Cavalier Wool Holdings Limited

Authorisation Application

Date: 22 October 2014

The Registrar
Business Acquisitions and Authorisations
Commerce Commission
PO Box 2351
WELLINGTON

Pursuant to s 67(1) of the Commerce Act 1986 notice is hereby given seeking authorisation of a proposed business acquisition.

EXECUTIVE SUMMARY

The Application

Cavalier Wool Holdings Limited (**CWH**) seeks authorisation for CWH (or an interconnected body corporate) acquiring control over New Zealand Wool Services International Limited's (**NZWSI**) wool scouring business and assets (whether by way of acquiring shares in the wool scouring subsidiaries, or assets, or both), and in consequence of that acquisition a wholly-owned subsidiary of Lempriere (Australia) Pty Limited acquiring a 45% shareholding in CWH.

The ultimate shareholding of CWH post completion will be:

- Lempriere 45%;
- Cavalier Bremworth 27.5%;
- Direct Capital 13.75%; and
- ACC 13.75%.

Once the merger is completed, CWH will be a standalone commission wool scourer with its own executive structure and dedicated Board of Directors completely divorced from Lempriere's wool trading division. The agreements bringing about the merger require the shareholders to enter an information sharing protocol designed to protect CWH's sensitive information, including information relating to CWH's customers and tariffs. It is a term of that protocol that sensitive information cannot be passed into the hands of any party's wool trading division.

Decision 725

The Commission previously granted authorisation to CWH in June 2011 to acquire all of NZWSI's wool scouring assets (being the wool scouring assets and stock located at Whakatu and Kaputone and 50% of the shares in Lanolin Trading Company Limited) and/or any interconnected body corporate of NZWSI that holds any of those wool scouring assets (**Decision 725**). This decision was appealed by Godfrey Hirst, but the appeal was dismissed by the High Court in November 2011 (the **High Court Decision**).[1]

For various reasons, the proposed merger consequent upon Decision 725 did not eventuate. However, the current owners have now reached a commercial agreement to merge their respective wool scouring businesses requiring a fresh authorisation, the previous authorisation having lapsed.

Other than a further reduction in the available wool clip, a new overseas scouring alternative and a slight increase in the volume of greasy wool exported to China, the substance provided in the course of the previous authorisation process remains largely unchanged.

[1] *Godfrey Hirst NZ Ltd v Commerce Commission* HC Wellington CIV-2011-485-1257, [2011] NZHC 691.

Wool scouring in context

Wool scouring is the process of washing greasy wool in hot water and detergent to remove the non-wool contaminants and then drying it. Wool that has not been scoured is “greasy wool”.

Greasy wool produced by New Zealand growers is used by manufacturers and processors around the world to manufacture a range of products including carpets, interior textiles and apparel.

These end-users specify to wool merchants or directly to wool growers the type of wool they need in order to be able to manufacture the products they wish to sell. They generally demand “clean wool” which is wool that has been scoured.

Decline in demand for scouring

The scouring industry is a relatively small part of the overall sheep meat and wool industry and relies heavily on an active and strong sheep farming industry.

The New Zealand wool industry continues to be in distress with sheep flocks rapidly reducing over the past twenty years. Between 2006 and 2011 alone, sheep numbers reduced by around 20% from approximately 40.1 million in 2006 to approximately 32.6 million at the previous application (based on year ending June 2010 statistics). This trend has continued since the previous application, with sheep numbers reducing by close to 3 million to approximately 29.8 million as at June 2014. This is less than half the peak of 70 million in 1982-1983.[2]

Indeed, in February 2010 the Wool Industry Taskforce described the state of the wool sector as “perilous” and said that the future of sheep farming in New Zealand was at risk. Since then, there has been continued pressure from conversions of sheep farms to dairy. Between 2007 and 2012 sheep and beef farms decreased from 29241 to 25113 in New Zealand, a decrease of 14% by number. The overall area of sheep and beef farms has decreased from 9.6 million to 9.3 million hectares over that time. In contrast, over that period there has been an increase in the area of dairy farms of almost 400,000 hectares, and the number of dairy farms has increased by 750 properties.[3] CWH sees this trend continuing, with large numbers of approvals for irrigation currently being granted, allowing the transition of farmland to dairy use. This is particularly evident in the South Island.

The continued and permanent retrenchment of the wool industry has materially reduced demand for wool scouring services and this will continue.

[2] The figures in this paragraph are all sourced from the Beef + Lamb New Zealand Stock Number Survey as at 30 June 2014, table 2, p 8 and the Beef + Lamb New Season Outlook 2014-15.

[3] The numbers in this paragraph have been collated from the Beef + Lamb Compendium of New Zealand Farm Facts 2014, p 5 (based on Statistics New Zealand 2012 Agricultural Census) and the Statistics New Zealand numbers from the 2007 Agricultural Census.

Increasing unit costs have led to industry rationalisation

As the Commission has recognised, the key driver of a wool scourer's profitability is volume. Greater volumes lead to material economies of scale benefits and reductions in unit costs.

The combination of reduced demand and the resulting increasing unit costs created has led to a consequent (although not corresponding) decrease in scouring participants and capacity. Whereas there were 20 scour sites in 1994, today there are only five sites operated by two operators being CWH and NZWSI.

The rise of Asian wool scouring

Not only has overall demand reduced, what demand is left has become even more contestable. The rise of the Chinese wool scouring industry has meant that already over 25% of all wool exports[4] (or 24% of the wool clip[5]) are scoured in China and that competition is intensifying:

- There are over 100 scour lines operating in China already (compared with five in New Zealand).
- A number of new scour lines have opened in China. A new three line plant has been opened which CWH estimates provides more capacity than the scouring capacity in the entire North Island. Since Decision 725, a New Zealand expert wool scour builder is now based full time in China and he is building new wool scouring equipment that is very efficient and low cost. He has built a new scour line for "Red Sun" in China and two lines for Compass Wool Processors (**CWP**) in Malaysia.
- Based on current pricing from Chinese scourers, it is cheaper for a merchant to scour greasy wool in China than it is to have that same wool scoured by CWH in New Zealand and exported as clean wool. With its current cost structure, CWH cannot compete effectively with this pricing.

The quality of wool scouring in China continues to improve (albeit that CWH believes it offers a better quality scouring service) and the extent of scouring in China indicates that it is commercially acceptable, particularly given Chinese based processers and manufacturers account for at least one third of the world's wool use[6] and China accounts for 47% of the world's wool imports[7] (down slightly from 49% at the time of the previous application).

However, the constraint imposed by Chinese scourers is not limited to greasy wool for which the ultimate customer is in China. For a number of reasons the constraint applies to all New Zealand greasy wool.

[4] Wool Export Data July 2013 to June 2014 (Table 6.1), Beef + Lamb New Zealand, available at: http://www.beeflambnz.com/Documents/Information/Wool%20exports%20July%202013%20to%20June%202014.pdf. This is in comparison to the time of Decision 725 where 18% of all wool exports or 14% of New Zealand's wool clip was scoured in China. (Note this was incorrectly stated to be 18% of New Zealand's wool clip at the time of Decision 725, but amended in the High Court decision).

[5] Assuming 92.2% of New Zealand's wool clip is exported (Beef + Lamb estimates employing a 77% yield).

[6] China's own production and imports combined account for 726,379 greasy tonnes in 2012, with total world production of 2,029,793 greasy tonnes, i.e. 35.8%. IWTO Market Information 2013 Edition.

[7] IWTO Market Information 2013, Table 22, p 32.

- CWH has limited visibility over the ultimate destination of wool prior to setting prices and so cannot charge a lower tariff where Chinese scouring is in fact a viable option, and a higher tariff where Chinese scouring is not a viable alternative.
- In any event, given the importance of volume and CWH's dependence on continued custom from merchants, differentiated pricing would risk alienating its merchants and undermine CWH's ability to retain their volumes.
- It is becoming increasingly viable for a merchant to export greasy wool to China and then to re-export that wool in a processed or semi-processed form from China to a customer in another country.

While the Chinese industry is a key driver of greasy wool exports, expansion of wool scouring capacity is not limited to China. Compass Wool Processors is a new wool processing company recently established in Malaysia. CWP aims to establish itself as a significant central processing hub for the world's wool, including New Zealand crossbred wool, with high density wool presses for re-export. CWH understands that the operation is highly subsidised, including paying no tax for the first five years.

While still very new, CWP is pricing at a level that CWH and Lempriere would expect merchants to transfer their greasy wool if CWH were to attempt to increase prices.

No substantial change in constraints

In these circumstances, while the acquisition reduces the number of domestic scourers from two to one, the constraints on CWH will not be materially lower.

The Commission accepted in Decision 725 that the primary constraints on CWH have been permanent reduction in the wool clip, the increasing constraint imposed by Chinese wool scourers and the threat of new entry.

A critical loss analysis carried out by NERA serves to illustrate the impact relatively small losses of volume would have on CWH's (post-merger) bottom line.

Demonstrable public benefits of the type previously accepted by the Commission

In any event, the acquisition will result in such material and demonstrable benefits to the public that it should be permitted.

NERA has quantified the present value of those benefits as being \$30.35 million over five years. This is similar to the level of benefits determined in Decision 725 in which the present value of those benefits was quantified by the Commission as being in the range of \$29.6 to \$33.6 million over five years, with the Commission considering \$31.6 million to be most likely.[8]

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[8] The rationale for having a range previously was because of a dispute at the conference as to the resale value of land. Both parties consider the current land valuations (based on independent third party reports) to be fair estimates.

The types of benefits claimed are not controversial in that they have generally been previously accepted by the Commission to constitute public benefits in Decision 725[9]. In the application giving rise to Decision 725, NERA quantified these benefits using approaches previously endorsed by the Commission. NERA has updated the benefits using the approaches endorsed by the Commission in Decision 725 (and the High Court).

Decreased costs and increased economies of scale

The primary benefits (both commercial and public) arise from the consolidation of New Zealand's existing scouring capacity upon CWH acquiring control of the NZWSI wool scouring subsidiaries.

The parties will:

- close the physically/environmentally constrained NZWSI scours at Whakatu (Hawkes Bay) and Kaputone (Canterbury) and sell the land and buildings with a covenant that they not be used for scouring for 50 years. The Whakatu and Kaputone scour lines will be moved to the physically unconstrained CWH sites at Awatoto and Timaru;
- modify the NZWSI scours currently at Whakatu and Kaputone to match their specification to the CWH lines' specification so as to substantially increase run-rate, quality output and capacity;
- close and sell **[REDACTED]** the current Timaru 2.4 metre scour line; and
- close and sell **[REDACTED]** the Clive scour line, with the land and buildings sold.

None of this restructuring can or will take place absent the acquisition.

This restructuring will generate material cost savings and improved economies of scale.

CWH has every incentive to pursue these efficiency gains because they will enable CWH to operate a lower cost, higher quality scouring service, thereby improving CWH's ability to compete more effectively in an environment of declining demand and increasing low cost supply off-shore.

CWH will realise industry non-capital cost savings of **[REDACTED]** per year or **[REDACTED]** (in present value terms) over a five year period. This equates to approximately **[REDACTED]** per greasy kg processed. (This is in comparison to Decision 725 in which the Commission considered CWH would realise industry non-capital cost savings of **[REDACTED]** per year or **[REDACTED]** (in present value terms) over a five year period.)

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[9] With the exception of sale of plant which was not going to occur at the time of Decision 725.

In order to achieve the rationalisation CWH will incur costs associated with redundancy and contingency **[REDACTED**[10])**]**, building work **[REDACTED]** and additional capital expenditure. Additional capital expenditure in year 1 (over and above regular capital expenditure incurred without the transaction) will amount to **[REDACTED]**. However, this will be offset by ongoing capex savings with the present value of **[REDACTED]** from reducing the number of sites resulting in a total plant and equipment capex cost of $1.09 million. (Previously redundancy and contingency accounted for **[REDACTED]** of cost, expenditure on buildings accounted for **[REDACTED]**, while plant and equipment capex savings of **[REDACTED]** were expected.)

In addition, CWH has allowed for **[REDACTED]**

Sale of surplus land for other uses

The restructuring releases the Whakatu, Kaputone and Clive sites for other uses. At the time of the previous application CWH was unsure whether Clive would continue to be required post-transaction. However, the continuing reduction in scouring throughput means following the intended restructuring, the Clive site will no longer be necessary as a backup source of capacity and can be sold. Post transaction, CWH will retain around 41.7% (previously 16.7%) spare capacity in the North Island and 28.4% (previously 21.6%) spare capacity in the South Island.[11]

Clive would, however, be required in the counterfactual as without the restructuring CWH would not have sufficient scouring capacity at Awatoto to cover expected demand in the North Island without Clive as an overflow facility. Applying the Commission's previous approach, this will result in a benefit of $**[REDACTED]** for land and buildings at Whakatu and Kaputone (previously the sale of Whakatu and Kaputone land and buildings were considered to result in a benefit of $8 million by the Commission). In addition, Clive land and buildings will result in a benefit of **[REDACTED]** giving a total benefit from land and buildings of **[REDACTED]**.

Sale of surplus equipment

An additional benefit of **[REDACTED]** arises in the current application as a result of the sale of equipment rendered surplus to requirement. This will occur from the sale of scouring equipment in the North and South Islands and the effluent system at Kaputone. This was not claimed as a benefit in the previous application because, at the time, both the Clive and Timaru scours were set to be mothballed and the evaporation plant at Kaputone (a key part of the effluent system) had not been recommissioned for use.

Wool superstore

CWH also expects to achieve savings as a result of being able to develop a wool superstore post acquisition. (The Commission previously accepted savings of $4.1 million per year in years four and five, resulting in a 5 year NPV of $7.2 million.) However, the benefits of the transaction described in this application significantly exceed the detriments, even without the wool superstore. Accordingly, while the Applicant again claims that a benefit exists of the ability to develop a wool superstore, it has not at this stage quantified the benefits of the wool superstore. The Applicant reserves the right to make further submissions on this point at a later date.

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[10] **[REDACTED]**
[11] Capacity figures are based on 2015/16 forecasts.

Improved scouring product

The modifications and extensions required to bring the NZWSI plant up to CWH's specification will not only improve the efficiency of CWH's scour lines post-transaction, but will also mean CWH will provide a higher quality scouring service to merchants.

In the application giving rise to Decision 725 the Applicant sought the benefit of this improved quality which arises because the modifications being made will cause the clean wool produced to be "whiter" than would be the case absent those modifications.

In Decision 725 the Commission recognised an improved quality product could have significant public benefits if it could be achieved in the scouring industry. However, the Commission did not put any weight on the estimated quantified benefits accruing from quality improvements, as it was not satisfied the benefit would occur in the factual.

In hearing the appeal from the Commission's decision, the High Court indicated if it had been crucial to whether or not the authorisation should be upheld, it would have considered further whether to refer the issue back to the Commission for reconsideration (with direction as to matters to be addressed).

Given the benefits described in this application significantly exceed the detriments, the Applicant again claims that a benefit exists of improved quality, but does not propose at this stage to quantify it. The Applicant reserves the right to make further submissions on this point at a later date.

Enhancement of the New Zealand scouring industry

While not quantified, the acquisition will act to strengthen and enhance New Zealand's wool scouring industry, an industry which employs 145 FTEs and contributes approximately **[REDACTED]** of direct wages to the New Zealand economy, with an industry revenue of approximately $58 million.

New Zealand is not immune to the trends sweeping the scouring world associated with an aggressively expanding Asian wool scouring industry. These trends have already seen the Australian, German, Italian and British wool scouring industries retrench to a point where they are competitively marginalised.

Indeed, while Australia grows significantly more wool than New Zealand it now has virtually no domestic scouring industry. Virtually all Australian wool is now scoured offshore, with a large proportion scoured in China.

The benefits cannot be achieved in the counterfactual

The benefits described above – arising as they do from industry consolidation – cannot and will not arise in any counterfactual.

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 occurred with the sale to Lempriere in early 2013. Therefore, the application is presented on the basis of a "status quo" counterfactual, i.e. Lempriere continuing to run NZWSI as a separate scouring entity.

Limited competitive detriments

For the reasons described, while the acquisition would consolidate the only two remaining domestic wool scour operators, CWH believes there would be limited competitive detriment compared to a status quo counterfactual.

Nevertheless, CWH recognises that the Commission had concerns about the consolidation of the wool scourers in its consideration in 2011. In the course of the previous application CWH engaged NERA to estimate the detriments that could be said to arise from the proposed transaction.

In doing so, neither CWH nor NERA sought to debate the merits of the Commission's previous approaches but simply applied those analyses to the transaction. The Commission largely approved these approaches in Decision 725 and accordingly the calculations for the present application take into account variations adopted by the Commission in Decision 725 and by the High Court on appeal. In comparison to the previous decision, where total detriments over five years based on that analysis were assessed by the Commission to be $1.4 million to $28.8 million (in present value terms) (and by the High Court to be $20.8 million), NERA considers the updated detriments to be in the range of $2.30 million to $22.36 million. These break down as follows (with figures from the previous application alongside in brackets):

- allocative efficiency losses of $9.17 million assuming a 10% price increase and elasticity of -1, or a range of $0.22 million to $14.36 million ($0.7 million to $22.7 million) based (conservatively) on a range of price increases of between 5% and 15% and elasticities of 0.05 to 1.0;
- productive efficiency losses of **[REDACTED]** for a 3% increase in costs, with a range of **[REDACTED]** for a 1% increase in costs to **[REDACTED]** for a 5% increase in costs; and
- dynamic efficiency losses of **[REDACTED]** for a 0.5% increase in costs or **[REDACTED]** using an upper limit of a 1% increase in costs **[REDACTED]**.

Employing the Commission's previous considerations of the most likely assessment of detriments provides a figure of $13.80 million detriment (compared to $18.1 million in Decision 725).

Proposed acquisition should be authorised

The net benefit arising would be $16.55 million. The Commission previously calculated a likely value of net benefits to be $13.5 million.[12] As indicated above, even adopting a worst case scenario by assuming a 15% price increase, 5% cost increase and a large fall in innovation, and excluding quantifications of quality uplift and wool superstore, the total benefits arising from the transaction (quantified and un-quantified) materially – by $7.99 million – outweigh any detriments that could be said to arise even before counting the un-quantified benefits.

On that basis, CWH believes that the proposed acquisition will result in such a benefit to the public that it should be authorised.

[12] Using an internally consistent assumption as to elasticity of demand for both benefit and detriment calculations.

Contents

Part 1: Transaction Details

1. The acquirer – Cavalier Wool Holdings Limited

1.1 This notice is given by Cavalier Wool Holdings Limited (**CWH** or the **Applicant**). CWH's contact details are:

Cavalier Wool Holdings Limited

c/- Hawkes Bay Woolscourers
Private Bag 6014
Napier

Contact person:	Nigel Hales Chief Executive Officer Cavalier Woolscourers Limited
Telephone:	06 834 1421/027 446 8163
Email:	nigel@hbws.co.nz

1.2 The Applicant requests that all correspondence is directed in the first instance to:

Bell Gully
Vero Centre, 48 Shortland Street
PO Box 4199
Auckland 1140

Attention:	Phil Taylor Consultant	Glenn Shewan Senior Associate
Telephone:	(021) 994 216 / (09) 372 8820	(09) 916 8726
Fax:	(09) 916 8801	(09) 916 8801
Email:	phil.t.taylor@gmail.com phil.taylor@bellgully.com	glenn.shewan@bellgully.com

1.3 The Applicant requests that any correspondence to, or any queries the Commission may have directly concerning, NZWSI or Lempriere be addressed to Lempriere at:

Lempriere Australia (Pty) Limited

Level 7, 460 Collins Street
Melbourne, Victoria
Australia 3000

Attention:	Tony McKenna	Michael Davis
Telephone:	+61 3 8625 6571	+61 3 8625 6505
Email:	tmckenna@lempriere.com.au	Michael.Davis@lempriere.com.au

1.4 CWH is 50%-owned by Cavalier Bremworth Limited (**Cavalier Bremworth**), which is itself a wholly-owned subsidiary of NZX-listed Cavalier Corporation Limited (together, the **Cavalier Group**).

1.5 The Cavalier Group is involved in the manufacture of woollen and wool blend carpets in New Zealand (through its subsidiaries Cavalier Bremworth and Norman Ellison Carpets Limited (**Norman Ellison**)). The Cavalier Group also ultimately owns Elco Direct Limited (**Elco Direct**), a wool procurement business, which is a service provider to both the wool industry and the Cavalier Group's carpet businesses. Elco Direct has wool buyers covering all major wool growing regions in the Central North Island.

1.6 The remaining 50% of CWH is owned in equal parts by the Accident Compensation Corporation and Direct Capital Investments Limited.

1.7 CWH through its wholly owned trading subsidiary Cavalier Woolscourers Limited (which trades as Hawkes Bay Woolscourers and Canterbury Woolscourers) owns and operates wool scours in Awatoto and Clive (Hawkes Bay) and Timaru. Utilising these scours CWH cleans and processes greasy wool for domestic and export markets on behalf of New Zealand wool buyers and carpet manufacturers. Hawkes Bay Woolscourers also scours all of the Cavalier Group's carpet wool requirements.

1.8 In contrast to the previous application to the Commission in 2011 which resulted in Decision 725, CWH no longer has an interest in the Lanolin Trading Co Limited (**Lanolin Trading**) which ceased trading on 31 December 2013.[13] CWH now sells its lanolin by-product directly, mostly into the international market.

2. New Zealand Wool Services International Limited (NZWSI)

2.1 Since the previous Commission application, Lempriere (Australia) Pty Limited (**Lempriere**) has acquired 100% of the shares in NZWSI through a public takeover offer.

2.2 The Lempriere family have been involved in the wool industry for over 150 years and William Lempriere is the current sole director of Lempriere. Prior to the acquisition of NZWSI, Lempriere had no real presence in the global strong wool market, as its activities were concentrated in the apparel or merino sector. The purchase of NZWSI provided the Lempriere group a comprehensive global footprint in all sectors of the wool market, making it one of the world's largest wool merchants and processors.

2.3 The Lempriere Group has other business operations in New Zealand, namely, The Merino Company Limited, Levana Textiles Limited and Encircle Medical Devices. The Merino Company Limited has businesses in the United States of America, Argentina and South Africa, and is one of the world's major suppliers of fine wool to European, Japanese and American fashion houses. Lempriere recently acquired J S Brooksbank, a New Zealand wool merchant. J S Brooksbank is now a wholly owned subsidiary of NZWSI.

2.4 NZWSI is a registered New Zealand company:

New Zealand Wool Services International Limited

30 Sir William Pickering Drive
Christchurch 8053

P O Box 29383
Christchurch

2.5 NZWSI operates two businesses:

(a) The first is the purchase of wool in New Zealand, primarily for export to a number of overseas countries, including India and China.

(b) Secondly, it owns and operates wool scours at Whakatu, Hawkes Bay (Whakatu Wool Scour Limited) and at Kaputone, just north of Christchurch (Kaputone Wool Scour (1994) Limited).

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[13] CWH and NZWSI each retain 50% ownership of the non-trading entity.

2.6 The title to land and buildings at Whakatu is presently in the name of Benwill Properties, which is a Lempriere family-owned company, and leased back to NZWSI.

2.7 As above, NZWSI no longer has an interest in Lanolin Trading which ceased trading 31 December 2013. It also now sells its lanolin by-product directly, mostly into the international market.

3. Interconnected and associated companies

3.1 See responses to question 1 and 2 above.

3.2 CWH and NZWSI each now individually manage the purchase and marketing of their raw wool grease (lanolin), a by-product of wool scouring.

3.3 NZWSI owns 50% of Rural Wool-Link Limited (**RWL**), with the remaining 50% owned jointly by Michael Youngman, Leanne Youngman and Lamb Trust Services Limited. RWL is a wool buyer which operates in the North Island and on-sells wool to NZWSI.

4. The proposed acquisition

4.1 In June 2011, the Commission granted CWH an authorisation to acquire all of NZWSI's wool scouring assets (being the wool scouring assets and stock located at Whakatu and Kaputone and 50% of the shares in Lanolin Trading Company Limited) and/or any interconnected body corporate of NZWSI that holds any of those wool scouring assets (**Decision 725**). This decision was appealed by Godfrey Hirst, but, subject to some variation in the calculation of detriments and benefits, the appeal was dismissed by the High Court in November 2011.

4.2 CWH and the NZWSI Board did not reach an agreement for the sale and acquisition of the scouring assets. 100% of the shares of NZWSI were eventually acquired by Lempriere (refer to paragraph 2.1 above).

4.3 CWH and NZWSI have entered into an agreement which will involve CWH (or an interconnected body corporate) acquiring control over NZWSI's wool scouring and lanolin by-product business and assets (whether by way of acquiring shares in the wool scouring subsidiaries, or assets, or both). NZWSI's wool trading business (including its shareholding in RWL) will remain with NZWSI, and the land and buildings at Whakatu will remain with the Lempriere family-owned Benwill Properties (subject to the existing lease to Whakatu Wool Scour Limited), although the Whakatu plant will be transferred to CWH. In consideration for the sale of the shares in NZWSI's Kaputone Wool Scour (1994) Limited and Whakatu Wool Scour Limited, CWH will issue shares to NZWSI, which will then immediately transfer to a wholly-owned subsidiary of Lempriere (note this entity and Lempriere (Australia) Pty Limited are referred to as Lempriere throughout this document) which will result in CWH being held post-merger:

(a) 45% by Lempriere;

(b) 27.5% by Cavalier Bremworth;

(c) 13.75% by ACC; and

(d) 13.75% by Direct Capital.

Once the merger is completed, CWH will be a standalone commission wool scourer with its own executive structure and dedicated Board of Directors completely divorced from Lempriere's wool trading division. The Board will be made up of two Lempriere representatives, two representatives from the current CWH shareholders, and one independent director. The agreements bringing about the merger require the shareholders to enter an information sharing protocol designed to protect CWH's sensitive information, including information relating to CWH's customers and tariffs. It is a term of that protocol that sensitive information cannot be passed into the hands of any party's wool trading division.

This agreement is conditional on Commission clearance or authorisation.

North Island restructuring

4.4 Once the sale is complete CWH will merge NZWSI's and CWH's wool scouring businesses, in the North Island. Based on an anticipated transaction completion of April 2015, it is expected Whakatu will remain open until the end of June 2015 (although Awatoto will be primarily used for scouring, with Whakatu available rather in the same manner as was proposed for the Clive plant in Decision 725). At this time, the Whakatu 3.0 metre scour line will be relocated to CWH's unconstrained site at Awatoto, thereby increasing the capacity at that site. Clive will be utilised while the scouring plant from the Whakatu site is installed in Awatoto. CWH will then cease wool scouring operations at NZWSI's wool scour at Whakatu and the Whakatu lease would come to an end.

4.5 Lempriere will be obliged to impose covenants on the Whakatu site, to exclude future wool scouring or related activities at the site. Given the reduction in the wool clip since Decision 725, the merger will allow for sufficient excess capacity such that the Clive site will no longer be required for peak excess. The Clive site will be closed at the end of September 2015 (based on an anticipated transaction completion of April 2015) and the plant, land and buildings will be sold. CWH will similarly be required to impose covenants on the Clive site to exclude future wool scouring activity there (subject to the transaction being duly authorised and completed).

South Island restructuring

4.6 Once the sale is complete CWH will merge NZWSI's and CWH's wool scouring businesses in the South Island and will immediately cease wool scouring operations at NZWSI's wool scour at Kaputone. The boilers currently at the Kaputone site will be transferred to the unconstrained CWH site at Timaru and the Timaru buildings will be expanded to fit the Kaputone 3.0 metre scour line. Once the Kaputone line has been transferred, CWH will close and sell its existing 2.4 metre scour. CWH will sell the Kaputone site with covenants which ensure the use of the site excludes wool scouring or related activities. The sale of this site with covenants has been agreed in the sale and purchase agreement between CWH and Lempriere, subject to the transaction being duly authorised and completed.

Outcome of the transaction

4.7 This North and South Island restructuring is described in more detail in response to Question 5 below. As the Commission is aware, NZWSI has previously operated both as a wool exporter/merchant and as a wool scourer. Following the transaction, the wool trading division will remain with NZWSI. A separate wholly owned Lempriere subsidiary will acquire the shares in CWH, ensuring the separation of these operations.

4.8 The outcome of this transaction is that CWH and NZWSI will no longer be independent wool scouring competitors. Accordingly, CWH or any interconnected body corporate of CWH seeks authorisation to acquire control over NZWSI's wool scouring business and assets (whether by way of acquiring shares in the wool scouring subsidiaries, or assets, or both) and the associated issue of shares in CWH to Lempriere.

5. Commercial rationale for the acquisition

5.1 The commercial rationale for the acquisition has its genesis in the significant changes which have taken place in New Zealand's agricultural, and broader, economy over the last two to three decades.

5.2 As the Commission recognised in Decision 725, wool scouring is a volume driven business and a wool scourer's ability to compete is dictated to a large degree by the extent to which it can obtain greater efficiency in its processes.

5.3 However, the wool scouring industry faces challenges in terms of both reducing demand and increasing production capacity from offshore suppliers of similar services. Loss of greasy wool volumes generates increasing unit costs which further undermines the ability for New Zealand scourers to compete to supply scouring services.

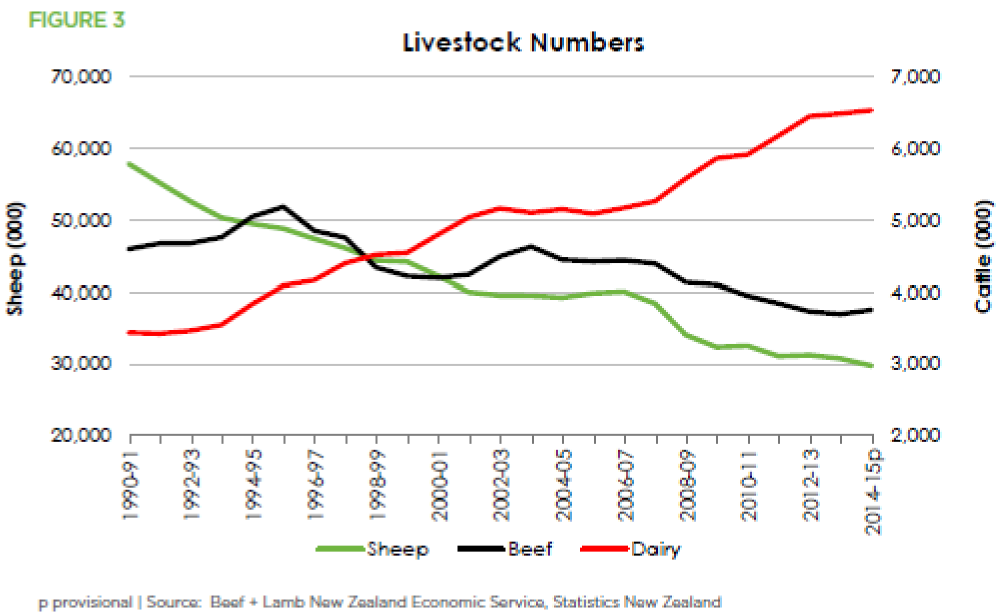
5.4 This transaction provides CWH and NZWSI with a path to addressing and responding to those challenges. Put simply, it will enable the parties to gain increased economies of scale and thereby enable the merged entity to compete more effectively with offshore scourers to supply scouring services in respect of New Zealand's greasy wool.

Wool scouring demand is a function of the size of New Zealand's sheep flock

5.5 As wool scouring demand is a function of the size of New Zealand's wool clip, the health of that broader industry necessarily impacts on the wool scouring industry. New Zealand's sheep flock has decreased from the peak of 70 million in 1983 following the Government's introduction of the Supplementary Minimum Prices. This massive sheep population generated a large wool clip which predicated a need for numerous scouring operations.

5.6 Today, the sheep flock is 29.8 million according to Beef + Lamb New Zealand.[14] The fall in New Zealand's sheep numbers is illustrated in Figure 1 below. This illustrates that in the last six years there has been a further step change reduction in sheep numbers from approximately 38.5 million in 2007/2008 to today's level of 29.8 million. This represents a fall of over 20% over this period. This downward trend has continued since the previous application in which flock numbers were at 32.6 million, a decrease of nearly 3 million.[15]

Figure 1: Beef + Lamb New Zealand Livestock Numbers



[14] Estimated 30 June 2014 figures as per Beef + Lamb New Season Outlook 2014-15, 2014, p 7.
[15] Note this figure is lower than that stated in Decision 725. Sheep numbers as at 30 June 2010 were revised down following Decision 725 by Beef + Lamb, and this number reflects the updated June 2010 total.

5.7 As the Commission has recognised, the reduction in the wool clip has resulted in substantial declines in scouring capacity from more than 20 sites in 1994 to five sites today[16].

5.8 New Zealand is not unique in this regard. The continued reduction in scouring capacity to meet a reducing wool clip mirrors experience in a number of countries where there has been a significant reduction in scouring capacity, e.g., the United Kingdom, Australia, Russia and most of Europe. By way of example, the United Kingdom now has only two commission wool scours for the whole market (one of which is running at very limited capacity)[17] and in Australia there are no scours in the western region and just three[18] scours in the eastern region.

5.9 Nor is there is any reason to be optimistic that the sheep flock will increase given international returns and the permanent conversion of many sheep farms to dairy, in addition to the impacts of a number of droughts and storm effects. The potential for land to be converted to dairy farming is on-going and these effects are permanent. Between 2007 and 2012 alone sheep and beef farms decreased from 29241 to 25113 in New Zealand, a decrease of 14% in number. The overall area of sheep and beef farms decreased from 9.6 million to 9.3 million hectares over that time. In contrast, over that period there has been an increase in the area of dairy farms of almost 400,000 hectares, and the number of dairy farms has increased by 750 properties.[19] CWH sees this trend continuing, with large numbers of approvals for irrigation being granted, allowing the transition of farmland to dairy use. This is particularly evident in the South Island, with Beef + Lamb commenting in their latest New Season Outlook for the 2014-2015 season, "[l]and use change continues in the South Island particularly toward dairy conversions and dairy support activities."[20]

5.10 For example, in June 2013 ANZ Bank noted there were plans in place for 16 new water storage and irrigation schemes around the country, expected to increase total irrigable land by a further 655,000 hectares. In Canterbury and Otago alone they estimated irrigation projects at various stages of development could add 135,000 hectares of newly irrigated farm land. Three quarters of such newly irrigated land is expected to go into dairy. Over the previous five years, the irrigable area increased by 17%, to 721,700 hectares. Of this increase, 76% was in the South Island.[21]

5.11 Those who do carry sheep are also producing less wool than previously, as farmers switch to animals that produce better quality meat in the face of rising meat prices relative to wool prices, rather than focusing on wool production. While wool per head of sheep was 5.02kg in 2009-10, this has decreased to an expected 4.68kg in the 2014-15 year.[22] Beef + Lamb estimate total sheep numbers as at 30 June 2014 to be 29.8 million. Sheep numbers as at 30 June 2015 are expected to have increased slightly to 30.2 million. Beef + Lamb have stated they expect sheep numbers to remain between 29.6 to 30.0 million in the next four years (to 2019/20). CWH believes (and expects other industry participants to agree) that total sheep numbers will be even lower than Beef + Lamb's prediction as at June 2015 and beyond, given CWH understands there are approximately 100 bales of greasy wool dropping out of the South Island each day, the fairly consistent decline in sheep numbers since the 1980s and the on-going land use changes discussed above.

5.12 While wool prices did recover somewhat in 2010, by June 2012 that gain had been lost. There has since been some small recovery, but not to the same extent as previously.

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[16] The plant at Clive operates a **[REDACTED]** weeks a year primarily at the peak of the processing season. For example, in the last financial year it operated 30 days.

[17] A third scour that operated at the time of the previous application has now shut.

[18] There are also two other plants, but these are specialist processors (concentrating on scouring wool contaminated with vegetable matter and involving a process of carbonisation). The overall process is complex and scouring is a relatively small part of the overall process. These are both relatively small plants. New Zealand does not have any scouring carbonisation processors due to low levels of vegetable matter affecting the greasy wool.

[19] The numbers in this paragraph have been collated from the Beef + Lamb Compendium of New Zealand Farm Facts 2014, p 5 (based on Statistics New Zealand 2012 Agricultural Census) and the Statistics New Zealand numbers from the 2007 Agricultural Census.

[20] Beef + Lamb New Season Outlook 2014-15, p 24.

[21] ANZ Agri Focus June 2013 p 32.

[22] Beef + Lamb New Season Outlook 2014-15.

Further, wool grease prices have significantly declined over the past 18 months, which has had a significant impact on wool scourers' incomes all over the world. It is not overstating the position to say that the New Zealand wool industry remains in distress. The Wool Industry Taskforce in its Final report in February 2010 started its executive summary with the following comment:

> There is no silver bullet for restoring profitability to the strong wool sector. Addressing the sustained decline in prices and volumes of wool exported from New Zealand over the last four decades will take concerted effort and commitment from within the wool and textiles sector. The challenge is real and immediate. The perilous state of the wool sector is placing the future of sheep farming in New Zealand at risk.

5.13 CWH believes that this concern remains equally valid and that returns remain below the level necessary to lead to a material restocking of the sheep flock and significant further initiatives are needed to improve returns. In this context, this transaction reflects one step in maintaining and enhancing value within New Zealand's wool industry by adding value to greasy wool grown in New Zealand.

5.14 In essence, wool scouring involves:

- receiving from wool merchants batches of greasy wool that are of a suitable mix of wool types to meet their customers' quality specifications – (quality means fibre strength, length and diameter, colour, brightness and cleanliness) and storing the batches prior to scouring;
- opening of the blended wool fibres by a mechanical flail process to allow full contact between fibres and washing liquid;
- washing (and sometimes bleaching) the wool in various numbers of bowls of hot water and detergent;
- extraction of wool grease for sale by the scourer;
- drying the wool;
- high density pressing packing into bales; and
- testing of each bale for correct wool specification.

5.15 The scouring and high density pressing processes currently account for only about 4-5% of the current value chain of scoured and packed wool.

5.16 Historically, the size of the wool scouring industry has been closely aligned to sheep numbers and the available wool clip. For instance, when the New Zealand sheep flock reached its peak of 70 million in 1982-3, there were about 20 separate wool scouring operations. However, the decline in sheep numbers to around 30 million at present has been accompanied by a significant reduction in the wool clip and this, along with the development of higher capacity modern scouring plants and presses, has resulted in a reduction in the number and total capacity of wool scours in New Zealand. Currently there are five wool scouring plants, three in the North Island and two in the South Island. If the acquisition proceeds all five existing wool scours will be owned by CWH which intends to centralise wool scouring at one site in each island.

Table 1: Beef + Lamb Wool Clip Volumes

	Total wool clip (tonnes)		Greasy/slipe wool exports (tonnes)	
	Year ended 30/6/10 (as at Decision 725)[23]	Year ended 30/06/14[24]	Year ended 30/6/10 (as at Decision 725)[25]	Year ended 30/06/14[26]
North Island	91,300	78,580	16,500	16,500
South Island	94,500	85,522	26,515	27,976
Total New Zealand	185,800	164,102	43,015	44,476

Increased competition for wool scouring services

5.17 The impacts of this steady decline in available demand have been further exacerbated by the emaciation of New Zealand's wool processing industry due, primarily, to the growth of low cost textile and apparel manufacturing in developing countries, most notably China.

5.18 This has led to the growth in exports of greasy wool to China and the increase in the capacity of the Chinese wool scouring industry. This has made the ever decreasing wool scouring demand even more contestable.

5.19 The Chinese wool scouring industry is expanding aggressively and in line with the general manufacturing growth in China. Since China's economic reforms the Chinese market has grown at unprecedented rate and, in the last decade, this has seen the rise of an enormous middle class and a very large affluent class. These economic changes have led to an increased demand for scoured wool and supported the growth of Chinese wool scours.

5.20 China is the largest manufacturer of wool based textiles and clothing in the world accounting for at least one third of the world's raw wool used for processing and manufacturing. The Chinese wool industry has responded and since the previous application China has surpassed Australia to become the world's largest grower of wool.[27] It is also the largest importer of raw wool, accounting for 47% of the world's wool imports.[28] This has grown from

[23] Beef + Lamb Stock Number Survey as at 30 June 2014, as updated by Rob Davison by email.
[24] Beef + Lamb New Season Outlook 2014-15.
[25] Beef + Lamb Stock Number Survey as at 30 June 2014, as updated by Rob Davison by email.
[26] Wool Exports July to June 2013-2014 (Table 6.1), Beef + Lamb New Zealand.
[27] In 2012 China produced 400,057 tonnes of greasy wool compared to Australia's 374,157 tonnes, according to the IWTO Wool Market Information 2013, p 11.
[28] IWTO Wool Market Information, 2013, p 22.

3% in 1990, reflecting an increase in imports from 35,000 tonnes in 1990 to 305,764 tonnes in 2012.[29] It does not export raw wool (prior to it being processed) to any material extent.

5.21 As China has developed its own wool industry, significant industry infrastructure has also developed and there is now a significant and growing scouring industry. As wool processing moved to China to supply integrated mills the scouring has moved as well. This has been particularly driven by the requirement to co-locate scouring with mill production, minimising the transportation damage to fibre. CWH understands that the top 18 scour lines in China alone have a combined capacity of nearly twice New Zealand's scouring capacity.

5.22 CWH understands Chinese scours are continuing to expand and actively target New Zealand wool volumes. Tianyu, the largest wool scourer and Top maker in China has recently purchased three 3.0 metre scour lines, in addition to collating two existing 2.0 metre wide ANDAR scour lines into one line. Tianyu is reportedly fitting a scour line to solely wash New Zealand and English greasy wool, which could take a further 50,000 – 100,000 bales of greasy wool from New Zealand.

5.23 As described, this overall Chinese growth makes the issues facing the New Zealand scouring industry even more acute. China is New Zealand's largest volume destination for wool exports. In the 12 months to June 2014, 50% of New Zealand's wool exports were sent to China; 50% of those exports were in greasy form.[30] Since the time of Decision 725, total New Zealand wool clip has decreased from 185,800 to 164,102 greasy tonnes (as at June 2014) and at the same time the volume of greasy wool shipped to China has increased from 26,863 to 28,948 tonnes (clean equivalent) (as at year ended 30/06/2014).[31] In other words, today, 25% of New Zealand's wool exports or 24% of New Zealand's entire wool clip[32] is being exported to China in greasy form (in comparison to 18% of New Zealand's wool exports and 14% of the total wool clip at the time of the previous application).[33]

5.24 Further, expansion of wool scouring capacity is not limited to China. Compass Wool Processors (**CWP**) is a new wool processing company recently established in Malaysia. CWP has been developed by a syndicate of experienced wool and industry professionals to provide specialist wool scouring, processing and treatment. It aims to establish itself as a significant central processing hub for the world's wool, including New Zealand crossbred wool, with high density wool presses for re-export. CWP is actively marketing in New Zealand and CWH has drawn its scouring tariff comparison from CWP's tariff schedule (provided to the Commission). CWH understands that the operation is highly subsidised, including paying no tax for the first five years. As a result, it is able to offer very low scouring tariffs. CWH understands that CWP is offering a commission Top making tariff for finished Top of USD55 cents per kg.[34] (Top making is not available in New Zealand.) This is approximately 50% lower than in China (see Table 3 for a comparison of CWP, Chinese and CWH scouring rates).

5.25 This scour will also benefit by close proximity to the busy Port of Tanjung Pelepas. Maersk shipping line has recently announced collaboration with Kotahi (the joint venture between Silver Fern Farms and Fonterra), and has committed to introducing new services and capacity from October 2014 between New Zealand and Tanjung Pelepas, which is a major Asian shipping hub with connections to major wool export destinations. This will likely result

[29] IWTO Wool Market Information, 2013, p 32.

[30] In the 12 months to June 2010, 46,282 tonnes of wool (greasy, scoured and slipe (clean equivalent)) were exported to China. New Zealand's total exports of all wool (greasy, scoured and slipe) were 122,893 clean equivalent tonnes. Greasy wool comprised 26,863 tonnes (clean equivalent) of the 46, 282 tonnes (clean equivalent) exported to China. Wool Exports July to June 2009-2010 (Table 6.1), Beef + Lamb New Zealand. In the 12 months to June 2014, 58,136 tonnes of wool (greasy, scoured and slipe (clean equivalent)) were exported to China. New Zealand's total exports of all wool (greasy, scoured and slipe) were 116,467 (clean equivalent) tonnes. Greasy wool comprised 28,948 tonnes (clean equivalent (with Beef + Lamb using a yield of approximately 74.6% given the higher proportion of fine wool going to China)) of the 58,136 tonnes (clean equivalent) exported to China. Wool Exports July to June 2013-2014 (Table 6.1), Beef + Lamb New Zealand.

[31] Wool Exports July to June 2013-2014 (Table 6.1), Beef + Lamb New Zealand.

[32] Assuming that approximately 92.2% of New Zealand's wool is exported.

[33] Note this was stated to be 18% of New Zealand's wool clip at the time of Decision 725, but amended in the High Court decision.

[34] "Top" is the name given to wool after it has undergone the process of scouring, carding, combing and gilling.

in decreased costs for transport from New Zealand to this scour, increasing its attractiveness as an alternative to CWH for New Zealand wool exports. This includes to the European Union, which accounts for 11% of New Zealand's greasy wool exports and 34% of scoured wool exports, or 28% of New Zealand's total wool exports.[35] **[REDACTED]**

5.26 On top of this growing Asian constraint, it remains the case – as the Commission concluded in Decision 725 that there is a likely threshold for price increases, which if breached would encourage domestic entry.[36] This would result in a permanent loss of business for CWH, and as the Commission concluded in Decision 666 "[g]iven the importance to CWH that it maintains high capacity utilisation, even the threat of entry may be sufficient to constrain the combined entity".[37] This conclusion applies equally whether volume is lost to Asian scourers or to merchant enabled new domestic entry.

Rationalisation resulting from the proposed acquisition

5.27 The commercial benefit to CWH from the acquisition lies in the economy of scale benefits arising from the rationalisation of the existing NZWSI scour lines with the existing CWH scour lines and, hence, the ability to generate incremental economies of scale benefits. The ability to drive incremental volumes to lower per unit costs of production allows a scourer to offer a more cost competitive product so as to effectively compete for greater volumes and further reduce unit costs.

5.28 CWH has updated its model of the financial benefits (previously provided to the Commission in relation to Decision 725) based on the cost savings it will generate (enclosed with this application). CWH has not forecast any increase in scouring prices because for the reasons outlined in this Application, it does not believe that it will be able to achieve increased prices.

5.29 CWH forecasts the proposed acquisition and the restructuring will deliver **[REDACTED]** in incremental EBITD. This improved EBITD results almost solely from economies of scale cost savings and the processing of all wools through upgraded Awatoto and Timaru scours, as CWH's analysis assumes only a not significant change in volumes scoured across New Zealand. In reality, CWH believes the acquisition will enable it to compete more effectively to hold existing volumes and obtain additional volumes. These additional volumes would add to the commercial benefits it would derive from the transaction. To do that CWH has to be able to effectively compete with overseas scourers.

A. Context of the rationalisation

5.30 CWH currently has three scour lines in the North Island (two 2.4 metre scour lines at Awatoto and one 2.0 metre line at Clive) and two scour lines at Timaru in the South Island (one 3.0 metre scour line and one 2.4 metre scour line). NZWSI has a 3.0 metre scour located at each of Whakatu in the Hawkes Bay in the North Island and Kaputone near Christchurch in the South Island.

5.31 The end result of the rationalisation will be: the transfer of the 3.0 metre scour lines from Whakatu to Awatoto and Kaputone to Timaru, the closure of two scour lines – the one at Clive and the 2.4 metre scour line at Timaru – and the removal of duplication of sites in each island. However, there will be, for the reasons described later, no significant reduction in available capacity.

CWH's scour lines today

5.32 Given the efficiency benefits from achieving increased throughput, CWH has continued to incrementally and innovatively upgrade its scour lines by making modifications to maximise throughput. Since the previous application, CWH has added a spare triple drum opener to

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[35] Wool Exports July to June 2013-2014 (Table 6.1), Beef + Lamb New Zealand.
[36] Decision 725, para 241.
[37] Decision 666, para 174.

the blending system at Awatoto. Consequently, throughput has increased and the quality of output has improved.

5.33 The 3.0 metre line at Timaru, being the newest CWH line, is the most developed and unconstrained, and represents CWH "best practice". It is operating at a level of efficiency and output materially above the level of NZWSI's 3.0 metre scour lines.

5.34 The two 2.4 metre scour lines at Awatoto have also been incrementally developed. Significant gains have been in terms of increasing throughput on those scour lines, and they are operating more efficiently than the existing NZWSI 3.0 metre lines. While CWH intended to further enhance and straighten these scour lines in its previous application, the continued decrease in sheep numbers, a greater emphasis on sheep meat and an even bigger reduction in wool clip has led CWH to determine this is no longer necessary. Since June 2010, sheep numbers have reduced year on year in both islands (apart from a small increase in the South Island in 2010-11) and latest figures are:[38]

Table 2: Beef + Lamb Sheep Numbers

Year	North Island Sheep Numbers (million)	South Island Sheep Numbers (million)	Total Sheep Numbers (million)
June 2010/11	16.0	16.5	32.5
June 2011/12	15.5	15.7	31.2
June 2012/13	15.3	16.0	31.3
June 2013/14	15.0	15.8	30.8
June 2014/15e	14.6	15.2	29.8
June 2015/16f	15.4	14.8	30.2

5.35 Beef + Lamb do not anticipate any significant increase in sheep numbers. The outlook is for sheep numbers to remain in a band of 29.6 to 30.0 million over the next four years to 2019/20.[39]

5.36 Despite the Awatoto lines no longer needing to be straightened, the building still must be extended to incorporate the 3.0 metre line from Whakatu and improve storage capacity (where Clive is currently utilised), with no site/environmental constraints to extending the building. The site would not need development absent the acquisition, given current capacity is more than sufficient to scour CWH's North Island volumes and Clive is available as a storage site.

NZWSI scour lines today

5.37 CWH believes there are efficiency gains to be made on NZWSI's lines as a result of applying the process developments it has achieved in Timaru and to a more limited extent at Awatoto.

[38] Beef + Lamb Stock Number Survey as at 30 June 2014, including forecasts of 2015/16.
[39] Beef + Lamb Stock Number Survey as at 30 June 2014, as updated by Rob Davison by email.

5.38 While NZWSI already has some of the equipment necessary to make the modifications to its lines, those gains cannot be realised absent this transaction primarily because site constraints at Whakatu and Kaputone (both physical and/or environmental) prevent further development of the scour lines or the addition of new scour lines.

5.39 The efficiency benefits available by bringing these NZWSI scours up to "CWH spec" plus the ability to avoid the duplicated costs of running two additional sites provides CWH with an incentive to relocate the Whakatu and Kaputone scour, a process which is reasonably straightforward.

Relocation requires capital investment in the North Island and South Island

5.40 While the relocation process is simple, the Awatoto buildings are currently not large enough to accommodate the 3.0 metre scour line – extensions to the building (there are no site constraints at Awatoto) will be necessary. Further, the site will be modified to improve storage capacity to remove CWH's reliance on its Clive site for storage. Similarly in Timaru, CWH will extend the buildings to accommodate the NZWSI 3.0m line and improve storage.

5.41 The benefits of the consolidation possible through the acquisition coupled with the incremental efficiency benefits on the 3.0 metre scour lines are more than sufficient to justify the investment, i.e. it is now economic to approve the capex.

B. Detail of North Island rationalisation

Relocation of the Whakatu 3.0 metre scour line

5.42 For the reasons outlined above, CWH will relocate NZWSI's 3.0 metre scour line, currently at Whakatu, to the CWH site at Awatoto.

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

5.44 As described in the summary above, there can be only limited further expansion of the NZWSI scour line at Whakatu in its current location.

5.45 More specifically this is because the Whakatu site is small and size constraints impact the layout of the scour line which is also installed on a 90 degree basis. Size constraints have also meant that the scour line is not optimally set up. Specifically, CWH considers that a lack of opening equipment and the length of the scour bowls are inhibiting performance of the line. CWH estimates that the Whakatu line operates at a capacity of **[REDACTED]** greasy kgs per hour, which compares unfavourably with CWH's 3.0 metre Timaru wool scour, which operates at **[REDACTED]** greasy kgs per hour based on South Island crossbred wool types but at **[REDACTED]** greasy kgs per hour when running on similar wool types to those processed in the North Island.

5.46 NZWSI has limited potential to expand the site to address these issues. Nor would CWH be able to do so, post transaction, if it did not relocate the scour line. This is in large part because the Whakatu site is landlocked with residential housing all around. CWH is aware that the neighbours surrounding Whakatu regularly complain about noise and smell; CWH is also aware that NZWSI have been involved in disputes with the neighbours and one is on a court restraining order. Accordingly, resource consent to extend the buildings or install a second line is highly unlikely.

5.47 Moving the scour line to Awatoto will thereby enable CWH to expand capacity on the NZWSI scour line. CWH believes it can achieve significant efficiency improvements by making the following additional modifications:

(a) reconfiguring the bowls to enhance the rinse capacity;

(b) modifying bowl 6 to become a longer shallow bottom chemical treatment bowl;

(c) installing jet spray bars on the rinse bowls;

(d) fitting a seventh squeeze press before the dryer;

(e) modifying the dirt loops and wool grease recovery system; and

(f) modifying the wool sorting area.

5.48 These modifications will not only bring the **[REDACTED]** For all intents and purposes, the modified Whakatu and Timaru 3.0 metre scour lines will be identical.

5.49 Management have set their initial budgets conservatively on the basis that the modifications will result in an increased throughput to **[REDACTED]** greasy kg per hour, although they believe the scour processing North Island wool types is likely to deliver up to **[REDACTED]** greasy kg per hour on certain wool types.

Expanding Awatoto and modifying the CWH scour lines

5.50 Since the last application was made, CWH has added a spare triple drum opener in the blending system. It did this to improve the quality of the wool and increase throughput. CWH still intends to extend Awatoto as it did in the previous application (as described above), but it no longer needs to modify the two 2.4 metre lines, currently in existence at Awatoto, given the continued reduction in wool throughput since Decision 725 and the benefits to be derived from transferring and modifying the Whakatu 3.0 metre line. In effect, the acquisition enables the cost of the extensions to Awatoto to be shared over a greater incremental gain in scouring volumes, while also enabling CWH to realise operating and administration cost savings from exiting the Whakatu site. The combination of the increased capacity benefits of developing the NZWSI 3.0 metre line to that scour mean that the Clive site can close permanently and the 2.0 metre line currently at Clive will become surplus. **[REDACTED]**

Selling the Clive plant

5.51 Currently the Clive plant is utilised to cover emergencies and peaks in demand. It is operated around 30 days per year (plus emergencies). As discussed above, Clive will no longer be required to run post acquisition. This is because post restructuring, CWH will have sufficient scouring capacity at Awatoto to cover expected demand in the North Island without the need to maintain the Clive plant.

5.52 As Clive will no longer be required, the plant and equipment will be able to be sold **[REDACTED]** along with the land and buildings. This will occur after the scour line at Whakatu has been moved to Awatoto, given Clive will be in use (for approximately three months) until the Awatoto restructuring is complete.

Overall commercial benefits in North Island

5.53 CWH has calculated the acquisition effects in the North Island would:

(a) reduce the combined entity's administration costs from **[REDACTED]** cents per kg greasy to **[REDACTED]** cents per kg greasy (in the previous application a reduction from **[REDACTED]** cents per kg greasy to **[REDACTED]** cents per kg greasy was estimated);

(b) reduce the combined entity's scour operating expenses (from scouring and pressing) from **[REDACTED]** cents per kg greasy to **[REDACTED]** cents per kg greasy (in the previous application a reduction from **[REDACTED]** cents per kg greasy to **[REDACTED]** cents per kg greasy was estimated);

(c) increase the combined entity's EBITD from **[REDACTED]** cents per greasy kg to **[REDACTED]** cents per greasy kg (in the previous application an increase from **[REDACTED]** cents per kg greasy to **[REDACTED]** cents per kg greasy was estimated).

In addition, following the South Island restructuring work (which potentially could involve shipping a small quantity of wool to the North Island for scouring), the Whakatu land and buildings will be released for alternative uses (to wool scouring) realising an estimated **[REDACTED]** (updated from the Commission's determination of $2.5 million in Decision 725) and the Clive land and buildings will be also released for alternative use and sold for an estimated **[REDACTED]** (based on their most recent independent valuations). (Both sales are conditional on the merger and restructuring taking place). CWH believes the cost of the building and plant capital works at Awatoto needed to achieve this rationalisation to be a one-off cost of **[REDACTED]** (previously estimated at **[REDACTED]**).

C. Rationalisation in the South Island

5.54 Post-acquisition CWH will control two scour sites in Canterbury (Timaru and Kaputone).

5.55 As with CWH's previous application to the Commission, CWH intends to relocate and develop NZWSI's 3.0 metre scour line, currently at Kaputone, to the CWH site at Timaru in replacement for the existing 2.4 metre line. However, in order to ensure sufficient capacity at all times during the rationalisation process, CWH will first expand the Timaru building to create an additional scour hall for the Kaputone 3.0 metre to be transferred to. Only once this is up and running will the existing Timaru 2.4 metre line be decommissioned and sold **[**(**REDACTED**)**]**. CWH expects to modify the NZWSI 3.0 metre line so that throughput increases to **[REDACTED]** greasy kilograms an hour from the current rate of **[REDACTED]** greasy kilograms an hour.

5.56 The immediate benefits of this plan will be that CWH will be able to avoid the duplication of cost by closing the Kaputone plant and spread Timaru's operating and administration costs over a greater volume of production thereby reducing per unit costs. One significant benefit worth noting here is the avoidance of the **[REDACTED]** effluent treatment costs incurred when operating Kaputone. **[REDACTED]** Timaru discharges to the Timaru council industrial sewer which passes through a Council operated milli-screen plant which is shared with other users. This discussion is expanded further below.

5.57 CWH expects to finalise all building plans and receive all consents prior to completion of the transaction. CWH will then begin building works as soon as the transaction becomes unconditional, to ensure the building is ready as soon as possible. While this building work is occurring, the Kaputone line will be dismantled and it will be installed in Timaru once the additional hall is complete.

Overall commercial benefits in the South Island

5.58 CWH has calculated the acquisition effects in the South Island would:

(a) reduce the combined entity's administration costs from **[REDACTED]** cents per kg greasy to **[REDACTED]** cents per kg greasy (in the previous application a reduction from **[REDACTED]** cents per kg greasy to **[REDACTED]** cents per kg greasy was estimated);

(b) reduce the combined entity's scour operating expenses (from scouring and pressing) from **[REDACTED]** cents per kg greasy to **[REDACTED]** cents per kg greasy (in the previous application a reduction from **[REDACTED]** cents per kg greasy to **[REDACTED]** cents per kg greasy was estimated);

(c) increase the combined entity's EBITD from **[REDACTED]** cents per greasy kg to **[REDACTED]** cents per greasy kg (in the previous application an increase from

[REDACTED] cents per kg greasy to **[REDACTED]** cents per kg greasy was estimated).

5.59 In addition, CWH will be able to sell the Kaputone land and buildings realising an estimated **[REDACTED]** (the Commission estimated this to be $5.5 million in 2011). CWH expects to move the boiler currently located at the Kaputone site to Timaru, to replace the existing boiler at Timaru. As Timaru will remain in use whilst the modifications are carried out Kaputone will not be required and will close immediately following completion of the merger. The effluent plant will also be sold. This has been conservatively valued at **[REDACTED]**.

5.60 CWH believes the cost of the building and plant capital works at Timaru needed to achieve this rationalisation to be a one-off cost of **[REDACTED]** (compared to **[REDACTED]** under the previous proposal in the earlier application).

6. Transaction documents

6.1 Attached are the following transaction documents:

(a) agreement relating to the sale and purchase of shares in Kaputone Wool Scourers (1994) Limited and Whakatu Wool Scourers Limited dated 21 October 2014 between New Zealand Wool Services International Limited, Cavalier Wool Holdings Limited, Direct Capital Investments Limited, Accident Compensation Corporation and Cavalier Bremworth Limited;

(b) agreed form of shareholders' agreement relating to Cavalier Wool Holdings Limited between Direct Capital Investments Limited, Accident Compensation Corporation, Cavalier Bremworth Limited, [Lempriere Subsidiary Entity] and Cavalier Wool Holdings Limited, to be entered into upon completion of the merger;

(c) the information sharing protocol between the parties referred to in (b) above and [Lempriere subsidiary entity]; and

(d) agreed form of a scouring agreement setting out the terms that apply in relation to all wool scoured by Cavalier Wool Holdings Limited for NZWSI.

7. No overseas dimension

7.1 The proposed acquisition has no overseas dimension.

Part 2: The Industry

8. Services supplied by CWH and NZWSI

8.1 As described above in response to Questions 1 to 3:

(a) CWH through its wholly owned trading subsidiary Cavalier Woolscourers Limited (which trades as Hawkes Bay Woolscourers and Canterbury Woolscourers) owns and operates wool scours in Awatoto and Clive (Hawkes Bay) and Timaru. As a commission scourer, CWH's scours are setup to be able to scour the full range of wool types which merchants want to have scoured, including Black, Merino, ½ Breed, Dag Wool, and all crossbred types of wool.

(b) While NZWSI operates two businesses, the relevant business for the purposes of this application is its wool scours at Whakatu and Kaputone. NZWSI's scour line is set up to scour the particular types of wool NZWSI typically supplies to its export customers (such as long runs of easy scouring types such as Fleece Wool and Slipe Wool) rather than being set up so as to scour that broad range of wool types for which other merchants require scouring services. For example, CWH understands that poorer style wools such as dag wool do not perform well on NZWSI's Kaputone scour.

(c) Each company individually manages the marketing and sale of raw wool grease, a by-product of wool scouring. Raw wool grease is refined by customers for use in a number of applications.

(d) Cavalier Group owns 100% of Elco Direct which operates as a wool buyer in the North Island.

(e) NZWSI owns 50% of RWL which also operates as a wool buyer in the North Island and which will remain part of the NZWSI wool trading business. As described above JS Brooksbank, a wool merchant, is also a wholly owned subsidiary of NZWSI.

9. New Zealand's wool scouring industry

9.1 Following the significant rationalisation of the wool scouring industry described in Question 5 above, New Zealand's wool scouring industry now comprises CWH and NZWSI which provide wool scouring services to a small number of wool merchants, the two domestic carpet makers (Cavalier Bremworth and Godfrey Hirst), yarn manufacturers (Wool Yarns and Christchurch Yarns), and other further processors (e.g., apparel manufacturers).

9.2 The continued migration of New Zealand's apparel industry means that the majority of wool merchants' sales are export sales. In fact, around 92% of New Zealand's wool production is exported (based on Beef + Lamb statistics).[40] This has increased from approximately 83% at the time of the last application.

9.3 The proportion of wool exported as opposed to utilised domestically has increased due to the decline in volume of New Zealand producers, **[REDACTED]** over recent years. **[REDACTED]** This alone represents over **[REDACTED]**% of the latest Beef + Lamb production estimate of 164,102 greasy tonnes as at June 2014.

9.4 Wool that is not scoured in New Zealand is generally sent to a wool dump prior to it being shipped overseas for scouring and further processing.

9.5 Merchants contract with end users to provide them with clean (i.e., scoured wool). A customer will generally specify to a merchant the parameters the customer requires in order to manufacture its product range which depends on the end product the customer wants to produce.

9.6 The merchant's job is to deliver to that specification. To do so, a merchant must determine the mix of greasy wool it needs to procure and then to engage a wool scourer to scour the wool. The merchant's margin reflects the difference between the price it pays for greasy wool and the clean wool price it has negotiated with a customer less the scouring costs it incurs.

9.7 As the Commission has previously recognised, this margin is very small and a merchant has the strong incentive to minimise the costs it incurs, namely:

(a) the cost of greasy wool; and

(b) the scouring costs associated with cleaning that greasy wool.

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[40] Beef + Lamb have reported, in their New Season Outlook 2014-15, 2014 exports as 116.5k clean tonnes (151.3 k greasy tonnes at 77% yield) which is 92.2% of 2013/14 production of 164.1 k greasy tonnes. Furthermore they are forecasting 2015 exports as 110.9 k clean tonnes (144.0 k greasy tonnes at 77% yield) which is 92.1% of 2014/15 estimated production of 156.3 k greasy tonnes.

9.8 Merchants operate globally with agents in most, if not all, of the world's major wool producing countries. Because wool is (largely) a commodity product, New Zealand greasy wool competes with greasy wools grown in other countries. New Zealand grows around 8% of the world's greasy wools, with the largest producers being China (20%) and Australia (18%).[41] If the total cost of procuring greasy wool in New Zealand is too expensive, a merchant can substitute wools acquired from another country provided it can meet its customer's specifications.

9.9 Scouring services add to a merchant's costs of goods sold and the merchant has an incentive to reduce those. A merchant has the ability to export greasy wool and have that wool scoured offshore instead of using a New Zealand scourer. The fact that a material proportion – 27%[42] – of New Zealand's wool is exported in greasy form (an increase from 22% at the previous application) indicates that merchants routinely substitute offshore scouring services for those provided by CWH or simply export greasy wool.

9.10 In summary, New Zealand wool may be[43]:

- scoured and used in New Zealand for the manufacture of carpet, yarn or apparel – 8% (compared to 17% at the time of the previous application) of the wool clip;
- scoured and exported as clean wool – 65% (compared to 61% at the time of the previous application) of the wool clip; or
- exported as unscoured greasy wool – 27% (compared to 22% at the time of the previous application) of the wool clip.

10. Recent trends in wool scouring

See response to Question 5 above.

11. Recent consolidation in the industry

11.1 The Commission considered the wool scouring market in March 2009 when it granted clearance for a series of transactions, the net effect of which was to combine the wool scouring assets of CWH and Godfrey Hirst, and to result in CWH and Godfrey Hirst no longer being independent wool scouring competitors.

11.2 For completeness, the Applicant notes that in September 2009, ACC acquired a 25% interest in CWH from NZ Woolscourers Limited and in December 2010, Direct Capital acquired from NZ Woolscourers Limited a 25% interest in CWH.

11.3 As noted above, CWH was granted authorisation to acquire the assets of NZWSI in 2011. This transaction did not proceed with Lempriere eventually acquiring 100% of the shares in NZWSI (refer to paragraph 2.1 above). The Applicant is not aware of any other relevant transactions.

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[41] IWTO Market Information 2013, Table 2, p 11. This is in comparison to the time of the previous application where New Zealand did produce about 8% of the world's greasy wools but the largest producer was Australia (20%) with China a close second (19%).

[42] Year ending 30 June 2014, Beef & Lamb New Zealand Economic Service (except local which is estimated), available at http://www.beeflambnz.com/. Of this 27%, 88% of greasy wool exports are to China and 11% are to the EU (mainly Germany and Italy) (88% and 8% respectively at the previous application).

[43] The numbers in brackets in this paragraph reflect what CWH believes to be the correct figures as at the time of the previous application. These were misstated previously to be 22%, 56% and 22% respectively. This was because local manufacturing was stated to account for 22% of the total market, when in fact it was 22% of scoured wool (i.e. 22% of the 78% of wool scoured in New Zealand, giving a total of 17%).

Part 3: Market Definition

12. Relevant markets

Wool scouring

12.1 The Commission defined the relevant markets in which scouring services are provided in June 2011 (Decision 725) as being:

(a) the North Island market for the supply of wool scouring services (the **North Island scouring market**);

(b) the South Island market for the supply of wool scouring services (the **South Island scouring market**);

(c) the national market for the purchase and supply of wool grease (the **national wool grease market**);

(d) the national market for the manufacture, import and wholesale supply of wool and synthetic carpets.

12.2 The Applicant adopts these markets for the purposes of this application.

12.3 In Decision 725, the Commission concluded that the competition issues in respect of the supply of wool scouring services were generic to both the North and South Island geographic markets and therefore treated them together for the purpose of the competition analysis. The Applicant takes the same approach in this application.

Wool procurement

12.4 In Decision 725 the Commission considered aggregation in the market for the procurement of greasy wool via the acquisition of NZWSI's wool trader business (including through its 50% interest in RWL) and the Cavalier Group's position as an acquirer of greasy wool (including through its ownership of Elco Direct). As set out above, NZWSI will separately retain the wool exporting/merchant business of NZWSI and relevant subsidiaries with shares in CWH transferred to a [separate Lempriere subsidiary]. Therefore, no aggregation will occur in this market and it is not considered further in this application. Further information can be provided if required. In any event, even if some aggregation will occur, there are a large number of market participants and as with the previous application, the aggregation would fall well within the Commission safe harbours.

13. Proposed acquisition reduces vertical integration

13.1 The proposed acquisition will, ultimately, reduce the level of vertical integration apparent in Decision 725 as the Cavalier Group shareholding in the merged CWH will be diluted to 27.5% from 50% and will be balanced by the ACC and Direct Capital shareholdings and the shareholding of Lempriere (with associated board representation). The wool merchant business of NZWSI and control of the wool scouring business by Lempriere will be separated as a result of the proposed acquisition.

13.2 Once the merger is completed, CWH will be a standalone commission wool scourer with its own executive structure and dedicated Board of Directors completely divorced from Lempriere's wool trading business. The shareholders have entered into an information sharing protocol designed to protect CWH's sensitive information, including information relating to CWH's customers and tariffs. It is a term of that protocol that sensitive information cannot be passed into the hands of Lempriere's wool trading division.

Part 4: Counterfactual

14. Relevant counterfactual

14.1 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 businesses to Lempriere in early 2013. Therefore, the Applicant has presented its competition analysis and net benefit analysis in this application on the basis that the relevant counterfactual is the status quo, i.e. Lempriere continuing to run NZWSI as a separate scouring entity, albeit still largely focussed on scouring its own wool and with only limited commission scouring.

Part 5: Competition Analysis

15. Existing Competition

Nature of wool scouring – a volume driven industry

15.1 In Decision 725 the Commission recognised that wool scouring is an industry in which participants have an incentive to seek additional volumes so as to increase capacity utilisation and decrease costs.

15.2 CWH's ability and incentive to increase prices both today and post-acquisition needs to be viewed in this context; an increase in price may result in reductions in volumes lost to competing suppliers.

15.3 In Decision 725, NERA undertook a critical loss analysis to assess CWH's incentives to increase prices post acquisition. That analysis, (up-dated), is described at Section 3.2 of NERA's report. In the previous application, the analysis was based on CWH estimates of gross margin and **[REDACTED]**. Those customers represented approximately **[REDACTED]** of post merger volume in the North Island and **[REDACTED]** in the South Island.

15.4 In the current NERA analysis, **[REDACTED]**

15.5 NERA's analysis indicates:

(a) CWH would have to lose only **[REDACTED]**% or **[REDACTED]** million kgs (previously **[REDACTED]**% or **[REDACTED]** million kgs) of its North Island volume to make a 5% price increase in the North Island unprofitable; and

(b) CWH would have to lose only **[REDACTED]**% or **[REDACTED]** million kgs (previously **[REDACTED]**% or **[REDACTED]** million kgs) of its South Island volume to make a 5% price increase in the South Island unprofitable.

15.6 To put those volumes in context[44]:

(a) in the North Island, **[REDACTED]** of CWH's clients scour more than the critical loss level by themselves **[REDACTED]** while **[REDACTED]** scours **[REDACTED]** million kgs and **[REDACTED]** other customers scour between **[REDACTED]** and **[REDACTED]** million kgs; and

[44] **[REDACTED]**

(b) in the South Island, **[REDACTED]** of CWH's clients scour more than the critical loss level by themselves (**[REDACTED]**), while a further **[REDACTED]** scour more than **[REDACTED]** million kgs each.

15.7 This analysis suggests that the loss of only one customer, or alternatively the loss of a relatively small amount of volume from a range of these customers, will have a material impact on CWH's post-merger profitability.

Domestic competition today

15.8 There are currently two providers of commission wool scouring services in New Zealand: CWH and NZWSI. The Commission considered in Decision 725 that, despite its limited commission scouring (the majority of its scouring being for its own wool purchase/export business), NZWSI places an indirect, but real, constraint on CWH:[45]

> That is, should Cavalier Wool increase its scouring prices to merchants, those merchants will become less competitive compared to WSI's trading arm. WSI would then be able to pay a higher price for farmers' wool relative to merchants facing higher scouring charges and/or offer lower prices to end consumers for scoured wool, therefore increasing its market share in scouring markets compared to that of Cavalier Wool.
>
> WSI's ability to capture volumes from Cavalier Wool is limited in the short-term by its scouring capacity. While WSI advised that it does run at maximum capacity at times in the peak season, it does generally have some excess capacity which would allow it to increase its market share.

15.9 CWH considers that the existence of alternative scouring options remains important and something which merchants both seek to develop and utilise to protect them should CWH seek to increase prices. However, a merchant's options are not limited to existing New Zealand participants.

15.10 In Decision 725 the Commission properly concluded that merchants (either individually or collectively) would have the incentive to either sponsor entry, or to enter themselves if they faced a price increase of 5-10%.[46] Such a move would result in a permanent loss of business for CWH, which would have major impacts on CWH's ongoing profitability, as shown by NERA's critical loss analysis. The Commission also recognised this same outcome in Decision 666 concluding that "[g]iven the importance to CWH that it maintains high capacity utilisation, even the threat of entry may be sufficient to constrain the combined entity"[47] and, hence, that *de novo* new entry would satisfy the LET test. It remains the case that given the critical importance of volume efficiencies, any threat by merchants to CWH that they would move some of their scouring business to another scourer (wherever located) or commence their own operations is a potent threat. In particular, in Decision 725, the Commission noted that Segard Masurel indicated there was potential for it to enter should CWH sufficiently provoke it to do so and Wool Equities Ltd had announced its interest in acquiring NZWSI should the opportunity arise.

15.11 CWH has, since Decision 725, continued to operate under the threat of merchants switching to Chinese scours to scour wool or establishing their own scour operations, which have constrained prices. The growth of the Asian scouring industry (with the entry of Malaysian CWP) and the imperative for CWH to seek to compete with Asian scouring tariffs to remain competitive are the primary constraining factors facing CWH today.

Constraint from overseas wool scourers

15.12 As already described, around 92% of New Zealand's wool is exported. Merchants can export wool to supply their customers overseas in either clean (i.e., scoured) or greasy form. If merchants are required to deliver a clean product to an offshore merchant, then they may

[45] Decision 725, p 24.
[46] Decision 725, para 168 and 179.
[47] Decision 666, para 174.

acquire scouring services outside New Zealand. On the basis of Beef and Lamb Industry Organisation Statistics for the 12 months to June 2014, around 28% of the total New Zealand wool exports were in greasy form (compared with 26% for the 12 months to June 2010).

15.13 Accordingly, CWH competes every day with wool scourers in offshore markets to provide scouring services. The constraint imposed by offshore providers of scouring services is particularly evident in relation to China.

A. 25% of wool exports (24% of New Zealand's wool clip) are already scoured in China

15.14 As described above, China:

(a) is the largest manufacturer of wool textiles and clothing in the world accounting for at least one third of the world's raw wool used for processing and manufacturing;

(b) since the time of the previous application has become the largest grower of wool;

(c) is the largest importer of wool in the world accounting for 47% of the world's wool imports (slightly down from 49% at the previous application),[48] with its share of the world's imports having grown from 3% in 1990 (reflecting an increase in imports from 35,111 tonnes in 1990 to 305,764 tonnes in 2012).

15.15 While China's broader wool industry has grown, correspondingly other major manufacturers have retrenched with imports by Western European countries (Italy, Belgium, Germany, France, Denmark, Spain and Portugal (together)) falling from 373,287 tonnes in 1990 to 104,465 tonnes in 2012 (although this is slightly up from the 98,287 tonnes in 2009), which represents a 72% fall. Similarly imports into the US fell from 41,271 tonnes in 1990 to 4,931 tonnes over the same period.[49]

15.16 China is New Zealand's most important wool export market. In the 12 months to June 2014, 50% of New Zealand's wool exports were sent to China; 50% of those exports were in greasy form.[50] In other words, 25% of New Zealand's wool exports are being scoured in China, which indicates the extent of competition CWH faces from Chinese scourers.

15.17 Figure 2 shows that both scoured and greasy exports to China have been increasing over recent years, and have increased since Decision 725.

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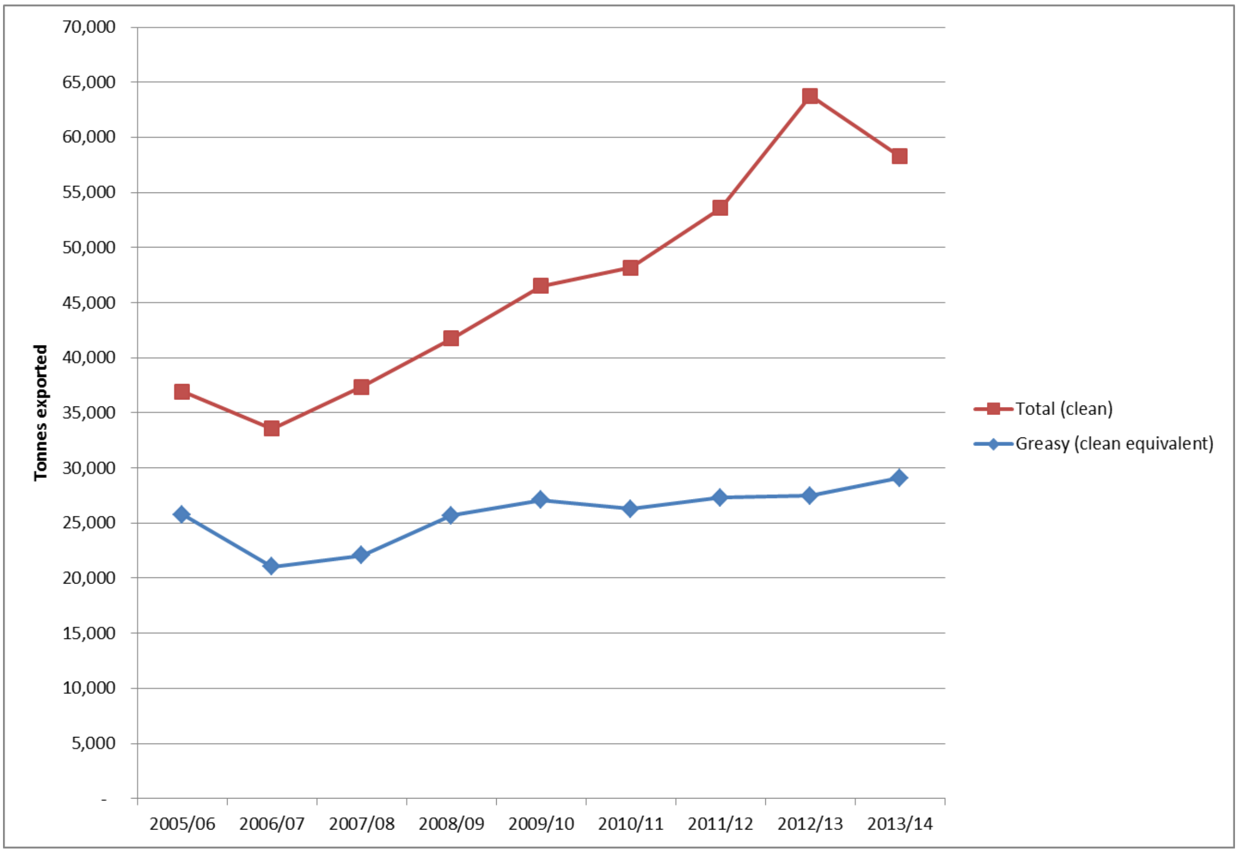
[48] The actual volume of China's imports has remained static over this time at around 305,000 tonnes, but total global wool imports have risen slightly.

[49] The next largest importer of raw wool is India with 11.5% (up from 10% in 2009). IWTO Market Information 2013, Table 22, p 32.

[50] In the 12 months to June 2014, 58,136 tonnes of wool (greasy, scoured and slipe (clean equivalent)) were exported to China. New Zealand's total exports of all wool (greasy scoured and slipe) were 116,467 tonnes (clean equivalent). Greasy wool comprised 28,948 tonnes (clean equivalent (with Beef + Lamb using a yield of approximately 74.6% given the higher proportion of fine wool going to China)) of the 58,136 tonnes (clean equivalent) exported to China. Wool Exports July to June 2013-2014 (Table 6.1), Beef and Lamb New Zealand. By comparison, in the 12 months to June 2010, 46,282 tonnes of wool (greasy, scoured and slipe (clean equivalent)) were exported to China. New Zealand's total exports of all wool (greasy, scoured and slipe) were 122,893 tonnes. Greasy wool comprised 26,384 tonnes (clean equivalent) of the 46,282 tonnes (clean equivalent) exported to China. Wool Exports July to June 2009-2010 (Table 6.1), Beef + Lamb New Zealand, available at http://www.beeflambnz.com/.

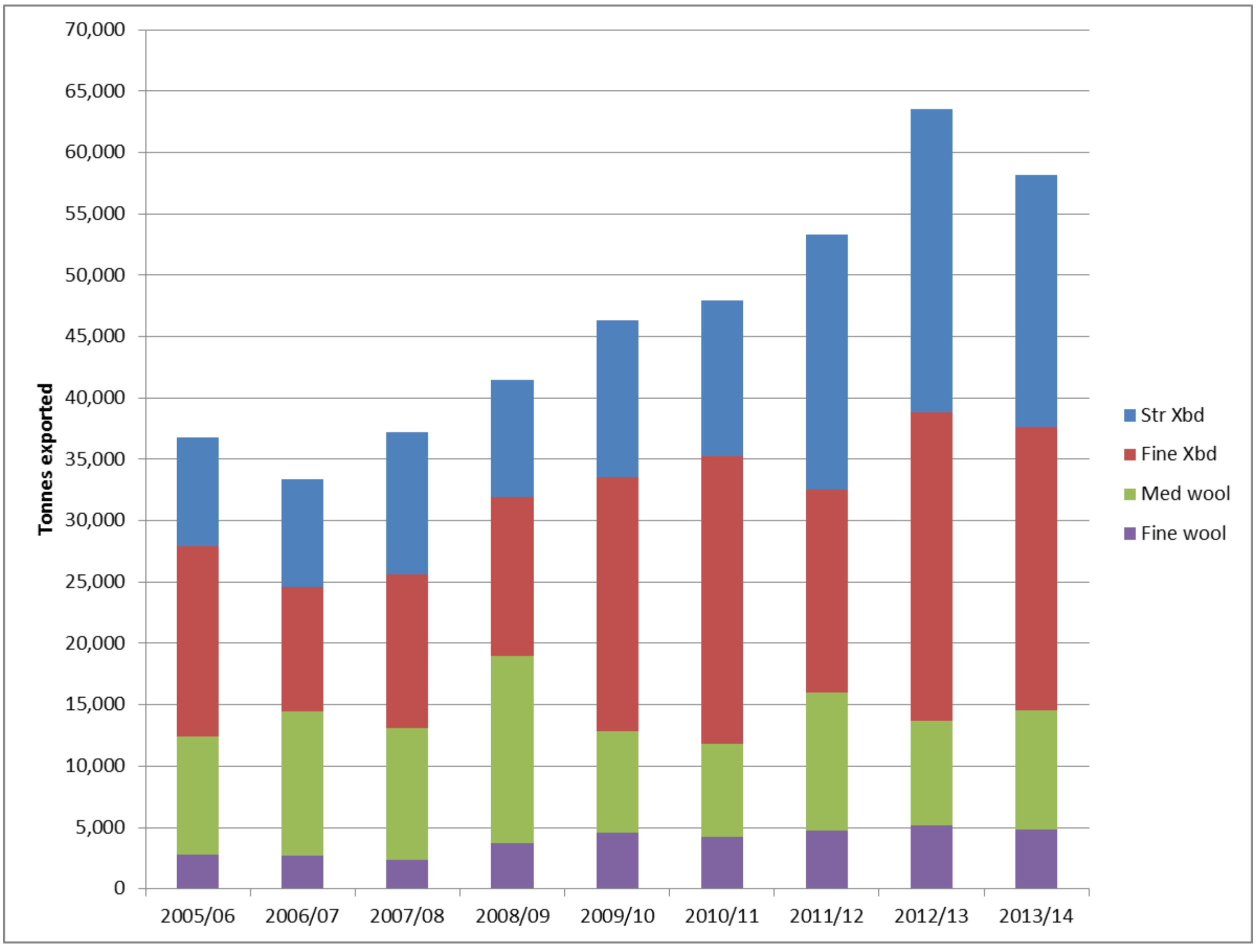
Figure 2: New Zealand Wool Exports to China over the Past Nine Years[51]



15.18 Further, as noted by the Commission in Decision 725, the Chinese wool industry uses all types of wool, not just fine wool. The amount of coarse wool being exported from New Zealand to China has continued to increase over time following Decision 725, as shown in Figure 3.[52]

[51] This figure uses clean wool weights exported. One kilogram of greasy wool is equivalent to about 0.77 kilograms of clean wool (based on output figures from the Lanolin Trading Company (this varies by wool type, among other aspects)).
[52] Note course wool is represented by Str Xbd in the graph.

Figure 3: Types of wool exported from New Zealand to China



B. Overseas wool scouring is economic for New Zealand wools

15.19 This degree of scouring of New Zealand wool in China is unsurprising given the large Chinese customer base and the fact that Chinese wool scours are extremely cost competitive. CWH understands scouring prices to be similar to those that applied under the previous application. In addition, the new CWP plant in Malaysia is specifically aimed at scouring wool from New Zealand (and other wool exporting countries) and is located near a key freight hub. This also makes CWP a very cost competitive scouring alternative for New Zealand wool exporters.

15.20 Chinese scours remain a cost competitive option for New Zealand wool. This cost advantage arises because Chinese scours operate with cheaper labour, lower effluent management controls and now have an industry scale that is highly efficient in grease extraction. Using the approach accepted by the Commission in Decision 666, CWH has set out comparative tariffs for crossbred and fine wool, both that destined for China and for Europe, at Confidential Annexure B. It has also included tariffs for CWP, the recent Malaysian entrant. The resulting figures are included in the table below. These figures include all relevant costs such as transport, tariffs/duties and pressing.

Table 3: Comparative costs of wool scouring for exports destined for China and Europe (cost in cents, per greasy kg)[53]

	CWH (post transaction (2016))	**China** (lower / upper level of tariffs given range of scours in China)	**CWP** (as per CWP Schedule July 2014)
Crossbred wool destined for China	**[REDACTED]**	**[REDACTED]**	**[REDACTED]**
Crossbred wool destined for Europe	**[REDACTED]**	**[REDACTED]**	**[REDACTED]**
Fine wool destined for China	**[REDACTED]**	**[REDACTED]**	**[REDACTED]**
Fine wool destined for Europe	**[REDACTED]**	**[REDACTED]**	**[REDACTED]**

15.21 For substantial committed volumes, prices can be expected to be discounted further.

15.22 The Chinese Government has set the duty applied to imported wools at a level which has the effect of making scouring greasy wool in China more cost competitive. A 17% charge continues to apply to imported clean wools while only 13% is applied for greasy wools, as set out in the previous application. This serves to exacerbate the price advantage enjoyed by Chinese wool scourers.

15.23 It is becoming increasingly viable for a merchant to export greasy wool to China or Malaysia and then to re-export that wool to a customer in another country. If the wool is exported processed or semi-processed from China the exporter can recover the import duty of 13%, eliminating duties as a potential barrier to re-exporting. For example, the 2013/14 financial year saw a 5.7% increase in finished carpet exports from China.

C. Chinese wool scouring is of commercially acceptable quality

15.24 CWH acknowledges that some parties have, in the past, expressed concerns with the quality of the services offered by Chinese wool scourers and issues associated with time delays and logistical problems.

15.25 Nevertheless, any issues which may exist have not been sufficient to outweigh the commercial advantage of having wool scoured in China, particularly given the growing end use demand in China. This is evidenced by the fact that half of all New Zealand wool destined for China and 25% of all New Zealand's wool exports are exported greasy to China i.e., are scoured by Chinese scourers.

D. No barriers to expansion – Chinese wool scouring industry is expanding

15.26 The Chinese scouring industry has been expanding and its capacity to grow is almost unlimited. Based on its own market intelligence, CWH understands that there are over 100 scour lines in China. Some of the major scours in China CWH understands to be of

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[53] Exchange rate of $0.79 ND/USD employed.

international standards (and which the Applicant believes continue to operate since the time of the previous application) are:

(a) Fine Wool Spinning Factory of Jiangsu Group;

(b) Hebei Diamond Cashmere Products;

(c) Inner Mongolia Muwang Co;

(d) Reward Ningbo Wool Industry;

(e) Zhejiang Xinao Textiles Group;

(f) Charguers;

(g) Schneider;

(h) JingAo Scour Company (Jiang Su);

(i) ZhongAo Top Company (trade free zone Zhang Jia Gang); and

(j) Tianyu Wool Industry Co, Zhangiagang.

15.27 CWH understands that the top 18 scour lines in China have a combined capacity of 375,000 tonnes, which is almost twice New Zealand's approximately 200,000 tonne capacity (this has not changed since the time of the previous application).

15.28 The expansion of the industry is exemplified by the fact that in 2010/11, Chinese interests acquired the wool scouring plant which became available due to scouring plant closures in Australia and Germany. Indeed, since the time of Decision 725 strong Chinese demand for second hand plants has continued, such that there are currently few on the market. A further example is Tianyu's move to install three 3.0 metre "Top Master" scour lines. The capacity of this plant alone exceeds the capacity in the North Island post acquisition.

15.29 Closures of scours in Australia, a larger exporter of wool than New Zealand, reflect the expansion and constraint imposed by Chinese wool scourers. This is illustrated by the comments from the Managing Director of Jandakot Wool Washing Pty Limited made in January 2009 when announcing the cessation of Jandakot's wool scouring operations in Western Australia:

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

15.30 In Decision 725 the Commission accepted that the "size of the Australian wool scouring industry has been severely reduced by competition from Chinese wool scours"[54] and recognised that "the Chinese scouring industry poses a significant long term competitive threat to the domestic industry in New Zealand."[55]

[54] Decision 725, para 129.
[55] Decision 725, para 128.

E. Chinese scouring does and will constrain CWH

15.31 A merchant's ability to utilise, or threaten to utilise, Chinese wool scourers continues to provide a compelling constraint on CWH's scouring tariffs.

Merchants have a presence in China

15.32 The majority of CWH's customers are active in the Chinese market with accredited representatives, with the following maintaining offices in China:

(a) Chargeurs Wool Trading Corporation, (Shanghai);

(b) H Dawson Sons & Co (Wool) Ltd;

(c) Michell, (Jiangsu);

(d) Standard Wool, (Nanjing); and

(e) Schneider.

15.33 All of these firms operate internationally and most have offices in several countries around the world. With established Chinese operations, these customers can readily access Chinese scour operators and, indeed, Chargeurs and Schneider have their own scours in China which they control.

15.34 **[REDACTED]**

Any loss of volume tends to be permanent

15.35 As already discussed, the profitability of wool scourers is highly sensitive to volume loss. NERA's critical loss analysis indicates that it would take very little diversion of demand to make a price increase unprofitable.

15.36 This is a dynamic constraint because CWH's ability to "win back" volume lost to China is difficult given the cost advantages that a merchant can extract and the permanent move of the world's wool processing base to China.

Constraint extends beyond just clean wool destined for China

15.37 The constraint imposed by Chinese scourers is not limited to only the clean wool currently scoured in New Zealand which is subsequently exported to China.

15.38 For its part, CWH has certainly not given up on attracting back some of the greasy wool exports, to be scoured in its plants and has every incentive to pursue that volume. CWH does not have the ability to discriminate its scouring tariffs depending on whether a customer presents a consignment destined for China as compared to some other destination.

15.39 Market practice is for a merchant and CWH to establish standard scouring tariffs and rebates and terms of supply periodically. These standard terms are then applied for any volumes of greasy wool that merchant decides to have scoured by CWH. Furthermore, CWH has limited visibility over the ultimate destination of wool prior to accepting a consignment.[56]

15.40 It follows that when setting the scouring tariff/terms of supply, CWH has no way of knowing whether a customer will utilise CWH to scour wool that is ultimately destined for China or wool that is ultimately destined for another market. Since it cannot determine the destination

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[56] **[REDACTED]**

prior to setting price, its ability to price discriminate is negligible to the point of being non-existent. Accordingly, the latent threat of a merchant scouring greasy wool in China instead of with CWH is a real constraint regardless of its ultimate destination, particularly given the impact on CWH of losing additional volumes.[57]

15.41 Importantly, the commercial and market place reality is that CWH's relationship with its merchant customers does not consist of a series of one-off negotiations whereby each party seeks to secure the best deal for each particular consignment of wool ignoring the longer term relationship implications.

15.42 As the Commission noted in Decision 725, "the boundary between greasy and scoured exports to China may be quite fluid. Some industry participants indicated that wool that has switched from clean to greasy exports to China is lost permanently, while others commented that at least some scoured volumes could be won back to New Zealand."[58]

15.43 To illustrate, CWH is and must be mindful of the ramifications of increasing prices to a customer for a consignment of wool for which Chinese scouring is not a viable alternative. Increasing the price for that consignment may result in that merchant retaliating by:

(a) shifting other wool consignments away from CWH;

(b) substituting overseas greasy wool for New Zealand wool in situations where the final destination is not China; or

(c) either alone, or together with other merchants, sponsoring the entry of a new scourer into New Zealand.

15.44 Over the medium term, any of these outcomes will exacerbate the competitive threats faced by CWH and expose it to further volume losses and increasing unit costs. As NERA's critical loss analysis indicates, it would not take a large loss of supply for a price increase to be unprofitable. Even if the Commission was of the view that constraint was limited to clean wool destined for China, approximately 25% of New Zealand's wool exports (or 24% of the wool clip) are currently exported in clean form to China and hence the prospect of losing a proportion of this volume would materially constrain CWH.

15.45 The Commission concluded in Decision 725:[59]

> The competitive pressure from China...may constrain price increases for sales to China, especially as it appears possible to price discriminate in favour of Chinese sales at least to some extent. Prices to other parties exporting to Australia or Europe, or for domestic production, could increase. However, such price increases would be capped by the possibility of entry and the ability for merchants to switch at least some of their sales from other markets to greasy wool exports to China. Alternatively, if price discrimination is not possible in the longer-term, it may be profitable for the combined entity to forgo a proportion of the wool currently scoured for China, in order to increase prices to exporters who have no real alternative to scouring in New Zealand. Again, price increases would be capped by the possibility of entry and the ability for merchants to switch at least some of their sales from other markets to greasy wool exports to China...
>
> Nevertheless, the Commission does recognise that the Chinese scouring industry poses a significant long term competitive threat to the domestic industry in New Zealand.

15.46 Further, at the time of the previous application, Godfrey Hirst had considered the possibility of moving its carpet manufacture to China. The Commission noted in Decision 725:[60]

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[57] In any event, given the scouring cost advantages enjoyed by Chinese mills and CWP the potential exists for merchants to export greasy wool to China for scouring and then re-export to customers in Europe and other markets.
[58] Decision 725, p 25.
[59] Decision 725, p 28.

> The Commission notes that Godfrey Hirst stated that it has considered the possibility of moving its carpet manufacture (particularly its more expensive plant) to China. Were scouring prices to increase too far in New Zealand, Godfrey Hirst appears to be saying there is a real risk that manufacturing may move offshore, causing an irreversible loss of volumes for New Zealand wool scourers.

15.47 CWH considers it remains the case that New Zealand manufactures could move production plants overseas, thereby more easily utilising overseas scours.

19. Potential Competition

19.1 While in Decision 725 the Commission concluded "potential competition is unlikely to occur within a two year timeframe to an extent that would be sufficient to constrain the combined entity and prevent the effect of a substantial lessening of competition in the relevant markets"[61] it did conclude that entry would be likely to occur with a price increase of at least 5-10%.[62]

19.2 The Applicant agrees with this conclusion, and considers entry would be likely to occur in response to a moderate price increase.

19.3 Given the likelihood of constraining entry, the Commission was of the view that potential entry would provide some constraint. In the Applicant's view, this likelihood of entry will be sufficient in itself to constrain the Applicant particularly, as the Commission accepted, it is important that CWH maintains high capacity utilisation.

19.4 The Applicant sets out below the considerations applied by the Commission in Decision 725, updating the information where necessary.

Requirements for new entry

<u>Production site with necessary consents</u>

19.5 The Commission concluded in Decision 725 that a new entrant was unlikely to face significant difficulties finding a suitable site for a scouring operation in the South Island. The Commission did find a new entrant in the North Island may incur modest difficulty in locating a suitable site, but concluded this was not a significantly high barrier. The Applicant adopts the findings of the Commission in this regard. As the Applicant sets out below, there have been no significant changes which would cause a production site with the necessary consents to be more difficult than at the time of Decision 725.

19.6 In terms of the North Island, it remains the case that new wool scouring operations could be sited within the Awatoto or Whakatu/Tomoana industrial areas. There remain no planning provisions or water/trade waste capacity restrictions that would create any substantive barrier to establishing such an operation in the Hawkes Bay. The same sites listed in Hawkes Bay in Decision 725 remain available and continue to be able to meet the environmental requirements to support a new scour operation.

19.7 In the South Island, it remains the case that a new scouring business could be established as a permitted activity in the Industrial H zone of Timaru (provided it met with all the parking, coverage and other requirements). Further, more land has been opened by the Timaru District Council since the time of Decision 725. The plan change stipulates a staged development with the first stage being the block of land between Seadown Rd and the coast and from the No. 1 drain by Light Leathers to half way between there and Aorangi Rd. Some of it has already been developed, but the area on the east of Meadows Rd that is available is

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[60] Decision 725, para 132.
[61] Decision 725, para 186.
[62] Decision 725, para 187.

about 22 hectares and there is about 8 hectares between Seadown Rd and the adjoining railway land.

19.8 CWH considers **[REDACTED]** in land costs, with **[REDACTED]** for buildings, to be an appropriate figure.

Scouring equipment

19.9 As noted in Decision 725, the specialised plant and equipment necessary for entry into the wool scouring industry can be purchased new from Timaru based engineering company, ANDAR Holdings Limited, and Chinese manufacturers, or potentially second-hand from overseas. The Commission concluded the most likely entry costs to be approximately $10 million for a second-hand 2.4 metre line and approximately $20 million for a new 3 metre line.

19.10 CWH has conservatively considered the cost of a new scour in the current application, rather than estimating the cost of entry on a second hand scour. CWH understands the former manager of ANDAR is now working in China building new 2.5 meter wool scours for approximately **[REDACTED]**, and as such entry is likely to be considerably cheaper than previously considered by the Commission. Plants range in price depending on technology / extras that come with the machine. CWH understands Sunshine has recently purchased a good quality 2.4m line for **[REDACTED]**. CWH has conservatively estimated **[REDACTED]** for a plant to be purchased and set up in New Zealand. Once the remaining scouring equipment is considered, CWH considers total plant costs for a new entrant could be as little as **[REDACTED]**.

Access to sufficient quantities of wool

19.11 As the Commission noted in Decision 725, a potential new entrant could be a wool exporter, or group of exporters, perhaps combined with a downstream user such that the entrant could secure enough wool for an economic scouring operation through its own wool trading and/or wool purchasing arms, or a large domestic downstream user. This remains the case.

Significant economies of scale

19.12 **NZCC said (p33-34):**

> The Applicant has stated that the Acquisition would result in significant economies gained by the rationalisation of the number of wool scour lines and operational sites to achieve better capacity utilisation and lower fixed and variable costs. Cavalier Wool's lower average unit cost arising from the rationalisation would give it the ability to act strategically and lower prices in response to entry. An entrant could face the significant risk of the under utilisation of its assets.
>
> Cavalier Wool in its Application states that its combined administration and scour operating expenses would be reduced by **[REDACTED]** in the North Island and **[REDACTED]** in the South Island after the acquisition. Therefore, it is likely that, post acquisition, Cavalier Wool's costs would be significantly lower than the present industry cost structure. Even if an entrant was able to enter on the same scale as a current industry competitor, it would initially face a significant cost disadvantage in doing so.

19.13 A new entrant, however, may have a significant advantage, depending on the initial set up costs. A small standalone plant that can wash 20,000,000 greasy kilograms could be set up for **[REDACTED]** total (including plant, buildings, land and **[REDACTED]** in working capital) and with very low overheads, i.e., **[REDACTED]**. If established by merchants, captive volumes will underwrite its costs while it seeks to win further customers away from CWH. CWH will be highly leveraged under the restructured model and debt will be an issue. CWH considers a new entrant poses a very real threat to the merged business.

Entry in both islands

19.14 The Applicant agrees with the Commission findings in Decision 725 that entry would not be required to take place in both islands simultaneously, if at all. Nothing has changed to dispute the Commission's findings that:[63]

> Wool scouring operations are run as standalone units and there do not appear to be any large efficiency gains that would be available to a two island operation.
>
> Moreover, given one of the main requirements for entry is the availability of sufficient wool to ensure economic capacity utilisation of the scouring plant, it is likely that entry by merchants or downstream customers would be more likely to occur in the particular island where the largest part of their wool business was located. If Cavalier Wool did discriminate against customers of the new entrant, this would likely spur further entry. In the Commission's view such discrimination would not be a profit maximising strategy for Cavalier Wool.

21. The LET test

21.1 The Commission concluded in Decision 725 that the potential for new entry into the scouring market provides only a moderate constraint on CWH in the factual in that entry would only be likely to occur with a price increase of at least 5-10%.

21.2 Unlike the previous application which was for a complete takeover of NZWSI, the current proposal is for a merger scenario, and it is difficult to know how customers will react. If customers are unable to compete with NZWSI, or feel that the NZWSI trading entity is being favoured they are more likely to react and enter or support the entry of a new wool scourer.

Wool Grease Market

21.3 As stated above, Lanolin Trading, which CWH and NZWSI owned in equal shares at the time of the previous application, is no longer trading. The parties instead each sell raw wool grease individually into the open market, as by-product of their wool scouring. The majority of raw wool grease is sold to overseas customers, with the small remaining volume purchased by a small number of New Zealand firms. Customers refine the raw wool grease for use as an input in a wide range of intermediate and final products (e.g., lanolin and lanolin products such as cosmetics).

21.4 As the Commission noted in Decision 725, barriers to entry in the wool grease market are low and "an entrant into scouring markets would have no difficulty selling its wool grease by-product at favourable prices by supplying the international demand mentioned above..." The Commission concluded the transaction would not have the effect or likely effect of substantially lessening in Decision 725 competition in the wool grease market. Therefore, the Applicant does not propose to make further submissions on this point, but is happy to answer any questions the Commission may have.

Effects of the acquisition in downstream carpet markets

21.5 The Applicant adopts the findings of the Commission in Decision 725 in relation to the effect of the transaction in downstream carpet markets. As the Commission noted, any attempt to raise downstream carpet manufacturers' costs will be limited by entry or the threat of new entry. Further, the presence of other market participants, imports and competition from synthetic carpets would not allow Cavalier Bremworth to raise carpet prices significantly in the event scouring foreclosure was successful.

21.6 In any event, post-transaction Cavalier Bremworth will no longer be the majority shareholder in CWH (as noted above at paragraph 4.3, Cavalier Bremworth will hold only 27.5% of

[63] Decision 725, p 34.

shares in CWH). As such, there will be no incentive for CWH to penalise downstream carpet makers, given the majority of the shareholders would only share the losses of such a strategy and none of the profits. Cavalier Bremworth will no longer have a degree of unilateral control of CWH post-transaction.

22. Countervailing Power of Buyers

22.1 In Decision 666 the Commission concluded that merchants were likely “to continue to exercise significant countervailing power” due to the “presence of NZWSI, the possibility of scouring some wool offshore, and the threat of entry” and merchants’ continued “ability to switch, or to credibly threaten to switch.”[64]

22.2 While the Commission did not make any express mention of the countervailing power of merchants in Decision 725, the High Court noted that as a scouring price increase of 5% to 10% would represent a significant erosion of the merchants’ margins, merchants “have a strong incentive to exercise any countervailing power they might have”, as the Commission had recognised in Decision 666.[65] The High Court noted that “it is apparent the countervailing power of merchants must diminish in the factual with the removal of NZ Wool Services and in the view of the Commission’s finding that potential entry failed the “LET” test.”[66] However, the Court also noted that “It is the threat of new entry and of increased greasy volumes to China that would enable merchants to exercise some countervailing power in response to price rises in the factual.”[67]

22.3 For the reasons explained above, CWH still regards merchants and other customers as having a degree of countervailing power. While NZWSI will no longer be an independent option, the other options available to merchants will be sufficient to prevent any attempt by CWH to increase prices above competitive levels.

Part 6: Other Factors

23. Other factors

23.1 Not applicable.

24. Annual reports

24.1 Attached as Confidential Annexure C is CWH’s most recent audited financial accounts.

24.2 Attached as Annexure D is NZWSI’s most recent audited financial accounts.

Part 7: Public Benefits and Detriments

25. Benefits to the public

Summary of benefits to the public

25.1 The acquisition will result in such material and demonstrable benefits to the public that it should be permitted.

25.2 The quantified benefits identified by CWH constitute benefits accepted by the Commission in Decision 725 as public benefits arising from the transaction. The assessment of these

[64] Decision 666, para 194.
[65] *Godfrey Hirst NZ Ltd v Commerce Commission* HC Wellington CIV-2011-485-1257, [2011] NZHC 691, para 31.
[66] *Godfrey Hirst NZ Ltd v Commerce Commission* HC Wellington CIV-2011-485-1257, [2011] NZHC 691, para 152.
[67] *Godfrey Hirst NZ Ltd v Commerce Commission* HC Wellington CIV-2011-485-1257, [2011] NZHC 691, para 157.

benefits has been updated using the approaches endorsed by the Commission in that decision and the High Court on appeal.

25.3 The primary commercial benefits arise from the consolidation of CWH's and NZWSI's scouring lines from five sites to two sites generating cost savings and improved economies of scale and enabling the Whakatu, Kaputone and Clive sites to be released for other uses.

25.4 CWH has every incentive to pursue these efficiency gains because they will enable CWH to operate at a lower cost and offer a higher quality scouring service, thereby improving CWH's ability to compete more effectively with Asian scourers.

25.5 The public benefits largely mirror these commercial benefits, although additional benefits will flow as a by-product of the capital works required to consolidate the wool scours. The capital changes will enable CWH to provide a higher quality scouring service to merchants which will be of benefit to them. In turn, this can be expected to increase demand for CWH's scouring services (all else being equal) creating further commercial benefits for CWH.

25.6 There are also benefits which will arise which cannot be readily quantified but are no less important and should be considered in the Commission's assessment.

25.7 None of the benefits can arise in the counterfactual.

25.8 Each element of public benefit is discussed in detail in the following paragraphs, but the public benefits are summarised in the table below, alongside the corresponding totals determined by the Commission in Decision 725:

	Decision 725 – 5 year NPV	**Updated – 5 year NPV**
Total benefits	**$29.6 to $33.6 million**	**$30.35 million**
• Non capital cost savings (economies of scale benefits, rationalisation of overheads / labour costs etc)	**[REDACTED]**	**[REDACTED]**
• Sales of surplus land and buildings	$8 million (midpoint of $6.0 to $10.0 million)	$12.65 million (including plant and equipment)
• Capital expenditure on land and buildings	**[REDACTED]**	**[REDACTED]**
• Capital expenditure on plant	$0.9 million benefit	($1.09 million) cost
• One off rationalisation costs	**[REDACTED]**	**[REDACTED]**
• Cartage **[REDACTED]**	N/A	**[REDACTED]**
• Superstore	$7.2 million	Not quantified, see para 25.47 on below

25.9 In Decision 725 the value of land was disputed and the Commission adopted a range for that benefit, giving a range for benefits overall. In the current application CWH and NZWSI have agreed a valuation based on third party valuations.

Non-capital costs savings – economies of scale benefits

CWH will realise industry cost savings of **[REDACTED]** per year or **[REDACTED]**over five years (updated from the **[REDACTED]**per year or **[REDACTED]**over five years accepted by the Commission in Decision 725) as a result of consolidating the wool scours. This equates to **[REDACTED]** per greasy kilogram processed.

25.10 The wool scouring business is driven by economies of scale with major benefits accruing to firms best able to utilise capacity. The Commission accepted this in Decision 725, and accepted cost savings of **[REDACTED]** per annum, with a five year NPV of **[REDACTED].** These cost savings are estimated to be even greater in respect of the proposed transaction, as described further below. At the same time, CWH will retain more than enough capacity to meet expected demand.

A. Rationalisation of plant

25.11 The acquisition will enable CWH to achieve increased economies of scale by rationalising the five plants currently operated by CWH and NZWSI to two. This will enable it to reduce both the operating and overhead costs associated with operating the scours. This reduction in operating costs per unit will enable CWH to more effectively compete to provide scouring services for the reducing New Zealand wool clip.

25.12 As outlined above in response to Question 5, following the acquisition CWH will:

(a) relocate the NZWSI 3.0 metre scour line currently located at Whakatu to its Awatoto plant;

(b) relocate the NZWSI 3.0 metre scour line at Kaputone to its Timaru plant;

(c) close CWH's scour line at Clive in the Hawkes Bay – this is currently used to cover emergencies and peaks in demand. This will no longer be needed post acquisition (and as discussed above will either be sold **[REDACTED]**); and

(d) close and sell CWH's 2.4 metre scour line at Timaru. CWH will also move the boiler from Kaputone to Timaru.

B. CWH will retain sufficient capacity to meet demand

25.13 Despite this rationalisation of capacity, based on current production figures (and estimated production figures for NZWSI) and the modifications CWH will make to the remaining scour lines, CWH will retain around 41.7% (previously 16.7%) spare capacity in the North Island and 28.4% (previously 21.6%) spare capacity in the South Island.[68] Given the benefits to be gained from increased production, it will have every incentive to seek to utilise this capacity to the fullest extent possible.

C. Total non-capital savings attributable to the transaction

25.14 CWH will obtain cost savings as a result of the transaction due to a reduction in non-capital costs, such as salaried and wage staff costs, administration expenses, repairs and maintenance costs, reductions in variable electricity, electricity lines charges and coal and gas costs, and a reduction in effluent system costs. Key areas of cost savings are described in further detail below, but do not cover all non-capital cost savings (details of which will be provided to the Commission).

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[68] This is based on the budgeted increase in the Whakatu line to **[REDACTED]** greasy kgs per hour. If, as management expect, throughput increases to a greater amount, then the level of excess capacity would increase. The modifications are described in detail above in response to Question 5. The capacity figures are based on 2015/16 forecasts.

25.15 CWH has estimated the cost savings that arise as being **[REDACTED]** per year or **[REDACTED]** over five years. This equates to **[REDACTED]** per kilogram of greasy wool processed. These savings were previously considered by the Commission to be **[REDACTED]** per year or **[REDACTED]**over five years.

25.16 As with the estimates accepted by the Commission in Decision 725, CWH's estimates are based on the level of production remaining largely unchanged as between the factual and the counterfactual. In reality, the reduction in costs resulting from the merger is likely to allow CWH to compete more strongly to recapture some of the volume it has lost to China such that volumes are more likely to be higher in the factual than the counterfactual (thus leading to greater efficiencies than forecast).

25.17 The types of cost savings claimed are those accepted by the Commission in Decision 725 and updated to accord with present circumstances. CHW has excluded cost savings claimed in the previous application that were not accepted by the Commission, namely savings on the fringe benefit taxes for cars and the savings on council rates.

25.18 The cost savings accepted by the Commission were supported in the High Court as public benefits as they are reduced inputs to achieve the same outputs, regardless of whether CWH passes on the cost savings in the factual. Further, the High Court noted the Commission was cautious in analysing the level of savings and considered no further downward adjustment was required. CWH has again employed the conservative estimates accepted by the Commission and the High Court previously. CWH have set out the main areas where savings are expected below.

Reduction in salaried and wage staff costs

25.19 As a result of the rationalisation of scour lines post transaction, cost savings will be made from the salaries and wages of workers that will no longer be required.

25.20 **[REDACTED]**

25.21 **[REDACTED]**

25.22 **[REDACTED]**

25.23 The Commission previously accepted the reduction in staff costs of **[REDACTED]** as a public benefit likely to occur and this was supported in the High Court which noted:

> ...the same amount of wool can be scoured in the factual as in the counterfactual, but with fewer employees. Those employees no longer required will be available to produce other goods and services for New Zealand consumers. It follows that New Zealand's labour use is more efficient in the factual. In the absence of any evidence or submission otherwise, the Commission was not wrong to value that available resource at the price an employer is willing to pay for it (here, as evidenced by Cavalier's saved salaries and wages), allowing for the social cost of redundancy.

The social cost of redundancy mentioned in that paragraph is included in the one-off rationalisation costs calculation, at paragraph 25.46 below.

Reduction in administration expenses

25.24 The Applicant expects a reduction in administration expenses as a result of the transaction, including cost savings from: ACC levies; fire protection; information systems; insurance; general office expenses; repairs and maintenance of buildings and grounds; and security. The Commission previously accepted these as "claims of the kind that would result from a reduction in staff numbers and a reduction in the number of operating sites."

CWH has updated this figure, and expects cost savings of **[REDACTED]**. This is in comparison to the administrative cost savings in Decision 725 which were expected to be **[[REDACTED]**, with an overall increase due to increased costs, such as insurance.

Reduction in repairs and maintenance costs

25.25 The reduction of scour lines in the factual compared to the counterfactual will result in savings in repair and maintenance costs. In addition to the reduction in scour lines, the 3.0 metre currently at Whakatu will be run for fewer hours and savings will be made from roller lap and separator service reductions. In addition, **[REDACTED]**.

25.26 The Applicant therefore expects **[REDACTED]** savings in repair and maintenance costs. The Commission previously considered the reduction in scour lines to result in a savings in repair and maintenance costs of **[REDACTED]**.

Reduction in variable electricity costs and electricity lines charges

25.27 Electricity savings are expected to arise as a result of the transaction due to the rationalisation of lines and savings due to the modification of the 3.0 metre Kaputone line. Conservative efficiency savings of **[REDACTED]** have been allowed for, resulting in a cost saving for lines and variable electricity costs of **[REDACTED]**. With the closure of Kaputone, Whakatu and Clive, electricity lines, transformers and switchgear resources will be released from wool scouring to be used elsewhere. Electricity lines charges comprise demand charges and asset charges. Set off against this, additional demand charges would apply to CWH's existing plants in the factual as result of the increased production (and hence increased kilowatt requirement) from Awatoto and Timaru.

25.28 In the previous application, savings in variable electricity costs and lines charges were considered separately. Efficiency gains were expected to result in variable electricity cost savings of **[REDACTED]**. This was due to the straightening of the 2.4 metre lines at Awatoto and other planned efficiency measures. While the Commission downgraded the claimed level of savings slightly, from **[REDACTED]** claimed by CWH to **[REDACTED]**, it accepted that the electricity savings as a result of rationalisation and technical improvements were feasible and a benefit would be achieved in the factual compared to the counterfactual. The Commission also accepted a reduction in lines charges as a result of ceasing wool scouring at Whakatu and Kaputone of **[REDACTED]**. As a resource saving the reduction was considered to be a public benefit by the Commission in Decision 725. This gave an overall electricity cost saving of **[REDACTED]**.

Reduction in coal and gas costs

25.29 The Applicant expects gas cost savings as a result of the transaction due to a decrease in consumption from the closure of Clive and modifications made. The Applicant believes energy savings of **[REDACTED]** in the factual compared to the counterfactual to be likely.

25.30 The Commission previously considered energy savings as a result of decreased gas consumption of **[REDACTED]** arising from the transaction. These savings were accepted to be the result of modifications contingent on the acquisition and the mothballing of Clive.

Reduction in effluent system costs

25.31 In addition, CWH expects significant cost savings as a result of ceasing to use the effluent system at Kaputone. **[REDACTED]**. An effluent system is a full or partial biological system that breaks down effluent, i.e. a filtration system so effluent can be released into the Christchurch system. **[REDACTED]** This effluent system is required at Kaputone given it is in a residential area. It will not be required at CWH's Timaru site which is located in an industrial area and shares effluent disposal into an industrial plant.

25.32 **[REDACTED]** CWH claims a benefit of **[REDACTED]** as a result of the sale of the system (being a conservative estimate based on the value of the system as parts, rather than a complete effluent system), and estimates **[REDACTED]**[69] in cost savings made up of chemicals, operators wages, repairs and maintenance.[70]

Overall non-capital cost savings

25.33 Overall, non-capital cost synergies in total amount to **[REDACTED]**. This is a significant saving given the small margins enjoyed in this industry. As the Commission noted in Decision 725, merchants' margins on average sit around 15 to 20 cents per kilogram of greasy wool sold.[71] CWH believes this remains the case.

25.34 As the Commission noted in Decision 725, in order for the rationalisation benefits to occur there must be consolidation of all operating scour lines onto two sites with an associated increase in production of scoured wool at each site. This will not happen in the counterfactual.

Sale of surplus land

The proposed acquisition enables the release of the Whakatu, Kaputone and Clive sites for other uses. Applying the Commission's previous approach, this will result in a benefit of **[REDACTED]** (updated from the Commission's Decision 725 conclusion of a range of $6 to $10 million, with an NPV of $8 million with the addition of the sale of Clive).

25.35 Following the restructuring described above, the Lempriere sites at Whakatu and Kaputone and CWH's Clive site will be surplus to scouring requirements and will be released for other purposes. While at the time of the previous application CWH had yet to determine whether it would sell the Clive site, CWH now considers this site to also be surplus to requirements given the continued decline in sheep numbers in New Zealand (as discussed above). It will also be sold as a result of the transaction.

25.36 The benefit of freeing up surplus land and buildings is a public benefit, as all those resources can be redeployed to other productive uses. This was accepted without dispute in the Commission's consideration of the application resulting in Decision 725. The High Court agreed, finding:[72]

> The public benefit is that fewer land and building resources are needed for the scouring operations in the factual compared with the counterfactual, thereby releasing land for other productive uses. It is not necessary to inquire into the relative level of productivity of the alternative use. The benefit lies in the release of surplus resources for other economic uses; and the best evidence of the value of these alternative uses is the price that is likely to be paid for the surplus resources.

25.37 The parties have received recent independent third party valuations of Whakatu and Kaputone, which indicate they will contribute a benefit of **[REDACTED]** and **[REDACTED]** respectively. Similarly, the benefit of the sale of the Clive land and buildings is expected to be **[REDACTED]** based on a recent valuation. This gives a total benefit as a result of the sale of land and buildings of **[REDACTED]**. In the Applicant's view, these valuations provide the most likely benefits to be achieved.

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[69] **[REDACTED]**
[70] CWH expect some increased effluent charges at Awatoto reflecting the use of the Napier City Council effluent plant. These have been incorporated into non-capital cost savings.
[71] Decision 725, p 49.
[72] *Godfrey Hirst NZ Ltd v Commerce Commission* HC Wellington CIV-2011-485-1257, [2011] NZHC 691, para 281.

25.38 The Commission previously considered a range of $6 to 10 million for Whakatu and Kaputone sites, judging $2.5 million for Whakatu and $5.5 million for Kaputone to be the most likely sale prices. Kaputone is likely to have risen in value due to the area being marked for rebuild and the land being re-zoned residential.

Sale of surplus plant

The proposed acquisition enables the release of scour lines and the Kaputone effluent plant, resulting in a benefit of **[REDACTED]** (this plant was not to be sold at the previous application).

25.39 The Applicant also anticipates sales of plant and equipment worth **[REDACTED]** consisting of selling the Clive 2.0 metre scour line, the Timaru 2.4 metre scour line and the Kaputone effluent equipment in the South Island. These scour lines were not intended to be sold at the time of the previous application, but were to be mothballed. As discussed above, the continued reduction in wool clip has ensured these lines are surplus to requirements. In addition, the evaporation plant as part of the effluent system at Kaputone was recommissioned following Decision 725 (in August 2012), and will not be required once Kaputone has closed post transaction.

25.40 The sale of this plant has been calculated in a similar manner to the sale of surplus land and buildings above, giving a total benefit of **[REDACTED]**. To achieve the rationalisation the parties will incur capital costs on building works of **[REDACTED]** (previously **[REDACTED]**). Capital costs on plant and equipment to achieve rationalisation will be partially offset by on-going capital cost savings, with the resulting net capital cost amounting to $1.09 million.

Capital costs of rationalisation and ongoing capex savings

Cost of **[REDACTED]** (previously a benefit of **[REDACTED]**) in relation to plant & equipment costs and a one-off cost of **[REDACTED]** for necessary alterations to buildings.

Capital expenditure on buildings

25.41 As described above, CWH will undertake capital works on the Awatoto site in order to accommodate the NZWSI 3.0 meter line from Whakatu. It will also expand the capacity for wool storage at Awatoto, given Clive’s closure. Capital works will be undertaken at Timaru to accommodate the Kaputone 3.0 metre scour line and boiler. CWH has updated the capital expenditure expected in this regard and expects the total capital outlay on these alterations to be approximately **[REDACTED]** (compared to the **[REDACTED]** previously accepted by the Commission when more extensive works were required). Applying the Commission’s preferred approach in Decision 725 to calculate the effect of this capital expenditure in a similar manner to the land sales benefit, **[REDACTED]** will be netted off the benefits arising from the rationalisation.

Capital expenditure on plant

25.42 CWH has also updated the estimate of the additional (non-building) expenditure required to relocate the NZWSI scour lines at Whakatu and Kaputone to Awatoto and Timaru, relocate the Kaputone boiler to Timaru, reinstate the buildings at Whakatu, Kaputone and Clive that they can be sold and carry out necessary modifications to the remaining scour lines. This is expected to be **[REDACTED]** (previously estimated at **[REDACTED]**).

25.43 CWH spends approximately **[REDACTED]** yearly on capital projects for enhancements and improvements in productivity/efficiencies carried out in the winter months. There is no reason this would change in the counterfactual. Given NZWSI's smaller operation, it currently spends approximately **[REDACTED]** across both sites on capital projects yearly.[73] Accordingly, combined capital expenditure across the two businesses would be approximately **[REDACTED]** per year. This capex will be avoided in year 1 as it is encompassed by the rationalisation capex described in the preceding paragraph. There will also be on-going savings from this figure as described below.

25.44 CWH believes its current maintenance programme has sufficient capacity to encompass maintenance for the NZWSI scour lines (particularly given the same number of lines will result in Timaru). Accordingly, CWH believes its maintenance costs would not increase post acquisition and it would avoid expenditure currently incurred by NZWSI on winter maintenance and improvements in productivity/efficiencies. Accordingly, this would result in a cost saving of **[REDACTED]** per year. Further, economies of scale in capital expenditure will also result in savings.

25.45 The Applicant has offset the year 1 saving of **[REDACTED]** and the present value of the years 2 to 5 savings of **[REDACTED]** against the **[REDACTED]** rationalisation cost. Total capex on plant therefore amounts to $1.09 million. (The Commission in Decision 725 found there to be a *benefit* of **[REDACTED]**).

One-off rationalisation costs

25.46 CWH is expecting to pay redundancy costs of **[REDACTED]**[74] (previously **[REDACTED]**) and has again allowed for contingency rationalisation costs of **[REDACTED]** in the first year of the factual. The Commission previously concluded that the NPV of one-off rationalisation costs was **[REDACTED]** and this was supported in the High Court. The Applicant is content to adopt this methodology and so has updated the NPV of one off rationalisation costs of **[REDACTED]**. In addition, CWH has allowed for **[REDACTED]** in cartage costs for the rationalisation period. **[REDACTED]**.

Wool superstore benefits

25.47 Greasy wool that is to be scoured needs to be stored prior to scouring. Currently, brokers operate their own collection and storage facilities. Wool is then transported to the wool scours.

25.48 A 'wool superstore' refers to the concept of centralised consolidation at purpose built independent greasy wool superstores sited adjacent to one or more wool scours. Wool sorting, classing, testing and storage would occur under one roof, which would lead to the elimination of the duplication of resources currently present in the wool industry.

25.49 A wool superstore would streamline the process by which wool is currently being aggregated in New Zealand and lead to a more efficient and shortened pipeline for getting wool from the farm gate to scour and then to market (both domestic and international).

25.50 In Decision 725 the Commission concluded that the implementation of a wool superstore would "deliver real commercial gains and significant public benefit".[75] The Commission estimated benefits from the superstore in the North Island to be $4.1 million for years four and five, with a NPV value of $7.2 million.

25.51 The High Court considered that:

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[73] Material relating to exact capex for NZWSI scours will be submitted directly to the Commission by Lempriere.
[74] **[REDACTED]**
[75] Decision 725, p 93.

> the reasons given by the Commission provided an insufficient basis for it to conclude that the superstore was likely in the factual but not in the counterfactual. In particular, commercial justification and broad industry support provide an insufficient basis on which to conclude that the superstore was likely in the factual; and, in the counterfactual, it was not enough to reject the prospect of NZ Wool Services developing the concept without discussing why any other instigator was unlikely. If the benefit found from the North Island superstore had been crucial to whether or not the authorisation would be upheld, we would have considered further whether the issue should be referred back to the Commission for reconsideration or whether we had sufficient information on which we could base our own view.

25.52 The Applicant adopts the Commission's decision and reasoning on the wool superstore in Decision 725, and the benefits to be obtained. Given the benefits described in this application significantly exceed the detriments, the Applicant again claims that a benefit exists of the ability to develop a wool superstore, but does not propose at this stage to quantify it. The Applicant reserves the right to make further submissions on this point at a later date.

Other unquantified benefits

25.53 There are a range of other benefits CWH considers are likely to arise as a result of the acquisition and which are not achievable in the counterfactual. They are benefits which should form part of the Commission's weighting of the benefits and detriments.

25.54 These have not been quantified either because it is impractical to do so, or because quantification was deemed unnecessary at this stage. Further information on those benefits can be provided if the Commission desires.

A. Enhancing New Zealand's scouring industry

25.55 The acquisition will act to fortify and enhance New Zealand's wool scouring industry, an industry which employs 145 Full Time Equivalents (**FTE**s) (in comparison to 170 FTEs at the time of Decision 725) and contributes approximately **[REDACTED]** in direct wages to the New Zealand economy, with an industry revenue of approximately $58 million.

25.56 New Zealand is not immune to the trends sweeping the scouring world and associated with an aggressively expanding Asian wool scouring industry, especially with the recent new entrant in Malaysia. These trends have already seen the Australian, French, Italian and British wool scouring industries retrench to a point where they are competitively marginalised.

25.57 Indeed, while Australia produces more wool than New Zealand it now has virtually no domestic scouring industry.

25.58 While enhancing CWH's ability to compete, the acquisition will also ensure that NZWSI's scouring assets are kept in New Zealand. Many of the Australian scours which have closed have been acquired by Chinese wool scourers and relocated to China. There is every reason to believe that this could occur if the acquisition does not proceed.

B. Improvements in scouring product quality

25.59 In the application giving rise to Decision 725, the Applicant sought the benefit of improvement in scouring product quality, which the Commission recognised could have significant public benefits if it could be achieved in the scouring industry. The Commission did not put any weight on the estimated quantified benefits accruing from quality improvements from the proposed acquisition, as it was not satisfied the benefit would occur in the factual.

25.60 The High Court in its decision indicated if it had been crucial to whether or not the authorisation should be upheld, it would have considered further whether to refer the issue back to the Commission for reconsideration (with direction as to matters to be addressed).

25.61 The quality benefits will arise post-transaction because CWH's planned scour line modifications will improve the quality of the scouring service CWH will provide to merchants. Put simply, after these modifications merchants using CWH will be able to deliver the same quality (whiteness and brightness) of clean wool to their customers utilising a lower quality mix of greasy wool.

25.62 Because greasy wool that is whiter and brighter is more expensive to procure, merchants will be able to lower the level of the mix of their greasy wool input quality thereby enabling them to achieve cost savings.

25.63 The quantified benefits above significantly exceed the detriments. However, the Applicant reserves the right to make further submissions on the unquantified benefits at a later date.

26. Public detriments

Proposed acquisition will generate limited detriments

26.1 Given the constraints imposed by the continued growth of the Chinese wool scouring industry, CWH believes that the proposed acquisition would result in little, if any, public detriment. Nevertheless, the Commission in Decision 725 found allocative, productive, and dynamic inefficiencies arising from the deal, with the quantified detriments determined summarised in the table below.

26.2 For the purposes of this application, the Applicant is content to adopt the findings in terms of detriments from the Commission's Decision 725. Accordingly, CWH has reengaged NERA to update the detriments accepted by the Commission in that decision. The analysis employed is discussed in detail below, but the updated estimates of detriments following the approaches adopted by the Commission in Decision 725 are summarised in the table below, alongside the Commission's previous findings.

26.3 The Applicant acknowledges the High Court's findings that Decision 725 did not provide sufficient findings to discount the higher end of the proposed ranges of productive and dynamic efficiency losses. It therefore adopted the higher end of that range. However, the Applicant submits that there are strong reasons why the "most likely" productive and dynamic efficiency losses are no greater than the relevant points that the Commission found to be most likely (updated with current figures). Accordingly, it proceeds on this basis below, although it also provides ranges as previously considered for the sake of comparison.

		Decision 725 5 year NPV	Updated 5 year NPV
Total detriments		**$18.1 million, range of $1.4 to $28.8 million**	**$13.8 million, range of $2.30 to $22.36 million**
•	Loss of allocative efficiency (assuming 5%-15% price increase)[76]	$14.7 million, range of $0.7 to $22.7 million	$9.17 million, range of $0.22 to $14.36 million
•	Loss of productive efficiency (range of 1% to 5% increase in variable costs compared to counterfactual)	**[REDACTED]**	**[REDACTED]**
•	Loss of dynamic efficiency (multiplying total revenue by a factor 0.5%-1.0%)	**[REDACTED]**	**[REDACTED]** [77]

Loss of allocative efficiency

26.4 Allocative inefficiencies depend on the extent to which a merged entity will increase prices and the sensitivity of demand to increases in price (i.e., the level of demand elasticity). For the reasons discussed above and in light of NERA's critical loss analysis, CWH's view is that it will have no greater ability or incentive to increase prices in the factual as compared to the counterfactual.

26.5 Nevertheless, CWH has asked NERA to update its previous estimate of the allocative efficiency detriments that might arise from the acquisition if the Commission took the view that CWH would have both the ability and incentive to increase prices post-acquisition.

26.6 As the Commission found in Decision 725 if Cavalier Wool were to increase scouring prices post-acquisition, there would be an upper bound for the allocative losses from such price increases. This is because post-acquisition:

- entry could occur at price levels below a 15% price increase and as such CWH would be constrained as to the level of any price increase it could impose;
- CWH would also be constrained by the potential for wool merchants to switch certain volumes of exports of wool to Asia from clean to greasy in the face of a price increase by CWH. China has a strong scouring industry with many plants and generally lower scouring costs than the New Zealand industry. In addition, Malaysia has a new scourer which, as discussed above, has significant cost advantages. It is not possible for CWH to know in advance exactly what quantities of wool would switch to greasy exports to Asia as prices increase. Loss of greasy wool volumes to China or Malaysia would likely be permanent and could undermine the economies of scale benefits from the proposed acquisition; and
- the possibility for some price discrimination would lower allocative losses.

26.7 In Decision 725 despite modelling allocative efficiency losses of 5%, 10% and 15% price rises "to be conservative"[78] (giving a range of $0.7 to $22.7 million for a five year NPV), the

[76] Previously a 1% to 15% range was considered. This application follows the Commission's reasoning in Decision 725 and adopts a range from 5% to 15% price increase. The point estimate is that considered most likely by the Commission of a 10% price increase and elasticity of 1.0.

[77] Following the decision of the High Court, CWH has excluded the possibility of 0 dynamic efficiency loss and uses a range of 0.5 to 1. However, for the reasons set out below, it considers 0.5% to be the most likely figure.

[78] Decision 725, para 255.

Commission considered that a price increase above 10% was not likely. It therefore settled on the upper range of the price increases it believed likely (namely combining a 10% price increase with a demand elasticity of -1.0) resulting in $14.7 million over a five year period.

26.8 The High Court in supporting the Commission's reasoning added that:[79]

> prices would be passed on to farmers without affecting wool production; and this outcome would support a lower allocative efficiency loss in the wool scouring markets. In assuming that merchants would be sensitive to price increases and respond by exporting more greasy wool to China, the Commission has, if anything, over-stated the allocative efficiency losses. For this additional reason we also consider that Godfrey Hirst and Wool Equities have not shown that the Commission was wrong to find that an intermediate level of detriment of NPV $14.5 million was the likely detriment.

26.9 Further the High Court stated:[80]

> "the Commission was not wrong to regard any higher level of detriment as unlikely. The Commission was cautious and allowed for uncertainties. We therefore conclude that Godfrey Hirst and Wool Equities have not shown that the Commission was in error in taking a single figure rather than a range when balancing the allocative inefficiency detriments against public benefits."

26.10 As set out in section 3.3 of NERA's report, NERA has utilised the Commission's framework in updating its estimate of allocative inefficiency detriments across a range of demand elasticises and price increases from 5% to 15% including the midpoint figure of 10%, up to the upper bounds of what the Commission considered to be likely, at a 10% price increase.[81]

26.11 **[REDACTED]**

26.12 NERA's analysis shows that:

(a) even if CWH was able to profitably increase prices by 10% above competitive levels as the Commission found to be most likely upper limit in Decision 725, and applying price elasticity of 1.0, the resulting loss in allocative efficiency would be **[REDACTED]** (previously $14.7 million) in present value terms; and

(b) with a more commercially realistic (although still unlikely in the Applicant's view) price increase of 5% above competitive levels, a loss in allocative efficiency would range from approximately $0.22 million to $4.38 million (previously as high as $7.1 million with elasticity of 1.0 (the Commission found a 5% price increase unlikely if elasticity was only 0.05 so did not calculate this lower level)) in present value terms.

26.13 Taking the updated figure of the Commission's most likely consideration in Decision 725 of a 10% price increase with a demand elasticity of 1, the detriment has decreased compared to the previous application, from $14.7 million over five years, to **[REDACTED]**.

26.14 The change in the "most likely" figure from $14.7 million in Decision 725 to **[REDACTED]** now is due to the decreased market volumes and **[REDACTED]**.

26.15 Further details of this analysis are set out in NERA's report, dated 22 October 2014.

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[79] *Godfrey Hirst NZ Ltd v Commerce Commission* HC Wellington CIV-2011-485-1257, [2011] NZHC 691, para 188.
[80] *Godfrey Hirst NZ Ltd v Commerce Commission* HC Wellington CIV-2011-485-1257, [2011] NZHC 691, para 190.
[81] NERA's critical loss analysis illustrates that CWH would have no incentive to increase prices if demand elasticity was greater than **[REDACTED]** (in absolute terms). Therefore, for demand elasticities greater than or equal to **[REDACTED]** (in absolute terms), the allocative efficiency detriment is $0 because CWH would not increase prices in such a scenario and so no allocative efficiency losses would accrue.

Loss of productive efficiency

26.16 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. Typically, a 2-to-1 merger would be considered to yield productive efficiency losses as it is presumed that a monopoly producer lacks the competitive pressure to produce products and services for the lowest cost.

26.17 As CWH explained in its previous application to the Commission, there is unlikely to be any productive efficiency losses given CWH will not be able to act as a monopoly supplier of wool scouring services due to the ability for merchants to acquire wool scouring services from offshore producers in China. The only way in which CWH can continue to offer sustainably competitive scouring services is to seek to minimise its own cost base. Any tendency to let costs increase will simply result in CWH becoming less price competitive and ceding further volume to Asian producers or encouraging new entry. Given the importance of volume in driving down costs per unit, any loss of volume due to productive inefficiency would be compounded through a loss of economies of scale, thereby creating a vicious cycle in which CWH's cost competitiveness would be eroded. Accordingly, there appears little incentive for CWH to allow its vigilance in keeping costs low to slacken.

26.18 It is the competitive constraint arising from China and Malaysia, coupled with the importance of increasing volume and throughput so as to drive profitability, that today provides the impetus for CWH to seek out greater efficiencies in production and to lower costs. These primary constraints will continue with or without the acquisition. 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.

26.19 The Commission concluded in Decision 725, "the on-going competitive threat from the Chinese scouring industry... will ensure any productive efficiency losses are unlikely to be large."[82] CWH and NZWSI have focused on ensuring operating efficiency due to the external pressure of declining sheep numbers and reducing wool clip. Further, the Commission concluded CWH would continue to have experienced investors as shareholders (ACC and Direct Capital) who wish to maximise their investment income and capital growth, and are therefore incentivised to continue to drive productive efficiencies. Any future shareholders of CWH would also have the incentive to continue to drive productive efficiencies.

26.20 The Commission considered the upper range for any loss in productive efficiency to be between 1% and 5% of pre-merger variable costs (employing pre-merger variable costs of about **[REDACTED]** per kg).[83] This equated to a range of productive efficiency losses of approximately **[REDACTED]** five year NPV. The Commission considered the midpoint of the calculated range (namely 3%) to be the most likely loss of productive efficiency, resulting in a five year NPV of **[REDACTED]**. While the High Court supported the Commission's reasoning of why productive efficiency losses were likely to be low, and the 1 to 5% range employed, it queried whether the Commission had adequately discounted the upper range as unlikely in reaching its finding of the midpoint.

26.21 The finding that productive efficiency losses are likely to be low as a result of the transaction remains appropriate in the current industry circumstances. Decline in both sheep numbers and wool clip have continued since Decision 725, and will continue to decline in future (as discussed above). The pressure to ensure operating efficiency will remain (and, if anything, will only increase). As discussed above, the competitive threat from China has not lessened in recent years; rather the volume of greasy wool exported to China has continued to increase and new Asian scourers (such as CWP) have also opened. It also remains the case that shareholders of CWH post-transaction will be incentivised to drive productive efficiencies.

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[82] Decision 725, para 270.
[83] In the extreme (and highly unlikely) scenario where costs increased by 10%, the loss would be **[REDACTED]** (previously claimed at **[REDACTED]**) per year.

26.22 NERA has updated the range of productive efficiency loss as between **[REDACTED]** five year NPV (compared to **[REDACTED]** in Decision 725). This is employing variable costs in the industry of **[REDACTED]** per kg (without netting off the lanolin revenue). The Applicant considers that the lower end of the range is the most appropriate. However, taking the midpoint of this range as the Commission did previously gives a five year NPV for productive efficiency losses of **[REDACTED]**. Please refer to NERA's economic report at 3.4 and 4.

26.23 The quantified range of productive efficiency loss has increased since the previous application due to the **[REDACTED]** effluent system installed in Kaputone since the time of that decision, as discussed above at 25.31-25.32. **[REDACTED]** This has increased the potential productive inefficiency detriment. In the Applicant's view, **[REDACTED]** the merged entity will no longer scour at Kaputone so the variable cost on which the detriment is based is **[REDACTED]** overstated in the model.

Increased supply risk

26.24 In Decision 725 the Commission considered the possibility that an increase in costs associated with plant closure post-acquisition should potentially be taken into account in the detriment analysis. The Commission concluded there would be only be a small increase in risk arising from the consolidation of scouring activities into a single location per island. The Commission noted the limited nature of the risk:

- there is a relatively low level of historical risk (with only one example of a scouring emergency noted);
- there remains the potential to use mothballed plants such as Clive, or the mothballed line at Timaru;
- there remains the potential to transport wool between islands; and
- the ability to store greasy wool until the plant problem is resolved limits the cost to the industry of such an outage.

26.25 In addition, the Commission noted the precautions already taken by CWH, i.e.:

- post-acquisition Cavalier Wool's scouring plants will not be operating at full capacity;
- CWH has comprehensive insurance to cover freight between Islands in the case of a plant shutdown; and
- comprehensive risk management infrastructure and processes are in place at all of its plants.

26.26 The limited nature of the risk and the precautions already taken by CWH led the Commission to conclude that any detriment was likely to be de minimis.

26.27 Given the reduction in the wool clip since Decision 725, the merger will allow for sufficient excess capacity such that the Clive site will no longer be required for peak excess, nor is there need for a mothballed plant in Timaru. However, the pilot plant will be retained at Timaru and can provide additional capacity as required. Despite these changes from last time, it remains the case that any detriment from a plant emergency is likely to be de minimis. This is because:

- CWH is not aware that any scouring emergencies have occurred since the previous application. The risk of such emergency remains low;

- the ability to transport wool between islands remains, CWH continues to hold comprehensive insurance to cover freight between islands in the case of a shutdown. Further CWH notes **[REDACTED]**;

- the ability to store greasy wool until the plant problem is resolved remains which limits the cost to the industry of such an outage;

- CWH will retain significant excess capacity at each of its scours (being approximately 41.7% in the North Island and 28.4% in the South Island); and

- CWH continues to have comprehensive risk management infrastructure and processes in place at all of its plants.

Loss of dynamic efficiency

26.28 The acquisition would result in a loss in dynamic efficiency if CWH had a lesser incentive in the factual than in the counterfactual to engage in product and process innovation.

26.29 As illustrated in the public benefits section, CWH has a demonstrated history of delivering process and service improvements to the benefit of the industry. NZWSI's presence has not driven this behaviour, but rather it has been driven by the nature of the industry and the global competition it faces. Accordingly, CWH believes it will face the same incentives to improve efficiency and seek out process and product innovation with or without the acquisition. Nevertheless, as with productive efficiency losses, CWH is content to adopt the Commission's findings in Decision 725 that although dynamic efficiency losses are difficult to estimate with any confidence, some dynamic efficiency losses may be possible.

26.30 In Decision 725 the Commission considered any losses in dynamic efficiencies may be very limited because of a number of factors, including:

- while some innovation in the scouring industry has occurred as a result of competitive pressures within the domestic scouring market, major innovations have occurred outside the competitive environment as a result of international research and engineering in industries unrelated to wool scouring, or improvements by equipment manufacturers who no doubt wish to remain competitive in their manufacturing markets, and research companies (for example ANDAR Holdings – a scouring plant manufacturer, Wool Research Organisation of New Zealand and AgResearch). Post-acquisition, CWH will continue to have the incentive to utilise new ideas where they contribute to profit and help ensure competitiveness with overseas scouring options. This includes CWH's ability to incorporate scouring innovations into its plant that take place offshore, such as in China;

- the post-merger financial performance of CWH is likely to be closely and efficiently monitored by its shareholders. The Board and shareholders have a profit maximising incentive and therefore an incentive to optimise dynamic efficiencies; and

- the Commission concluded it is the long-term competitive threat of the Chinese scouring industry that most reduces potential dynamic efficiency losses. The Chinese threat is likely to be a major spur for ongoing innovation as there is a real risk that if the Chinese scouring industry innovates more rapidly than that of New Zealand, then most wool scouring would move offshore, as happened in Australia. The risk of this occurring is real for CWH. The proposed merger is predicated on achieving efficiency from greater throughput over a similar asset base. Should sufficient wool volumes be lost in the future to China, the advantages gained from the acquisition would soon be undone.

26.31 The Commission determined that any loss of dynamic efficiency as a result of the transaction would, therefore, be likely to be small. These factors remain as relevant today as they were in 2011. As discussed above, China continues to be a strong threat to CWH, with the volume of greasy wool exported to China continuing to increase since Decision 725 and a new **[REDACTED]** scourer in Malaysia has emerged which poses a significant threat.

26.32 In terms of the quantification of any detriment, the Commission adopted the approach previously used in the by the *Air New Zealand / Qantas*[84] case as the most pragmatic approach (an approach that was supported in the High Court). Using this approach, the Commission estimated the likely range of dynamic efficiency losses to be zero to one percent of total industry revenue, which equated to a range of **[REDACTED]** five year NPV. The Commission considered the midpoint of this range, namely 0.5% of total industry revenue to be the most likely loss of dynamic efficiency, amounting to a five year NPV of **[REDACTED]**.

26.33 While the High Court supported the Commission's finding that any dynamic efficiency losses were likely to be low and the approach to quantifying such losses, it considered the Commission should not have started at zero and had not articulated why the midpoint was the most likely outcome, rather than simply likely. It therefore allowed for a dynamic efficiency loss of up to **[REDACTED]** (being the upper range of the Commission's finding of zero to one percent of total industry revenue).

26.34 The Applicant submits that the Commission was correct in concluding that 0.5% would be the most likely outcome for the reasons set out above and those contained in NERA's economic report.

26.35 NERA has updated the estimate of the extent of any loss in dynamic efficiency using the Commission's approach in Decision 725 (taking into account the High Court's finding regarding the starting point of zero). NERA estimates the current five year NPV to be **[REDACTED]**, but submits that **[REDACTED]** is the appropriate figure. A full description of NERA's analysis is provided at Section 3.5 of their report.

26.36 This result is similar to Decision 725, but has slightly decreased because of lower industry revenues.

Production disruption

26.37 Concerns were raised in the previous authorisation process as to the ability of CWH to scour New Zealand's entire requirement for scoured wool during the rationalisation process. The Commission was satisfied that while there is potential for production disruption, on the balance of probabilities it is unlikely to occur and therefore no weight in terms of public detriments should be afforded. This was because post-acquisition:[85]

> ...Cavalier Wool would continue to have the incentive to process its merchant customers' wool in an orderly and timely fashion, in order to prevent those merchants switching to greasy wool export sales. Also, Cavalier Wool would wish to conclude the rationalisation promptly in order to achieve early benefits arising from the acquisition.

26.38 While it was conceivable in the South Island that scouring demand could outstrip Timaru's capacity during the rationalisation process, the Commission considered that CWH would likely maintain sufficient capacity throughout most of that period:[86]

> Any short term demand peaks can be handled by scouring some quantities of wool in advance, for example for Cavalier Bremworth. As only limited quantities of wool would have to be stored for short periods of time the Commission considers any additional costs would likely be de minimis. Moreover, the Commission notes that Cavalier Wool has set aside a contingency sum

[84] *Re Air New Zealand Ltd and Qantas Airways Ltd* (Commerce Commission, Decision 511, 23 October 2003).

[85] Decision 725, para 316.
[86] Decision 725, para 317.

of **[REDACTED]** for any additional costs which should be sufficient to cover any additional storage costs that may be incurred. In respect of that contingency, the Commission has counted it in the calculation of Cavalier Wool's one-off rationalisation costs which are netted off the total of the benefits.

26.39 The Applicant has again carefully considered its restructuring plan so as to minimise disruption to its scours. In Timaru, the current 2.4 metre and 3.0 metre lines will continue in operation until the Kaputone 3.0 metre line has been installed at Timaru and can be used. **[REDACTED]**.

26.40 As modifications to the building at Awatoto will occur immediately following settlement in the North Island, Whakatu will not be closed initially but will remain available until July 2015, with the 3.0 metre scour line then transferred to Awatoto. During that period, Awatoto will be primarily used, with Whakatu employed for any overflow volumes. Clive will also remain open and will be utilised in the North Island if needed for scouring (but likely only utilised for storage) until the Whakatu scour line has been moved to Awatoto, and Awatoto is fully operational.

26.41 There will, therefore, be very little disruption to production, with CWH overall maintaining sufficient capacity at all times during the rationalisation process. As with Decision 725, CWH has again set aside a contingency sum of **[REDACTED]** for any additional costs, which will continue to cover any additional storage costs in the unlikely event storage of greasy wool would be required. In addition, as set out above at 25.46, CWH has allowed for **[REDACTED]**. The potential for any other production disruption remains unlikely to occur and therefore no weight in terms of public detriments should be afforded.

Disruption to wool prices

26.42 Concerns were also raised during the previous authorisation process that there would be a disruption to wool prices as a result of the sale or discontinuation of NZWSI's trading division. The Commission considered it to be unlikely there would be such a disruption that there would be a detriment to the public of New Zealand. Regardless, no such disruption is relevant in this case given NZWSI will continue to operate the wool trading division as separate from CWH's wool scouring entity.

Balancing of benefits and detriments

26.43 Overall, the Applicant believes the proposed acquisition will generate real gains for the public of New Zealand. Even without taking into account the benefits that have not been quantified, the benefits significantly outweigh the detriments by **[REDACTED]** (compared to the Commission's conclusion in the previous application that the detriments would be outweighed by $13.5 million). Even taking a "worst case" scenario benefits outweigh detriments by **[REDACTED]** (previously $0.8 million).

Summary of benefits

Category	Evaluation	5-year NPV
Non-capital cost savings	**[REDACTED]**	**[REDACTED]**
Land and building cost savings	$12.65 million one off benefit	$12.65 million
Plant cost savings	**[REDACTED]**	$-1.09 million
Capex on buildings	**[REDACTED]**	**[REDACTED]**

Cartage to North Island	**[REDACTED]**	**[REDACTED]**
Redundancy/Contingency	**[REDACTED]**	**[REDACTED]**
Total quantified benefits		**$30.35 million**

Summary of detriments

Category	**5-year NPV (range)**	**5-year NPV (most likely)**
Allocative efficiency	$-0.22 to $-14.36 million	$-9.17 million
Productive efficiency	**[REDACTED]**	**[REDACTED]**
Dynamic efficiency	**[REDACTED]**	**[REDACTED]**
Total of detriments	**$-2.30 to $-22.36 million**	**$-13.80 million**

Part 8: Interested parties

27. Other interested parties

Name of interested party	Contact details	Contact person
Carpet Manufacturers		
Godfrey Hirst NZ Limited	142 Kerrs Road Wiri +64 9 268 3300 www.godfreyhirst.co.nz	Tanya Pauling
Cavalier Bremworth Limited	7 Grayson Avenue Papatoetoe PO Box 97040 Auckland www.cavbrem.co.nz	Colin McKenzie
Wool Merchants		
Segard Masurel (NZ) Ltd	Level 9, PSIS House 20 Ballance Street Wellington Central P O Box 3473 +64 4 472 3596	Peter Whiteman, Managing Director
Fuhrmann NZ Ltd/Waihi Wools (1981) NZ	75 Peterborough Street Christchurch P O Box 1164 +64 3 379 6173	John Henderson
J S Brooksbank[87]	Floor 3, 125 Featherston Street Wellington 6011 04 385 1055	Andrew Campbell
John Marshall & Company/Otago Wool Exports Ltd	63 Mandeville Street Christchurch P O Box 8332 +64 3 341 2004 www.joma.co.nz	Peter Crone, Managing Director
Standard Wool NZ	Unit B, 8 Homersham Place Christchurch P O Box 1814 +64 3 357 4613	Gary Doherty
H Dawson & Sons Co NZ Ltd	PO Box 21135 Christchurch 8144 +03 366 6917 www.hdawson.co.nz	Brett Woods
Bloch & Behrens Wool (NZ) Ltd	PO Box 9024 Christchurch 8149 +03 343 9100 www.blochwool.com	Palle Petersen

[87] Note J S Brooksbank has been acquired by Lempriere.

Name of interested party	Contact details	Contact person
J L Crichton & Co Ltd	PO Box 1916 Christchurch 8140 +03 366 0389	Michael Inkson
Schneider New Zealand Ltd	PO Box 36010 Christchurch 8146 +03 379 5241 www.gschneider com	Helen Cameron
Textile Wools Ltd	Essentially Building Level 2 2 Heather St Parnell Auckland +09 921 4253	Dean Hegan
Rokelay Wool NZ Ltd	19C St Stephens Ave, Parnell Auckland +09 575 8360	Alan Robertson
Wool Associations		
New Zealand Council of Wool Exporters	PO Box 2857 Canterbury 8140 +64 3 353 1049 www.woolexport.net	Nick Nicholson
Beef + Lamb New Zealand	Level 4 Wellington Chambers 154 Featherston Street Wellington www.meatnz.co.nz	Scott Champion
New Zealand Council of Wool Interests	PO Box 40859 Upper Hutt 5140 +64 4 934 5668	Peter Crone
New Zealand Federation of Wool Merchants	PO Box 338 Ashburton 7740 + 64 3 308 0150	Dean Harrison
Merino New Zealand	Level 2, 114 Wrights Road Addington Christchurch 8144 +64 3 335 0911	John Brackenridge

Part 9: Confidentiality

28. Confidentiality

28.1 Confidentiality is not claimed for the fact of the transaction.

28.2 The Applicant claims confidentiality for this Application pursuant to section 9(2)(b) of the Official Information Act 1982. A Public Version will be provided separately which will identify confidential information by enclosing it in bold square brackets (i.e., **[ ]**) (the **Confidential Information**). The Confidential Information is commercially sensitive and valuable information which is confidential to the Applicant (vis-a-vis the public), and disclosure would be likely to unreasonably prejudice the commercial position of the Applicant.

28.3 The Applicant requests it be notified of any request made under the Official Information Act for release of the Confidential Information, and that the Commission seeks their views as to whether the Confidential Information remains confidential and commercially sensitive at the time responses to such requests are being considered.

Annexure A: Declaration

THIS NOTICE is given by Cavalier Wool Holdings Limited (**CWH**)

CWH hereby confirms that:

- all information specified by the Commission has been supplied;
- if information has not been supplied, reasons have been included as to why the information has not been supplied;
- all information known to the Applicant which is relevant to the consideration of this application/notice has been supplied; and
- all information supplied is correct as at the date of this application/notice.

CWH undertakes to advise the Commission immediately of any material change in circumstances relating to the application/notice.

The confirmations and undertakings in this Declaration do not apply to information supplied to CWH's advisors by Lempriere and kept confidential from CWH, or information that relies on information supplied by Lempriere but which has not been evidenced to CWH by reason of confidentiality of underlying material.

Dated this day of 2014.

Nigel Ralph Hales

I am an officer of the Cavalier Wool Holdings Limited and am duly authorised by Cavalier Wool Holdings Limited to make this application/notice.

Confidential Annexure B: Tariffs Comparison CWH / China / CWP

See attached.

Confidential Annexure C: CWH Audited Financial Accounts

See attached.

Annexure D: Lempriere Audited Financial Accounts

See attached.