SH8-3-3

Date 2 August 2006

John Macilree
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Ministry of Transport
PO Box 3175
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Attention: John Macilree

APPLICATION FOR AUTHORISATION UNDER SECTION 88 OF THE CIVIL AVIATION ACT

Dear John,

On 16 June 2006, you wrote to the Secretary of the Treasury to invite comments on the application, currently being considered by Hon. Peter Hodgson, for authorisation under section 88 of the Civil Aviation Act. The Secretary has asked me to respond on his behalf. I am attaching Treasury's submission.

I do not consider that any part of this submission ought to be withheld from an Official Information Act request.

Our submission is about whose gains and losses should count in regulatory decision-making. Given the language of the Act, we understand that this might be a central concern in considering whether or not to authorise the arrangements proposed by Air New Zealand and Qantas.

Note that in our submission we introduce a level of technical economic argument. We do so because it is a convenient way to talk about the logic of counting gains and losses to affected parties. We are not suggesting that similar techniques are required in your analysis.

Yours sincerely

Len Starling
Manager, Markets, Infrastructure and Governments
The Treasury

Submission on the application by Air New Zealand and Qantas for authorisation under section 88 of the Civil Aviation Act 1990

Introduction

As you are aware, the Minister of Finance is the shareholding minister with respect to the Crown's equity holdings in Air New Zealand. He has delegated matters concerning aviation regulation to the Associate Minister of Finance, Hon. Phil Goff. Mirroring this split in ministerial responsibilities, the Treasury considers regulatory matters in the aviation sector separately from matters pertaining to its commercial interests in Air New Zealand.

This comment was prepared within the Regulatory and Tax Policy Branch from the regulatory policy perspective. It uses publicly available information, and the views expressed in this note reflect that perspective, rather than the perspective of Treasury in its role as an equity-holder. For the purposes of putting together this submission, we have neither sought, nor sought to represent, the views of those in Treasury who oversee the Crown's commercial investments.

For the purposes of this comment, we have not considered, and do not state a view on:

- whether or not the proposed Tasman Network Agreement (TNA) ought to be authorised;
- whether or not the TNA would be likely to be in the national interest;
- whether or not there would be likely to be detriments or benefits to any interested parties, including the applicants, competing airlines, travellers, airports and travel agents;
- the effects of the TNA on related markets;
- the degree of confidence in the likelihood of alternative outcomes that the Minister must have before authorising or declining the authorisation; or
- jurisdictional matters raised by various commentators.

This comment concerns only the appropriate regulatory test to apply in considering the application. Simply, Treasury's position is that regulatory policy and enforcement should act in New Zealand's public interest. Public interest is the sum of private interests. A public interest regulatory test counts all material changes to private interests.

We understand that a further question that might arise in the consideration of this issue is the nationality of those affected. That is, should there be a different treatment of gains and losses depending on whether or not those who gain or lose are New Zealanders or members of the New Zealand public. Treasury submits no view on this question.

There is a close alignment of the policy objectives of Treasury, the Ministry of Transport and competition policy in New Zealand: policies aim towards higher living standards by increasing consumer welfare

We note that there is a close compatibility between the broad policy aims of Treasury and the Ministry of Transport, reflecting the priorities of the government. While Treasury's goal is to achieve "higher living standards for New Zealanders", the Ministry of Transport's is to obtain "leading transport solutions for New Zealand", and as

transport problems are pervasive and important, transport solutions are fundamental to higher living standards.

An important element of living standards is consumption, interpreted broadly. The government wants New Zealanders to be able to consume more and to determine their consumption choices in more satisfying ways. By consumption, we refer not only to consumption of market goods and services, but consumption of public goods, of leisure time, and so on. And, in the same way that transport is fundamental to living standards, transport solutions are fundamental to consumer benefits.

We note that competition policy is aimed at achieving public interest goals, too. For example, the purpose of the Commerce Act is "to promote competition in markets for the long-term benefit of consumers within New Zealand" (section 1A). (Similar purpose statements can be found in other competition policy statutes and regulations.) The rationale for promoting competition is that competitive markets are thought to produce greater benefits than non-competitive markets. Generally speaking, competition, the theory goes, encourages innovation, better resource use and greater consumer satisfaction.

We note further that the Commerce Act says that it is there to promote the interests of consumers in the long term. It does not say that it is there to help some consumers more than others, nor yet that it is there to help consumers only as they are engaged in the act of consuming a particular product at a particular time. Beyond the length of a phone call, or a flight, or a meal, or when he or she steps outdoors, the long term interests of any consumer in New Zealand depends on more than just the consumer surplus from one particular product. It depends, indeed, on the level of personal wealth and overall wealth in the economy. It depends on the ability of markets generally to provide and enhance a range of consumer benefits. It depends on total gains from trade.

Section 88(4)(c) of the Civil Aviation Act can be read in the same light and, in this submission, we argue that it should be read in the same light. The Act requires that authorisation should not be given where the provision in question "unjustifiably" impedes consumers' access to competitive tariffs. Where the provision does impede consumers' access, the detriment should be justified—presumably, by an offsetting benefit. We submit that, from a policy perspective, this would be the most sensible reading. As section 90 makes clear, section 88 stands in place of the public benefits welfare test under the Commerce Act.

The "consumer welfare test" and the "public benefits test": a false dichotomy

In New Zealand competition law, the question is often debated about whether the correct welfare test to use is a "consumer welfare" (or "consumer benefits") test on the one hand, or a "public benefits" test on the other. You might receive submissions on this question as part of your process. Treasury's position is that this is a false dichotomy: the long term interests of consumers in New Zealand are in fact equivalent to New Zealand public interests. The reason is that the New Zealand public consists of consumers.

There are times when public interests might be improved in ways other than increasing consumer welfare. Defence, heritage, the environment and distributional needs sometimes require the surrender of some measure of consumer benefits in order to

achieve other national goals. But competition policy is an instrument designed to link consumer and public welfare. It is about improving markets—all markets.

In relation to competition policy, then, Treasury submits that there is a close identity between the public benefits test and the consumer welfare test.

Models are unavoidable

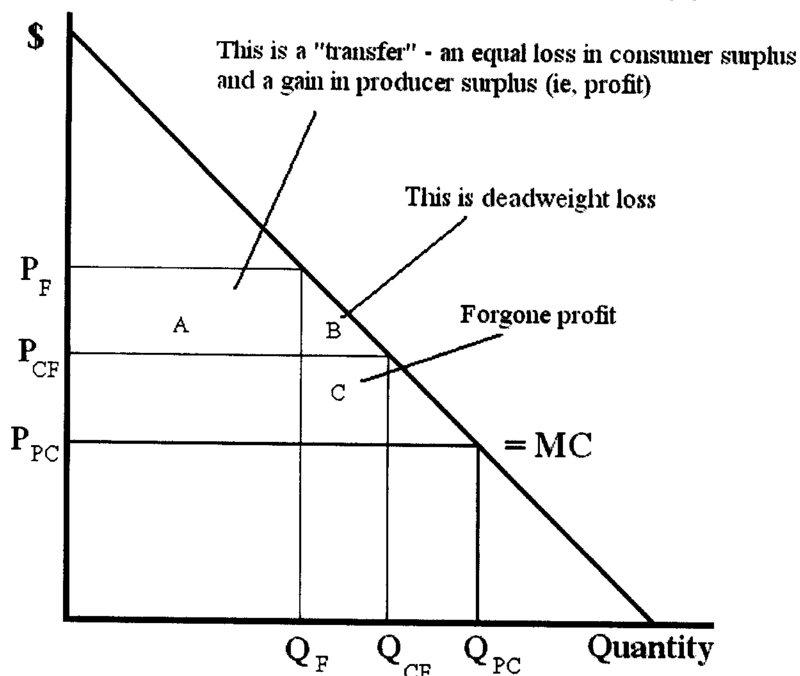
In regulatory policy and enforcement, economic models are inevitable. Policy statements and laws that talk about public or consumer costs and benefits are concerned with economic effects. The only way to intelligibly analyse economic effects is with economic models—so rational competition regulatory decision-making is impossible without economic models. In saying this, however, we use a broad definition of economic model. It is not the case that rational decision-making depends on the use of explicit, formal, mathematically-based models. Economic models may be implicit, informal and verbal—and, in fact, they usually are. But it is the case that models are always used, even when they are not determinative.

Talking about consumer and public welfare requires a particular language. Economics supplies such a language. In the context of formal, partial equilibrium economic models, we argue that both public benefits and the long term interests of consumers in New Zealand, could best be represented by counting changes to total surplus. An extreme interpretation of the "consumer welfare" test suggests counting only changes to consumer surplus. Calculating only changes to consumer surplus, and interpreting that calculation as representing changes to either public or consumer benefits has two problems. First, it is analytically flawed. Second, applying such a test is inequitable and harmful to economic performance—and to consumer benefits.

In New Zealand, it is common to use formal, partial equilibrium, comparative static economic models to represent welfare changes—the familiar supply and demand diagrams from economics textbooks are one kind of these. Figure 1 is an example of such a model.

(Note that Treasury does not believe that regulatory enforcement necessarily requires the use of explicit economic models. But, in considering economic regulatory decisions, models—formal and informal—are inevitable. It is impossible to think about long term competitive effects and welfare changes without, at least implicitly, using economic models. Since the partial equilibrium, comparative statics approach is widely used in New Zealand, and since, for all its limitations, it is a neat and disciplined way to organise thoughts and arguments about the costs and benefits of changes in a particular market, we use it in this note.)

Figure 1: Diagram of the welfare effects of monopoly power



In a perfectly competitive market, consumers would pay (and producers would receive) a price P_{PC} equal to the marginal cost (MC) of producing the product. In this perfectly competitive market, producers have no market power: they are price-takers and they receive "normal" returns. But no one (and no market) is perfect. Imagine an imperfectly competitive market in which the price is set at P_{CF} (where "CF" denotes "counterfactual"). Consumers buy less of the product than they would have were the market perfectly competitive and they pay a higher price: there is a greater amount of welfare in the perfect market.

Using the model to test the effects of the acquisition and use of market power

Now imagine that a regulator were asked to consider some transaction that would enable an exercise of market power such that producers were able to increase the price to P_F ('F' for 'factual'). The response by consumers is to demand less: Q_F. The welfare effects of the transaction are as follows:

- Consumers lose an amount of consumer surplus equal in area to A.
- Producers gain an amount of producer surplus (profit) equal in area to A, but they also forgo some producer surplus from selling more of their product. The total effect on producers is, then, A minus area C.
- Area B is lost consumer surplus: deadweight loss of consumer benefits.
- The total welfare effect of the transaction is therefore:

Change in welfare between counterfactual and factual
= Producer surplus gain minus consumer surplus loss minus deadweight loss
= (A – C) – A – B
= – (B + C)

So, from a total surplus perspective, the proposed transaction decreases total welfare. That is, $(A - C) - (A + B) < 0$. A regulator should only authorise the transaction if there is some compensating public benefit, x, that exceeds the total welfare loss. That is, the transaction is beneficial if $(A - C) - (A + B) + x > 0$, or $x > B + C$.

The general argument against monopoly, and the motivation behind competition laws and economic regulation, is that the exercise of monopoly power reduces welfare in society by creating deadweight losses. But an extreme interpretation of the consumer welfare test argues that regulators should count not only deadweight loss as a welfare loss, but also the consumer surplus loss (area A). The extreme argument, then, says that the welfare effect of the transaction would be: $-(A + C + B)$. In as much as they would admit that transactions leading to the increased use of market power can have positive effects, proponents of this view would require $x > A + B + C$ as the test for authorisation. Effectively, they treat area A as another deadweight loss.

The question, then, is whether gains to producers achieved through the acquisition and use of market power ought to count as one of the "pluses" in the calculation of the costs and benefits of a certain transaction.

The Treasury's position is that they should count, and they must be given their full weight in the calculus. They should count because competition policy is about consumer welfare, and ultimately "profits" are only considered a welfare measure at all because they represent potential consumption. They should count because consumers' losses are not society's losses if producers are members of society, and because producers' gains are likely to stimulate further economic gains. They should count because the relevant policies and laws demand that we consider long term effects, but the partial equilibrium model world assumes that nothing changes except prices and quantities in a particular market. They should count because there is no widely held *a priori* ethical standard in New Zealand that says that surpluses earned by producers have no value to society. Finally, they should count because the test that demands that $x > B + C$ is stringent enough, and all we can hope of any economic activity: that the social benefits exceed the social costs.

Market power potentially creates inefficiencies, and the standard welfare analysis of monopoly is sufficient to prohibit socially destructive abuses of market power. But where some transaction considered under competition law is likely to create net public benefits, Treasury submits that in almost all cases, it will also generate consumer benefits—if not in the specific markets in question, then in the economy more generally. In determining the likely, long term effect on consumer welfare, it would be inappropriate to use partial equilibrium analysis to completely discount a significant gain to certain parties.

Distributional and moral arguments

Often the argument for treating area "A" as a social loss is stated as a moral one. Producers do not deserve "A", the argument goes, because they got it through antisocial behaviour, and consumers do not deserve to lose it.

Other than noting that Treasury is interested in improving living standards for all New Zealanders, and competition policy is concerned with long term benefits to all New Zealand consumers and to the New Zealand public, we have no particular view on whether any one member of society deserves wealth more than another.

So long as market participation is voluntary, Treasury does not regard seeking profits as an immoral act; rather, where profit-seeking generates greater benefits for New Zealand as a whole, including innovation, returns to scale and positive externalities and network effects, then it is to be cultivated and encouraged. Treasury considers that, with their emphasis on long term effects, competition laws admit these special cases, too.

If the act of seeking profit is not inherently immoral, then distributional arguments depend on identifying those who gain and those who lose and determining which of them is inherently more deserving. In a competition law case, a distributional argument should first identify who the consumers are and who the producers are. For the purposes of regulating on distributional and equity grounds, it is unreasonable to assume that consumers are powerless individuals while producers are powerful corporations. In some product markets, the typical consumers might be relatively few well-paid business executives, while the producer shareholders might be a great number of average members of the public. Were these shareholders able to extract "monopoly rents" from such consumers, the result might be a more even distribution of wealth.

To say that we should count only changes in consumer surplus is to say that we should value only gains accruing to particular people in the act of consuming a particular product. It is to say that the welfare of producers should be discounted completely—that it should have zero weight in regulatory decisions—even though "producer surplus" is a consumer welfare measure and even when these same producers might themselves be consumers in the market being analysed. There seems to be no sustainable efficiency or equity argument for taking this general position.

We do not use cost-benefit analysis in murder or robbery cases because we can rely on our moral senses to tell us that these acts are socially destructive. But the acquisition and use of market power are acts of a different kind. We ought to be, and competition policy rightly is, highly suspicious of them. But, in voluntary economic markets, we cannot simply rely on moral sense to offer a verdict: to do so is to substitute prejudice for reason. We must instead count all the long term gains and losses and determine whether consumers are better or worse off over all.

Conclusion

In this submission, Treasury has made the following points:

- there is a close alignment between the objectives of Treasury, the Ministry of Transport and the government's competition policy;
- the acquisition and use of market power can be socially harmful;
- socially harmful effects of market power should only be authorised where there is likely to be some social benefit that exceeds social costs;
- 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;
- the extreme view, whereby transfers from consumers to producers is treated as a deadweight loss, is not a legitimate application of partial equilibrium modelling, nor the basis for sound economic regulation and competition law enforcement; and

- where regulatory decisions are made on distributional grounds rather than on overall welfare, regulators should identify who ultimately gains and loses from a transaction, and why those particular people are more or less deserving.

Treasury submits that the correct welfare test to apply to competition regulation decisions is that transactions ought to be approved where, on the balance of probabilities, they are likely to lead to long term benefits to consumers in New Zealand.

We wish you all the best in your deliberations. If you wish to discuss any aspect of this submission further, please contact Anthony Casey on 917 6919 (or Anthony.Casey@treasury.govt.nz) or Len Starling on 917 6285 (or Len.Starling@treasury.govt.nz).