THE TREASURY
Kaitohutohu Kaupapa Rawa

Treasury Report: Air New Zealand: Proposal for a Strategic Partner – Preliminary Views

Date:	11 April 2002	**Treasury Priority:**	High
Security Level:	C-S	**Report No:**	T2002/482

Action Sought

	Action Sought	Deadline
Treasurer/Minister of Finance	Note	Nil

Contact for Telephone Discussion (if required)

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Executive Summary

Protection of Information

The information contained in this report has not yet been made available to the market. The disclosure of this information could affect the market for Air NZ's securities that could lead to claims of insider trading and may bring with it the possibility of further action by the Securities Commission.

It is possible that Air NZ will shortly present a proposal to you seeking Government approval for a partnership with Qantas. The details of a possible proposal have not been agreed as yet. We expect to receive information as to progress and details in the next two weeks.

A proposal is likely to include an equity placement to Qantas of up to 15% of total shares on issue in Air NZ (that may or may not be part of the Government's 82 percent stake). It may also seek your agreement to provide pre-emptive rights to Qantas over a portion of Crown shares. In addition, the Government would need to consider any proposals put forward for it to enter into a shareholders agreement with Qantas. The right to appoint directors would also need consideration.

It is probable that, if the proposal is progressed, Air NZ will wish to have a final decision from the Government before the end of May 2002 after which time the two airlines will inform the market. The reasons for the urgency of the transaction have not been made clear to us at this stage. There are a number of issues that require consideration and the Government might wish to ensure it has sufficient time in which to do so.

The most serious issue to arise from a proposal is likely to be the competition implications. At best, it is likely that both the New Zealand and Australian competition authorities would take two months to issue determinations. It might be expected that if authorisations are not granted, Air NZ would seek legislation to override competition regulation and enable a partnership with Qantas to proceed. Such a request could therefore arise in September/October this year.

The Treasury is currently discussing with Air NZ expectations for business cases to support its proposal, as agreed with your office.

Recommended Action

It is recommended that you:

a **note** that full details of an Air NZ-Qantas partnership proposal, if one is to be progressed, are unlikely to be made available to the Treasury before mid April;

b **note** that Air NZ is likely to seek a response from the Government by mid May, and if approved, it will progress to a Heads of Agreement with Qantas and statements to inform the market;

c **note** that competition approvals from the New Zealand Commerce Commission and the Australian Competition and Consumer Commission would be sought after a Heads of Agreement is signed;

e **note** that the Air NZ Board has sought a meeting with you in early May to discuss issues such as the Government's role as principal shareholder and the longer term investment intentions of the Government and to update you on progress with the turnaround following the end of the first quarter (March 2002).

Linda Dixon
Senior Analyst, Commercial Investments
for Secretary to the Treasury

Hon Dr Michael Cullen
Treasurer/Minister of Finance

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Purpose of Report

1. This reports sets out some preliminary views on a possible Air NZ proposal that it form a strategic partnership with Qantas Airways.

Analysis

Possible Proposal

2. We understand that Air NZ and Qantas are continuing to discuss the nature and content of a proposal for a strategic partnership. While it is not clear whether any proposal will proceed or what the components of a proposal would be, we think it could include at least the following:

    - an equity component of up to 15 percent;

    - co-operation agreements between the two airlines that could lead to:

        - a reduction or removal of Qantas services on the Tasman and in the New Zealand domestic market;
        - provision for Qantas to have certain aircraft serviced at Air NZ's maintenance facilities (likely to be 737s and 767s in New Zealand and 747s in Australia);
        - Air NZ to take on some international services that are currently run by Qantas but would be more profitable run by Air NZ (eg to destinations such as South America);

    - pre-emptive rights to shares in Air NZ, to enable Qantas to increase its stake in time;

    - one Board appointment at present, to increase with any increase in stake over time (Qantas would probably seek one Board member for every 12.5 percent stake it held in Air NZ).

3. Qantas is likely to want to enter into a shareholder agreement with the Crown. The issues that Qantas is likely to wish to make subject to such an agreement could be:

    - Crown undertakings relating to any proposed divestment of its shares to parties other than Qantas (this could be the issuing of pre-emptive rights to Qantas or undertakings from the Crown that it will not sell any significant tranches of shares to another shareholder or airline or a requirement for consultation with Qantas if the Crown wishes to sell shares);

    - Board appointments.

4. It is likely that any material partnership arrangements between the two airlines will require competition authorisations from the New Zealand Commerce Commission and the Australian Competition and Consumer Commission. We expect that these processes will take considerable time to complete.

5. It is not clear whether a proposal would seek the transfer of Government shares to Qantas or would be an issue of new equity. The latter would require a special resolution to be passed by Air NZ shareholders at a general meeting.

6. The Takeovers Code would have implications for a proposal if the purchase of shares would provide Qantas with at least a 20 percent stake in Air NZ. In the event pre-emptive rights to acquire shares in the future is provided the requirements of the Code would need to be assessed.

Timing

7. It is likely that if a partnership proposal is progressed, Air NZ will want to achieve Government approval by mid-late May before proceeding to a Heads of Agreement with Qantas and at that time, a public announcement. Competition approvals would not be achieved in such a short period of time. Therefore, an agreement between the two airlines would need to be conditional on approvals being gained.

8. The Minister of Transport, as Kiwi Shareholder, will be required to give his consent to Qantas taking an equity stake in Air NZ. The Ministry of Transport may wish to investigate whether the partnership proposal raises any significant issues with respect to bilateral air traffic rights held by Air NZ.

9. The immediate urgency of the transaction is not clear. There are a number of consequences that arise as a result of the proposal including the need for the Crown to engage with Qantas over a shareholders agreement and the need for the Crown to be informed of the value implications of the components of such an agreement.

10. We recommend that, if there is no compelling reason as to why the transaction must be completed in the space of one month, the Government takes the time necessary to consider these implications and ensure effective strategies are in place to mitigate any risks.

Issues for consideration

11. We do not comment, at this early stage, on the merits of a partnership between Air NZ and Qantas beyond noting that it would, prima facie, be beneficial to shareholders in Air NZ as a result of synergies achieved between the two airlines. We set out the major issues that we consider would need to be addressed in order to progress the proposal:

Implications for value of Air NZ

- if new equity is issued, current Air NZ shareholders will have their stakes in the airline further diluted (including Singapore Airlines);

- an increase in the value of Air NZ would be expected as a result of less competitive tension between the two airlines;

- a decision now in favour of Qantas as a strategic partner will effectively lock it in for the future. Therefore it is important to consider now the implications of allowing Qantas to increase its stake in Air NZ over time and to consider what exit strategies may be available in the event the partnership does not provide the intended benefits.

Implications for the value of the Crown's shareholding

- lack of contestability would probably lead to a lower value outcome, although we note that at this time, an invitation to other potential partners to participate may not increase the pool of interested parties;

- synergy benefits accruing to all shareholders would also accrue to the Crown.

Competition Implications

National Interest Implications

Case to be put to the Government by Air NZ

12. We have had preliminary discussions with Air NZ about it developing a case for Government consideration, as agreed with your office. The key issues that Air NZ will need to develop are:

    - What are the other options available to the airline? For example, an option might be seeking a partner at a later date that could have the advantages of both allowing a contestable process and doing so at a time when the fundamentals of the global aviation markets are healthier and more stable.

    - What happens if the current proposal cannot proceed (eg because of either Government, shareholder or regulatory authority veto)?

    - If a case is made that the airline is unsustainable without the proposed partnership, then the implications (eg cost) over the next two or three years should be identified.

    - Clear identification of the costs and benefits to shareholders and to the economy in general.

    - Governance arrangements.

    - Risk mitigation strategies.

    - Clearly documented assumptions underpinning options analysis.

Treasury Assessment

13. It would be our intention to provide you with advice as to the merits of a proposal put forward by Air NZ. In order to do this, we may need to seek the services of consultants. You will be aware that Cameron & Co is working for Air NZ on this issue and is therefore not available to the Crown. Until we see the detail of any proposal, we are unable to determine what use of consultants we will require and consequently what costs may be involved.

14. We are particularly concerned that any proposal might state, as its counterfactual, that the Air NZ business is unsustainable without the proposed partnership. We would want to make an assessment of:

    - the validity of such an argument;

    - the capital shortfall that would arise in order to assess the cost of deferring a search process for a strategic partner; and

    - the probability of quality potential partners, including Qantas, being able and willing to become a strategic partner at a later date.

15. If a proposal is agreed in principle between Air NZ and Qantas, we expect to be provided with its details in mid April.

Other Issues

Capital Raising

Meeting with the Board of Air NZ

16. We understand that you have been asked to meet with the Board in early May to discuss issues such as the Government's role as principal shareholder and the Government's intentions regarding its ownership stake in the airline. The Board is also likely to discuss progress to date with the turnaround of Air NZ. The Board is likely to have its final results for the first quarter ending March 2002.

17. We will report to you before the meeting with information that may assist you in that meeting, including any commentary we are able to make on the March quarter end results.

18. We have proposed to provide the Chair of the Board with a copy of the report to Cabinet entitled "Air New Zealand – Role of the Government as Principal Shareholder". Your office has agreed to us doing so after Cabinet has considered the paper.

February Results

International Commentary

19. International commentators on aviation markets and airlines are reporting that yields and loadings are improving for international travel. A recent study of North American airlines suggests that a number of airlines have mitigated losses through substantial internal cost cutting, including a helpful significant reduction in fuel costs.

20. One measure in particular that has yielded substantial benefits has been a shift to greater use of the internet for bookings coupled with an industry-wide cut in commission fees paid to travel agencies imposed in August 2001. In part the reduction reflects a greater number of travellers using the internet; in part it reflects a reduction in high yield business class passengers that attract higher commissions.

21. Budget airlines have generally done well in the adverse conditions, some recording profitable December quarter results. Some are recording increases in market share largely attributable to the major carriers cutting back their capacity.

22. For the industry as a whole, the commentators expect business travel will return by the second half of 2002 and the US industry will return to profitability in 2003.