APPLICATION FOR AUTHORISATION OF AN ACQUISITION OF NEW ZEALAND WOOL SERVICES LIMITED BY CAVALIER WOOL HOLDINGS LIMITED

Submission by Cavalier Wool Holdings in Response to the Draft Determination of the Commerce Commission

PUBLIC VERSION

1. Introduction

Cavalier Wool Holdings Limited (**CWH**) agrees with the Commerce Commission's (the **Commission**) preliminary view contained in the Draft Determination issued on 13 April 2011 that the benefits to the public would outweigh the loss of competition arising from the Acquisition.

Points of clarification or disagreement are set out in this submission generally with a cross reference to evidence or earlier submissions filed by or on behalf of CWH or others or by reference to additional evidence provided in this submission.

2. Principal submission on variations to the Commission's preliminary conclusions

2.1 Constraints generally

In general terms, CWH considers that the Commission's view of the wool scouring industry and its operations are accurate and its conclusions on the competition analysis are a fair summation of how competition currently occurs and is likely to occur post merger.

CWH's views differ from those of the Commission only relative to the nature and extent of the several post merger constraints discussed by the Commission and the point at which those constraints are likely to take effect to constrain CWH's pricing and other market behaviour.

In respect of the nature and extent of those constraints, CWH makes the following comments.

2.2 WSI is a weak constraint

For the reasons discussed in the Authorisation Application and supporting submissions CWH considers that WSI provides only a weak constraint on CWH's competitive behaviour.

CWH does not agree with the Commission's finding at paragraph 76 that WSI provides a "significant" competitive constraint on CWH either today or in the counterfactual. Indeed, in Decision 666, the Commission said at paragraph 142:

> Accordingly, the Commission considers that NZWSI is likely to provide **some degree of competitive constraint** in the factual. (Emphasis added.)

In its overall conclusion at paragraph 207 of Decision 666, the Commission said:

> The Commission considers that the following factors are likely **when taken together** to provide a sufficient constraint on the combined entity in the factual:
>
> - the constraint from NZWSI;
> - the constraint from potential competition;

- the presence of excess capacity and economies of scale;
- the potential constraint from offshore scouring; and
- the countervailing power of wool merchants.

(Emphasis added)

Accordingly, Decision 666 did not find WSI to be a significant constraint in the sense that by itself it would constrain CWH. In CWH's view, nothing has changed in the market or within WSI which should cause the Commission to reach a different view.

WSI by its own admission[1] is a vertically integrated merchant scourer which places its emphasis on scouring its own wool.[2] WSI's primary focus remains internal as it always has been.

In its submission through Futures Consultants Limited, WSI appears to accept that any constraint it creates is limited to an indirect constraint by virtue of WSI buying more greasy wool in the counterfactual which would encourage CWH to keep its scouring prices low to enhance other exporters/merchants' ability to compete for the acquisition of that wool.

The best estimate of WSI's market share is that WSI holds approximately a [ ] share of total commission scouring (a level which in CWH's opinion WSI has now held generally unchanged for many years give or take a few % points up or down). This is supported by Figure 2 of the Draft Determination which implies that WSI has only [ ] ([ ]) of New Zealand's commission scouring volume, with the remaining [ ] ([ ]) scoured by CWH.

This small and relatively unchanged market share supports the view that WSI provides only a limited and weak constraint.

The Commission refers to an explicit concern in relation to the competitive threat that WSI imposes in Cavalier Corporation's Board papers.[3] CWH points out that these papers reflect the views of only one shareholder and were provided by Cavalier Corporation in fulfilment of a section 98 notice which was issued for a different purpose.

More specifically, it appears that in forming its views about WSI as a constraint the Commission has relied on a section in a paper entitled "CWH offer for the scouring business of WSI" in the Cavalier Corporation's Board papers of April 2010 in which management considered, and expressed its concerns about, [ ] that was speculative and included in the papers purely as a discussion point. CWH stresses that the concerns expressed in that paper about WSI [ ].

This context is important and the Commission should be cautious before drawing broad conclusions from such a snap shot of comment.

In any event, even within the specific documents mentioned, the Commission has not referred to an equally explicit concern expressed in Cavalier Corporation's Board minutes in February 2011 (nine months later) regarding concern over the increase in greasy wool exports and a note that CWH does not believe that it has lost any new commission work of significance to WSI:

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[1] Report by Futures Consultants Limited to New Zealand Wool Services Limited, 7 March 2011.

[2] See also [ ].

[3] Draft Determination, ¶75.

][4]

There are similar comments in the November 2010 Board minutes:

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][5]

The reference to WSI being "active in the market" is a reference to WSI actively buying stock in the greasy wool acquisition market and to WSI being "well positioned" is a reference to its position as the holder of large wool stocks in a rising international wool distribution market. This is the reference to WSI having a "long position in wool". As prices increased, the value of WSI's stock increased. These are not references to how WSI is performing in commission wool scouring, which is what CWH would be more concerned about.

Separately, the Board minutes of Cavalier Corporation for November 2008, when the Board considered the financial models relating to the proposal to acquire the Godfrey Hirst scours and well before the proposal to acquire WSI was formulated, contain the following comment:

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As the Commission has concluded, loss of volume of greasy wool for scouring detrimentally affects scouring revenues. However, CWH's view is that whilst the loss of volume to WSI is a threat, it is a relatively small one that can be rectified and addressed and certainly not as material to CWH as the permanent loss of large volumes to China or as a result of a new entrant or a decreasing wool clip over which it has no control.

When it acquired the Godfrey Hirst scouring business in 2009, CWH expected that WSI would actively engage in seeking to expand its commission wool scouring business. However, that did

[4] Extract from minutes of Cavalier Corporation's Board of Directors, February 2011.

[5] Extract from minutes of Cavalier Corporation's Board of Directors, November 2010.

not happen and although WSI acquired additional plant for modifications to enable it to better engage in that part of the industry, it did not implement the modifications and it has not attempted to increase its commission scouring operations. As discussed above it has continued to place its emphasis on the merchant scouring of its own wool.

Nor have exporters attempted to leverage the WSI presence by actively splitting their scouring demand between CWH and WSI.[6] Rather, as the Commission discussed in Decision 666, most exporters remain strongly opposed to using WSI to scour their wool. It is understood this is driven by the belief that by doing so they will assist their direct competitor in the international trading of scoured wool to gain an advantage in that market.

Yet despite being well aware of that unwillingness of exporters to scour through WSI, and despite having a [ ] share of the New Zealand commission scouring business, CWH has not been able to increases prices as evidenced by the failed 2011 price increase referred to by the Commission. The discussions CWH had about price increases were with exporters who did not regard WSI as an alternative.

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

In summary, at best, the WSI constraint, if it exists at all, is a weak, indirect, imperfect and uneven constraint which in CWH's view should not be given weight relative to the other constraints faced by CWH.

2.3 The real constraints

What are much more significant and direct constraints for CWH is the risk of loss of greasy wool volumes to off-shore scouring facilities or the threatened loss to new entry, because each of those losses is likely to be permanent in nature and in practical terms unlikely to be capable of being retrieved (the gross volume of greasy wool being scoured in China has consistently trended upwards, implying that it is extremely difficult to reverse such losses once they occur).

In respect of the point at which those constraints take effect:

- The risk of a loss of greasy wool to overseas scouring facilities or to new entry comprises an immediate threat, the pricing point when it will become reality is virtually impossible for CWH to accurately assess. Get it wrong and the customer implements a decision to cease scouring in New Zealand or commits to support an entrant; it is then too late to save that volume as it is highly unusual for any company to reverse such a decision.

- It follows that CWH can never accurately gauge the tipping point when a price increase is likely to result in lost volume to off-shore facilities or to a new entrant. It is that risk that CWH considers to be its real risk and CWH believes that the Commission should give that "threat" of likely permanent loss of volume much greater weight than the weak constraint imposed by WSI which has not and will not bite in reality. CWH believes that threats of permanent loss of volume in a high fixed asset business that is incentivised to achieve increased throughput strongly suggest that CWH will be constrained at a much lower level than that considered by the Commission in its Draft Determination.

- It is that "threat" of permanent loss of volume that is the real constraint that will drive estimated efficiency losses from the merger to be at the lower end of the Commission's range/s.[7]

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[6] [ ]

[7] While not relied on by CWH, as noted by [

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2.4 The impact of a reducing wool clip

Additional to the matters raised above, there is another constraint that currently drives the behaviour of CWH and which will continue to drive behaviour post merger and into the longer term and that is the impact of a constantly downward trending wool clip.

It is the concern arising from a medium to long-term decline in greasy volumes that has driven all previous wool scouring restructuring and again it follows that long term the desire to encourage grower re-investment will limit the ability of CWH to increase price, especially if, as the Commission concludes higher scouring prices will translate into lower margins for growers.[8]

2.5 Wool scouring and China

Largely CWH agrees with the Commission's conclusions on the wool scouring process in China and the impact of Chinese wool scouring, apart from the nature and extent of that constraint discussed above.[9]

However, to give added confidence to the Commission's analysis and conclusions, CWH has sought additional information about the Chinese wool industry. This information has been sourced from various participants in, or suppliers to, the Chinese wool industry.

A copy of a slide presentation prepared by Market Strategy China[10] is enclosed with this submission as **Annexure A**. Market Strategy China is a market research and strategy consulting firm based in Shanghai, China. It develops strategic plans for companies to enter China market and expand their existing China business by providing market intelligence and insights.

This information confirms:

- The pricing information provided in the Authorisation Application is accurate.[11]

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[8] Draft Determination, ¶141.

[9] At ¶27 of the Draft Determination the statement is made that China accounts for 32% of New Zealand wool exports in 2009/10. The Beef + Lamb New Zealand Wool Exports July to June 2009-2010 spreadsheet indicates 38% of New Zealand's wool exports were sent to China.

[10] http://www.marketstrategychina.com/

[11] [

- There are more than 100 scouring plants in China scouring 450,000 tonnes of wool. These plants are set up to wash both fine wool and coarse wool. [
]

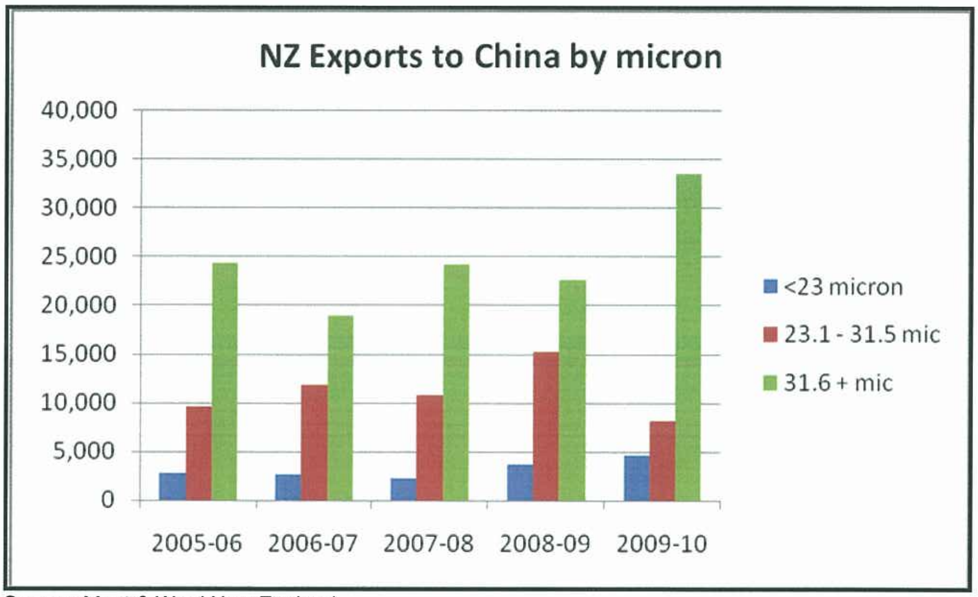
  [
  ]

- China is the second largest grower of wool in the world and imports nearly half of the world's total wool exports. Around 1/3rd of China's wool production is coarser than 32.5 micron with around 30% in the 24.6-32.5 micron range and around 1/3rd in the 18.6-24.5 micron range with the balance being fine wool.

- The Commission's conclusion that the Chinese wool industry uses all types of wool.[12] In relation to course wool specifically:

  - Figure 1 shows that New Zealand exports a full range of wool types and that coarse wool exports have been growing strongly.

Figure 1: New exports to China by micron



Source: Meat & Wool New Zealand

  - There are many processors in the North of China, particularly in the Hebei Province situated around Baoding, Shijiazhung and Tianjin. These include commission, carpet wool scourers.

  - There are a number of large end users. For example, CWH is told that Hebei Taihang Woollen purchases approximately 5,000 tonnes of Mongolian coarse wool, 2,000 tonnes of Irish and UK wools and 1,000 tonnes of New Zealand carpet wool. This is all purchased greasy.

  - China has a growing carpet industry with an estimated 1,700 carpet mills processing pure wool and wool blended carpets.[13] Carpet manufacturing is centred in Shandong

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[12] Draft Determination, ¶80.

[13] [

province and Heber province. There are a number of mid and small sized carpet mills in Baoding, Shijiazhuang and Tianjin, but the top three are in the Shangdong province, being Shangdong Dongsheng, Shanua Carpet and Haima Carpet Company. The major carpet manufacturers are shown below:

Company name	Location	Annual production million m^2
Shandong Dongsheng	Shandong province	2.300
Haima group	Shandong province	1.000
Shanhua Carpet	Shandong province	1.500
Liyang Kaili Carpet Material	Jiangsu Province	1.000
Shandong Hongye Carpet	Shandong province	0.240
Shandong Shenlong Carpet	Shandong province	0.300
Zhejiang Art Carpet	Zhejiang province	0.300
Bingzhou Orient Carpet	Shandong province	0.500
Dalian Jiamei Carpet	Liaoning province	0.500
Huayuan group Carpet	Shanghai	0.750
Changzhou Global Carpet	Jiangsu Province	0.180
Huade Yongjia carpet	Beijing Henan province	2.000
Chongqing Helen Carpet	Chongqing	0.660
Qinghai Tibet sheep Carpet	Qinghai province	0.090

- The British company S Lyles & Sons' former carpet yarn plant was bought by Chinese company Hangzhou Fuxing Group which relocated the plant to Hangzhou. British and American carpet manufacturer Brinton's carpets has opened a plant in Hangzhou.

- China's exports of carpet are increasing. Total carpet exports increased by 65% between 2006 and 2010 and wool carpet exports increased by 61%.

- China also imports coarse wool from Kazakhstan and Mongolia.

  - Approximately 2/3rds of Kazakhstan's wool is coarse wool.[14] The majority of this wool leaves Kazakhstan for China unprocessed or semi processed as scoured wool.

  - Mongolian wool is almost exclusively coarse wool. Approximately 2/3rds is exported to China in greasy form.

- There are a number of woolscour manufacturers in China and there are companies that are now building Andar style woolscours, including::

  - Wuxi Xing Cheng Printing and Dyeing Machinery Co. Ltd.[15] This company has recently built three 2.0 metre wide Andar style woolscours for use by Chinese scourers. One was installed in the Sunshine Group and the other was sold to a company called Zhen Xin;

  - Taixing Xinggang Woolspinning Machinery Co., Ltd[16];

  - Wuxi Wangda Printing & Dyeing Machinery Co., Ltd;[17] and

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[14] There are three main sheep types in Kazakhstan. The breeds are a Merino type, Karakul and the Native Fat Tail. The Merino is a fine wool breed and the Karakul and Native Fat Tail are coarse wool types. Of the 36,400,000 greasy kilograms of wool produced in Kazakstan each year, less than 10,000,000 greasy kgs is fine wool.

[15] Dongxiang Village, Qianzhou Town, Xishan, Wuxi, Jiangsu, China 214181. www.wuxi-machinery.com.

[16] NO.13 Tong Jiang South road, Guo Chuan town Taixing, Jiangsu, China 25442.

- o Taixing Ronsen Machinery Co., Ltd.[18]

For the reasons discussed in Section 4.1(b) below, CWH's inability to effectively impose destination price discrimination results in this constraint filtering throughout the market and constraining the prices CWH can charge customers for scouring wool that ultimately is not destined for China.

2.6 Constraint from New Entry or Expansion

As discussed above, the entry constraint which most impacts CWH's pricing decisions is the threat of entry by any of Godfrey Hirst, exporters/merchants, or a third party encouraged or supported by merchant/s or Godfrey Hirst, rather than actual entry.

It is enough that CWH believes entry can or will occur, not that it will happen and not that it will happen because of an increase to a particular price level.

The rationale for the acquisition is driven by the efficiency gains which derive from the combination of greater volumes of greasy wool throughput and the benefits of the restructuring and relocation of the WSI scouring assets. Loss of a substantial volume of greasy wool to an entrant (with guaranteed volumes for an extended period) would render nugatory the benefits to CWH of the substantial capital expenditure involved in making the acquisition and implementing the restructuring.

It would be very courageous for CWH to put that at risk by imposing a supra competitive price against the risk that entry will not occur. Furthermore, it is unlikely to happen given the constraints imposed by the presence of three experienced and well informed investing shareholders.

In CWH's view, the Commission is correct when it says that the effectiveness of the threat of new entry is determined by the nature and effect of market conditions that impede entry.[19]

While there are likely to be conflicting views as to whether or not there are true impediments to entry, CWH is clear that:

- There are available sites in both the South Island and North Island that would enable entry by a "determined" entrant. CWH has provided independent support for that view from Mr Stephen Daysh.
- While there is less second hand plant available in Australia now than there was at the time of Decision 666 (due to sales of that second hand plant to Chinese scour operators) there is still plant available. CWH understands that second-hand plant is available in [ ] and that second-hand plant remains available in [ ]. This was available at the time of Decision 666.[20]
- The cost of new scouring equipment has significantly declined over the last two years. As discussed above, there are now a number of well established woolscour manufacturers in China building Andar style woolscours. CWH has made enquiries relating to the availability and cost of scouring equipment. Wuxi Xingcheng has quoted a price of US$ 1 million for a new 2.0 metre scouring line with capacity to process 1,300 to 1,500 kgs per hour.[21] The plant could be delivered in six months.

[17] Shizhuang Industrial zone, Qianzhou Town, Huishan District, Wuxi, Jiangsu, China 214182.

[18] Tong Jiang road, Taixing Economic & Industrial Park, Taixing, Jiangsu, China 25442.

[19] Draft Determination, ¶94.

[20] See Bell Gully letter, 22 February 2011 at section 2.1.

[21] The specifications of the scour line was a 2.0 metre line with 2 hoppers, 1 x triple drum opener, 6 wash bowls, 1 x 8 bay dryer, 1 x stepped drum opener post dryer.

CWH agrees with the Commission[22] that there are a number of options for an entrant to achieve volumes in the event of the imposition of an unacceptable price increase by CWH post merger. [

][23]

While Godfrey Hirst, or a third party sponsored by Godfrey Hirst is the most likely entrant, one of the larger exporters could enter in its own right or in conjunction with Godfrey Hirst. For example, [

][24]

2.7 Conclusion

All of the constraints discussed above, in combination, place a material limit on the ability for CWH to achieve or exercise market power.

Certainly, CWH believes, for the reasons discussed above, that imposing any level of price increase in these markets is close to impossible – imposing price increases in the order of 10% to 20% have never been and will never be feasible, with or without WSI.

High price increases of the order suggested by economic advisers lack supporting evidence and have no plausible economic support (see section 4 below and **attached** NERA Report).

3. Public benefits

3.1 Productive efficiencies

CWH agrees with the Commission's assessment of productive efficiencies likely to arise from the acquisition and agrees that the best evidence of the likely productive efficiency gains is provided by the gains actually realised following CWH's acquisition of Godfrey Hirst's scouring assets.

As stated in Bell Gully's letter dated 18 March 2011, and as recorded in the Commission's decision,[25] CWH's actual performance since the acquisition confirms that these efficiencies were gained. The process CWH went through to assess the benefits of the Godfrey Hirst acquisition is the same as the process it has gone through for the WSI acquisition.

[22] Draft Determination, ¶¶102 to 105.

[23] Indeed, [
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[24] [ ]

[25] Draft Determination, ¶199.

In light of this evidence, general observations or assertions about experience in other matters is simply irrelevant. No specific evidence has been provided which calls these benefits into question.[26]

3.2 Sale of surplus land and buildings

CWH continues to believe the value of the land and buildings are $[ ] million. However, it agrees with the Commission that the lowest value that should be ascribed is the value included by the Receiver in the Information Memorandum, namely $8.792 million.

The Commission notes its view that "any delay in the sale of the land and buildings would also reduce the present day value of those assets".[27]

For the reasons outlined at page 8 of Bell Gully's letter to the Commission dated 14 March 2011, any discount should only be applied if it takes longer than a year and there is no reason to believe that any sale would be delayed more than a year.

Again, the Godfrey Hirst acquisition provides a natural experiment: following that acquisition David Ferrier sold the Clifton wool scour site [ ]. That sale was made during the global economic recession.

In any event, while CWH recognises that if a sale took longer than one year to complete it would be appropriate to discount the future value received to present day terms, it would also be necessary to consider the fact that land values are likely to appreciate over time. That is, a sale in one or two years' time is likely to realise a higher price than a sale today. It is then this expected higher price that then should be discounted.

3.3 Capital costs

CWH agrees with the Commission's assessment of reduction in on-going capital costs of $0.88 million over five years.

3.4 One-off rationalisation costs

CWH has no comment on the Commission's approach.

3.5 Removal of a weak seller

As recorded in the Draft Determination, exporters have informed the Commission – just as they have informed CWH – that WSI tends to undercut other exporters in world markets resulting in reduced export prices for New Zealand wool.[28, 29]

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[26] CWH notes the submission from Mr Robert Pratt, formerly an employee of E. Lichtenstein & Co, Cavalier Group's merchant scourer. Mr Pratt has been an advisor to WSI for some time and CWH understands that WSI asked Mr Pratt to provide a submission.

Mr Pratt states that E. Lichtenstein & Co was producing 500 kilos of scoured wool every 7 minutes (which equates to an average run rate of 5,273 greasy kilograms per hour). This is incorrect. CWH has E. Lichtenstein & Co's production records and these show that the average run rate was 2,200 greasy kilograms per hour. CWH can provide this data if the Commission would find it useful.

[27] Draft Determination, ¶203.

[28] See for example, [

CWH remains of the view that the evidence suggests that this "weak selling" is in fact occurring and hence removing this effect will result in a substantial benefit to New Zealand.

(a) ***Benefit does not require an assumption that WSI is acting irrationally***

The Commission has commented that it sees "no apparent reason why WSI should choose to sell its wool at less than the market price".[30]

CWH accepts that if the "world price" resulted from a perfectly competitive world market, then the Commission is correct in that there would be no apparent reason why WSI should choose to sell its wool below the perfectly competitive world price.

However, as outlined in Bell Gully's 9 March letter, the "world price" does not result from a perfectly competitive world market.[31]

The commercial reality is that there are various frictions in the market which mean that the actual contract price struck between an exporter and a customer for each consignment will reflect a bargained outcome around the prevailing world benchmark price. Accordingly, the actual price will depend on the particular bargaining strength of the exporter and the customer at the time the contract is negotiated, and also the particular position of the exporter. This sphere of bargaining may not be large, but it exists nonetheless.

It is within that context that this benefit should be viewed and this is the reason why CWH is not asking the Commission to reach a finding that WSI is acting irrationally (although there is certainly a general perception that WSI does not always act rationally).

Economic theory predicts that a firm will be willing to price at a level where marginal revenue equals marginal costs.

Simply put, the merchant scouring model has different marginal costs compared to other exporters:

- An exporter's key marginal costs are the cost at which it acquires wool and the scouring costs it pays to CWH. This scouring cost in turn reflects CWH's costs and a return on capital.
- In contrast, WSI's key marginal costs reflect the price at which it acquires wool and the marginal costs to it of its scouring operations. Since most of the scouring costs are fixed, WSI's *marginal* scouring costs are very low.

Consistent with economic theory, all else being equal, WSI would be willing to sell wool at a lower price than other exporters. This is because any revenue WSI earns above its marginal costs contributes towards its fixed costs.

Since there is some degree of bargaining to determine the final price, WSI's ability to price down will influence the final price.

The customer's bargaining position will be informed by its awareness that WSI has more latitude to sustainably reduce their prices than other exporters. As a result they are likely to request a lower price safe in the knowledge that WSI can actually sustainably offer this.

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[29] [

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[30] Draft Determination, ¶215.

[31] See Bell Gully letter, 9 March 2011 at page 3.

However, compounding this is the bargaining position that WSI is likely to find itself in due to its practice of procuring greasy wool ahead of concluded sales.[32] It does this because the large proportion of fixed costs associated with scouring provides an incentive for WSI to pursue greasy wool volume. Any sale price above marginal cost provides a contribution towards these fixed costs.

This creates an incentive to chase volume; since other exporters have shown a marked reticence to use WSI as a commission scourer, the only option for WSI is to procure more of its own greasy wool.

The result of procuring volume ahead of having committed sales is that WSI is placed in a position of having to sell the clean wool blends so as to generate a cash-flow. Financing requirements will mean it cannot simply stockpile this wool.

Hence, WSI has to create a demand for these blends as WSI is seeking to sell volumes above a customer's budgeted requirement.

This results in a significant shift in bargaining power to the customer which will affect the ultimate concluded price, regardless of the magnitude of the bargained proportion of price.

(b) ***Evidence of the impact***

As set out in Bell Gully's letter of 9 March 2011, exporters have expressed concern that WSI is and has for some time been trading wool at prices which suppress the New Zealand price of wool. Indeed, the complaints have a history back to at least 2003 and were voiced at the time of Decision 666.[33]

The 9 March letter provides an analysis of the price positioning of New Zealand wool in the Indian market as compared to similar coarse wools from the United Kingdom. This shows that:

- New Zealand wool generally enjoys a price premium of around 10 cents per kg compared to similar wool types from the UK.
- In India, a market where WSI has stated it enjoys a 65-70% share of New Zealand sales into India, recent sales data 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.[34]

The exporter evidence[35] confirms that the impact is significant as does the submission of Mr Roger Buchanan, a submitter with no ties to exporters, scours or to CWH or WSI and with extensive experience in the wool industry, including as a director of an unrelated wool scouring business and as CEO of the Wool Board before its disestablishment in 2003.

While CWH does not ask the Commission to reach a finding that WSI acts irrationally, WSI's financial performance is relevant. An analysis of this is contained in the 9 March letter and it reinforces the conclusion that WSI is selling wool at a level below what New Zealand wool would be expected to obtain.[36] In summary it shows:

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[32] [ ]

[33] See Bell Gully letter, 9 March 2011 at page 1.

[34] [ ]

[35] Draft Determination, ¶213.

[36] See Bell Gully letter, 9 March 2011 at page 5.

- The Commission's findings in Decision 666 imply that WSI's trading operations were substantially underperforming other stand-alone trading operations.[37]

- After stripping out a subvention payment recorded in the accounts and a one-off impairment charge, the trading division lost around $(3.8) million in 2009. The two comparably large exporters (Masurel and Fuhrmann) reported NPATs of $2.874 million and $0.67 million.

- After stripping out a subvention payment recorded in the accounts the trading division actually lost approximately $(7) million in 2010. Fuhrmann reported a NPAT of $0.487 million.

- WSI's reported return on equity averages only 5.7% from FY2002 to FY2010, well below a workable and sustainable return on capital. It indicates that WSI has not been earning sufficient revenue to cover its fixed costs including providing a return on capital employed.

- WSI's dividend payout has averaged only 1.8c per annum, representing a dividend yield of 3.6%.

WSI's improved financial performance in the current year has been driven by its large inventories of wool increasing in value as the wool price has rapidly risen. It does not represent a fundamental change in WSI's operating business performance.

CWH believes the weight of this evidence indicates that WSI is, for whatever reason, not achieving the returns that other exporters of wool are achieving. Furthermore, in CWH's view the weight of this evidence overwhelms the information provided by WSI and Godfrey Hirst to refute this:

- Godfrey Hirst has said that WSI is not always the cheapest supplier to it.[38] However, Godfrey Hirst does not acquire wool from WSI other than in New Zealand. Accordingly, it is difficult to see what impact its response has on this question. And, in any event, Godfrey Hirst says it acquires [ ]% or around [ ] tonnes of its wool from WSI which accounts for less than [ ]% of the wool sold by WSI.

- In relation to the WSI "data" [

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[37] The Commission concluded that WSI had lost $(47,000) dollars on its trading division while other exporters were operating profitably.

[38] Draft Determination, ¶215.

Of course, CWH accepts that WSI might not always be the cheapest, but the evidence from exporters, the concerns expressed and WSI's own financial performance suggest it is routinely selling its wool at a level that is providing a much lower return than that enjoyed by exporters. WSI's "data" does not refute this.

(c) ***Size of the benefit is material***

The evidence from exporters indicates that the size of this benefit is material:

- Mr Petersen of Bloch and Behrens indicated the impact as a loss of export earnings of [ ]. He also explained "[ ]".
- Mr Whiteman of Segard Masurel said that [ ]

3.6 Superstore

CWH agrees with the Commission that substantial benefits could accrue from implementation of the superstore concept.

CWH acknowledges the Commission's concerns about the certainty that can be placed on the development of the project. CWH is continuing to work with stakeholders to further the project [ ].

CWH believes that the evidence illustrates that the superstore project will be implemented in the factual, but will not be implemented in the counterfactual. Even at worst, there still remains a real chance that the superstore project will be developed and hence generate benefits that should be counted by the Commission in its benefits and detriments assessment.

However, to assist the Commission, NERA has estimated the likely benefits arising from the superstore taking into account the probability of the project proceeding and the uncertainty as to when the project would be implemented. This is set out at section 4 of the NERA report. They conclude:

> ... even if one only placed a 25% probability on the super store occurring in 5 years time, this still results in a probability-weighted benefit of roughly $[ ].

3.7 Y value benefits

CWH continues to believe there will be substantial Y value benefits arising from the acquisition, benefits that would not be available absent the acquisition.

Based on the Commission's Draft Determination:

- There is no dispute that wool with a higher base Y earns a premium over wools with a lower base Y value.[39]
- There is a consensus that a conservative estimate of the premium is 4 cents per kg.[40]

[39] Draft Determination, ¶225.

- There also seems no dispute that certain mechanical processes can have the result of increasing base Y – all the experts seem to agree on this, albeit that Dr Carnaby appears not to accept that the CWH data shows an uplift has been achieved and even if it has he does not know what has caused it.[41]

Accordingly this submission does not cover those issues.

However, the Commission has indicated it is not yet satisfied that:

- CWH has in fact achieved an improvement in base Y value in the South Island. This issue is dealt with in sections (a) and (b) below which demonstrate that the benefits have been achieved in the South Island.

- The base Y benefits affecting the WSI wool volumes and the CWH Awatoto wool volumes would not arise in the counterfactual. In relation to whether the benefit will accrue in the counterfactual, the base Y value benefits arise from two different sources and each raise different counterfactual issues which are covered in sections (c), (d) and (e) below:

    - WSI wool volumes, i.e., transferring WSI volumes to CWH and modifying the WSI scour lines. This is in effect bringing WSI scour lines up to "CWH spec". The counterfactual question of relevance is whether WSI could and/or would make the same changes as CWH has made absent the transaction. (See sections (c) and (d) below.)

    - CWH Awatoto wool volumes, i.e., modifying the Awatoto scour lines to match the modifications made to the Timaru 3.0m scour line. The counterfactual question of relevance is whether CWH would make the same changes as it already has in Timaru absent the transaction, particularly since there would be substantial building capex required to remove the bend out of the Awatoto lines. (See section (e) below.)

(a) ***CWH has achieved base Y improvements at Awatoto***

The Commission has recognised the "potential for Cavalier Wool to have achieved the claimed quality (both increased run rate and brightness) improvements".[42] [43]

That CWH has achieved this uplift at Awatoto is demonstrated by the evidence presented in the Bell Gully letter dated 28 March. CWH presented evidence to show the trends were statistically significant.[44]

No substantive evidence has been presented to suggest otherwise. Dr Carnaby has not challenged the evidence on the statistical significance of the trend.

(b) ***CWH has achieved base Y improvements at Timaru***

CWH believes that the base Y benefits have been achieved at the 3.0m Timaru line. However because the base Y data for Timaru includes a mix of coarse and fine merino (merino is not present in the North Island flock) it is not possible to show the increase in base Y value in the same way as CWH can do for the North Island.

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[40] Draft Determination, ¶224.

[41] See Dr Carnaby further submission to the Commerce Commission, 4 April 2011.

[42] Draft Determination, ¶233.

[43] The evidence clearly shows run-rates have improved and are above those of WSI. At Awatoto CWH has improved its throughput at Awatoto from [ ] greasy kgs per hour to [ ] greasy kgs per available hour, an increase of close to [ ].

[44] See Bell Gully letter, 28 March 2011 at sections 1.4 and 1.5 of the Annexure.

Nevertheless, CWH has made the same *types* of mechanical changes at Timaru as it has at Awatoto, although it has made more of these changes at Timaru (see **Confidential Annexure B**).

The reason it has made more of these changes at Timaru is because the Awatoto scour lines are configured in a dog-leg fashion due to the existing size of the Awatoto buildings. This is sub-optimal and CWH cannot make the necessary further modifications to the Awatoto scour lines (i.e., increasing the number of openers etc) to bring the Awatoto 2.4 metre line up to the Timaru 3.0 metre standard without extending the buildings.[45]

As outlined in the Authorisation Application and referred to above, while comparative data on greasy wool base Y values is not available for the South Island,[46] CWH believes:

- CWH's run rate at Timaru is higher than WSI's at Kaputone:
    - This is despite Timaru scouring merino and dag wool which are not scoured at Kaputone. Merino and dag wool are harder scouring wools and so would tend to depress CWH's run rate performance.
    - All else being equal, Kaputone should have a higher run rate as it does not scour these types of wool. It does not.[47]
- CWH's run rate throughput at Timaru equates to that of Whakatu.
    - This is despite CWH's Timaru scour scouring merino, which is not scoured at Whakatu, and the Whakatu line being in the North Island and hence scouring easier wool types (on average).
    - Again, all else being equal Whakatu should have a higher run rate. It does not.[48]

Given the nature of the changes made to CWH's Timaru scour lines and the interdependency between the run-rate improvements and base Y improvements evident in the Awatoto data, the run-rates at Timaru underpin CWH's belief that the base Y benefits have been achieved at that scour.

The Commission has said it would have expected to see the benefits at Timaru manifested by a higher revenue per kg than other New Zealand scouring plants. The Commission says this is not evident from CWH's financial modelling.[49]

However, a comparison between Awatoto and Timaru is not a like for like comparison due to different costs and different types of wools scoured:

- As compared to Awatoto, variable costs in the South Island are **[**

  ].
- North Island wool is easy scouring because it has less extraneous matter than South Island wool. All else being equal this will slow down the scouring process raising per unit costs.

[45] See Authorisation Application, ¶5.30 and Bell Gully letter, 22 February 2011 at ¶1.2.

[46] As noted in paragraph 18.49 of the Authorisation Application, comparative data on greasy wool Y values is not available for the South Island.

[47] See Bell Gully letter, 14 March 2011 at page 15.

[48] See Bell Gully letter, 14 March 2011 at page 15.

[49] Draft Determination, ¶229.

- No merino is scoured at Awatoto. Merino is slower scouring but also earns a scouring premium.

In short, it is not possible to draw any conclusions from the difference in average revenue per kg scoured in the North Island versus the South Island.

The Commission also refers to opinions from two New Zealand wool spinners in relation to their experience with Timaru. Against these opinions ([ ]) the Commission has also been provided with the following evidence:

- The exporter comments that CWH is better at blending different wool types.[50]

  By definition, a better blending technique enables lower cost blends. It is inferred from the inclusion of these comments in a footnote that they have been downplayed as against the evidence from WSI's customers.

- [.]:

  [ ]

- [ ]

- As described above, the evidence from CWH that it believes its throughput at Timaru is higher than WSI's at Kaputone and on a par with Whakatu despite Timaru scouring vastly inferior or harder scouring wool types.

However, even if the Commission considered those benefits had not been achieved at Timaru, there is no evidence to suggest the improvements have not been achieved at Awatoto (see (a) above).

(c) ***WSI volume benefits will not be achieved in the counterfactual (at either Kaputone or Whakatu)***

CWH believes it is neither possible, nor likely that WSI *can and is likely to* make the same modifications as CWH has made at its scour lines absent this acquisition.

CWH's modifications are not simply "off the shelf" products or widely known technologies.[51] CWH acknowledges that the broad *concepts* might be widely known but their *implementation* in the scouring process is another matter entirely.

It is true that CWH started with off the shelf products. However, it has undertaken bespoke modifications over a period of 10 years to achieve a much enhanced performance than was originally envisaged from the standard "off the shelf product".

The CWH "modifications" are not items that can be bought readily from Andar or other scour equipment suppliers. CWH has developed and built its own bespoke technology in house. CWH has actively engaged in protecting its intellectual property and the modifications remain confidential to CWH.

[50] Draft Determination, footnote 49.

[51] Draft Determination, ¶234.

A description of the bespoke modifications CWH has made is contained in **Confidential Annexure B**. This Annexure is highly confidential to CWH.

These bespoke modifications are not visible to CWH's competitors or any of the three experts involved in this matter.

Because they represent CWH's closely protected IP, WSI could not copy or replicate the modifications without substantial trial work and many years of development at a significant cost. CWH has taken 10 years to develop and refine these modifications.

Accordingly, there is simply no way in which WSI can achieve the performance improvements which CWH has achieved. They have not done so to date, and there is no evidence that they will do so in the future.

Furthermore, as a merchant scourer, WSI will not have any incentive to invest to create the ability to service increased volumes of greasy wool in the counterfactual – they already have excess capacity so spending on capex to achieve more capacity does not make sense.[52] Without the drive to gain additional capacity, there is no incentive to spend the capex required to make the modifications from which the increased Y benefit flows.

(d) ***Benefits from WSI volumes***

(i) *Benefit as claimed*

CWH has to date, in effect, claimed a 2 unit base Y uplift across all of WSI volumes in both the North and South Islands, although the North Island benefit was split into two parts.

However, even assuming only a 1 base Y unit uplift is achieved and using the consensus figure of 4 cents per kg, the benefit amounts to:

- [ ][53] over five years in the North Island; and
- [ ][54] over five years in the South Island.

(ii) *Benefit as a reduction in bleach costs*

Section 2.2 of the Annexure to Bell Gully's 28 March letter describes an alternative way to conceptualise the base Y benefit arising from moving the WSI scouring volumes to CWH's plants as a saving in bleach costs.

As discussed in that submission, one way to increase the base Y (and decrease the Y-Z) value of clean wool is to add hydrogen peroxide (i.e., bleach) during the scouring process. Adding bleach allows a customer to achieve a higher base Y value (lower Y-Z value) holding all the other parameters of the wool constant.

It is exporters who instruct CWH to apply bleach and they pay separately for the bleach they instruct CWH to apply.

As noted in that submission, modifications which increase base Y through the scouring process enable a customer to reduce its bleach costs.

[52] [ ]

[53] Representing the range of demand elasticities from -0.5 to -3.0.

[54] Representing the range of demand elasticities from -0.5 to -3.0.

Accordingly, bringing the WSI scour line up to CWH spec will enable that wool to be scoured with less bleach than is currently the case. As NERA comment in their report the effect is:

> ...bleach costs being avoided, which should be counted as a (further productive efficiency) benefit.

Even assuming the uplift was only 1 base Y unit and only on WSI volumes, this would avoid [ ] volume of bleach per kg.[55] As NERA explain:

> ...this equates to a cost saving of $[ ] = $[ ] per greasy kilogram. Based on WSI (North and South Island) volumes, this implies a saving of [ ] per year, or a present value of [ ] over five years. Splitting this into the North and South Islands gives an annual cost saving of [ ] in the South Island and an annual benefit of [ ] in the North Island.

(e) ***CWH will not pursue the changes achieved at Awatoto in the counterfactual***

The Commission has suggested that CWH *could* achieve the quality benefits at its Awatoto plant in the counterfactual.

CWH believes that the appropriate question is whether CWH *would* invest to achieve the quality benefits at its Awatoto plant.

CWH's commercial rationale for investing in the modifications was to increase capacity to be able to service increasing volumes and demand. Being able to scour more of this increasing demand, increased throughput and thereby improved performance and efficiency.

CWH did not change its pricing practices to extract some of the base Y benefits achieved by its customers. The only quality benefit to CWH has been in encouraging repeat custom and thereby achieving efficiencies through increased volumes.

Today, CWH has excess capacity at Awatoto and can cope with additional demand in the counterfactual absent any investment. In reality it faces decreasing demand as the wool clip continues to decline. Accordingly it does not need additional capacity and so would not invest for that purpose or a purpose of generating efficiencies where the benefits do not flow to it, rather they flow to others.

Absent efficiency benefits deriving from greater throughput, there is no commercial rationale for an investment in the counterfactual purely to deliver an increase in base Y.

Investing some $[ ] in the hope that it will be able to secure sufficient of the benefits flowing from the base Y improvement is a risky proposition, particularly where:

- the necessary by-product would be to increase its excess capacity position for much of the year; and
- when, as the Commission recognises "at present, the cost of scouring is about 8% of the value of the wool being scoured".[56]

In the factual the position is different. As a result of the restructuring post the acquisition, the mothballing of Clive and of the 2.4 metre scour line at Timaru, CWH needs to extend Awatoto to have sufficient capacity to service demand. The incremental costs of realigning the CWH scour lines in that scenario are low and CWH achieves benefits by servicing an

[55] As explained in that submission, in CWH's experience, on average it takes approximately a [ ] volume of bleach to improve the base Y value of the clean wool by 1 unit.

[56] Draft Determination, ¶114.

increased demand and thereby increasing throughput. Purely as a side benefit it increases base Y.

(f) ***Benefits from Awatoto changes***

The benefit from the Awatoto changes using the consensus level of four cents and assuming a 1 base Y unit uplift is [ ] over five years for the Awatoto volumes.

(g) ***Summary***

In summary:

- an increase in base Y of 1 unit has a minimum 4 cent per kg premium;
- CWH has demonstrated that at Awatoto it has increased base Y by at least 1 unit;
- CWH confirms it has made the same modifications at Timaru as it has at Awatoto but has been able to do more at Timaru due to having more space within the existing buildings;
- Timaru is achieving much greater throughput than Kaputone (and the latter does not scour merino or dag wool);
- WSI cannot replicate the CWH modifications in the counterfactual:
  - o WSI does not have the IP that CWH has achieved through 10 years of trial and innovation;
  - o the innovations are implementation secrets, not "widely known technologies"; and
- CWH will not modify Awatoto in the counterfactual because the cost of doing so (which includes major building alterations) would not achieve a revenue benefit absent a substantial increase in throughput revenue flowing from the proposed restructuring efficiencies.

4. Detriments

4.1 Loss of allocative efficiency

As the Commission correctly notes, the size of the allocative efficiency loss depends primarily on CWH's ability and incentive to increase prices post-acquisition.

The primary reason why CWH says allocative efficiency losses will be minimal – if they arise at all – is that CWH's ability and incentive to increase prices post-acquisition will not be materially changed.

CWH reiterates that it has modelled the financial benefits based on the cost savings it will generate and it has not forecast any increase in scouring prices because it does not believe that it will be able to achieve increased prices.[57]

Even if price increases were possible, there are a number of other reasons why the extent of allocative efficiency detriments is likely to be – at worst – at the lower end of the scale identified by the Commission.

[57] Authorisation Application, ¶5.23.

These are discussed in this section and in section 2 of the NERA report which should be read in conjunction with this section.

(a) ***WSI is only one of a number of constraints***

The primary reason why allocative efficiency losses will be minimal – if they arise at all – is that CWH's ability and incentive to increase prices post-acquisition will not be materially changed.

This is because, for all the reasons discussed in Section 2 of this submission, WSI is only a weak constraint and in any event is only one of a number of constraints CWH faces and it is by no means the most pressing. Indeed:

- Figure 2 in the Commission's Draft Determination implies that WSI has only [ ]% ([ ]) of New Zealand's commission scouring volume with the remaining [ ]% ([ ]) scoured by CWH.
- Exporters have continued to express the view to the Commission that they would not use WSI as a commission scour provider.
- CWH is already the predominant supplier to most domestic customers.

Furthermore, as NERA explain, CWH's real prices have fallen since at least 2006/07 despite ongoing industry rationalisation including the removal of the other two remaining non-exporter owned scourers (Feltex and Godfrey Hirst). As NERA explain:

> Against this background, it seems implausible to suggest that the removal of the constraint from WSI will cause prices to increase by 10-20%, when real prices have been decreasing as shown even during periods of rationalization.[58]

(b) ***Ability and incentive to price discriminate unchanged***

Broadly, CWH's customers can be divided into customers that buy for their own use in New Zealand (e.g., Summit Wool Spinners, Godfrey Hirst) or exporter customers that sell scoured and greasy wool to a number of markets around the world including New Zealand.

CWH offers different customers different prices depending on the particular economics of supplying that customer.

However, CWH does not charge separate prices depending on whether that wool is destined for use in New Zealand/Australia, China or some other market such as Italy. For the purposes of this submission, we refer to this as "Destination Pricing".

In relation to exporters, CWH does not have Destination Pricing despite the fact that history has indicated that exporters do not regard WSI as a viable alternative to CWH. Accordingly, if it was possible and profitable for CWH to have Destination Pricing for exporters, it would be expected that this would already be evident.

First, CWH has very limited visibility over the final destination of the wool it scours for its customers.[59] This is particularly so given that even if CWH attempted to charge different prices based on different markets, since the majority of clean wool is hubbed through Hong Kong, CWH could not make sure the wool ultimately ends up in one of the target markets. There would be ample opportunities for exporters to arbitrage the different prices.

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[58] See also [ ]. This supports the view that real prices have declined.

[59] See Bell Gully letter, 22 February 2011 at section 5.

There is a suggestion in the Draft Determination that following the acquisition it "may be profitable for the Applicant to forgo most or all scoured wool volumes that currently go to China in order to achieve higher margins on wool destined for other markets".[60] This is not likely:

- Given exporters do not regard WSI as a viable alternative supplier, and CWH has not found it profitable to price discriminate to date, there seems little reason to believe they will do so post-acquisition.

- As the Commission's proposition implicitly recognises, it would be an extremely risky strategy for CWH to increase prices and expect to retain, for scouring in New Zealand, any of its China bound volume given the cost advantages China enjoys and the fact that 34,000 tonnes of greasy wool is already scoured in China.[61] As NERA explain, their critical loss analysis demonstrates that such a strategy would not be a profitable strategy:

  > ...our original critical loss analysis ... demonstrates that a 10% price rise would not be profitable if the merged entity lost more than [ ] in the North Island or [ ] kg in the South Island. For smaller price increases the critical quantity is much lower. In 2009/10 approximately 18.3m kg of wool was exported to China in scoured form. Assuming this volume is spread evenly between the North and South Islands would mean that approximately 9m kg of scoured wool goes to China from each Island. Because 9m kg is greater than the critical quantities mentioned above ([ ]), it would not be profitable for the merged entity to raise price to this level if it meant all Chinese volumes would be lost.

In relation to domestic customers, CWH acknowledges that the position is slightly different. Does the removal of WSI increase CWH's ability to charge a "New Zealand" price as distinct from an "International Price"? The answer is no:

- In relation to Godfrey Hirst and Cavalier Bremworth the answer is no due to [ ]

- In relation to other domestic customers, WSI is only one of a number of constraints operating on CWH and any strategy where CWH attempts to charge a New Zealand price will simply open up a plethora of arbitrage opportunities for exporters, and/or Godfrey Hirst to exploit the difference between the New Zealand Price and the International Price.

Accordingly, even for domestic customers CWH's ability to price discriminate is unlikely to be materially enhanced.

(c) ***Offsetting impact of variable cost reductions not considered***

Even in the unlikely event of a price increase above counterfactual levels, any such price increase would be suppressed by the reductions in variable costs resulting from the acquisition.

The Commission has accepted that cost savings will arise and economic theory predicts that any reduction of variable costs would reduce the extent of any post-merger price increases.[62]

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[60] Draft Determination, ¶163.

[61] Draft Determination, ¶80.

[62] This concept that is acknowledged by the Commission in its *Mergers and Acquisitions Guidelines*, and is widely accepted in the economics literature.

NERA explained but did not quantify the offsetting impact of variable cost reductions in its original report at page 14 and then quantified the impact in its 25 March memorandum.

Even assuming only 50% of these variable cost efficiencies are passed through to price,[63] the cost savings are a [ ] per kg price drop in the North Island and [ ] per kg in the South Island from counterfactual levels. If the price increases are then applied then the overall impact there is an effective price increase *above counterfactual levels* of 7.99% in the North Island and 6.10% in the South Island.[64]

NERA explain in their report on the Draft Determination that the preliminary allocative inefficiency losses outlined in Table 2[65] do not seem to take these variable cost savings into account. The inclusion of this would tend to reduce the notional allocative efficiency calculated, and quite significantly so. They should be included in the analysis.

(d) ***The declining demand environment***

Another factor identified by NERA that will mitigate any allocative efficiency losses is the continuing decline in market demand over time. In this regard, there seems little debate that demand for scouring is declining over time and hence the demand curve is shifting inwards. As NERA explain "[a]ll else equal, a fall in demand... leads to a lower price", and hence any post-acquisition price increases would be lessened as would allocative efficiency losses.

NERA have calculated the impact of an expectation of declining demand on the estimates of allocative efficiency in Table 2.2 of their report.

(e) ***Summary of CWH's position***

For the reasons expressed above and in section 2, CWH believes that no price increases are likely as a result of the acquisition.

Certainly, price increases of 20% are unrealistic and these should be excluded from the analysis. Price increases of 10% are also extremely unlikely to be profit maximising based on the NERA report accompanying this submission, and in light of:

- the weak constraint provided by WSI;
- the constraints provided by the risk of loss of greasy wool volumes to off-shore scouring facilities or the threatened loss to new entry;
- the inability to price discriminate; and
- the fact that CWH already has [ ]% of the commission scouring volumes and that exporters have shown a reluctance to use WSI.

Accordingly, CWH believes a worst case scenario would be price increase of 5%, although it has not been able to achieve these from exporters to date despite their reticence to utilise WSI.

Even if a price increase did occur, this would be a price increase from the lower factual price levels likely as a result of variable cost savings from the acquisition. As NERA illustrate this reduces the top end of the detriments identified by the Commission.

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[63] As NERA explain on page 2 of their 25 March memorandum "As noted by Hausman and Leonard (1999), 50% is the lower bound for pass-through of cost savings".

[64] See Table 1, NERA memorandum, 25 March 2011.

[65] Draft Determination, page 29.

Accordingly, CWH believes that even on a worst case scenario any loss of allocative efficiency would be at the low end of ranges identified by the Commission, at most 5%.

4.2 Loss of productive efficiency

CWH believes that, if anything, the Commission's estimate of productive efficiency losses is overstated. There is certainly no reason to consider that the Commission has understated likely losses.

(a) ***No reduction in incentives to minimise costs***

As CWH stated in its application, the acquisition would result in a loss in productive efficiency if CWH had less incentive in the factual compared to the counterfactual to minimise its costs of production.

In this respect, CWH agrees with the Commission that a firm seeking to maximise profits will have an incentive to minimise its costs, and it is only to the extent that the incentive is weakened that productive efficiencies are likely to arise.

As the Commission has correctly recognised, the key drivers for CWH to remain efficient have not been competition from WSI, but:

- the declining sheep numbers and declining wool clip, which is unlikely to be reversed;
- the threat of wool being exported in greasy form rather than as clean wool; and
- its small shareholder base containing as it does two experienced investors wishing to maximise its investment but also a downstream manufacturer which competes in a very competitive carpet market and so has every incentive to ensure that the product it receives is the lowest price possible. As the Commission is aware, CWH monitors its performance across a range of production metrics on a minute by minute basis with weekly reports provided to the shareholders.[66]

These pressures will continue unabated in the counterfactual, providing every incentive for CWH to continue to maintain productive efficiency. There appears little incentive for CWH to allow its vigilance in keeping costs low to slacken.

In this context, CWH believes that the presence or absence of NZWSI provides no (or an imperceptible) additional incentive to minimise production costs and therefore there will be no productive efficiency losses from the acquisition.

(b) ***No material increase in supply risk***

CWH also agrees with the Commission that no value should be ascribed to the risk of increased supply risks for the reasons listed by the Commission.[67]

It should be noted that the issue of business continuity is not unique to Godfrey Hirst; Cavalier Bremworth is a major customer of CWH and is satisfied that any increased risk is being mitigated appropriately and that there is little risk to its business.

[

[66] See Bell Gully letter, 14 March 2011, at pages 14 and following.

[67] Draft Determination, ¶177.

[68]

]

In summary, the Commission is correct that no value should be ascribed to an increased supply risk.

4.3 Dynamic

CWH believes that, if anything, the Commission's estimate of dynamic efficiency losses is overstated. There is certainly no reason to consider that the Commission has understated likely losses.[69]

5. Weighting of benefits and detriments

CWH agrees with the overall conclusion reached by the Commission i.e., that the benefits to the public would outweigh the loss of competition arising from the Acquisition.

However, for the reasons explained in sections 3 and 4, CWH believes:

- The superstore benefit is sufficiently certain that it should be given weight as a benefit. Even if the Commission only placed a 25% probability on the super store occurring in 5 years time, this still results in a probability-weighted benefit of in excess of $[ ] million.
- The acquisition will result in significant improvements in base Y. At a minimum and counting only WSI volume being switched to CWH in the North Island these amount to [ ] over five years. For the reasons explained above, CWH believes the benefits would be significantly higher than this.
- Consistent with the apparently overwhelming majority of feedback the Commission has received, and consistent with economic theory, the removal of WSI's merchant scouring model is likely to result in material and sustainable benefits to New Zealand through increased export receipts.

Benefit claimed	Draft Determination	CWH
Production and administration cost savings	[ ]	[ ]
Sale of Land	$8.792 million	Minimum of $8.792 million
Capital expenditure	[ ]	Maximum of [ ]
Capital cost savings	$0.88 million	$0.88 million
One-off rationalisation costs	[ ]	Maximum of] allowed as a contingency

[68] [ ]

[69] [ ]

Benefit claimed		Draft Determination	CWH
Superstore		Not quantified	Minimum of [ ] million
Y benefits valued at 4 cents per kg clean	**WSI volume to CWH in North Island – 1 Y unit uplift**	$0	[ ]
	WSI volume to CWH in South Island – 1 Y unit uplift	$0	[ ]
	CWH Awatoto extensions – CWH volume	$0	[ ]
	Further 1 Y unit uplift on WSI North Island volume	$0	[ ]
Removal of weak seller		$0	Minimum of $[ ] million
Total benefits		**$25.87 million**	**$66 million to $84 million**

- Losses of allocative efficiency – if any – are unlikely to be large and are likely to be at the lower end of the scale identified by the Commission in Table 2.[70] This is because the acquisition will remove only one – and by no means the most important – of a number of constraints operating on CWH.

Detriments	Draft Determination	CWH
Allocative	$0.733 million to $15.645 million	$0 to $2.493 million (5% maximum price increase, net of variable cost reductions and declining demand)
Productive	[ ]	[ ]
Dynamic	[ ]	[ ]
Total detriments	**$1.439 million to $21.736 million**	**$0 to $8.584 million**

[70] Draft Determination, page 29.

Annexure A: Market Strategy China "Wool Industry Statistics China", 27 April 2011

Confidential Annexure B

[ ]