FIRST NZ CAPITAL

DRAFT FOR DISCUSSION

COMMERCIAL SECRET

Memorandum

To	Kirsty Flannagan The Treasury
From	First NZ Capital
Date	12 December 2002
Subject	Project Vanilla – Scale Back of Air NZ's Long-Haul Operations

1. Introduction

We refer to David Taylor's e-mail dated 11 December 2002. Set out below are some of the points that you may wish to consider in assessing the possible scale back of Air NZ's operations. We note that our assessment is qualitative only; Air NZ has not provided us with any financial modelling of the Scale Back scenario. We have requested the analysis provided to the NECG on this scenario.

2. Contribution of long-haul to domestic operations

- The contribution of Air NZ's long-haul operations to the Company's overall profitability is difficult to quantify due to the network nature of the airline business.

- International traffic is estimated to provide of Air NZ's domestic bookings. If Air NZ were to scale back its international operations some of this feeder traffic could be replaced by services operated by a partner airline, but there is likely to be some loss of business. For example another carrier such as United Airlines may be unprofitable were it to operate a twice-daily Auckland - Los Angeles service because it would receive little benefit from the flow-on domestic New Zealand traffic. Because of this, United Airlines may restrict its flying on this route to a once-daily service. The reduced capacity flown on this route would have a negative impact on the feeder traffic for Air NZ's domestic operations. This contrasts to Air NZ's current position where a twice-daily service is unprofitable on a stand-alone basis, but it may be optimal when the additional revenues generated for its domestic operations are included.

- Air NZ's domestic operations are likely to be negatively impacted under the Scale Back scenario because of reduced passenger demand for New Zealand as a holiday destination. For example in the event that Air NZ ceases to fly the Atlantic route, British tourists that formerly visited New Zealand may instead travel to Australia. This may occur because there is a reduction in the marketing of New Zealand as a destination. Additionally, under the Scale Back scenario, passengers flying between the United Kingdom and New Zealand would be required to fly with more than one carrier potentially resulting in reduced connectivity, this is likely to reduce the attractiveness of New Zealand as a destination.

3. Cost of retrenchment

4. Sustainability of scaled back operations

In addition to the one-off costs involved in scaling back Air NZ's operations, the implementation of this strategy would have significant implications for the profitability and viability of Air NZ's remaining businesses. Relevant considerations include:

- Air NZ currently enjoys relatively high yields on its domestic operations. Under the Scale Back scenario it is questionable whether the Company would continue to earn premium yields on its domestic New Zealand flying – a reduced international network may impair Air NZ's customer loyalty. Air NZ would essentially evolve as a regional airline and may be forced to compete on price with other regional competitors, such as a potential VBA entrant;

- Under the Scale Back scenario, Air NZ would have increased difficulty in attracting and retaining high yielding customers. It is likely that many of Air NZ's customers may migrate to Qantas, as the latter offers an integrated domestic and international network. Air NZ provides the example of Ansett Australia that struggled to secure large corporate accounts because it could not offer its customers attractive packages on combined domestic and international flying;

- There is some question regarding Air NZ's ability to reduce fixed costs at same rate as it scales back its operations. This is because of the economies of scale that are a feature of the airline industry. For example Air NZ believes that it is unlikely to be able to materially reduce the cost of its IT systems if it reduced its international flying. This may result in Air NZ's remaining operations having a significantly higher cost structure than many of its competitors such as a potential VBA entrant;

- ANZES, Air NZ's engineering business would be affected in a number of ways by a scale back of the Company's operations. First, it would no longer have a core fleet to service, which underpins its critical mass. Second, it would lose its leading edge position in technological advancements. ANZES would probably need to be sold;

- Air NZ would have reduced bargaining power when negotiating terms for code sharing and determining pro-rates with other airlines. For example, in conjunction with United Airlines, a scaled back Air NZ may offer New Zealand package holidays to the North American market. Because of Air NZ's reduced size and bargaining position it is likely to receive a lesser portion of the package fare;

- The scale back of Air NZ's operations and resulting reduction in the number of long-haul aircraft is likely to reduce the efficiency of its aircraft utilisation.

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In summary, based on our qualitative assessment, the scaling back of Air NZ's long-haul operations is likely to be complex, involve substantial costs and have a significant effect on the viability of Air NZ's remaining businesses. Air NZ claims that no other international airline has successfully scaled back its operations.