Chapman Tripp
Barristers & Solicitors NEW ZEALAND

Chapman Tripp Sheffield Young. 1-13 Grey St, PO Box 993, Wellington, New Zealand. Tel +64 4 499 5999. Fax +64 4 472 7111. DX SP20204.
www.chapmantripp.com Offices also in Auckland and Christchurch.

Our ref: Grant David / Sam Cooper
Direct dial: +64 4 498 4908 / +64 4 498 6341
Email: grant.david@chapmantripp.com / sam.cooper@chapmantripp.com
by email

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John Macilree
Principal Adviser, Air Services Team
Ministry of Transport
PO Box 3157
Wellington

TASMAN NETWORKS AGREEMENT – WIAL RESPONSE TO TREASURY SUBMISSION

1 We refer to your invitation that we comment on Treasury's submission dated 2 August 2006 on whose gains and losses should count in regulatory decision-making.

Summary

2 We asked LECG, the expert economic consultant assisting Wellington International Airport Limited, to also comment. Their report by Kieran Murray and Simon Hope is **attached**.

3 The LECG report shows that the differences in outcome from the application of the two different tests described by Treasury can indeed be material. Further, that the application of a net consumer benefits test rather than a public benefits test (which test Treasury advocates) would raise a number of key considerations in relation to the application for authorisation of the TNA.

4 As a matter of general principle, we would agree with Treasury's thesis that a public benefits test is to be preferred as a matter of sound competition and regulatory policy. But, the Ministry is not here engaged in a law reform exercise. It must advise the Minister only to apply the economic test which the wording and intent of Part 9 of the Civil Aviation Act currently mandate.

5 The test that the present wording requires the Minister to apply is unequivocally a net consumer benefits test. Treasury should not be encouraging the Ministry, or the Minister, to do otherwise.

6 Treasury should not be the applicants' cheerleader.

Treasury had an earlier say

7 Treasury's involvement in this matter began well in advance not only of its August submission, but also of the Application itself. On 17 March 2006 Treasury presented its Minister, who holds the government's 80% shareholding in Air New Zealand, with *Treasury Report T2006/401 : How an application for a code-sharing arrangement between Air New Zealand and Qantas might be handled*.

8 The contents of that report are said to have been referred to Hon Phil Goff, as Associate Minister of Finance to whom responsibility for aviation regulation issues have been delegated.

9 Some contents of that report continue to protected from interested parties' scrutiny. It has been withheld by the Minister of Finance under the Official Information Act, initially in its entirety and since 13 June with substantial deletions. On 7 September the Chief Ombudsman provisionally upheld the Minister's decision to withhold the balance of report on the basis that:

> *… the overall public interest would not be served by the disclosure of information that would undermine the ability of the Hon Pete Hodgson to consider, in an effective and orderly manner, the decision required of him.*

10 We have asked the Chief Ombudsman to reconsider his decision as a matter of extreme urgency. Put simply, we cannot see why the contents of a report prepared more than one month before any application was made – and which must therefore be confined to generalities – should be withheld, if Treasury's subsequent submission on the actual application by Air New Zealand and Qantas (the *Application*) – made some 4 or 5 months later – could be readily volunteered for interested parties' comment.

11 Our concern at Treasury's earlier involvement is not academic. In exercising an opportunity to comment on what Treasury is now saying in its submissions, we need to compare that with what Treasury may have said previously. Given the political nature of the Minister's decision, there is the possibility that Treasury's own thinking may have "evolved" once the Application was received.

12 At the least, as we demonstrate below, Treasury seems to have become a cheerleader for an application that does not fit the loophole it must pass through. Treasury demonstrates considerable intellectual dexterity in reaching the view it expresses in its submission, despite the constraints of the actual language of Part 9 of the Civil Aviation Act.

What Treasury is saying now

13 Although it includes some seemingly intimidating economic models, the Treasury submission is relatively straight-forward. It deals only with the appropriate regulatory test to be applied by the Minister of Transport in considering the Application. That test, says Treasury, should be "a public interest regulatory test [which] counts all material changes to private interests". Put more technically, Treasury states that where partial equilibrium models are used to represent the effects of a transaction, then the best representation of long term consumer welfare effects is the total surplus test. In particular, transfers from consumers to producers should not be treated as a detriment.

14 The submission argues strongly against applying a net consumer benefit test rather than a net public benefit test. To do so, advises Treasury, "is not a legitimate application of partial equilibrium modelling, nor the basis of sound economic regulation and competition law enforcement."

15 Treasury is careful however not to express a view on the further question of whether there should be gains or losses depending on whether or not those who gain or lose are New Zealanders or members of the New Zealand public. Or, to put the question more simply, whether transfers from New Zealand consumers to Qantas should be discounted because Qantas is an overseas firm, the current shareholders of which are mostly not New Zealanders and the shareholding of which is protected from New Zealanders by the Qantas Ownership Act (Aust).

What Treasury ignores

16 Generally speaking, we would agree with Treasury's thesis that a net public benefit test is to be preferred as a matter of sound competition and regulatory policy.

17 But, it is not our role – or Treasury's role - in commenting on the Application which the Minister must determine now, to opine on what ideally the law relevant to that decision *should* be for the future.

18 The Minister is not here engaged in a law reform exercise. We agree that Part 9 of the Civil Aviation Act 1990 (*CAA*) does need to be changed – and more broadly than in the single aspect to which Treasury's submission relates.

19 We have asked repeatedly, since the OECD commented adversely on Part 9 last year, that the law be changed. Successive Ministers of Commerce, Pete Hodgson and Lianne Dalziel, acknowledged that CAA would be reviewed "when time permits"; but also indicated that such review would be a major exercise, "requiring extensive consultation".

20 Lianne Dalziel also warned expressly that any change might not be in place in time to address our concerns about an Air New Zealand/Qantas code share. That is, we should recognise that any pending application by those airlines would be dealt with under the existing law. The Minister of Commerce should perhaps have explained that to Treasury, too.

21 The fact is that the whole of the Treasury submission is directed at presenting Treasury's view of what form the test in the CAA should be, not what the law currently provides.

22 The submission neglects to state that actual wording of Part 9 – and the current approach of the Commerce Commission in relation to similar regulatory legislation – mandates that a net consumer benefits test be applied by the Minister of Transport in determining the Application. That broad statement requires some detailed historical context, which we provide below. We agree with Treasury in its conclusions that:

- *the acquisition and use of market power can be socially harmful; and*
- *socially harmful effects of market power should only be authorised where in some social benefit that exceeds social costs.*

23 But, it cannot simply be assumed, as Treasury does, that the relevant legislation and judicial precedent will require that that balance be measured in terms of net public benefit. Treasury ignores that the nature of that test must depend, in the particular case, on the wording of the legislation prescribing the particular intervention and, ultimately, the purpose of that

legislation. And, for Part 9 of the CAA in its present form the prescribed test is clearly net consumer benefits.

The CAA is different to the Commerce Act

24 That is not just our view. The purpose and legislative history of Part 9 of the CAA are well described in the opinion of Galbraith QC to the applicant airlines dated 3 August 2006. He says:

> *It is apparent from the legislative history that the inappropriateness of the Commerce Act regime applying to international air carriage arrangements was early recognised. For that reason the 1986 Ministry Report to the Cabinet Development and Marketing Committee concluded that a separate authorisation regime would "more readily fit within accepted aviation regulatory systems". The Hansard references at the time of the introduction of the Civil Aviation Amendment Act 1987, which included the authorisation provisions in similar form to those at present applying, clearly indicate that the scheme of authorisation was to be separate from the Commerce Act regime and that the then equivalent of section 88(4) was intended to define the relevant parameters of unfair competition in respect of air services which would prevent authorisation being given.*

25 Put simply, he is saying that Parliament determined that a different test to that applicable under the Commerce Act was appropriate for allowing objectionable arrangements in respect of air services under the CAA – Parliament therefore used different language in Part 9.

26 Having already been denied authorisation under the wording of the Commerce Act, the applicant airlines have chosen now to subject themselves to the wording of Part 9.

Test applicable to Parts 2 and 3 of Commerce Act

27 The test under the Commerce Act for allowing cartel conduct (and objectionable structural arrangements) has been well established, at least since the 1990 Amendment required that that regard be had to efficiency considerations in assessing public benefits. The subsequent insertion by the 2001 Amendment of the new section 1A purpose statement, providing expressly for a long-term benefit of consumers approach, has not affected that.

28 The nature of the test applicable to both Part 2 conduct and Part 3 structural arrangements under the Commerce Act was stated most recently by the High Court in *Air New Zealand* v *Commerce Commission No. 6 (2004) 11 TCLR 347* as follows:

> *[241] We are satisfied that the introduction s 1A should not disturb the Commission's established practice of treating as neutral any wealth transfers between New Zealand consumers and producers. Determinations of authorisation applications under the Act are properly concerned with balancing any efficiency detriments associated with breaches of the statutory competition standard, against any efficiency gains that may result from the business acquisition or contractual arrangement in question. It is the balancing of these real resource impacts on the economy that best serves the long-term interests of consumers. The inclusion of ad hoc wealth transfers, which are not losses to society, would distort the efficiency assessment by assuming additional economic harm to the public of New Zealand. In any event, consumers might well be the ultimate beneficiaries.*

How the test applicable to Part 4 of Commerce Act went wrong

29 Unfortunately, the position in relation to the test applicable to the generic price control provisions (Part 4 of the Commerce Act) and regulation of electricity lines businesses (Part 4A of the Act), is less clear-cut.

30 Both Parts 4 and 4A provide for the imposition of price control on particular goods or services where specified conditions prevail. In the case of Part 4, a relevant condition is that intervention is necessary or desirable "in the interests of person acquiring the goods (whether directly or indirectly)."

31 Part 4 in fact had lain dormant for many years. The Commission's first public statement of the applicable test under Part 4 was in relation to its enquiry into airport pricing in 2001. The Commission, in its Draft Report, adopted a "net public benefit" test, consistent with the Parts 2 and 3 of the Act. It stated at para 134:

> *The Commission considers that any recommendation as to whether control should be imposed should be based on efficiency grounds and an assessment of the likely benefit to consumers within New Zealand. This is done by conducting a "public benefit" (also referred to as a "net benefits") test. Such an approach is consistent with the Commission's approach to determining applications for an authorisation under sections 58 and 67 of the Act,*

32 At the subsequent conference, Air New Zealand's counsel argued strongly to the contrary. Lyn Stevens QC, acting for Air New Zealand, stressed that while the rest of the Commerce Act is directed toward making competition workable and effective, Part 4 is designed for situations where there is no workable and effective competition and is directed at the elimination of monopoly rents. He argued:

> *It is not appropriate to introduce a threshold from other parts of the Act, such as benefit to the public, where there is no … express statutory reference.*

33 His words are especially apposite to the approach Treasury are proposing here.

34 The Commission accepted Air New Zealand's proposition that Part 4 of the Commerce Act mandates a net acquirer benefit test. The Commission stated at para 2.70 of its Final Report that "[it] must confine its consideration to the net benefits to acquirers (and the removal of monopoly profits)". This was a complete shift from its Draft Report. It also established an inconsistency to run throughout the Commerce Act.

35 The Commission's next consideration of the public benefits v consumer benefits issue was in its investigation into Unbundling the Local Loop Network, carried out under the Telecommunications Act 2001. In its Final Report on that matter (December 2003), the Commission concluded that "there was no absolute rule in relation to wealth transfers." Rather, it depended on the particular nature and circumstance of the inquiry:

> *Control as a regulatory mechanism has a different philosophical base from competition as a regulatory mechanism. It is precisely because there is a concern about monopoly rents, and a lack of competition to drive them out, that control is justified. In such an environment, the Commission considers it must address distributive issues explicitly.*

36 Then, in October 2004 the Commission issued its Guidelines in relation to electricity, under Part 4A of the Commerce Act, in which it adopted the position as under Part 4, that is, in assessing benefits, the question of wealth transfers should be taken into account.

37 The Commission persisted with the consumer benefits test in its Gas Inquiry Final Report (November 2004) under Part 4 of the Commerce Act. In that report, the Commission developed a form of cost benefit analysis which it called "Net Acquirer Benefit", being in the main the value of excess returns that are transferred from the supplier to acquirers as a result of imposing control. In adopting such an approach, the Commission clearly gave primacy to a net acquirer (or consumer) benefit test at the expense of a net public benefit test. There is no clear path of reasoning in the report why the Commission gave such preference, but its decision currently stands.

38 Finally, the Commission issued its Final Report on Regulation of Mobile Termination (June 2005), again under the Telecommunications Act. In that report, the Commission characterised its approach to wealth transfers as "the consumer welfare approach". The Commission repeated its assertion that control as a regulatory mechanism has a different philosophical base from competition, with a need with the former to address distribution issues explicitly.

Review announced to correct things

39 All of this apparent inconsistency in policy intent as between the regulatory control provisions in Parts 4 and 4A of the Commerce Act (and elsewhere), and Parts 2 and 3 of the Commerce Act, and supplier unhappiness with the outcomes, has prompted Government to announce a review of Parts 4 and 4A. Specific matters the review is to examine include:

- what is the purpose of imposing control; and
- in what circumstances should control be imposed.

40 Implicit in those questions are: should the relevant test be net consumer benefit or net public benefit?

41 Meanwhile, the tests presently applicable under Parts 2 and 3 of the Commerce Act (i.e., net public benefit) are expressly left untouched.

42 The Cabinet Committee paper providing for that review stresses a "whole of-government" process led by the Ministry of Economic Development, in consultation with Treasury "A detailed timetable is attached. The paper stresses this any legislative amendment resulting from the review will not come into effect until 2008 at the earliest "and therefore will not affect the outcome of current regulatory processes" (involving Vector, Unison Networks and Transpower).

43 The process prescribed by the Cabinet Committee paper cannot be faulted. In essence, there will be full consultation before any change to the law is contemplated; and any such change will not apply to any current matter, especially one in the outcome of which the Government might have an interest.

44 That process is in stark contrast to Treasury's efforts here in respect of what is effectively the same issue.

Conclusions to be drawn

45 The conclusions to be drawn from the above history of the Commerce Commission's original adherence to, but subsequent deviation from, the public benefit test in the regulatory context, and the Government's announcement that review of that development, are relatively straight-forward:

- Authorisation under Parts 2 and 3 of the Commerce Act uses a public benefit test and that is not to be reviewed.
- Part 4 of the Commerce Act was thought to impose a public benefit test, too and the Commission initially applied one in its Airfields Draft Report.
- At the airport pricing conference, Air New Zealand and BARNZ persuaded the Commission that the net acquirer benefits test is appropriate given the statutory scheme of Part 4 of the Commerce Act, and this was adopted in the Airfields Final Report.
- The Commission subsequently applied a consumer (or acquirer) benefits test under the Telecommunications Act;
- The Commission continued to apply the consumer benefits test in relation to Part 4 of the Commerce Act in the Gas Inquiry Final Report.
- The Government has recently announced a review of the tests applicable under Parts 4 and 4A of the Commerce Act, but Parts 2 and 3 are not to be touched.
- The test under Part 9 of the CAA was intended by Parliament to be different from the test applicable under Parts 2 of the Commerce Act.
- The wording of Part 9 of the CAA is much closer to the wording of Part 4 of the Commerce Act than to the wording of the public benefit test applicable to Parts 2 and 3 of the Commerce Act.
- OECD last year recommended that Part 9 of the CAA be repealed or at least brought into line with Parts 2 and 3 of the Commerce Act.

Treasury may be well intentioned, but …

46 Of course, Treasury has a legitimate interest in pursuing its over-riding objective that "there is a close alignment between the objectives of Treasury, the Ministry of Transport and the government's competition policy". The problem is that the present wording, and legislative intent of Part 9 of the CAA, simply does not allow for such close alignment. And that non-alignment can only be remedied by legislation, not advocacy.

47 OECD has said, and we agree, that the form of the regime which Part 9 currently provides is out of kilter with not only this country's competition regime, but those of its major trading partners. That situation should be reviewed, as Ministers have indicated it will be when time permits; and the law then changed.

48 Meanwhile, the Application which the Minister will shortly determine, must be dealt with under the existing provisions of Part 9. Those provisions contain no reference to "benefit to the public" or similar wording. But, they do provide expressly, in section 88(4) that authorisation cannot be given to any arrangement that –

(b) *Has the purpose or effect of breaching the terms of a commission regime issued under section 89; or*

(b) *Unjustifiably discriminates between consumers of international air services in the access they have to competitive tariffs;*

49 That is, authorisation cannot be given if consumer interests with regard to pricing – whether mandated or achieved by competition – are to be compromised. There is nothing to suggest that these consumer losses might be offset by transfer of surplus to the airlines supplying those air services.

50 Meanwhile, the wording of Section 90(2) is even more stark in the consumer benefit preference it requires. In determining whether to authorise any tariff the Minister must have regard to: on the Supplier side, (a) whether the tariff provides a reasonable return on investment and (b) whether the relevant service can be carried on for a reasonable period at the level proposed; and on the consumer side, (c) whether there is likely to be substantial degree of benefit accruing to consumers generally, or to a significant group of consumers,

51 Philosophically, we may not like that wording either. But, we cannot ignore it – and neither can the Minister.

Treasury should not be the applicants' cheerleader

52 What Treasury should not be doing is to advocate "alignment" when the law in its present form, and judicial precedent, simply do not allow for it.

53 In particular, Treasury should not be encouraging the Minister to apply a net public benefit test to achieve policy outcomes it may desire, when the above wording clearly requires something different. Treasury should leave the applicants to take their loophole as they find it.

54 This is not the first shortcoming the applicants have encountered with Part 9. First, their Application claimed the Minister has no discretion to not grant the authorisation. But even their own QCs now contradict that claim.

55 Then, the airlines claimed an authorisation crafted for a code share could be stretched to embrace a joint venture, something the Act patently does not allow.

56 Now, there is the advocacy from Treasury that the Minister should ignore the test in the Act, and apply one that is less favourable to consumers. That is, on behalf of Air New Zealand, to adopt the position that is the reverse of the one which Air New Zealand's own counsel argued strongly (and successfully) for on a previous occasion. And for Treasury itself, represents a sorry contrast with the proper public administration and legislative process that the review of Part 4 and 4A of the Commerce Act contemplates.

57 No cheerleader should try to be that agile.

Yours faithfully

Grant David
Partner

Sam Cooper
Solicitor