Closing Address - John Palmer, Chairman, Air New Zealand Limited

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Bell Gully
P R T Taylor / R J C Partridge / T R Crowther
BARRISTERS AND SOLICITORS
PO Box 4199 DX CP20509 Auckland
Tel 64 9 916 8800 Fax 64 9 916 8801

Minter Ellison Rudd Watts
Andrew Peterson/Sarah Keene
BARRISTERS AND SOLICITORS
PO Box 3798 DX CP24061 Auckland
Tel 64 9 353 9700 Fax 64 9 353 9701

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Madam Chair, Commissioners…

In closing our case, I don't want to add to the mountain of information you already have, but rather to distil this case down to it's essential elements, and focus on the issues and questions that are at the heart of this application. However, I make no apology for the amount of material we have provided the Commission – it simply reflects how critical the issue is for Air NZ - how meticulous we've been to ensure every question is properly answered, and the importance we attach to the applications being successful.

To approve the applications, the Commission, in our view, needs to choose between an outcome that delivers substantial public benefits, and at the same time gives Air NZ a business platform for long-term viability, and one in which the market is left to decide which of the existing FSA's will survive.

We think it is helpful to answer a few other questions and clarify some important background issues that demonstrate why we have chosen to take this difficult, time consuming, and expensive route, and why the applications should be granted.

Those questions are:

(a) What is the current real world situation?

(b) what if anything has changed since the applications were lodged nine months ago?

(c) Why doesn't Air NZ simply transform itself in to a VBA?

(d) Can two FSA's survive in NZ?

(e) If two FSA's can't survive in NZ why is Air NZ the most likely casualty?

(f) Post approval, will effective competition remain?

I want to examine these issues, and then return to the key question.

What is the current real world situation and what, if anything, has changed since the applications were lodged nine months ago?

The following simple facts are crucial and, some are, easily overlooked:

- Air NZ is less than two years on from the brink of bankruptcy;

- Air NZ has made an excellent and commendable recovery but has not yet addressed the core operational weaknesses that contribute significantly to its problems. These applications are crucial to solving those;

- We cannot escape from our geography;

- The advent of the VBA or LCC in recently de-regulated markets has irreversibly changed worldwide aviation markets for FSAs; and

- We could not have predicted 9/11 or the SARS epidemic, but those were chilling demonstrations of how the airline business is exposed to severe one off events, and that over the course of time that type of event occurs often, and unpredictably.

The lesson, poorly learned in global aviation, is that you need a business structure and a balance sheet strong enough to cope with those events.

Air NZ currently has neither.

The Alliance would give us the prospect of both.

In summary, the real world situation that we face, is one of volatile demand and excess capacity. Since lodging our application, that has only changed for the worse, and we endorse Geoff Dixon's comments to the Commission on these issues. These in turn reflect views expressed recently by the Director General of IATA.

The next question to address is:

Why doesn't Air NZ transform itself in to a VBA?

Post the recapitalisation of Air NZ in late 2001, the Board and management were faced with some difficult decisions.

- What should our business be?

- What strategy should we pursue?

- What real options did we have?

- What would give us the best chance of generating shareholder value over time?

- What other stakeholder considerations were important?

In developing a new strategy we vigorously debated the whole spectrum of possibilities.

Some facts were inescapable:

- Air NZ's strategy based around Ansett had failed, and the company had no immediate replacement strategy.

- The business as structured was not sustainable.

- The balance sheet was too weak to cope with any downturn.

- The profitable bits (especially the domestic airline), would almost certainly come under sustained attack from both Qantas and Virgin Blue as they turned their focus on New Zealand and the Tasman.

- The unprofitable bits would continue to be subject to intense competition.

  (Some people would say, welcome to the international airline business).

- We had to address the issue of operating cost in all of our business.

- Although the Ansett implementation had failed, we agreed the underlying driver of an Australasian basis for our business, was correct.

- We had no realistic prospect of entering the domestic Australian market with either of our brands (Air NZ or Freedom).

After intense scrutiny, the board and management resolved that our aspiration for our shareholders and stakeholders, was to be an international aviation business. International operations make up 75% of our airline revenues. It is also the part of our business where being New Zealand's International flag carrier provides us with a distinct market advantage. Our judgement was that being the major air bridge between New Zealand and the world, particularly the Pacific Rim was likely to provide us with the most sustainable long term business model.

However, all successful business strategies have to fill the void between aspiration and realisation.

For Air NZ this required examination as to whether this was the highest value alternative, and could it be achieved.

The idea of transforming into a VBA was considered, and rejected.

Our long haul business, 70% of which derives from inbound passengers, and is therefore dependent on offshore distribution, is the foundation of our business. At the other end, we have a thin regional network. Neither of these businesses are suitable for a VBA.

We agreed that we should always be a network airline, although one with a much more competitive cost structure. Our customers and their needs would be the heart of this and we will certainly not imperil the loyalty of more than 800,000 frequent fliers.

Given our existing business and assets, we also decided that the costs of transformation to a VBA would be prohibitive.

From there, it wasn't hard to agree that Air NZ would not be successful going it alone. Star Alliance or oneworld provide international presence, but do nothing for our cost base.

We do not have the scale and connectivity to be a successful long haul carrier alone. In looking for potential partners, Qantas provided the best fit, was willing to form an alliance, and shared our view of the current and emerging problems of aviation in this part of the world.

The Alliance arrangement met the tests of strategic alignment, shareholder value and do-ability.

The arrangements we have reached with Qantas are fair to Air NZ. We wouldn't have agreed to the deal if they weren't. We reject the comments of Prof Hazledine suggesting the deal was somehow skewed in favour of Qantas. Confidential information provided by Air NZ to the Commission including Air NZ's Board papers show he was wildly astray.

This Alliance will give Air NZ the foundation for a sustainable business and the equity arrangement strengthens the capital base of the company. Access to capital, while important, was secondary to getting the strategic framework right. Capital should follow strategy, not lead it.

The next question to consider is:

Can two FSA's survive in NZ, and if not why is the counterfactual the most likely outcome?

In deciding whether these applications should be granted, the Commission must decide whether two FSA's can survive in NZ.

In our view they cannot. The market is too small to support two FSA's. The evidence from a range of experts last week, surely put this question beyond doubt.

Based on his experience with Ansett NZ, Mr Sheriden was also very clear that two FSA's cannot survive in this market.

We share that view, and recent history gives ample evidence of it.

It is a simple reflection of our geography and demography.

The question then becomes, can Air NZ win that battle with Qantas?

The business logic of the stronger company winning that battle is hard to get past. As a result of the Single Aviation Market this is an Australasian market, which gives Qantas huge advantage. Of course Air NZ would seek to be competitive – and our Express initiatives are a good example of this. However, the core advantages of scale and connectivity would inevitably prevail.

In any event, even if Qantas were the loser, the outcome must surely be the same in competition terms.

Neither of those outcomes in our view would be as good for New Zealand as allowing both airlines to cooperate within the Alliance.

That brings us to the question…

Post the approval, will effective competition still exist?

In essence, what that means, is VBA entry certain?

The evidence of last week, and the statements and activities of Virgin Blue both at this conference and in the market, signal the certainty of entry on the Tasman and in domestic NZ.

The weight of economists' advice is also in favour of that conclusion.

A VBA in the form of Virgin Blue will enter these markets and have a sustainable position.

Further and more importantly, is the weight of economists' views that a VBA that will provide effective price competition both in domestic NZ and on the Tasman. It is also our view.

That leaves two areas where issues have been raised.

The first is regional NZ. Origin Pacific has acknowledged that it is currently facing extremely difficult trading conditions. It has said those difficulties have been largely brought about as a result of the introduction of Air NZ Express. In a very real way, Origin Pacific is facing on a smaller scale the same issues that bring Air NZ before the Commission.

As matters presently stand, there can be no certainty that Origin Pacific will continue to provide competition, either with or without the Alliance. Under the Alliance it is likely to be assisted by arrangements with Virgin Blue of the type Virgin Blue told the Commission it has with regional carriers in Australia.

The second is the Auckland-Los Angeles route. The Commission has heard a suggestion from Prof Hausman that the Alliance might result in a 42% price increase on this route. It doesn't require much analysis or industry knowledge to dismiss this suggestion. Among other things, Prof Hausman appeared to be unaware of the other carriers currently flying this route – including Air Tahiti Nui, with its modern fleet of A340's operating from New Zealand to Los Angeles via Tahiti three times a week, or of the 5th freedom carriers who could fly this route – including Singapore Airlines and Air Canada, not to mention the likelihood of United Airlines or another US Airline resuming this service if prices rose in the way Prof Hausman suggested.

That leaves the final key question:

Should the Commission grant the applications on the basis of the demonstrated net public benefits, or should the market be left to decide which of the existing FSA's will survive?

While others may argue that the Commission should allow the competitive forces to "play out", I believe that would risk serious harm to New Zealand, as well as to Air NZ.

The Alliance proposal is a market response, but one which needs approval.

Forcing the airlines to "fight it out" will waste resources and will diminish the benefits that are available to the airlines and to the country, from allowing the Alliance. And if the structural changes force Air New Zealand into an ever more marginal role or, worse still, lead to its collapse, the opportunities both parties have today to secure a future in global markets, is likely to have been foregone, to the serious detriment of New Zealand. There is not likely to be a second chance.

The benefits of the Alliance to the New Zealand economy have been subject to detailed examination by some of the world's leading economists. I believe there is overwhelming evidence that the benefits are substantial in terms of cost savings, scheduling benefits, benefits to employment in engineering, freight benefits and tourism. No other airline is so central to NZ tourism or is likely to be, at any time in the foreseeable future.

Qantas Holidays will add to that by making Air New Zealand Holidays a much more powerful marketing vehicle.

At the same time, both airline industry experience and economic analysis demonstrate that the competitive detriments of the Alliance on the New Zealand economy are likely to be slight – either because the Alliance will be constrained by Virgin Blue (and other carriers on long haul routes) or because the counterfactual will involve Air New Zealand being at best competitively marginalised.

Air NZ is not seeking special treatment from the Commission.

We are seeking authorisation of a transaction under a statutory procedure which provides for authorisation where the benefits of a transaction exceed the detriments.

We believe that threshold has been exceeded.

The Commission should in our view authorise the Alliance either permanently or for a period long enough to enable the benefits to be achieved.

Madam Chair, Commissioners, we know this has been an exhausting case. For Air NZ, we have committed a huge amount of management time and effort, and significant expert help to ensure we've made our case compelling. We've done that because its crucial to Air NZ's future. We sincerely believe that the demonstrated benefits make it equally compelling for New Zealand.