Office of the Minister of Finance

COMMERCIAL: SENSITIVE

Chair
CABINET

RE-CAPITALISATION OF AIR NEW ZEALAND

Executive Summary

1. The Air New Zealand (Air NZ) Board is reconsidering its re-capitalisation plan and is yet to agree finally to:
   - the immediate capital requirements of Air NZ to enable it to embark upon its turnaround strategy for Ansett (this is now expected to be in the order of $1.2 – $1.5 billion);
   - whether Virgin Blue is an acquisition that is critical to the successful turnaround of Ansett (it is expected the Board will advise that the acquisition is critical); and
   - the level of funds Singapore Airlines (SIA) is prepared to commit to the Air NZ recapitalisation, given the substantially higher immediate capital requirements.

2. Air NZ is to announce its financial results for 2001 on 13 September. It is expected that by this date the Board will have taken final decisions and the Crown will be advised of any issues that require its attention.

3. In the meantime, it is proposed that Cabinet takes the following decisions:
   - the Qantas proposal, in its current form, be declined because its implementation is not feasible within the required timeframe;
   - the foreign ownership limits for Air NZ be changed to impose a constraint on ownership by one, or several, airlines of 49%, and that all other ownership constraints be removed;
   - the 'A' and 'B' share structure be merged to provide for one class of shares for investors in Air NZ.

4. It is likely that, if as expected Air NZ's immediate capital requirements are substantially greater than the first estimate of $850 million, then the capital injected by SIA to lift its shareholding will be insufficient to meet the immediate capital requirements. If this is the case, it is probable that Air NZ will seek financial assistance from the Crown.

5. The risks of the Crown becoming an equity holder in Air NZ are high. Ministers consider that Crown capital should be advanced only after all other sources of capital are exhausted (including current shareholders, other market investors, SIA). Any Crown capital contribution would be on full commercial terms and would be tradable to allow the Crown to exit in the future.

6. Negotiations between Air NZ, SIA and the Crown Negotiating Team are continuing towards agreeing national interest packages with each airline, governance arrangements and changes to the Air NZ Constitution to ensure protection of bilateral air traffic rights.

Background

7. At its meeting on 30 July 2001, Cabinet agreed that officials progress options for the re-capitalisation of Air NZ with Qantas and SIA (CAB (01) 23/20 refers).

8. A Crown Negotiating Team, led by Rob Cameron of Cameron & Co was appointed and has met with representatives of both airlines and their advisers.

Air NZ/Singapore Airlines' Re-capitalisation Proposal

9. The Air NZ Board endorsed a re-capitalisation proposal from SIA to:

   - increase its equity stake in Air NZ from its current 25% to 49% by injecting new capital of $450 million;

   - subscribe to a subsequent rights offering made by Air NZ at a cost of $200 million towards the raising of a further $400 million for Air NZ; and

   - have the 'A' and 'B' share structure merged to provide for one class of shares (with ownership nationality monitored by Air NZ).

10. This proposal was tailored to meet Air NZ's immediate capital needs, then estimated to be $850 million, to enable it to embark on the turnaround strategy for Ansett. Over the course of the next five years, Air NZ has estimated its full capital needs to be around $8 billion. It would raise this by a mixture of new debt financing, other equity financing and revenue growth.

State of Play with the Re-capitalisation Proposal

11. The Crown's advisers have been concerned that the Air NZ business plan has shifted over time, and has pressed the airline to revise and confirm its business plan as soon as possible. The major areas of concern are:

    - the capital required immediately to enable Air NZ to embark upon its turnaround strategy for Ansett; the requirement was previously advised to be $850 million, but indications are now that it will be substantially higher (see below);

- whether Air NZ's acquisition of Virgin Blue is critical to the Ansett turnaround strategy and therefore absent the acquisition, is the Ansett turnaround strategy commercially viable;
- the level of funds SIA is prepared to commit to the Air NZ recapitalisation.

12. The Air NZ Board is currently considering these issues. While the Board's position on these issues has not been finalised, it is anticipated that the Crown will be advised that:
    - Air NZ requires an immediate capital injection in the order of $1.2 – 1.5 billion dollars; and
    - the acquisition of Virgin Blue is an essential requirement for the Ansett turnaround strategy *(this information is commercially sensitive given that negotiations with Virgin Blue are still proceeding)*.

13. Given Air NZ must report its 2001 financial results to the Stock Exchange on 13 September, the Air NZ Board must reach its conclusions on these issues in the next week or so.

Options for Re-capitalising Air NZ

1. Qantas

14. The Qantas proposal requires SIA to sell its 25% shareholding in Air NZ to Qantas and Air NZ to divest Ansett to SIA. It is also conditional upon Qantas undertaking a due diligence of Air NZ's financial position.

15. The proposal was accompanied by a national interest package that included undertakings with respect to tourism expenditure and ensuring Air NZ preserves and enhances direct flights into and out of New Zealand.

16. However Qantas is poorly positioned to implement its proposal primarily because:
    - SIA has consistently stated that it has no intention of selling its 25% stake in Air NZ to Qantas or to any other party;
    - competition approvals are unlikely to be obtained in either New Zealand or Australia without new legislation to implement a complementary regulatory package, which could take up to six months to enact;
    - it is doubtful that SIA would wish to purchase Ansett absent the profitable Air NZ operation.

17. In addition, the Qantas proposal does not address Air NZ's capital needs (eg a significant loss on sale of Ansett would require financing).

18. Therefore, irrespective of the merits of the Qantas proposal, it cannot be implemented in its current form within the required timeframe.

2. *Singapore Airlines*

Financing Options

19. The Crown Negotiating Team progressed the following two options with SIA under the previous advice that the immediate capital requirement was $850 million:
    - an increase in SIA's equity stake to 35% and a placement of equity to the Crown of 10% (as directed by Cabinet on 30 July); and
    - an increase in SIA's equity stake to 49% with voting rights to 14% of that stake frozen for three years.

20. These options (and any subsequent options) would be accompanied by agreed governance arrangements and national interest packages between SIA and the Government and between Air NZ and the Government. Draft national interest packages, which are subject to ongoing negotiation with the airlines, are detailed in the annexes attached to this report.

21. Given that the immediate capital requirements will be substantially higher than $850 million, Air NZ's advisors are currently exploring financing options. The Crown Negotiating Team has advised Air NZ that the Crown will consider being an equity provider of last resort, on strictly commercial terms. Options for structuring the capital injection, including any specific requests for Crown support, are expected to be presented to the Government early in the week commencing 1st September.

Proposed Government Action

22. It is proposed that the Government provides SIA with the means to increase its investment in Air NZ by agreeing to:
    - change the foreign ownership limits for Air NZ to provide only a limit of 49% for airline ownership (that could be taken up by one or several airlines); and
    - merging the 'A' and 'B' share structure to provide for one class of shares for investors regardless of nationality.

23. Both these measures are necessary to facilitate Air NZ's recapitalisation, through the certification effect created by a cornerstone airline shareholder, and to allow Air NZ to access deeper capital markets. Aviation businesses are capital intensive and Air NZ has a significant challenge in front of it with its Ansett turnaround strategy. Cameron & Co have advised that it would not be possible for the New Zealand market to provide sufficient capital to enable the re-capitalisation strategy to proceed as have Air NZ's advisers, Salomon Smith Barney and SIA's advisers, Morgan Stanley.

Risks

24. In the face of increasing immediate capital requirements, Air NZ is likely to advise that its re-capitalisation plan cannot be financed notwithstanding SIA increasing its equity stake to 49%. While the proposed rights offering to current shareholders will raise further equity, it may also be insufficient to meet the requirements. Absent any other commercial investor, the Crown will probably be asked to fund the shortfall.

25. Ministers consider that investing Crown capital in Air NZ is undesirable for the following reasons:

    - the aviation industry is a high risk industry that is capital intensive and is currently in a global downturn (fuel prices are high, the NZ and Australian dollars are low relative to the US dollar). The Crown as a shareholder would bear the consequences of any adverse market outcomes over time relative to its shareholding;

    - the turnaround strategy for Ansett is risky (competition in the Australian domestic market continues to be strong with the continuing operation of the value-based airline Virgin Blue) and has heavy capital requirements over the next five years for which the Crown would be asked to help meet;

    - there are other pressures on the Crown's capital fund that may be higher priority expenditure than investing in a private commercial company like Air NZ.

26. However, Air NZ may have no other source from which to attract funding in which case an approach to the Crown is likely. In the event Air NZ/SIA sought Crown financing, I recommend that any injection of Crown capital be based on the following criteria:

    - that as much financing as possible is raised from current Air NZ shareholders, including SIA and other market sources;

    - that other options for Crown financing, aside from pure equity, are considered (eg debt or debt that is convertible to equity) although it should be noted that the Air NZ Balance Sheet is unlikely to withstand much additional debt financing;

    - that any financing instrument taken by the Crown is tradable to allow the Crown to exit the investment at a future date;

    - that the terms and conditions attaching to any Crown equity are fully commercial.

27. Given Air NZ needs to finalise its re-capitalisation plan in time to present it to the market when making its profit announcement on 13 September, it is unlikely to be possible for Ministers to revert to Cabinet for final approval. It is therefore recommended that any further decisions required (eg finalising national interest

packages, governance arrangements, changes to the Air NZ Constitution and Crown capital injections), are sought from Cabinet Policy Committee and if time does not permit, the decisions are sought from the ad hoc Ministerial group comprising the Minister of Finance, Prime Minister, Deputy Prime Minister, Minister of Transport, Minister of Tourism and Minister of Commerce.

28. Details of any further decisions would be subsequently advised to Cabinet.

Bilateral Air Services Agreements

29. Changing the foreign ownership limits for investment in Air NZ will require the merging of the 'A' and 'B' share structure. The 'A' and 'B' share structure was initially put in place as a means of transparency for bilateral air services partners to readily see the proportion of Air NZ owned by New Zealand nationals.

30. Given the prospect of Air New Zealand's total foreign ownership exceeding 49% in the near future, one or more bilateral partners may question Air NZ's continued access to New Zealand's air traffic rights. To reduce this risk, it is proposed that the Air NZ constitution be strengthened to include provisions for Air NZ to survey the nationality of its shareholders in the event traffic rights are challenged, and to have access to a range of remedial measures. Other proposed changes to the constitution shift the onus towards Air NZ demonstrating that New Zealand nationals effectively control the airline, even if they are not in majority ownership. While these changes are expected to be satisfactory for most bilateral partners, there is still a risk some bilateral partners will continue to place weight on the ownership of the airline.

Governance

31. There are four key drivers of the desired composition of the Air NZ Board:

- that it be a well functioning board comprising individuals with strong commercial skills; and
- that it be representative of the shareholders that have capital invested in Air NZ;
- that it comprises a majority of New Zealand citizens in order to protect bilateral air traffic rights (by showing that Air NZ is effectively controlled by New Zealanders); and
- that it comprise one quarter Australian citizens in recognition of the Foreign Investment Review Board's requirements imposed on Air NZ when it purchased Ansett.

32. A benchmark of board sizes for similar sized companies to Air NZ indicates a size of eight to ten is the norm. The Air NZ Board at 13 members is too big. It is proposed that negotiations include a proposal to reduce the Board to 11 (it cannot be reduced further due to the board composition requirements discussed above).

Process Forward

Further Negotiations

33. The Crown Negotiating Team will continue negotiating the details of the national interest package with each of SIA and Air NZ as well as governance arrangements and changes to the Air NZ Constitution.

34. In the event Air NZ/SIA reverts to the Crown seeking additional financing, Ministers will instruct the Crown Negotiating Team on the acceptability of various options.

Regulatory and Shareholder Approvals

35. To allow SIA to inject new equity into Air NZ, the following approvals must be sought by Air NZ:

    - clearance from the Australian government under its foreign investment regulations (this decision is put before the Treasurer who takes into account the advice of the Foreign Investment Review Board);

    - approvals of 75% of each class of shareholders to the issuing of new equity and by 50% of unaffected shareholders (eg all but SIA) under the Takeovers Code;

    - clearances from the Australian and New Zealand competition authorities (these should be straight forward given there is little adverse change to competition in either market).

Financial Implications

36. This proposal has no financial implications. However, financial implications may arise in short course. The magnitude of any Crown financing is not yet clear.

Legislative Implications

37. The proposal has no legislative implications.

Regulatory Impact Statement

38. A regulatory impact statement is not required.

Publicity and Communications

39. It is my intention to advise the Australian government and Qantas of the decision to accept a re-capitalisation proposal with SIA.

40. Statements should not be made to the media about the decisions at hand regarding Air NZ until the Air NZ Board has finalised its re-capitalisation plans. A final statement will coincide with my return from China. If an interim statement is to be made, I will do so before I leave for China.

41. Air NZ and SIA will be advised of the decisions made today. They will be advised that the information is provided in the strictest confidence and that it is not to be made public.

Consultation

42. The Treasury and the Ministry of Transport have been consulted in the preparation of this report. Tourism New Zealand has been consulted during the development of the national interest packages.

Recommendations

43. It is recommended that Cabinet:

1. **note** that Air New Zealand is to announce its financial results for the 2001 year on 13 September and that it is imperative that it be able to present a credible strategic plan to the market for the turnaround of Ansett at that time;

2. **agree** that the present Qantas proposal for re-capitalisation of Air NZ cannot be implemented within the timeframe required and that it be formally declined by the Government;

3. **agree** that the foreign ownership limits for Air NZ be changed to provide only one limit on any airline, or airlines, of 49% and no other limits on foreign ownership;

4. **agree** that the 'A' and 'B' share structure is merged to provide for one class of shares for all investors in Air NZ;

5. **agree** to delegate authority to make decisions on all outstanding matters (eg finalising national interest packages, governance arrangements, changes to the Air NZ Constitution and Crown capital injections), to, in the first instance Cabinet Policy Committee or if time does not permit, to the ad hoc Ministerial group comprising the Minister of Finance, Prime Minister, Deputy Prime Minister, Minister of Transport, Minister of Tourism and Minister of Commerce;

6. **invite** the Minister of Finance to report to Cabinet with the details of the final package agreed with Air NZ/SIA including any agreement to provide Crown capital;

7. **agree** that if Crown capital is sought, it be provided only after the following conditions have been met:

- that as much financing as possible is raised from current Air NZ shareholders, including SIA and other market sources;

- that other options for Crown financing, aside from pure equity, is considered (eg debt or debt that is convertible to equity);

- that any financing instrument taken by the Crown is tradable to allow the Crown to exit the investment at a future date;

- that the terms and conditions attaching to any Crown equity are fully commercial;

8. **agree** that matters agreed by Cabinet in this report are to remain confidential.

Hon Dr Michael Cullen
Minister of Finance

Annex

Draft National Interest Packages –
Air New Zealand and Singapore Airlines

Proposed Commitments By Air New Zealand To The Kiwi Shareholder

1. Inbound Tourism Growth

1.1 Air New Zealand will use its best endeavours to achieve an increase of not fewer than 150,000 short-term visitors to New Zealand per annum beyond current forecast arrivals, while preserving an average per capita visitor spend in New Zealand - adjusted for foreign exchange and CPI movements - of not less than NZ $3,000 in 2001 dollars ("the Increased Tourism Goal").

1.2 The Increased Tourism Goal will be measured against a current forecast of tourism growth of 7.6% per annum. The relevant figures are set out below for ease of reference for the years 2002 - 2007:

Year Ending 30 June	Base Number	7.6% Growth	Forecast Number	Target Number (150,000 increase)
2002	1,884,000	143,184	2,027,184	**2,177,184**
2003	2,027, 184	154,066	2,181,250	**2,331,250**
2004	2,181,250	165,775	2,347,025	**2,497,025**
2005	2,347,025	178,374	2,525,399	**2,675,399**
2006	2,525,399	191,930	2,717,329	**2,867,329**
2007	2,717,329	206,517	2,923,846	**3,073,846**

1.3 In late 2006 the New Zealand Government will appoint an expert to determine whether, in that expert's opinion the Increased Tourism Goal has been achieved.

1.4 If the expert is satisfied that the Increased Tourism Goal has been achieved, the commitments set out in clauses [1.1 and 2 – 4 below] will be deemed to have been performed in full, and will cease to be binding on Air New Zealand.

1.5 If the expert is not so satisfied:

(a) the commitments set out in clauses [1.1 and 2 – 4 below] continue in effect;

(b) the expert review will be repeated in late 2007, and annually thereafter, until such time as the expert is so satisfied. Clause 1.4 and this clause 1.5 shall apply to such reviews, with all necessary modifications.

2. Growth of Air New Zealand's International Fleet

Air New Zealand will use its best endeavours to add additional aircraft to direct (non-stop) international operations to and from New Zealand, commensurate with growth in international visitors to New Zealand.

3. Maintaining Direct International Services to / from New Zealand

3.1 Air New Zealand will maintain its current overall level of direct (non-stop) international operations to and from New Zealand, assessed in accordance with clause 3.2 below or in accordance with such other methodology as may be agreed between Air New Zealand and the Kiwi Shareholder.

3.2 The initial requirement under clause 3.1 is that the direct service index value must not be less than [new number], where the index value is equal to the weighted number of services to and from New Zealand flown using aircraft operated by Air New Zealand under its New Zealand Air Operator Certificate or by its wholly-owned subsidiaries under their New Zealand Air Operator Certificates. Each weekly return service is allocated a weighting as follows:

1.00	Each weekly frequency to a point outside of Australia, Singapore and islands of the South West Pacific
1.00	Each weekly same-aircraft frequency to and beyond islands of the South West Pacific
0.75	Each weekly frequency terminating in Singapore
0.50	Each weekly frequency terminating in one of the islands of the South West Pacific
0.50	Each weekly same-aircraft frequency to and beyond Australia
0.25	Each weekly frequency terminating in Australia

[Note: Applying these weightings, the current index value of the April – October 2001 Air New Zealand schedule, plus 26 Freedom Air trans-Tasman weekly return journeys, is [new number] units. The reference base of [new number] units per week is set at 95% of current levels.]

3.3 Nothing in clauses 3.1 or 3.2 prevents Air New Zealand from altering its services in such manner as it thinks fit, subject to maintaining the required index value.

3.4 If a new international carrier is designated by the New Zealand Government, Air New Zealand and the New Zealand Government will negotiate an appropriate modification of the target referred to in clause 3.2.

4. Engineering / Maintenance "Centres of Excellence" at Auckland & Christchurch

4.1 Air New Zealand will use its best endeavours to preserve high levels of aviation technical engineering and maintenance skills in New Zealand. In particular, Air New Zealand will:

(a) subject to paragraph (b), establish and/or maintain "Centres of Excellence" in Auckland for maintenance, repair and overhaul (MRO) work on Air New Zealand B767s and in Christchurch for MRO work on Air New Zealand B737s;

(b) if Air New Zealand ceases to operate significant numbers of B767s or B737s, and replaces those with significant numbers of other jet aircraft, establish and maintain Centres of Excellence for MRO work on one or more classes of the replacement jet aircraft in addition to, or in place of, the Centres referred to in paragraph (a) above;

(c) use its best endeavours to secure third party contract work from abroad to underpin the overall economics and efficiencies of these Centres.

4.2 Nothing in clause 4.1 prevents Air New Zealand from commissioning ad hoc external MRO work on individual Air New Zealand jet aircraft, where deployment elsewhere is dictated by base capacity constraints or circumstances beyond the reasonable control of Air New Zealand (including industrial action).

5. New Zealand Government may waive requirements

The New Zealand Government may, at the request of Air New Zealand, agree to waive or modify any or all of the requirements set out in clauses [1-4] above. Any such waiver or modification must be in writing.

Proposed Commitments By Singapore Airlines To The Kiwi Shareholder

1. Promotion of New Zealand Tourism

1.1 SIA will commit not less than NZ$2.5 million per annum over the next five years towards marketing New Zealand as a major tourist destination, in cooperation with New Zealand Tourism Board.

1.2 SIA will establish a New Zealand focus within its Tradewinds organization, and will use its best endeavours to ensure that Tradewinds is an effective vehicle for increasing the level of tourism in New Zealand.

2. Protection of Air NZ's Access to New Zealand's Traffic Rights

2.1 SIA will support such measures as may be necessary (including, without limitation, amendments to the Air NZ Constitution) to safeguard of Air NZ's traffic rights, in the event that those rights are threatened by virtue of Air NZ's ownership or governance structure.

3. Strengthening of Air NZ's Position Within International Aviation Industry

3.1

3.2

3.3 SIA will use its best endeavours to negotiate and enter into a commercial relationship with Air NZ on terms no less favourable than the most advantageous bilateral commercial relationship SIA has with another airline.

3.4 SIA will use its best endeavours to enter into arrangements with Air NZ to adjust networks and schedules to maximize the flow of interconnecting customers, with emphasis on coordination at London, Singapore, Hong Kong, Tokyo and Los Angeles as well as to develop widespread, reciprocal code sharing throughout the networks of both airlines on terms no less favourable than those on which SIA code shares with any other airline.

4. Technology Transfer

4.1 SIA will provide Air NZ with access to state of the art versions of its technological developments and methodologies, subject to mutual agreement on reasonable commercial terms and subject to legal restrictions on SIA.

4.2 SIA will give Air NZ staff access to its training programmes and facilities.

5. Most Favoured Customer Status

5.1 SIA and its wholly owned subsidiaries will provide, and SIA will use its best endeavours to procure its other subsidiaries and associated companies to provide, Air NZ with goods and services on terms and conditions which are no less favourable than those enjoyed by SIA's best customers, provided that Air NZ provides the same assurance to SIA.

6. Support for Air New Zealand's National Interest Commitments

6.1 SIA will use its best endeavours as a shareholder and strategic partner of Air NZ to support and encourage the performance by Air NZ of the national interest undertakings given by Air New Zealand [set out in schedule XX] in the following specific areas:

- Inbound Tourism Growth;
- Growth of Air New Zealand's International Fleet;
- Maintaining Direct International Services to / from New Zealand; and
- Engineering / Maintenance "Centres of Excellence" at Auckland & Christchurch.

7. Audit of National Interest Commitments

[to be completed]