THE TREASURY
Kaitohutohu Kaupapa Rawa

Treasury Report: Ownership Assessment of Air New Zealand Strategic Alliance Proposal

Date:	6 December 2002	**Treasury Priority:**	**High**
Security Level:	Commercial Sensitive	**Report No:**	T2002/1712

Action Sought

	Action Sought	Deadline
Minister of Finance	• Note that, on balance, Treasury considers that if the proposal is approved there would be significant benefits to the Crown from an ownership perspective; • Note that if the proposal is approved, we recommend that you write to the Air NZ board setting out your expectation that Air NZ will retain the capacity to operate autonomously in the event the strategic alliance terminates; • Note that FNZC and Treasury will be presenting their findings to you on 9 December at 3pm; and • Note that we intend to provide a Cabinet paper including both an ownership and a national interest assessment to you and other Ministers on Thursday 12 December.	Monday 9 December

Contact for Telephone Discussion (if required)

Name	Position	Telephone		1st Contact
David Taylor	Manager, Commercial Investments, ALM	471 5975 (wk)		✓
Mike James	Deputy Secretary to the Treasury, Asset and Liability Management Branch, ALM	471 5022 (wk)		
Kirsty Flannagan	Senior Analyst, Commercial Investments, ALM	471 5129 (wk)		

Enclosure: **No**

6 December 2002 AL-4-1

Treasury Report: Ownership Assessment of Air New Zealand Strategic Alliance Proposal

Protection of Information

This report provides commercially sensitive information about Air New Zealand's strategic alliance proposal. **This information is likely to have a material impact on the share price if disclosed and should not be revealed publicly.** Comments should be limited to the decision-making process the Government will apply to the proposal and the timetable for that process.

Executive Summary

The proposed strategic alliance between Air New Zealand (Air NZ) and Qantas involves two parts:

- An equity placement to Qantas of 22.5% of new Air NZ shares;
- A joint venture between Air NZ and Qantas that will include all of Air NZ's flying operations, and all of Qantas's flying operations that touch New Zealand. Air NZ will manage the joint venture.

Strategic Rationale

Without an alliance, Air NZ will remain in a weak strategic position for the future. The only part of Air NZ's *flying* business that is 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, which over the long term will not be sustainable.

Air NZ's recent improvement in profitability is largely driven by uncontrollable factors: better oil prices and a rising New Zealand dollar. Air NZ's weak balance sheet makes it extremely vulnerable to changes in these factors and to other uncontrollable factors – particularly to competition from Qantas and from value-based airlines that may enter the market.

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

If Air NZ does not upgrade its long-haul fleet, it will probably need to reduce its long-haul business instead. Air NZ's view is that this is not practical as the associated cost (losses on sale of planes and redundancy costs) will be extremely high and could not be managed from within its current balance sheet. Air NZ also advises that no other airline has managed to successfully shrink its network.

Benefits From An Alliance

The proposed strategic alliance offers significant value to Air NZ's shareholders, by putting Air NZ in a much more sustainable strategic position for the future. Our advisors, First New Zealand Capital (FNZC), estimate that the value of the Crown's shares will increase by between million and million. This increase in value will not form part of the Crown's net worth but the Crown's share of Air NZ's improved net profit will be included in the operating balance. There will also be a significantly reduced risk that Air NZ will need further capital from the Crown.

Air NZ's Autonomy

An advisory group to the joint venture, the Strategic Alliance Advisory Group (SAAG), will include three members from Qantas and three from Air NZ. The SAAG does not control the JAO (Air NZ has management control) but the SAAG will be able to exercise significant influence over Air NZ. Four or more Qantas secondees will also have an input into Air NZ's operations and planning.

We cannot predict how much influence the SAAG will have over Air NZ in practice, but the SAAG is likely to play a key role in JAO decision-making. Ultimately, however, the success of the JAO will depend on both parties working together constructively to make the alliance work. We expect both Air NZ and Qantas will work hard to do this, in order to generate the greatest benefit from the alliance.

Air NZ will need a strong negotiating position in its ongoing relationship with Qantas. As part of this, Air NZ will need to minimise the downside risk from termination of the strategic alliance. It will therefore be important that the Air NZ board ensures that Air NZ has the capacity to exit the alliance in a practical sense (for example, ensuring that Air NZ's information technology can operate independently from Qantas). Air NZ is very aware of the importance of its independence, but there is a risk that its focus will reduce over time. We suggest that, if the proposal is approved, you write to the board setting out your expectation that Air NZ will retain the capacity to operate autonomously in the event the strategic alliance terminates. We would put in place arrangements to monitor against this expectation.

Alternatives

Several alternatives to the strategic alliance have been considered. None can offer the benefits that an alliance with Qantas can.

Recommended Action

We recommend that you:

a **note** that, on balance, Treasury considers that if the proposal is approved there would be significant benefits to the Crown from an ownership perspective;

b **note** that if the proposal is approved, we recommend that you write to the Air NZ board setting out your expectation that Air NZ will retain the capacity to operate autonomously in the event the strategic alliance terminates;

c **note** that FNZC and Treasury will be presenting their findings to you on 9 December at 3pm; and

d **note** that we intend to provide a Cabinet paper including both an ownership and a national interest assessment to you and other Ministers on Thursday 12 December.

Mike James
Deputy Secretary to the Treasury

Hon Dr Michael Cullen
Minister of Finance

Treasury Report: **Ownership Assessment of Air New Zealand Strategic Alliance Proposal**

Purpose of Report

1. This report provides you with our assessment of Air NZ's strategic alliance proposal received on 25 November.

2. Cabinet has agreed to the following timeline and process for assessing the proposal (CAB Min (02) 31/23 refers).

Table 1: Process and Timeline

25 November 2002	Air New Zealand and Qantas announce proposals and application made to Kiwi Shareholder
25 November to mid-December 2002	Separate groups of officials undertake ownership and national interest analyses
16 December 2002	Cabinet considers officials advice on the ownership and national interest issues
18 December 2002	Cabinet Business Committee, with Power to Act, makes an in-principle decision on the ownership case, and a conditional Kiwi Shareholder decision
May-June 2003, subject to favourable in-principle decisions by Cabinet	Competition authorities advise decisions
Following competition and other regulatory approvals, if granted	Cabinet confirms ownership decision and reconfirms the Kiwi Shareholder's decision
Following Cabinet approval, if granted	Air New Zealand shareholders' meeting

3. We intend to provide a Cabinet paper for the 16 December Cabinet meeting, covering both ownership and national interest cases, on 12 December. The Cabinet paper will be for joint signature by you, the Associate Minister of Finance (Hon Mallard), and the Minister of Transport.

4. This report is structured as follows:

Table 2: Report Structure

Part 1	Overview description of proposal
Part 2	Ownership Analysis (i) Rationale for strategic partner (ii) Impact of the strategic alliance agreement - Allocation of financial outcome - Financial impact - Exit provisions - Management and governance (iii) Impact on the Crown (iv) Key risks (v) Pricing provisions (vi) Alternatives (vii) Assessment
Annex A	Glossary of terms
Annex B	Detailed description of proposal
Annex C	Scenario modelling (description and assumptions)
Annex D	Analysis of Alternative Options

5. Our report was prepared with advice from First New Zealand Capital Ltd (FNZC) on the detail of the proposal and the financial modelling supporting the proposal, as well as information from and discussion with Air NZ.

Part 1: Description of Proposal

The Strategic Alliance Agreement between Air NZ and Qantas involves two parts: an equity placement of up to 22.5%, and a joint venture – the Joint Airline Operation – between the airlines.

6. This section provides an overview description of the proposal for a Strategic Alliance Agreement (SAA) between Air NZ and Qantas. A more detailed description is attached as Annex B.

7. The main features of the SAA are:

- **Equity placement to Qantas:** Qantas would subscribe for new equity in Air NZ for a total shareholding of 22.5%. After consent from the Kiwi Shareholder, Qantas would buy convertible notes equating to 4.99% of Air NZ's shares[1]. After getting all the other necessary consents to the deal, Qantas must decide whether to buy new shares totalling a further 10.01% of Air NZ, or a further 17.51%. If it decides on 10.01%, it must buy another 7.5% three years later. The first two tranches (convertible notes and either 10.01% or 17.51%) will cost 44.5 cents per share. If the final 7.5% is issued three years later, the price will be at a 15% discount to the volume weighted average price (VWAP) for the 20 trading days before the issue.

1 If the Kiwi Shareholder gives assent, but competition authorities do not approve the proposal, Air NZ will retain the $98 million Qantas pays for the convertible notes.

- **Establishment of a Joint Airline Operation (JAO):** all of Air NZ's domestic and international *flying* operations, and all of Qantas's *flying operations that touch New Zealand* would be managed through a joint venture between the two airlines. Each airline would keep responsibility for its own flight operations (for example, provision of aircraft and aircrew).

- **Air NZ Manages the JAO:** Air NZ would manage the day-to-day operations of the joint venture but would be required to consult the Strategic Alliance Advisory Group (SAAG), an advisory group to the JAO, made up of three members from Qantas and three from Air NZ, on material matters affecting the JAO. Qantas would also have veto rights over decisions relating to material changes in Qantas's capacity;[2]

- **Management Fee and Adjustment Payment:** a management fee and adjustment payment would have the effect of allocating the JAO financial outcome 60% to the airline that provided the aircraft capacity with the remaining 40% shared 50/50 between Air NZ and Qantas. An ingoing-adjustment payment from Qantas to Air NZ has been designed to preserve Air NZ's superior ASK[3] profitability going into the JAO (see Annex B for further details);

- **Reciprocal Board Rights:** Qantas would have the right to nominate up to two directors to Air NZ's board under the SAA. Air NZ would have the right to appoint one director to the Qantas board.

8.

.

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

There are also a number of other termination events if breaches of the SAA occur. In particular, Qantas may terminate the SAA if:

- Qantas nominees to the Air NZ board are not elected or re-elected at shareholders' meetings; or

---

2 Air NZ does not have the same veto rights as it manages the JAO and therefore has control over the capacity it provides.

3 Available Seat Kilometres – a measure of capacity. A flight's number of ASKs is equal to the number of seats on the aircraft multiplied by the number of kilometres flown.

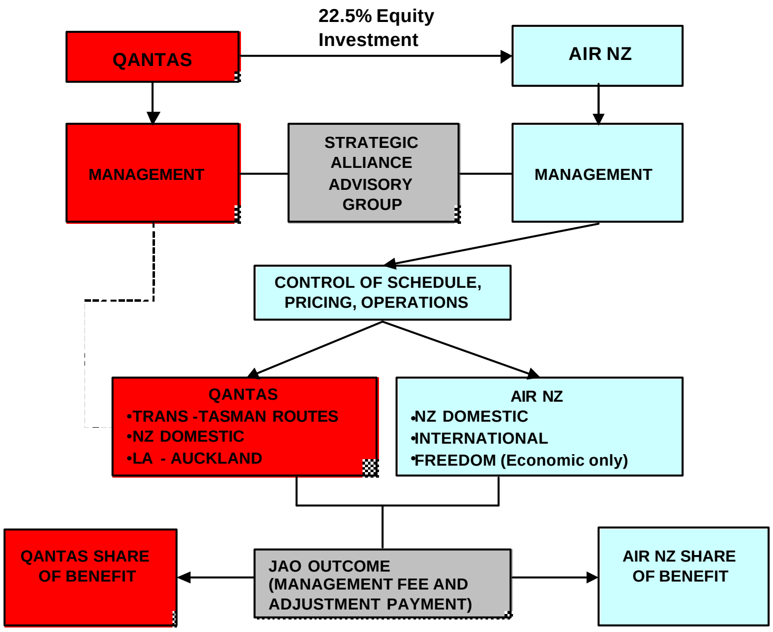
4

5

6 The Kiwi shareholder's approval would be needed for another airline to purchase a share in Air NZ.

10. Figure 1 sets out the major elements of the proposed JAO:

Figure 1: JAO Elements



Part 2: Ownership Analysis

(i) Rationale for Strategic Partner

Air NZ requires a strategic partner to secure its future. Without a partner, Air NZ will be extremely vulnerable to external factors and will likely need to seek a significant amount of capital from the Government as principal shareholder.

Air NZ considers that Qantas is the best partner – it can offer major benefits in terms of revenue generation, cost savings, and protection of Air NZ's competitive position.

An alliance with Qantas will provide Air NZ with:

- around $540 million in capital, which will improve Air NZ's balance sheet; and
- a more stable competitive position for at least five years.

Even if the alliance ends after five years, Air NZ should be in a stronger position for the future.

However, there are risks associated with the alliance, which are discussed later in the paper.

11. While Air NZ's performance has been improving recently and it is working on its competitive response to other airlines (eg Air NZ Express class), it remains in a weak strategic position for the future. The only part of Air NZ's *flying* business that is 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, which over the long term will not be sustainable[7].

12. Air NZ profitability has been recently improving. However, this is largely driven by uncontrollable factors: better oil prices and a rising New Zealand dollar. Air NZ's weak balance sheet makes it extremely vulnerable to changes in these factors and to other uncontrollable factors. Additionally, all airlines are extremely capital-intensive, requiring strong cash flows to support the business.

Nonetheless, it remains extremely vulnerable to uncontrollable factors.

13. Without a strategic partner, Air NZ expects that it will become increasingly difficult to (in other words, its balance sheet will continue to be highly geared and it will not meet its cost of capital). There will be an ongoing risk that Air NZ will need further shareholder support.

14. If Air NZ does not upgrade its long-haul fleet, the probable result will be that it will need to reduce its long-haul business. Air NZ's view is that this is not practical as the associated cost (losses on sale of planes and redundancy costs) will be extremely high and could not be managed from within its current balance sheet. Air NZ's also advises that no other airline has managed to successfully shrink its network.

15. Air NZ considers that a strategic alliance with Qantas has more to offer than with any other airline. The New Zealand market is not strategic to any other major

7 With or without the SAA, Air NZ will need to give careful consideration to its long-haul strategy given the large losses from long-haul routes. Further detail is provided in Annex D.

airline except Air NZ and Qantas, and as such Qantas is the only airline that is both interested in an alliance with Air NZ **and** that can offer benefits in terms of:

- reducing the competitive threat facing Air NZ domestically;
- better capacity utilisation (fewer empty seats);
- coordination of scheduling; and
- providing feed from the Australian market.

16. Air NZ advises that the key benefits that the alliance could provide include:

- **Enhanced revenue:** higher yields and higher loadings[8] without the need to increase fares; better flight schedules and improved frequency; improved connectivity between Air NZ and Qantas flights; joint development of travel packages; increased feed from excess passengers booked on Qantas flights; and enhanced engineering revenue from becoming Qantas's 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 NZ to remain competitive against a value-based airline entrant competing against it on selected routes;
- **Balance sheet improvement:** Qantas will purchase new Air NZ shares at a total cost of around $540 million, which will allow Air NZ to reduce its debt to more sustainable levels.

17. Other airlines do not offer the same benefits to Air NZ. 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 NZ.

(ii) Impact of the SAA

JAO Management Fee and Adjustment Payment

The SAA provides for a JAO management fee and adjustment payment. The effect of this is that the JAO financial outcome is shared partly according to aircraft capacity provided by each airline with the remainder shared equally.

8 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.

18. The detail of how the JAO management fee and adjustment payment between Air NZ and Qantas is discussed in detail in Annex B. Essentially, the effect of the fee model is to allocate the JAO financial outcome, after an 8% capital charge on aircraft, 60% to the airline that provided the aircraft capacity with the remaining 40% shared 50/50 between Air NZ and Qantas. The approximate share to each party is shown in Figure 2.

Figure 2: Allocation of JAO Financial Outcome

19. Under the JAO, Qantas receives a disproportionate part of the JAO financial outcome against the capacity it provides. However, the impact of this is reduced because the management fee and adjustment payment is calculated separately for each route group. This favours Air NZ because it provides more capacity on some better-performing route groups and less capacity on some poorer-performing route groups. Further, an 8% capital charge is the first call on earnings. At current profitability, the aircraft charge represents around   of the earnings generated as a result of the JAO.

Table 3: Relationship Between Profitability and Capacity Share

JAO Outcome	**Net Profit Before Tax**
Base case	Favours Qantas
Increased earnings	Advantage to Qantas increases
Reduced earnings	Favours Air NZ

20. To prevent manipulation of the JAO management fee and adjustment payment, the SAA specifies capacity ranges that must be maintained by each airline: Air NZ must provide 70% to 80% of capacity, and Qantas 20% to 30%. Additionally, Air NZ is entitled to an adjustment payment (the base management fee) to protect its ingoing profitability, reflecting that Air NZ is currently slightly more profitable than Qantas on the JAO routes. Further detail is provided in Annex B.

Financial Impact of JAO

Scenarios for Air NZ with the JAO and without the JAO have been modelled. The "worst case" **with** the JAO is still better than the "best case" **without** the JAO.

21. Six main scenarios have been modelled by Air NZ: a base case with the JAO (JAO scenario) and without the JAO (stand-alone scenario), and an upside and

downside scenario for each. The JAO 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. More detail on the assumptions underlying the scenarios can be found in Annex C.

22. In addition to Air NZ 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 NZ Earnings

23. In all three competitive scenarios modelled by Air NZ, EBITDRA[9] and earnings per share under the JAO are projected to be higher than in the stand-alone case (refer Figure 4.). Further Air NZ’s “worst case” JAO scenario is still better than the “best case” stand-alone scenario.

24. However, the extra stand-alone scenario requested by FNZC (which assumes a continuing benign competitive environment) is slightly better that the worst-case JAO 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 JAO will provide benefits from an ownership perspective in most circumstances, there are risks around these benefits.

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

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

- **Higher revenue:** the JAO modelling shows moderate revenue increases on all routes operated by Air NZ, 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 JAO and stand-alone cases. Higher load factors are derived from stimulation in demand caused by improved connectivity and scheduling under the JAO. Airline profitability is highly sensitive to load factors.

- **Lower cost:** the modelling projects that operating costs per ASK will decrease under the JAO 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.

Will The Benefits Occur?

26. Anecdotal evidence suggests that the benefits from joint arrangements between companies are often lower in practice than promised at the outset. But a qualitative assessment of the proposal supports the quantitative modelling: by working together instead of being fierce competitors, Air NZ and Qantas can generate benefits for both companies. We think there are major benefits for shareholders to be had from the proposal. There are risks inherent in the proposal, but we think they are less than the risks for Air NZ as a stand-alone airline.

Air NZ Capital Structure

27. Air NZ forecasts that the JAO will allow it to reach its target capital structure of between 50% and 60% debt by 2005. This would give Air NZ greater financial flexibility and the ability to fund a larger proportion of its capital requirements by debt rather than calling on shareholder contributions. Without the JAO, Air NZ forecasts that it will not meet its target capital structure within five years, with debt remaining at over 60% even under the upside stand-alone scenario modelling.

Figure 3: Air NZ Gearing – Base Case JAO Against Stand-Alone Base Case

Exit Provisions

There are detailed exit provisions for the SAA. However, there will be some difficulties for Air NZ to exit the JAO in practice.

28. The SAA includes detailed exit provisions (Annex B refers). However, in practice there will be difficulties for Air NZ in exiting the alliance. Although Air NZ is extremely focused on being able to operate independently from the JAO and intends to take steps to ensure it is able to do this,[10] it is inevitable that over time the two airlines operations will become more difficult to separate as they begin to share resources. This risk, and our suggested mitigation strategy, is discussed further under "Management and Governance" below.

29.

Management and Governance

Qantas has the ability to exercise significant influence over the JAO. The success of the JAO depends on both parties working together constructively. Both airlines have incentives to do this, in order to generate the greatest benefit from the JAO.

30. Qantas receives rights as a 22.5% shareholder, and rights as a JAO member.

Shareholder Rights

31. As a 22.5% shareholder, Qantas would have the right to nominate two directors to the Air NZ board, with Air NZ nominating one director to the Qantas board. These rights are commensurate with Qantas's level of equity.

JAO Member Rights

32. Qantas can also nominate one director to the Air NZ board as a JAO member. However, Qantas is limited to a maximum of two directors in total – essentially even where Qantas only has a 15% shareholding, it will still nominate two directors to the Air NZ board.

33. Qantas can also exert a significant influence over Air NZ through its:

- role in the SAAG: as outlined further in Annex B, the SAAG can exert a significant influence over JAO operations and therefore over all of Air NZ's flying operations. The SAAG must be consulted on JAO budgets and business plans, capacity changes, strategies, and a range of other matters. However, the SAAG does not have formal decision-making rights;

---

10 For example, it intends to use information technology that is compatible with Qantas's, but not shared.

- secondees to Air NZ: Qantas will offer, and Air NZ must accept, four Qantas secondees who will to assist in network management, revenue management, pricing and marketing. The secondees are required to be involved in Air NZ budgets and business plans[11], and part of their role is to keep Qantas informed about operations and developments relating to the JAO networks. While the secondees will share expertise with Air NZ, they will also have access a large amount of Air NZ information that relates to its flying operations.

34. Qantas's influence over Air NZ's operations depends on the way the SAAG works in practice. The SAA does provide that nothing in the SAA "shall in any way fetter…the rights and obligations of the Board of Air NZ…to manage the business and affairs of Air NZ". Where there are unresolved disputes that cannot be resolved between chairpersons, each airline has the right to make its own independent decision on the issue. However, if this occurs it probably means a significant breakdown in the relationship has occurred, and the alliance itself would be at risk of breaking down.

35. Qantas clearly has the ability to exercise *significant influence* over Air NZ's part of the JAO through the SAAG. Equally, Air NZ has the ability to exert significant influence over Qantas's part of the JAO. It is understandable that Qantas would not wish to transfer the management of its trans-Tasman and New Zealand domestic operations fully to Air NZ without any right to influence Air NZ's behaviour. Joint venture arrangements typically provide for power sharing among the parties. The rationale is to protect the rights of minority partners and to give them the ability to contribute valuable ideas and resources to the governance of the joint venture.

36. We cannot predict how much influence the SAAG will have over Air NZ in practice, but it is likely that the SAAG will play a key role in JAO decision-making. Ultimately, the success of the JAO will depend on both parties working together constructively to make the alliance work. We expect both Air NZ and Qantas will work hard to do this. Both parties have the right incentives because the maximum benefits of the alliance will come from working together.

37. Air NZ will need to ensure it has a strong negotiating position in its ongoing relationship with Qantas so that it can ensure Qantas's influence over it is kept to appropriate levels. It will inherently be in a relatively weaker negotiating position than Qantas since it has more of its business within the alliance and because Qantas can threaten it with increased competition domestically. As part of ensuring a stronger negotiating position, Air NZ will need to minimise the downside risk from termination of the SAA. It will therefore be important for the Air NZ board to ensure that Air NZ has the capacity to exit the alliance in a practical sense.[12] Air NZ is very aware of the importance of its independence, but there is a risk that its focus will reduce over time. We suggest that, if the proposal is approved, you write to the board setting out your expectation that Air NZ will retain the capacity to operate autonomously in the event that the SAA terminates. We would put in place arrangements to monitor against this

---

11 For Air NZ's *flying* operations.

12 For example, ensuring that Air NZ's information technology can operate independently from Qantas.

expectation. Your ultimate sanction if the board does not comply is to replace the directors.

(iii) Impact on the Crown

38. FNZC's estimate of the incremental increase in the value of the Crown's shareholding (in net present value terms) from the JAO is shown in Table 4. Because of the large number of assumptions underlying the cash flow analysis used to calculate the gain per share, the estimates are indicative values only.

39. Although the Crown's shares will be more valuable as a result of the SAA, it will be difficult to realise all of that value without triggering the potential termination of the SAA.[13] The benefit to the Crown is then limited to its share of Air NZ profits (non-cash, but which appear in the operating balance[14]) and through a likely reduced call on Crown capital.

40. The estimated improvement on the Crown's operating balance **with** the JAO compared to **without** it is shown in Table 5.

41. 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 NZ's long-haul strategy (both capital required and the strategy itself have yet to be determined). However, an illustrative

---

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

14 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.

example is provided in Table 6, assuming a target gearing of 60% debt (current actual target: 50% to 60%).

42.

(iv) Key Risks

There are risks to Air NZ (and to shareholders) both with the SAA and without it. With the SAA, Qantas could exert significant influence over Air NZ, and both Air NZ and the Crown may find it difficult to exit. Without the SAA, Air NZ faces a very competitive domestic market and may be reliant on ongoing shareholder support – because of reduced domestic profits, continuing international losses, and potentially large capital expenditure requirements

With the SAA

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

- **Difficulty of exit**: most of Air NZ's business[15] will be in the JAO and despite Air NZ's focus on maintaining independent operations, it is inevitable that exit will become increasingly difficult over time;

- **Sustainability of JAO**: there are a number of factors that could influence sustainability of the JAO including the complexity of the JAO structure, which will mean Air NZ has less flexibility in dealing with industry developments as they arise; the importance of sustained good relationships between Air NZ and Qantas; and the long implementation timetable which could lead to decreased focus on necessary changes;

15 Except engineering and Freedom (Freedom is included on an economic basis).

- **Qantas's influence and access to information:** Qantas has the ability, even if it does not use it, to significantly influence Air NZ's operations through its role on the SAAG. It also has access to Air NZ information through its Qantas secondees. If the SAA were terminated, Qantas would be in a good position to compete with Air NZ given it will have had access to a wide range of Air NZ information before the SAA terminates.

44. 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 or some of the financial benefits of the JAO. Air NZ 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 JAO financial outcome as a result of undertakings;

Without the SAA

45. If the SAA does not proceed, the key risks are:

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

Risks to the Shareholder

46. The Crown's principal risk, apart from risks that fall directly on Air NZ, is its effectively reduced ability to exit its shareholding.

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

(v) Pricing

The price that Qantas pays for its shares is considered fair.

48. The issue price for the convertible notes (tranche one) and for tranche two is 44.5 cents per share, 10% below the volume weighted trading price of Air NZ shares for the 20 trading days prior to 25 November. FNZC considers this a fair price taking into account that analysts' consensus valuation is around 42 cents, and that Air NZ is trading at well over comparable net tangible assets multiples of other airlines.

49. While Qantas is not paying a premium for its purchase of Air NZ, Air NZ and Qantas will each get part of the benefits generated by the alliance on an equitable basis. Qantas is bringing significant value to the transaction quite apart from its purchase of Air NZ, so this is considered a fair approach.

50. The pricing of tranche three depends on whether Qantas elects to purchase it at the same time as tranche two or in three years time.

51. If tranche three is at the same time as tranche two, the price will be 44.5 cents. If it is in three years time, the price will be a 15% discount on the VWAP for the 20 days trading prior to the tranche three issue. While the deferral of payment for three years would provide Qantas with additional financial flexibility, Air NZ's share price would be expected to increase at Air NZ's cost of equity for each of the three years. The result would be a theoretical subscription price well in excess of the 44.5 cents.

52. If tranche three is in three years time, then Air NZ's gearing would be negatively affected compared to tranche three being at the same time as tranche two. Gearing would not fall below 50% debt until 2006, rather than by 2004.

(vi) Alternatives

There are no viable alternatives that offer the same benefits as the SAA with Qantas.

53. Air NZ has assessed a number of alternatives to the SAA with Qantas. A summary of the options and an overview assessment is shown in Table 7:

54. In summary, Air NZ considers that a strategic alliance with Qantas has more to offer than any other option. The New Zealand market is not strategic to any other airline except Qantas – and therefore a Qantas/Air NZ alliance offers more benefits than other options.

55. A more detailed analysis of these options is attached as Annex D.

(vii) Ownership Assessment

On balance, we consider that there would be significant benefits from an ownership perspective if the proposal is approved.

56. The *key benefit* of the proposal from a shareholder perspective is that the value of Air NZ is likely to increase. As well, 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 NZ because it will be on a more secure strategic footing. *Without* the alliance, Air NZ faces an uncertain future in a fiercely competitive market – and it may well have to consider downsizing its long haul offering significantly since it makes such large losses on long haul routes. Air NZ considers that this would be very difficult and costly.

57. The key risk for Air NZ is the potential for Qantas to exert significant influence over Air NZ's operations. 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 in a joint venture. The key drawback to the

Crown is the lack of ability to exit from its shareholding and thereby realise the increased value of its shareholding.

58. In the end, an assessment from a principal shareholder's perspective comes down to a balance between Air NZ's enhanced strategic position and the financial gains from the strategic alliance – in terms of gains per share, from increased profits, and from a reduced call on Crown capital – against the risks from Qantas's ability to influence Air NZ and the more difficult exit options for the Crown. Without the strategic alliance, Air NZ faces an uncertain future where its weaker balance sheet will make it more vulnerable to uncontrollable factors such as exchange rates and oil prices, subject to an extremely competitive environment domestically (where it currently gets most of its profits), and likely to be reliant on ongoing shareholder support.

59. This proposal is likely to be the best on offer for Air NZ for the foreseeable future, that will give Air NZ a better ability to make choices about its long-term strategy. Despite the risks arising from the proposal, in our view, on balance, if the proposal is approved the Crown would receive significant benefits from an ownership perspective.

Other Relevant Information

Rights Issue

60.

61.

ANNEX A

GLOSSARY OF TERMS

Air NZ	Air New Zealand
ASK	Available Seat Kilometres
CAGR	Compounding Average Growth Rate
EBIT	Earnings Before Interest and Tax
EBITDRA	Earnings Before Interest, Tax, Depreciation, Rentals and Amortisation
JAO	Joint Airline Operation
SAA	Strategic Alliance Agreement
SAAG	Strategic Alliance Advisory Group
VBA	Value Based Airline
VWAP	Volume-Weighted Average Price

ANNEX B

DETAILED DESCRIPTION OF PROPOSAL

1. This section provides a detailed description of the proposal for a SAA between Air NZ and Qantas. There are two parts to the proposal: first, Qantas's purchase of a minority equity interest in Air NZ, and second a joint venture between the two airlines (the JAO).

Qantas's Equity Interest

2. The deal proposes that Qantas will subscribe for new shares in Air NZ, in either two or three tranches and will ultimately own 22.5% of Air NZ. Table 4 shows the timing of the three tranches:

Table 4: 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 NZ 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 ordinary shares (2) Tranche 2 placement shares: Qantas subscribes for 521 million new Air NZ shares at 44.5 cents per share to take its shareholding to 15%.
At Qantas's option: **either** (1) at the same time as tranche 1 (at a price of 44.5 cents per share), **or** (2) three years from the date of tranche 1 (at a price that is a 15% discount on the volume weighted average price of Air NZ ordinary shares for the 20 trading days prior to the issue).	Tranche 3 placement shares: Qantas will subscribe for a further 478.6 million shares to take its shareholding to 22.5%.

3. 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 2 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.

4. Table 5 shows the tranches to be issued to Qantas and the Crown's resulting shareholding at each stage.

Table 5: Qantas and Crown Shareholding

	Number of shares issued (millions)	Cost to Qantas ($million)	Qantas shareholding	Crown shareholding	Total shares 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[16]	22.5%	63.5%	5432.7
TOTAL	1220.3	543.0			

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

5. Under the SAA, Qantas would have the right to nominate two directors to the Air NZ board. Other shareholders would have to vote for the two Qantas-nominated directors for them to join the board. One Air NZ director would be invited onto the Qantas board.

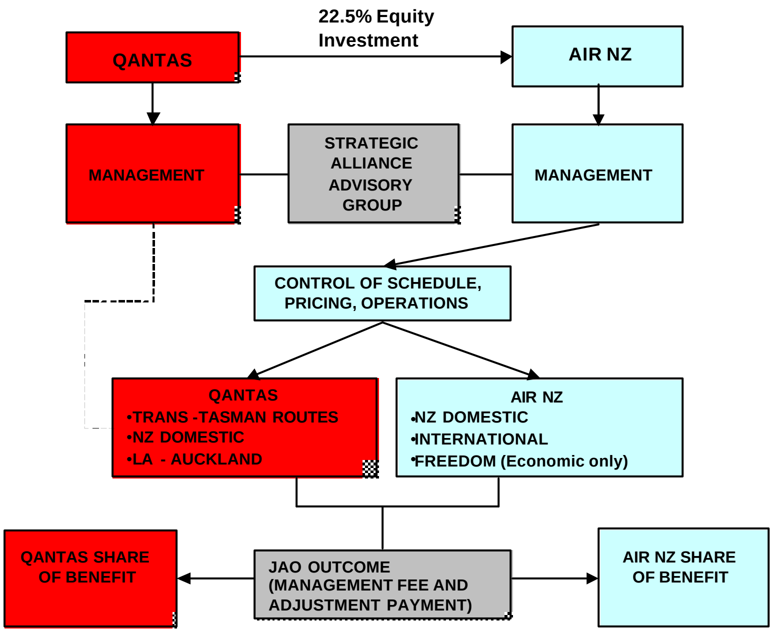
Joint Airline Operation (JAO)

6. 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's network not included in the JAO; or
- Restricting either airline's ability to grow in markets where it reasonably foresees profits.

7. Figure 4 sets out the major elements of the proposed JAO:

Figure 4: JAO Elements



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

9. Air NZ will manage all commercial aspects of the JAO network, including pricing, network capacity, and scheduling. This provides Air NZ 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).

10. Qantas participates in the management of the JAO by its participation in SAAG as well as by contributing up to four Qantas secondees to Air NZ to assist in network management, revenue management, pricing and marketing. Air NZ must accept the Qantas secondees, who are required to be involved in Air NZ budgets and business plans.

11. 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 NZ 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

12. The SAAG is a group comprising six representatives, three from Air NZ and three from Qantas. The SAAG's function would be to advise Air NZ in its management of the material elements of the JAO. The SAAG would need to be consulted on all material decisions affecting the JAO including:

- business plans and budgets;

13.

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

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

Allocation of JAO Financial Outcome

15. A management fee and adjustment payment would allocate the incremental JAO financial outcome (ie the incremental profit from the JAO) between Air NZ 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

16. The effect of the management fee and adjustment payment is that the JAO financial outcome (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 NZ, which provides around 70% of capacity in the JAO, will get around 65% of the gains generated by the JAO.

17. 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 Qantas's capital charge). This would be beneficial to Qantas, but not to the JAO or Air NZ. To mitigate against this, the SAA specifies capacity ranges that must be maintained by Air NZ and Qantas: Air NZ must provide 70% to 80% of capacity, and Qantas 20% to 30%. Additionally, any changes in capacity flown by either Air NZ or Qantas on any JAO route must be approved by the SAAG.

Base Position Protector

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

19. The base position protector reduces as the JAO generates increased earnings – but the reduction in fee is more than offset by Air NZ'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 NZ 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.

20. 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 NZ overall and provides an incentive for both parties to improve the JAO outcome.

Transition Issues

21.

22.

Exit Provisions

23. Either party can terminate the Strategic Alliance Agreement at any time after the fourth anniversary of the later of Twelve months notice must be given – in other words, the minimum term of the agreement is five years However, there are also a number of termination events, where one party or the other can request termination. These include:

- At the request of Qantas if Qantas nominees on the Air NZ board are not elected or re-elected at shareholders meetings;

24.

ANNEX C

SCENARIO MODELLING

Table 6: Stand-Alone Scenarios (Counterfactuals)

	Qantas	VBA
"Status quo"[17]	• Increases capacity from 5 to 6 aircraft domestically • Trans-Tasman ASKs CAGR[18] of 10.6% (2003-2006) • No increase in capacity on Auckland-Los Angeles	• No VBA entry on trans-Tasman or New Zealand domestic
Upside Case	• Increases capacity from 5 to 8 aircraft domestically • Trans-Tasman ASKs CAGR of 8.6% (2003-2006) • Increased competition on other selected routes	• No VBA entry on NZ domestic routes • 3 aircraft on Tasman in 2004
Base Case	• Increases capacity from 5 to 8 aircraft domestically • Trans-Tasman ASKs CAGR of 17.7% (2003-2006) • Increased competition on other selected routes	• No VBA entry on NZ domestic routes • 3 aircraft on Tasman in 2004
Downside Case	• Increases capacity from 5 to 8 aircraft domestically • Trans-Tasman ASKs CAGR of 17.7% (2003-2006) • Increased competition on other selected routes	• 6 aircraft in NZ domestic in 2005 • 3 aircraft on Tasman in 2004

Table 7: JAO Scenarios

	JAO Services	VBA
Upside Case	• New services to Adelaide, Canberra and Hobart	• No VBA entry on trans-Tasman or NZ domestic routes
Base Case	• New services to Adelaide, Canberra and Hobart • JAO trans-Tasman ASKs 6.9% less than upside in 2006	• No VBA entry on NZ domestic routes • 3 aircraft on Tasman in 2004
Downside Case	• New services to Adelaide, Canberra and Hobart • JAO trans-Tasman ASKs 6.9% less than upside in 2006 • JAO New Zealand domestic ASKs 9.1% less than upside in 2006	• 5 aircraft in NZ domestic • 3 aircraft on Tasman in 2004

Revenue Forecasts

1. Revenue and earnings forecasts for 2004-2006 have been generated using a "bottom up" approach on a city-pairs basis. Individual route revenues have been generated using forecast weekly aircraft schedules in each of the forecast years. The schedules model expected flights for Air NZ, Qantas, and a potential VBA entrant for each of the three cases.

---

17 Continued benign competition – considered unlikely.

18 Compounding average growth rate.

Using airline route schedules, market share and revenue allocation among the airline are then calculated using the Quality of Service (QSI) methodology. QSI is commonly used in the airline industry and is used to estimate the passenger split across carriers based on frequency of service and aircraft type. Based on QSI, projected passenger numbers, and average route fares, individual route revenues are then calculated and aggregated into summary route groups eg trans-Tasman and New Zealand domestic. The route fares used to calculate revenues are based on current average route fares in real terms in future years.

Cost Forecasts

2. Air NZ's projections of direct and indirect operating costs are based on its 2003 revised budget. All operating and fixed costs (excluding aircraft charges) are assumed to grow at the same real rate as Air NZ's ASKs. Air NZ management advise that around 30% of total expenses are fixed. We would expect there to be economies of scale in costs such that they would grow more slowly than aircraft capacity. While the approach to the costs is a simplified one, it is used in all the scenario modelling. This means the *difference* between the stand-alone and the JAO scenarios (ie the estimated improvement in financial outcome from the JAO) should not be materially affected.

ANNEX D

DETAILED ANALYSIS OF ALTERNATIVE OPTIONS