BELL GULLY

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Public version

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Dear David and Hamish

Cavalier Wool Holdings - follow up on 10 March meeting

We refer to our meeting on 10 March. Given the range of matters discussed, we thought it would be useful for you if we set out the basis of Cavalier Wool Holding's (**CWH**) responses to the various questions raised in your emails of 8 March (from Hamish Forsyth) and 9 March (Dave Ainsworth) and a response to your query as to how the Commission should measure the efficiency of the various woolscours. The responses to your questions as discussed in the meeting are set out under the question numbers you set out.

In relation to benefit questions 13 to 15 which deal with the Y value / brightness increase benefit claimed, we will provide a separate response to you in relation to the issues discussed.

Having said that, it suffices to say that it appears to us that at least a part of the confusion around this Y value claim has arisen from it being loosely termed as a "quality" benefit. To be clear, CWH is not claiming that it increases all parameters of wool. Nor is CWH saying that merchants will now be able to use vastly lower quality wool to achieve the same desired result. All merchants blend the wool they use and by increasing the Y value, they have a great flexibility to use wools of lower greasy Y value at a lower cost to achieve the desired clean specification.

We understand that the Commission has been told that a lower greasy Y value carries with it a degradation of all the other properties of a greasy fleece and therefore reductions in the blend for scouring by using a lower greasy Y is not possible because the lower related properties make that reduced greasy Y blend detrimental to the value of the clean output. We note that our client says that such a claim is quite wrong and they will obtain expert opinion to refute it. Some of that opinion is attached.

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These letters demonstrate that exporters have in fact obtained an ability to alter ('dumb down') their blends in response to the Y parameter improvements CWH has achieved.

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We are keen to ensure that you have all the information you require prior to the draft determination; if you have any outstanding questions on the issues outlined in this letter or more generally, please let us know and we will endeavour to provide a response as soon as possible.

Email from Hamish Forsyth, 8 March

Part A: Competition Assessment

1. **No account appears to be taken of the recent increase in wool prices and the likely effect on New Zealand's sheep numbers**

   We understand that, following your meeting with a group of wool farmers, you accept that the recent increase in wool prices is not sufficient to lead to a long term and material reversal of the general declining trend in wool numbers. Please let us know if our understanding is incorrect.

   CWH agrees with this conclusion. In fact, as Nigel Hales indicated to you, CWH expects the number of sheep to decline over the next two years due to the reduction in lambs this year having the effect of reducing the number of breeding stock which will be available in New Zealand in two years time by **[ ]** million head.

Potential entry

2. **Further detail on possible sites with existing consents in place would be appreciated**

   CWH believes that most current examples of former freezing works or wet processing sites would be potential future wool scour sites. Wool scouring produces dirt in the washes but does not produce outputs which contain risk contaminants. **[**

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In the Hawkes Bay, there are a number of existing sites which could be available.

One such site is **[**

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In respect of Timaru, as an example, 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.

China constraint

3. **In respect of scouring in China no party of many interviewed agreed that it would be possible for it to commission scour in China. This was due to the production delays, the need to, and cost of, closely supervising the process in China from import dock to scour to export dock and the cost of transport**

CWH has never intended to give the impression that an exporter would use a commission scourer on its own account in China, although this remains possible.

Rather, the constraint on CWH exists because the alternative for an exporter to supplying clean wool at the export port is to provide greasy wool at the export port. The customer then assumes responsibility for having the wool scoured.

The reality is that this raises no issue for customers as 22% of New Zealand's wool clip is already exported in greasy form. (See wool flow diagram provided to the Commission on 21 February 2011.)

Moreover, the suggestion that this constraint is limited only to wool going to China overlooks the fact that it is not possible for CWH to determine in advance where the wool it scours or is competing to scour is destined for. Nor is it correct that there is no constraining impact on domestic volume.

In general terms, any attempt to price discriminate against local producers opens an opportunity for an exporter to arbitrage into the New Zealand domestic market.

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4. **In respect of China acting as a constraint on the merged entity, contrary to statements in the application the proportion of NZ greasy wool sales to China in respect of total NZ wool exports to China is declining**

The volume of greasy wool being exported to China is increasing as is the proportion of greasy wool to China as a proportion of total exports. That said, CWH acknowledges that scoured volumes to China have also increased, although off a lower base. The result is the proportion of greasy wool exports to scoured wool exports to China has decreased to 60% in recent years.

The reason why the volume of scoured wool being exported to China wool is increasing is, CWH believes, because CWH is competing effectively to retain this volume in New Zealand.
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There is nothing to stop customers exporting this wool as greasy wool. Certainly, if CWH tried to increase prices above competitive levels or dropped its service standards, this would be the result. The Commission recognised this in Decision 666.

For completeness, the figures from Meat & Wool NZ are set out below:

New Zealand greasy wool exports

	China Greasy	Total Greasy exports	% China
Jun-10	36,142,000	41,405,000	87%
Jun-09	34,258,000	41,221,000	83%
Jun-08	29,435,000	38,048,000	77%
Jun-07	28,025,000	37,316,000	75%
Jun-06	34,370,000	46,996,000	73%

New Zealand wool exports to China

	Greasy	Scoured	Yield adjusted at 77% to bring back to Greasy	Total Exports to China	Scoured exports % of total
Jun-10	36,142,000	18,288,000	23,750,649	59,892,649	39.66
Jun-09	34,258,000	14,483,000	18,809,091	53067091	35.44
Jun-08	29,435,000	13,587,000	17,645,455	47080455	37.48
Jun-07	28,025,000	11,312,000	14,690,909	42715909	34.39
Jun-06	34,370,000	10,578,000	13,737,662	48107662	28.56

5. **In addition apparently the predominance of Chinese scour/manufacturers are only interested in finer wools to be made into "tops" and into apparel and not in the strong wools that are the bulk of New Zealand's production**

This is not correct.

CWH estimates that New Zealand exports approximately 250,000 bales of greasy wool each year (see table in response to question 4: 41,405,000 kgs divided by 165kg per bale is 251,000).

For the 2010 year, New Zealand exported 36,142,000 greasy tonnes or 219,000 greasy bales to China.

CWH estimates that the make up of greasy wool exported from New Zealand is made up of approximately:

- 56,000 greasy bales of Merino wool;
- 50,000 greasy bales of Mid Micron wool; and
- 144,000 greasy bales of coarse wool (cross-bred or XBD).

A mix of each of these categories above is exported to China, however the predominant mix is mid-micron and coarse. Indeed, of the 56,000 greasy bales of Merino wool, CWH

estimates that 21,000 greasy bales or 38% of Merino wool is exported to Italy, Czech Republic and Germany.

Nor is it correct that the type of cross-bred wool being exported is limited to lower/finer microns within that category. China demands all wool types; it is now the world's second largest grower of wool and the majority of sheep that are farmed in China are coarse wool types.

Further its manufacturing industry covers the spectrum of coarse wool types. Based on IWTO Market Information 2010, China is:

- The 2nd largest exporter of Wool Knitwear (behind Hong Kong);
- The 2nd largest exporter of Wool Knotted Floor coverings (behind Iran);
- The largest exporter of Wool Woven Floor; and
- The 3rd largest exporter of Wool Tufted Floor coverings (behind New Zealand and India).

Of course, that is only the export trade. The predominant market for Chinese manufacturers is the Chinese domestic market. As Wools of New Zealand state in their 15 December 2010 Press Release (copy distributed at the meeting):

> Manufacturers in China are primarily focused on the domestic market and in particular the demand from wealthy consumers for distinctive, quality carpets and furnishings. This is also being mirrored in hotels and commercial premises where wool carpets meet the criteria for design, performance and environmental values.
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> China is the world's fastest growing market for luxury goods, and wool carpets and rugs have a strong appeal to this group. Wools of New Zealand's China Brand Partners are capitalizing on this new market with a wide range of high-end high quality products.
>
> China is the world's largest destination for strong wool exports. Manufacturers there bought 40 million kilograms of New Zealand strong wool in 2009 and are expected to increase imports to 50 million kilograms in 2010, and show further growth through 2011.

Part B: Benefits

Land sale benefit

1. **In respect of the benefit claimed from the sale of the land, the valuations provided by CWH appear based on WSI's annual report of 2007 in the height of the property boom. A more recent valuation shows the claimed values may have fallen by one third**

CWH provided the basis for its estimate of the value of the land and understands that WSI has provided a valuation dated April 2010 for the Kaputone land in which its value is **[ ]** lower than what has been estimated by CWH.

While we have not seen that valuation, we do note that WSI has not seemed to have updated its accounts to reflect this valuation.

Note 4(a) to their 2010 Financial Statements for the 12 months to 30 June 2010 records:

> The land and buildings at Kaputone Wool Scour were valued in March 2007 by Mr C Stanley, a registered valuer with TelferYoung (Canterbury) Limited. Mr Stanley is a member of the New Zealand Institute of Valuers. The valuations were undertaken on a current market value basis.
>
> The land and buildings at Whakatu Wool Scour were valued in April 2007 by Mr F Spencer, a registered valuer with Logan Stone Limited. Mr Spencer is a member of the New Zealand Institute of Valuers. The valuations were undertaken on a current market value basis.

Further, the Interim Accounts for the 12 months to 30 December 2010 record the asset value for "Property, plant and equipment" as being NZ$16.137m compared to $16.598m for the 12 months to 30 June 2010.

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WSI is a publicly listed company and as such is subject to continuous disclosure obligations. If WSI truly believes the April 2010 valuation is a genuine and correct valuation, then not disclosing this reduced valuation could potentially place it in breach of its continuous disclosure obligations to the extent the value reduction would, if generally available to the market, be expected by a reasonable person to have a material effect on the price of WSI's securities.

Moreover, CWH understands **[**

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2. **In addition we wonder whether the properties will be able to be sold on day one following the proposed acquisition and as such the benefits should be discounted over some years**

CWH will go through a sale process to sell the land. While this may take a little time, any discount should only be applied if it takes longer than a year. This is unlikely.

It is noted that following the acquisitions forming part of Decision 666 David Ferrier sold the Clifton wool scour site **[**
]. That sale was made during the global economic recession.

Capital cost savings

3. **It appears to us that there is no guarantee that the proportionally small additions to the buildings proposed as part of the post-acquisition rationalisation will result in any increase in a potential sale price of the land and buildings and that that part of the cost of building rationalisation should be considered as sunk along with the cost of relocating the plant and machinery**

As discussed at the meeting, CWH will provide further information in relation to this question.

4. **The method of obtaining the cost of the rationalisation has not been described and in this respect we notice that considerable rounding of the numbers appears to have**

been applied. Is there an accredited engineering estimate that could be provided to the Commission?

While no quotes for the work have been obtained at this stage, CWH management have prepared these estimates based on experience of previous scour operations.

As discussed at the meeting, CWH will provide further information in relation to this question.

5. **Please explain the difference in winter maintenance (claimed as capital expenditure) and repairs and maintenance (claimed as an operating cost saving).**

Please let us know if you need any further information on this.

6. **How will CWH maintain its current capital expenditure amounts given the increased size of the merged entity (especially at Awatoto given the larger number of scour lines)?**

Please let us know if you need any further information on this.

7. **What is the cost of mothballing Clive?**

There will be no incremental cost of mothballing Clive – **[ ]**.

There will be an extremely immaterial cost in mothballing the Timaru 2.4 m scour line reflecting some additional grease and the need to run the machine occasionally.

8. **Why can Clive not be closed in the counterfactual given that the Whakatu scour line will actually scour less wool in the factual?**

As a commission scourer, CWH does not control when its customers want to scour their wool and Clive is currently needed to cover peak periods in the North Island. Demand at these times exceeds what can be supplied on the Awatoto 2.4m scour lines.

9. **Most of the operating cost savings will be achieved via reduced wages and fuel/electricity costs – explain how this will be achieved**

Jim Drake is available to meet with you to discuss this further. Please let us know a time that suits you.

Non-capital cost savings

10. **Most of the overhead savings come from salaries – please explain how this will be achieved.**

Jim Drake is available to meet with you to discuss this further. Please let us know a time that suits you.

11. **The evidence that we have gathered appears to show that contrary to statements in the application there are no environmental or physical constraints on expansion at Kaputone or Whakatu and that some of the benefits proposed would be available in the counterfactual as well as in the factual**

This is contrary to CWH's understanding based on its due diligence in 2010 and investigations to date.

In any event, the scourer benefit arises from the efficiencies gained from increasing the throughput and from an increased volume of greasy wool. As WSI is unlikely to gain any increased wool volumes of sufficient amount to incentivise capital expenditure for the purposes of increasing throughput, no Y value benefit will flow.

12. **As a merchant scourer, WSI is able to arrange long runs of identical batches which do not require adjustments to the scouring process. It has been submitted that this is a very efficient method of operation of a scour which will be lost in the factual because CWH is a commission scourer which operates on the basis of much shorter runs. As such, any efficiency gains may be less than claimed**

CWH does not consider this to be a particularly "efficient" scouring outcome, and notes that very long runs of similar wool types suggests that WSI is scouring to stock. This is a risky proposition as its exposes WSI to currency and pricing risks and also means that WSI has to sell a certain specification as opposed to supplying to order. This would tend to support the observations made in our letter dated 9 March regarding the impact of removing WSI.

In any event, the net impact of having more line changes due to shorter runs would be minimal.

The example given during the meeting was for the North Island, although the same principle applies in respect of the South Island. Suppose that:

- CWH at its Awatoto plant has **[ ]** line changes per day. CWH's data shows these average **[ ]** minutes for CWH. Accordingly, each day CWH averages **[ ]** minutes of downtime for changeovers.

- Assume that because it has longer runs, WSI has only **[ ]** line changes per day at Whakatu. Assume also that these line changes take **[ ]** minutes (although CWH understands that WSI take a lot longer to finish their line changes on average than CWH). Accordingly, each day CWH averages **[ ]** minutes of downtime for changeovers.

- The difference in downtime is therefore **[ ]** minutes per day from **[ ]** additional line changes. Using WSI's current Whakatu run-rate of **[ ]** kgs per available hour, this equates to **[ ]** kgs of lost production (**[ ]**).

- Balanced against this, CWH is forecasting incremental volume on the Whakatu line of **[ ]** kgs per available hour by increasing the run rate from **[ ]** kgs to at least **[ ]** kgs per hour. Over a day this amounts to an additional **[ ]** kgs in comparison.

- Any loss through more line changes therefore amounts to around 1.8% of the gain in volume.

Quality benefits

13.-15. We will provide a separate response in relation to this issue.

Additional benefits

16. **[**

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17. **How far down the planning process is the superstore concept?**

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17.1 ***Superstore in the North Island***

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To date it has only been developed for the North Island although the same concepts will apply in the South Island. CWH would expect to develop and implement the North Island model and then roll that model out for the South Island. You were shown the land at Timaru where the superstore would be located once the model is rolled out the South Island.

17.2 ***The position today***

Today, exporters/brokers have their own woolstores scattered throughout the country which they use to store their own procured wool. Operating a woolstore requires investment in the land and buildings and requires exporters/brokers to employ staff to operate the facility.

Exporters/brokers have the wool they procure delivered into their own woolstores. It is then transported to the export port (Napier in the North Island) or for scouring in Napier. This results in what is known as "reverse cycle freight". For example, wool might be transported to a woolstore in Wanganui and then transported to Napier.

There is also no sharing of woolstore infrastructure between exporters/brokers today. This is because of the conflict associated with the owner of a store also being a competing wool trader. In many respects it mirrors the reasons why merchants/exporters choose not to scour their wool with WSI.

The outcome of this natural conflict is the large duplication of woolstores and the associated investments we see in the market today.

17.3 ***The superstore concept***

In broad terms the concept is to build a central wool facility (superstore) adjacent to Awatoto (and Timaru).

The woolstore would operate on an open access basis and would be large enough to handle approximately **[ ]** of the wool grown in the North Island.

The superstore would be operated by CWH or another entity not involved in the ownership/trading of wool. This is necessary to ensure that there would be no actual or perceived conflict of interest between the superstore owner/operator and its customers. If there was such a perception, the model would not work and WSI's inability to secure commission scouring work is testament to that.

While it would require existing parties to exit their current facilities, the removal of any conflict issues and the very significant rationalisation and cost savings benefits would provide the incentive for wool merchants and brokers to participate:

- CWH estimates there is over **[ ]** million invested in duplicated infrastructure. This could be released for other uses and CWH expects such rationalisation benefits would be welcomed by participants.

- Removal of this duplication would also result in operational cost savings. CWH has estimated these at NZ$**[ ]** million per year. Although this would be spread over a number of participants, coupled with the reduction in capital involved it would provide significant benefit to merchants/exporters.

- The other key benefit would be the removal of duplicated freight. Wool could flow direct or though hubs from farm gate to the superstore. CWH has estimated the freight savings to be in the order of $**[ ]** per year. CWH also estimates there would be local Hawkes Bay freight savings of $**[ ]** per year. From a NZ Inc perspective, neither of these benefits includes the emissions benefits which flow naturally from reduced freight.

So while CWH acknowledges that some work will be required to settle the final design, the benefits to exporters/merchants are so material that CWH has complete confidence that it would secure their participation.

17.4 ***Why the concept cannot be implemented in the counterfactual***

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Absent CWH involvement, there is no independent body which would facilitate the development of this model. CWH is incentivised to pursue the model so as to improve the competitive/cost position of New Zealand's growers and exporters. As a service provider CWH's performance depends directly on the performance of the New Zealand wool industry. Anything CWH can do to improve that position is a benefit to its core scouring business.

From CWH's perspective, however, the commercial viability of the model relies on securing sufficient volumes of wool into the store to make the investments worthwhile so as to achieve costs savings etc.

This requires the WSI volumes to be part of the model, or to be able to become part of the model.

However, absent the transaction this will not occur. This is because – put bluntly – absent the transaction either:

- WSI <u>will not</u> commit its volumes – an outcome which is reasonably likely given its commercial strategy in general – with the result that the model will not be viable; or

- while WSI would commit its volumes, the necessary by-product would be that sufficient other exporters/merchants/brokers <u>would not</u> commit their volumes as a direct result of WSI's involvement in the project. You should now be well acquainted with the general attitude of the industry to WSI. Again, the result is that the model will not be viable.

17.5 ***Overall benefits to New Zealand***

Based on the analysis conducted by CWH to date it expects the benefits flowing from this concept to be in the order of NZ$**[ ]** million per year in cost savings and the ability for in excess of $**[ ]** million in duplicated resources to be released for other uses.

Part C: Detriments

Allocative

1. **[**

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2. **CWH has said it will not increase prices post-acquisition but what about its investment company shareholders ACC and Direct Capital – who may have different incentives**

Both ACC and Direct Capital have the incentive of maximising the long term profitability of the company and that is the same incentive as Cavalier Corporation and CWH. This will not be achieved by increasing prices above competitive levels.

Productive

3. **Various parties submitted that they would be very concerned at the risk of natural disaster, fire or union action if New Zealand's scours were centralised under single ownership in one location in each island. Parties were concerned that this would be a risk that would fall on New Zealand's downstream wool processing industry that was described as valued at $1 billion per annum. In this respect we have been told that there was a fire at Awatoto in 1999 that shut down half the plant for month. Also we note that Awatoto is situated on land zoned as subject to inundation once every 50 years. This extra risk should be factored in as a detriment. We note that the remaining Clive scour proposed to be mothballed could not be described as a back up to one or other of CWH's plants post acquisition.**

CWH does not consider that the position will be materially changed *vis-a-vis* the counterfactual.

Neither the Timaru nor Awatoto plants will be operating at full capacity in the factual. Also, Clive and the Timaru 2.4m line will remain (mothballed) in the factual providing overflow capacity. If Awatoto burns down completely then CWH has plenty of space to fit a scour line next to the existing scourlines at Clive so would not be constrained from building a temporary facility while waiting for the original building to be re-built.

CWH already has comprehensive insurance that would cover the cost of freight between the Islands in the event of a disaster.

Customers also have the option of exporting greasy wool.

In relation to "inundation", most industrial sites are now tagged with "Inundation, flood or climate change" clauses. There is no evidence of this Council provision becoming a realistic occurrence. Furthermore, if such an event occurred in the counterfactual, it would likely affect both CWH and WSI premises.

In terms of preventative measures, both Awatoto and Timaru are completely covered by sprinklers. In the case of Timaru, it is being upgraded to run two separate fire sprinkler systems with two separate feeds and pumps. The result is that in the event of a fire, only half of the building would be affected. A preventive maintenance program is in place at all sites and thermo imaging is carried out once a year at all sites.

CWH believes the reference to the Awatoto Fire in 1999 is mischievous. It is true there was a fire, however, the fire was a small one emanating from a switch board. It affected one scour line only and did not even burn out the control room (the small room that it is located in). Even the cabinet that the fire was in is still used today.

It is true that it took two months to repair, but this was at a time when the scour was processing 80,000 bales annually and there was no time pressure to get the second line up and running again. The electrical contractor (still the same one used today) took his time and did most of the work himself. He took the opportunity to upgrade some old parts.

CWH believes that even a major electrical failure would be repaired in less than 48 hours.

Dynamic

4. **Incremental efficiency gains appear to have been achieved by CWH and WSI over previous years. Moreover, competition for throughput seems to be a major driving factor in this industry. Are there any reasons why we should not expect to see losses in dynamic efficiencies with the reduction in scourers from two to one?**

NERA is preparing a response on this issue.

Email from Dave Ainsworth, 9 March

It also appears to us, after examining the list of major shareholders that the shareholding members of the Board and staff of WSI would be in a position to block any special resolution. As CWH's "rationalisation" benefits rely on the transfer of WSI's scouring assets to CWH, should we place a weighting factor on those claimed benefits because, due to the above, there is a risk that the rationalisation might not occur.

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Measuring efficiency – question from Awatoto site visit on 23 February

CWH understands that WSI disputes CWH's claim that CWH is the most efficient scour operator in New Zealand (WSI claims it is the most efficient). You asked how the Commission should determine whether CWH or WSI is most efficient.

As an initial point, CWH does not believe that the relative efficiency of each scour operator is determinative of whether all or any public benefits will flow from the transactions. This is because:

- The primary public benefits arise in the form of increased economies of scale; these will arise regardless of whether the Commission is of the view that WSI or CWH is more efficient.

- The quality benefits also arise as a by-product from increased throughput as a result of modifications being made to existing scour lines which would not occur absent the transaction. Even if WSI is more efficient than CWH believes it to be, the effective performance of the scours will increase further, as will the Y value of the outputs.

- Even if WSI were more efficient, there is no reason to believe that CWH would forsake the efficiencies that have been gained. Indeed, CWH's history has been one of constantly searching for improvements in efficiency.

Notwithstanding those comments, CWH believes it is the most efficient scour operator across the broad range of metrics it uses to assess its efficiency. The measures CWH relies on for its business are those associated with **[ ]**. Each efficiency measure is recorded by CWH on a minute by minute basis, reviewed daily by Senior Management and is the subject of weekly reports to the shareholders.

By comparison, it is understood that WSI has told the Commission that width of the scour line is the proper gauge of efficiency and is the measure the Commission should use in this case. CWH does not consider or use the working width of its scours as an efficiency measure and considers the WSI claim to be inappropriate and mere advocacy.

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1. **How CWH measures its efficiency**

The efficiency of a wool scour can be measured in a number of ways such as:

- Total Greasy Kilograms Washed per hour (run rate) – this is <u>available hours</u> divided by greasy kilograms washed;

- Total number of hours expected to be working – this is <u>available hours</u> less <u>downtime</u>;

- Total <u>downtime</u> – including scheduled and unscheduled downtime;

- Repairs and maintenance cost per greasy kilogram;

- Gas, Coal, Electricity, Water, Effluent etc usage per kilogram;

- The quality of the scoured product versus run rates; and

- Labour used per kilogram scoured.

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As noted above, CWH examines these measures on a minute by minute basis with Shift Supervisors and Production Managers making necessary adjustments. Senior Management

review the operational data on a daily basis and the data is reported to shareholders each week. This data is available on a historic basis should the Commission require it.

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The fact that CWH operates its business on the basis of these figures indicates the validity of these measures as measures of operating efficiency.

2. **Unit of measurement – available hours versus operative hours, cost per greasy kg**

CWH uses different unit bases to measure its efficiency.

2.1 ***Volume/speed based measures***

For volume based measures or speed based measures, the unit of measure is per "available hour". There are 168 (24 x 7) available hours per plant per week.

The alternative would be to use "operative hours" which is available hours less total downtime, or "productive hours" which is available hours less scheduled downtime (such as washdowns, scheduled R & M etc).

CWH uses available hours as the unit of measure because, as a commission wool scourer, it is incentivised to reduce all downtime whether scheduled or ad hoc.

2.2 ***Cost based measures***

As CWH's services are sold on a "cents per greasy kilogram basis" (cpkg), CWH reports all costs in cpkg, i.e., cost or category of costs divided by greasy kgs processed.

2.3 ***Width of a scour line not a measure of efficiency***

CWH does not use this as a measure of efficiency. If used this measure would show that:

- [
  ]; and
- [
  ]

CWH considers this is not the most appropriate way to measure efficiency as it overlooks a number of important elements.

To illustrate, as Commission staff are aware from the site visits, bowls 1, 2 and 3 on a wool scour are known as the "wash bowls". These are the high cost bowls for a wool scourer because the liquor in the bowls needs to be constantly heated and detergent needs to be added. These are also the bowls from which "heavy effluent" is discharged.

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3. **Assessing whether CWH or WSI is more efficient?**

There are a number of factors the Commission should consider when assessing whether CWH or WSI is more efficient on the measures outlined above.

3.1 ***Types of wools scoured***

The types of wools scoured will impact on the measures of efficiency described above.

For example, some wools are "harder scouring" and therefore throughput on the scour lines will not be as fast when those wools are being scoured. In general terms and on average, South Island wools are harder scouring than North Island wools (South Island wools are generally muddier).

As a commission scourer, CWH has to scour all the types of wool which is supplied to it by its exporter customers. In contrast, as a merchant scourer, WSI controls the types of wools which it scours. For example:

- WSI's scour lines are not able to scour lines with a high percentage of "cots", while CWH is able to scour these; and
- WSI's scour lines are not able to scour merino, while CWH is able to scour these.

That does not mean that a scour line is operating less efficiently when those wools are being scoured, simply that it has to run slower to scour those wools to the required standard.

The relevant question is which scour line would have the greater throughput and efficiency if they were both scouring the same type of wool.

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Size of batches

As a commission scourer, CWH scours for a range of customers and to meet a range of specifications and customer orders. By necessity, this requires more downtime associated with changing from scourment to scourment.

In contrast, WSI is likely to scour larger scourments as it is its primary scouring customer.

Again, the relevant question is which is more efficient on a like for like basis.

See also response above to Detriments Question 12.

3.2 ***Costs per greasy kg***

Because CWH operates as a stand-alone commission scourer and WSI operates as a vertically integrated merchant scourer, efficiency comparisons between scouring costs need to be carefully drawn.

As a stand-alone business, all CWH's revenues and costs are contained in its accounts. Conversely, WSI will have costs which are shared between its trading and scouring divisions.

[

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Overall, CWH believes **[** **]**. CWH is also aware that **[**

].

4. **Measuring WSI's efficiency**

CWH suggests that the Commission should compare WSI and CWH figures across the range of measures but most importantly over a 12 month period:

- Total greasy kilograms processed per available hour (average run rate);
- Total greasy kilogram capacity per available hour (capacity);
- Total downtime; and
- Costs per greasy kilogram scoured (with overheads costs attributed to WSI's scouring activities).

As described above in interpreting these figures, it is important to recognise that the differences in the business models of WSI and CWH will affect comparisons of cost calculations and run-rates etc.

5. **CWH has made a decision to acquire the assets based on its expectation it can improve WSI's performance**

The commercial rationale for the transaction is to increase economies of scale and decrease unit costs. This increased efficiency will result regardless of whether WSI or CWH is the most efficient operator today.

Nevertheless, CWH believes its operations are the most efficient across the broad range of measures and its assessment of the value of the transaction to it has been made on the basis that it expects to increase the performance of WSI's plants. This is the best evidence that CWH is in fact the most efficient operator in the market.

Please let us know if you have any questions in relation to this letter.

Yours sincerely

[Sgd: Phil Taylor / David Blacktop]

Phil Taylor / David Blacktop
Partner / Senior Associate