 11% over the past five years. Further, wool provides only about 18% of farmers' sheep alone revenue.¹⁰² This would suggest that farmers make their sheep stocking decisions on parameters other than just their returns from wool sales and these decisions would be unlikely to be affected by an increase in wool scouring prices.
235. Further, wool scouring services account for only about 8% of the current value of wool. It is, therefore, very unlikely that a change in the price of wool scouring services by itself would have a significant influence on the amount of wool available for export, either in scoured or greasy form.¹⁰³
236. The Commission must determine the demand elasticity facing the merged entity for scouring in New Zealand (the *residual* demand elasticity), and not the *global market* demand elasticity for wool scouring. In order to determine the appropriate residual demand elasticity the Commission must make assumptions about how merchants will respond to different price increases and how that will depend on alternatives available to merchants.

Possible responses to price increases

237. The Applicant has assessed the size of the loss of allocative efficiency on the basis of post-acquisition price increases of between 1% and 10%. Castalia estimated a 20% price increase in its calculation. Futures' initial assumption was a price increase of between 10% and 20% in its first submission but it later altered its figures to 40% in its submission on the Draft Determination.
238. NERA submits that wool merchants always have the option of exporting a certain proportion of the wool clip in greasy form to be scoured in places such as China. As noted previously, the Commission considers that there is a real possibility that

¹⁰⁰ Commission interview with Peter Whiteman, 21 February 2011.

¹⁰¹ Commission interview with Andrew Campbell, 22 February 2011.

¹⁰² Ministry of Agriculture and Forestry, Farm Monitoring Report 2010.

¹⁰³ This leads some, including Futures, to conclude that the demand for wool scouring is likely to be very inelastic. For example, a 5% increase in the cost of scouring would represent just 0.4% of the value of wool. A market demand elasticity of -1.0 for wool scouring (that is if a 5% increase in the price for wool scouring would result in a 5% drop in demand for wool scouring services) would suggest that the demand elasticity for wool itself was -8. In other words a 5% increase in New Zealand wool prices would result in a 40% decline in the demand for wool, which seems intuitively very unlikely.

merchants would switch to additional greasy wool exports to China if scouring prices were to increase. As discussed in the competition analysis section, this threat of switching by merchants does not satisfy the Commission that the Acquisition would not have the effect of substantially lessening competition. However, the Commission accepts that if greasy exports were a very close alternative for exporters (and therefore, the demand elasticity for scouring services was high), then the Applicant would be unlikely to increase prices at all.

239. Another scenario is that the Applicant would be able to implement a moderate price increase in the factual without sufficient quantities of wool being switched to greasy wool exports so as to make the price increase unprofitable. As outlined in the competition analysis section, the Commission considers that China would not impose a significant constraint because:
- China would be only a proportion of the market for New Zealand wool;
 - there would be some potential for Cavalier Wool to price differentiate between wool destined for China and wool destined for other markets;
 - wool scouring costs would be only a small proportion of the total wool price, which would limit the impact of any price rise on demand; and
 - there would be a number of non-price factors in customers' choices between scouring their wool in New Zealand rather than in China.
240. In this scenario, where China would not be a significant constraint on moderate price increases, the elasticity of demand would be relatively low as customers would not be sensitive to scouring price increases. In turn, allocative efficiency losses would be relatively low as price increases would have little effect on the demand for scouring services in New Zealand.
241. In other scenarios with larger price increases, China would become a stronger constraint as the export of greasy wool would become increasingly more attractive to merchants. Moreover, it is likely there would be a threshold for price increases, which if breached would prompt domestic entry. Again, as noted in the competition analysis, domestic entry would not, in the Commission's view, be a sufficient constraint to prevent the effect of a substantial lessening of competition arising. However, the Commission considers that domestic entry would provide an ultimate cap on price increases. Therefore, very large price increases in the factual appear improbable.
242. As discussed in the potential entry section, the Commission considers that entry with a 2.4 metre wide scour could be prompted with a price increase of 15%. The Commission also notes that WSI currently competes profitably with a single 3.0 metre wide scouring plant in each island. WSI's scouring division made a total profit of \$4 million in the 2009 financial year with property, plant, and equipment assets of \$18 million and \$8 million in the 2010 financial year with property, plant, and equipment assets of \$16.6 million. This suggests that a new entrant could be profitable if it had sufficient wool volumes, similar cost structures to WSI, and could achieve the current market price.

Experience from the previous acquisition

243. Godfrey Hirst has argued that some guidance about the possible price effects can be drawn from the price changes following the merger involving David Ferrier, Cavalier and Godfrey Hirst in 2009.

[

].¹⁰⁴

244. Cavalier Wool has responded to this argument:

[

].¹⁰⁵

245. [

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246. [

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247. The Commission does not accept that there were across the board price increases of the size claimed by Godfrey Hirst following the acquisition by Cavalier Wool of its scours in 2009.

248. As noted above, NERA has argued that Cavalier Wool's real scouring price has actually declined since 2006/07 as the company has gained market share through closure of competing scours, acquisition and rationalisation. NERA has provided the Commission with two graphs (Figure 6 and Figure 7) showing Cavalier Wool's scouring prices over the last five years.

¹⁰⁴ Commission interview with Godfrey Hirst, 24 February 2011.

¹⁰⁵ Bell Gully letter of 8 March 2011.

Figure 6: Cavalier Wool's scouring prices in the South Island

[

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Figure 7: Cavalier Wool's scouring prices in the North Island

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249. Cavalier Wool has also submitted that in late 2010 it began discussions with some customers in relation to a 4-5% price increase, but faced such resistance that it decided against implementing the increase. Cavalier Wool considers this is evidence that it would not have the ability to raise prices post-acquisition.
250. However, the Commission does not consider that the competitive dynamic will be the same in the factual as in the counterfactual and, as such, Cavalier Wool's decision not to increase prices recently is not conclusive evidence that it would not do so post-acquisition.

Decreased variable costs

251. As noted above, NERA has argued that Cavalier Wool would have lower variable costs in the factual that would have the effect of reducing the extent of post-merger price increases.
252. The Commission accepts that lower post-merger price increases would reduce allocative efficiency losses. However, in this case, Cavalier Wool would not set the post-acquisition price on the basis of its own costs, rather as stated, the Commission considers that a primary constraint on Cavalier Wool's ability to increase prices in the factual is the threat of potential entry. That is, the cap imposed by entry is below Cavalier Wool's otherwise profit maximising price. Therefore, Cavalier Wool would be able to increase prices to just below a level where the provocation would be such that entry would occur, irrespective of Cavalier Wool's own reduced variable costs.

Price discrimination

253. As stated, any ability of the Applicant to price discriminate in the factual could ameliorate allocative efficiency losses. If the Applicant were able to price discriminate it could increase prices for wool destined to markets other than China, while maintaining (or lowering) scouring prices for wool destined to China. This would mean that increased prices could be achieved without resulting in lower scouring volumes. The Commission notes, however, that the Applicant has submitted that its lack of knowledge, and oversight of, the scoured wool's destination may restrict its ability to price discriminate over the long-term. Moreover, the ability and incentive for merchants to arbitrage is likely to limit Cavalier Wool's ability to price discriminate. The Commission has treated as a worst case assumption that no significant price discrimination will take place in the factual, but notes that if it were possible, price discrimination would limit the impact of allocative efficiency losses.

Measuring the loss of allocative efficiency

254. The Commission considers that the demand elasticity would likely be relatively low for small to moderate price increases, but would increase significantly for larger price increases to a point where such prices increases would not be profitable because either, diversion of greasy wool exports to China would increase, or domestic entry, would occur.
255. As shown in Table 2, the Commission has modelled allocative inefficiency losses for a range of demand elasticities. This is equivalent to considering different amounts of scouring volume loss before the price increase reaches the 15% level that would prompt entry. The Commission has calculated above that it considers domestic entry is likely to occur following a 5 - 15% post-acquisition price increase. To be conservative, the Commission has modelled a maximum price increase of 15%. As shown in Table 2, the Commission has modelled allocative inefficiency for the following demand elasticities:
- The demand elasticity of -0.05 represents a scenario where switching to greasy wool exports to China is not a close substitute, and where the Applicant would be able to increase prices up to a point where it provoked new entry (10% to 15% price increases). For a demand elasticity as low as -0.05, the Commission considers a price increase of only 5% appears unlikely.
 - The demand elasticity of -0.5 represents a scenario where greasy wool exports to China are a closer substitute, and where the Applicant would face volume losses

as prices increase. The threat of new entry still imposes the ultimate cap on price increase in this scenario.

- The demand elasticity of -1.0 represents a scenario where greasy wool exports to China are a much closer substitute, and where the Applicant would face significant volume losses as prices increase.

Table 2: Estimated national allocative inefficiency detriments (NPV over 5 years)¹⁰⁶

Demand elasticity	Price increase		
	5%	10%	15%
-0.05	n/a	\$0.7 million	\$1.1 million
-0.5	\$3.6 million*	\$7.3 million	\$11.4 million
-1.0	\$7.1 million	\$14.7 million	\$22.7 million

256. The Commission has quantified the range for allocative efficiency detriments as \$0.7 to \$22.7 million for a five year NPV.
257. The Commission therefore needs to make a qualitative judgement as to what is the most likely level of detriment. For the reasons set out below the Commission considers that an intermediate value of detriment corresponding to a 10% price increase is the most likely:
- Entry could occur at price levels well below a 15% price increase and as such Cavalier Wool will be careful not to increase prices too far.
 - It will not be possible for Cavalier Wool to know in advance exactly what quantities of wool will switch to greasy exports to China as prices increase.
 - Volumes of wool losses to China are likely to be permanent and could undermine the economies of scale benefits from the proposed acquisition.
 - The possibility for some price discrimination would lower allocative losses.
 - The presence of any long term contracts will limit the immediate scope for price increases.
258. The Commission is therefore of the view that the likely allocative efficiency loss is a NPV of \$14.7 million over a five year period.

Loss of Productive Efficiencies

259. One outcome generally associated with a loss of competition is that a firm gaining market power has less incentive to minimise costs and to avoid waste. Organisational slack may creep into its operations, and costs may increase, because a satisfactory level of profit is assured even when the firm is less than fully efficient.
260. Determining the extent to which a firm may be susceptible to losses of productive efficiency is difficult. A firm seeking to maximise its profits will have an incentive to minimise its costs, irrespective of the level of competition in the market. Nevertheless, there is the possibility that a firm's management, without the day to day pressures from

¹⁰⁶ Note: These estimates exclude quantities of wool currently going to Cavalier Bremworth and Godfrey Hirst. The Applicant argues these quantities should not be included as they would not be subject to any price increase due to a 50% ownership of Cavalier Wool by Cavalier Bremworth and the [] supply contract that Godfrey Hirst possesses.

*The initial published determination contained a drafting error in this cell. It incorrectly stated the figure \$4.2 million, rather than the correct figure of \$3.6 million. Corrected on 28/9/11.

competitors and the benchmark they provide against which the firm's management can be measured, may become less productively efficient.

The Applicant's views

261. In its submission on behalf of Cavalier Wool, NERA states:

The Commission typically estimates productive efficiency losses by assuming that the merged firm's costs will increase. It does this by applying a factor (usually somewhere between 1-10%) to the pre-merger variable costs. This yields the increase in costs resulting from the merger or, equivalently, the productive efficiency losses.¹⁰⁷

262. NERA initially provided productive efficiency detriment calculations based on 1%, 5% and 10% of the pre-merger variable costs of the two companies. In a later additional submission, NERA stated that a figure at the low end of this range (1% to 2.5%) would be most appropriate as pressures on Cavalier Wool to maintain its productive efficiencies would remain post-acquisition. NERA has also recognised that fixed costs, as well as variable costs, may be affected by losses in productive efficiencies over time.

Other submitters' views

263. Castalia, on behalf of Godfrey Hirst, suggests that NERA's calculation ignores other potential losses of productive efficiency.¹⁰⁸ These could include the increased supply risk if either of the single post-acquisition scouring plants in each island suffers a natural disaster, fire, strike or major breakdown. The Commission accepts that this increased risk is relevant, and it is discussed further below.
264. Futures, on behalf of WSI, agrees with the Commission's approach in the Draft Determination, to the estimation of loss of productive efficiencies but suggests a range of 5%-10% of variable costs is more appropriate than the 1%-10% applied by NERA.¹⁰⁹ This is because, unlike the *Air New Zealand/Qantas* case¹¹⁰ where the Commission used a range of 1%-5%, this merger would leave just one firm remaining in the market. Futures posited a range of 5%-10% of variable costs as "the range used by the Commission in the "NewCo" dairy case, which also proposed the establishment of a single major provider".¹¹¹
265. The Commission notes that the "NewCo" dairy case only progressed to the point that the Commission published a Draft Determination. No submissions on its preliminary views expressed in Draft Determination were considered by the Commission because the Application was withdrawn. Hence those preliminary views on an appropriate methodology for the estimation of loss of productive efficiencies were untested.
266. Moreover, the facts of the NewCo dairy case differed significantly from those of this authorisation application. Some of the factors that were considered to increase the potential level of productive inefficiencies in the NewCo case, and which the Commission considers do not apply in this case are as follows:
- NewCo would have been a very large operation by New Zealand standards. Local managers were considered to lack experience in the management of such a large undertaking.

¹⁰⁷ NERA, *Proposed CWH/WSI Merger – Costs Benefit Analysis*, 8 February 2011.

¹⁰⁸ Castalia, *Initial Economic Analysis of the Cavalier Wool Holdings Application for Merger Authorisation*, 4 March 2011.

¹⁰⁹ Futures, *Cavalier Wool Holdings Limited's Authorisation Application February 2011*, 7 March 2011.

¹¹⁰ Decision No 511, *Air New Zealand Limited and Qantas Airways Limited*, 23 October 2003.

¹¹¹ Futures, *Cavalier Wool Holdings Limited's Authorisation Application February 2011*, 7 March 2011.

- NewCo would have been so large, and cover such a diversity of geographic regions and farmer interests, that the voice of the individual suppliers or group of suppliers was considered unlikely to be heard or heeded by the managers. It would have been impossible for those persons to monitor and assess the performance of NewCo's managers. Finally, there was little scope for takeover and displacement of an inefficient management team with the proposed cooperative structure.
267. As a result, the Commission considers that the NewCo case has no relevance or precedent value to this case in respect of the estimation of loss of productive efficiencies.
268. While the Commission considers competition to be an important driver of productive efficiency, it also considers that the weight which should be given to this factor is quite speculative. It has noted the efforts made by the two firms to operate efficiently in recent years and considers that an important driver of this has been the external pressure placed on Cavalier Wool and WSI by declining sheep numbers and reducing wool clip. This external pressure is likely to continue notwithstanding some improvements in wool prices and a recent stabilisation in sheep numbers.
269. Cavalier Wool currently has only three shareholders. These are Cavalier Bremworth, a major customer of Cavalier Wool, ACC and Direct Capital. The latter two are experienced investors wishing to maximise their investment income and capital growth. Whilst the ongoing shareholder composition cannot be assured to continue in the factual, the Commission considers any future shareholders will have the incentive to continue to drive productive efficiencies.
270. Moreover, the Commission is confident that the on-going competitive threat from the Chinese scouring industry, as discussed previously, will ensure that any productive efficiency losses are unlikely to be large.
271. While it recognises the uncertainty of any assumed productive efficiency losses, the Commission considers the upper range for loss of productive efficiency is between 1% and 5% of pre-merger variable costs. This equates to approximately [] per annum.¹¹² The Commission's qualitative judgement as to what it considers to be the most likely loss of productive efficiency is the midpoint of this range, namely 3% of pre-merger variable costs. This amounts to a five year NPV of [] million.

Increased supply risk

272. In its submission, Castalia states:

{NERA's calculation of productive efficiency losses} ignores other likely sources of productive inefficiency, such as the increased supply risk of relying on one entity employing one scouring plant in each of the North and South Islands. The lack of redundancy resulting from such a concentrated production process in the wool value-chain means that the cost of outages is likely to be significantly higher than historically because more wool volumes are affected. A higher risk of industrial action post-merger would also increase plant downtime. A high level estimate of lost production from supply outages can be obtained by assuming that a level of demand is unmet. For this report, we assume additional plant outages of 1 percent, which at market prices would lead to an efficiency loss of []^{113, 114}.

¹¹² The Commission has used Cavalier Wool's pre-merger variable cost figures for the industry of about [] cents per kg to calculate the estimated productive efficiency losses. Futures, on behalf of WSI, advised that its estimates of pre-merger variable costs are [] cents per kg, which is similar to Cavalier Wool's estimates.

¹¹³ Net present value over five years.

¹¹⁴ Castalia, *Initial Economic Analysis of the Cavalier Wool Holdings Application for Merger Authorisation*, 4 March 2011.

273. NERA has responded. While it states that it cannot comment on the factual accuracy of the 1% outage assumption used by Castalia, it does question the accuracy of Castalia's calculation which suggests an efficiency loss under this head of [] Net Present Value (NPV) over five years. NERA has also suggested that the calculation should be modified to base it on the gross margin (rather than on sales), in which case the 5 year NPV would become [].
274. Cavalier Wool does not consider that there will be an increased supply risk in the factual for the following reasons:
- Post acquisition, Cavalier Wool's scouring plants will not be operating at full capacity and the Clive plant will remain as back-up capacity.
 - Cavalier Wool has comprehensive insurance to cover freight between Islands in the case of a plant shutdown.
 - As a temporary alternative to scouring their wool, customers could export wool greasy or store it until the scouring plant once more became available for production.
 - Comprehensive risk management infrastructure and processes are in place at all its plants.
275. Nevertheless, the Commission considers that some higher costs associated with a plant closure post-acquisition should potentially be taken into account in the detriment analysis. Like Castalia and NERA, the Commission is uncertain at this time of the level of risk of a major plant outage, post acquisition. The Commission has found only one example of a scouring plant emergency - during 1999, one scour line at Cavalier Wool's Awatoto plant was shut down for a short period due to a small fire in a control cubicle. Cavalier Wool submitted that any electrical failure at a time of high demand on one of their scouring plants would be repaired within 48 hours.
276. There is thus a relatively low level of historical risk. The Commission also notes that during the period of any plant outage post-acquisition there will be some potential to use other mothballed plants, such as Clive in the North Island or the mothballed 2.4 metre line in Timaru, or transport wool between Islands, while the ability to store greasy wool until the plant problem is resolved does limit the cost to the industry of such an outage. The Commission considers that because of these factors there would be only a small increase in risk arising from the consolidation of scouring activities into a single location per Island. Due to the limited nature of the risk and the precautions already taken by Cavalier Wool, the Commission view is that any likely detriment is likely to be de minimis.

Loss of Dynamic Efficiency

277. The Commission stated in the reasons for its decision on the *Air NZ/Qantas* matter :

Dynamic inefficiency arises when a business or industry is less innovative than it might be. Innovations bring benefits to consumers either through the introduction of improved new products that buyers value more highly ("product innovations"), or through the use of new, lower cost ways of producing existing products ("process innovations").

and

Monopolists in general have a reputation for being poor innovators. Although they have the resources to undertake innovative activity, and are well-placed to appropriate the gains from the introduction of a significant innovation (because of the absence of imitating rivals), the lack of any competitive spur to take risks and embrace new ideas has the opposite effect. The removal of

competitive pressure lessens the incentive for companies to innovate in order to match or keep ahead of rivals.

and

A reduction in innovation may cause social welfare to suffer in two ways: buyers may be deprived of the benefit of product innovations; and the public as a whole would lose the benefit from the introduction of process innovations that save on inputs, measured by the additional outputs that could be produced by the saved inputs being used in alternative employments.¹¹⁵

278. As is the case with the loss of productive efficiency, it is difficult to measure with any precision the cost to society of a lessening in innovation attributed to a substantial lessening in competition in a market. Consequently, a qualitative element is always a significant part of this assessment.
279. NERA initially adopted the approach used in the past when the Commission assessed a loss of innovation by multiplying total sales by factors of 0.5% - 1.5% (the Commission used 0.5% - 1% in the *Air NZ/Qantas* case).¹¹⁶ To be conservative, NERA has also modelled a reduction in demand across a range of demand elasticities (the approach used by the Commission in the *Ruapehu/Turoa* case).¹¹⁷ It has assessed the NPV sum of the detriments from a loss of product innovation and process innovation for 5 years as falling within the range of []. In a subsequent submission, NERA advised that based on the facts of this industry it expected the detriment would likely be at the lower end of this range.

Opponents' views

280. Castalia stated that it would expect any loss of dynamic efficiency to be at the upper end of the estimates provided by NERA.¹¹⁸ In Castalia's view, NERA has not recognised the significant change to the industry dynamics from the removal of merchant scouring from the New Zealand business environment. Castalia further suggests that NERA incorrectly allows for an increase in demand from a lower price, while it considers that Cavalier Wool post merger would have no incentive to lower its price.
281. In its response to the Draft Determination, Cavalier reiterated its view that a range of 0.5% - 1.5% in lost sales was a conservative estimate of dynamic inefficiency. On that basis it provided an estimate of detriments of [].
282. Futures stated:

The Commission's approach to estimating dynamic inefficiency detriments is not founded in theory or easy to rationalise and NERA's complement of a separate demand reduction component does not address this fundamental concern either. Moreover, it utilises a price elasticity range which I consider to be inappropriate for reasons I have already explained. To my knowledge there is no theoretically robust methodology for estimating dynamic efficiency losses.

The ad hoc nature of the estimates used by the Commission and NERA would be more acceptable if the results were plausible. However, they are not. It is widely held by economists that dynamic inefficiency detriments are more material than either allocative or productive inefficiency detriments. This is because dynamic inefficiency is thought to have a cumulative effect. The Commission shares this view and as a result has consistently paid more attention to dynamic efficiency benefits than to either allocative or productive efficiency.

¹¹⁵ Decision No 511, *Air New Zealand Limited and Qantas Airways Limited*, 23 October 2003.

¹¹⁶ Decision No 511, *Air New Zealand Limited and Qantas Airways Limited*, 23 October 2003.

¹¹⁷ Decision No 410, *Ruapehu Alpine Lifts Limited and Turoa Ski Resort Limited*, 14 November 2000.

¹¹⁸ Castalia, *Initial Economic Analysis of the Cavalier Wool Holdings Application for Merger Authorisation*, 4 March 2011.

283. In addition, Futures noted that its estimates of dynamic inefficiencies based on 0.5% - 1.5% of revenue [] is materially smaller than the plausible estimates of allocative and productive inefficiencies combined. Rather than adopting these amounts, it has suggested using a factor of 100 - 150% of the combined allocative and productive inefficiencies detriments. It believes that this ensures that the three forms of inefficiency have orders of magnitude “more consistent with economists’ (and the Commission’s) view of their relative importance”.¹¹⁹
284. Using this approach Futures has calculated the 5 year NPV of the dynamic efficiency detriments as being in the range of [].
285. In its response to the Draft Determination, Futures submitted that an alternative approach to the above would be to assume the dynamic inefficiencies were twice the rate the Commission used in the Air New Zealand/Qantas case, although no reasons why the Commission should adopt this alternative approach were provided by Futures. Futures calculated that if this idea was adopted a range of 1% - 3% of revenue would be appropriate and Futures calculated the NPV over 5 years to be [] to [].

Commission’s assessment

286. As discussed above, the Commission recognises that it is very difficult to calculate dynamic efficiency losses with any strong confidence about the precision of the calculation. In this instance the Commission has considered a number of industry characteristics which may affect its qualitative assessment.
287. Cavalier Wool has emphasised the innovations it has made to its processes resulting in, amongst other improvements, a better brightness of the scoured wool output from its plants. These product and process changes were made in a competitive climate and with declining volumes. It is arguable that such innovations would not have been as likely to have occurred if there had been just a single operator. Moreover, despite its recent concerns over the loss of scoured volumes to China, it appears that Cavalier Wool’s main concerns have been with WSI and its competitive threat in the scouring markets. In particular, Cavalier Wool has needed to innovate in order to ensure it retains sufficient throughput for the efficient operation of its scouring plants.
288. The industry has a very long history in New Zealand going back over 100 years and both product and process improvements have been incremental over this period. There are a number of factors that suggest that any losses in dynamic efficiencies may be very limited in this instance. These include the following:
- While many of the most significant innovations in both product and process have had their origin in New Zealand, others have been as a result of international research and engineering in industries unrelated to wool scouring. Also, many of the innovations have occurred through the work of equipment manufacturers and research companies (for example ANDAR Holdings – a scouring plant manufacturer, Wool Research Organisation of New Zealand and AgResearch). Post-acquisition, Cavalier Wool will continue to have the incentive to utilise new ideas where they contribute to profit and help ensure competitiveness with overseas scouring options. This includes Cavalier Wool’s ability to incorporate

¹¹⁹ Futures, *Cavalier Wool Holdings Limited’s Authorisation Application February 2011*, 7 March 2011.

scouring innovations into its plant, that take place offshore, such as in China. This point is discussed further below.

- The post-merger financial performance of Cavalier Wool is likely to be closely and efficiently monitored by its shareholders. The Board and shareholders have a profit maximising incentive and therefore an incentive to optimise dynamic efficiencies.
289. In the Commission’s view, it is the long-term competitive threat of the Chinese scouring industry that most reduces potential dynamic efficiency losses. While the Commission is not satisfied that this threat would constrain the combined entity in terms of its ability to raise prices, the Chinese threat is likely to be a major spur for ongoing innovation as there is a real risk that if the Chinese scouring industry innovates more rapidly than that of New Zealand, then most wool scouring would move offshore, as happened in Australia. The risk of this occurring is real for Cavalier Wool. The proposed merger is predicated on achieving efficiency from greater throughput from a similar asset base. Should sufficient wool volumes be lost in the future to China, the advantages gained from the Acquisition would soon be undone.

Innovation in the scouring industry

290. One of the major efficiency developments in wool scouring in New Zealand was the three metre wide scour. Until the first such plant was installed at Kaputone, scouring plants had been 2.4 metres wide or less. While the plant was contracted for by WSI and installed at Kaputone, its actual development was undertaken by ANDAR Holdings, the Timaru based equipment manufacturer. ANDAR Holdings also developed the on-site effluent control system now installed at Kaputone.
291. Another major industry innovation was the development and implementation of the high density wool press, operated by one person and including automatic wool quality sampling. These presses as installed in New Zealand scours were not developed in New Zealand, rather by the German firm Autefa and by the Italian firm Gaularchine.
292. Again, the SCADA¹²⁰ equipment now employed which allows automatic control of the scour trains and remote monitoring of performance were not developed by the New Zealand scour industry, rather by other industries which require automatic control of manufacturing equipment. In this respect, the scouring industry followed the leader.
293. The automated triple drum wool cleaning and opening systems installed at the beginning of the scouring train were developed by WRONZ about 20 years ago.
294. While the Commission accepts that the industry does innovate in respect of process and product, these innovations are of the kind whereby the equipment provided by the manufacturer is improved by that person, to suit local conditions and requirements. Moreover, most of the innovation tends to be in respect of improved processes, rather than new products, In this respect the Commission notes the following:
- Multiple local improvements to dirt extraction equipment.
 - The installation of post-scour “rumblers” as a final dirt removal mechanism.
 - Internal changes to the opening device mechanisms.
 - The adjustment of the size of washing bowls to achieve optimal wool cleaning.

¹²⁰ Supervisory control and data acquisition equipment.

295. Therefore, the Commission considers that while some innovation in the scouring industry has occurred as a result of competitive pressures within the domestic scouring market, major innovations have occurred outside the competitive environment as a result of improvements by equipment manufacturers, who no doubt wish to remain competitive in their manufacturing markets.
296. As noted above, post-acquisition, Cavalier Wool will continue to have the incentive to utilise new ideas where they contribute to profit and help ensure competitiveness with overseas scouring options.

Differing constraint offered by WSI

297. In the Draft Determination, the Commission stated:

Because Cavalier Wool's commission scour operation is different in nature to WSI's vertically integrated merchant scour model, in the counterfactual the competitive tension between the two would be not likely to be as strong as would exist between wool scour competitors using the same model of operation.¹²¹

298. Futures submitted that in that sentence the Commission's comparison is about competition in the counterfactual between Cavalier Wool and WSI. Futures submitted that the Commission was wrong and the proper comparison should have been about the difference between the factual and the counterfactual.
299. Competition in the counterfactual (as a basis for comparison) may be less if a merchant scourer provides less of a competitive constraint than would have been in the case of two competing commission scours.
300. As previously noted, Cavalier Wool has argued that a vertically integrated WSI provides a weak competitive constraint.¹²² Also, many merchants advised that they would not use WSI's scouring services because WSI was a merchant scourer and was a competitor in downstream markets. For the volumes of wool owned by this type of merchant, the loss of competition from the Acquisition is less than if the Commission were considering a two-to-one merger between commission scours who competed across all volumes.
301. Castalia, on the other hand, argues that the removal of the vertically integrated scouring model will lead to greater dynamic efficiency losses as the rivalry between the differing business models is lost.¹²³ Also, as noted previously, the Commission considers that WSI's merchant scouring business places an indirect, but real, constraint on Cavalier Wool.
302. On the basis of the evidence before it, the Commission considers that any loss of dynamic efficiency would not be affected, positively or negatively, by WSI's vertically integrated scouring model.

Ability to appropriate innovation benefits

303. At the conference, Mr Dwyer raised the issue of WSI's ability to appropriate the benefits of innovation. Mr Dwyer stated that

¹²¹ Cavalier Wool Draft Determination, para 189.

¹²² Cavalier Wool authorisation application, 8 February 2011.

¹²³ Castalia submission, 4 March 2011.

...that's the one big problem we've faced in this industry, is that anybody who has done anything gets copied very quickly, and the key from our point of view is to be able to develop new products and be able to hold on to the IP of those developments.¹²⁴

304. Should the proposed Acquisition go ahead, then the concern about the appropriability of innovation benefits will be ameliorated, as the innovations will not be quickly copied by others within the New Zealand scouring industry. Of course, the exclusivity of innovations could be lost, if they become widely known by new entrants or overseas scouring operations. However it is likely that, in the factual, Cavalier Wool would have greater confidence that it could appropriate a greater proportion of innovation than could a wool scourer in the counterfactual.

Previous cases

305. Both Futures and Castalia have made comments about the need for the Commission to be consistent with previous cases and have thus relied in some part on the Commission's previous cases such as Air NZ/Qantas.¹²⁵ The Commission recognises the need for a consistent framework to be applied but notes that each business acquisition is fact specific and secondly that markets are ever changing. It is the particular characteristics of an industry that will determine the size of likely dynamic efficiency losses. Thus the Commission considers it appropriate to take these factors into account when assessing the likely public detriment, rather than simply to rely on estimates from previous decisions which were made in relation to entirely different sets of facts in entirely different markets at another time.

Quantification of loss of dynamic efficiency

306. The Commission recognises that it is very difficult to quantify the size of any loss in dynamic efficiency. The Commission considered several approaches to quantify this loss. These included:
- Multiplying total revenue by a factor estimated from qualitative information. It was used in the Air NZ/Qantas case;¹²⁶
 - Estimating the change in consumer surplus from an inward shift of the demand curve. This approach seeks to measure the loss of product innovation (not process innovation). It was used in the Ruapehu/Turoa case;¹²⁷ and
 - Multiplying the combined allocative and productive inefficiencies detriments by a factor of 100 - 150%. This approach was advocated by Futures.
307. The approach used in Ruapehu/Turoa was not chosen as it is unlikely to be more robust in this instance as it requires estimation of the assumed percentage demand shift (as well as demand elasticity), which is difficult. Furthermore, it attempts to measure only product innovation, which for the wool scouring industry is likely to be significantly less important than process innovation.
308. The Commission has also not chosen to apply the Futures approach because it is not convinced that the loss of dynamic efficiency will be fixed multiple of allocative and productive inefficiencies. Dynamic efficiency is about ongoing potential for innovation,

¹²⁴ Cavalier Wool Authorisation conference transcript, 5 May, page 73.

¹²⁵ The Commission also notes that parties referred to the Commission's approach in the dairy industry merger proposal, where a range of 1 to 5% was applied. As noted during the conference, the dairy merger was a draft decision and no final determination was ever reached. It therefore does not have the status referred to by parties.

¹²⁶ Decision No 511, *Air New Zealand Limited and Qantas Airways Limited*, 23 October 2003.

¹²⁷ Decision No 410, *Ruapehu Alpine Lifts Limited and Turoa Ski Resort Limited*, 14 November 2000.

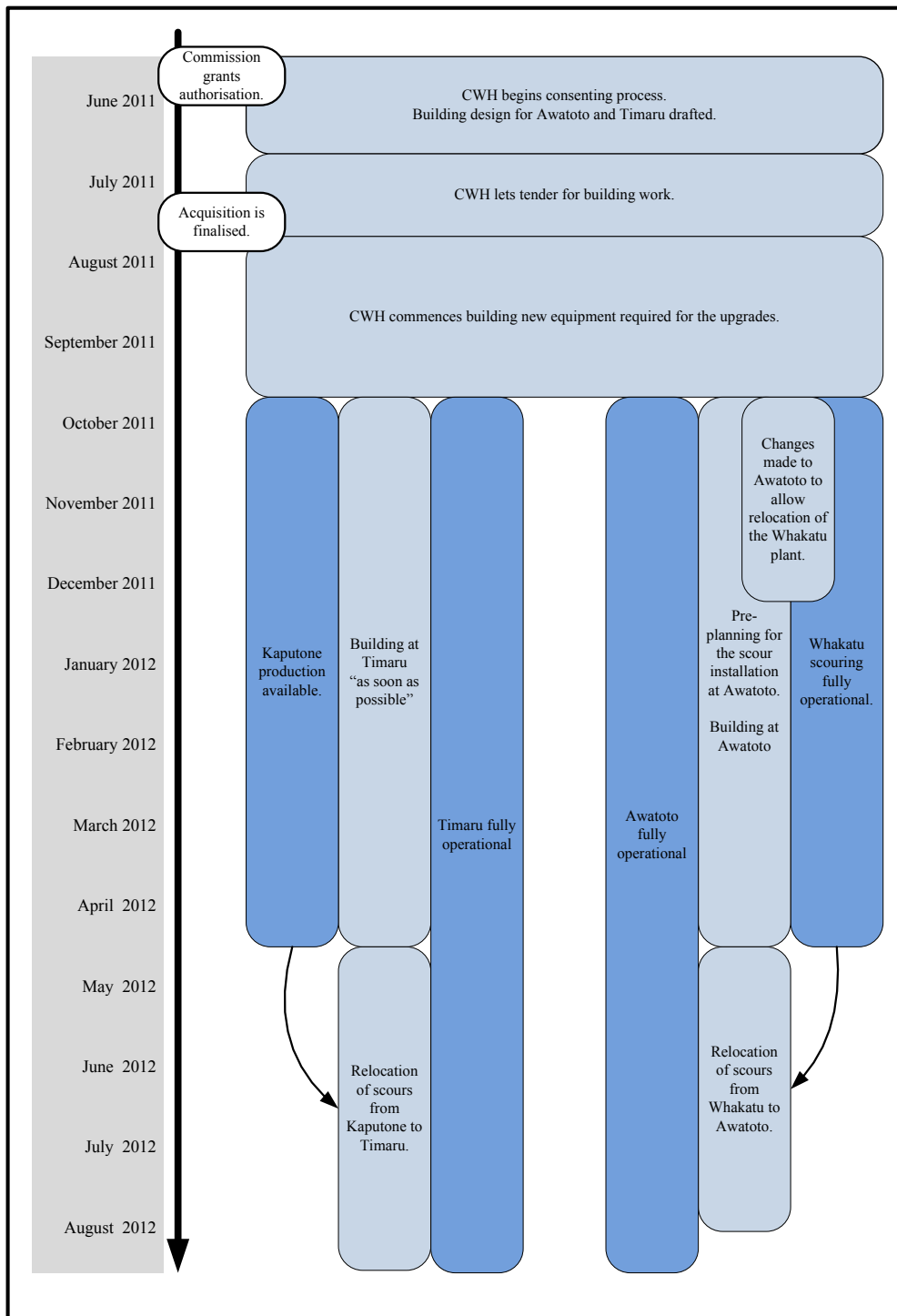
while productive efficiency is about minimising current costs. While the Commission recognises these concepts overlap at the edges, we do not consider that an industry's innovation potential is linked by a certain ratio to the ongoing pressures for cost minimisation. Moreover, while dynamic losses do have a cumulative effect, in the timeframe analysed it is likely that cost increases through reduced productive efficiencies may in fact have a greater detriment.

309. The Commission has therefore chosen to apply the approach used in the Air NZ/Qantas case. While the Commission notes that this approach is not fully robust in terms of its ability to predict dynamic efficiency losses, we consider it the most pragmatic approach as all case specific factors are able to be taken account of and then compared to the range of losses that have been used in previous cases and losses that have been empirically quantified in the academic literature on the subject.
310. To apply the approach used in Air NZ/Qantas, the Commission had to estimate a factor to apply. From the above qualitative analysis, the Commission is of the view that any loss of dynamic efficiency in this instance is likely to be small. The Commission has estimated a likely range of dynamic efficiency losses of zero to one percent of total industry revenue. This equates to a range of \$0 to [].
311. The Commission's qualitative judgement as to what it considers to be the most likely loss of productive efficiency is the midpoint of this range, namely 0.5% of total industry revenue. This amounts to a five year NPV of [] million.

Production Disruption

312. Concerns have been raised by Futures acting for WSI about Cavalier Wool's ability to continue to service New Zealand's entire requirement for scoured wool production while plant is out of commission during the period when the rationalisation is undertaken; that is, for the period of time when some of Cavalier Wool's post-acquisition scour lines would be out of service during the period of dismantlement, transport, reassembly and re-commissioning. No substantial evidence was provided by WSI to support its argument in this regard.
313. Futures has estimated this cost by assuming that 10 million to 30 million kilograms of wool would need to be stored during the above period for an additional two months before it could be scoured. At an interest rate of 7% and average price of \$5 per kg of wool, the interest cost is \$0.88 million to \$2.63 million on that quantity of wool which must be held longer by wool merchants before its sale. Futures argues that with the addition of storage costs, the total detriment in this respect is likely to be \$1.00 million to \$3.00 million.
314. Cavalier Wool has argued that as the moving of the scour lines will take place in the off season, there will be very little production disruption. Cavalier Wool has stated:
- 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.*
315. Cavalier Wool indicative timing for the rationalisation is shown in Figure 9.

Figure 9: Indicative programme for Cavalier Wool’s scour rationalisation



316. The Commission considers that post-acquisition Cavalier Wool would continue to have the incentive to process its merchant customers’ wool in an orderly and timely fashion, in order to prevent those merchants switching to greasy wool export sales. Also, Cavalier Wool would wish to conclude the rationalisation promptly in order to achieve early benefits arising from the acquisition.
317. Cavalier Wool has provided a comprehensive timetable for its rationalisation which shows relocation of the Whakatu and Kaputone scouring plants would take place between May and September 2012, the low season for wool production in New Zealand. In the South Island it is conceivable that scouring demand of 4.5 to 6 million kilograms

per calendar month could outstrip Timaru's 4.8 million kilograms of processing capacity per four weeks during that time. The Commission considers that Cavalier Wool will likely maintain sufficient capacity throughout most of this period. Any short term demand peaks can be handled by scouring some quantities of wool in advance, for example for Cavalier Bremworth. As only limited quantities of wool would have to be stored for short periods of time the Commission considers any additional costs would likely be de minimis. Moreover, the Commission notes that Cavalier Wool has set aside a contingency sum of [] for any additional costs which should be sufficient to cover any additional storage costs that may be incurred. In respect of that contingency, the Commission has counted it in the calculation of Cavalier Wool's one-off rationalisation costs which are netted off the total of the benefits.

318. Moreover, no evidence of production disruption during the rationalisation of the Godfrey Hirst scours (and in particular the closure of the Clifton Scour) was provided to the Commission. The Commission is therefore satisfied that while there is the potential for production disruption, it considers that on the balance of probabilities this is unlikely to occur and therefore does not afford this argument any weight in terms of public detriments.

Disruption To Wool Prices

319. Futures, on behalf of WSI, submitted that in the factual there will be disruption costs to wool prices in New Zealand as Cavalier Wool intends to sell or discontinue WSI's wool trading division. Futures submitted that WSI currently purchases about 30% of New Zealand's wool clip and an abrupt withdrawal from the market by such a large purchaser would result in a short-term reduction in the wool price as supply outstrips demand. While Futures acknowledges that other merchants will in time expand their purchases and absorb WSI's market share, it argues that it will take time for merchants to establish the increased credit lines and business networks that would be necessary to expand their market shares. Futures submitted that, as a result, the price of wool in New Zealand may drop by up to 30% in the short-term following the proposed acquisition.¹²⁸
320. Futures argues that this disruption in the wool market will lead to detriments between:
- \$1.83 million, which is equivalent to two months' wool production in New Zealand at a price of \$5 per kilogram being funded at 7% interest. That is Futures assumes that extra holding costs would be incurred as growers/brokers/merchants retain and store wool until prices recover after two months; and
 - \$18.85 million, which Futures has calculated by assuming a 30% drop in price of the New Zealand average wool clip below \$5 per kilogram for a one month period.
321. The Commission has given consideration as to whether wool prices are likely to temporarily decrease in the factual as a result of the acquisition. The Commission notes the factual could result in Cavalier Wool purchasing:
- WSI in its entirety, including the trading arm; or
 - WSI's scouring assets only, with the trading arm being kept structurally separate.
322. The Commission considers the analysis below is relevant for either of these occurrences.

¹²⁸ Futures' submission on the Draft Determination, 27 April 2011.

Speed of WSI's exit

323. Cavalier Wool advised that, if it acquires WSI's trading division, it does not intend to close down WSI's trading division immediately; rather it is intending to sell it as a going concern, post acquisition.¹²⁹ If WSI's trading division has value, it would be commercially rational for Cavalier Wool to continue to operate the division as a going concern in order to maximise its sale price.
324. The other possibility in the factual is that Cavalier Wool acquires WSI's wool scouring sites, but not its trading arm. In that situation, WSI's trading arm would be run as a wool merchant independently of the scour business. In either case, the Commission considers it likely that WSI's trading division will continue to be active in the market for wool in the period immediately following the acquisition.

Barriers to merchants' expansion

325. The Commission considers that the Acquisition will provide other merchants with the opportunity to significantly increase their market shares. Merchants' access to capital and business networks do not appear to be significant constraints that would prevent other merchants expanding their businesses to account for WSI's market share.
326. Mr Ferrier of Cavalier Wool advised that that he is aware of a merchant that has obtained increased funding of \$10 million in the expectation of increased trade post-acquisition.¹³⁰ Moreover, the Commission notes the evidence that many merchants are indeed supportive of the proposal as it will give them a commercial opportunity to expand their businesses.
327. For example, Mr Whiteman of Segard Masurel considers that the acquisition, which will within a short period separate the scouring business from the trading business, will actually have a strong positive effect on New Zealand wool prices in international markets, and as such lift returns to New Zealand.
328. It also does not appear that merchants will take time to expand their business networks or customer list in order to account for WSI's market share. Mr Mark Johnston, H Dawson Wool, advised that WSI's trading arm would probably be sold to another party, [
-] John Henderson, Director of Fuhrmann NZ, also advised that WSI's trading arm would not have a lot of value to sell as a standalone business as other merchants already have existing business contacts.
329. Therefore, the Commission does not consider that there are significant barriers to merchants readily expanding their businesses to take advantage of any prospective opportunity to increase their market shares.

Previous experience of merchant exit

330. A previous example of a large merchant scourer exiting in the market is E Lichtenstein and Co,¹³¹ which was closed in 2000 due to a lack of profitability. Mr Chung, Cavalier Corporation's Managing Director, advised that E Lichtenstein was at the time in as dominant a wool trading position as is WSI now.¹³² E. Lichtenstein was closed, rather

¹²⁹ Cavalier Wool Authorisation conference transcript, 5 May 2011, pages 15-16.

¹³⁰ Cavalier Wool Authorisation conference transcript, 5 May 2011, page 16.

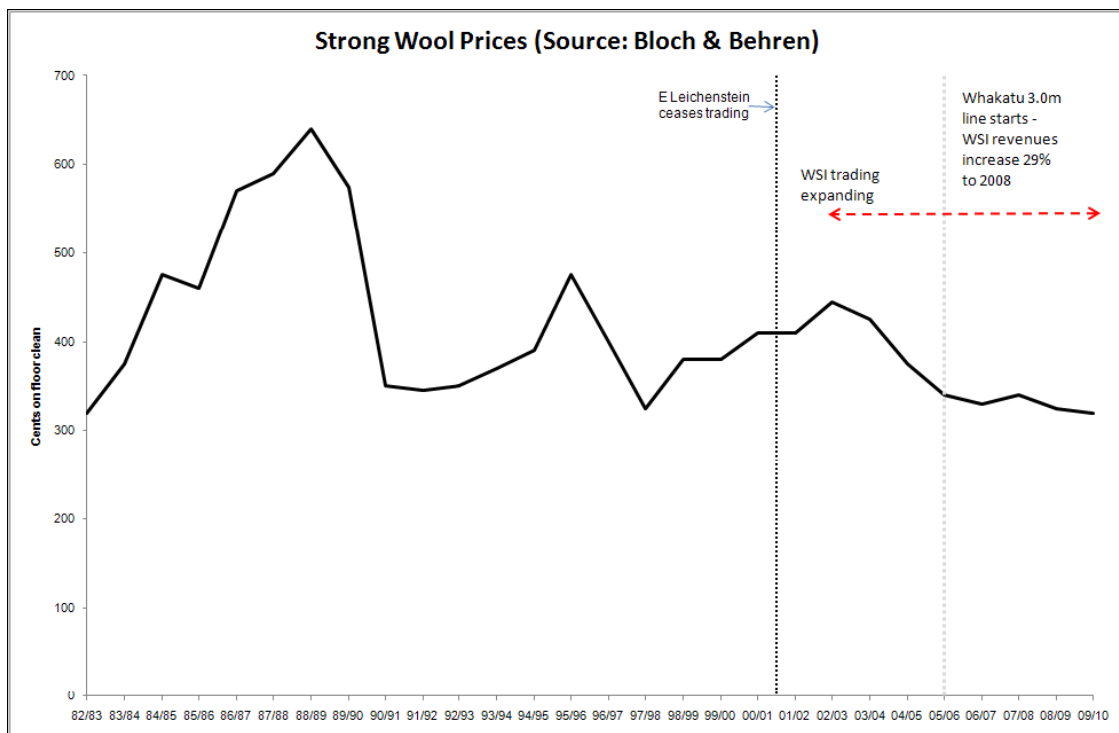
¹³¹ E Lichtenstein and Co Ltd wool scour in Onehunga was owned by Cavalier Corporation. It was run as a merchant scouring operation.

¹³² Cavalier Wool Authorisation conference transcript, 5 May 2011, page 15.

than being sold as a going concern, and as such its exit was more abrupt than is likely in the current case.

331. At the conference, WSI inferred that the closure of E Lichenstein led to a reduction in wool prices. Mr Dwyer advised that “when Lichenstein was withdrawn from the market we’ve had a period of nine years of low prices, nine years, and it’s only just recovered in the last 12 months”.¹³³
332. However, the evidence suggests that the closure of E Lichenstein has had no negative impact on wool prices. For instance, Mr Whiteman advised that at the time he was concerned about the market for wool collapsing. However, he advised that the closure was seamless and that other merchants just “picked up the slack”. The following day he had 25 messages from new customers and “got on with it”. [] advised that “the moment Lichtenstein stopped its operations, the prices increased”.¹³⁴
333. Also, the Applicant has provided the Commission with Figure 8, which shows New Zealand strong wool prices over the last 20 years. While there are numerous factors that affect the wool price, rather than a drop in wool prices after E Lichenstein ceased trading, there was an increase in wool prices for about two years. The Commission considers that the past experience of E Lichenstein supports the conclusion that there is unlikely to be a disruption to the New Zealand wool prices as a result of the proposed acquisition.

Figure 8: New Zealand strong wool prices



International demand unchanged

334. In the factual, the national and international demand for wool will remain. That is, wool merchants are intermediaries between producers and the final manufacturers or customers. Therefore, even if New Zealand wool prices to farmers were to drop below

¹³³ Cavalier Wool Authorisation conference transcript, 5 May 2011, page 17.

¹³⁴ Commission interview with [].

otherwise competitive prices, merchants and buyers would have the incentive to purchase increased quantities of wool at this lower price, quickly bidding back up the price of wool. However, as discussed above, Futures have questioned the amount of time it may take for this to occur, due to the barriers to merchants expanding.

335. Even if it did take some months for merchants to expand their market shares (which the Commission does not accept), it is unlikely that the price that merchants receive in international markets would be affected. As such, returns to New Zealand would be unlikely to decrease and any temporary drop in wool prices within New Zealand would tend to be a wealth transfer rather than a public detriment.

Conclusion on disruption to wool prices

336. Therefore, the Commission is satisfied that it is unlikely that there would be a disruption to New Zealand wool prices as a result of the proposed acquisition, to the extent that there would be a detriment to the public of New Zealand.

BENEFITS

Production Efficiencies

337. Cavalier Wool argues that an important commercial benefit would arise, as a result of the acquisition, from the incremental economies of scale that would occur if the existing WSI scour lines were rationalised within the existing Cavalier Wool plants. The Applicant forecasts that the rationalisation would result in cost savings and increased capacity utilisation of the wool scouring equipment of Cavalier Wool and WSI.¹³⁵
338. In part, Cavalier Wool relies on its experience in 2009 when it merged the wool scouring operations of Godfrey Hirst with its own. As is discussed further below in that case Cavalier Wool achieved actual audited cost savings of [] cents per greasy kilogram of scoured wool between the years 2009 and 2010 during which it rationalised Godfrey Hirst's volumes with its own existing production. Cavalier Wool expects to achieve larger cost savings in the factual, this time, because the volumes available from WSI's production will be greater than for the previous merger [].
339. In addition, Cavalier Wool states the increased volumes allow it to economically justify additional investments in the factual to achieve further production efficiencies by modifications to its own and WSI's equipment.
340. Cavalier Wool states that it is only by carrying out such rationalisations to achieve the maximum possible capacity utilisation and minimum possible fixed and operating costs that a much diminished scouring industry (as has happened in Australia where rationalisations did not generally occur) will be avoided in New Zealand. Cavalier Wool, and other interested parties, submitted that it is crucial for the New Zealand wool industry for there to be a healthy domestic scouring industry to allow New Zealand wool to be sold into a wide range of different export markets and not merely to those which possess a domestic scouring industry (of which there are fewer and fewer as time passes).

¹³⁵ In the material obtained by the Commission from WSI under a section 98 notice,
[

341. Cavalier Wool has submitted that the costs savings in the factual will be achieved in the North Island as follows:

- By relocating WSI's 3.0 metre scour line, currently at the Whakatu site, to the Cavalier Wool's Awatoto site.

*The immediate benefits of this will be that CWH will be able to avoid the duplication of cost associated by closing the Whakatu plant and spread Awatoto's operating and administration costs over a much greater volume of production thereby reducing per unit costs.*¹³⁶

- By making various technical modifications to WSI's 3.0 metre scour line so as to increase the capacity of that plant from an estimated [] greasy kilograms per hour to up to the [] greasy kilograms per hour that is achievable on Cavalier Wool's 3.0 metre Timaru scour line if it were processing the generally cleaner North Island wools.
- By making various technical modifications to Cavalier Wool's own two 2.4 metre scour lines at Awatoto to increase the capacity of each from [] greasy kilograms per hour to [] greasy kilograms per hour.

*As described above, realising the synergy benefits from relocating the Whakatu line will require CWH to modify the Awatoto building in a way that will enable CWH to also make the necessary modifications to its existing 2.4 metre lines so as to bring them up to the Timaru scour best practice level. This will generate increased throughput and efficiencies.*¹³⁷

- by mothballing Cavalier Wool's scouring plant at Clive for its use, only in the event of an emergency at another plant, saving the difference between its higher variable costs and the lower variable costs that will be achieved at Awatoto.

342. Cavalier Wool has submitted that these costs savings will be achieved in the South Island as follows:

- By relocating WSI's 3.0 metre scour line, currently at WSI's Kaputone site, to Cavalier Wool's Timaru site and mothballing Cavalier Wool's existing 2.4 metre scour line at Timaru, again for use only in the event of an emergency at another plant.

The primary benefit in the South Island results from the relocation and development to CWH best practice of NZWSI's 3.0 metre scour line, currently at Kaputone, to the CWH site at Timaru in replacement for the existing 2.4 metre line which will be mothballed.

*The immediate benefits of the relocation will be that CWH will be able to avoid the duplication of cost by closing the Kaputone plant and spread Timaru's operating and administration costs over a greater volume of production thereby reducing per unit costs.*¹³⁸

343. The major categories of costs saved are shown in Table 3. In total, according to Cavalier Wool, the savings would amount to []. This is [] of the industry's operating and administration costs pre-acquisition.

¹³⁶ Cavalier Wool authorisation application, page 11, 8 February 2011.

¹³⁷ Cavalier Wool authorisation application, page 12, 8 February 2011.

¹³⁸ Cavalier Wool authorisation application, page 13, 8 February 2011.

Table 3: Most significant annual cost savings from proposed acquisition¹³⁹

Expense category	Department	Amount	Percentage reduction in factual
Operating expenses (scour and press)	Electricity - Unit Charges	[]	36%
	Electricity - Fixed	[]	34%
	Gas/Coal	[]	18%
	Repairs & Maintenance	[]	12%
	Total Wages & Salaries	[]	14%
Administration expenses	Salaries	[]	31%
	Other administration	[]	24%

Note: This table only includes the major cost categories, and therefore does not add to [].

344. Cavalier Wool has submitted that these savings can only arise in the context of the acquisition. The operating and administration cost savings in each island cannot occur if the Whakatu and Kaputone plants remain in WSI's ownership on their present sites. Cavalier Wool also submits that the improvements to its 2.4 metre Awatoto scour lines require alteration to the site and the buildings at Awatoto and that can only be justified economically if there is greater revenue generated at the site as a result of the relocation of the 3.0 metre wide Whakatu scour line to the Awatoto site.
345. The Commission has had to ascertain whether these claimed savings would in fact occur in the factual and whether the savings would be real public benefits rather than mere transfers of wealth between parties.

Opponents' views

346. Godfrey Hirst has disputed that substantial energy saving costs can be made.

*Godfrey Hirst's experience, having operated scours itself for a number of years, is that increasing run rates through a scour results in increased energy consumption although not quite in proportion. This is because the "additional" wool that is being processed through higher run rates requires just as much energy to move, heat and dry as wool processed at slower run rates. Substantial savings therefore are not possible.*¹⁴⁰

347. Castalia, on behalf of Godfrey Hirst, suggests that the actual benefits of the merger would be towards the lower end of the range estimated by NERA. Castalia argues that mergers generally, irrespective of the industry concerned, do not have a strong history of delivering promised benefits and that the management of putative acquirers have incentives to over-state merger benefits.
348. Futures, on behalf of WSI, has also noted a general tendency for firms to overestimate the efficiency gains achievable from mergers. It suggests that a reasonable range of cost savings of between zero and 10% of variable costs could be applied by the Commission, although this range is cited without evidence in support. In this merger, that range would amount to between [] - which has a five year NPV of [].

¹³⁹ For an almost identical output of scoured wool that occurs in the counterfactual.

¹⁴⁰ Godfrey Hirst submission, pages 8-9, 20 May 2011.

Moreover, Cavalier Wool has submitted that the model used to demonstrate the cost savings from the rationalisation is exactly the same model that was used to justify the proposed WSI transaction to its Board of Directors.

Cavalier Wool's submission on energy savings

354. Cavalier Wool provided the Commission with an extensive explanation of its energy savings as part of its post-conference submission. Cavalier Wool has argued that scour lines have a flat electricity load, relatively independent of the quantity of wool passing through the line at any one time. That is, increasing the throughput of a scour line results in little incremental electricity usage. If more wool can be scoured for a similar electricity unit cost, that implies a reduction in operating costs per unit weight of wool scoured.
355. Cavalier Wool stated that in addition to the increase in output reducing the per kilogram of wool costs, the North Island transaction would, for the same scoured wool volume:
- remove one fixed electricity line charge as a result of the closure of the Whakatu plant;
 - remove the variable electricity unit charges associated with running Clive as a peaking plant; and
 - make modifications to reduce the wool moisture content prior to it entering the drier to reduce gas use.
356. In the South Island, the proposed Acquisition would, again for the same production of scoured wool, remove one fixed electricity line charge (closure of Kaputone) and reduce the high density press electricity usage by the reduction of the total number of such presses in the South Island from three to two.
[
]. These modifications require the extension of the building, including the removal of the substantial office building, in order to be completed.
357. More generally, Cavalier Wool has argued that in both islands, greater scour utilisation would allow for better production management and more continuous scouring, which would significantly save the amount of necessary re-heating of water in the scour washing bowls, thus also reducing energy use.
358. The Commission is satisfied that these energy savings will occur in the factual. The Applicant has provided robust reasoning as to how the savings will be achieved. Moreover, the Applicant's past experience and the modelling of its own current energy expenditure give comfort that the level of savings suggested are achievable.

Commission's assessment

359. The Applicant has provided the Commission with details of the operating and administration expenses for its plants at Awatoto, Clive and Timaru and has estimated those expenses for WSI's plant at Whakatu and Kaputone, all for 2009/2010. The Applicant also provided similar projected information for Awatoto, Clive (in a moth-balled state) and Timaru post-rationalisation. The Commission has inspected internal Board of Director's documents from Cavalier Wool which were part of the Director's assessment of the viability of the rationalisation project and which were provided in total to the Commission. That the cost savings model constructed by Cavalier Wool's staff was approved by the Board of Directors as part of their agreement to the

commitment to an eventual bid for WSI of \$40 million was noted by the Commission as part of its examination of Cavalier Wool's claimed production benefits.

Reduction in salaried and wage staff costs

360. Cavalier Wool has submitted that in the factual it would achieve the same scoured wool production as is presently achieved by itself and WSI combined but without the need for the following categories of salaried and wage staff costs:

- []¹⁴²
- []¹⁴³
- []¹⁴⁴
- []
- []
- []

361. The Commission accepts these potential savings in wages and salaries and Cavalier Wool's justification of them. Inherently, it appears to the Commission that if there was

¹⁴² Two 2.4 metre operational plants.

¹⁴³ One 2.4 metre plant and one 3.0 metre plant, in operation.

¹⁴⁴ To operate one scouring plant takes three operators, one supervisor and one lanolin extraction plant operator to give a total of five per scour lines. There are two 12 hour shifts meaning 10 per scour line and three scour lines in the South Island in the counterfactual. That would be reduced to two in the factual, hence the reduction []

a reduction in the number of scouring sites from five to two, and a reduction in the number of operating scouring lines from seven to five, between the counterfactual and the factual, that would be a strong indication that there would be a reduction in the costs of wages and salaries.

Reduction in administration expenses

362. The Commission has examined the Cavalier Wool's claimed reduction in administration costs. Examples of cost savings proposed by Cavalier Wool are savings in:

- ACC levies;
- fire protection;
- information systems;
- insurance;
- general office expenses;
- repairs and maintenance of buildings and grounds; and
- security.

363. None of the claimed administration savings is large in itself and it appears to the Commission that all of the claims are of the kind that would result from a reduction in staff numbers and a reduction in the number of operating sites. Therefore, the Commission accepts Cavalier Wool's claimed savings in administration expenses which total [].

Reduction in repairs and maintenance costs

364. The approximate 10% savings in repairs and maintenance costs mostly would result from reducing the South Island's operating scour plants from three to two, with one mothballed at Timaru and from the mothballing of the North Island Clive plant. Applying a 10% reduction in repairs and maintenance costs between the factual and the counterfactual on the basis of a reduction in the number of scouring plants from seven to five would appear to be a conservative estimate and the Commission accepts that cost savings of [] proposed by Cavalier Wool.

Reduction in variable electricity costs

365. Wool scouring operations consume substantial amounts of electricity to (mostly) power the multifarious electric motors that drive the scouring line, wool grease recovery and the high density presses that are part of a wool scouring plant. The electricity unit load on a wool scouring plant is relatively flat in profile and is a seven days per week steady load. This allows wool scouring companies to negotiate relatively low unit electricity prices. For example Cavalier Wool purchases electricity from []. Nevertheless, Cavalier Wool has calculated that it would be able to make electricity unit savings between the counterfactual and the factual for the same volume of wool scoured in each Island.

366. In the North Island, Cavalier Wool estimates that savings of about [] per annum on unit electricity costs would be achievable.¹⁴⁵ It states that in essence these saving would arise from:

¹⁴⁵ See Appendix 4 for detailed calculations for North Island savings which are based on a unit charge of [] cents per kilowatt-hour.

- a net reduction of the variable electricity costs to run WSI's Whakatu scouring plant at Awatoto as a result of rationalisation and modifications to reduce electricity consumption [];
- removing the variable electricity costs of running Cavalier Wool's mothballed, higher running cost Clive scouring site for the purpose of dealing with peak wool load flows []; and
- a net reduction of the variable electricity costs to run the existing two Awatoto 2.4 metre scour lines as a result of rationalisation and modifications to reduce electricity consumption [].

367. In the South Island, Cavalier Wool estimates that variable electricity cost savings of about [] would be achievable, again between the counterfactual and the factual for the same overall scoured wool volumes.¹⁴⁶ These savings would, according to Cavalier Wool, arise from:

- a net reduction of the variable electricity costs to run WSI's Kaputone scouring plant at Timaru as a result of rationalisation and modifications to reduce electricity consumption [];
- removing the variable electricity costs to run Cavalier Wool's, higher running cost 2.4 metre scouring line at its Timaru plant, which will also be mothballed []; and
- a net reduction of the variable electricity costs to run the existing 3.0 metre scour line at Timaru as a result of rationalisation and modifications to reduce electricity consumption [].

368. The rationalisation and modifications that would be made to reduce electricity consumption include:

- the removal of an operating high density press in each island;
- a reduction in the number of necessary wool grease separators;
- an increase in the run rate of the two relocated 3.0 metre ex WSI scouring plants for a less than proportionate increase in electricity consumption with a reduction in the number of high electricity consuming stops and re-starts due to better capacity utilisation;
- the installation of certain new motors of greater electrical efficiency together with variable speed drives; and
- the installation of power factor controllers on certain electrical motors.

369. The Commission notes that the cost of these rationalisations and improvements is included in the capital expenditure costs accounted for later in these reasons.

370. The Commission considers these electricity savings from rationalisation and technical improvements are feasible, and accept that a variable electricity savings benefit of [] would be achieved in the factual compared to the counterfactual. This is slightly less than the [] claimed in the Applicant's cost savings model.

¹⁴⁶ See Appendix 5 for detailed calculations for South Island savings which are based on a unit charge of [] cents per kilowatt-hour.

Reduction in electricity lines charges

371. With the proposed closure of both the Whakatu and Kaputone sites certain electricity lines, transformers and switchgear resources will be released from wool scouring to be used elsewhere. Electricity lines charges comprise demand charges and asset charges. Based on its own fixed line charges, Cavalier Wool has calculated that the closure of Whakatu and Kaputone would result in a reduction in demand and asset charges of []. However, there would be an addition demand charge that would apply, in the factual, to its existing plants of [] as a result of the increase production (and hence increased kilowatt requirement) from Awatoto and Timaru. Therefore, a net reduction of [] is likely between the counterfactual and the factual. In addition, there will also be a reduction of the demand charge from the mothballed Clive site. This has not been quantified by Cavalier Wool.
372. The Commission considers there would be a reduction in line charges as a result of the ceasing of wool scouring at the Whakatu and Kaputone sites and the mothballing of the Clive site and that the amounts claimed are plausible. Moreover, as these are resource savings the Commission considers them to be public benefits.

Reduction in coal and gas costs

373. The two wool scours in the North Island employ natural gas as their base heating fuel. In the case of Awatoto, some of the necessary process heat is provided by a steam boiler (which is gas fired) and some by direct firing of natural gas with hot flue gases passing over heat transfer surfaces. Whakatu on the other hand, does not have a boiler and all heating is done by direct gas firing. The two South Island scours both use coal fired boilers to produce either hot water or steam for process heat.
374. Cavalier has calculated that North Island gas savings of [] per annum would be achievable as a result of saving natural gas fuel.
375. Cavalier Wool has submitted that this reduction would be achieved in the factual for the same total North and South Island wool flows as in the counterfactual by the following methods:
- []
-].
- Elimination of gas consumption at the mothballed Clive scouring plant.
 - []
-].
- []
-].

376. The Commission accepts that these modifications are contingent upon the Acquisition because of either the need for Cavalier Wool to own the equipment before it can make modifications to it, or because of the necessity to make modifications to the scour buildings to make room for the new installations, which in turn requires the increased wool throughput for its justification.
377. The process heat for both the South Island wool scours is provided solely by coal fired boilers. Either steam or hot water is reticulated to the various components of the scouring plants.
378. Cavalier Wool has submitted¹⁴⁷ that savings of [] in coal costs would be achieved in the factual for the same total North and South Island wool flows as in the counterfactual by the following methods:
- The elimination of coal consumption to provide process heat to the mothballed Timaru 2.4 metre wide scouring plant with the transfer of scouring capacity to the two 3.0 metre scour lines.
 - The reduction of coal consumed to provide process heat to the ex-Kaputone 3.0 rinse bowls on that scouring plant. Cavalier Wool disagrees with WSI's scouring technique in this regard and states that rinse bowls do not need to be heated (as is the case with the present operation at Timaru).
 - []
-].
379. The Commission considers these technical improvements are feasible and accepts that an energy saving benefit of [] would be achieved in the factual. This is slightly less than the [] claimed in the Applicant's cost savings model.

Timing of benefit

380. Cavalier Wool's indicative timeline (in Figure 9) is also relevant to the time when the public benefits which arise from the rationalisation would occur. The modified scour lines are not likely to be in place and operational in their improved state until the second half of 2012.
381. Futures argues that as the benefits of the rationalisation proposals would not be achieved in the first year, that the year one benefits should be discounted (by up to 50%) in the Commission's NPV calculation.
382. Cavalier Wool has responded to Futures' argument in its post-conference submission:

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

¹⁴⁷ Details are shown in Appendix 6.

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.

383. Cavalier Wool also argues that if the benefits are to be discounted to allow for the fact that they would not be achieved immediately, then a similar approach needs to be taken for the detriments. It argued some of the detriments, such as slackness or a loss of innovation, in the absence of competitive pressures, would in fact take longer to materialise than would the benefits in this case.
384. The Commission recognises that for many of the benefits and detriments, their full impact would not be felt in year one. Moreover, the identified benefits and detriments would also be likely to have some impact after year five. The five year NPV method for calculating benefits and detriments arising from a merger is not perfect, no method is; but the Commission considers it to be a pragmatic way forward in terms of balancing the quantified detriments and benefits. If a benefit would not occur for a significant period (such as the superstore benefit which the Commission considers would not arise until years four and five) the Commission would discount this appropriately. However, in this instance, as for the allocative, productive and dynamic efficiency detriments, the Commission considers is appropriate to give an equivalent (but time discounted) figure for each of the five years. The Commission considers this approach provides the most reliable comparison of detriments and benefits in this particular case.

Impact of confidentiality

385. Godfrey Hirst has submitted that the amount of confidential information in Cavalier Wool's Application and subsequent submissions has limited its ability to test that information:

As Godfrey Hirst has previously submitted, and repeats below, the extensive confidentiality accorded to the Applicant in this case has substantially hindered parties with relevant industry experience from commenting on the detail of those claims. The resulting lack of transparency has meant those claims have not, for the most part, been subjected to the rigorous testing that the requirement of certainty as to benefit involves.

386. Godfrey Hirst argues that the Commission should put less weight on these claimed cost savings benefits as they have not been able to be fully tested by industry participants.
387. WSI has also raised issues in respect of confidentiality, and the impact that this has had on the ability of it to comment usefully on the argued cost savings.
388. The Commission recognises the requirement to keep parties' information confidential competes with the requirement to test information with other informed parties. In this instance, the Commission considers that, while parties have not had access to confidential information regarding production efficiency benefits, they have been able to provide useful information and comment on the application of the concepts involved. Moreover, interested parties, particularly WSI, have had the opportunity to provide the Commission with their own costing data and experience in scouring, against which the Applicant's information was tested.

Conclusion on production efficiencies

389. The Commission considers that the budgeted costs of rationalisation are plausible and that the cost reductions that Cavalier Wool anticipates, are within the range of the efficiencies that might be expected from a reduction in the number of scouring plants from five to two (with one other mothballed) between the counterfactual and the factual,

whilst still maintaining a similar level of production. Moreover, as stated, the cost savings would not be achievable in the counterfactual by either of Cavalier Wool or WSI. In order for the rationalisation benefits to occur there must be consolidation of all operating scour lines onto two sites with an associated increase in production of scoured wool at each site. Clearly that cannot occur in the counterfactual.

390. Cavalier Wool has confirmed that the most of the cost savings in its model would arise from a reduction in consumption, and not from a reduction in price. Any price reduction would be a private saving to Cavalier Wool and not a public benefit as there would be a corresponding transferred detriment to another party. There are two specific cost savings claimed by Cavalier Wool that the Commission considers are transfers, rather than public benefits. Those are the savings on the fringe benefit taxes for cars and the savings on council rates. The Commission considers that the cost savings on both of these taxes are transfers. In this case the Commission considers that such a private saving from lower rates costs is unlikely to translate to a savings in the total amount of resources used by society. As Futures notes, most of the services provided to industrial users by councils are on a “user pays” basis and the rates payment has little correlation with services required or provided.¹⁴⁸ These savings of [] respectively are therefore not accepted by the Commission.
391. The Commission is satisfied that the Applicant’s calculations which have been provided to the Commission which include extensive detail of its historical costs and estimated future costs post-acquisition are accurate. Cavalier Wool has undertaken modelling to assess its own business case in respect of the Acquisition which has received the approval of its Board of Directors. Moreover it has the recent experience of its amalgamation with the former scouring operations of Godfrey Hirst as a benchmark on which to base its expected costs of, and savings from, the rationalisation that it proposes.
392. The Commission is therefore satisfied that [] million per annum in cost savings would be achieved. This equates to a saving of approximately 14% of pre-merger operating and administration costs. The five year NPV for this benefit is [] million.

Sale of Surplus Land and Buildings

393. The Applicant has stated that following the Acquisition it would sell the land and buildings that comprise WSI’s Whakatu and Kaputone wool scour sites. Following Cavalier Wool’s proposed rationalisation of scouring equipment in the factual, those sites would be surplus to its requirements. Cavalier Wool has claimed as a public benefit the value of the land and buildings at those sites.
394. Freeing-up of surplus land and buildings is considered to be a public benefit as those resources can be redeployed to other productive uses. During the Commission’s conference on the Application, a specific question was put to the interested parties, including those opposed to the Acquisition such as Godfrey Hirst and WSI, as to whether, as a general theory in a business acquisition scenario, there was any dispute that the sale of land and buildings surplus to requirements would count as a public benefit.¹⁴⁹ There was no dissent from that concept and the Commission has proceeded on the basis that the releasing of surplus land and buildings for other productive purposes amounts to a public benefit for the purpose of this analysis. The

¹⁴⁸ Futures post-conference submission, 20 May 2011.

¹⁴⁹ Cavalier Wool Authorisation conference transcript, 5 May 2011, page 21.

issue that was disputed by Godfrey Hirst and WSI was the amount of the benefit that the Commission could properly assign under this head.

395. The Applicant submitted the following:

- [] is the benefit that would accrue from the sale of the land and buildings at WSI's Whakatu and Kaputone wool scouring sites. This amount is based on ratings valuations, recent comparable sales in the area and market intelligence.
- WSI's annual report for the 12 months to 30 June 2010 records the value of its land and building as being \$9.053 million. If WSI has obtained a lower valuation subsequent to the March and April 2007 valuations (on a current market value basis), its business accounts have not been adjusted to reflect that lower valuation.
- The Receiver of Plum Duff Ltd and Woolpak Holdings stated in its Information Memorandum of February 2011 that the value of WSI's land and buildings was \$8.792 million as at 31 December 2010.
- In respect of the Whakatu site, it already has an unsolicited expression of interest to purchase the land and buildings, should the Acquisition proceed, in the indicative range [] million.¹⁵⁰
- Cavalier Wool would place an encumbrance on the sites as part of its sale and purchase.¹⁵¹ The encumbrance would only prevent the purchaser of the land and buildings from using it for the purposes of wool scouring, wool processing, wool dumping and wool grease extraction. Wool storage would be a permitted use under the encumbrance.¹⁵²
- The evidence from sales of other scour sites is that the land and buildings of a wool scour are not specialised and may readily be used for other purposes. Cavalier Wool provided a list of eight former wool scour sites in Invercargill, Timaru, Wanganui, Onehunga, Petone, Napier, Gisborne and near Fielding. These are respectively used as a trucking company depot, for refurbishing imported farm equipment, as a furniture manufacturing plant, for manufacturing wire and sheet metal products (previously used for car auctions), as an industrial warehouse, for storage of canned food, as a wool store and as a chicken processing factory.
- Other scouring sites which have closed down have been attractive to purchasers. The Clifton Wool Scour site which was valued at \$5.2 million on a going concern basis and at \$3.6 million on a vacant possession basis was sold in 2009 on the day Mr Ferrier's company acquired it for \$5 million.¹⁵³ The total cost of reinstatement of the site was \$100,000 which was more than covered by the sale of scrap metal and surplus equipment. There are other similar examples of the sale of wool scour sites.
- When the valuation of industrial land and buildings on a vacant possession basis is significantly lower than on a going concern basis that implies that the property is specialised to its current use. The evidence shows that this not the case with redundant wool scour properties.

¹⁵⁰ Cavalier Wool Authorisation conference transcript, 5 May 2011, pages 23, 30.

¹⁵¹ Cavalier Wool Authorisation conference transcript 5 May 2011, page 22.

¹⁵² Two e-mails from Bell Gully to the Commerce Commission dated 16 May 2011.

¹⁵³ Cavalier Wool Authorisation conference transcript 5 May 2011, page 27.

- The earthquakes in the Christchurch area have resulted in a number of displaced operators in the transport, logistics, engineering and construction industries who remain uncertain about their future locations. These include SB Global Logistics, Move Logistics, Crown Relocations, Christchurch Removals, Chapman Engineering, Peter Stephen Construction, McVicars and Able Logistics, all of whom could be interested in obtaining land and buildings the size of the Kaputone site.

396. Cavalier Wool has provided factual evidence of the wide ranging uses to which eight sites, previously used as wool scours, are now put. It does not appear to the Commission that such sites are confined to use as wool scours. Cavalier Wool has also provided evidence that the most recent wool scour land and building sale¹⁵⁴ occurred quickly and for a value that was substantially above the vacant possession valuation.
397. Cavalier Wool advised that it had received an unsolicited offer to purchase the Whakatu site in the factual. The putative acquirer,
[

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398. [

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399. The Commission considers that [] statements are genuine and are uncontaminated by the existence of any “side deal”¹⁵⁵ of which there is no evidence in this case.
400. Cavalier Wool advised the Commission that it has been approached by
[

]

401. Cavalier Wool has also provided the Commission with a valuation range for the Kaputone site, prepared by Bayleys Realty. Bayleys Realty provided the following estimates:^{156,157}

¹⁵⁴ Clifton, Invercargill.

¹⁵⁵ WSI’s economic expert, Mr Layton suggested that such “side deals” were commonplace.

¹⁵⁶ Bayleys Realty, *Kaputone Wool Scour May 2011*.

¹⁵⁷ Bayleys Realty notes that it has not carried out an onsite inspection.

- Sale and leaseback: \$5.4 - \$8.5 million.
 - Vacant possession: \$5.0 - \$5.4 million.
402. The Commission notes that this evidence has not been tested directly with interested parties and, as such, the Commission is unable to put significant weight on this.
403. WSI, in opposition, submitted the following:
- WSI provided the Commission with alternative valuations of the land and buildings at its Kaputone and Whakatu sites which were carried out in April 2010 for WSI by independent registered valuers. These two valuations totalled [] and were on a vacant possession basis. These values were not included in their annual report, because they were not going concern valuations.
 - There is a difference between valuation as a going concern and valuation on a vacant possession basis. The WSI provided valuations from early 2010 were explicitly stated to be on a vacant possession basis, which is appropriate given that Cavalier Wool intends to remove all the equipment from the buildings before offering them for sale empty.
 - The value of the land should be discounted over a number of years on a rental basis and not taken as the full sale price in year one. Futures noted that the sales value of the land and buildings reflect the benefits those assets will provide their owner (in present day value) over their full life. However, the detriments against which the benefits are assessed are those which occur over just five years. Thus, for the weighing exercise, the benefits are overstated relative to the detriments.
 - A practicable timetable would see the land and buildings not available for sale for over a year following the completion of the Acquisition .
 - The proposed encumbrances would reduce the value of the land and the value should therefore, be discounted further.
 - Kaputone and Whakatu sites have a number of issues, such as low roof studs, no insulation, and the limited bearing capacity of the floors, which limit their alternative uses.¹⁵⁸
 - Before sale was possible the buildings at Whakatu and Kaputone might require either repairs and maintenance or demolition and removal and the cost of such should be taken into account in assessing the benefits. If the value of the two sites is discounted over five years at 10% and allowance is made for demolition and refuse disposal and the asset realisations are delayed for two years and one year respectively, there would be a net cost of [], rather than a public benefit.
 - There may be a “side deal” between the person who expressed an interest in purchasing the Whakatu land and buildings and Cavalier Wool.¹⁵⁹
404. The Commission is, therefore, faced with conflicting views on the realisable value of the Whakatu and Kaputone sites as outlined in Table 4.

¹⁵⁸ Dr Alan Reay, consulting engineer for WSI, submission of 27 April 2011.

¹⁵⁹ Cavalier Wool Authorisation conference transcript 6 May 2011, page 53.

Table 4: Summary of land and building valuations

Valuation by	Date	Comment	Kaputone (\$)	Whakatu (\$)	Total (\$)
Christchurch City Council Hastings District Council	1 August 2007	Capital value	8,100,000	900,000	9,000,000
Information Memorandum of the Receiver	February 2011	Both sites provided by WSI			8,800,000
WSI annual report	30 June 2010	Both sites			9,100,000
Colliers International Crighton Stone	8 April 2010 6 April 2010	Vacant possession Vacant possession	[] []	[] []	[] []
Cavalier Wool	8 February 2011	Both sites, in the Application	[]	[]	[]
[]	10 May 2011	Whakatu only – indicative bid		[]	
[]	May 2011	Kaputone only – indicative bid	[]		
Bayleys Realty	May 2011	Kaputone – sale and leaseback Kaputone – vacant possession	5,400,000 – 8,500,000 5,000,000 – 5,400,000		

405. The Commission, in its Draft Determination, considered that the Receiver’s Information Memorandum value was the most appropriate valuation. That was because the Receiver has a duty to be accurate in these matters and would otherwise expose itself to liability for any inaccuracies in its Information Memorandum. Moreover, the figure provided by the Receiver is the most up to date of the various amounts quoted. However, Cavalier Wool submitted that the Commission had taken a conservative approach and the sale price of the two sites was likely to be higher.
406. One of WSI’s main points of disagreement with the Draft Determination is its argument that the Commission should use a vacant possession basis for valuation and this is likely to be considerable less than the going concern valuation basis accepted by the Commission. This is especially so if there is an encumbrance placed on the site. WSI has provided various statements by its valuers to support this argument.

407. On the other hand Cavalier Wool argues that this thesis applies generally only if the relevant land and buildings have a specialised use and are not suitable for sale for alternative uses.
408. The Commission notes that the vacant possession valuations provided by WSI were valuations that were made during April 2010. Crighton Stone, which undertook the Whakatu valuation, noted the valuation was undertaken during
[
] ¹⁶⁰
409. The Commission has, however, checked with Gary Sellars of Colliers Property, who undertook the valuation of the Kaputone site in 2010.
[

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410. The Canterbury Earthquake Recovery Authority has announced that it believes that about 1,200 buildings will be demolished in the commercial areas of Christchurch. The Commission has also noted the following media comment:
- The move comes as Izone¹⁶¹ says it is seeing demand spike for its industrial and commercial space at the 190-hectare {site} following the Canterbury earthquakes, particularly the February 22 event.*
411. It appears to the Commission that it is likely that an undamaged site and building at Kaputone could be valuable for a multipurpose warehouse site. Moreover, Cavalier Wool has submitted a list of major entities which it states are presently looking for sites of the kind and size of Kaputone, to replace their earthquake damaged land and buildings in the Christchurch area. As noted above, however, Mr Sellars does not consider that, at this time, the earthquake would have significantly increased the value of the Kaputone site.
412. There was evidence from WSI about the need for costly reinstatement of the two WSI scour buildings before they could be sold. Cavalier Wool with its experience of operating scours described WSI's expert's list of work required as minor repairs and maintenance. Cavalier Wool noted that the Clifton scour required \$100,000 of reinstatement work before it was sold for \$5 million.
413. The Kaputone site has a land area of 23,000 square metres and a building area of 11,700 square metres and a rating valuation of \$8.13 million. The Commission has noted other properties in Christchurch for sale of comparable size and function. For example, an industrial building leased to a packaging firm at 66A Carmen Road Hornby with a floor area of 8,000 square metres and a land area of 21,300 metres is for sale for \$6 million. A factory/warehouse at Russley with a floor area of 14,200 square metres on a land area of 30,000 square metres has a capital value of \$10.8 million. While there will be differences in sites and buildings these amounts provide the Commission with some comfort about the conclusion reached below.
414. Finally, the evidence of [] appears to establish the value of the Whakatu site at between []. The Commission considers the most appropriate value for its calculations is \$2.5 million.

¹⁶⁰ Crighton Stone valuation, 6 April 2010.

¹⁶¹ From www.stuff.co.nz dated 6 May 2011. Izone is an industrial subdivision at Rolleston.

415. For Kaputone, the Commission considers the likely range to be between \$4 million and \$7 million. The Commission notes that the value of Kaputone is more uncertain, in part because of the earthquake and that there is a wider range of possible valuations. The Commission considers that in this instance the midpoint is the most appropriate value for its calculations, which is \$5.5 million.

Conclusion on Benefit Attached to Sale of Land and Buildings

416. The Commission has received a broad range of evidence on the likely value of the Kaputone and Whakatu wool scour sites. All valuations are to some degree subjective. It is not until the sale is made that the true value is revealed. As such, the Commission considers the range for the two sites of \$6-10 million, although it recognises that the actual combined sale prices could be significantly larger than this amount. The Commission's judgement is that the midpoint of \$2.5 million for Whakatu and \$5.5 million for Kaputone are the most likely sale prices. The Commission considers that the full estimated sale price should be ascribed as a benefit as the sales would be likely to take place soon after the proposed Acquisition would proceed. Hence the five year NPV for this benefit is \$8 million.

Capital Expenditure

417. As part of Cavalier Wool's proposed rationalisation, additions would be required to the buildings at Awatoto and Timaru. This would require capital expenditure on buildings, estimated to be [] at Timaru and [] at Awatoto. NERA has calculated the NPV of the cost of capital and depreciation associated with this expenditure over a five year period as being [] at Timaru and [] at Awatoto. However, as stated above the Commission's preferred approach is to calculate the effect of this capital expenditure in a similar manner to the land sales benefit. That is on the basis of the lifetime cost or value of the particular asset. The Commission can be satisfied that these costs (and benefits) will be incurred almost immediately and, therefore, there is, unlike in the case of other benefits and detriments, minimal uncertainty as to whether or not they will be real. Therefore, the Commission considers that [] should be netted off any benefits arising from the rationalisation.
418. Additional initial expenditure would also be required to:
- dismantle WSI's scouring plants and relocate them at Cavalier Wool's sites;
 - reinstate WSI's buildings such that they might be sold; and
 - carry out various modifications to the scouring plant that Cavalier Wool regards as necessary to obtain its claimed cost savings, production increases and other efficiencies.
419. During the first year that expenditure would be []. NERA has stated that after that first year, the ongoing capital expenditure on plant will be less than in the counterfactual, [] per year as opposed to [] per year. This reduction would occur because once the plants were upgraded and relocated onto two sites there would be relatively less capital expenditure required over the short to medium term. Also, according to NERA, there would be some economies of scale in capital expenditure projects. These savings are claimed by Cavalier Wool to have a five year NPV of [].
420. The Commission has reviewed Cavalier Wool's internal planning documents in relation to the capital cost associated with the proposed acquisition. Cavalier Wool has also

provided detailed costings of the projects involved. It has had recent experience in wool scour rationalisation. As a result, the Commission accepts that Cavalier Wool's data is likely to be an accurate estimate of the capital expenditure required. Therefore, the Commission has concluded that the NPV of capital expenditure in terms of public benefit over next five years is minus [] million for capital expenditure on buildings and plus [] million for capital expenditure on plant.

One-off Rationalisation Costs

421. NERA notes that Cavalier Wool is expecting to pay redundancy costs of [] and has allowed for contingency rationalisation costs of [] in the first year of the factual.

422. Futures has commented on this:

The reduction in the number of operating scours from five to two will give rise to some staff redundancies and some redundancy payments. There are two ways to look at such payments. Firstly, they can be considered as a straight wealth transfer from the employer to the (former) employee. If this is what they are, they should not be included in a cost benefit analysis of net public benefit as transfer payments between members of the public net out. Secondly, redundancy payments can be viewed as compensation to employees for the loss of human capital in the form of on-the-job experience. If the payments are of this nature, they represent a social cost and so should be included in a calculation of net public benefit.

423. The Commission accepts the second of those two views. As NERA notes, the Applicant in this case has adopted a conservative position and treated redundancy costs as a social cost to be deducted from the benefits arising from the acquisition. These costs, if incurred by Cavalier Wool, are likely to fall in the first year following the Acquisition or very soon after. The Commission has therefore concluded that the NPV of one-off rationalisation costs is [].

Removal of a Weak Seller

424. During meetings with wool merchants and with some other market participants, a consistent theme emerged that WSI tends to undercut other merchants in international markets. This, according to the submitters, results in export prices for New Zealand wool being reduced. This is said to be particularly so in markets such as China and India where WSI has a strong presence. The claim was based on a view that WSI as a vertically integrated scourer/merchant has a strong incentive to maximise the throughput of its scours to ensure they remain profitable. The parties interviewed submitted that WSI frequently had more scoured wool stock than it could efficiently sell in export markets, which meant that it tended to accept a lower price than other merchants to increase the volume of its sales, thus forcing the price down.¹⁶²

425. The merchants who held this view believed that the industry would benefit by the Acquisition as it would remove WSI as a merchant, leaving them to sell the wool at a higher price:

- Mr Palle Petersen of Bloch and Behrens stated that as a trading company who also owned wool scours, WSI had no choice but to operate with a very aggressive pricing policy – simply to ensure its scouring capacity was utilised to the maximum. Mr Petersen provided evidence that WSI prices were

¹⁶² The Commission notes that the total amount of wool sold in export markets would remain the same, irrespective of whether or not WSI remained as a merchant.

[]¹⁶³

- Mr John Henderson of Fuhrmann NZ Ltd said that WSI's position as a merchant scourer was the worst feature of the New Zealand wool industry.¹⁶⁴ He said this was particularly so in India, where WSI had a strong presence and in China where WSI's low prices for clean wool meant that he could not sell such wool in that market and was forced to sell greasy wool – such sales by Fuhrmann were increasing.
- Mr Peter Whiteman of Segard Masurel said that the problem with merchant scouring operations is that “the tail wags the dog”.¹⁶⁵ If WSI's scouring operations were separated from its wool trading operation that would have a very strong effect on New Zealand's export wool prices. WSI was particularly low priced in India and China.

[]

- [] said that WSI is detrimental to the industry.¹⁶⁶ It buys the wool to ensure its scours are fully utilised and must subsequently find markets for the unsold stock. Because greasy wool prices [] can obtain are the same as WSI's clean wool prices, [] now sells more greasy wool than scoured wool.

[

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426. This claimed public benefit was not amongst those claimed in the application, nor was it mentioned in the NERA submission. However, Cavalier Wool, later submitted that:

Exporters' view that Cavalier Wool's acquisition of WSI will increase New Zealand's export receipts for wool is supported by the evidence which suggests that, for whatever reason, WSI is selling New Zealand wool at a price below the price which would be obtained if that wool were being sold by other exporters. The impact of this is not only on WSI volumes – the price expectations create a contagion effect for all other exporters of New Zealand wool.

While it is difficult to precisely isolate the extent to which this is the case, however:

- *WSI's dismal financial performance suggests that WSI's prices are clearly below market levels;*
- *recent sales data from India suggests that New Zealand wool prices in the market are between 20 and 130 cents per kg lower than would be expected based on sales in other markets; and*
- *as stated previously, even if the benefit of New Zealand were only 10 cents per kilogram, a 10 cent per kg price differential across New Zealand's wool exports of approximately 169,000 tonnes (excluding domestically processed wool products) implies a benefit to New Zealand of \$16.9 million per year.¹⁶⁷*

427. Cavalier Wool in its submission on the Draft Determination argued that a merchant scouring model has different marginal costs compared to other exporters. As such, WSI would be willing to sell wool at a lower price than other exporters. Also, Cavalier Wool argued that WSI's position as a merchant scourer weakens its bargaining position

¹⁶³ Commission interview with Palle Petersen, 16 February 2011.

¹⁶⁴ Commission interview with John Henderson, 17 February 2011.

¹⁶⁵ Commission interview with Peter Whiteman, 21 February 2011.

¹⁶⁶ Commission interview with [].

¹⁶⁷ Bell Gully Letter of 9 March 2011.

because its clean wool customers know that it has incentives to maximise scour throughput.

428. Castalia argues that the weak seller claim ignores the fact that wool merchants can put downward pressure on commission scours' prices, as the commission scour would need to decrease its prices to compete for the necessary wool volumes. That is, it is not only merchant scours that have the incentives to price down to marginal cost to increase throughput. As such, a vertically integrated scour would be no "weaker" than any other business model. Castalia also questions "why a merchant scour would accept a price that results in losses, simply for the sake of increasing scouring throughput".
429. The Commission has not placed any weight on this claimed benefit. The Commission is of the view that there is no compelling reason why WSI should choose to sell its wool at less than the market price.
430. WSI has provided the Commission with evidence that suggests that it is not the cheapest option for customers of clean New Zealand wool in markets such as China. Similarly Godfrey Hirst has advised the Commission that of its wool suppliers, including WSI and various wool merchants, WSI sometimes tenders the lowest price and at other times is more expensive than other merchants.
431. Moreover, selling at less than market prices would not be economically rational for WSI. Over the longer term, WSI needs to cover its fixed costs as well as its marginal costs – just like a commission scour does. There is no justifiable reason why a vertically integrated exporter would reduce its prices to such an extent that it could not recoup its costs. Furthermore, there is no reason for the Commission to be satisfied that WSI would persist with a loss making business model in the counterfactual, even if it was currently a "weak seller". Therefore, the Commission is not satisfied that there will be a material public benefit from the removal of WSI as a "weak seller" in the factual.

Wool Superstore Benefits

432. The Applicant has submitted that substantial public benefits would arise in the factual because it would develop the concept of a "wool superstore", initially in Hawke's Bay and later in Timaru. According to the Applicant, a wool superstore refers to the concept of centralised consolidation of a majority of the greasy wool produced in each Island at purpose built, independently operated, wool stores sited adjacent to a wool scouring plant and close to an export port. Aggregation of large volumes of wool and its sorting, classing, testing, and storage would occur under one roof. The proponents of the scheme argue this would eliminate the duplication of storage resources currently present in the wool industry. It would also ensure that the flow of the wool stream was always in the direction of the initial wool processing plant and the port of export. Thus such a location of the superstore adjacent to wool scours and near to the current export ports would streamline the process by which wool is currently aggregated, sold and transported from farm gate to store, to scour, and to domestic and international markets.
433. According to the Applicant, currently there is a multiplicity of duplicated wool aggregation and storage sites throughout both Islands owned by wool brokers and merchants such that there is overcapacity. Also, initial flows of wool from farm to store may be in a direction away from the point of processing and port of export. Cavalier Wool argues that it is the elimination of this overcapacity and "reverse cycle freight" that is the public benefit.
434. The Applicant considers the superstore concept requires an operator that is independent of the existing entrenched interests of wool merchants, wool brokers and auctioneers to

develop and operate the facility. This is necessary to ensure that there would be no actual or perceived conflict of interest between the superstore owner/operator and its customers. The Applicant advised that although it is anticipated that it would be the promoter and catalyst of a superstore, it is possible that once the concept is established it may be transferred to an independent operator. In this respect, the concept does not rely on Cavalier Wool's on-going participation in the concept. Cavalier Wool advised¹⁶⁸ that it had an independent investor that was prepared to commit time and capital to the project. It also had expressions of interest from a wide range of other investors who wished to become shareholders in the proposed superstore. Cavalier Wool advised that it had negotiated with, and intended to appoint, an executive to manage its part of the project, if the merger of Cavalier Wool and WSI scours occurred.

435. The Applicant considers that the benefits of the superstore will accrue to investors, wool merchants and wool producers.

Size of benefit

436. The Applicant has submitted that the North Island costs for growers presently associated with wool handling, storage and sale operations is approximately [].
437. The Applicant has submitted that the superstore, once fully operational, will have costs of approximately []. However, other wool handling costs will remain in the industry, such as collection and freight from farm gate to superstore and wool testing. Mr George for Cavalier Wool advised that the cost savings will arise through consolidation of logistics and warehousing, with no impact on service to farmers.¹⁶⁹
438. According to Cavalier Wool, the projected cost savings would arise from:
- the rationalisation of duplication of wool storage facilities and other wool handling infrastructure;
 - reduced labour costs;
 - reduction in reverse freight (wool freight whereby wool is transported in some part in a direction away from the processing plant and/or export port; and
 - overheads, interest, and wool holding costs.
439. The Applicant has advised that the initial North Island superstore located near Napier would have annual throughput of 325,200 bales (53,625 tonnes) per annum (currently 62% of the North Island wool clip).
440. The Applicant has submitted figures which show the superstore concept is likely to achieve annual cost savings of approximately [], made up from:
- reverse freight savings of [];
 - local freight savings of []; and
 - superstore efficiency savings of []. These savings are calculated by subtracting the estimated costs of the superstore (plus a 20% contingency), in the factual, from the average of wool brokers' and merchants' handling costs, in the counterfactual.

¹⁶⁸ Cavalier Wool Authorisation conference transcript, 4 May 2011, page 78.

¹⁶⁹ Cavalier Wool Authorisation conference transcript, 4 May 2011, pages 77-80.

441. While this is the Applicant's analysis, there was no disputation of the potential cost savings by interested parties, including Godfrey Hirst and WSI who were opposed to the Acquisition throughout the process.
442. Cavalier Wool has provided the Commission with a breakdown of how the local and reverse cost savings will be made. Essentially some of the wool that is grown in Hawke's Bay is transported out of the region (away from the scour) for storage, before being transported back for storage. Similarly, local costs savings can be made as wool could be transported direct to the superstore rather than to Napier and back. The Commission considers that Cavalier Wool's estimates are conservative in this instance. Reverse freight savings could be made for wool other than that grown in the Hawke's Bay, if it transported directly to a superstore located adjacent to the scour. Therefore, the Commission accepts the local and reverse freight savings of [] million per year as a public benefit.
443. Cavalier Wool has also provided a breakdown of the superstore's estimated costs as compared to current costs in the industry. The Commission has calculated that operational savings in the order of \$5.157 million per year could be obtained if both the forecast costs and volumes are achieved.
444. However, as the superstore is still in its planning stage, the Commission considers that the level of costs savings are not as certain as the cost savings put forth by Cavalier Wool in terms of its scour operations. Moreover, the forecast volumes rely on maximising the capacity of the store, which may not be achievable for some time. Therefore the Commission has modelled likely benefits which include superstore costs of 20% higher than those forecast by Cavalier Wool and wool volumes of 20% less than those forecasted by Cavalier Wool. Using these assumptions, the Commission calculates likely annual operational cost savings of \$3.476 million. The Commission has adopted this cost saving as a conservative and most likely estimate of the annual operational savings as a public benefit from the superstore.
445. The Applicant has advised that a North Island superstore would require an investment of about []. This figure is based on a 30,000 m² building at a cost of \$500 per m². Mr Dwyer of WSI agreed that such a building would cost about that figure.¹⁷⁰
446. The Commission notes that its analysis has included a cost allowance for rental of the superstore building at 10% per annum of the [] investment in the calculation of operational cost savings. Such a cost model is appropriate to allow a proper comparison with the industry's costs in the counterfactual to be made.
447. In the Draft Determination, the Commission considered an additional public benefit may have arisen from the freeing up of existing wool stores for other productive uses. However, the Commission accepts that the costs of the land and buildings have been implicitly included in the current brokers' fees that the Commission is using as a counterfactual comparison. The savings in operational cost include the implicit lease costs of the current wool stores. Therefore, including the freeing up of land and buildings in this instance as a separate benefit would be double counting.
448. The Commission recognises the potential for a South Island superstore in due course, with significant public benefit likely to occur from such a development. However, the South Island superstore concept is admitted by Cavalier Wool to be a more distant project in time to that of the North Island, and, as such, the Commission is not satisfied

¹⁷⁰ Cavalier Wool Authorisation conference transcript 4 May 2011, page 81.

that it will become a reality within the five years that the Commission has calculated the benefits and detriments of the Acquisition .

Likelihood of the benefit

449. The Commission must decide whether it is satisfied that the superstore concept would be likely to occur in the factual, but not in the counterfactual, for it to be counted as a public benefit.
450. WSI, as an interested party which is opposed to the granting of authorisation, agreed that the superstore concept is viable and has previously acknowledged that it would be beneficial to the wool industry.¹⁷¹ Indeed it stated it had investigated a similar concept itself but was put off by the potential capital cost. Other industry parties, particularly wool merchants agreed that the benefits of the concept were as “plain as a wart on your nose.” While some parties were concerned at the establishment of a logistics “monopoly”,¹⁷² the main point of contention of those in opposition to the Acquisition was that the superstore could also occur in the counterfactual and therefore could not be counted as a benefit arising from the acquisition.
451. Cavalier Wool stated that the superstore concept relies on promotion and eventual operation by an independent third party. It argues that it is the only industry third party capable of successfully implementing the concept. A potential wool merchant customer of the superstore would be reluctant to use the store if it was operated by one of its wool merchant competitors. Conversely, an existing wool merchant owning a wool store would be unlikely to expand its existing wool storage facilities if this required the support of its competitors’ wool volumes. The Applicant considers it is this rivalry that has led to the present duplication of wool storage facilities with every merchant large and small finding it necessary to own a wool store.
452. Cavalier Wool advised that it will only implement the project in the factual. It states that it would only have the incentive to invest in the concept if it could be sufficiently certain to attract enough volumes to reduce costs to a level such that a superstore will provide a return on the investment.¹⁷³ This is why it has not advanced the concept to date. Cavalier Wool considers that if it developed the concept pre-acquisition, there would be no prospect of the superstore obtaining the considerable wool volumes of WSI and this would make the achievement of the requisite volumes for profitable operation too risky.
453. As stated, WSI has also investigated the possibility of developing its own superstore. Mr Dwyer advised that WSI has undertaken a feasibility study but that the concept has not been “too encouraging” due to the high costs of the building. As such, the Commission considers it unlikely that WSI would develop a superstore in the counterfactual. Even if it were to build its own store, it is unlikely that most other merchants would support such a WSI-owned facility given their current reluctance to scour with WSI, their main trading competitor.

171

[

] Cavalier Wool authorisation transcript, confidential

session 5 May 2011, page 2.

¹⁷² For example, Cavalier Wool authorisation conference transcript, 4 May 2011, page 77.

¹⁷³ As stated, Cavalier Wool has based the economics of the superstore project on a take up rate of 62% of the North Island wool clip.

454. Given that the superstore concept is still in its development stage, the Commission has had to carefully consider whether the concept will, or will be likely to go ahead, if the proposed Acquisition goes ahead. Issues that need to be resolved to ensure its development include the fact that there are existing entrenched interests in the storage and sale of wool throughout New Zealand. The wool volumes of those parties would be necessary for the superstore concept to succeed. It is possible that a developer of a superstore would be required to fund the exit costs of such parties, which may alter the economics of the project for the worst.
455. However, the Commission has been given comfort by the strong industry support for the concept. Mr Whiteman of Segard Masurel¹⁷⁴ advised that “anything that consolidates the wool off farm to a first point is good” and that consolidation in the scouring industry makes a superstore concept obvious.¹⁷⁵ Mr Crone of John Marshall¹⁷⁶ agreed with this.¹⁷⁷
456. The Commission has also been provided with letters that indicate support for the concept from
[]].
457. Given the broad industry support for the concept and the underlying commercial justification for such consolidation, the Commission is satisfied that the superstore would be likely to occur in the factual.

Timing of the benefit

458. The Commission has to give consideration as to when the public benefits arising from the superstore would be likely to occur.
459. The Commission considers that it would likely be three to five years before benefits of the size described above are achieved.
460. This timeline is based on Cavalier Wool’s admission that it may take a period of time before the superstore attracts enough wool volumes to reduce the costs to the levels described above. The Applicant submitted that in the initial stages Cavalier Wool would have to offer attractive prices without the benefit of economies of scale.¹⁷⁸ Mr George also advised that “we’re not expecting everyone to come onboard on day one”.¹⁷⁹
461. As such, while the Commission considers it likely that Cavalier Wool will be able to undertake the superstore relatively swiftly post-acquisition, the Commission considers it appropriate only to assign significant benefits from years four and five.

Legal impediments

462. Godfrey Hirst submitted that “...to the extent that the merged entity would need to acquire any assets of a business to establish the superstore, that acquisition itself could substantially lessen competition and consequently need a further authorisation.” Godfrey Hirst also submitted that “...the merged entity as operator of the superstore would want to enter into a series of arrangements with the suppliers of various services to the superstore, as well as industry participants who want their wool handled there. All

¹⁷⁴ New Zealand’s second largest wool exporter after WSI.

¹⁷⁵ Cavalier Wool Authorisation conference transcript, 4 May 2011, page 82.

¹⁷⁶ Another large wool exporter.

¹⁷⁷ Cavalier Wool Authorisation conference transcript, 4 May 2011, page 82.

¹⁷⁸ Bell Gully letter, 28 March 2011, paragraph 2.1.

¹⁷⁹ Cavalier Authorisation conference transcript, 4 May 2011, page 85.

such arrangements, taken together as s 3(5) requires, may also give rise to a substantial lessening of competition or foreclosure.”

463. In the Commission’s view the submission that the superstore may raise competition issues before it could be implemented is ill founded. It is not clear to the Commission on the facts of this case how the creation of the superstore could potentially suppress the supply by anybody else of transport and storage services. Section 27 of the Act prohibits contracts, arrangements or understandings which substantially lessen competition. It is directed against particular provisions of such contracts rather than against the contracts themselves and it is the provision which must have the requisite anticompetitive purpose or effect. As Godfrey Hirst noted, s 3(5) provides for the aggregation of provisions in a contract, arrangement or understanding, to help assess overall anticompetitive effect.
464. The Commission has not been provided with copies of any potential contracts or details of any arrangements which may be put in place. However, the Commission has been advised by the Applicant that there would be no obligation on farmers or transporters to provide wool directly to the superstore and that the existing services offered by brokers, wool testing authorities and transport operators would be unaffected. Therefore, the Commission does not believe that a Commerce Act issue would arise.

Conclusion on Superstore Benefits

465. The Commission is satisfied that benefits from the superstore will, or will likely, occur in the factual. While the Commission recognises the difficulties in quantifying this benefit, it is apparent that its implementation would deliver real commercial gains and significant public benefit. In this instance, the Commission has estimated benefits of the superstore in the North Island as \$4.1 million¹⁸⁰ for years four and five, with a NPV value of \$7.2 million.

Quality Benefits

466. The Applicant has submitted that a substantial public benefit arising from the proposed Acquisition would be an improvement in the quality of New Zealand’s scoured wool. That benefit, it is claimed, would arise from Cavalier Wool producing scoured wool with an improved brightness. Improved brightness would allow greater returns from the sale of New Zealand’s wool clip.
467. Cavalier Wool states that, by using its existing superior scouring techniques, it is able to produce scoured wool of superior brightness to that produced by WSI’s scouring plants. Therefore, submits Cavalier Wool, post-acquisition it would scour the wool that would otherwise be processed by WSI in the counterfactual, achieve a superior brightness, and increase the value of WSI’s proportion of the wool clip. In addition under the rationalisation proposed in the factual, Cavalier Wool says that it would make additional improvements to its existing scouring equipment to further improve the brightness of the wool it scours.
468. The wool industry’s measure of brightness (or whiteness) is “the Y value.” The Y value of wool is tested both in its greasy form (as an *input* to the scouring process), and in its clean form after scouring (as an *output* of the process). Wool testing for Y value is carried out at the individual scours and also by independent test houses on behalf of wool merchants, brokers, and end users.

¹⁸⁰ [

469. The Applicant submitted the following:

- Increasing the brightness of scoured wool would provide a public benefit due to higher returns for the same quantity and initial quality of wool. In particular, a one unit increase in the base Y value of wool provides a sale price increase of at least 4 cents per kilogram of wool.
- Cavalier Wool argues that it could achieve improved Y values for the wool that it scours compared to WSI output. These improvements in the base Y value would arise from scouring techniques, equipment modifications and liquor conditioning.
- Cavalier Wool has already made all of the necessary Y value improvement equipment modifications to its Timaru plant. There are further such Y value improvements achievable at the Awatoto plant but these would not be implemented in the counterfactual as Cavalier Wool would need the increased throughput that the general rationalisation proposals would achieve, to justify the modifications that would improve the Y value of the output.

470. WSI submitted the following:

- The base Y value is a “very minor factor taken into account when scouring wool.” Customers’ specifications for their scoured wool are much more focused on the (Y-Z) value which measures wool’s yellow discolouration.
- WSI’s scouring quality is as high as that of Cavalier Wool. There is no evidence that Cavalier Wool can achieve a higher Y value than WSI. However, even if it could be shown that WSI’s output has a lower average base Y value than that of Cavalier Wool, that is because it scours a different product mix of dirtier, more yellow wool. WSI said that the reason for this is that a large proportion of its wool is sold to India, which proportionally purchases more of the lower quality wools. Thus WSI wool inputs into its scouring processes are different than Cavalier Wools and, as such, the output would be different regardless of scouring quality achieved.

The value of increasing Y

471. Dr Garth Carnaby,¹⁸¹ giving expert evidence on behalf of WSI, submitted that the wool auction system has consistently rewarded suppliers for higher colour quality wool - the Y value. Dr Carnaby’s opinion was that an average value of \$0.04 per kilogram per unit increase in base Y value could be used as a conservative estimate to calculate its economic value. This is consistent with feedback from a number of other parties in the industry.

472. In this respect, the Commission accepts that wools of a higher quality (i.e. a higher base Y) can, and do, earn a premium over wools with a lower Y value.

Cavalier Wool’s ability to improve its output Y value

473. The Applicant has claimed that its plant rationalisation proposal would allow it to increase the quality of the wool scouring services it would provide in the factual. The Applicant estimated such quality improvements would yield a benefit of [].

474. The Applicant claims these benefits would be achieved by modifying WSI’s two existing three metre-wide scour lines (from Kaputone and Whakatu) and Cavalier’s two

¹⁸¹ A former head of the Wool Research Organisation of New Zealand.

2.4 metre-wide scour lines at Awatoto. The quality modifications would include additional wool openers and washing bowls. Cavalier Wool claims that these modifications would allow it to increase the run rate of the scour lines to increase production, and with an added advantage of improving the brightness of the wool by 1 to 2 “Y value units”. In this respect, the Applicant is claiming that it is both a more efficient scourer than WSI and it could further improve the output Y value of its own existing wool scouring process.

475. Dr Carnaby, for WSI, is sceptical about the Applicant’s claimed quality benefits.¹⁸² He stated that improvements in the brightness value of scoured wool cannot be achieved by simply changing WSI’s existing scouring configuration to replicate that of Cavalier Wool. In particular, Dr Carnaby noted the following:

- All the “improvements” described in the Application appear to relate to more vigorous agitation, cleaning or rinsing which might produce a cleaner looking product (or the “as is” Y value). These are unlikely to greatly improve the base Y value as it is generally not possible to significantly affect the base colour Y by scouring alone.
- The testing process used to determine Y values can be imprecise and so it can be difficult to assess the claimed improvements as statistically significant.
- Proprietary technology is not limited to Cavalier Wool. For example, WSI has its own technology such as its trademark “Glacial” scouring method which uses an additional process to lift the base Y and this can be used to produce a very bright white carpet wool.

476. On the other hand, the Applicant has provided additional reports on wool quality from Stephen Fookes, former Chief Executive Officer of the New Zealand Wool Testing Authority, and Steve Ranford, a scientist involved in wool research. Mr Fookes and Mr Ranford concur with Cavalier Wool’s view that:

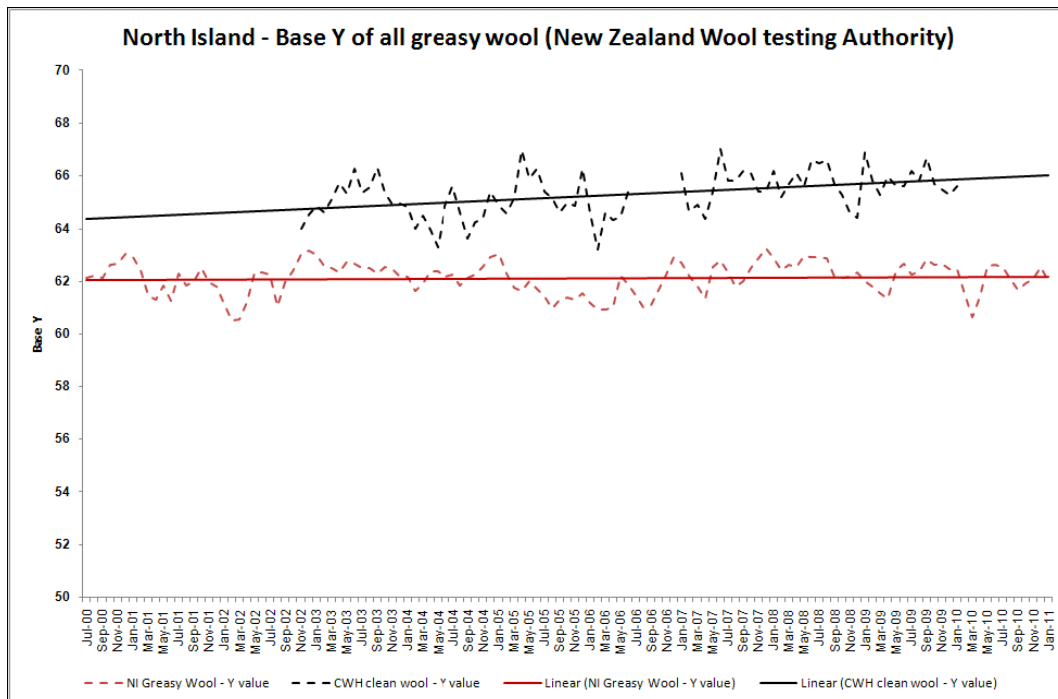
- the scoured brightness value can be increased through improvements to the scouring process (other than by the addition of peroxide bleach);
- the evidence it has presented indicates that it has achieved the claimed increase in the brightness value by scouring alone;
- an increase in the brightness value has a significant value; and
- merchants would be able to purchase greasy wool with a lower brightness value (and continue to meet the customers Y value specification) without degrading all, or any, of the other important properties of the greasy wool they acquire.¹⁸³

477. Cavalier Wool has provided the Commission with a chart (below) that compares the output clean wool average Y value from its North Island plant with the North Island greasy wool average Y value (Figure 9). Cavalier Wool argues that this evidence proves that it has increased the Y value of its clean wool output, in the face of generally unchanging input Y values, over the last eight years. Cavalier Wool has advised that a similar data set is not available for the South Island, but that it considers even greater improvement in the Y value have been achieved in the South Island.

¹⁸² Report from Dr Garth Carnaby 8 March 2011.

¹⁸³ Other properties include fiber diameter; length; strength; and yellowness.

Figure 9: Cavalier Wool's base Y of scoured wool versus the base Y of all greasy wool in the North Island



478. The Commission notes that Figure 9 compares Y values from two different data populations - the greasy wool from the entire North Island wool clip (the input) is compared with the clean wool, only from Cavalier Wool's plant (the output). As such, there are two possible explanations for Cavalier Wool's clean wool Y values' upward sloping line:

- Cavalier Wool has improved its scouring quality, as measured by the base Y value, over the last eight years; or
- Cavalier Wool has been scouring initially cleaner wool than the average North Island value that has higher than average greasy Y values and that this has changed over time, leading to higher clean Y values. That is, Cavalier Wool's inputs into its scouring process differ materially from the average input across the North Island.

479. Dr Carnaby stated:

In my first submission I cautioned against inferring causality from the data available. I specifically referred to the risk that the claimed Base Y improvement, if real, could be just due to selection of a whiter subset of NI wools by Cavalier.¹⁸⁴

480. Cavalier Wool does not collect the input Y values of the greasy wool it scours, that would allow the Commission to resolve this issue, because as a commission scourer it does not own wool at any stage of the process. It is the merchants, rather than the commission scourer who needs that data. Cavalier Wool has advised, however, that the proportion of oddments it has scoured during the last five years, in comparison to its total processing, has increased from 18.5% to 23%. Oddments (such as belly wool) have lower average greasy Y values than does body wool. Cavalier Wool argues that

¹⁸⁴ Letter from Dr Carnaby, 4 April 2011.

this indicates that the quality of its greasy wool input has been decreasing, if anything but it has, nevertheless, managed to increase the brightness of its scoured output. Oddments are, however, only a proportion of scouring volumes,¹⁸⁵ and therefore this data does not show conclusively whether or not the Y value of Cavalier Wool's scour inputs have increased or decreased in recent years.

481. On the other hand, as a merchant scourer WSI owns a large proportion (85% – 90%) of the wool that it scours and, therefore, wishes to know the Y value of the greasy wool it purchases. Mr Dwyer advised that every greasy bale that WSI purchases is tested for, amongst other parameters, its Y value. Each high density pressed clean bale is also tested.¹⁸⁶
482. The Commission requested WSI to provide its average Y value figures for both greasy and clean wool in order that it might test WSI's submission that, while Cavalier Wool may have improved its output base Y value, WSI had achieved at least the same result, if not better. This would mean that Cavalier Wool would be unlikely to achieve the quality improvements in respect of WSI wool volumes together with the benefit that it had claimed. Whilst WSI advised at the conference that it would provide these figures, it did not submit them as part of its post-conference submission.¹⁸⁷ WSI submitted that it has had difficulty in providing results on average Y values for greasy and clean wool due to the following:
- Scoured wool is sourced from a number of batches. One test sample is provided for each batch, irrespective of its size. It is not a weighted average and identifying and determining the size of each batch in order to calculate such a weighted average would be a very time consuming exercise.
 - Y-Z value is the crucial factor for its customers, not Y.
 - Y values can be affected from year-to-year by varying climatic conditions and shearing patterns and it would be difficult to extrapolate a reliable trend.
483. In the Commission view, none of the reasons provided by WSI would preclude it from providing the Commission with its average Y values for greasy and clean wool, as it advised it would.
484. In its post-conference submission, Cavalier argued that:
- 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.*
485. Cavalier Wool has also submitted that a number of internal WSI documents indicate that the claimed quality benefits would arise from the transaction. In a letter of 16 July 2010 from David Stock to Pat Morrison (WSI Chair at the time) Mr Stock stated:

[

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¹⁸⁵ On average, oddments make up about 15% of the total sheep fleece.

¹⁸⁶ Cavalier Authorisation conference transcript, 4 May 2011, page 100.

¹⁸⁷ The Commission notes that WSI submitted that it obtained both its and Cavalier Wool's Y value data from the Wool Testing Authority. While WSI provided Cavalier Wool's data to the Commission, it did not provide WSI's data.

486. The Commission appreciates Cavalier Wool's concerns that WSI has not been forthcoming with its information.
487. However, the Commission has concerns with the data shown in Figure 9 that would not be rectified by access to WSI's data, as follows:
- Evidence provided by Godfrey Hirst indicated that the proportion of poorer quality wool that WSI has been scouring at Whakatu has increased between 2005 and 2010, with the corollary that the proportion of poorer quality wool that Cavalier Wool has been scouring has decreased.¹⁸⁸
 - The test results for the North Island are not a weighted average. Mr Pike, Godfrey Hirst, advised that the results show only one test per lot, and that a lot of wool can range between half a bale to several dozen.¹⁸⁹
 - The test results for the Cavalier Wool are not a weighted average. Mr Pike, Godfrey Hirst, advised that the results show only one test per scourment (or batch), and that scourments can range from between 10 tonnes to several hundred.¹⁹⁰
 - The test results for the Cavalier Wool's clean wool do not show results for the periods May 2006 to March 2007 and November 2009 to November 2010. WSI argues, and has provided evidence, that Cavalier Wool's average Y value decreased during those periods.
488. The Commission therefore does not consider that the testing evidence to be conclusive in terms of Cavalier Wool's ability to outperform WSI scouring in relation to the Y value.

Evidence from customers of scouring quality

489. In the Draft Determination, the Commission included evidence showing that customers who obtained wool scouring services from both WSI and Cavalier Wool (such as Summit Woolspinners and John Marshall and Co) did not consider that Cavalier Wool's Timaru plant provided higher quality scouring services than did WSI's Kaputone plant. Nor did the customers agree that, as merchants or users of clean wool, they could purchase inferior wool and still achieve the same quality output at the Timaru plant.¹⁹¹ In short, the Commission had been unable to find sufficient evidence that Timaru is currently providing a higher quality output that is valued by its customers.
490. However, in its submission on the Draft Determination, Cavalier Wool provided letters from []:

- []

[

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¹⁸⁸ Cavalier Authorisation conference transcript, 4 May 2011, page 104-105.

¹⁸⁹ Cavalier Authorisation conference transcript, 4 May 2011, page 104.

¹⁹⁰ Cavalier Authorisation conference transcript, 4 May 2011, page 104.

¹⁹¹ Some exporters such as [] advised the Commission that Cavalier was better at blending than WSI, but none advised that this reduced their input costs in any noticeable manner.

- []

[

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491. Thus there appears to be conflicting views from customers about Cavalier Wool's ability to improve the Y value of scoured wool. The Commission did find, however, in the course of its investigation that the major concerns merchants had with WSI were because it was a competitor in wool markets, rather than the quality of its output.

Ability to achieve benefits in the counterfactual

492. Godfrey Hirst argues that any benefits in terms of improved Y value could be achieved in the counterfactual, and as such are not contingent on the proposed Acquisition proceeding. Godfrey Hirst has submitted:

There is no nexus between the proposed acquisition and the benefit occurring. CWH itself states that the quality of scouring has been incrementally increasing over the past ten years and there is no reason that process would not continue. Further, there is no reason why any enhanced technology that gives rise to the higher Y value could not be obtained by WSI in the counterfactual either through WSI developing that technology itself or licensing it from CWH or another supplier.

493. The quality enhancing process improvements that Cavalier Wool has implemented up to the present time have been achieved absent the rationalisation that Cavalier Wool argues is a necessity to make new improvements viable. Therefore, the Commission considers that any quality enhancing process improvements, if achievable, are likely to be attainable in the counterfactual.

494. For example, Cavalier Wool has estimated a five year NPV benefit of between [] in quality benefits could be achieved by process enhancements. This would require only an initial capital expenditure on buildings of [] (or using Cavalier's figures, a 5-year present value of []). This would suggest that it would be rational to make the investment in the counterfactual as long as Cavalier Wool was in fact, able to capture a significant proportion of this benefit.

495. Cavalier Wool submits that the appropriate question for the Commission to ask is "would" (as opposed to "could") the benefit be achieved in the counterfactual. The Commission agrees. In the Commission view, if Cavalier Wool could provide a benefit of 4 cents per kg of wool, in excess of that provided by WSI, to be shared by itself and its customers, then this investment would be commercially rational as it would give it a significant competitive advantage in an industry where throughput is crucial.

496. Cavalier claims that it would not be able to capture all of the quality benefits, and that this is why it would not undertake the improvements in the counterfactual. That is, the quality benefits would only be achieved as a by-product of the rationalisation, which in turn would be driven by the improved efficiencies and economies of scale available.

497. However, in the Commission's view, Cavalier Wool would be able to capture at least a proportion of the quality benefits in the counterfactual if it was providing a superior quality scouring service to its customers.

498. The Commission is therefore not satisfied that the benefits, if indeed they are real, would not be achieved in the counterfactual.

Incidence of benefit

499. Futures, on behalf of WSI, has submitted that much of the benefits of any quality improvements would be likely to be captured by customers, as woollen products compete in vigorously competitive downstream markets. As about 85% of New Zealand wool is exported, Futures submitted that this proportion of any quality benefit would not accrue in New Zealand and therefore should not be counted as a public benefit. It is likely that the benefits of quality improvements, if they were achievable, would be shared between growers, New Zealand-based wool merchants, scourers, NZ-based downstream processors and overseas-based processors and customers. The Commission has not considered this point further as it is not satisfied that this benefit will occur.

Conclusion on quality benefits

500. While the Commission recognises the potential of significant public benefits if an improved Y value could be achieved by the scouring industry, it is not satisfied that this benefit will occur in the factual. In light of the above, the Commission's view is that it cannot put any weight on the claimed [] benefits accruing from quality improvements from the proposed acquisition.

BALANCING OF BENEFITS AND DETRIMENTS

501. This Application involves a balancing of the public benefits and detriments which would, or would be likely to, result from the Acquisition. Only when there is a net positive public benefit can the Commission be satisfied that the Acquisition should be permitted, and that it should grant an authorisation for the Acquisition.

502. Table 5 and 6 summarise the Commission's quantitative assessment of the likely detriments and benefits arising from the acquisition.

Table 5: Summary of Detriments

Category	Evaluation	5-year NPV
Allocative efficiency	\$0.2 million to \$3.8 million per year	\$0.7 - \$22.7 million
Productive efficiency	[]	[]
Dynamic efficiency	[]	[]
Total of quantified detriments		\$1.4 - \$28.8 million

Table 6: Summary of Benefits

Category	Evaluation	5-year NPV
Reduction in Production and Administration Costs	[]	[]
Sale of land	One-off benefit	\$6.0 - \$10.0 million
Capital expenditure on land and buildings	One-off cost	[]
Capital expenditure on plant	[]	\$0.9 million
One-off Rationalisation Costs	One-off cost	[]
Superstore	Savings of \$4.1 million per year in years four and five	\$7.2 million
Total of quantified benefits		\$29.6 - \$33.6 million

Note: A 10% discount rate was used in these calculations. Figures have been rounded to one decimal place after the calculations have been made and therefore all columns may not sum.

503. The Commission is required to assess likely benefits and likely detriments. The above represents the Commission's quantitative assessment of these benefit and detriment ranges. The Commission notes that the high estimates for the detriments and the lowest number for the quantified benefits are relatively close.
504. As previously noted, the Commission considers quantification is only one tool to be used in its judgements in such a case. The necessary balancing of benefits and detriments is also informed by the Commission's qualitative judgements of the most likely benefits and detriments within any ranges. As already noted, the quantitative assessments informs upon the ultimate qualitative assessment of both benefits and detriments.
505. Using the midpoint estimates, as identified throughout this document, gives an estimate of the likely net present value of detriments over five years of \$18.1 million and benefits of \$31.6 million. Accordingly, the benefits in total and in various combinations, are sufficient to outweigh the detriments. For example, the Acquisition would be authorised even without the Commission's acceptance of the superstore benefits. The Commission is therefore of the view that the public benefits are likely to significantly outweigh the public detriments. The proposed Acquisition has the potential to generate real gains for the public of New Zealand.

DETERMINATION

506. The Commission's view is that it is not satisfied that the Acquisition will not have, or would not be likely to have, the effect of substantially lessening competition in both the North and South Island markets for the supply of wool scouring services and that the Commission would not give a clearance for the Acquisition .
507. Having regard to all the circumstances, the Commission's view is that it is satisfied that the benefits to the public would outweigh the loss of competition arising from the Acquisition. Therefore, the Commission 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.
508. Therefore, the Commission determines to decline to give clearance to, but grants an authorisation of, the Acquisition under s 67(3)(b) of the Act.

Dated this 9th day of June 2011.

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Dr Mark Berry
Chair

APPENDIX 2: TWENTY YEAR BALANCING OF DETRIMENTS AND BENEFITS

Twenty year Summary of Detriments

Category	Evaluation	20-year NPV
Allocative efficiency	\$0.2 million to \$3.8 million per year	\$1.6 - \$51.0 million
Productive efficiency	[]	[]
Dynamic efficiency	[]	[]
Total of quantified detriments		\$3.2 - \$64.7 million

Twenty year Summary of Benefits

Category	Evaluation	20-year NPV
Reduction in Production and Administration Costs	[]	[]
Sale of land	One-off benefit	\$6.0 - \$10.0 million
Capital expenditure on land and buildings	One-off cost	[]
Capital expenditure on plant	[]	\$0.9 million ¹⁹²
One-off Rationalisation Costs	One-off cost	[]
Superstore	Savings of \$4.1 million per year in years four and five ¹⁹³	\$33.1 million
Total of quantified benefit		\$81.7 - \$85.7 million

Note: A 10% discount rate was used in these calculations. Figures have been rounded to one decimal place after the calculations have been made and therefore all columns may not sum.

¹⁹² The Commission has left this figure unchanged, although it may in fact be a greater benefit if capital spend is reduced for a period beyond five year. The Commission does not have the data to accurately assess this, however, and notes that this is a very small component of the benefits.

¹⁹³ Note that the Commission has not included a benefit for the superstore in the South Island, which is likely to occur within the next 20 years.

APPENDIX 3: BALANCING OF DETRIMENTS AND BENEFITS USING RENTAL VALUES RATHER THAN SALES

Summary of Detriments

Category	Evaluation	5-year NPV
Allocative efficiency	\$0.2 million to \$3.8 million per year	\$0.7 million - \$22.7 million
Productive efficiency	[]	[]
Dynamic efficiency	[]	[]
Total of quantified detriments		\$1.4 - \$28.8 million

Summary of Benefits

Category	Evaluation	5-year NPV
<i>Reduction in Production and Administration Costs</i>	[]	[]
Sale of land	Annual rental of 10% of properties' values is \$0.6 million - \$1.0 million per year	\$2.5 - \$4.2 million
<i>Capital expenditure on land and buildings</i>	Upfront cost of [] million depreciated over 50 years.	[]
Capital expenditure on plant	[]	\$0.9 million
<i>One-off Rationalisation Costs</i>	One-off cost	[]
Superstore	Savings of \$4.1 million per year in years four and five	\$7.2 million
Total of quantified benefits		\$28.2 - \$29.9 million

Note: A 10% discount rate was used in these calculations. Figures have been rounded to one decimal place after the calculations have been made and therefore all columns may not sum.

APPENDIX 4: CAVALIER WOOL'S ESTIMATED ELECTRCITY UNIT SAVINGS IN THE NORTH ISLAND

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APPENDIX 5: CAVALIER WOOL'S ESTIMATED ELECTRCITY UNIT SAVINGS IN THE SOUTH ISLAND

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APPENDIX 6: CAVALIER WOOL'S ESTIMATED COAL SAVINGS IN THE SOUTH ISLAND

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