

14 March 2014

**Inquiry into the Services Sector
Productivity Commission**

By email: info@productivity.govt.nz

Dear Sir/Madam,

Boosting productivity in the services sector: Air New Zealand response to 2nd interim report

Air New Zealand welcomes the opportunity to comment on the Commission's 2nd interim report on Boosting Productivity in the Services Sector (**Report**). Our comments focus on Chapter 4 of the Report, *Improving competition law* and in particular the recommendations relating to a reform of section 36 of the Commerce Act 1986 (**section 36**). As well as being a market leader in the provision of air services, Air New Zealand transacts with a number of suppliers who have substantial market power, so has experience in applying section 36 to its business decisions.

The central theme of our submission is that the Commission should recommend that a full analysis of the current prohibition needs to be undertaken, including whether any potential reform is suited to the New Zealand economic environment. New Zealand's small economy means that there will be a number of industries which support only a single or very few large New Zealand-based suppliers, competing globally or against overseas competitors and needing to benefit from the scale of their home markets. Any reform must therefore avoid promoting inefficient entry or increasing uncertainty for incumbent suppliers. The current purpose-based factual/counterfactual approach provides firms with a high degree of certainty regarding their business decisions, as purpose can generally be assessed at the time the decision is made. In contrast, an effects based test requires large firms to make a forward looking assessment of the market consequences of their decision. In contrast, the competition authority will be able to assess the actual effect of conduct with the benefit of hindsight.

We elaborate on these issues below.

Arguments for and against the current market power prohibition

Air New Zealand considers that the concerns in the Report regarding the current market power prohibition have been over stated. In addition, any debate on the positives and negatives of the current market prohibition cannot be had in isolation, but must be considered relative to any proposed reform.

False positives

The current market power prohibition has a very low risk of false positives. The examples provided by Professor Gavil during the Competition Matters conference, and which appear to be repeated in the Report, suggest that firms with market power (or perceived market power) will be dissuaded from undertaking efficiency enhancing activities such as setting supply-chain standards and making technology investments.

The examples cited by the Commission ignore the 'purpose' limb of the current prohibition. The purpose limb requires any misuse of market power to be for one of three anti-competitive purposes: restricting entry, prevent or deterring competitive conduct, or eliminating competition. While the examples given are relatively broad, on their face they would appear very unlikely to breach the purpose test, provided that it is reasonably discernable from the available evidence and surrounding circumstances that the actions were efficiency enhancing. In fact, these activities would appear more likely to be in breach of an effects based test, despite them being efficiency enhancing.

Application of the counterfactual test

Air New Zealand considers that the test, as currently formulated, is relatively clear cut and is not a "much more complex test" than similar provisions in the Act. We also understand that there is broad support for the test amongst New Zealand businesses, which we hope will be reflected in submissions to the Commission. Any new test which requires firms to assess the range of possible competitive effects of a particular business decision would require a costly, risky and subjective analysis, and has the potential to result in the business community taking a business risk averse approach to decisions. Because the effects tested is judged in hindsight, and it is often difficult to assess the effects of a business decision, any effects based test would have a greater risk of false positives in the current section 36, and is likely to discourage efficiency enhancing behaviour. For example, a business may be reluctant to invest in research and development if the resulting innovation puts it at a significant cost advantage to a new entrant, and risks breaching an effects test. Even if the business can demonstrate an efficiency defence, the effort and expense required to rebut any allegation of anti-competitive effect may tip the balance against investing.

Test must be appropriate for the New Zealand market

Air New Zealand agrees with the Report's interim recommendation that New Zealand should take a 'wait and see' approach to reform, given the review currently being undertaken in Australia. While the Australia review will be relevant, the Commission is correct to acknowledge that a competition law framework based on large-country models may not be appropriate for a small, remote economy such as New Zealand's, and that in many cases the size of a market in New Zealand may only support one efficient supplier.

As the Report recognises, a healthy competitive process can take many forms. It cannot therefore be assumed that high levels of concentration in market equates to a lack of competition. Given the small size of the New Zealand economy, competition is often 'for the market', requiring businesses to continuously monitor the threat of potential competition. In such markets, reform should recognise the constraint provided by the threat of overseas entry, and aim to reduce barriers to entry to encourage efficient entry rather than limiting the ability of the incumbent firm to react to the threat of competition. One good example in the airline industry are 'thin' airline routes, being regional or international airline routes that only have sufficient patronage to support one airline, but

in which Air New Zealand is constrained in its pricing decisions by the potential entry of competitor airlines.

Reform must be demonstrably better

Any misuse of market power prohibition, however characterised, is likely to involve trade-offs between the various issues on pages 70 – 71 of the Report. Debate on these issues has been a feature of the recent Australian reform and the US review of single-firm conduct. The Australian experience in implementing the “Birdsville Amendments” in 2008 illustrates the need to comprehensively consider the consequences of any reform of the market power provisions. The motivation behind the changes was to provide small businesses with greater protection from predatory pricing. However, following implementation, the amendments were criticised and described by the ACCC itself as both a case of one step forward, but perhaps a couple backward, and “ill-conceived and created more problems than it solved by increasing complexity rather than removing it”.¹

Air New Zealand agrees with the view stated in the Report that “any review of the current law should include a thorough legal and economic analysis of the extent and costs of any anti-competition behaviour” regarding the current section 36. A similar rigorous analysis should also be applied to any proposed reform, together with the costs, including “hidden” costs, of compliance and enforcement. This should include an examination of real examples of innovation or entry that have failed due to the application of the current section 36 and whether any proposed reform would have assisted. Any proposed reform of section 36 is likely to raise its own complexities, and should only be adopted if it can be demonstrated that such reform is clearly superior to the current section 36.

Further debate is required

Air New Zealand believes that further debate and analysis is required before it can be concluded that “[t]he Government should review section 36....to assess how best to improve its accuracy in identifying situations where firms take advantage of market power for anti-competitive purposes”. We suggest that the Commission recommends further debate on the merits of the current section 36, particularly relative to any proposed reform, before any such reform is deemed necessary.

The Report places a heavy reliance on material provided to or procured by the Commerce Commission, which has consistently expressed its dissatisfaction with section 36 following unfavourable (to the Commerce Commission) Privy Council and Supreme Court judgments. The Report refers to the Competition Matters conference, and in particular a panel of speakers chosen by the Commerce Commission. While the members of the panel discussion on section 36 were all very distinguished speakers, the only speaker at the conference who spoke against reforming section 36 was given less than 10 minutes of speaking time, and during the formal part of the conference there was very little of the ongoing discussion referred to in the Report.

Professor Gavil, a speaker at the Competition Matters conference, is quoted extensively with approval in the Report. However, the Report refers only to the slides presented by Professor Gavil

¹ *Delivering for Australian consumers: making a good Act better*, 25 June 2008, Graeme Samuel, Chairman, see <http://www.accc.gov.au/system/files/Delivering%20for%20Australian%20consumers%3A%20making%20a%20good%20Act%20better.pdf>

at the Competition Matters conference, and Air New Zealand is unaware of any supporting paper. In the absence of any such supporting paper, and therefore any real ability to critically analyse Professor Gavil's analysis, it is difficult to see how the Commission can conclude that Professor Gavil's conclusions are "persuasive".

Air New Zealand understands that there remains a genuine divergence of views on whether section 36 requires reform. Air New Zealand hopes that the Commission receives responses to the Report from the business community which confirms this divergence of views, and that it actively seeks out the views of the business community before it releases its final report.

Thank you again for providing us with the opportunity to respond to the Commission's Report. Please feel free to contact the author, or John Blair (General Counsel) at john.blair@airnz.co.nz if you wish to discuss this submission further, or to seek Air New Zealand's view on any other issues.

Regards



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