PUBLIC VERSION

Memorandum

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To: The Chairman and Members
Commerce Commission

by email

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PRIVATE AND CONFIDENTIAL

CAVALIER WOOL HOLDINGS AND NEW ZEALAND WOOL SERVICES INTERNATIONAL – GODFREY HIRST FINAL SUBMISSION

Introduction

1 On behalf Godfrey Hirst (NZ) Limited (Godfrey Hirst) we present this final submission on CWH's proposed acquisition of NZWSI. Godfrey Hirst repeats the submissions it has made previously, including its:

1.1 submission on the Commission's draft determination dated 21 April 2015;

1.2 cross-submission dated 11 May 2015; and

1.3 post conference submission dated 23 June 2015.

2 Godfrey Hirst also repeats all the observations that we have made on Godfrey Hirst's behalf about the Commission's process and, in particular, the decision to seek final submissions on everything except valuations and without issuing a revised draft determination. As we have stated, it is artificial to isolate the valuation evidence from the rest of the analysis.

3 Further, given how much has changed in the application since the draft determination, it is unreasonable and a breach of natural justice to require that final submissions be made in a vacuum, without the benefit of knowing the Commission's views on the altered position.

4 Indeed, not only does it deny interested parties the opportunity to make informed submissions, it also denies the Commission the chance of the parties correcting any errors or flaws in its thinking.

5 So, we urge you to reconsider your position on this. As we have said, the better process would be for the Commission to hold the valuation conference, issue a revised draft determination, and then call for final submissions. Such an approach would ensure greater fairness and transparency and have limited effect on the timetable. The further extension of time involved would not adversely affect the

Applicant as the Commission cannot be satisfied that [

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6 So saying, we refute the reliability and relevance of [ ] and will be making detailed submissions on it in the context of the Commission's further inquiry into valuations.

7 In the meantime, however, in lieu of our preferred approach, we respond to the Commission's confirmation of 7 August to us and Bell Gully that final submissions on all matters other than valuation are due today. We do so on the express expectation that the Commission will not allow further submissions from either party on any matter other than valuations. In particular, the Commission must now stop the persistent drip feeding of "follow up" information on behalf of the Applicant.

Counterfactual

8 By way of backdrop, the Application paints a bleak picture of the wool scouring industry with or without the acquisition: further reduction in the available wool clip; increase in greasy wool exports to China; increase in competition from overseas scours; decline in demand for scouring services within New Zealand; farmland previously used for sheep converting to dairy; and generally a wool industry that continues to be in distress.

9 Those claims seem well borne out by the Applicant's own experience. By the time the Commission makes its final determination it will be over 10 months since the date of the Application. That has been a tumultuous time for CWH and its ultimate 50% shareholder, Cavalier Corporation Limited (Cavalier).[1]

10 Briefly, Cavalier has seen its share price fall by 77% in the last year, to a 20 year low, after continued poor financial performance. Dividends were suspended. At last November's AGM the Board and senior management of Cavalier were severely criticised by shareholders, and subsequently by analysts.

11 Things then got worse. Cavalier's latest half year results, announced on 20 February 2015, stated:

11.1 Profit decreased 99 percent for the first half year;

11.2 Net profit dropped to $32,000, from $3.4 million a year earlier;

11.3 Operating cash flow shrank to $12,000 from $3.5 million a year earlier;

11.4 Net debt was $59.1 million, meaning Cavalier's debt-to-equity ratio was at 39 per cent.

[1] The Commission has already determined to proceed on the basis that Cavalier Bremworth (and thus its parent company, Cavalier) and CWH should be considered as one head in the market: Paragraph 80 of the draft determination. That finding has not been challenged by the Applicant.

12 Cavalier's travails have continued. On 20 May Cavalier announced that its earnings for the 14/15 year are likely to be at, or slightly below, the lower end of the previous advised earnings range of $1 million to $4 million tax paid. In addition to those reduced earnings, Cavalier announced anticipated write-downs of assets, the impact of which will turn the 14/15 normalised tax paid profit into a loss. On the same day, Cavalier also announced that its Managing Director and CEO, Colin McKenzie, had stepped down with immediate effect.

13 Cavalier also stated that it had "prepared an updated strategy and business plan, which has been reviewed by the accounting firm Deloitte and which has been laid before Cavalier's bank, Bank of New Zealand". Details of that plan have not been released, but commentators suggest that it will involve urgent reduction of debt, requiring reduction of operating expenditure and sale of surplus or underperforming assets.[2]

14 Cavalier subsequently announced a new Chair, Sarah Haydon, and three new Board members, and the appointment of an acting CEO, Paul Alston. At the end of last month he announced significant organisational changes within Cavalier Bremworth's head office business and marketing and sales team. The aim of such changes was said to be to "decrease debt levels" and "streamline the business".

15 Then on 4 August Cavalier announced it was selling manufacturing assets in Australia, outsourcing operations and reducing staff, as its restructured Board and new management battle debt and declining earnings.

16 It must therefore be assumed that, absent the acquisition – which is effectively a reverse takeover by Lempriere/NZWSI of CWH, resulting in Cavalier immediately reducing its shareholding from 50% to 27.5% - the restructured Cavalier Board, acting rationally, would proceed immediately to divest surplus and underperforming assets held by Cavalier Bremworth and CWH.

17 Against that background of Cavalier's continued travails and recent drastic attempts at debt reduction, the "relevant counterfactual" claimed in paragraph 14 of the Application now appears largely irrelevant. It states simply that "the relevant counterfactual is the status quo, i.e. Lempriere continuing to run NZWSI as a separate scouring entity …". In fact, no reference is made in the Application to Cavalier's future intentions, absent the acquisition. Presumably the implication is that Cavalier would continue with its present scouring operations independent and wholly intact, too.

18 The only reasoning given for proposing that counterfactual is that "the Commission previously considered the most likely outcome absent the proposed transaction giving rise to Decision 725 was the sale of NZWSI to a third party, which in fact occurred with the sale of the NZWSI business to Lempriere in early 2013".

19 But Decision 725 dates back to June 2011. And, there has been no suggestion here of NZWSI being sold to a third party. On the contrary, the assumption is that

[2] For example, The Shoeshine column in last week's NBR (which is attached as Appendix A) colourfully refers to this process as "Cavalier Corporation … putting its carpet business through the cash wringer."

Lempriere would retain ownership of NZWSI. Much else has changed in the last four years for the wool scouring and carpet manufacturing industries, as Cavalier's own plight graphically illustrates.

20 Given the relevant counterfactual claimed in the Application makes no reference to Cavalier's or CWH's own intentions absent the proposed acquisition, the Commission cannot make assumptions in that regard. There is no statement in the Application (or elsewhere) to the effect that CWH would retain, and more particularly that Cavalier would allow CWH to retain, all of its current scouring capacity and all of its three scouring sites.

21 Whatever the position at the date of application, for CWH and Cavalier now **not** to consider selling assets that are surplus to requirements, or under-utilised, in order to reduce debt – absent the transactions contemplated by the Application - defies commercial common sense.

22 The Application stresses (at paragraph 5.27) that the commercial benefit from the acquisition lies in the economy of scale benefits arising from the rationalisation of existing CWH scour lines with existing NZWSI scour lines and hence the ability to generate incremental economies of scale benefits. The Application notes that CWH currently has three scour lines in the North Island, being two 2.4 metre scour lines at Awatoto and one 2.0 metre line at Clive. The proposal would see the transfer of the 3.0 metre scour line from Whakatu to Awatoto and the closure of the 2.0 metre scour line at Clive.

23 The Application also notes (at paragraph 5.32) that "since the previous Application, CWH had added a spare triple drum opener to the blending system at Awatoto. Consequently throughput has increased and quality of output has improved". However, incorporating the 3.0 metre scour line from Whakatu would require an extension to the Awatoto building. Significantly, the Application notes (at paragraph 5.36) that:

> *The [Awatoto] site would not need development absent the acquisition, given current capacity is more than sufficient to scour CWH's North Island volumes.*

24 The Application further explains (at paragraph 5.51) that CWH's other North Island plant at Clive currently is used only to "cover emergencies and peaks in demand". Specifically, Clive is said to have operated only for around [ ] days in 2014.

25 [ ] that the scour at Clive – and certainly the Clive scour site - in fact is itself largely redundant. [ ]

26 Godfrey Hirst understands that the Clive scour has a capacity of 50-60T per day and could operate 6.5 days per week if fully utilised. [ ], Clive would have processed less than 1500T last year. Meanwhile, Table 2 at paragraph 69 of the draft determination records that total volume of wool scoured in the North Island reduced from [ ] to [ ] from the time of Decision 725 to 2014.

Even at that reduced total volume, Clive scoured a mere [ ]% of wool scoured in the North Island in 2014.

27 Godfrey Hirst doubts that Clive has operated at all this year.

28 Given that very limited operation, and extreme under-utilisation of capital intense resource, surely the Clive scour would be closed down and the site sold in the counterfactual, just as is proposed in the factual. If the scouring capacity presently at Clive really were required on occasions, there are much less costly alternatives. For example, the Clive plant could relocate quite easily to Awatoto without any need for costly building extensions. In fact, there was previously a third scouring line, similar to Clive, installed at Awatoto, but was removed around 2000. That at least would release the Clive site for sale but retain overflow capacity.

29 Other alternatives, given the small and occasional volumes involved, could include diverting any surplus demand to Timaru or entering into a mutual back-up arrangement with NZWSI (as is common practice with other processing industries).

30 Maintaining a plant, simply on the basis that it may occasionally be required, is gold plating of a kind that the Commission's own pricing input methodologies for regulated industries would not allow. The Commission should apply the same discipline here and not assume that Cavalier's newly constituted Board and management will allow CWH to continue to operate in profligate fashion.

31 As is shown in Professor Guthrie's brief report entitled "Net benefits of closing Clive and Kaputone" (which is attached as Appendix B), retaining the Clive scour for occasional use involves CWH foregoing around $[ ] of savings it could achieve (on the basis of the net benefits of the proposed merger calculated in the draft determination).

32 The draft determination (at paragraph 116) accepts the Applicant's counterfactual that in the absence of the acquisition, each of Cavalier and Lempriere would run their wool scouring business independent of one another as a separate scouring entity. So they might. But, it does not follow that CWH, acting rationally, would retain *all* its current scouring capacity.

33 On the contrary, it is more likely that, in the absence of the acquisition, Cavalier would want – indeed, *need* – unilaterally to reduce its exposure to reducing demand for scouring services in the North Island, particularly in light of its own debt reduction imperatives. And, if it is commercially rational for the factual to see three scours in the North Island reduce to one, it is equally rational for the counterfactual to see CWH's two scours reduce to one(if necessary, with alternative arrangements being made for occasional overflow).

34 The Commission's *Mergers and Acquisitions Guidelines* explain that, as something can be "likely" even when the chance of it occurring is less than 50%, there may be multiple scenarios that are likely without the merger. Thus, the Commission must compare the state of competition and carry out its benefits/detriments analysis in relation to *each* likely scenario without the merger. The Court of Appeal in *Commerce Commission v Woolworths (and others)* made it clear that the

Commission could not exclude an alternative counterfactual (i.e. of Warehouse getting to a position where it had 7 to 10 Extra stores operating) if it determined there was a "real chance" or a substantial possibility of that happening.

35 Notably, the *Guidelines* also state that the status quo may not provide a good guide as to the future state of the market if the target firm is failing. Unusually here, it is the putative acquiring firm, CWH, and its major shareholder, Cavalier, that are failing – perhaps not to the stage that either is likely to disappear, but certainly to the stage that Cavalier is already having to divest surplus and underperforming assets.

36 At the least, the Commission must consider the counterfactual of CWH unilaterally closing its Clive scour as one of the outcomes that is likely to occur without the acquisition. The touchstone is whether there is a "real chance" or substantial possibility of Clive being closed permanently. Plainly, that must be the case, given the other "desperate measures" Cavalier is currently taking to reduce its burden of debt.

37 If the Commission cannot exclude that possibility, it must adjust its net benefit analysis to address this counterfactual. Under this scenario, the Commission would need to exclude *all* the benefits that would otherwise have been attributable to the closure of the Clive scour. At the least, all proceeds from sale of the Clive site, sale of redundant plant at Clive and reduction of production and administration costs attributable to closure of the Clive scour, must be excluded.

38 Professor Guthrie's brief report provides the required analysis. Using the figures provided in the draft determination in relation to relevant items, he calculates benefits resulting from the acquisition should be reduced by $[ ]if closing the Clive scour were to occur in any event in the counterfactual and no longer be regarded as a benefit of the merger.[3]

Other Detriments

39 In addition to compelling consideration of the revised counterfactual, the changes to Cavalier's financial position described above, as well as other changes in the economy (such as the shifts in the New Zealand exchange rate), require that the Commission reconsider its position on other detriments that may arise from the proposed merger.

40 Although it did not reach a firm conclusion on the point, the High Court in *Godfrey Hirst v Commerce Commission* appeared open to the approach of considering impacts outside the markets under consideration:

> *[73] An acquisition may however result in detriments (other than competition detriments) beyond those markets in which an increase in market power has been found. As to such detriments, the High Court in Telecom said this:*

[3] Of course, these figures would require adjustment to account for the Commission's ultimate conclusions on valuations, and other benefits claimed by the Applicant and Lempriere.

> *Moreover, we would caution that the detriments attributable to the strengthening of dominance are not the only detriments that could conceivably be relevant.* ***The very concept of benefit to the public allows for some netting out, in an appropriate case, of any detriments to the public from the acquisition itself*** *– albeit, again, it is a question of what difference is made to the shape of the future and without the acquisition. (emphasis added.)*
>
> *[74] It is well accepted that, in assessing public benefits, a "net" approach is taken whereby the costs in realising the efficiencies are deducted. This point was expressly noted by the Commission in this case. The above passage refers to a wider concept of "net benefit" to the public than that. We are not aware of any New Zealand decision, after these comments by the High Court in Telecom, which has viewed "net benefit" in this wider way. That is, where there are "other detriments" that fall outside the defined markets, these can be considered "disbenefits" or "negative benefits" and then offset (along with the costs of realizing efficiencies) against the (positive) public benefits claimed. The assessed detriments from the loss of competition in the defined markets would then be weighed against the net public benefit (i.e. deducting negative benefits as well as realisation costs) from the proposed acquisition to give the overall result.*[4]

41 In Godfrey Hirst's submission, the High Court implicitly accepted that this was the correct approach (as had the High Court in *Telecom*), but the High Court did not need to decide the point, because it was not taken to any detriments falling outside markets in which the substantial lessening of competition was said to be likely.

42 As the Commission is aware, Godfrey Hirst has expended considerable time and expense in opposing this Application. Godfrey Hirst plainly perceives a real risk that its interests will be harmed if the transaction proceeds. Specifically, it contemplates negative impacts on its business from (among other things) CWH favouring Cavalier Bremworth's interests over Godfrey Hirst's.

43 This could manifest itself in a number of different ways, including:

43.1 Increased prices charged to Godfrey Hirst;

43.2 Non-price effects, such as the Commission recognised in paragraph 231 of the draft determination.

44 At paragraph 233 of the draft determination, however, the Commission found that while CWH would have the ability to engage in such discrimination and other practices, it was unlikely to have the incentive to do so because they would not be profit-maximising for CWH, because of the risk it could lose volume. Presumably, that is on the basis that Godfrey Hirst could elect to scour its wool elsewhere or to exit the market.

[4] The High Court had earlier referred to the judgment of the Court of Appeal in Telecom as supporting the Commission's approach of only assessing competitive detriments in the markets in which competition was likely to be substantially lessened). See [72]. With respect, that is reading too much into what the Court in that case was saying.

45 But plainly CWH could significantly harm Godfrey Hirst's interests up to the point at which it would be prepared to take the drastic steps that the Commission posits as limiting factors. While this is may not result in a substantial lessening of competition in the downstream carpet market, it nevertheless results in a detriment that the Commission should take into account.

46 In particular, if Godfrey Hirst chooses not to exit the market, but is close to tipping point, Godfrey Hirst is unlikely to invest further capital in New Zealand. Put simply, while Godfrey Hirst might not go, it is not going to grow or innovate while under such threat. Thus, there will be loss of dynamic efficiency.

47 There may be similar, or other, effects on other interested parties. At the very least, in light of the excerpts from the High Court judgment, including the quote from *Telecom*, the Commission should investigate these matters.

Loss of Allocative Efficiency

48 The Commission considers in the draft determination that the merged entity's ability to increase prices is constrained by two factors: if prices rise too far, a new scouring operation may enter the industry and/or merchants may choose to export wool in greasy form for scouring overseas.

49 Potential entrants' required rate of return on investment affects the merged entity's ability to increase prices without triggering entry. The Commission has calculated that the post-entry scouring price would have to be 20% higher than the current price for entry to be financially viable. However, if entrants set a hurdle rate for investment that is within the range of plausible values, then the post-entry price would need to be 25% higher than the current price. Any potential entrant would be likely to consider the realistic possibility that the scouring price would fall following entry, in which case even bigger price rises than 20-25% could occur without triggering entry.

50 The increase in scouring prices that will induce merchants to switch to exporting greasy wool is much more difficult to quantify, because New Zealand wool merchants will cease scouring wool locally only when the scouring price exceeds the sum of:

50.1 the premium that scoured wool attracts over greasy wool, adjusted for exchange rate movements;

50.2 the higher costs associated with transporting greasy wool (including extra compliance costs and delays due to MPI and Chinese border requirements);

50.3 the value of the intangible benefits of scouring wool locally; and

50.4 the value of the option to delay switching to exporting greasy wool until conditions are so favourable that a quick reversal is unlikely.

51 The intangible benefits of scouring wool locally include retaining control of the scouring process and being able to respond quickly and make any necessary changes to wool blends, which would not be possible if the wool was processed in

Malaysia or China. New Zealand scours also offer pre-scour blending and machining of greasy wool, whereas overseas scours do not have such equipment. In short, overseas wool scours do not offer the same level of service as New Zealand-based scours.

52 We and Professor Guthrie had discussions with two wool merchants who had indicated to Godfrey Hirst that they opposed the merger but feared retribution from the monopoly scourer if the merger went ahead. Our file notes of those interviews, as requested by the Commission, are attached as Appendix C. The two wool merchants made it clear that they regard switching to exporting greasy wool to China to be both undesirable and irreversible.

53 Their business model is based on a reputation for reliably delivering clean wool to specific and demanding standards. Exporting greasy wool requires a different skill set, including the ability to deal effectively with Ministry of Primary Industries' export requirements and China's demanding border controls. It would be prohibitively costly to reassemble a team with the skill set needed for successfully exporting clean wool if a decision to switch to greasy exports was reversed. In situations like this, firms tolerate substantial losses before abandoning an existing business model.

54 Based on our discussions with the merchants, this is likely to be the case for other wool merchants, too. Indeed, one merchant indicated that scouring costs would have to rise by 25-30% before he would consider abandoning New Zealand-based scours and exporting greasy wool instead.

Loss of Productive and Dynamic Efficiency

55 Godfrey Hirst made extensive submissions on these potential losses in its comments on the draft determination. In particular, Godfrey Hirst warned against the taking of a single point in its quantitative analysis when there is considerable uncertainty about the best means of measuring these losses.

56 As the Commission properly notes, a qualitative assessment of the losses is also required. But, in making its qualitative assessment the Commission cannot rely on shibboleths. Here, with particular regard to loss of dynamic efficiency, the Commission, having considered a number of industry characteristics which it had perceived in Decision 725, expressed the preliminary view in the draft determination (at paragraph 298) that dynamic efficiency losses may be limited.

57 At the conference, however, Mr Hales, Chief Executive Officer of Cavalier Woolscourers, corrected the Commission. In response to the Chair's question about the threat of productive or dynamic inefficiencies, Mr Hale said:

> *I think when you look at the costs it covers a wide range of areas, and to remain competitive with China we have to continually innovate. We spend quite a lot of time researching the markets overseas, including China. So we make regular trips to China to assess what level their scouring – the competition's at; what changes they're making and what new developments.*
>
> *Were continually having to adjust our operation modes to keep abreast of what's happening in China through innovation and technology, here. And if I*

> *could use the example of Hawke's Bay Wool Scourers. In this past year we've managed to improve the average run rate by 200 kilograms per plant and improved the quality of the wool by colour, by basically making a new formula of detergent. I can't see for any reason why we would stop doing that. I just doesn't make any sense. If we're unable to keep abreast of what's happening overseas, and I'd include Malaysia and other countries in that, then simply wool is going to go greasy. The tipping point is so fine.*
>
> *So I hope that answers your question.*

58 In relation to a follow up question from Lilla Csorgo, the Commission's chief economist, on whether that ongoing work and research had changed since Decision 725, Mr Hale responded:

> *No not at all. We've made step changes every year, and we plan to make changes every year going forward. It's just if we don't we'll be left behind.*

59 Mr Hale emphasised that, while from the outside it might not look like a dynamic industry, to those in the know there are continual efforts to innovate and to get or keep ahead of the competition.

60 Clearly, Mr Hale regards the wool scouring industry as dynamic, with continued change, innovation and new technology required to remain competitive. The question is, how much of that might be lost if Mr Hale's only local competitor were to disappear?

61 Clearly, there can be no exact answer to that question. This demonstrates the very real danger of taking a specified point (rather than a range) and thus implicitly providing for greater certainty than really exists. Or, as Justice Mallon put in in discussing allocative losses in the 2011 High Court judgment:[5]

> *in quantifying the loss as a single figure, [the Commission] gave the appearance of more certainty of the likely loss than the reality, given the assumptions that were a necessary part of the quantification analysis and the impossibility of predicting precisely future market influences and responses.*

62 Those comments are not just limited to allocative losses, they apply across the board. Indeed, they have even more relevance here, where there is so much uncertainty around the figures – both in terms of the Applicant revising its own calculations substantially and the independent experts hired by the Commission to test those calculations identifying numerous shortcomings with them.

63 In *Telecom*, the Court said:[6]

> *[I]t may be necessary to reduce the weight to be given to some categories of quantified detriments and benefits if there are doubts about the reliability of the calculation or when the quantification process is necessarily abstract in*

[5] At [189].

[6] At [416].

> *nature. The balancing process is not to be seen as a purely arithmetical exercise. It should be leavened with a healthy regard for any shortcomings in the way in which detriments and benefits have been quantified.*

64 One method of allowing for such uncertainty is to broaden the range of plausible outcomes. The broader the range, the greater the degree of confidence the Commission can have in the outcome ultimately falling within that range. Thus, Godfrey Hirst submits that the Commission should be looking to include ranges in its calculations, rather than attempting to discern specific points.

65 Again, the High Court judgment helps in this regard:[7]

> *We also consider it would be wrong for the Commission, in the quantitative assessment, to attribute greater certainty to its estimates of detriments or benefits than is warranted on the facts. The quantitative analysis is a tool to assist the Commission, but it rests on assumptions, often contested, and on assigning dollar values that can at best only approximate the detriment or benefit being considered. It is legitimate therefore for the Commission to be left with a value range for a particular detriment or benefit where the level of uncertainty indicates that any further precision would be unwarranted.*

66 The Applicant appears to take the view that, so long as the Commission provides reasons for its choice of a specific point, that is sufficient for it to choose that point. If that is the Applicant's submission, or the Commission's position, then it is premised on a flawed understanding of the High Court judgment.

67 Undoubtedly, the High Court did state that it was wrong for the Commission in the first determination not to have given reasons why it chose particular points (in that instance, mid-points). And the Court did say that the Commission could chose specific points if there was good reason to do so. So it is easy to jump from that to say if the Commission thinks one point is the most likely point and it states why, then that is sufficient. But that is not correct. It is not the end of the enquiry.

68 What the High Court said is that the reasons cannot be just the reasons why this point is the "most likely" point. Rather, they must include why no other point is likely. That is, as the Court said:[8]

> *We consider that unless the Commission has good reasons for **excluding** other values within the (likely) range that it has determined, it is the range rather than any point within the range that should form the basis for the balancing exercise. [Emphasis added.]*

69 In Godfrey Hirst's submission, even if the Commission is correct to have concluded that certain specific values for productive and dynamic losses are the more likely (and for the reasons previously described we do not believe that it is), it is still in error unless it can exclude any other point in the range as being likely. Put another

[7] At [105].

[8] At [105].

way, to settle on one point, the Commission has to be satisfied that there is no real chance of any other point in the range actually occurring.

70 Given the uncertainty about these figures, and the assumptions and approximations that underpin them, we submit that the Commission cannot be so satisfied. It cannot have the necessary confidence. And, accordingly, it should adopt a range, to allow for the uncertainty.

Overseas Ownership

71 Godfrey Hirst has had extensive interaction with the Commission and presented detailed submissions on the issue of overseas ownership, in particular, the existence of the Lempriere option and its significance for the analysis here. In particular we refer to Godfrey Hirst's submission on the draft determination.

72 The key points that Godfrey Hirst has made on this issue include:

72.1 The Commission was correct in its original view that it would need to take the Lempriere Option into account in its analysis and assess the overseas ownership of the merged entity as 72.5%;

72.2 The insertion of the clearance/authorisation condition into the Lempriere option does not change that position because there is nothing to stop the parties amending that condition in the future.

73 In the course of submissions on this point, several other issues have come to light. [

] But, even if that were indeed the case, it does not change the fact that the option exists, and that the parties have gone to considerable lengths to retain it, in the face of the Commission's initial indication that it would need to take it into account in its analysis.

74 Moreover, to disregard the option on the basis of that representation is to ignore the reality that circumstances can and often do change. Witness, for example, Lempriere's representations to the Overseas Investment Office that it had no intention of selling the scours – a position that seemingly changed within months of the acquisition being completed. The Commission simply cannot ignore the existence of a clear and enforceable contractual right just because, at present, the holder of that right claims to have no present intention of exercising it.

75 Second, there is the position that the Commission (and the Applicant) have taken that, because exercise of the amended option is conditional on Commission approval, Lempriere has no equitable interest in the additional 27.5% and thus the Commission cannot take it into account in its analysis.

76 But that position confuses what is being assessed. While the Commission, in reliance upon *NZ Bus*, is correct that the conditional option does not confer equitable ownership, that is not the appropriate test. Rather, what the Commission should be considering is the likelihood of the option being exercised and clearance of that exercise being granted. Put another way, the question for the Commission is not

whether Lempriere has an "equitable interest" in the 27.5%; rather it is whether it is likely – that is, whether there is a "real chance" – that Lempriere will acquire the 27.5%. That involves two questions:

(a) First, will Lempriere attempt to exercise the option?

(b) Second, would the Commission clear or authorise the application?

77 On the first question, as noted above, plainly there is a real chance that Lempriere will acquire the 27.5%. That is apparent from the fact that it has negotiated for itself the option of doing so, with a complicated method of pricing that option. While it asserts other reasons for doing so, the Commission cannot simply take that at face value. Rather, unless the Commission can say there is no real chance or substantial possibility that Lempriere would attempt to acquire the extra shares, it must consider this as at least one of the plausible outcomes. Certainly, that was the way the Commission intended to proceed before it negotiated the insertion of the clearance condition into the option.

78 On the second question, the starting point is that the Commission itself can have no clear view in this regard, as the draft determination carefully notes (at paragraph 9) that the Commission has received no application for clearance or authorisation in respect of NZWSI's acquisition of its initial 45% shareholding in CWH. Plainly the Commission would have to assess the future transaction on the basis of NZWSI already being a 45% shareholder – which it presumably would already consider as "one head in the market" with CWH[9] - acquiring a greater interest. That is a fundamentally different exercise than the Commission is undertaking here. It is brought about by the way that the Applicant has structured this transaction (or, at least, the way they have amended it (with the Commission's involvement), and the attempt to bypass a real problem.

79 Looking at it today, there must be a real prospect of the Commission determining to clear such an increase in shareholding. Similarly, in the authorisation context any detriment from resulting lessening of competition would likely be seen as negligible. In 2011, the Commission was prepared to allow CWH to be the sole scour owner. Why not Lempriere? Certainly, it cannot be the case that the Commission, looking at things now, can say there is no real chance of it clearing or authorising the future acquisition.

80 Thus, what we are left with – even putting aside arguments about the Commission's involvement and the ability of the parties to amend the option arrangements again in the future – is a real chance that the option would be exercised and a real chance that the acquisition of the additional shares could thereafter be cleared or authorised.

81 If that is so, it falls to be considered as one of the "likely" options that the Commission must consider. As set out above, it does not have to be the most likely. But to disregard it, the Commission has to explicitly conclude that there is no real

[9] Footnote 1 above refers.

chance or substantial possibility of it occurring. For the reasons set out above, we submit that the Commission cannot do that.

82 Thus, the Commission must analyse the transaction on the basis that there is a likely scenario where Lempriere owns 72.5% of the merged entity. It is one of the possible eventualities that the Commission must weigh in its assessment.

Redundancies

83 Bell Gully's letter dated 6 August 2015 protests that it is now "seven weeks after the redundancy update", on the basis that the redundancy update was provided to the Commission in June.

84 That bold statement requires clarification. In fact:

84.1 The update was provided on 15 June, being almost two weeks after the Commission held a conference, the purpose of which was to test the submissions of the Applicant (and interested parties) and to enable interested parties to hear and comment on each other's views;

84.2 That "update" of 15 June in fact comprised two brief paragraphs the first of which claimed that "CWH had recently received information on NZWSI's redundancy exposure which was lower than that calculated at the time of Application." No mention was made of the information being to hand *since early in January*. The second paragraph indicated that "CWH, working with NZWSI/Lempriere has since been able to finalise necessary redundancy payments in conjunction with its specialised advisor, [ ], an employment consultant. The brief results of [ ] calculations then claimed the maximum redundancy exposure to be substantially lower than the $[ ] previously allowed, with that adjustment increasing net benefits by [ ];

84.3 On 31 July the Commission provided us with a confidential file note of its discussion with [ ] held on 20 July in relation to the revised redundancy claim; and on 3 August forwarded to us [ ].

85 Given the confidentiality strictures imposed in relation to all that information we, as Godfrey Hirst's advisors, have had no opportunity to test the accuracy or indeed the commercial rationality of the claims being made in relation to substantially reduced redundancy exposure by the Applicant.

86 Put bluntly, the provision of "information" that departs so radically from information provided in the Application some eight months previously, but carefully concealed from scrutiny, shows both disregard for proper process and fairness, and contempt for other parties who have had vital interest in the outcome of this matter.

87 While we are unable to comment on the detail of the claims he makes, the tenor of [ ] interview with the Commission does not fill us with confidence as to the "expertise" that is claimed for him. We acknowledge that the Commission's file note may not do justice to [ ] expertise or experience. But the

conference process is intended to provide the opportunity for such expertise to be demonstrated – and of course properly tested.

88 There is a more serious issue to be raised in relation to [ ] independence – particularly as he is providing material on the basis of his expertise. [ ]self-introductory comments at his interview are as follow:

[

]

89 So, [ ] is a long-time provider of dedicated employment relation services not just to [ ] Leaving aside the propriety of the [

] the independence of [ ] advice must be seriously questioned.

90 Put bluntly, [ ] is unlikely to volunteer information that is contrary to the interests of his longstanding client, [

]

91 Even that is not the end of the matter. If [ ] had been properly introduced as an independent expert and made available at the conference, he may have been able to assist the Commission on a matter of primary importance to the Commission's final determination, rather than simply the detail of redundancy. The question of redundancy only arises because of the claimed public benefit arising from cost savings from the avoided salaries and wages of workers which would no longer be required as a result of rationalisation of scour lines post-merger.

92 But, for those cost savings to constitute a benefit, the Commission must first be satisfied that such a benefit is transaction – specific, in the sense that it arises with the transaction but not without the transaction. The Commission's preliminary view, as expressed at paragraph 115 of the draft determination, is that without the transaction "each of Cavalier and Lempriere would run their wool scouring businesses independent of each other as a separate scouring entity". That begs the question of how much of their present wool scouring businesses *either* of those parties would continue to operate.

93 As is noted above, and succinctly described in Appendix A, it is clear from recent events that Cavalier is currently downsizing substantial parts of its operations. It can only be a matter of time before Cavalier's manufacturing operations - including CWH's wool scouring business - will come under close scrutiny, if they are not already – and certainly will be if the Application is declined or the parties otherwise do not proceed. Indeed, Godfrey Hirst understands that CWH have already made redundant at least one senior management position at Awatoto and Canterbury Wool Scourers recently.

94 Similarly, given Lempriere's apparent discovery after its acquisition of NZWSI that the demand for wool scouring services in New Zealand is not as large as they anticipated, and [ ] are not operating as effectively as their due diligence seemingly indicated, then Lempriere too, presumably would be looking at downsizing their operations.

95 Given [ ] the Commission at the conference could have put to him questions on any likely scenarios on the potential for [ ] costs associated with NZWSI's unilateral downsizing of those scours.

96 In summary, it is possible that [ ] – if properly introduced to the Commission as an independent expert – could have provided relevant information to the Commission. But he was not; and the drip-feeding of his material post-conference and in a way that cannot be effectively commented on by interested parties, must not be allowed.

97 Further, given Cavalier's current endeavours at downsizing and Lempriere's litany of laments in relation to [ ] the Commission must have regard to an alternative counterfactual which sees each or both of Cavalier and Lempriere downsizing their respective wool scouring businesses independent of one another.

[ ]

98 Godfrey Hirst in its post conference submission demonstrates both the paucity of detail, and the extravagance, of the Applicant's late claims as to the need to [ ], and cost of [ ], [ ] We repeat our criticisms of those claims as to avoided capex and the way in which they were introduced on behalf of the Applicant. Bell Gully's protest in their letter of 6 August 2015 that their "capex updates" were simply in response to the Commission's questions and parties' comments is tendentious. All information known to the Applicant and relevant to the Application should have been supplied at the date of the Application – as the declaration requires – not six months after application.

99 In any event, the claimed benefits arising from the avoided capital expenditure [ ] cannot be viewed in isolation from the recent revelation that [

]

100 [ ] the removal of the three metre scour presently located at Kaputone, which presumably has a resale value significantly in excess of the $500,000 to $650,000 cited at paragraph 336 of the draft determination for the smaller scour lines referred to there.

101 In addition, at paragraph 335 of the draft determination there is reference to the ability to sell the current effluent equipment at Kaputone [
]

102 Thus, even allowing modest resale values for the [ ]scour and effluent equipment at Kaputone, it must be assumed that the sale of that site without that surplus equipment would return at least [ ] to Lempriere.

103 Further, Lempriere claims it will avoid future capital expenditure [
] Godfrey Hirst does not accept the validity, and certainly not the quanta, of those avoided capex claims and repeats the view it has expressed in this regard in its post conference submission and subsequently. But, assuming that those avoided capex claims were valid – and allowing for operating savings that could be made (including avoidance of salaried and waged staff costs, [
] by closing Kaputone, those total avoided costs would be substantial .

104 Indeed, Professor Guthrie in his brief report calculates that, on the basis of Lempriere's claims, the net benefit of closing the scour at Kaputone would be in excess of $[ ].

105 Given that the report of the Overseas Investment Office on Lempriere's application indicates that the total consideration it paid for 100% of NZWSI was less than $20 million, the Commission must ask whether it is commercially rational for Lempriere to retain a wool scouring operation at Kaputone that faces substantial capital expenditure, significant operating costs and declining demand for wool scouring services. The Investment Plan lodged with the Overseas Investment Office in support of Lempriere's application for consent to acquire NZWSI refers to Lempriere's previous divestment of two businesses it had acquired in New Zealand.

106 Again, for claimed benefits to be taken into any account, the Commission must be satisfied that they are "transaction-specific in the sense that they arise with the transaction, but not without a transaction".

107 Without the merger, [
] that it previously assumed were fit for purpose, reducing demand for wool scouring services in New Zealand, competitive threat from wool scouring capacity in China and elsewhere, and the certain knowledge that [
] Lempriere must be likely to decide unilaterally to close its Kaputone plant.

108 Certainly, the Commission can't exclude that there is a real chance or substantial possibility that Lempriere would make that decision, as it has previously to divest two businesses it had acquired in New Zealand.

109 In the Application much is made of the "comprehensive global footprint [of Lempriere Group] in all sectors of the wool market, making it one of the world's largest wool merchants and processors." Surely a group with so big a footprint and experience would know when to walk away from a scour the present operating condition of which is so deficient?

110 Again, we asked Professor Guthrie to calculate all the benefits attributable to closure of the Kaputone scour, which are also likely to occur without the acquisition. He calculates that, on the basis that Lempriere could decide to close that scour in any event, benefits resulting from the acquisition should reduce by $[ ] on the basis of the benefits of the proposed merger calculated in the draft determination – and by much more if Lempriere's subsequent claims were to be accepted.

Balancing of benefits and detriments

111 In the course of the argument before Justice Mallon, Godfrey Hirst made submissions about the balancing of benefits and detriments that must occur before the Commission can be satisfied that there is "such a benefit" to the public that authorisation should be granted.

112 While Godfrey Hirst maintains its position on the appropriate test, it acknowledges for present purposes that not all of its arguments were accepted by the High Court. Nevertheless, the Court was clear that:[10]

> *[A] purely quantitative assessment is not sufficient. A judgment (also referred to as a qualitative assessment) is required as to whether the Commission is satisfied on the evidence before it that the public benefits do outweigh the detriments such than an authorisation should be granted. That judgment will include an assessment of the quality of the information on which the quantitative analysis was carried.*

113 As we have stressed, the Commission must have real concerns about the reliability of the information that the Applicant has provided to it. Much has been provided late and contradicts earlier information. Much, when independently tested, has been shown to be flawed. Even were the Commission to consider that most identified issues now have been resolved, it must surely retain residual uneasiness that there are other matters that have not yet come to light.

114 The Commission is obliged to take these uncertainties and this uneasiness into account in making its qualitative assessment. It must be careful about not allowing the estimations of likely outcomes – which depend as much on assumptions and best guesses as they do on hard data – to yield an artificial degree of precision to the exercise that confronts it.

115 As we have noted, the High Court said that it may well be that uncertainties surrounding an assessment will mean that the best the Commission can do is to say that a particular gain or loss falls within a likely range. And, as noted above, we consider the Commission should be very cautious before rejecting this advice and choosing specific points. Because it is only if the Commission uses sufficiently broad ranges to account for the uncertainty that it can consider the quantitative information sufficiently reliable as to properly form the basis for the overall qualitative assessment.

[10] At [115].

116 This is particularly so where we anticipate that any (net) benefit would be very narrow – much narrower than that which was before the High Court.

117 But even if it applies just broad ranges, the Commission will nevertheless still be left with the fact that this application has been beset with amendments, alterations, and flawed information. In that situation, Godfrey Hirst submits that the Commission cannot be satisfied that this anti-competitive acquisition will result in such a benefit to the public that it should be permitted.

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APPENDIX A : NBR ARTICLE

APPENDIX B : ECONOMIST'S REPORT

APPENDIX C : FILENOTES OF CHAPMAN TRIPP INTERVIEWS WITH TWO WOOL MERCHANTS