THE TREASURY
Kaitohutohu Kaupapa Rawa

Treasury Report: Air New Zealand: Update on Proposal for Strategic Partner

Date:	10 May 2002	Treasury Priority:	High
Security Level:	Commercial Secret	Report No:	T2002/648

Action Sought

	Action Sought	Deadline
Treasurer/Minister of Finance	Note	Nil

Contact for Telephone Discussion (if required)

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Enclosure: **No**

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Executive Summary

Confidentiality

The content of this report is commercially sensitive and, if disclosed, would be price sensitive. Disclosure could give rise to claims of insider trading and may bring with it the possibility of further action by the Securities Commission.

We would caution against making any comment to the media on this issue. If pressed, we consider you could at most confirm the Government's understanding that Qantas and Air New Zealand (Air NZ) are talking to one another on a number of issues on a regular basis.

Confirmation of the existence of a proposal for a strategic or equity partnership or the likely components of such a proposal should not be made. Such comments would be price sensitive with the consequence that the Air NZ share price would probably be affected.

Air NZ and Qantas are currently progressing discussions towards finalising the details of a proposal for a strategic partnership between the two airlines and developing business cases. The Chair of the Board of Air NZ has advised that the proposed partnership involves the following key parameters, with timing adjusted to allow for Government decision-making processes to be conducted:

- an announcement of an initial stake of 10 percent equity to be issued to Qantas in the form of new equity around early August;

- a further 15 percent of new equity to be issued to Qantas and a joint venture between the two airlines to commence following authorisations from the Commerce Commission and the Australian Competition and Consumer Commission, around late September/early October;

The Treasury proposes to seek consultancy advice as soon as possible in order to have advisers in place as soon as Air NZ's proposals and business cases are received by the Crown, expected to be mid June.

The key risk in seeking an early engagement is that it and/or the Terms of Reference for the engagement becomes public knowledge. In order to mitigate this risk, we would not run a contestable engagement process. We note there are likely to be very few potential providers because of conflicts of interest. We consider the benefits of having consultants ready to go immediately the proposal and cases are received, and with sufficient notice to bring themselves up to speed with pertinent issues, outweigh the risks. We propose to consult with Air NZ on this proposal before implementing it.

The costs of a consultancy could be around $150,000 that the Treasury would endeavour to absorb within its 2001/02 baselines. Any further delays in timing could push the engagement of consultants into July that would lead to the costs being met, if possible, from the Treasury's 2002/03 baseline.

A Terms of Reference for the proposed consultancy is attached as Annex One to this report.

The proposal has not been formally advised to other Government departments at this early stage. We understand the Minister of Transport and subsequently the Ministry of Transport were, in error, provided with a copy of our earlier report (T2002/482 dated 11 April 2002 refers) scoping out a possible proposal. As a result, the Ministry of Transport has advised that it will be reporting to Ministers on issues it considers relevant to a partnership proposal between Air NZ and Qantas (eg competition impacts on international routes).

It is proposed that the Ministry and other relevant agencies are officially informed of the proposal and their input into advice sought only after it is formally received by the Crown at the earliest, estimated to be mid June.

Recommended Action

It is recommended that you:

a **note** a formal proposal from Air NZ for a strategic partnership with Qantas is unlikely to be provided to the Crown, with associated business cases underpinning the proposal, until mid June;

c **agree** that the Treasury advises Air NZ that the Government will need a period of six weeks to consider the proposals and business cases and for Ministers to take decisions that would have Ministers considering proposals and taking decisions at the end of July or early August (assuming Air NZ delivers robust cases on time);

agreed/disagreed

d **agree** that the Treasury seeks to engage consultants as soon as possible on a non-contestable basis (in order to minimise risk of disclosure to the market) to provide advice in accordance with the Terms of Reference attached as Annex One to this report;

agreed/disagreed

e **note** that the Treasury will endeavour to absorb the estimated costs of a consultancy of up to $150,000 within its baseline (regardless of whether it is charged in 2001/02 or 2002/03) and that if the costs are any greater than this estimate, or insufficient baseline funding is available, the Treasury will report back to you with options for additional funding; and f **agree** that the Treasury consults other departments (the Ministry of Transport, Department of Prime Minister and Cabinet, Ministry of Economic Development and Ministry of Foreign Affairs and Trade) when appropriate and at the earliest being after a formal proposal is received by the Crown, estimated to be mid June.

agreed/disagreed

David Taylor
Manager, Commercial Investments
for Secretary to the Treasury

Hon Dr Michael Cullen
Treasurer/Minister of Finance

Treasury Report: **Air New Zealand: Update on Proposal for Strategic Partner**

Purpose of Report

1. This report advises you on process issues related to the Air NZ proposal for a strategic partnership with Qantas. It seeks your agreement to the Treasury engaging consultants as soon as possible in order to ensure that when a proposal and business cases are received, consultants are both prepared and capable of engaging to provide advice immediately.

Analysis

Key Parameters of Proposal

2. A formal proposal is yet to be received. We do not anticipate its delivery until mid June. The Chair of the Board of Air NZ has provided the following preliminary information about the likely composition of a proposal:

   - a new issue of equity will be made to Qantas to give it a 10 percent stake in the airline (this will not, in Air NZ's view require statutory competition approvals in New Zealand or Australia; it is permitted by the Air NZ Constitution and will not therefore require prior shareholder approval);

   - submissions will be made to both the New Zealand and Australian competition authorities to seek regulatory approval for Qantas' stake in Air NZ to be lifted to 25 percent. Air NZ signalled its preference was for the issue of new equity, but we understand it may be prepared to include a sale of some of the Government's shares as part of this parcel;

   - at the time Qantas' stake is lifted to 25 percent, Qantas and Air NZ would also enter into a joint venture agreement encompassing both airlines' operations that touch New Zealand, but excluding Air NZ's Freedom and engineering operations. This joint venture would also require competition authorisations.

3. We note the following:

   - the Commerce Commission is likely to wish to engage with Air NZ over its proposal to commence a strategic partnership with Qantas. Even at a level of 10 percent the Commission may bring proceedings for a breach of the Commerce Act (if it considers the transaction will lead to a substantial lessening of competition) and if so would probably seek a Court order to direct Qantas to sell that stake;

   - the issue of the additional 15 percent of new equity will require the approval of a majority of more than 50 percent of shareholders at a general meeting (this is a requirement of the New Zealand Stock Exchange Listing Rules and the Takeovers Code) and, if the Government has entered into a shareholder agreement with Qantas, the Government would be precluded from voting on the transaction (unless Air NZ gains a waiver) as it would be a related party to the transaction;

- an issue of 25 percent new equity to Qantas would dilute the Crown's stake from its current 82 percent to 61 percent, although the value of its shareholding would probably increase as a result of the net benefits to the company of the proposal;
- if competition approvals are declined, we think the airlines will probably seek Government legislation next year to permit the partnership to proceed (note that Air NZ has not indicated this course of action).

Proposal for Consultancy

4. In order to ensure Ministers are fully informed of the commercial implications of the proposal, the Treasury would propose to engage consultants to advise on the following issues:
   - the advantages, disadvantages and value implications of the proposal on the Crown's shareholding;
   - lost opportunities, in terms of value for the Crown, from options foregone;
   - the cost that might accrue to the Crown (as principal shareholder) if it elected to wait and seek a strategic partner at a later date;
   - the value implications of the content of a shareholders' agreement between the Government and Qantas;
   - identification and analysis of the advantages and disadvantages of exit strategies to remove Qantas if the partnership was not beneficial to Air NZ;
   - governance implications;
   - measures that could be taken by Air NZ/Qantas to mitigate any public detriments.

5. We consider it desirable to seek a consultancy as soon as possible (ie in time for the receipt of a formal proposal and business cases from Air NZ) in order to allow sufficient time to undertake a considered process of engagement. We expect there may be price benefits when not under pressure to appoint consultants quickly. It will also provide time in which consultants can bring themselves up to speed with the issues, which is likely to lead to a better quality outcome.

6. There are risks however with this approach. For every additional person aware of the proposal, the risk of a leak to the market increases. To minimise this risk, we consider it would be undesirable to undertake a contestable search process. We note that it may not be possible, in any event, to conduct a contestable process given the number of potential providers is likely to be very small and possibly only one or two.

7. It would also be desirable to prepare a media strategy in advance to deal with any possible leak of information regarding the Air NZ proposal or the Crown's engagement with consultants.

8. A proposed Terms of Reference for consultants is attached to this report as Annex One to this report.

Indicative Costs

9. We estimate the costs of the consultancy may be up to $150,000 that the Treasury would endeavour to absorb within its 2001/02 baselines. In the event the timeline is further delayed, it is possible the engagement of consultants will occur in July, being the 2002/03 financial year. In that case, the Treasury would, if possible, absorb the costs from its baseline in that year.

10. If the cost of the consultancy is any higher than our estimate, or we are unable to meet the costs from our baseline, we will report to you with other funding options. These options may include new funding or incurring unappropriated expenditure in the 2001/02 financial year.

Timing for Government Consideration

11. We think that consultants would need a period of at least three weeks to complete this work. We have estimated that Ministers might need two weeks to complete consideration and make decisions through Cabinet committee processes. We also consider contingency time of one week to be desirable.

12. Therefore, we propose seeking a period of six weeks for the Government to make decisions on Air NZ's proposals. This would extend Air NZ's announcement date to early August (from its previously indicated date of mid June (including its advice of a one month delay)).

13. We note that this timeline depends on Air NZ delivering business cases in accordance with its own timetable and that they are of sufficient quality to ensure that we do not need to revert to the airline for further information and/or submissions.

Risks

14. The key risk to the proposal is that the Terms of Reference become publicly known and the Government and/or Air NZ are pressured by the media to explain. Our intention to approach a firm of consultants, rather than tender contestably, should minimise this risk. In addition, we would require the consultants to sign confidentiality agreements to protect the information they receive, including the Terms of Reference.

Consultation with Air NZ

15. If you agree to this process for engagement, we will seek Air NZ's agreement to the strategy. We would also seek their advice as to likely conflicts of interest that potential consultants may have.

Full Indicative Timetable for Progressing Proposal

16. An indicative timetable was previously advised by Air NZ that would provide for the Crown to receive the formal proposal and business cases in the middle of May with decisions sought from the Government by the end of June. Air NZ asked us to advise the timeframe that the Government would need to complete assessments of the cases and make decisions. Subsequently, Air NZ has informally advised that its initial timetable has slipped by a couple of weeks and could potentially slip by a further two weeks.

17. The following indicative timetable draws in Air NZ's advised timetable, a one month delay and our estimate of six weeks for the Government to consider the proposals and make decisions.

Now	Air NZ commissions economic analyses for company value plus national benefit/detriment; Treasury gets alongside Air NZ and its consultants to hear progress with development of business cases
Early June	Treasury engages consultants
Mid June	Air NZ provides to the Crown options analyses (to be assessed from the ownership perspective) and preliminary national interest assessment
Mid June	Ministries of Transport, Foreign Affairs, Economic Development and DPMC consulted.
Mid June – late July	Treasury reviews financial analyses and reverts to Air NZ for any clarifications or omissions. Officials advise relevant Ministers.
Late July	Air NZ provides national interest economic assessments (those that are to be provided to the Australian and New Zealand competition authorities)
End July/early August	Ministers' consideration process and decisions
Early August	If Government approval received, Air NZ announcement that it will: • issue 10% equity to Qantas • make submissions to the Commerce Commission/ACCC so that Qantas can lift its stake in Air NZ to 25% and enable the implementation of the joint venture agreement • make a rights offering to the market
Late September/early October	Issue of a further 15 percent equity to Qantas and formalisation of the joint venture between the two airlines (assuming the New Zealand and Australian competition authorities approve the proposal).

18. The Treasury accepts Air NZ's advice that the transaction needs to be completed in as short a time period as possible in order to minimise the risk of any publication of the proposal that would give rise to a significant risk to Air NZ.

Other Relevant Information

Consultation within Government on Partnership Proposal

19. We recommend that, at this early stage, the details of the proposal are limited to your office and the Treasury.

20. Upon receipt of a formal proposal from Air NZ (timed for mid June), it will be necessary for the Treasury to engage with the following departments for input into advice to Ministers:

- Ministry of Transport primarily for advice on risks to bilateral air traffic rights;
- Ministry of Economic Development for advice on competition issues;
- Ministry of Foreign Affairs and Trade for advice on Government to Government relationships with Australia and Singapore;
- Department of Prime Minister and Cabinet.

21. We understand the Minister of Transport, and subsequently the Ministry of Transport, were provided in error with a copy of our earlier report (T2002/482 dated 11 April 2002) scoping out a possible proposal. As a result, the Ministry of Transport has advised that it will be reporting to Ministers on issues it considers relevant (eg competition implications on international routes).

Annex One

DRAFT

AIR NEW ZEALAND/QANTAS PROPOSAL FOR A STRATEGIC PARTNERSHIP

Proposal

The Government is to be approached shortly by Air NZ to consider a proposal that it enter a partnership with Qantas. The proposal will provide for Qantas to take a 25 percent stake in Air NZ by an issue of new equity, together with implementation of a joint venture agreement that would include both airlines operations that touch New Zealand with the exception of Air NZ's Freedom Air and engineering businesses.

The Treasury wishes to assess the proposal in terms of value for money for the Government as principal shareholder. This includes assessing the value of any opportunities forgone.

Terms of Reference

Analyse the business cases provided by Air NZ regarding strategic options available to it. Identify the advantages and disadvantages of each option, comment on the robustness of the cases presented and Air NZ's recommendations, identify any omissions, errors or inconsistencies.

Identify and comment on any ownership options that may be available to Air NZ that have not been included in the Air NZ submission and the risks, costs and benefits of each option *from the perspective of the principal shareholder*.

Advise on the implications for the Crown, as principal shareholder, if it wished to preserve an option to seek a strategic partner at a later date including the likely cost of that option (ie the magnitude of any further capital required from shareholders over the period if Air NZ's business is not sustainable in the absence of a strategic partner immediately), an assessment of the valuation implications of selling a stake now versus selling a stake later and the probability of a strategic partner presenting itself.

Comment on the value implications of all viable options from the perspective of the principal shareholder (the Government).

Comment on the value implications of the content of a shareholders agreement between Qantas and the New Zealand Government. If one is not identified, advise the issues that the Crown could agree to have included in a shareholders agreement.

Comment on and/or identify any potential exit strategies that could be invoked in order to remove Qantas at a later date if necessary.

Comment on the implications of the proposals on the governance of the airline, including risks and benefits.

Advise on measures that the airlines (particularly Qantas) could take to mitigate any public detriments that are likely to arise as a result of reducing competition in the marketplace (note, the Commerce Commission will analyse and report on competition implications).

Timing

The contract should be completed within three weeks, with a first draft due after two weeks.