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John Macilree
Ministry of Transport
PO Box 3157
Wellington

TASMAN NETWORKS AGREEMENT – WIAL RESPONSE TO TRETHEWAY

1 We refer to your letter of 13 September 2006, inviting comment on the two reports provided by the applicant airlines, authored by Dr Michael Tretheway (the *Tretheway Reports*), in relation to the proposed authorisation of the Tasman Networks Agreement (*TNA*).

Summary

2 We asked LECG, the expert economic consultants assisting Wellington International Airport Limited (*WIAL*), to respond to the Tretheway Reports.

3 LECG has duly prepared two further reports, which we **attach**. The report by Kieran Murray entitled "Response to review of Dr Michael Tretheway of LECG Report" responds to selected points asserted in the Tretheway Reports. The report by Tim Maloney entitled "Review: Report of Dr Michael Tretheway" examines whether the Tretheway Reports apply sound and accepted principles of statistical and econometric analysis. It makes a number of criticisms.

4 Following our own review of the tenor of Tretheway Reports, we thought it might assist if we provided some guidance on the proper role of the

economic expert, as that role has been defined in this jurisdiction. This we do so below. We expressly asked LECG to observe those parameters in preparing the above reports. We recognise that the Ministry will not be assisted by partisan advocacy on the part of our, or other, experts.

5 Nor will the Ministry be assisted by arguments that have been developed by experts on the basis of incomplete information. In that regard, since receiving your letter, we have also received a letter dated 15 September 2006 from the Assistant Secretary of Transport (*Bradbury Letter*), in which he responds to our Official Information Act request to the Ministry of Foreign Affairs and Trade seeking information relating to any review that might be occurring of New Zealand's air services arrangements with the United Arab Emirates (*UAE*). That letter is **attached**.

6 We have also obtained, from other official sources, a copy of the New Zealand – UAE Air Services Agreement, signed between the respective Governments on 1 March 1998 (*ASA*), to which the Bradbury Letter makes reference.

7 The Bradbury Letter, together with the ASA itself, reveal for the first time that not only does Emirates in fact have only limited rights to fly to and from New Zealand, but the Ministry already has taken preliminary action to enforce those restrictions on Emirates more vigorously.

8 It seems clear that these constraints on Emirates' ability to compete were not made known to Dr Tretheway. Thus, his expert evidence is based on erroneous assumptions, and as a result, has limited probative value. It would only be fair to invite Dr Tretheway to reconsider his evidence after he has received a full briefing on the ASA and the review described in the Bradbury Letter.

9 Of course, that same briefing should be given, as a matter of urgency, to ourselves and other interested parties, including the ACCC.

10 More generally, the fact that this new information has just come to light – as a result of our inquiries to another Government Ministry - raises serious questions about the credibility of the whole authorisation process the Ministry is carrying out. We set out some of these questions.

Proper role of the economic expert

11 It may be helpful if we begin by setting out the proper role of an expert witness.

12 Both statute (High Court Rule 330A) and case law in this country require an economic expert, when acting as an advocate, to provide disinterested expert evidence. It is worth including the full statement of the High Court in *Commerce Commission v Carter Holt Harvey Building Products*:

> *As with other experts, the role of economists is to provide disinterested opinion evidence to the Court based on the evidence of other witnesses and the experts' particular field in order to assist the Court in arriving at conclusions on topics which are often complex and outside the Court's normal area of inquiry. But the key to such evidence is that it is disinterested and, in this case, although it has been taken into account as the only economic evidence, it must be said that the Court found the evidence of both economists of restricted assistance in reaching conclusions on the principal matters in issue. This was because neither,… was disinterested in the evidence they gave. Neither, …seemed able to contemplate the possibility of accepting conclusions other than their own on particular facets of the evidence they found of importance. Each,… was partisan in his advocacy for the point of view of the party for which he appeared, selective in the evidence which he chose to accept in order to support the view reached, and dismissive of all other evidence which did not fit their theory of the case and what should be the outcome.*

13 Put more succinctly, the Court is saying that economic experts have more legitimate authority when they provide impartial economic analysis that applies objective professional judgement without apparent bias toward the party that engages them.

14 We suggest that Dr Tretheway employs some language that indicates he has a too partisan approach for this jurisdiction. For example, he criticises accepted economic modelling practices (which he has previously endorsed) as leading to "spurious results" due to "simplistic analysis of concentration [which] finds a large but spurious effect." We refer you to the LECG reports, where the authors note the apparent shift of Dr Tretheway's views in respect of Cournot modelling.

15 We do not seek to protect our experts from rigorous examination and criticism where that is warranted. But, we do ask that that criticism be expressed in an appropriate fashion, and more importantly, that it be given with professional disinterest. Certainly, we have asked LECG to observe the parameters described above.

The Tretheway Reports contain substantive errors

16 Their tone aside, the Tretheway Reports contain some serious substantive errors, as the LECG reports show. His regression analysis is a broad

repetition of his analysis prepared several years ago. His central conclusion is that as long as a low cost carrier (*LCC*) is present in an airline market, then market concentration is of no relevance.

17 While the LCC model may reduce average airfares in airline markets, by far the greatest competitive dynamic on the Tasman is presently between Qantas and Air New Zealand. It is a leap of logic to say that the presence of a LCC would effectively constrain the proposed joint venture because it presently constrains those two airlines, operating separately, from raising prices.

18 In any event, Emirates is not a LCC.

19 Further, at the very time Dr Tretheway is inviting us to make this leap of logic, it has now become apparent that Emirates' ability to compete is in fact being curtailed. The Bradbury Letter indicates that officials are currently reviewing Emirates' right to fly the Tasman or, at least, to fully contest those routes with Air New Zealand. There is a clear implication that Emirates' is already pushing the envelope of the competitive conduct it can engage in without losing its right to remain on the Tasman.

ASA constrains Emirates' ability to complete

20 Even on its face, the ASA which grants and governs the right of Emirates to fly into New Zealand (and conversely, Air New Zealand's right to fly to into UAE), substantially restricts Emirates' ability to compete vigorously on the Tasman. If we are correct in the assumption that Air New Zealand is the "designated airline" for New Zealand as a Contracting Party, then:

- Emirates must consider Air New Zealand's interests on the Tasman;
- Emirates must operate at "reasonable" load factors, and charge "reasonable" tariffs on the Tasman;
- the Ministry of Transport has the power to withdraw approval of Emirates' airfares on the Tasman so far as they are below that of Air New Zealand; and
- it is arguable that Emirates could be precluded from expanding its capacity beyond the levels justified by the needs of passengers and freight from New Zealand to Dubai.

21 The existence – and competitive impact - of those restrictions has not been considered previously. Certainly, they were not drawn to the attention of

either the Commerce Commission or the ACCC when those regulators considered the previous Alliance proposal.

22 We do not know the extent to which Emirates' may have observed the letter of those restrictions to date. But, the threat that they now may be enforced must constrain Emirates' future ability and willingness to compete. That loss of competitive tension must impact on the reliability of the regression analysis performed by Dr Tretheway.

23 It would seem however that the existence of those restrictions in the ASA must have been known to other parties. We assume that would include Air New Zealand by virtue of its status as "a designated airline" for the purposes of the ASA. That it had such knowledge certainly would go some way to explaining Air New Zealand's protestations about Emirates for dumping capacity and dropping prices on the Tasman (to the extent of attributing the "bloodbath" to Emirates).

24 It may also be relevant to the meeting between senior Air New Zealand executives and Ministers at the Boulcott Street Bistro where, it has been acknowledged by the Chairman of Air New Zealand, Emirates' impact on the Tasman was discussed.

25 It now seems that Air New Zealand may have been complaining to Ministers, and in the media, about the non-enforcement of restrictions on Emirates ability to compete on the Tasman, which most people – including presumably the Commerce Commission and the ACCC – simply did not know existed.

26 We have set out Air New Zealand's public comments, apparently targeted at Emirates' disregard to the principles of the ASA, in ***Appendix 1***.

The Bradbury Letter has serious implications

27 Seen in new light, these public statements suggest that Air New Zealand may have sought to have greater pressure be placed on Emirates. At the least, it may fairly be assumed that Air New Zealand would have been consulted by the Ministry before it sent its letter to Emirates encouraging that airline to bear in mind the principles in the ASA.

28 The Bradbury Letter implies that that letter to Emirates was stimulated by the Ministry's monitoring of the nature of traffic on Emirates' services to New Zealand – that is, mostly across the Tasman and very little between the Middle East. But, we ask whether the Ministry is also taking action because of complaints it has received about the nature of that traffic. We ask what other parties were consulted as part of that process.

29 We infer from the Bradbury Letter that the Ministry is intending to review Emirates' trans-Tasman rights, especially if Emirates does not respond appropriately to the letter it has received. Such a review naturally would have serious implications in relation to the TNA application, and submissions provided by the Applicants.

30 Put simply, it is not possible for a proper competition analysis of the Tasman market to be concluded with any reliability while doubt remains about Emirates' ability to compete freely in the future. The fact that Emirates' air rights are currently being reviewed, and the revelation that the ASA contains limitations on the competitive conduct that Emirates can safely engage in, must impact adversely on Dr Tretheway's analysis - and indeed the Applicants' own submissions.

31 By way of example, as we show below, Dr Tretheway's view that "Emirates' has the short-term ability to expand capacity in terms of both flights… and seats", must be misfounded given the principles governing capacity contained in the ASA.

ASA and Bradbury Letter undermine Dr Tretheway's analysis

32 Irrespective of the outcome of any such review, the limitations which the ASA already places on Emirates ability to charge competitive tariffs undermine Dr Tretheway's analysis. His economic regression uses figures provided by the Applicants to the ACCC. Any conclusion drawn from those figures assumes that the status quo will continue to prevail.

33 Dr Tretheway clearly places significance on the presence of Emirates' in constraining trans-Tasman flight prices. He is seemingly unaware of the constraints the ASA places on Emirates' from acting competitively. He states in regard to regulatory barriers facing Emirates (para 9.3):

> *New Zealand and [UAE] have an open skies treaty which provides carriers of the UAE unlimited frequencies and capacity on trans-Tasman routes.*

34 And he concludes (para 9.3.7):

> *Thus Emirates has the short-term ability to expand its trans-Tasman capacity in terms of both flights, and especially in terms of seat capacity.*

35 This can be contrasted with comments in Bradbury's Letter:

> *Although the Memorandum of Understanding accompanying the ASA with the UAE provides for no restriction on capacity, the ASA does outline the principles governing that capacity. These include…[Article 9 of the ASA]*

36 In fact, the relevant sections of the ASA significantly constrain Emirates' in the competitive punches they can pull, without jeopardising its air rights, in relevant part it provides:

- Emirates must have regard to Air New Zealand's interests when flying the Tasman, so as not to affect unduly the agreed services which Air New Zealand operates (*Article 9(2)*);
- Emirates must provide trans-Tasman services that "bear a close relationship to the requirements of the public for transportation… they shall have as their primary objective the provision, at a reasonable load factor, of capacity adequate for the current and reasonably anticipated requirements of passengers…" (*Article 9(3)*);
- Emirates' tariffs must be at "reasonable" levels on the Tasman (*Article 10(1)*); and
- the Ministry (and the equivalent Australian authority) must approve Emirates' tariffs on the Tasman, with the Ministry having the ability to refuse tariffs below that of Air New Zealand (*Article 10(5)*).

37 Those constraints are not consistent with Emirates providing the "fare reducing impact" that Dr Tretheway contemplates.

38 Those constraints are also quite inconsistent with the claims Air New Zealand has made about its competitor. Rob Fyfe has stated that Emirates has the financial muscle to be able to dump capacity and drop ticket prices "so low that they would reduce any accountants in the audience to tears". Hypothetically speaking that may be so. But, that muscle is irrelevant if it cannot be used.

39 Regardless of Dr Tretheway's misconception about the ability of Emirates' to expand in reaction the joint venture, Emirates' presence was also a significant factor in Dr Tretheway's regression analysis, and subsequent conclusions. He states at para 5.5.1:

> *If we also introduce an indicator for the presence of Emirates [in a simple regression], we also see the important, fare reducing impact of the presence of this carrier in the market.*

40 And continued at para 5.8.2:

> *Controlling for the presence of an LCC is essential for analysis of average airfares. In the case of the trans-Tasman market, the long-haul, low cost 5th freedom carrier, Emirates, also appears to have a large impact on average air fares, and must be controlled for in the analysis.*

41 The Ministry's letter to Emirates encouraging them to bear the principles of the ASA in mind is clearly intended to restrict Emirates in their competitive conduct. It can only be assumed the Emirates is currently pushing the envelope, and it is not safe to assume that it will be allowed to continue to act in this competitive manner.

42 It is also highly relevant that the Ministry is encouraging Emirates to commence direct flights between the UAE and New Zealand, especially following delivery of the new A380 Airbus. Those direct flights, if introduced, would almost certainly lead to a reduced Emirates' presence on the Tasman. All interested parties should be informed that Emirates' is tied to a chain that is dictated by foreign policy. The existence of such a chain is contrary to New Zealand's rhetoric surrounding its "open skies policy".

A full briefing on the ASA and its review required

43 As we demonstrate above, Dr Tretheway's analysis has been rendered unreliable by the disclosure of the restrictions contained in the ASA and the Ministry's latent threat to enforce them. It would be only fair to invite him to reconsider his analysis after he has received a full briefing on the ASA and the Ministry's intentions.

44 Indeed, it would be wrong for the Ministry to allow the public submission process to proceed, or for the Minister to be left to rely on the evidence given by Dr Tretheway in its present form.

45 Fortuitously, we and LECG have had access to a copy of the ASA to guide us in preparing this submission. The Bradbury Letter was regrettably brief in its own description of the obligations and principles contained in the ASA. If we had not had the benefit of actually seeing the ASA (which the Ministry had withheld from us), we too would have been misguided, as we can only assume other interested parties have been.

46 The only appropriate course now is for the Ministry to provide all interested parties with a full briefing on the ASA and the Ministry's intention (just as for Dr Tretheway) and to give them an opportunity to comment on that new information.

Implications for the "Code Share" Authorisation Process

47 While the course we advocate would delay the authorisation process, that delay has been caused by a substantial change of circumstances.

48 Clearly, the Ministry has been put in an invidious position by the possible review of the ASA. On one hand, some officials at the Ministry are unwilling participants in a process to constrain (and potentially eliminate) Emirates as a competitor to Air New Zealand on the Tasman. They are of course well aware of the constraints imposed on Emirates under the ASA and have an enforcement role.

49 On the other hand, their colleagues at the Ministry are being asked to advise the Minister on the proposed authorisation of the TNA. To them, the applicant airlines – and their expert - are arguing that Emirates is an unconstrained competitor.

50 This untenable paradox has only just come to light.

51 It would seem that there has been a process going on within the Ministry and the Government more widely, involving at least Air New Zealand, that has not been revealed to either the public or the other parties interested in the Tasman "code share". That this has come to light at this late stage means the credibility of the whole process by which the TNA is being assessed must be questioned.

52 Particular questions that require answers include:

52.1 What role did Air New Zealand play in having the Government pursue Emirates about their traffic on the Tasman and compliance with the ASA?

52.2 Was Air New Zealand aware of the pressure being applied to Emirates when they made submissions asserting that they are unconstrained competitors? If so, how does that fit with their submissions and public statements about Emirates?

52.3 Was the need for enforcement of the ASA discussed with Ministers at Boulcott St Bistro on 13 March 2006? If so, why has that not been explained more clearly?

52.4 Why was the ACCC not told of the active threat to Emirates' rights and freedom to compete on the Tasman?

52.5 Why were other parties who made submissions to the Ministry and the ACCC not advised of the restriction in the ASA and its review?

52.6 Why was Air New Zealand's expert economics witness not advised of this extremely significant factor before he provided his latest evidence to the Ministry and to the ACCC?

Yours faithfully

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