Net Public Benefit Test vs. Net Consumer Benefit Test

Issues for consideration by the Ministry of Transport

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1 Introduction

In August 2006 the Treasury wrote to the Ministry of Transport (the Ministry) outlining the gains and losses it believed should be considered in regulatory decision making.[1] The Treasury submitted that the Ministry should apply a net public benefits (NPB) test when evaluating the application by Air New Zealand and Qantas for authorisation under section 88 of the Civil Aviation Act 1990. Chapman Tripp has advised Wellington International Airport Limited that the relevant test to be applied under the Act is a net consumer benefits test. Wellington International Airport asked us to summarise the primary differences between the NPB and net consumer benefits tests, and to highlight the implications, for the Ministry's analysis, of applying a net consumer benefits test to the Air New Zealand/Qantas application.

2 Context

In April 2006, Qantas and Air New Zealand applied for approval of a Tasman Networks Agreement (TNA) under section 88 of the Civil Aviation Act. Responsibility for the decision on this application has been delegated to Hon Pete Hodgson.

In assessments of the potential welfare impacts of such proposals (whether by the Minister, as in this case, or by the Commerce Commission in the case of the earlier application for an alliance), comparisons of the estimated gains and losses of factual and counterfactual scenarios are typically adopted. The frameworks are used in assessing the potential welfare impacts of market power, and in assessing the consequences that control may have on a participant, or group of participants in an industry. The use of recognised frameworks provides common metrics or threshold tests for comparisons in different industries, and in different jurisdictions.

Two common metrics or welfare threshold tests for such evaluations are the net public benefit test (NPB) and net consumer benefit test. The Commerce Act (1986) contains both tests. Applications for mergers or for anti-competitive practices are subject to a NPB test. Price control investigations under Part 4 of the Commerce Act (1986) apply a net acquirers benefit (NAB) test. The NAB test focuses more explicitly on acquirers as being a sub-set of all consumers. The use of the tests in the Commerce Act means that there is a large body of experience, knowledge and precedent in their application.

3 Relevant threshold test

Legislation typically identifies the appropriate metric or welfare threshold test to be adopted in various circumstances, and this is the case for the Civil Aviation Act – the Act

[1] "*Submission on the application by Air New Zealand and Qantas for authorisation under section 88 of the Civil Aviation Act 1990*", Attached to letter from Len Starling, Manager, markets, Infrastructure and Governments, The Treasury to the Ministry of Transport, 2 August 2006. Sourced from http://www.mot.govt.nz/international-air-carriage-competition/

under which the applicants for the TNA have sought approval. It is important to identify the correct test, required by the relevant Act, as the different tests can potentially imply opposing outcomes if applied to the same issue.

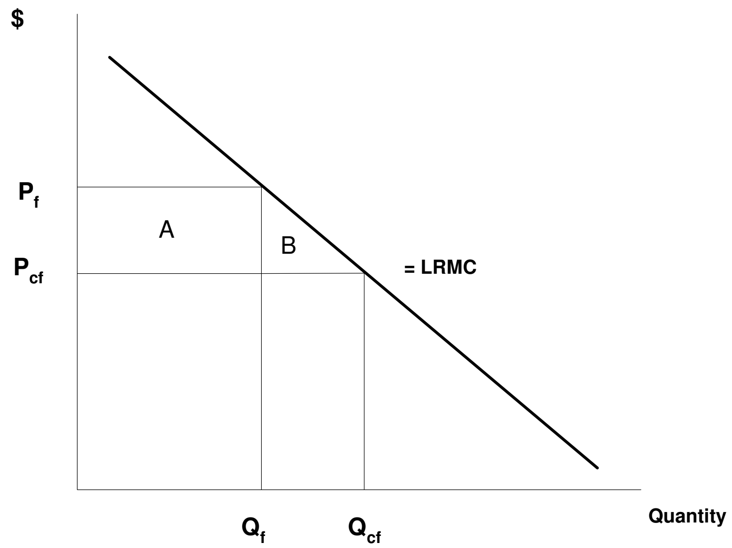
Wellington International Airport have submitted legal opinion by Chapman Tripp, which identifies the appropriate threshold test for the application under the Civil Aviation Act as the net consumer benefit test:[2]

"The fact that Part 9 of the CAA measures pricing by the consumers' interests standard has significant implications for the Minister's decision. The Minister must be satisfied the TNA is of net benefit to consumers, and not just the private benefit of the Airlines".

4 Differences between the net public benefit, and net consumer benefit tests

The NPB and net consumer benefit tests are two common metrics for assessing the relative magnitudes of gains and losses in welfare that could result from particular actions or interventions. These actions could include the assessment of the welfare impacts of market power or the potential consequences of control.

In order to identify the key differences between the NPB and net consumer benefit tests, we make use of a comparative static economic model to assess welfare changes resulting from a hypothetical situation of applied market power. The model and its interpretation are adapted from the Treasury submission to the Ministry referred to earlier.



In a market with workable competition, the price that consumers pay, and producers receive, for the product would be P_{cf}, and would trend towards its long marginal cost (LRMC).

[2] *"Joint business", Submission on the application by Qantas and Air New Zealand for specific authorisation of a Tasman Networks Agreement pursuant to Part 9 of the Civil Aviation Act 1990,* Wellington International Airport Limited, 31 July 2006, p. 117.

Given this model, the NPB or consumer benefit tests could be applied to a situation where a participant exercising market power (for example) increased its price to P_f. At price P_f the quantity demanded is reduced to Q_f. This level of demand is inefficient, because the demand that has been discouraged would be worth more to the consumers, than it would cost to produce. The loss in economic welfare is shown by the triangle labelled B. Economists call this loss of welfare the 'dead-weight loss'.

Under these hypothetical conditions, the NPB test assumes that the area of surplus lost by consumers, and gained by producers (A) is a neutral welfare transfer. The total change in welfare is restricted to the dead-weight loss (area B).

A net consumer benefit test, however, proposes that welfare losses should include not only the dead-weight loss, but also potentially any part of the producer surplus gain (area A) that relates to a producer earning excess profit.[3] The Commerce Commission in its application of a NAB test, determines that profit above a firm's WACC is a detriment to consumers.

The difference in treatment of a proportion of the producer welfare gain that relates to estimated excess profits is the key difference between the NPB and net consumer benefit tests.

The differences in outcome from the application of the two different tests can be material. Indeed, the Gas Pipelines Control Inquiry undertaken by the Commerce Commission in 2004 undertook both a NPB test and NAB test and found a positive NAB from regulating all pipeline providers, but a negative net public benefit from regulating all pipeline providers.

5 Implications for analysis of net consumer benefits test

The application of a net consumer benefits test to the Air New Zealand/Qantas TNA application under the Civil Aviation Act, would raise a number of key considerations that the Minister's deliberation should be cognisant of:[4]

- The implications of the structure of the proposed TNA in terms of calculating a reasonable rate of return on capital that will form an acceptable producer surplus welfare gain. These implications include:
    - The ability to accurately distinguish capital associated with the TNA from other capital held by both parties to the proposed TNA (which will influence the value of the return on capital i.e. profit)
    - The appropriate level of return i.e. the WACC determined to be reasonable for the TNA. How will this reflect the combined costs of debt and equity

[3] This approach assumes that it is in the interests of consumers for firms to earn reasonable profits; otherwise firms would cease to supply the relevant service.

[4] In addition to the calculation of consumer losses, and simple deadweight losses.

inherent for each of the parties to the proposed TNA? How will their costs of debt and equity be weighted?

- The ability of the analysis to ensure that cross-subsidisation between capital associated with the TNA, and other capital held by parties to the TNA, does not occur. Cross-subsidisation will distort the signals intended to be created by allowing a reasonable return on capital.
- The allocation of common costs between TNA routes and other routes.

- The appropriate consideration and treatment of foreign ownership in terms of its influence on the producer surplus. Given the strong foreign ownership component for Qantas, the treatment of returns to foreign owners will be pivotal to the results of the test. The consideration will have to reflect a view on the comparability of returns to domestically owned capital, as opposed to foreign capital involved in the TNA.
- The extent to which factors in the proposed TNA that fall outside of the scope allowed by the Civil Aviation Act should be considered in the application of a consumer benefit test. In the legal opinion attached to Wellington International Airport Limited's submission, Mr Michael Taggart identified that the Minister can authorise provisions in an agreement respecting and relating to international carriage by air between two or more airlines (legal persons), that "relate, whether directly or indirectly, to the fixing of the tariffs, the application of the tariffs, or the fixing of capacity, or any combination thereof".[5] Consideration will need to be given to how factors outside of this mandate will be treated in a welfare test.

[5] "*Tasman Network Agreement*" Letter from Michael Taggart, 23 May 2006, para 14. http://www.transport.govt.nz/assets/NewPDFs/24-May-06-letter-from-Chapman-Tripp.PDF