THE TREASURY
Kaitohutohu Kaupapa Rawa

Treasury Report: Air New Zealand – Financial Modelling for Alternative Scenario

Date:	13 December 2002	**Treasury Priority:**	**High**
Security Level:	COMMERCIAL-SENSITIVE	**Report No:**	T2002/1776

Action Sought

	Action Sought	Deadline
Minister of Finance	Note	Monday 16 December
Associate Minister of Finance (Hon Trevor Mallard)	Note	Monday 16 December
Associate Minister of Finance (Hon Paul Swain)	Note	Monday 16 December

Contact for Telephone Discussion (if required)

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Enclosure: **No**

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Background

On Tuesday 10 December, we reported to you on a new alternative scenario (Qantas withdrawal) that evaluated the impact on Air NZ, if Qantas pulled out of the New Zealand market (T2002/1740). We provided a qualitative assessment of this scenario, but reported that we required further time for Air NZ to complete, and for our advisors to assess, the financial forecasts and analysis of this scenario.

In summary our analysis was that if the JAO did not proceed, Qantas was likely to increase its New Zealand capacity from 5 planes to 8 and was unlikely to exit the New Zealand market. Our advisor on the ownership cases, First New Zealand Capital, considered that the most benign competitive response they expect would be slightly increased Qantas competition, but no entry by a value based airline – and even this was considered unlikely. Air NZ also considered that exit was unlikely because of the value of Qantas' Trans-Tasman feeder traffic, Qantas' need to pre-empt rivals such as Singapore Airlines, Qantas' strong market and financial position and Air NZ's correspondingly weak position.

Analysis

We have now received and evaluated the financial analysis conducted by Air NZ. The scenario assumes:

- Qantas ceases New Zealand domestic operations from 2004;
- Qantas' Trans-Tasman capacity increases at a rate of 8.6% per annum between 2003 and 2006;
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- Qantas continues flying the Auckland – Los Angles route with at least 10 flights per week; and
- A value based airline begins flying on the on the Trans-Tasman and enters the New Zealand domestic market with six aircraft.

First New Zealand Capital considers Air NZ's assumption that Qantas will continue to increase Trans-Tasman capacity after exiting New Zealand may be conservative (eg it may not occur), given load factors are likely to fall because of lower feed from New Zealand flights. New Zealand First Capital considers that Air NZ's assumption that entry by a value-based airline after Qantas exits is reasonable.

Under the Qantas exit scenario prepared by Air NZ profit before tax increases by per annum relative to the stand alone scenario, as Air NZ faces less competition and has fuller planes. This is less than the increase in profitability under the JAO, because:

- Of Air NZ's lower interest costs under the alliance due to the additional $543 million capital provided by Qantas; and
- the alliance is assumed to stimulate demand through for instance, better scheduling and better connectivity and lower costs from better aircraft utilisation. The Qantas exit scenario does not incorporate these benefits. These benefits are relatively small.

In our view, there does not seem to be a substantial difference between Air NZ's financial performance under the alliance and under the Qantas exit scenario once the benefits of additional capital are eliminated.

First New Zealand Capital has also confirmed their view that Qantas exit from New Zealand is unlikely.

Recommended Action

This report is for your information only.

David Taylor
Commercial Investments
for Secretary to the Treasury

Hon Dr Michael Cullen
Minister of Finance