

Treasury Report: Air New Zealand – Strategic Partnership Update

Date:	19 August 2002	Treasury Priority:	Medium
Security Level:	Commercial Sensitive	Report No:	T2002/1092

Action Sought

	Action Sought	Deadline
Minister of Finance	Note	None

Contact for Telephone Discussion (if required)

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Enclosure: No

19 August 2002

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Treasury Report: Air New Zealand – Strategic Partnership Update

Protection of Information

The information in this report contains confidential information about the expected timing and content of proposals for a strategic partnership between Qantas and Air New Zealand. This information, if released to the public, could have a material impact on the share prices of Air New Zealand and/or Qantas. As such, public comments on the matter should be limited to media information that we have previously provided to you.

Purpose of Report

1. This report updates you on the latest expected timing and content of potential proposals for a strategic partnership between Qantas and Air New Zealand (Air NZ).

Analysis

New Timeline

2. We understand that discussions between Air NZ and Qantas on proposals for a strategic partnership are continuing with no final agreements yet reached. Two of the major hurdles appear to be the pricing for Qantas's subscription of shares and the development of a case to be put to the Commerce Commission dealing with competition issues. Proposals will be advanced only if these issues are resolved. We think there is still some uncertainty as to whether proposals will eventuate at all.
3. In any case, the timeline for receiving proposals from Air NZ has been significantly delayed. Air NZ and Qantas were previously working towards 22 August 2002 for both boards to sign off on proposals. However, delays in the development of proposals mean the earliest expected date for board sign off is now 25 October. The late-October date is because Qantas will be engaged in capital raising processes from late August until late October and it wishes to avoid making significant announcements during this time.
4. We met with Air NZ on Friday 9 August 2002 to discuss the timing and possible content of proposals. Air NZ indicated a revised timeline as follows:

Early September	Air NZ provides information about the proposals to Treasury and to Treasury's advisers, First NZ Capital (FNZC).
September/October	Treasury/FNZC assess information.
18 October	Treasury reports to you with our assessment of information from an ownership perspective.
24 October	You provide a signal to Air NZ as to whether you are likely to have major objections to proposals, from an ownership perspective, based on the information provided to Treasury/FNZC. This would not be a final decision.
25 October	Assuming your signal is positive, Qantas and Air NZ submit formal proposals and make announcements to their respective stock exchanges. Competition cases will be provided to the Commerce Commission within 14 days of stock exchange announcements.
November	Cabinet Committee and Cabinet processes.
Early to mid 2003	Commerce Commission and shareholder approvals advised.

5. However, we note that timing still appears fluid and is subject to change. At this stage, we understand that Air NZ intends that the timeline for kiwi shareholder approvals would run concurrently with the ownership approvals processes.

Content of Proposals

6. Air NZ has also indicated that the detail of the proposals is still subject to change. We understand that Air NZ's board want more information about the possibilities for alternative proposals (that still involve a Qantas shareholding).
7. The latest information we have on the possible details of the potential proposals is as follows:
- Qantas would take a 4.99% stake in Air NZ on announcement of proposals (this would require kiwi shareholder approval);
 - Qantas would acquire a further 10% share once all approvals have been gained. Qantas would seek to appoint one director to Air NZ's board at this point. Qantas would hold a warrant¹ to increase its holding to up to 25% within the next three years, and would seek the right to appoint one further director once this option was exercised. Air NZ would also appoint one member to the Qantas board.
 - Once approvals have been gained, Qantas and Air NZ would establish a joint venture (JV). The JV would include all Air NZ flying operations, and all Qantas flying operations that touch New Zealand. Air NZ would have management control over the joint venture but Qantas would have veto rights over material changes to Qantas's capacity, and consultation rights over all strategic and management decisions related to the JV. The JV's initial term would be four years with a 12-month notice period.
 - A profit sharing formula between Qantas and Air NZ would allocate JV profits according to ingoing profitability and would share incremental profits partly according to capacity and partly equally between the two airlines.
8. A strategic partnership between Air NZ and Qantas has the potential to provide significant benefits from an ownership perspective. However, we are not yet in a position to provide an assessment of the merits of the proposals, as there are several key issues yet to be resolved and because the proposals could substantially change over the next weeks and months. Further, we have not yet been provided with financial information underpinning the proposals.
9. The merits of the proposals critically depend on the counterfactual case: an assessment of Air NZ's future prospects if the proposals do not proceed. Air NZ and its advisers are still working on this. Some of the other issues that have yet to be resolved include the pricing for the shares, the level of Qantas shareholding, the structure of the joint venture arrangements, and the possibility for an equity swap rather than Qantas paying cash for their shares.
10. Some of the initial issues with the possible structure of the proposals, that we are working through with our advisers and Air NZ, include:
- The complexity of the JV arrangements. Complex arrangements are more likely to lead to disputes and delays in decision-making;

¹ Warrants are similar to options, but provide the holder with the right to acquire new shares issued by the company rather than existing shares.

- The risks and benefits of an equity swap between Qantas and Air NZ rather than Air NZ issuing shares to Qantas for cash;
- The use of warrants for Qantas to increase its holding in the future, which exposes Air NZ to uncertainty about whether additional shares will be subscribed for;
- The governance rights Qantas might expect to receive as a cornerstone shareholder. In our view, Qantas should receive no more rights than any other shareholder with a similar size holding would expect; and
- The lack of development of the counterfactual case and alternative options (for example, options for strategic partners in the future).

Legal Issues

11. On the Crown's side, all those involved with the proposals need to take particular care that actions taken do not place the Crown in the position of being seen to be a related party to the transaction, as this would preclude voting on the transaction at a shareholders' meeting because the Crown could be considered a related party. In particular, the Crown cannot sell any of its shares to Qantas without becoming a related party. The proposal will therefore necessarily involve Air NZ issuing new shares.
12. Further, you, as majority shareholder, should not enter into any commitments, arrangements, agreements, or accommodations with Air NZ or Qantas prior to a shareholder meeting at which approval for the transaction is sought. To do so could preclude the Crown from voting at the shareholders' meeting. In particular, you should not make any agreement about governance issues through a shareholders support agreement or through changes to Air NZ's constitution. However, you would be able to signal where you have difficulty with any proposals advanced.

Rights Issue

Other Relevant Information

Financial Results for 2001/02

Air NZ's provisional financial results for 2001/02 have not been provided to the market. No public comments on this information should be made at this stage.

Recommended Action

We recommend that you:

- a **note** the expected timing and content of proposals for a strategic partnership between Qantas and Air NZ, with late October the earliest date for Air NZ and Qantas to make announcements;

- b **note** that timing and content are still very fluid and subject to change;
- c **note** that you should not enter into any commitments, arrangements, agreements, or accommodations with Air NZ or Qantas prior to a shareholder meeting at which approval for the transaction is sought; and
- d **agree** that the Treasury should continue to progress discussions with Air NZ about placing some of the Crown's entitlement in the upcoming rights issue in the market.

agreed/declined

David Taylor

Manager, Commercial Investments
for Secretary to the Treasury

Hon Dr Michael Cullen

Minister of Finance