THE TREASURY
Kaitohutohu Kaupapa Rawa

Treasury Report: Air New Zealand - Alternative Scenario and Other Issues

Date:	10 December 2002	**Treasury Priority:**	**High**
Security Level:	COMMERCIAL-SENSITIVE	**Report No:**	T2002/1740

Action Sought

	Action Sought	Deadline
Minister of Finance	Note	Tuesday 10 December
Associate Minister of Finance (Hon Trevor Mallard)	Note	Tuesday 10 December
Associate Minister of Finance (Hon Paul Swain)	Note	Tuesday 10 December

Contact for Telephone Discussion (if required)

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Enclosure: **Yes**

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Executive Summary

At a meeting on Monday 9 December, Ministers asked for additional information on Air NZ's proposed strategic alliance with Qantas:

- The impact of a new counterfactual scenario with Qantas pulling out of the New Zealand market;
- The benefits and costs of an alliance deal that did not involve equity; and
- The Government's ability to ensure that Air NZ retained the ability to operate autonomously in the event that the strategic alliance terminated.

New Counterfactual: Qantas Exit From New Zealand

The current base-case counterfactual assumes that Qantas will increase its New Zealand domestic capacity from five to eight planes, and that a value-based airline will have three aircraft flying the Tasman by 2004. In the time available we have not been able to provide details of the financial impact on Air NZ of the new counterfactual scenario, showing Qantas pulling out of New Zealand. This report provides our initial view of this alternative counterfactual. We expect to provide financially modelling and any further information on our view later this week.[1]

In our view, if the alliance does not go ahead, Qantas would probably not exit the New Zealand market. Rather, it would probably increase its New Zealand domestic capacity in order to improve the profitability of its New Zealand operation. There is unlikely to be a more opportune time to do this given Qantas's strength in its own market and Air NZ's current weakness. Our advisor on the ownership cases, First New Zealand Capital, supports the view that the most likely stand-alone scenario for Air NZ would involve increased competition from Qantas. FNZC advises that the best upside case for Air NZ without the alliance is a slightly higher level of competition from Qantas (rather than Qantas exit) and no competition from a value-based airline entry – and that even this is unlikely.

Air NZ also believes a Qantas exit is highly unlikely. Without the alliance, Air NZ expects Qantas to expand its New Zealand capacity in an attempt to gain market share and weaken Air NZ's competitive position. The reasons for this include that:

- Qantas values the feeder traffic from its trans-Tasman and New Zealand domestic services for its Australian operations – in other words, the New Zealand operations provide it with significant benefits elsewhere in its network;
- Qantas is in a strong financial position to sustain potential losses for some time (until it reaches a sustainable market share for itself);

1 If Qantas were to exit, it would make the New Zealand market more attractive for another entrant. Therefore, the scenario modelling for this scenario is likely to include the entry of a value-based airline sooner and with more capacity than the proposed alliance and counterfactual scenarios.

- Air NZ believes Qantas wishes to significantly expand to protect itself from rivals such as Singapore Airlines; and

- New Zealand represents an important geographic market for Qantas.

We also note that an Air NZ stand-alone strategy that involved it simply hoping Qantas would exit the market would be very risky. If it wanted to choose this strategy, Air NZ would need the ability to take on Qantas competitively even if it increased its capacity. This would require a stronger balance sheet in order to sustain losses in its only profitable market for some time – which would most likely need a high level of principal shareholder support in the form of equity.

Alliance Without Qantas Equity

It would be possible for Air NZ and Qantas to work together in a contractual alliance, without Qantas putting any capital into Air NZ. Such an alliance may be able to generate many of the benefits of the current proposal. However, an alliance without equity is likely to be less attractive to both parties.

For **Qantas**, putting in $540 million provides it with board representative to allow it to monitor Air NZ's performance and influence its strategy. It also restricts other airlines from entering into a strategic alliance with Air NZ.

For **Air NZ**, $540 million in equity capital:

- significantly strengthens its balance sheet; and

- provides Qantas with incentives to work together with Air NZ to ensure the alliance works.

Air NZ is unlikely to be able to source such a large amount of capital from the market – if it were able to, the bulk would probably need to come from the Crown as principal shareholder. Even though some market participants have stated that Air NZ could source capital from the market, it would extremely difficult to get such a large amount given Air NZ's fragile position and the risky industry it operates in.

Qantas will want to ensure that it makes a return on the significant level of capital it has invested. It can only do this if Air NZ is strong and profitable. Without the capital invested, it would be much easier for Qantas to walk away from the alliance and/or act in ways that make it difficult for the alliance to operate effectively. While it may be possible to design a contract to reduce Qantas's ability to game the alliance, Air NZ would not be in a strong position to get Qantas to sign up to such contractual provisions. Qantas was willing to sign up to an equity deal because it also provides Qantas with benefits that it wants from the deal (discussed above).

Finally, we note that the Government does not have the ability to negotiate with Air NZ on the details of the deal without risking becoming a related party.

Air NZ Autonomy

Air NZ's autonomy is a critical issue from both an ownership and regulatory perspective. 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 the Company has the capacity to exit the alliance in a practical sense.[2] 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, the Minister of Finance writes to the board setting out the expectation that Air NZ will retain the capacity to operate autonomously in the event the strategic alliance terminates, to ensure that shareholders' interests are well protected. Our legal advisors have advised that the Minister of Finance would be able to set high-level expectations in this way. The board itself would have control over the strategic and operational decisions to put the expectation into practice. However, we would put in place arrangements to monitor against the expectation (for example, by seeking regular assurances from the board over Air NZ's autonomy and regular reporting on the level of systems integration and other practical matters). But monitoring can only go so far – the Government would need to place reliance on the board, as it already does with Air NZ's entire operations. The ultimate sanction for board non-performance would be to replace the board members.

Over time the Air NZ board will face some difficult trade-offs in making decisions that could affect Air NZ's future autonomy. There will be some decisions that would result in significant cost savings but which would interlink Air NZ's operations with Qantas to a greater extent than may be considered desirable by shareholders. In our view it is inevitable that the two airlines will become more interlinked over time as the alliance beds in. The trade-off between cost savings and autonomy will be a matter for the board to decide taking into account the environment at the time. The board has incentives to ensure that Air NZ can operate autonomously, to place Air NZ in a better negotiating position with Qantas and to mitigate risks from the alliance terminating.

Other Information

We have attached some other relevant material on the ownership cases for regulatory Ministers. The Treasury solicitor advises it is appropriate for regulatory Ministers to receive this information at this time. The material includes the executive summary of the Treasury report to the Minister of Finance on the ownership case, assumptions underlying the factual and counterfactual cases, and presentation notes by First New Zealand Capital. This information is confidential and should not be discussed publicly.

Recommended Action

We recommend that you **note** this report.

David Taylor
for Secretary to the Treasury

Hon Dr Michael Cullen
Minister of Finance

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