

CAMERON & COMPANY
Investment Bankers

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AIR NEW ZEALAND: CURRENT STATUS

SIA PROPOSED OPTIONS

SIA has proposed the following options for Air NZ's re-capitalisation:

- Option 1: Singapore Airlines 49% proposal, with the voting rights to 14% of the shares frozen for three years;
- Option 2: Singapore Airlines 35% and Crown equity 14%.

Both options include a national interest package and a proposal on governance arrangements. Annex One sets out SIA's position on the national interest issues and their

governance proposals. Note that SIA has also indicated interest in reducing the size of the Board.

SIA's order of preference is likely to be as shown above. SIA has not provided detail on how it would see a combined Crown/SIA equity option work in practice. For example, SIA may be unwilling to agree that the Crown appoints two directors as part of that option.

At this stage we propose that both options be progressed and developed with SIA and presented for Cabinet's decision on the preferred option. Please advise if you would like us to limit our work to just one of these options. Annex Two sets out ongoing work to be completed for the Cabinet paper required on Monday, 27 August.

QANTAS

We advised you last week of the Qantas proposal to "force" SIA to sell to Qantas. Even if this occurred it is extremely unlikely that the Qantas' proposal is in any way workable in the time available. The Crown Negotiating Team (CNT) is, however, continuing to progress discussions with Qantas to clarify its view of how it would achieve regulatory clearances from competition authorities in both Australia and New Zealand.

You may wish to give consideration to the timing and content of communications to the Australian government regarding the status of the Qantas' proposal.

AIR NZ BUSINESS PLAN

The management of Air NZ have indicated to us that they do not believe the turnaround of Ansett is feasible without the acquisition of Virgin Blue. The Board has reached a consensus that the acquisition of Virgin Blue is desirable and preferred. However it is not clear that there is Board consensus that the acquisition is an essential element of the business plan. The SIA letter says that it is not.

Prior to the Crown agreeing to commit any equity to the recapitalisation we need to :

- ▶ Obtain a Board consensus on this issue
- ▶ Establish the likelihood of Air NZ successfully negotiating the acquisition; and
- ▶ Understand the potential ACCC regulatory hurdles

RECAPITALISATION

We have asked Air NZ management to review and confirm its capital requirements prior to any decision by the Crown. In our discussions over the past week it has become clear that:

- ▶ The timetable for the Ansett turnaround is extending
- ▶ The operating outturn for the next financial year (2001/02) is now forecast to be materially worse than the case underpinning the original recapitalisation proposal;

These factors suggest a higher initial equity requirement than the proposed \$850 million.

It is important that the assessment of the initial equity requirement be accurate so that:

- ▶ Air NZ has sufficient financial flexibility going forward to weather reasonable downside risks without early recourse to shareholders for further funding
- ▶ The risk of relitigating the SIA's level of equity ownership within a relatively short period of time is avoided; and
- ▶ The Crown can accurately gauge its likely financial commitment should it decide to invest.

If SIA is to be limited to a 35% holding, any increase in initial capital required will result in a disproportionate increase in the Crown's contribution. For example:

- ▶ With a capital requirement of \$850 million, SIA would contribute \$392 million and the Crown \$257 million;
- ▶ With a capital requirement of \$1 billion, SIA would contribute \$449 million and the Crown \$330 million

If Air NZ's operating results in the next financial year are significantly adverse, it will not be able to source further capital from the markets as intended (ie to meet its strategic plan requirements of \$7 billion over the next five years) and will inevitably revert to its major shareholders for finance.

Given the business plan and recapitalisation issues outlined above it will be important to structure any joint recapitalisation to ensure that both SIA and the Crown inject capital contemporaneously and that the equity placement is conditional upon directors signing a prospectus for a subsequent rights offering.

If for some reason directors are unable to approve a prospectus (e.g. The Virgin Blue process fails or market conditions materially worsen) it is highly likely that the Board will seek a rescue package from the Government. The extent of this rescue package will reflect the business plan at that time and may or may not include the retention of Ansett.

Note that the numbers above have been calculated on the basis of capital requirements and issue price for new equity as set out in the original SIA proposal. It is likely that this may no longer be realistic on both grounds. As noted above this is currently being reviewed. Changes will result in the Crown increasing its proportionate holding in the company as more new shares are issued to source the required capital.

ISSUES FOR DISCUSSION

- ▶ Should we progress a “third way” with SIA involving a 40% SIA economic interest, freeze on 5% of their voting rights and 10% Crown equity?
- ▶ At what time do we decide on the Qantas proposal and how would this be communicated?
- ▶ Do you wish us to assist you in briefing other Ministers?

Rob Cameron

Lead Negotiator – Crown Negotiating Team, Air NZ

National Interest Package

The national interest package that is proposed to accompany all options includes general assurances by SIA with respect to:

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- using all reasonable efforts to provide, and procure its subsidiaries to provide, Air NZ goods and services on reasonably favourable terms and conditions;
- encouraging Air NZ to expand its route network both domestically and internationally;
- encouraging Air NZ to grow its fleet;
- using all reasonable efforts to provide Air NZ with access to technological developments on commercial terms;
- committing up to \$2 million per annum over the next five years towards marketing New Zealand as a major tourist destination, dependent on the New Zealand Tourism Board matching that sum dollar for dollar.

SIA notes that the above commitments lead to employment benefits for New Zealand. In addition, SIA will support Air NZ's headquarters remaining in New Zealand and will use reasonable endeavours to give Air NZ's staff access to its training programmes.

SIA notes that Air NZ's traffic rights are highly unlikely to be threatened as a result of any of the proposals that have been put forward due to ongoing liberalisation of the aviation industry.

While the package of measures put forward by SIA is promising, SIA has stated that it is not willing to be held legally accountable for any of the undertakings. In its view, its proposal to inject significant capital into Air NZ is commitment enough of its intent to work in the interests of Air NZ which will bring tangible benefits to the New Zealand national interest.

GOVERNANCE

SIA supports a Board restructuring as long as it preserves the current requirement for a majority of the Board to be New Zealand citizens.

SIA continues to seek a right of veto over the Chair of the Board and the Chief Executive. In return, SIA is prepared to provide the New Zealand Government with the same right of veto over the Chair. We do not consider these rights of veto to be conducive to effective governance within the Air NZ board. Therefore, we propose to continue negotiating down these requirements. SIA may be seeking these provisions in parallel to a Crown veto over the Chairperson.

We understand that Brierley Investments is willing to assign to the Crown a right of appointment of two trustees to its Trust that holds Air NZ shares.

ONGOING WORK

The Crown Negotiating Team will continue progressing the following matters with SIA and Air NZ:

- further work on tying down elements of the national interest package and in particular endeavouring to introduce mechanisms by which SIA may be held accountable for delivery of the national interest measures;

- consensus of the Air NZ board on:
 - the criticality of acquiring Virgin Blue to Air NZ's ability to achieve its strategic plan; and

 - capital requirements for achieving the strategic plan, both immediately and over the five year time horizon.

- governance provisions, and in particular whether:
 - SIA should be permitted a right of veto over the Chair and Chief Executive;

 - the Crown should be permitted a right of veto over the Chair;

 - the proposal for the Crown to appoint two members to the Brierley Trust is feasible;

 - the size of the Board can be reduced while still providing for the appointment of persons of particular nationalities so as to satisfy the requirements of air services agreements and major shareholders.

- structuring a joint re-capitalisation deal so as to minimise risk to the Crown (including due diligence requirements).

We intend to invite SIA to meet with the CNT as soon as possible, with a mandate to negotiate. We will also recommend that Air NZ representatives accompany SIA for that meeting. It may be desirable for you to engage with SIA towards the end of the week to broker any final agreement.

CABINET DECISIONS

Given the current uncertainty as to which options might be feasible, it is unlikely that a draft paper for you to present to Cabinet will be ready prior to Sunday, 26 August. It is proposed that a draft paper be faxed to you at your Napier residence on that day. Copies for Cabinet would be provided to your office first thing on Monday morning.

It will be vital that Cabinet makes a decision at its meeting on 27 August or within a day or so of that meeting.