Commercial in Confidence

Office of the Minister of Finance
Office of the Associate Minister of Finance
Office of the Minister of Transport

17 December 2002

Chair
Cabinet Business Committee

AIR NEW ZEALAND QANTAS STRATEGIC ALLIANCE

Proposal

1. At its meeting on 16 December 2002 Cabinet authorised the Cabinet Business Committee on 18 December 2002 to have Power to Act in considering the submission on the proposed Air New Zealand – Qantas Strategic Alliance (the "Alliance") [CAB Min (02) 34/23].

2. We are seeking the Committee's agreement to:

   (a) Qantas being granted unconditional Kiwi Shareholder consent to acquire an interest of up to 4.99% of the equity securities in Air New Zealand;

   (b) Qantas being granted conditional Kiwi Shareholder consent to acquire the balance of equity securities they are seeking, up to 22.5% of total Air New Zealand equity securities;

   (c) Air New Zealand being granted conditional Kiwi Shareholder consent to make changes to the Air New Zealand constitution; and

   (d) approve in-principle the Alliance from an ownership perspective.

3. Agreement to the conditional consents (b) and (c) above would mean that Kiwi Shareholder approvals would be granted immediately for the entire 22.5% equity holding in Air New Zealand sought by Qantas, and associated constitution changes, subject to:

   - all necessary authorisations for the Alliance being granted by the New Zealand and Australian competition authorities;

   - there being no material changes to the Alliance proposal, or significant new information revealed, during the competition authorisation and any other regulatory processes; and

   - approval of the Alliance transaction by Air New Zealand shareholders, with respect to any portion of equity securities requiring shareholder approval.

4. In the event that the competition authorities granted authorisations in mid 2003, Cabinet would then decide whether there had been any material changes to the proposal, or significant new information revealed. Any change to the proposal or significant new information would only be considered material or significant if it would alter the original national interest judgements made by the Cabinet. If Cabinet were satisfied that this condition had been met, then the Kiwi Shareholder would be invited to reconfirm his consents prior to a shareholders' vote taking place.

5. The in-principle ownership decision means that the Minister of Finance, as principal shareholder, sees no obstacles to voting for the transaction at a shareholders' meeting. However, if there were material changes to the proposal, or significant new information revealed, during the course of the competition authorisation processes, this decision would be reconsidered at the same time that Cabinet decided whether to confirm the conditional Kiwi Shareholder consents.

6. Favourable decisions in December would also mean that the initial 4.99% equity holding in Air New Zealand sought by Qantas would be approved unconditionally. Qantas intends to pay for this equity holding soon after Kiwi Shareholder approval is granted. By itself, the 4.99% holding represents a passive portfolio holding. Accordingly, this approval would not be revisited even if there were material changes made to the wider proposal, or significant new information revealed during the competition authorisation processes.

Executive Summary

Strategic Rationale: Airlines' Perspective

7. From Air New Zealand's perspective the Alliance represents an opportunity to remove a critical threat to its long-term viability. Without the Alliance, Air New Zealand would remain in a fragile financial position for the foreseeable future. The only part of Air New Zealand's flying business that is currently profitable is its domestic routes. These routes are vulnerable to increased competition from Qantas, and the market is small with limited opportunity for growth. International routes usually make large losses.

8. From Qantas' perspective the Alliance represents an opportunity to establish a significant airline grouping within Australasia, and an important step towards securing Qantas' long-term position as an Australasian based global network carrier.

9. Both airlines are of the view that the Alliance represents a one-off window of opportunity to develop a sustainable regional airline group, while preserving two strongly branded, locally based international airlines.

Key Judgements

10. Ministers will need to make two significant judgements before they will be in a position to make a decision on the proposed Alliance:

- **Factual and Counterfactual** – Ministers need to have confidence in the airlines' assessment of Air New Zealand's likely prospects within the Alliance (the "factual") and how this compares without the Alliance (the "counterfactual"). This will allow Ministers to benchmark the benefits, detriments, and risks associated with the Alliance; and

- **Effective Control** – Ministers need to have confidence in the effectiveness of the proposed governance arrangements, and in particular the incentives the Board and management of Air New Zealand face to safeguard the welfare and autonomy of Air New Zealand within the Alliance. Even though both parties have incentives to work together to make the Alliance work, Qantas may still have a greater level of influence than would be expected given their proposed level of shareholding. Any judgement on the increased influence Qantas may exert over Air New Zealand ultimately rests on whether Air New Zealand's Board and management will consistently take decisions that preserve the option of Air New Zealand terminating the Alliance at minimal cost. The credible threat of exit is one of the key disciplines on Qantas. We are conscious that the Air New Zealand Board is keenly aware of the need to preserve its autonomy over time. A letter of expectations to Air New Zealand's Board reinforcing the need to preserve its autonomy is attached to this report as *Annex Three*.

Competition Issues

11. It has always been clear that one of the biggest national interest issues associated with any possible alliance between Air New Zealand and Qantas would be the effects on competition. Ministers have addressed that issue from the outset by making it clear that the Commerce Commission, and the Australian Competition and Consumers Commission (ACCC), would be relied on to assess any competition issues.

12. Naturally, we are concerned about the potential adverse impacts on consumers arising from the Alliance, including potential increases in prices and reductions in capacity. In our previous term, we introduced a number of reforms to strengthen New Zealand's competition law, and we now have one of the toughest regimes in the world. We are confident that the Commerce Commission (and ACCC) will carefully scrutinise the public benefits and detriments associated with the Alliance, should Cabinet allow the proposal to proceed through the authorisation processes. Commerce Commission and ACCC decisions on the authorisation applications would not be expected until July-August 2003, and may not be finally confirmed until much later if appeal rights are exercised.

Ownership Assessment

13. The key benefit of the proposal from a shareholder's perspective is that the value of Air New Zealand is likely to increase. The specific benefits to the Crown include an improvement to the Crown's operating balance, and a reduced need

to provide Air New Zealand with additional equity. A key drawback to the Crown is the reduced ability to exit from its shareholding and thereby realise the increased value of its shareholding. Other risks associated with the Alliance include:

- the durability of the Alliance, given industry volatility and the reliance of the proposal on sustained cooperation between Qantas and Air New Zealand;
- Qantas' influence and access to information;
- the financial impact of undertakings that may be required by the competition authorities;
- the magnitude of the likely competitor response; and
- the possibility of minority buy-out rights being exercised, though this is considered unlikely.

14. While there are risks attached to the Alliance proposal, these risks need to be compared with the risks that Air New Zealand would face if it does not enter the Alliance. In our view, without the Alliance, Air New Zealand faces an uncertain future where it would:

- continue to have a weak balance sheet, making it more vulnerable to uncontrollable factors such as exchange rate and oil price movements;
- be subjected to a fiercely competitive environment domestically, where it currently generates most of its profits;
- have to bring forward its consideration of its long-haul strategy, including the possibility of downsizing its international networks, with consequent adverse impacts on Air New Zealand's remaining network, and on tourism and trade; and
- have to rely on the Crown, as principal shareholder, for ongoing financial support.

15. In summary, this proposal is likely to be the best on offer for Air New Zealand for the foreseeable future. Given the volatile global airline environment, there is considerable value in Air New Zealand securing a strategic airline partner as soon as possible to help it improve its long-term prospects. The Alliance would give Air New Zealand greater flexibility and options to develop its long-term strategy, particularly with respect to its long-haul operations. As principal shareholder, the Crown would receive significant benefits from the Alliance from an ownership perspective. While the Alliance proposal is not without risk, we consider that these risks are manageable, and of less significance than the risks Air New Zealand would face if it did not enter the Alliance.

National Interest Assessment

16. Officials have undertaken an assessment of the Alliance against the six national interest considerations set by the government, as summarised in the table below.

National Interest Consideration	Summary
Maintenance of effective control of Air New Zealand by New Zealand nationals	This is the most significant issue associated with the proposed Alliance, outside of the competition issues. At an operational level, Qantas will have significant influence over Air New Zealand through the Strategic Alliance Advisory Group (SAAG) and seconded employees. The presence of Qantas directors, even as a minority, also represents a reduction in autonomy of Air New Zealand. There are, however, a number of features of the Alliance that are likely to discipline the behaviour of the two parties.
Continuation of Air New Zealand's ability to exercise New Zealand's existing and future air rights	, officials consider that the risks associated with Air New Zealand's continued ability to exercise New Zealand air rights are manageable.
Preservation of the unique New Zealand identity of Air New Zealand	Air New Zealand will maintain its distinctive brand and identity within the Alliance. The trading name is also protected in the company's constitution. While there is some risk of an erosion in presence through increased co-branded activity, officials expect this will be offset by increased promotional spending and co-location in new international markets.
Provision of effective channels for international tourism and travel	The Alliance will enhance Air New Zealand's options to manage its international networks profitably. The airlines have claimed public benefits arising from the Alliance with respect to scheduling efficiencies, new trans-Tasman services, increased tourism, and improved freight operations. Against this, reduced competition may adversely affect consumers. The Commerce Commission is well placed to explore the public benefits and detriments of the Alliance with respect to New Zealand's international aviation markets.
Provision of a durable domestic air services network	The proposed Alliance can deliver a durable domestic network, but reduced competition may adversely affect consumers. A key concern is the impact of the Alliance on Origin Pacific, as it currently code shares with Qantas. The Commerce Commission is well placed to explore the public benefits and detriments of the Alliance with respect to New Zealand's domestic aviation markets.
Preservation of New Zealand based employment	The net effect of employment changes is likely to be positive compared to the outcomes likely under the counterfactual.

17. On balance, the Alliance proposal satisfies the six national interest considerations, though some aspects would benefit from the scrutiny of the competition authorities. Specifically, the impact of the Alliance on New Zealand's international and domestic aviation markets would be important elements of the

Alliance examined during the competition authorisation processes. While we have concerns about whether Qantas' influence over Air New Zealand may attenuate the control being exercised by New Zealand nationals, we consider this risk to be manageable under the proposed arrangements.

Recommendation

18. We recommend that the Alliance proposal be allowed to proceed through the competition authorisation processes.

Introduction

19. This report provides our assessment of proposals for Air New Zealand and Qantas to enter into a Strategic Alliance, from both an ownership and a national interest perspective.

20. The report is organised as follows:

- **Part One**: Key Issues *(page 6)*
  - The counterfactual scenario that is most likely to occur
  - Effective control of Air New Zealand
- **Part Two**: Summary of the Alliance *(page 10)*
- **Part Three**: Competition Considerations *(page 11)*
- **Part Four**: Ownership Considerations *(page 13)*
- **Part Five**: National Interest Considerations *(page 17)*
- **Part Six**: Other Issues *(page 21)*
- **Recommendations** *(page 22)*
- *Annex One*: Detailed Description of Proposal *(page 28)*
- *Annex Two*: Confidential Annex: Not for Release *(page 34)*
- *Annex Three*: Letter of Expectations *(page 43)*

PART ONE: KEY ISSUES

21. Ministers will need to make two significant judgements in order to be in a position to make a decision on the proposed Alliance:

- **Counterfactual scenario** - Ministers need to broadly agree with the airlines' assessment of Air New Zealand's likely prospects within the proposed Alliance and how this compares with the counterfactual.

- **Effective Control of Air New Zealand** – Ministers will need to have confidence in the effectiveness of the proposed operational and governance arrangements, and in particular the incentives the Board and management of Air New Zealand face to safeguard the welfare and autonomy of Air New Zealand within the proposed Alliance.

22. These two key issues are discussed below.

Counterfactual scenario

23. In our view, without the Alliance, Air New Zealand will remain in a weak strategic position for the future, as set out in more detail in *Annex Two*. The only part of Air New Zealand's flying business that is currently profitable is its domestic routes. These routes are vulnerable to increased competition from Qantas, and the market is small with limited opportunity for growth. International routes usually make large losses, and this would be unsustainable over the longer term.

24. We believe Air New Zealand's major risk going forward is Qantas' ability to compete aggressively on the domestic market, taking market share from Air New Zealand, and reducing its domestic profitability. Such an outcome would bring forward Air New Zealand's need to review its long-haul strategy. A decision to reduce Air New Zealand's long haul services would have adverse implications for the remainder of its network, and for New Zealand's trade and tourism.

25. In our view, should the Alliance not go ahead, Qantas is very likely to increase its New Zealand domestic capacity to build market share and improve profitability. There is unlikely to be a more opportune time to do it given Qantas' strength in its own market, and Air New Zealand's current financial weakness. Under this scenario, Air New Zealand profits are forecast to be relatively weak and its balance sheet would remain highly geared. This would mean it would be vulnerable to increased competition from Qantas, and there would be an ongoing risk that further shareholder support would be required.

26. The assumptions underlying the airlines' assessment of Air New Zealand's likely prospects within the proposed Alliance and how this compares with the counterfactual are as follows:

With the Alliance ("Alliance base case")	Without the Alliance ("stand-alone base case")
• Alliance provides new Trans-Tasman destinations • Air New Zealand and Alliance total capacity rises between 2003 and 2006 • Value-based airline (VBA) has 3 aircraft on the trans-Tasman by 2004, but no entry in New Zealand domestic	• Qantas increases New Zealand domestic capacity from five to eight aircraft to improve its market share and profitability • Qantas increases trans-Tasman capacity and on other selected routes between 2003 and 2006. • VBA has 3 aircraft trans-Tasman by 2004 but no entry on New Zealand domestic

27. Treasury's ownership advisors, First New Zealand Capital (FNZC), confirm that the base case above provides a reasonable assessment of the competitive environment with, and without, the Alliance.

28. Based on this counterfactual, throughout this report we assume that in the absence of the Alliance:

- Air New Zealand would not receive a $540 million capital injection to improve its financial position;
- Air New Zealand would face increased trans-Tasman and domestic competition;
- Air New Zealand would face reduced earnings; and
- less resources and lower earnings would reduce Air New Zealand's options to respond to the volatility that characterises the airline industry.

29. *Annex Two* contains more detail of the counterfactual scenarios and analysis.

Effective Control of Air New Zealand

30. We consider that this is the most significant issue raised by the proposed Alliance, outside of the matters that are expected to be addressed in the competition authorisation processes. It is important both from a national interest and ownership perspective. The analysis from both of these perspectives is brought together in this section of the report.

31. The Alliance combines the commercial management function of the Joint Airline Operation (JAO), while maintaining separate management and governance arrangements within each company. This maintains the independence of each company entity, but adds complexity to their management structures. It is apparent that Air New Zealand has judged that the benefits of the Alliance outweigh the risk that effective control may drift from New Zealand hands. The actual outcome will depend on the behaviour of the two airlines. We discuss the incentives created by the Alliance below.

32. Effective control can be thought of as comprising of operational influence, and more importantly, governance.

    - At an **operational** level (scheduling, pricing, and flight operations), Qantas will have significant influence, but not control, over Air New Zealand through the Strategic Alliance Advisory Group (SAAG) and seconded employees.
    - At a **governance** level, the presence of Qantas directors, even as a minority, represents a reduction in autonomy for Air New Zealand.

Operational Influence

33. While Qantas will have significant operational influence over Air New Zealand, we believe that the processes, and the coincident incentives for profit created by the Alliance, mean that this influence will either work in Air New Zealand's favour, or be muted in practice.

34. The key operational structure in the Alliance agreement is the SAAG. The SAAG's role is restricted to one of influence, not control, and it does not substitute the management-reporting lines within each airline. SAAG's role is to review and endorse the commercial planning, operations, and performance of the

Joint Airline Operation (JAO) Networks, and provide advice to Air New Zealand as commercial manager of the JAO Networks. SAAG is made up of equal representation from each airline, requires consensus for all recommendations, and has a comprehensive disputes resolution procedure (see *Annex One* for more detail).

35. The structure of the proposed Alliance is not dominated by contractual remedies that force a particular outcome. Rather, the Alliance places a focus on processes that provide more than one opportunity for each party to resolve issues.

36. The dynamic created from this approach is likely to bring negotiated outcomes that benefit each airline. The approach effectively creates veto rights, as each party has to consider the benefit gained from remaining in the Alliance and the cost of terminating it. In some circumstances this may create advantages for Qantas, as it is a larger airline and approximately 85% of its operations are outside the JAO. However, the Alliance includes “safety valve” options for both parties, such as placing non-performing new routes in “intensive care”, or excluding operations from the management fee calculation. These arrangements provide some assurance to Air New Zealand, in particular, that existing routes will be preserved.

37. Both airlines face strong incentives to maximise earnings from the Alliance. The incentives are created from the calculation of the management fee, and the potential to achieve higher profit margins from, amongst other things, increasing the efficiency of operations, and improved scheduling. The discipline is reinforced by Qantas’ proposed equity stake in Air New Zealand and consequent expectation for a return on its investment. Further, any breach of the terms of the Alliance by Qantas would require Qantas to sell down its equity share in Air New Zealand. A sell down may not necessarily advantage Qantas in terms of timing, Kiwi Shareholder considerations, or access to other buyers.

Governance

38. Qantas is able to nominate two directors to the Board of Air New Zealand.

39. While the presence of Qantas directors, and the shareholding restrictions, represent a reduction in the autonomy of Air New Zealand, we believe that the ongoing option to terminate the Alliance, reinforced by explicit principal shareholder expectations, will go some way towards managing this issue. The Alliance agreement recognises this and it focuses on ensuring both airlines will be able to exercise the right to terminate the Alliance in the event one party’s behaviour is detrimental to the other’s interests. This is the ultimate discipline at a governance level.

40. The key risk that we see around governance is that Air New Zealand is likely to face increasing pressure to integrate its operations with Qantas, particularly where this will maximise Air New Zealand’s profitability. Areas that could be integrated to achieve efficiencies, but which would also be costly to separate, include IT systems, distribution systems, and sales teams. Such integration

carries the risk of attenuating Air New Zealand's autonomy by increasing its separation costs, potentially to the point where the option to terminate is no longer a credible discipline on Qantas.

41. The Air New Zealand Board is keenly aware of the need to preserve the company's autonomy. To reinforce this, we recommend that, if the proposal is approved, the Minister of Finance writes to the Air New Zealand Board setting out his expectation that the Board continue to ensure that the company retains the capacity to operate autonomously in the event the Alliance terminates. Treasury's legal advisors confirm that the Minister of Finance would be able to set high-level expectations in this way. Treasury would put in place arrangements to monitor this expectation, but the Government would need to place significant reliance on the Board (*Annex Three* is a letter of expectations to the Board of Air New Zealand).

PART TWO: SUMMARY OF THE ALLIANCE

42. The main features of the Alliance are:

- **Equity placement to Qantas:** Qantas would subscribe for new equity securities in Air New Zealand for a total shareholding of 22.5%;
- **Establishment of a Joint Airline Operation (JAO):** all of Air New Zealand's domestic and international *flying* operations, and all of Qantas' *flying operations that touch New Zealand* would be managed through a joint venture between the two airlines;
- **Air New Zealand Manages the JAO:** Air New Zealand would be responsible for managing the day-to-day operations of the joint venture but would be required to consult the Strategic Alliance Advisory Group (SAAG), made up of three members from Qantas and three from Air New Zealand, on material matters affecting the JAO. Qantas would also have veto rights over decisions relating to material changes in Qantas' capacity;
- **Management Fee and Adjustment Payment:** a management fee and adjustment payment formula has the effect of allocating profits generated by the Alliance 60% to the airline that provided the aircraft capacity with the remaining 40% shared 50/50 between Air New Zealand and Qantas.
- **Reciprocal Board Rights:** Qantas would have the right to nominate up to two directors to Air New Zealand's Board. Air New Zealand would have the right to nominate one director to the Qantas Board.

43. The Alliance is for an unspecified term, but either party may terminate the agreement, with 12 months notice, any time after the fourth anniversary of either

the date when all other preconditions for the Alliance are met. Default events that could lead to termination are set out in *Annex One*.

44. In addition, Qantas may terminate the Alliance if:

- Qantas nominees to the Air New Zealand Board are not appointed or re-elected to the Air New Zealand Board; or

45. Air New Zealand may terminate the Alliance if:

- the Air New Zealand nominee to the Qantas Board is not appointed or re-elected to the Qantas Board.

46. *Annex One* contains more detail on the Alliance.

PART THREE: COMPETITION CONSIDERATIONS

47. It has always been clear that one of the biggest issues in the assessment of any possible alliance between Air New Zealand and Qantas would be the effects on competition. Ministers have addressed that issue from the outset by making it clear that the Commerce Commission (and the ACCC in Australia) would be relied on to assess competition issues, using the processes and criteria in the law. That is why the airlines submitted authorisation applications to the regulators on 9 December 2002, and why the Government's national interest considerations did not specifically include competition issues.

48. Naturally, we are concerned about the adverse impacts on consumers that may arise under the Alliance. In our previous term, we introduced a number of reforms to strengthen New Zealand's competition law, and we now have one of the toughest regimes in the world. We are confident that the Commerce Commission (and ACCC) will carefully scrutinise the public benefits and detriments associated with the Alliance, should Cabinet allow the proposal to proceed through the authorisation processes. Commerce Commission and ACCC decisions on the authorisation applications would not be expected until July-August 2003, and may not be finally confirmed until much later if appeal rights are exercised.

Overlap between Authorisation Processes and National Interest Considerations

49. There is likely to be some overlap between the national interest considerations discussed in this report, and the issues that would be considered by the Commerce Commission in its assessment of the public benefits and competitive detriments arising from the Alliance.

50. The Commerce Commission can be expected to examine each benefit claimed by the applicant in some detail, to assess whether the claimed benefit is likely to result from the proposal and, if so, whether the claimed benefit would be as likely

to result in any event under the counterfactual chosen by the Commission. It is therefore relevant that the NECG report[1], which has been submitted as part of the airlines' authorisation applications, claims a number of public benefits, including:

- cost savings;
- scheduling efficiencies through improved flight frequency and enhanced connectivity;
- new direct Trans-Tasman services;
- increased tourism;
- increased engineering and maintenance work in New Zealand; and
- improved freight operations.

51. These areas are therefore likely to receive detailed scrutiny from the Commission. In its assessment the Commission will focus primarily on net economic benefits, and in particular on efficiency gains and losses. The Commission analysis will focus on quantifiable benefits. The weighting given to public benefits by the Commission could differ from Ministers' assessments, particularly with respect to employment. The preservation of New Zealand based employment will not in itself be seen as a public benefit by the Commission.

52. Under a number of the national interest considerations discussed in Part Five of this report we identify areas of overlap with the Commission's work. In two instances we note that there is an opportunity to allow the Commission's determination to be the primary mechanism for testing the benefits claimed by the airlines.

Enforceable Undertakings

53. The airlines' application for authorisation to the ACCC states that the airlines believe that enforceable undertakings will assist the ACCC's consideration of the application. The airlines have signalled their willingness to discuss with the ACCC undertakings intended to achieve the following objectives:

- to facilitate and protect new entry on trans-Tasman and domestic New Zealand routes, including (if necessary) access to terminals, ground services, and engineering facilities;
- to ensure that the Alliance does not take unreasonable actions relating to capacity and prices on routes where the Air New Zealand and Qantas will be the sole operators; and
- to ensure the delivery of certain public benefits identified in the application.

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1 Network Economics Consulting Group: Report on the Competitive Effects and Public Benefits Arising from the Proposed Alliance between Qantas and Air New Zealand.

54. During the course of the ACCC authorisation process, Qantas may be asked about its views on further liberalisation of Australia's air traffic rights, including the granting of further "fifth freedom" rights for third country airlines wishing to fly trans-Tasman routes. While decisions to liberalise these air traffic rights rest with the Australian Federal Government, and are therefore unlikely to materialise as enforceable undertakings to the ACCC, any movement on these issues would be significant for competition in the whole Australia/New Zealand aviation market, and could have a bearing on the outcome of the ACCC authorisation process.

PART FOUR: OWNERSHIP CONSIDERATIONS

55. This section provides an overview of ownership considerations. Further detail is provided in Annex two.

56. The key benefit of the proposal from a shareholder perspective is that the value of Air New Zealand is likely to increase. The Crown will gain a share of increased profits, which will impact on the Crown’s operating balance (even if this does not represent cash paid to the Crown). Further, the Crown is less likely to need to inject capital into Air New Zealand because it will be on a more secure strategic footing.

57. Without the Alliance, Air New Zealand faces an uncertain future where it would continue to have a weak balance sheet, which will make it vulnerable to uncontrollable factors such as exchange rates and oil prices. It is also likely to be subjected to a more competitive domestic environment, where it currently generates most of its profits. This will have implications for the sustainability of the long haul routes, which are usually unprofitable. Air New Zealand may have to consider downsizing its long haul offerings significantly, which the company considers would be very difficult and have a significant effect on the viability of Air New Zealand’s remaining business (for example through the feed effect on domestic routes). Air New Zealand would most likely require a greater level of ongoing financial support from the Crown as principal shareholder, than without the proposed Alliance.

58. This proposal is likely to be the best on offer for Air New Zealand for the foreseeable future. It would give Air New Zealand more flexibility to make choices about its long-term strategy. Despite the risks arising from the proposal, in our view, if the proposal were approved and implemented the Crown would receive significant benefits from an ownership perspective.

Benefits From The Alliance

59. Air New Zealand advises that the key benefits that the Alliance could provide include:

- **Enhanced revenue:** higher yields and higher loadings[2] without the need to increase fares; better flight schedules and improved frequency; improved

[2] For example, by using schedules (such as flying one plane at 6am and one at 11am rather than two at 6am) to provide for different passenger types, so that peak-time planes fly higher-priced business passengers and off-peak planes are fully loaded with price-sensitive leisure travellers. Different-sized planes that better fit demand also reduce cost per passenger.

connectivity between Air New Zealand and Qantas flights; joint development of travel packages; increased feed from excess passengers booked on Qantas flights; and enhanced engineering revenue from becoming Qantas' preferred supplier;

- **Cost savings and efficiencies:** savings from rationalising duplicated infrastructure and overheads; better aircraft utilisation; and other scale efficiencies;
- **Competitive positioning:** Coordinated scheduling, connection requirements and route planning will improve the product offering and allow Air New Zealand to remain competitive against a value-based airline entrant competing against it on selected routes; and
- **Balance sheet improvement:** Qantas will purchase new Air New Zealand equity securities at a total cost of around $540 million, which will allow Air New Zealand to reduce its debt to more sustainable levels.

60. Other airlines do not offer the same benefits to Air New Zealand. For example, Singapore Airlines cannot offer a reduced competitive threat or feed from the Australian domestic market. Nor, we understand, is Singapore Airlines interested in an alliance with Air New Zealand.

Financial Impact of Alliance

61. The Alliance is positive for both Air New Zealand and the Crown as principal shareholder. The two key benefits for the Crown are:

- The improvement to the Crown's operating balance with the Alliance compared to without (i.e. the Crown's share of Air New Zealand's increased profits); and
- The reduced need to provide Air New Zealand with additional equity. Air New Zealand's capital requirements going forward could well be significant given the capital-intensive nature of the airline industry. The reduced need for the Crown to inject capital into Air New Zealand arises from Qantas' equity injection of $540 million as well as Air New Zealand's improved financial performance from the Alliance.

Risks under the Alliance

62. In our view the key risks from the proposal are:

- **Difficulty of exit**: most of Air New Zealand's business[3] will be in the Alliance, and despite Air New Zealand's focus on maintaining independent operations, it is possible that exit will become more difficult over time (however, see *Annex Three* for shareholder expectations letter);
- **Sustainability of Alliance**: there are a number of factors that could influence sustainability of the Alliance including:

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3 Except engineering. Freedom is included in the Alliance but its management and governance are outside it.

  - the complexity of the Alliance structure, which will mean Air New Zealand has less flexibility in dealing with industry developments as they arise;
  - the importance of sustained good relationships between Air New Zealand and Qantas;
  - the long implementation timetable which could lead to a decreased focus on necessary changes; and

- **Qantas' influence and access to information:** Qantas has the ability to significantly influence Air New Zealand's operations through its role on the SAAG. It also has access to Air New Zealand information through its Qantas secondees. If the Alliance were terminated, Qantas would be in a good position to compete with Air New Zealand given it would have had access to a wide range of Air New Zealand information through the Alliance.

63. Other risks to the proposal include:

- **Potential undertakings required by competition authorities:** undertakings and conditions that may be imposed by competition authorities could compromise the commercial rationale of the Alliance. Air New Zealand advises that financial benefits should not be materially affected by possible undertakings. However, if the proposal is approved in principle, we recommend that approvals be reconsidered if there are material changes to the Alliance's forecast financial outcomes as a result of any undertakings;

Risks Without the Alliance

64. We think the most likely scenario without the Alliance is a significant competitive response from Qantas. As such, if the Alliance does not proceed, the key risks are:

- **Competitive response by Qantas:** It is likely that, if Air New Zealand and Qantas do not enter into the Alliance, Qantas will increase its capacity on some of Air New Zealand's most profitable routes to build market share and improve profitability. This would have been likely in the absence of discussions with Qantas in any case. Air New Zealand has taken care to prevent Qantas obtaining specific information that would be advantageous to Qantas if the Alliance does not proceed; and

65. Alternatives, such as Qantas' exit from New Zealand, are considered unlikely. New Zealand domestic services provide Qantas with significant feeder traffic on its trans-Tasman and Australian domestic markets, and it is in a strong financial position to sustain losses for some time until it has established a sustainable market share. If Qantas did exit, it is more likely that another airline (such as a value-based airline) would enter the market and replace Qantas as Air New Zealand's major competitor.

Risks to the Shareholder

66. The Crown's key risk, apart from risks that fall directly on Air New Zealand, is its reduced ability to exit its shareholding.

67. The Government has signalled its intention to remain a majority shareholder in Air New Zealand long term. However, having the flexibility to sell down some or all of its shareholding remains a valuable option for any shareholder.

Alternatives

68. Air New Zealand considers, and we agree, that possible alternatives to the Alliance either have little prospect of occurring or have little to offer Air New Zealand in comparison with the current proposal.

PART FIVE: NATIONAL INTEREST CONSIDERATIONS

69. On 20 November 2002 the Cabinet Policy Committee [POL Min (02) 20/7], having been authorised by Cabinet with Power to Act [CAB Min (02) 31/23], inter alia:

    6 **agreed** that the following considerations should be used to assist the Government's national interest evaluation:

    6.1 maintenance of effective control of Air New Zealand by New Zealand nationals;

    6.2 continuation of Air New Zealand's ability to exercise New Zealand's existing and future air rights;

    6.3 preservation of the unique New Zealand identity of Air New Zealand;

    6.4 provision of effective channels for international tourism and travel;

    6.5 provision of a durable domestic air services network; and

    6.6 preservation of New Zealand based employment.

70. The Alliance proposal has been assessed against these considerations, as discussed below. It should be borne in mind, however, that the Alliance agreement represents a framework for future co-operation, and at this time the airlines have not formulated specific plans in areas such as domestic and international scheduling, joint marketing, global alliance membership, and initiatives impacting on employment

Maintenance of effective control of Air New Zealand by New Zealand nationals

71. This represents the most significant issue associated with the proposed Alliance, outside of the matters that may be addressed in the competition authorisation process. The national interest assessment of this consideration has been incorporated into the analysis of *Effective Control* issues in Part One (page 8) of this report.

Continuation of Air New Zealand's ability to exercise New Zealand's existing and future air rights

72. , we consider that the risks associated with Air New Zealand's continued ability to exercise New Zealand air rights are manageable. Bilateral partners are more likely to express concern where Air New Zealand is seeking to expand operations. In such cases, we would be able to point out that the operations concerned are Air New Zealand's, although sanctioned by the SAAG, and that the SAAG cannot force Air New Zealand to initiate or change operations.

73. Under most of New Zealand's air services agreements, other countries may deny operating authorisations to Air New Zealand if the airline is not able to demonstrate that it is substantially owned and effectively controlled by New

Zealand nationals. Our newer 'open skies' agreements are silent on where ownership capital is drawn from but they do state that operating authorisations can be refused to an airline that is not incorporated in, or have its principal place of business in, New Zealand, or which is not effectively controlled by New Zealand nationals.

74. In terms of substantial ownership, the proposed 22.5% equity stake in Air New Zealand by Qantas is within government policy, which permits a single foreign airline to hold up to 25% stake in a New Zealand airline. And it is within the bounds of what has been generally accepted in other international airlines (for example, Singapore Airlines' recent 25% stake in Air New Zealand and British Airways' 25% of equity securities in Qantas). There is virtually no risk that any country would question Air New Zealand's substantial ownership while the Crown is a majority shareholder.

75. Under the proposed Alliance, Air New Zealand will remain incorporated in New Zealand and its principal place of business will be New Zealand. These are also requirements of Air New Zealand's constitution and cannot be changed without the Kiwi Shareholder's approval.

76. The meaning of effective control is not defined in air services agreements. New Zealand nationals will formally remain in control of Air New Zealand through entrenched provisions in the airline's constitution relating to the nationality of directors and Qantas' ability to only appoint directors in proportion to its minority shareholding. In addition, the Crown as majority shareholder retains significant influence over appointments to the Board.

77.

78.

Preservation of the unique New Zealand identity of Air New Zealand

79. Air New Zealand will maintain its distinctive brand and identity within the Alliance. The trading name is also protected in the company's constitution.

80. There is some downside risk of a reduction in presence through co-branding of locations, and endeavours to extract further efficiencies from the marketing activity. This is offset by potentially greater spending on international marketing available through reduced domestic marketing expenditure, and through dual destination marketing with Qantas.

81. Co-location and shared facilities have the potential to enhance the global presence of Air New Zealand through establishing a brand presence in more locations. In addition there will be benefits in new markets and those locations

where Air New Zealand is currently not represented, or is represented through sales agents.

Provision of effective channels for international tourism and travel

82. New Zealand tourism is almost totally reliant on air travel for visitor arrivals. Consequently the quality and convenience of inbound channels is a vital determinant of how the New Zealand tourism industry performs. The open nature of the industry, however, means that the provision of these channels comes from a variety of sources including offshore. Airfreight is also an increasingly important channel for trade, especially for highly perishable and other time-sensitive exports.

83. Air New Zealand's long haul operations are currently unprofitable, and the airline must decide if it has the ability to reverse this trend or alternatively scale back its operations. Network effects may prevent Air New Zealand from cutting some international routes without also adversely impacting on its traffic feed into connecting routes, and the domestic network.

84. Under the Strategic Alliance the airlines expect the following outcomes to arise:

- the Alliance will enable the Air New Zealand to maintain its position in its international markets. This implies that this may be less assured under the counterfactual;
- marketing expenditure will be able to be shifted from domestic promotion to international promotion to improve demand for international services;
- new routes across the Tasman will be established;
- scheduling is likely to improve on some routes, thereby providing a wider range of departure times and potentially improved convenience, especially on the Tasman (the capacity rationalisation is designed to improve load factors);
- there will be some growth in output across other JAO services; and
- freight access to major markets will be maintained, and in some cases improved.

85. The NECG report, which has been submitted as part of the airlines' authorisation application, claims public benefits arising from the Alliance with respect to scheduling efficiencies, new direct Trans-Tasman services, increased tourism, and improved freight operations. In addition, the NECG report predicts price increases and capacity decreases. In light of this, we are confident that the Commerce Commission would closely scrutinise most of the relevant issues associated with this national interest consideration. Accordingly, there is an opportunity to allow the Commerce Commission's authorisation process to be the primary mechanism for testing the claims made by the airlines regarding the effects on New Zealand's international aviation markets.

86. There are specific issues which we have identified as warranting examination by the Commission, including:

- **the effect of both Qantas and Air New Zealand possibly shifting into one global alliance** – the STAR and **one**world alliances represent 40% of global airline travel, each having important traffic feed from key markets into New Zealand. Qantas and Air New Zealand together have around 75% market share of the to/from New Zealand international air travel market. If the proposal resulted in only one alliance serving New Zealand this could have a material impact on travel from key markets; and

- **interline arrangements** - rival carriers may find New Zealand less attractive to service if they are unable to locate effective domestic partners to provide inter-line services beyond Auckland and Christchurch.

87. We expect that public submissions made to the Commerce Commission through the authorisation process will address these issues.

Provision of a durable domestic air services network

88. The proposed Alliance can deliver a durable domestic network, but reduced competition may adversely affect consumers. The NECG report states that prices will rise and capacity will fall. These latter effects would be fully explored by the Commerce Commission if the proposal proceeds further.

89. Against any potential changes in the competitive environment, there could be other benefits. Joint scheduling, for instance, is likely to improve convenience of travel on certain routes. On many domestic routes Air New Zealand and Qantas now both operate similar schedules at peak times, resulting in excess capacity at some times and a more narrow spread of departure times than could be achieved by joint scheduling.

90. One critical factor will be the extent to which Origin Pacific remains a viable competitor on provincial routes and new carriers are able to enter the domestic market. The ability and willingness of Origin Pacific and potential new entrants to compete in New Zealand could constrain the ability of the Alliance to exercise market power. Origin Pacific currently receives passenger feed from Qantas and it is unknown what effect the Alliance will have on its profitability. Qantas has stated that they intend to continue an Origin Pacific feed but this would be counter to the interests of the Alliance, and so this should be viewed with caution.

Preservation of New Zealand based employment

91. The net effect of employment changes is likely to be positive compared to the counterfactual.

92. There are three likely sources of employment changes generated by the proposed transaction:

- changes to engineering services;

- changes to frontline Air New Zealand staff, to the extent activity levels are maintained or grow; and
- changes to tourism employment.

93. The Alliance agreement states that Qantas will treat Air New Zealand as a preferred supplier of heavy maintenance engineering services, so long as Air New Zealand's charges and service level remain competitive with alternative external suppliers. In 2001/02, Qantas subcontracted Air New Zealand to supply 43% (NZ$20 million) of all its outsourced heavy maintenance work. For 2002/03 this has increased to 78% (NZ$40 million) of Qantas' outsourced heavy maintenance work. The NECG report states that under the Alliance, Qantas would have an incentive to direct up to 80% of its subcontracted external heavy maintenance to Air New Zealand, providing revenue of $NZ45 million and supporting 224 skilled engineering staff. There is also a suggestion in the NECG report that without the Alliance, the current level of contracted work from Qantas may reduce to NZ$6 million, which would support only 30 skilled staff.

94. The Alliance may also increase employment of front-line staff to the extent that Air New Zealand can maintain or grow its operations. This is a judgement that needs to be considered in relation to the growth forecasts that have been presented by the airlines.

95. We are unable to assess the extent to which any second round benefits from the claimed increases in tourist numbers may result in an increase in employment generally. The NECG report claims that over 2500 jobs in the tourism industry will be created under the Alliance.

96. The Alliance transaction also raises the possibility that the airlines will pursue joint initiatives to rationalise labour costs in order to achieve efficiencies. The impact of such initiatives on New Zealand based employment is difficult to assess. Nevertheless, the scope for such initiatives may be constrained to the extent that Air New Zealand maintains independent operations in order to protect the option of the company terminating the Alliance agreement.

PART SIX: OTHER ISSUES

Communications

97. The communication of the Government's decision will require careful management. Air New Zealand may request a suspension of trading in its shares on the morning the Government's decision is taken. Air New Zealand also require a 30 minute window between being privately advised of the decision, and any Ministerial public announcement.

98. It is proposed that the Minister of Finance, Associate Minister of Finance (Hon Trevor Mallard) and Minister of Transport jointly announce the government's decision.

99. Ministers' oral and written statements, including media releases, will need to be carefully constructed to manage the legal risks arising from the Crown being an insider of Air New Zealand. All Ministers will receive a copy of separate legal advice to the Minister of Finance on this issue.

Financial Implications

100. There are no immediate financial impacts.

Legislative Implications/Regulatory Impact Statement/Treaty Implications/ Human Rights Act

101. None.

Consultation

102. The Treasury has consulted the Ministry of Transport, Ministry of Tourism, and Department of the Prime Minister and Cabinet during the preparation of this report.

RECOMMENDATIONS

103. We recommend that Cabinet Business Committee:

Nature of Decision

1. **note** that on 16 December 2002 Cabinet authorised the Cabinet Business Committee on 18 December 2002 to have Power to Act in considering the submission on the proposed Air New Zealand – Qantas Strategic Alliance (the "Alliance") [CAB Min (02)34/23]

2. **note** that on 25 November 2002 Qantas submitted an application to the Air New Zealand Kiwi Shareholder (Hon Paul Swain) seeking approval for Qantas acquiring 22.5% of the equity securities in Air New Zealand, including unconditional approval for Qantas acquiring up to 4.99% of the equity securities in Air New Zealand;

3. **note** that on 26 November 2002 Air New Zealand sought approval from the Kiwi Shareholder for changes to the Air New Zealand Constitution arising from the proposed Alliance;

4. **note** that Air New Zealand has also sought an indication from the Minister of Finance, as principal shareholder, as to whether he supports the Alliance;

5. **note** that an agreement to provide conditional Kiwi Shareholder consents for Qantas acquiring 22.5% of the equity securities in Air New Zealand, and associated changes to the Air New Zealand constitution, would be subject to:

   5.1 all necessary authorisations for the Alliance being granted by the New Zealand Commerce Commission (Commerce Commission) and Australian Competition and Consumer Commission (ACCC);

5.2 there being no material changes to the Alliance proposal, or significant new information revealed, during the competition authorisation and any other regulatory processes;

5.3 approval of the Alliance transaction by Air New Zealand shareholders, with respect to any portion of equity securities requiring shareholders' approval;

6. **note** that should conditional Kiwi Shareholder consents be granted, and the Commerce Commission and ACCC subsequently grant all required authorisations, then Cabinet will decide whether there have been any material changes to the proposal or significant new information revealed;

7. **note** that any material change to the Alliance proposal, or significant new information, would only be considered material or significant if it would alter the original national interest judgements made by the Cabinet or substantially shifted the value of the proposal to the Crown as shareholder;

8. **note** that any agreement to provide unconditional Kiwi Shareholder consent for Qantas acquiring up to 4.99% of the equity securities in Air New Zealand would not be revisited by the government even if there were material changes to the Alliance proposal, or significant new information revealed, during the competition authorisation and other regulatory processes;

Factual and Counterfactual Scenarios

9. **note** that before Cabinet can make a decision on whether the Alliance should be allowed to proceed through the competition authorisation processes, Ministers need to make a judgement about Air New Zealand's prospects within the Alliance, and how this compares with its position without the Alliance (the counterfactual);

10. **note** that Air New Zealand and Qantas have agreed that the competitive environment with and without the Alliance would be characterised as follows:

With the Alliance ("Alliance base case")	Without the Alliance ("stand-alone base case")
• Alliance provides new Trans-Tasman destinations • Air New Zealand and Alliance total capacity rises between 2003 and 2006 • Value-based airline (VBA) has 3 aircraft on the trans-Tasman by 2004, but no entry in New Zealand domestic	• Qantas increases New Zealand domestic capacity from five to eight aircraft to improve its market share and profitability • Qantas increases trans-Tasman capacity and on other selected routes between 2003 and 2006. • VBA has 3 aircraft trans-Tasman by 2004 but no entry on New Zealand domestic

11. **note** that Treasury's ownership advisors, First New Zealand Capital (FNZC), confirm that the base cases in paragraph 10 above provide a reasonable assessment of the competitive environment with and without the Alliance;

Effective Control of Air New Zealand

12. **note** that the most significant issue raised by the Alliance from an ownership and national interest perspective (and outside of the matters that may be addressed in the competition authorisation processes), is whether effective control of Air New Zealand remains in the hands of New Zealand nationals;

13. **note** that at an operational level Qantas will have significant influence, but not control, over Air New Zealand through the Strategic Alliance Advisory Group and seconded employees, and that at a governance level, the presence of Qantas directors, even as a minority, represents a reduction in autonomy for Air New Zealand;

14. **note** that the Alliance agreement, and associated documents, include provisions which are likely to discipline the operational behaviour of the two parties, including strong commercial incentives to maximise the profitability of the Joint Airline Operation, provisions designed to facilitate negotiated outcomes, and provisions which would facilitate the efficient termination of the Alliance;

15. **note** that Air New Zealand is likely to face strong financial incentives to increasingly integrate its operations with Qantas, but that such integration carries the risk of attenuating Air New Zealand's autonomy by increasing its separation costs, potentially to the point where the option to terminate is no longer a credible discipline on Qantas;

16. **note** that the Air New Zealand Board is keenly aware of the need to preserve its autonomy within the Alliance, and that there is an opportunity to reinforce this by sending a letter of expectations as set out in *Annex Three* from the Minister of Finance to the Air New Zealand Board if the proposal is approved;

Competition Considerations

17. **note** that one of the most significant national interest issues raised by the Alliance is the possible adverse effects on competition, and that both the Commerce Commission and ACCC would closely scrutinise the public benefits and detriments associated with the proposal;

18. **note** that Commerce Commission and ACCC decisions on the authorisation applications would not be expected until July-August 2003, and may not be finally confirmed until much later if appeal rights are exercised;

Ownership Assessment

19. **note** that the Alliance will bring a range of financial benefits for Air New Zealand, including enhanced revenue, costs savings and efficiencies, a stronger competitive positioning, and an improvement to the company's balance sheet;

20. **note** that the likely benefits of the Alliance to the Crown include an improvement to the Crown's operating balance, and a reduced need to provide Air New Zealand with additional equity;

21. **note** that alternative options to the Alliance, such as enhanced cooperation with Star alliance members or entering strategic alliances with other airlines, have either little prospect of arising or have little to offer Air New Zealand in comparison with the current proposal;

22. **note** that given the absence of any interest from other airline partners, the option of deferring the selection of a strategic partner runs the risk that Air New Zealand will be in a weaker negotiating position if, and when, Qantas reactivates negotiations;

23. **note** that from an ownership perspective the key risks associated with the Alliance include:

    23.1 the Crown facing greater difficulty exiting its shareholding in the future;

    23.2 the durability of the Alliance, given industry volatility and the reliance of the proposal on sustained cooperation between Qantas and Air New Zealand;

    23.3 Qantas' influence and access to information;

    23.4 the financial impact of undertakings that may be required from competition authorities;

    23.5 the likely competitor response;

    23.6 the possibility of minority buy-out rights being exercised (considered unlikely);

24. **note** that, on balance, the Alliance proposal would generate significant benefits to the Crown from an ownership perspective;

National Interest Assessment

25. **note** that on 20 November 2002, Cabinet Policy Committee having been authorised by Cabinet with Power to Act, agreed that the following considerations should be used to assist the Government's national interest evaluation [POL Min (02) 20/7 refers]:

    25.1 maintenance of effective control of Air New Zealand by New Zealand nationals;

    25.2 continuation of Air New Zealand's ability to exercise New Zealand's existing and future air rights;

    25.3 preservation of the unique New Zealand identity of Air New Zealand;

    25.4 provision of effective channels for international tourism and travel;

    25.5 provision of a durable domestic air services network;

    25.6 preservation of New Zealand based employment;

26. **note** that the Alliance that has been negotiated between Qantas and Air New Zealand represents a framework for future co-operation, and at this time the airlines have not formulated specific plans in areas such as domestic and international scheduling, joint marketing, global alliance membership, and initiatives impacting on employment;

27. **note** that the maintenance of effective control of Air New Zealand is the most significant national interest issue raised by the Alliance, outside of competition issues, and is discussed in paragraphs 12 to 16 above;

28. **note** that the Alliance is likely to enhance Air New Zealand's options to manage its international network profitably, and can deliver a durable domestic network, but reduced competition may adversely affect consumers;

29. **note** that given the airlines claim that the Alliance will deliver better scheduling, new services, increased tourism, enhanced freight services and other public benefits, the Commerce Commission can be expected to closely examine most of the issues of concern to Ministers with respect to the following national interest considerations:

    29.1 the provision of effective channels for international tourism and travel;

    29.2 the provision of a durable domestic air services network;

30. **note** that there is an opportunity to allow the Commerce Commission's authorisation process to be the primary mechanism for testing the claims made by the airlines with respect to the considerations in paragraph 29 above;

31. **note** that the Alliance satisfies the national interest considerations with respect to:

    31.1 continuation of Air New Zealand's ability to exercise New Zealand's existing and future air rights;

    31.2 preservation of the unique New Zealand identity of Air New Zealand;

    31.3 preservation of New Zealand based employment;

Decision on Air New Zealand - Qantas Alliance

32. **agree** that the relevant Ministers should grant:

    32.1 Qantas unconditional Kiwi Shareholder consent to acquire an interest of up to 4.99% of the equity securities in Air New Zealand;

    32.2 Qantas Kiwi Shareholder consent to acquire the balance of equity securities they are seeking, up to 22.5% of total Air New Zealand equity securities, subject to the conditions set out in paragraph 5 above;

    32.3 Air New Zealand conditional Kiwi Shareholder consent to make changes to the Air New Zealand constitution, subject to the conditions set out in paragraph 5 above;

    32.4 in-principle approval of the Alliance from an ownership perspective, subject to the conditions set out in paragraph 5 above;

33. **invite** the Minister of Finance to advise the Chairs of Air New Zealand and Qantas of the Government's decision, prior to any public announcement;

34. **invite** the Minister of Finance, Associate Minister of Finance (Hon Trevor Mallard) and Minister of Transport to jointly announce the Government's decision;

35. **note** that Ministers' oral and written statements, including media releases, will need to be carefully constructed to manage the legal risks arising from the Crown being an insider with respect to Air New Zealand;

36. **note** that all Ministers will receive separate legal advice on what they can and cannot say in oral and written statements concerning this proposal;

37. **invite** the Minister of Finance to write to the Air New Zealand Board setting out the principal shareholder's expectation that Air New Zealand will retain the capacity to operate autonomously in the event the Alliance terminates as set out in *Annex Three*; and

38. **invite** the Kiwi Shareholder (Hon Paul Swain) to write to the Chief Executive Officers of Qantas and Air New Zealand before 20 December 2002 advising them of the Government's decision to grant conditional approvals for the Kiwi Shareholder applications made by the airlines, including unconditional approval for Qantas to acquire up to 4.99% of the equity securities in Air New Zealand.

Hon Dr Michael Cullen	**Hon Trevor Mallard**	**Hon Paul Swain**
Minister of Finance	Associate Minister of Finance	Minister of Transport

ANNEX ONE

DETAILED DESCRIPTION OF ALLIANCE PROPOSAL

104. This section provides a detailed description of proposals for the Alliance between Air New Zealand and Qantas. There are two parts to the proposals: first, Qantas' purchase of a minority equity interest in Air New Zealand, and second a joint venture between the two airlines (the Alliance).

Qantas' Equity Interest

105. The deal proposes that Qantas will subscribe for new equity securities in Air New Zealand, in three tranches and will ultimately own 22.5% of Air New Zealand. The following table shows the timing of the three tranches:

Timing of equity placement

Timing	Event
Kiwi shareholder consent (18 December)	Tranche 1: Convertible notes: Qantas subscribes for 220.8 million (4.99%) new Air New Zealand convertible notes at 44.5 cents per note
Once full approvals granted (authorisation from competition regulators, shareholder approval, and Kiwi shareholder approval)	**(1)** Convertible notes convert to equity securities **(2)** Tranche 2: placement equity securities - Qantas subscribes for 521 million new Air New Zealand equity securities at 44.5 cents per share to take its shareholding to 15%
At Qantas' option: **either** **(1)** at the same time as tranche 2 (at a price of 44.5 cents per share), **or** **(2)** three years from the date of tranche 2 (at a price that is a 15% discount on the volume weighted average price of Air New Zealand equity securities for the 20 trading days prior to the issue)	Tranche 3 placement equity securities: Qantas will subscribe for a further 478.6 million equity securities to take its shareholding to 22.5%.

106. If tranche three is at the same time as tranche two, Qantas will invest approximately $543 million to acquire its 22.5% holding. If Qantas exercises its option to delay tranche three for three years, it would invest approximately $330 million up front, with the price of the final tranche dependent on the share price in three years time.

107. The following table shows the tranches to be issued to Qantas and the Crown's resulting shareholding at each stage.

Qantas and Crown Shareholding

	No.of equity securities issued (millions)	Cost to Qantas ($million)	Qantas shareholding	Crown shareholding	Total equity securities on issue (millions)
Tranche 1: Convertible notes	220.8	98.3	4.99%	77.9%	4424.1
Tranche 2	521.0	231.8	15.00%	69.7%	4945.1
Tranche 3	478.6	213.0[4]	22.5%	63.5%	5432.7
TOTAL	1220.3	543.0			

4 Assuming tranche 3 purchased upfront. Price in three years time depends on the share price at the time.

108. Under the SAA, Qantas would have the right to nominate two directors to the Air New Zealand Board. Other shareholders would have to vote for the two Qantas-nominated directors for them to join the Board. One Air New Zealand director would be invited onto the Qantas Board.

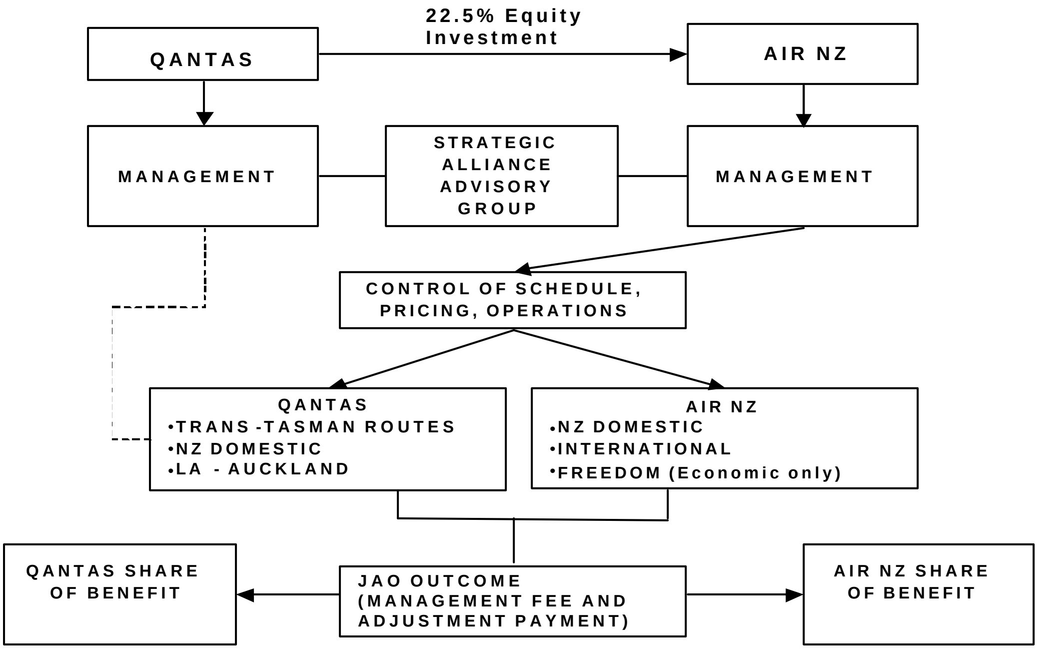
Joint Airline Operation (JAO)

109. The purpose of the JAO is to maximise profits on the passenger and cargo services on the JAO network by maximising revenues and minimising costs without:

- Adversely affecting the parts of Qantas' network not included in the JAO; or
- Restricting either airline's ability to grown in markets where it reasonably foresees profits.

110. The following diagram sets out the major elements of the proposed Alliance:

Alliance Elements



111. The JAO would cover all domestic and international *Air New Zealand flying* operations, and all *Qantas flying operations that touch New Zealand.* Air New Zealand's engineering services do not form part of the JAO. Freedom Air is included on an economic basis but its management and governance are outside of the JAO.

112. Air New Zealand will manage all commercial aspects of the JAO network, including pricing, network capacity, and scheduling. This provides Air New Zealand with day-to-day management of the aircraft contributed by Qantas to the JAO. Each airline would remain responsible for its own flight operations (eg provision of aircraft, aircrew, and maintenance).

113. Qantas participates in the management of the Alliance by its participation in SAAG as well as by contributing up to four Qantas secondees to Air New Zealand to assist in network management, revenue management, pricing and

marketing. Air New Zealand must accept the Qantas secondees, who are required to be involved in preparing Air New Zealand's budgets and business plans.

114. In addition to cooperating on flight related services (such as product offerings, scheduling, frequent flyer points, sales and marketing, and fleet planning) the SAA also provides that Air New Zealand and Qantas may explore and pursue joint purchasing for third party goods and services; joint human resources activities; and joint information technology.

Strategic Alliance Advisory Group (SAAG)

115. The SAAG is a group comprising six representatives, three from Air New Zealand and three from Qantas. The SAAG's role is restricted to one of influence, not control, and it does not substitute the management-reporting lines within each airline. SAAG's role is to review and endorse key aspects of the JAO Networks, and provide advice to Air New Zealand as commercial manager of the JAO Networks. The SAAG would need to be consulted on all material decisions affecting the JAO including:

- business plans and budgets;

116.

117. Qantas' written consent would be required for matters that relate to Qantas' branding and capacity, including:

- removal of Qantas' brand from major JAO markets;
- capacity increases or decreases for Qantas product;
- schedule changes for Qantas product; and
- changes in Qantas product specification.

SAAG Dispute Resolution Process

118. The escalation process should SAAG be unable to reach a unanimous decision is as follows:

- SAAG shall refer any unresolved dispute **in relation to the Management Fee and Adjustment Payment Calculation** to the respective Chief Financial Officers and Strategy Heads of Air NZ and Qantas for resolution within 5 Business Days.
- If the respective Chief Financial Officers and Strategy Heads of Air NZ and Qantas are unable to resolve the dispute, the dispute will be referred to the respective Chief Executive Officers of Air NZ and Qantas for resolution within 10 Business Days of such referral. Each party will prepare a separate brief on the dispute for consideration by the Chief Executive Officers. Each party's brief will be provided to the other party.
- SAAG shall refer any unresolved dispute **in relation to matters other than those concerning the Management Fee and Adjustment Payment Calculation** to the respective Sales/Marketing and Strategy Heads of Air NZ and Qantas for resolution within 5 Business Days of such referral.
- If the Sales/Marketing and Strategy Heads of Air NZ and Qantas are unable to resolve the dispute, the dispute will be referred to the respective Chief Executive Officers of Air NZ and Qantas for resolution within 10 Business Days. Each party will prepare a separate brief on the dispute for consideration by the Chief Executive Officers. Each party's brief will be provided to the other party.
- Where a dispute has not been resolved through the process set out above, the matter shall be referred to the respective chairpersons of Air NZ and Qantas, who will meet within 15 Business Days to attempt to resolve the dispute.
- If the chairpersons are unable to resolve the dispute, then each party is entitled to take legal action.

Allocation of JAO Outcome

119. A management fee and adjustment payment would allocate the incremental JAO financial outcome (ie the incremental profit from the JAO) between Air New Zealand and Qantas. The calculation of the management fee and adjustment payment is intended to recognise going-in profitability and allocate incremental gains on an equitable basis.

Management Fee and Adjustment Payment

120. The effect of the management fee and adjustment payment is that the JAO outcome for each route group (after operating costs and an 8% aircraft capital charge) is allocated to each airline, with 60% allocated according to the capacity provided by each airline and 40% equally. This means that Air New Zealand, which provides around 70% of capacity in the JAO, will get around 65% of the gains generated by the JAO.

121. Because the 8% aircraft capital charge is the first call on JAO earnings, Qantas has an incentive to redeploy less profitable aircraft from outside the JAO to within

the JAO, and thereby gain a greater share of capacity (to increase its capital charge). This would be beneficial to Qantas, but not to the JAO or Air New Zealand. To mitigate against this, the SAA specifies capacity ranges that must be maintained by Air New Zealand and Qantas: Air New Zealand must provide 70% to 80% of capacity, and Qantas 20% to 30%. Additionally, any changes in capacity flown by either Air New Zealand or Qantas on any JAO route must be approved by the SAAG.

Base Position Protector

122. The base position protector provides an adjustment payment of up to million per annum from Qantas to Air New Zealand. The base position protector is necessary because Air New Zealand has slightly higher earnings per Available Seat Kilometre (ASK) than Qantas (that is, its capacity contributes more profit to the JAO than Qantas'). If there was no incremental benefit from the JAO, and no base position protector, under the management fee and adjustment payment calculation Qantas would gain part of Air New Zealand's superior earnings per ASK.

123. The base position protector reduces as the JAO generates increased earnings – but the reduction in fee is more than offset by Air New Zealand's increased management fee. The base position protector is consistent with both parties intention that for Qantas to benefit from the JAO, there must be an improvement in both parties' going-in position rather than a reallocation of profits from Air New Zealand to Qantas. If the JAO results in a decrease in overall earnings, the base management fee also declines so that both parties share in that decline.

124. The calculation of the base management fee is static: in future years, the adjustment payment may decrease as both airlines' profits rise from natural market growth rather than the efforts of the airlines. However, the base management fee is advantageous to Air New Zealand overall and provides an incentive for both parties to improve the JAO outcome.

Transition Issues

125.

126.

Exit Provisions

127. Either party can terminate the Alliance at any time four years after either , or after all other pre-conditions for the

Alliance have been satisfied
Twelve months notice must be given. In other words, the minimum term of the agreement is five years. Default events, that could lead to termination, would arise if:

- either airline breached any provision in the Alliance agreement (or the related documents) and which had or would have a material adverse effect on the JAO networks, the Alliance or the non-JAO network of the non-defaulting party;

128. In addition, Air New Zealand may terminate the Alliance if:

- the Air New Zealand nominee to the Qantas Board is not appointed or re-elected to the Qantas Board.

129. Qantas may terminate the Alliance if:

- Qantas nominees to the Air New Zealand Board are not appointed or re-elected to the Air New Zealand board; or

130.

ANNEX TWO

CONFIDENTIAL OWNERSHIP INFORMATION – NOT FOR RELEASE

131.

132.

133.

134. As an illustration of Air New Zealand's vulnerability, Standard & Poors has assessed Air New Zealand's credit rating at B (Qantas: BBB+). Historically, nearly 25% of companies with a B rating have defaulted on their debts within 36 months (that is, they have been unable to pay debts as they fall due). BBB+ default rates within 36 months are less than 1%. Credit ratings do take into account company ownership.

Air New Zealand Domestic Without the Alliance

135. Air New Zealand's major risk going forward is Qantas' ability to compete aggressively on the domestic market, taking market share from Air New Zealand and reducing its domestic profitability. In our view, should the Alliance not go ahead, Qantas is very likely to increase its New Zealand domestic capacity in order to improve the profitability of its New Zealand operation because:

- There is unlikely to be a more opportune time to do this given Qantas' financial strength and Air New Zealand's current weakness;
- New Zealand is an important destination for Australian's (20% of outbound traffic). This will provide feed for Qantas in the New Zealand domestic market; and
- New Zealand is a natural market for Qantas with a similar culture and existing brand recognition.

136. Air New Zealand expects Qantas will increase its New Zealand domestic fleet from five to eight planes in the absence of the Alliance (Air New Zealand has 11 jets flying domestically with a further seven on trans-Tasman routes). With eight planes, Qantas will have:

- greater schedule depth – more round-trip flights per day on main-truck routes;
- greater network breadth – more destinations on the schedule. Qantas currently flies Auckland – Wellington and Auckland – Christchurch, as well as some seasonal Christchurch – Queenstown flights. Eight planes would allow Qantas to include other destinations such as Wellington – Christchurch; and

- better reliability – a larger fleet allows more scope to cope with breakdowns with less impact on schedules.

137. The risk that Air New Zealand faces is that by improving its network in this way, Qantas will become much more attractive to high-yield customers. "Last-minute" travellers (usually business travellers) tend to want a regular and reliable schedule to provide greater flexibility to easily arrange and change their travel plans. Qantas will be able to offer this with eight planes. Qantas will also offer:

- full-service compared to Air New Zealand's value-based offering;
- similar connectivity trans-Tasman as Air New Zealand; and
- better connectivity with Australian domestic and many long-haul routes.

138. In other words, Air New Zealand's current competitive advantage over Qantas could be lost. At least some travellers are likely to choose Qantas domestically. Most likely to transfer are the "last-minute" travellers – who provide some 50% of Air New Zealand's domestic revenues.

139. If a value-based airline enters the New Zealand market, Air New Zealand could also face a competitive squeeze, between Qantas' full service offering that appeals to business travellers, and a value-offering that appeals to leisure travellers.

> In summary, there is a risk that Air New Zealand domestic will lose its premium domestic position. Its services could be under pressure in both the high-yield business market and low-end leisure market. If so, its ability to support its international operations will be compromised and it will be faced with increasingly difficult decisions over its future scale and scope.

Air New Zealand International Without The Alliance

140. The impact of Qantas competition is unlikely to be limited to New Zealand domestic routes. Qantas' improved connectivity to trans-Tasman and long-haul destinations means Air New Zealand will risk losing customers on those routes as well. Long haul, in particular, is already a problem for Air New Zealand. Its service offering is not as good as some other airlines (for example, no individual in-flight entertainment in economy class and no first class sleeper beds). Further, to fly long haul routes requires very high levels of capital investment (Air New Zealand has $2.5 billion invested in long-haul assets), and Air New Zealand has very low levels of profitability (usually losses) on these routes.

141.

Impact on The Crown Without the Alliance

142. Air New Zealand is in an inherently risky business. Financial modelling indicates

It will be particularly vulnerable to increased competition and to uncontrollable factors such as fuel prices and it will not necessarily continue to be profitable over time.

143. Without a strategic partner, Air New Zealand's balance sheet will continue to be highly geared. There will be an ongoing risk that Air New Zealand will need further shareholder support – which over time could be significant given the capital-intensive nature of the airline industry.

Benefits From The Alliance

Air New Zealand advises that the key benefits that the Alliance could provide include:

- **Enhanced revenue:** higher yields and higher loadings[5] without the need to increase fares; better flight schedules and improved frequency; improved connectivity between Air New Zealand and Qantas flights; joint development of travel packages; increased feed from excess passengers booked on Qantas flights; and enhanced engineering revenue from becoming Qantas' preferred supplier;
- **Cost savings and efficiencies:** savings from rationalising duplicated infrastructure and overheads; better aircraft utilisation; and other scale efficiencies;
- **Competitive positioning:** Coordinated scheduling, connection requirements and route planning will improve the product offering and allow Air New Zealand to remain competitive against a value-based airline entrant competing against it on selected routes; and
- **Balance sheet improvement:** Qantas will purchase new Air New Zealand equity securities at a total cost of around $540 million, which will allow Air New Zealand to reduce its debt to more sustainable levels.

144. Other airlines do not offer the same benefits to Air New Zealand. For example, Singapore Airlines cannot offer a reduced competitive threat or feed from the Australian domestic market. Nor, we understand, is Singapore Airlines interested in an alliance with Air New Zealand.

Scenario Modelling

145. Six main scenarios have been modelled by Air New Zealand: a base case with the Alliance (Alliance scenario) and without the Alliance (stand-alone scenario), and an upside and downside scenario for each. The Alliance scenarios assume new services to Australian destinations and entry of a value-based airline (VBA), and the stand-alone scenarios assume Qantas competition and VBA entry.

5 For example, by using schedules (such as flying one plane at 6am and one at 11am rather than two at 6am) to provide for different passenger types, so that peak-time planes fly higher-priced business passengers and off-peak planes are fully loaded with price-sensitive leisure travellers. Different-sized planes that better fit demand also reduce cost per passenger.

Alliance Base Case	**Stand-alone base case**
• Alliance provides new services to Australia • Air New Zealand total capacity rises by around 6% in total between 2003 and 2006, and Alliance capacity rises by around 16% in total between 2003 and 2006 • Value-based airline (VBA) has 3 aircraft on the trans-Tasman by 2004, but no entry in New Zealand domestic	• Qantas increases New Zealand domestic capacity from five to eight aircraft to improve its market share and profitability • Qantas increases trans-Tasman capacity by 17.7% compounding average growth rate between 2003 and 2006 • Increased Qantas capacity on other selected routes • VBA has 3 aircraft trans-Tasman by 2004 but no entry on New Zealand domestic
Alliance Upside Same as base case except: • Higher Alliance capacity growth • No VBA entry on trans-Tasman or domestically	**Stand-alone Upside** Same as base case except: • Lower Qantas capacity increase on trans-Tasman
Alliance downside Same as base case except: • Lower Alliance capacity growth • VBA entry on trans-Tasman (five planes) and domestically (three planes)	**Stand-alone downside** Same as base-case except: • VBA has 3 aircraft trans-Tasman by 2004 and 6 domestically by 2005

146. In addition to Air New Zealand scenarios, FNZC requested a further stand-alone base case, the “status quo” base case. This case, considered unlikely, assumes a continuing benign competitive environment with no VBA entry. It is much more likely that Qantas would seek to increase its presence in the domestic market, and a VBA entry is also likely.

Air New Zealand Earnings

147. In all three competitive scenarios modelled by Air New Zealand, EBITDRA[6] and earnings per share under the Alliance are projected to be higher than in the stand-alone case. Further Air New Zealand’s “worst case” Alliance scenario is still better than the “best case” stand-alone scenario.

148. However, the extra stand-alone scenario requested by FNZC (which assumes a continuing benign competitive environment) is slightly better that the worst-case Alliance scenario (which assumes a high level of VBA competition on both trans-Tasman and New Zealand domestic routes). This comparison is of two very different competitive environments (benign competition compared to a high level of competition). Nonetheless, it illustrates that although the Alliance will provide benefits from an ownership perspective in most circumstances, there are risks around these benefits.

6 Earnings before interest, tax, depreciation, rental and amortisation.

Net Profit Before Tax: Stand-Alone Base Case Compared to Alliance Base Case

149. Comparing the two base case scenarios, the principal reasons for the increased earnings under the Alliance are from:

- **Higher revenue:** the Alliance modelling shows moderate revenue increases on all routes operated by Air New Zealand, with the exception of Sydney – Los Angeles (discontinued in FY2005). Revenue growth is driven primarily by an improvement in load factors – up approximately by FY2006. Prices and ASKs do not vary between the Alliance and stand-alone cases. Higher load factors are derived from stimulation in demand caused by improved connectivity and scheduling under the Alliance. Airline profitability is highly sensitive to load factors.

- **Lower cost:** the modelling projects that operating costs per ASK will decrease under the Alliance from better utilisation of aircraft, such as deploying larger aircraft on trans-Tasman routes. This is a key driver of profitability.

  Modelling also assumes other cost savings of approximately million per annum. Air New Zealand also achieves interest cost savings because of debt reductions from Qantas' equity injection of $540 million.

Air New Zealand Capital Structure

150.

Impact on the Crown

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153. The potential reduction in any call on Crown equity is difficult to estimate, because it depends on a number of factors, particularly on the actual level of capital expenditure required for Air New Zealand's long-haul strategy (both capital required and the strategy itself have yet to be determined). However, the $540 million in equity contributed by Qantas, as well as Air New Zealand's improved net surpluses as a result of the Alliance, will have a significant positive impact on the level of further capital Air New Zealand may require from the Crown going forward.

Alternatives

154.

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7 Since the agreement provides that Qantas may seek to terminate the agreement if anyone other than the Crown acquires or holds more equity securities than Qantas. What the Crown can realise will depend on termination costs and ongoing operating impacts.

8 Air NZ is fully consolidated into the Crown accounts. This means all its revenues, costs, assets, and liabilities are included as part of the Crown financial statements. The share of Air NZ's profit that "belongs" to other shareholders (the "minority interest") is then subtracted from the Crown's overall operating balance.

155. A further possible alternative, of a contractual-based alliance instead of Qantas purchasing 22.5% of Air New Zealand is considered less attractive from both airlines' perspective. For Qantas, purchasing 22.5% of Air New Zealand provides it with board representation to allow it to monitor Air New Zealand's performance and influence its strategy. For Air New Zealand, $540 million in capital significantly strengthens its balance sheet and provides Qantas with incentives to work together with Air New Zealand to ensure the alliance works.

Air New Zealand Operating Fleet

	Number of Aircraft	Average Aircraft Age (years)	Newest (years)	Oldest (years)
B744	8	8.5	3.2	13.1
B763	9	6.6	2.2	10.8
B762	4	17.0	16.3	17.7
A320	0	n.a.	n.a.	n.a.
B733	19	5.1	2.9	11.8
Total Jets	40	7.3		
ATR72-500	9	2.5	2.8	3.1
SF340A	15	14.7	13.4	16.9
B1900D	16	0.9	0.1	5.4
Metro III	2	14.7	14.3	16.3
Total Turboprops	42	6.8		
	82	7.1		

Commercial in Confidence

ANNEX THREE

LETTER OF EXPECTATIONS

John Palmer
Chairperson
Air New Zealand Limited
Private Bag 92007
AUCKLAND

Dear John

AIR NEW ZEALAND/QANTAS STRATEGIC ALLIANCE

I am advising you, in my role as principal shareholder, of my in-principle decision to support Air NZ's proposal for a strategic Alliance with Qantas. As you will be aware, this in-principle decision means that if the proposal in its current form gains all other necessary approvals, I expect to vote for it at a shareholders' meeting. If there are material changes to the proposal over the course of gaining other approvals or were significant new information to emerge, I would reconsider my decision.

I know the Board is keenly aware of the need to preserve Air New Zealand's autonomy and to consistently safeguard Air New Zealand's ability to quit the Alliance at minimal cost. I fully support the Board in this view as I agree it is necessary to protect the best interests of Air New Zealand and of all its shareholders. I therefore expect the Board will ensure that direct and indirect costs to Air New Zealand from any future termination of the Alliance are minimised and that, in the event of termination, Air NZ will be able to operate independently from Qantas within a reasonable period of time.

If the proposal gains all necessary approvals, I will be instructing the Treasury to put in place arrangements with Air New Zealand to monitor the Board's fulfilment of this expectation. If I am not satisfied that the Board is continuing to meet this expectation I would need to consider exercising my rights as principal shareholder accordingly.

Yours sincerely

Hon Dr Michael Cullen
Minister of Finance