David Goddard QC

Thorndon Chambers
PO Box 1530
Wellington 6140
NEW ZEALAND
Level 6
10 Customhouse Quay

Tel: (64 4) 499-6040
Fax: (64 4) 499-6118

e-mail: david.goddard@chambers.co.nz

Memorandum

TO: David Stock

DATE: 27 April 2011

NEW ZEALAND WOOL SERVICES INTERNATIONAL LTD: CAVALIER WOOL HOLDINGS LTD AUTHORISATION APPLICATION

1 You have asked me to review the Commerce Commission’s draft determination dated 13 April 2011 concerning the application by Cavalier Wool Holdings Ltd (“Cavalier”) for authorisation to acquire up to 100% of the assets and/or shares of New Zealand Wool Services International Ltd (“WSI”), and to comment on any significant legal issues that arise from that draft determination.

2 I consider that there are three significant legal issues raised by the draft determination:

2.1 the implications of the Takeovers Code and the Listing Rules for the ability of Cavalier to achieve the predicted benefits from rationalisation of WSI assets;

2.2 the relevance of the current ownership of Cavalier to the assessment of productive and dynamic efficiency detriments;

2.3 the Commission’s suggestion at [242] that the estimated benefits from the acquisition should be given greater weighting than the detriments in the balancing exercise under s 67(3) of the Commerce Act 1986 (the Act), because their quantification has a higher degree of certainty.

3 I discuss each of these legal issues briefly below.

Ability to achieve claimed benefits

4 The Commission has formed the preliminary view that the proposed acquisition will have the effect of substantially lessening competition in the relevant wool scouring markets, for reasons which seem to me to be entirely persuasive. As the Commission has noted at [6] – [7], the Commission may grant an authorisation if and only if it is satisfied that the acquisition will result, or will be likely to result, in such a benefit to the public that it should be permitted. The burden of proof lies with the applicant to satisfy the Commission on the balance of probabilities that the public benefits are likely to be achieved, and will outweigh the detriments that are likely to result from the acquisition.

5 I understand from you that the rationalisation of assets proposed by Cavalier can take place only if either:

5.1 Cavalier acquires more than 90% of the shares in WSI, so is entitled to proceed to acquire the balance of the shares compulsorily; or

5.2 the rationalisation is approved by a special resolution of WSI shareholders other than Cavalier (which would be precluded from voting under the listing rules).

6 In these circumstances, the benefits claimed by Cavalier could be achieved only if one or other of these conditions was met.

7 It follows that the Commission can only be satisfied that the claimed benefits are likely in the event that the acquisition proceeds if any authorisation is conditional on one or other of these conditions being met. The Commission has said at [63] that it accepts Cavalier's factual scenario, in which the benefits are achieved, because Cavalier has advised the Commission that "if for any reason it was not able to carry out the [rationalisation], it would not proceed with the transactions". The difficulty with this is that the proposed authorisation in the draft determination is unconditional, and would permit Cavalier to proceed with the acquisition and seek necessary approvals, but retain control of WSI even if those approvals were not obtained. The harm to the market would be done, and even if the Commission could take action to revoke the authorisation (which does not appear to be possible, as there is no equivalent to s 65 in the context of business acquisition authorisations) that harm would continue for a significant period.

8 It seems to me that any authorisation of the proposed acquisition must, in these circumstances, be conditional on Cavalier either:

8.1 acquiring 100% of the shares in WSI; or

8.2 obtaining, before it proceeds with the acquisition, all necessary approvals to enable it to proceed with the proposed rationalisation.

Relevance of ownership of Cavalier

9 One of the factors that the Commission takes into account in assessing productive and dynamic efficiency detriments is the current ownership of Cavalier. The Commission expresses the view at [172] that the small number of shareholders in Cavalier, two of which are experienced investors, "is likely to have the ability and incentive to continue to drive productive efficiencies in the factual". The Commission identifies two reasons at [173] for its view that productive efficiency losses are unlikely to be large, one of which is "strong oversight ability and profit maximising incentives of the shareholders."

10 The Commission also identifies the current ownership and management of Cavalier as a factor that should be taken into account in the assessment of dynamic efficiency losses. The Commission at [189] refers to the operational performance of Cavalier post-merger as being "closely and efficiently monitored by an experienced and well informed board and shareholders."

11 I consider that this approach, which in assessing likely productive efficiency and dynamic efficiency losses looks to the current composition of the ownership and management of the acquiring firm and how well the shareholders and board can be expected to perform in those roles, is wrong in principle.

12 There is an obvious factual difficulty with an assessment of productive and dynamic efficiency performance over a 5 year period that depends on the identity and expertise of particular owners and directors, when the current composition may change over the relevant period. There is no basis identified in the draft determination on which the Commission could be satisfied that it is likely that the current owners and board will remain in those roles for 5 years post-acquisition.

13 But the issue is in my opinion more fundamental than this. The Act is concerned with market structure and with external disciplines on the performance of firms through the process of competition, not with the internal ability or willingness of firms to charge market prices or innovate despite the absence of competitive pressures. This point was well made in the frequently cited *QCMA* case, where the Tribunal said:[1]

---

[1] *Re Queensland Co-operative Milling Association*(1976) 8 ALR 481 (TPT) at 515.

> " … the antithesis of competition is undue market power, in the sense of the power to raise price and exclude entry. That power may or may not be exercised. Rather, where there is significant market power the firm (or group of firms acting in concert) is sufficiently free from market pressures to "administer" its own production and selling policies at its discretion. Firms may be public spirited in their motivation; but if their business conduct is not subject to severe market constraints this is not competition. In such cases there is substituted the values, incentives and penalties of management for the values, incentives and penalties of the market place."

14 The Commission should assess the losses of productive and dynamic efficiency that are likely in this sector as a result of a material reduction in competitive constraints on both current market participants, as the result of a merger between them. In doing so, the Commission should not discount the likely efficiency losses by reference to "the values, incentives and penalties of management" – these cannot be assumed to continue, and are not relevant for the purposes of the Act.

Weighting of benefits

15 The Commission suggests at [242] that the benefits it has identified should be given greater weighting than the detriments in the balancing exercise, because their quantification has a higher degree of certainty.

16 This approach is in my view problematic for three reasons.

17 First, the uncertainty surrounding benefits and detriments is already reflected in the ranges assessed for those figures. There is a risk of double-counting in taking that uncertainty into account a second time, when it comes to weighing the (aggregated) ranges against each other.

18 Second, if the quantification of detriments is uncertain then that means there is a real risk that there may be *greater* detriments than the Commission has been able to quantify, not just that the detriments may be smaller so can be given *less* weight. The greater the uncertainty surrounding the extent of detriments, the more cautious the Commission should be, and the greater the benefits that must be identified before the Commission can be satisfied (as required by s 67(3)(b)) that the public benefit from the acquisition will outweigh the associated detriments.

19 Put another way, it does not follow from the proposition that a loss is hard to quantify that the loss must therefore be small. Similarly, it cannot be assumed that any estimate of the loss is more likely to be too high than too low.

20 The third, closely related, reason is that if the Commission is giving less weight to detriments because they are hard to quantify, that approach would be inconsistent with the approach approved by the High Court in *Air New Zealand v Commerce Commission (No 6)*:[2]

> The appellants were critical of the Commission's failure to give consideration in the course of the balancing exercise to unquantified benefits. Based on the way in which the Commission explained its thinking in this area, this criticism seems justified. It may be the Commission thought it unnecessary to discuss unquantified benefits because its quantified detriments so clearly outweighed its quantified benefits. But this is to assume that a benefit (or a detriment) should be accorded less weight simply because it has not been quantified. That approach would be wrong. As our discussion has already shown, there may be categories of detriments and benefits which, for one reason or another, cannot be readily expressed in monetary terms. That is no reason to exclude them from the balancing process, as the Commission itself had much earlier in its determination (at para 899) acknowledged.
>
> At the same time, it may be necessary to reduce the weight to be given to some categories of quantified detriments and benefits if there are doubts about the reliability of the calculation or when the quantification process is necessarily abstract in nature. The balancing process is not to be seen as a purely arithmetical exercise. It should be leavened with a healthy regard for any shortcomings in the way in which detriments and benefits have been quantified.

21 In carrying out the balancing exercise required by the Act, the Commission should adopt the approach approved by the High Court, and should bear in mind that uncertainty about quantification of detriments:

21.1 does not mean they should be given less weight;

21.2 does not mean they should be discounted – rather, the potential for the detriments to be either greater or less than the estimates arrived at needs to be borne in mind.

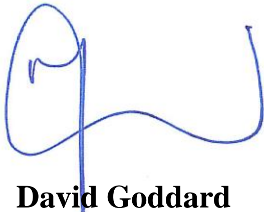
---

[2] *Air New Zealand v Commerce Commission (No 6)* (2004) 11 TCLR 347 (HC) at [415] – [416].

Final comments

22 I understand that this memorandum will be made available to the Commission, as I am not able to be present at the conference scheduled for 4-5 May, due to trial commitments in the High Court in Auckland for most of May.

23 If I can be of further assistance on these issues, please let me know and I will do my best to make myself available to you or to the Commission, subject of course to those other prior commitments.



David Goddard