2010/11 financial review of Air New Zealand Limited

Report of the Finance and Expenditure Committee

Contents

Air New Zealand Limited

Recommendation

The Finance and Expenditure Committee has conducted the financial review of the 2010/11 performance and current operations of Air New Zealand Limited and recommends that the House take note of its report.

Introduction

Air New Zealand Limited is a public company listed on the New Zealand and Australian stock exchanges. It is deemed, under a sessional order, to be a public organisation for the purposes of Standing Orders and therefore subject to financial review.

The Crown is the major shareholder in Air New Zealand; at 30 June 2011 it owned just less than 74 percent of the shares. The Crown's shareholding diminishes each year as it does not participate in Air New Zealand's dividend reinvestment plan. The Government has announced its intention to reduce its shareholding in Air New Zealand further as part of its plans to extend the mixed ownership model.

The Crown also holds one special rights share, the Kiwi Share, which does not carry general voting rights but requires the Crown's consent for certain actions by the company. This is designed to maintain Air New Zealand's status under international aviation agreements as a substantially New Zealand-owned and -controlled company.

Financial performance

Normalised earnings before tax in 2010/11 were $75 million, 45 per cent lower than the previous year.[1] While the airline achieved a profit of $112 million in the first half of the year, this was eroded in the second half by reduced demand for travel after the Christchurch and Japan earthquakes, and by rising fuel prices. The average price of jet fuel was 28 percent higher than it had been in the previous year, and has doubled over the past three years.

The company has estimated that its earnings were $70 million lower as a consequence of the Christchurch and Japan earthquakes, which reduced tourist traffic and entailed costs such as providing additional capacity into Christchurch to help the relief effort, and compassionate fares for those affected by the Christchurch quakes.

Because the 2010/11 results are now rather dated (the 2011/12 results are due to be announced on 30 August), our review focused on Air New Zealand's current performance and the strategic challenges it faces. The interim results for the six months ending 31 December 2011 show that its operating environment continues to be difficult, the weak

[1] Air New Zealand Limited, *Annual Financial Results 2011*, p. 2. This document, in conjunction with the *Annual Shareholder Review 2011*, constitutes Air New Zealand's Annual Report for 2010/11.

global economy making it hard to pass on higher fuel costs to passengers. It announced normalised earnings before tax of $33 million for the six months to December, which it termed a "disappointing" result, and acknowledged that it will be a challenge to repeat the 2010/11 annual result.

The Office of the Auditor-General issued an unmodified audit opinion on Air New Zealand's financial statements, rating its management control environment and financial information systems and controls as "very good".

Operating environment

The airline industry is capital-intensive, and highly vulnerable to changes in demand and costs, particularly oil prices. It operates on extraordinarily fine revenue margins; we were informed that IATA projects the industry's profit margin to be only 0.5 percent in 2012, half that of 2011, which in turn was half the previous year's.

International demand for air travel has been clearly affected by the economic turmoil in Europe and the slow recovery in Japan. Domestic demand has been mixed but relatively flat, with passenger numbers through Christchurch still 5 percent below the pre-earthquake average, and travel from Wellington reduced as a result of public sector cost savings. Air New Zealand has, however, seen good growth in demand around the Pacific Rim (China, the United States, the Pacific Islands, and Australia, and more recently some growth from Japan), and has introduced new services to Bali and the Sunshine Coast.

The cost of jet fuel has doubled over three years, presenting a major challenge, particularly on the airline's long-haul routes where fuel can represent 50 percent of total costs. Together, these issues of demand and cost shape Air New Zealand's strategy for the next few years.

Strategic priorities

Despite the challenges, Air New Zealand has announced publicly that it aims to improve its underlying profitability by $195 million a year by 2015 through cost reductions, efficiencies, and revenue growth. Its main costs are labour and fuel. It is reducing its workforce by 440 employees (about 3.8 percent) in the current financial year, and says that major investment over the past several years in progressively replacing its fleet with more fuel-efficient aircraft has been critical in remaining profitable. It plans to invest a further $2 billion in new equipment over the next five years.

The airline is reviewing its long-haul services, which it says are not operating profitably because of high fuel costs and reduced demand. Over the next five years it plans to focus increasingly on Pacific Rim routes and less on Europe, and to make increasing use of partnerships with other airlines to provide effective services. It sees this as part of a world-wide trend, with airlines focusing increasingly on short- and medium-range services where costs can be more readily controlled, and on alliances and mergers between airlines. The airline stressed, however, that it takes an integrated view of its network, as loss-making routes can be important for feeding into profitable ones.

Air New Zealand has been expanding its Australasian presence. It recently consolidated its alliance with Virgin Airlines by taking a shareholding of just under 20 percent. It explained that this was an efficient approach, equivalent to putting 12 aircraft onto Australian routes.

Air New Zealand's priorities include continuing to invest in domestic services to a world-class standard, and stimulating domestic demand by offering plenty of low fares. It says that a recent independent survey showed that relative to its population, New Zealand is well served for flights, and domestic fares are among the lowest in the world.

Scrutiny and performance under mixed ownership

As Air New Zealand is already a mixed-ownership company, we sought its views on how well the mixed ownership model works. The company's chairman, John Palmer, said he considers that Air New Zealand's ownership mix provides a good balance, and he has been a strong public advocate for the model. Having the Crown as a cornerstone shareholder gives the company stability, allowing it to exercise its broader responsibilities to "New Zealand Inc." as the national flag carrier alongside its commercial responsibility to a wider body of shareholders. Unlike a purely profit-driven organisation, he said, Air New Zealand pursues profit in the context of its wider corporate social responsibilities.

In terms of scrutiny, Air New Zealand is accountable both to Parliament, and to the markets through the New Zealand and Australian stock exchanges. We explored with the company how well it believes this scrutiny works, as some of us are concerned about parliamentary scrutiny being removed from companies under mixed ownership. The company's chairman said he sees no conflict between the dual accountabilities; appearing before a parliamentary select committee does not compromise the company's responsibility to the markets. However, he was careful to note that results for the 2011/12 year, just ended, could not be discussed before they were released publicly. On the other hand, as the company's market disclosure includes opportunities for questions at public meetings, he does not consider that parliamentary scrutiny adds information of value that cannot be gained by other means. He observed that the intense scrutiny undertaken by analysts of the performance of listed companies exceeds that of any public forum, but he also emphasised his view that the most valuable form of scrutiny was that which the management and board demand of themselves.

Some of us are concerned about the removal of companies under mixed ownership from the coverage of the Official Information Act 1982. Air New Zealand is not subject to the Act, but its chairman commented from his experience as chair of Solid Energy that the Act can entail a significant drain on management time and resources, and a balance is needed to achieve the most effective disclosure.

An argument for mixed ownership is that it can help companies raise capital. We sought Air New Zealand's view about its options should it wish to raise funds. The company said the situation has not arisen, as it manages its balance sheet conservatively. It conceded that the Crown was unlikely to wish to inject equity in the current economic climate, but saw the alternative of debt financing through bonds as undesirable in view of the lessons learned from the global financial crisis.

Tourism strategy

Air New Zealand expressed disappointment in the effectiveness of tourism efforts by "New Zealand Inc.". It accepted a share of responsibility for this, but argued there is an urgent need for all parties in the tourism sector to review New Zealand's collective approach to developing trade and tourism. In this regard, it noted that the Government's focus has tended to be on the supply side—stimulating competition and attracting more airlines and seats on routes to and from New Zealand—whereas Air New Zealand considers the focus should be on increasing demand and thus the number of passengers. With fuel costs high, airlines need 80 percent load factors just to break even, and several carriers have pulled out of the New Zealand market over the past 12 months as low patronage made their services uneconomic. Rather than seeking to stimulate competition in a stagnant market, Air New Zealand believes a clear strategy is needed for the deployment of New Zealand's tourism resources to develop the markets of greatest opportunity.

Airport charges and regulation

The company expressed strong concern about increases in the landing fees charged by New Zealand airports. It noted that such fees represent a significant cost to the business, and are projected to rise steeply over the next five years (by 54 percent in the case of Wellington airport), increasing Air New Zealand's costs by $200 million.

We were interested to hear that Air New Zealand considers the services provided by the Airways Corporation and Metservice, in contrast, to be well-priced and their approach cooperative and productive. It does not attribute the difference to the fact that they are State-owned enterprises while airports are in mixed ownership, but rather to the regulatory regime which it believes allows airports to abuse their monopoly power. It notes that the recommendations from a Commerce Commission review of airports in 2002 were not acted on, and it hopes that a current review will lead to regulatory change. We are aware that airport charges have long been of concern to the company, and will be interested in the outcome of the Commerce Commission's review.

Subsidy for Cook Islands route

We asked Air New Zealand about the subsidy it receives from the Government of the Cook Islands for its service between Rarotonga and the United States, which amounts to about $13 million in 2012—a significant part of the Cook Islands' budget. Air New Zealand said the service is not commercially viable, but as the Cook Islands Government considers it vital for the country's tourism industry, it has for some years covered Air New Zealand's losses on the route to allow it to break even.

Air New Zealand acknowledged that the subsidy is substantially higher in 2012 (reportedly a 50 percent increase from 2011), but said this is because global conditions have meant fewer passengers on the route, not because Air New Zealand's costs have risen. The chairman added that the airline's willingness to provide the service on a cost-recovery basis illustrates its sense of social responsibility. We note that the airline has been commended in international forums for its transparent disclosure of the costs involved.

Change of chief executive

We wish to record our appreciation of the work done by Air New Zealand's chief executive, Rob Fyfe, who has announced that he will step down at the end of December 2012. His dedication to the job and personal touch have been much appreciated. He will be replaced by the current group general manager international, Christopher Luxon, who came to the company in 2011 from an international career with Unilever.

Appendix A

Approach to this financial review

We met on 18 July and 15 August 2012 to consider the financial review of Air New Zealand Limited. We heard evidence from Air New Zealand Limited and received advice from the Office of the Auditor-General.

Committee members

Todd McClay (Chairperson)
Maggie Barry
David Bennett
Dr David Clark
Hon Clayton Cosgrove
Paul Goldsmith
John Hayes
Dr Russel Norman
Hon David Parker
Rt Hon Winston Peters
Hon Dr Nick Smith

Evidence and advice received

Office of the Auditor-General, Briefing on Air New Zealand Limited, dated 18 July 2012.

Organisation briefing paper, prepared by committee staff, dated 18 July 2012.

Appendix B

Corrected transcript of hearing of evidence 18 July 2012

Members

Todd McClay (Chairperson)
Maggie Barry
David Bennett
Dr David Clark
Hon Clayton Cosgrove
Hon Ruth Dyson
Paul Goldsmith
John Hayes
Dr Russel Norman
Rt Hon Winston Peters
Hon Dr Nick Smith

Witnesses

Rob Fyfe, Chief Executive Officer, Air New Zealand
Rob McDonald, Chief Financial Officer, Air New Zealand
John Palmer, Chairperson, Air New Zealand

McClay [*Introductions*]

Palmer Chairman and committee members, thank you for the opportunity. Chairman, I realise that this is officially a review of 2011, but, given the dated nature of the numbers, the fact that they have been in the public domain for some time, what we thought we'd do as an introduction is to talk about some of the key issues currently facing the company. I will give an introduction. Rob Fyfe, our chief executive, will talk a little bit to that, and we'll talk very briefly about some of the issues that we see facing us, so that the committee can then focus on the issues that they think are important.

I should stress that we are past the end of our financial year. We will be announcing our financial result to the market on 30 August, and clearly, as committee members will be aware, we have to respect both our responsibilities to the market and the issues around that. We will answer the questions of the committee as best we can, but there may be some issues in relation to current financial performance that we are unable to answer.

Cosgrove A process question just on that, so we're not compromising anyone. I take it, Mr Palmer, that your appearance before us, given your responsibilities for disclosure to the market, that your appearance here doesn't compromise the company or yourselves in any way; you're not uncomfortable about appearing before the committee?

Palmer Absolutely not, Mr Chairman. We understand the responsibilities here to the committee, but we also understand that if there are issues of market information and sensitivity, our responsibility is to have already disclosed those to the market, and where they haven't been disclosed they clearly, until we get to the—

Cosgrove So there's no compromise, in your view, from appearing here, in your responsibilities to the market?

Palmer Absolutely not.

Cosgrove Thank you very much for that answer.

Palmer Chairman, I thought that I would just talk about some of the key issues facing the company before Rob talks in a little more detail about the business. We have also with us Rob McDonald, our CFO. The three big issues that we see facing Air New Zealand are the issues of demand, cost, and, specifically, fuel. The demand side is clearly influenced by the economic turmoil in Europe, what that's doing to global economies. One of the consequences we see, not of that, but around the world, is also the very slow recovery from the Japanese market, which has been a challenge for us but is showing signs of recovery. Domestically, demand has been mixed and relatively flat. Some of that is a consequence of the earthquake in Christchurch, and our numbers out of Christchurch are still 5 percent below pre-earthquake levels. And we're also seeing some effect in Wellington as a result of cost pressures in the Government sector, and the effect on air travel as a result.

We are seeing good growth and demand around the Pacific Rim; China, increasingly some growth now out of Japan, USA, Pacific Islands, and Australia. It's an area we are focusing intently on, and you may have noticed that we have just recently introduced new services to Bali and Indonesia, and also to Maroochydore on the Sunshine Coast. We are seeing very good results in the Tasman from our alliance with Virgin and the introduction of our new product called "seats to suit", which was introduced in 2010.

The cost of jet fuel has been very challenging, particularly challenging for an international operator like Air New Zealand, which flies very long sector lengths, where fuel is a larger proportion of your total cost base, and our performance should be seen in the light of the price of jet fuel that has doubled over the last 3 years. What we are seeing, though, is that our fleet investment decisions—some of them made some time ago, more recently the A320 decision, which was made about 3 years ago—have been critical to our ability to reposition the business and to remain profitable despite the challenges that we're facing. About a $2 billion investment over the next 5 years in new equipment—and what we have seen already is a significant improvement in fuel efficiency from our new fleet.

We've also stated publicly and working very hard to take cost out of the business, and our aim is to improve the underlying profitability by $195 million a year by 2015. That has resulted in some job losses. There are 440 fewer employees as a result of that; the redeployment of some aircraft exiting from Beijing; and, particularly, the exiting of a number of our 747 aircraft and replacement with much more fuel efficient triple-7 aircraft, which have been highly successful. All of those things have been important strategic decisions for us to both improve our efficiency and our competitiveness, and Rob might talk a little bit more shortly about how we see our position relative to one of our major competitors, Qantas, in Australia.

We have set our strategic priorities as being to continually invest in New Zealand, to provide domestically world-class air services; to expand our regional presence in Australasia, which we have done through the Virgin alliance and through our investment in Virgin, where we now hold just under 20 percent of the Virgin share register; and to improve our long-haul business by the growth of airline partnerships, where we can use our skills, presence, and product in association with other people's balance sheet, to provide a much more effective service than we have historically.

The disappointments, I guess, are, despite all of these efforts, we consider our financial performance is not where we think it should be. We are currently operating on a revenue margin of just over 1 percent—1.4 percent. That is an extraordinarily fine margin to run a business like this, in a high-risk business, and our aim is to continually look into how we can improve that margin. One of the consequences is a disappointing share price, and we don't think that some of the improvements that we see, looking forward, are yet reflected in the share price.

The other disappointment, which we share some responsibility for, is the fact that tourism and a "New Zealand Inc." approach to tourism, which requires airlines, airports, the Government, and everybody involved in the tourism sector acting anywhere near effectively enough collectively, and despite some efforts by all of those parties, we think that all of us need to improve our game there, because there is and are gains to be made, and we don't think that the progress in tourism is anywhere near what it needs to be. As I say, we take our share of responsibility for that not being achieved.

I think the key achievement, though, is that we have been consistently profitable. We perform well relative to our aviation peers, and more recently we have made a new appointment to CEO with the appointment of Christopher Luxon, who has been attracted to the business from a very high-profile international role. He is a Kiwi, and we think that that is an excellent appointment, and we are feeling very positive about that. We should also acknowledge that he will take over from Rob Fyfe, who has made an outstanding contribution to the airline over a number of years, and has been responsible for a lot of the current positioning. So on that basis—Rob.

Fyfe Thanks Chairman, and thanks to the committee for the opportunity to make a few comments. If I can just set the industry context, ours is a very volatile industry. IATA projects that this year, 2012, the industry will make a 0.5

percent profit margin. That's halved from the previous year, and that year was halved the year before that again. So it is a challenging business in which to make money. That said, Air New Zealand has stated publicly that we expect an improved performance in the coming 12-month financial period starting 1 July, albeit high fuel prices, the instability in Europe, some early signs of slowing growth in China, and continuing intense competition will certainly test us through that period.

Nearer to home, it's hard to not open the newspaper these days without seeing commentary on Qantas, and the challenges our largest competitor is having across the Tasman with labour relations, competition, and financial performance. I guess it's very symbolic and characteristic in this industry: if you cannot adapt your business quickly to those changing market conditions, you'll very soon find yourself struggling.

John outlined our strategic priorities, and at the heart of all of those strategic priorities is growth. Growth is essential to the survival and future of Air New Zealand, and, clearly also, our growth is important to New Zealand in terms of trade and tourism. We have seen a strategy from successive Governments actively looking to entice new airlines and new capacity on to air routes in and out of New Zealand, and we have maintained relatively a very liberal air policy compared with other countries.

Despite that, what you have seen in my time as CEO, which is just coming up to 7 years, is long-haul capacity, total airline long-haul capacity, in and out of New Zealand, has actually declined in that 7-year period. That's despite air travel globally having grown by 30 percent. So, clearly, we are losing position relative to other key markets, long haul. At the same time, if I look at the number of airlines flying in and out of New Zealand when I arrived in this job almost 7 years ago, we have the same number of airlines flying in and out of New Zealand today—different airlines but the same number: 10 international carriers. So the focus on competition is a good one. It does create the right outcomes in the market.

The challenge for us is that we can attract airlines but we actually need to attract customers to those airlines, because airlines will disappear very quickly if their seats aren't full. That's what we're currently experiencing. To put it in context, it costs half a million dollars to fly one of our wide-body aircraft on a round trip from New Zealand to somewhere in the Pacific Rim and back. So you burn cash very quickly if you're not supporting that with revenue, and in today's fuel prices we typically need load factors above 80 percent to get to a break-even position.

We've seen the departure of Air Asia, Aerolineas, Royal Brunei, and Qantas from long-haul routes in and out of New Zealand in the last 12 months. We've seen United cancel its planned Houston-Auckland service. We've seen JetStar reducing capacity on its trans-Tasman and Singapore service, and Cathay Pacific has been reducing capacity on Auckland-Hong Kong as a result of the impact of the new China Southern services.

In light of these contractions, we think there's an urgent need to review our approach—and when I say "our approach" I'm talking about "New Zealand Inc."—to the development of trade and tourism routes to and from New Zealand. We've submitted to the Government's review of international air transport policy that we need to move on from a pure supply-led ideology, which is about attracting airlines, to far more of a demand-led approach, which is stimulating demand and interest in New Zealand as a destination. I have no doubt that if we can stimulate that demand the capacity will quickly be added by existing and new airlines.

Our collaboration both domestically with airports, with Tourism New Zealand, with tourism operators, and internationally with other airlines is critical to support that growth. I think there is an opportunity for us all to do better.

Just a couple of comments before I conclude, on the domestic market. On the domestic front we are working hard to stimulate demand. We'll offer in the coming year over a million fares below $100. If you actually look at the last 5 years in aggregate across domestic and trans-Tasman routes, our fares have fallen by 7 percent in absolute terms, despite the price of fuel having doubled and wages inflating by 12 percent during that period. Underpinning that has been some quite mercurial productivity improvements in the business. We have invested significantly in growth domestically. Our new A320s that are coming in to replace the 737s contribute 28 percent more seats into the domestic market. We have grown our ATR fleet on the regional routes, as well.

Last year an independent review was undertaken of our regional services, and confirmed that New Zealand, for its population, is better served in terms of air network than Australia, Canada, and the US. It also showed that New Zealand, along with Sweden, has amongst the cheapest regional fares globally. On average the fares in Australia on their regional services are 15 percent higher; they are higher again in the US and Canada.

Airport pricing: we clearly comment often on airport pricing. It is a big issue for our business. We spend more than three-quarters of a million dollars per day on airport and air navigation charges. That is about four times our FY 11 profit. Our airport landing fees over the next 5 years, in aggregate, will increase by $200 million. So it's a very significant cost to our business. In Wellington alone, for example, over the next 5 years, the aeronautical revenue will increase by 54 percent. The consequence of that is increased domestic fares, and the consequence of that is us reducing our aircraft orders, to reflect the demand that is suppressed by those significant profits that are being generated within airports. That is why we comment regularly on that issue.

We don't see all suppliers or, for that matter, all monopoly suppliers as problematic. In fact, Airways and MetService are classic examples of suppliers collaborating with us to provide very good services at appropriate prices and high levels of productivity. I'll now hand you back to John, just to conclude our comments.

Palmer Mr Chairman, perhaps just a couple of comments before we go to questions. If we look ahead, say, given the issues around our profit announcement, which I can't talk about, we are more confident about the coming year. That is a reflection of intense efforts by the company to both position itself competitively in areas where we think we can grow, to pay very close attention to our cost base, and, helped by the hedge position that we've had in what has been a rising exchange rate now being neutral, and the fuel position looking a little more positive for us in the coming years. All of those give us some confidence about the position for the company in the coming 12 months.

But given where I started, that the issues for us are cost, demand and fuel, there is not much we can do about fuel, but for the other two we are working hard. The issue around airports is that that is in a position that we think the current regulatory regime has failed. Fortunately, Parliament did timetable a Commerce Commission review for right where we are now. We think that that means that an amendment to the Commerce Act is necessary, because that is, in our view, market voting.

Bennett Thank you, John and Rob, you've done a great job building up a very strong company. So well done, and especially to you, Rob, for the great work you've done for that company. I think everyone in the room would congratulate you on that.

Fyfe Thank you.

Bennett It is interesting to see the industry, I guess, probably just your perspective, it's a really tough industry and it's probably been a little bit dormant in the world scene, as you've got a changing world economic environment where probably that long haul is a reflection of the lack of disposable income people have got and the potential growth of some really medium sort of routes, you know, through China, through Asia, that could really take off. How do you see the structure of a company like Air New Zealand fitting into that environment? Do you think that there's going to be a situation where you see some really big players in that Asian market evolve that are going to then put some tension on the wider market, on the alliances that you have? How do you see that running so that you're competitive on that long haul long term, so that you can keep a strong company going?

Fyfe They are insightful questions in relation to the challenges we face. I am currently Chairman of Star Alliance and as well sit on the Board of the IATA, so I get a good perspective of those global issues. We are seeing consolidations, so we are seeing a number of airlines start to now acquire their counterparts in other markets. There is a lot of regulation that restricts that from occurring today, in terms of cross-border ownership of airlines. We've seen BA acquire Iberian recently, we've seen Air France and KLM merge, and a number of other alliances mooted. That will occur.

Your comment about a shift from long haul to mid haul is also a reality. In a market like Croatia, tourism is growing between 15 and 20 percent per year, and a lot of that is coming out of the likes of the UK and Western Europe. It's a lot more affordable and it also creates a lot less environmental impact, for example, someone flying a short distance rather than flying all the way down to New Zealand. So we clearly have some challenges. The consequence for us as a company is twofold. One, we need to keep adapting very fast to those changing market conditions. Most importantly, what that means for us is moving our network to where the demand opportunities are greatest. We need to be prepared to move and forgo traditional markets that are moving into decline, and replace those with markets that we see as the growing markets. The focus of our strategy in the coming 3 to 5 years in terms of long haul is very much around the Pacific Rim, and it will shift in a relative sense further and further away from Europe, because we'll just—the structural impediments are too great for us to be competitive in the long term in that market.

Palmer I think if I could add that it's interesting to observe that in low-margin businesses you would expect that size and scale would be one of the ways in which you would solve that. Well, if you look at international airlines and global aviation over the last decade, scale has not been an answer. Scale has helped some carriers and has been a dead weight on others. The issue for a company like Air New Zealand: it is the quality of the management and the flexibility that you build into your business so that your positioning can adapt in the way that Rob talks about. That is much more about the quality of the decisions you make than the size of your balance sheet. Coupled with that, one of the things that I think that we have done successfully is we have run a relatively conservative balance sheet, which has allowed us in our investment phases to take advantage of market opportunities and new aircraft purchase, simply because we've had the balance sheet to support it.

Clark Firstly, just to reiterate some of David Bennett's comments to Rob—my question is actually to Mr Palmer, but, Rob, thank you for your work with the company. I know, personally, my father-in-law, whose voting preferences would make Maggie Barry blush with delight, has been very grateful for the personal experience. He has lost some bags, and immediately you were in touch with him. I know he's a frequent flyer. But that personal touch has been widely recognised, as well as the successes with the business. So thank you for that work.

My question for Mr Palmer: you said at the beginning that this kind of scrutiny with Parliament doesn't affect the business in a negative way. I don't know whether you used the words "welcome it", but you said effectively that the appropriate commercial confidence arrangements are there, such that your disclosure obligations are met, and so on, that your shareholders are looked after, and that this doesn't compromise you in any way, coming here and appearing before the committee. Given all of that, I guess it's odd to us that the partial sale of the SOEs in the mixed ownership model is proposing to exclude this kind of parliamentary scrutiny.

We in the Labour Party find that an odd thing, when there is no unfortunate obligation on you; it is an opportunity for transparency and accountability to the taxpayers of New Zealand, who have a significant stake in your company. I wonder whether you would share the view that it wouldn't be a bad thing for some parliamentary scrutiny—certainly not negative, for parliamentary scrutiny—to fall in respect of the Mixed Ownership Model Bill as it's proposed.

Palmer Well, it's not a specific question I've thought about, quite frankly, in relation to Air New Zealand. The question was, did I see that the company was in any way compromised by appearing here today or that there was any conflict, and my answer to that was no. If I was asked the question in a different way, that said was there any value to the company in us appearing here, I think my answer again would be no.

Clark Presumably the benefit today is to the taxpayers of New Zealand, who are getting the opportunity to have their representatives ask you how the company is performing in respect of their interests as the taxpayers, who have a significant stake in the company.

Palmer That may be the case, but the situation is for us as a company, taking our disclosure responsibilities in the market very seriously—and we think that we have gained a reputation for the quality and timeliness of our disclosure—that if people see that the quality of that disclosure is good then that information is clearly publicly available. Now, whether taxpayers in the normal course of events would use market disclosure as a source of information, I'm not sure. But there should be no difference between the quality and extent of the information available by market disclosure and—

Clark With respect, we get an opportunity to ask you on behalf of taxpayers direct questions here, in an environment where there can be a conversation take place that may be reported in the media, and we have the opportunity to ask those questions that are in the public interest, given that it's a company that has a significant public stake in it. You must surely agree that that can't be a bad thing.

Palmer Well, I go back to my answer: not negative, no.

Clark Thank you. Can I also ask briefly about your—I understand you've written some letters to the editor promoting the mixed ownership model. You've said today you hadn't thought through these particular issues. Firstly, do you think it's appropriate for someone in your position as the chairman of a public company to be making positive noises about the mixed ownership model at all?

Palmer I think it's not only proper; the position that I have taken is that I think that, given my experience and my specific experiences, I think I have an obligation to help lead public discussion about the issues around the ownership of these sorts of assets.

Clark With respect, though, you've indicated already that you haven't thought through the issues of public scrutiny that I've just raised. Those are pretty important issues; they certainly are to us. We think that these SOEs like Air New Zealand should be subject to public scrutiny, because there is a wider public interest at stake here.

Palmer Well, perhaps it's because of the answer I've just given you, and that is to say that the extent of the disclosure required by listed companies—and increasingly now required by SOEs—is something that I take seriously in my role either as Chairman of Air New Zealand or as chairman of a SOE, and that the extent of that information, properly disclosed in a timely way, and the availability of public meetings where those questions can be asked, I think would elicit all of the information that can be elicited in any other forum.

Smith Can you confirm that the letter to the editor that has raised the question was in response to a public comment that those supporting the mixed ownership model were traitors to New Zealand and that in fact it was perfectly proper, given that level of accusation against your own integrity, as a person who has given distinguished services to *Trust Bank, to the kiwifruit industry, and now to New Zealand, that for those to claim that, having had that accusation of a very strong word—a traitor to New Zealand—it was perfectly proper for you to respond in the way of a letter to the editor?

Palmer Well, I've written more than one letter.

McClay And not just to the editor.

Palmer That particular letter was a response to public comments that I took exception to as a matter of principle, and I took some exception to personally.

Cosgrove Mr Palmer, just going back to the disclosure issue: The reason we'd like your opinion is because you're here today, and you're here today I think with Solid Energy in your role as chairman. It's been put to us that there will be greater scrutiny through market mechanisms, including continuous disclosure reports, of State-owned enterprises, or, if not greater, sort of better or higher quality scrutiny, if an SOE is subject to the mechanisms you are, OK? I accept that there is a different level of scrutiny with continuous disclosure, having worked for companies.

Could I put this question to you, given your unique experience, about the fact that we can have you here today with your chief executive and your executive team, and the fact that we can have a free-flowing discussion with you and effectively ask you anything. We could ask you about salaries, we could ask you about all the sort of colourful things I suspect that the media would like, but we can have a free-flowing conversation. That is not a level of scrutiny that in theory you would get from basic continuous disclosure, annual quarterly reports, and—no disrespect to our media kith and kin—disclosure from media. This is almost a quasi-judicial forum, if you like—likewise, parliamentary questions and all those other mechanisms.

I suppose the fact that you are here today, that you've been here before, that you're comfortable with your executive team participating in that, though you are constrained on certain bits on information, I would have thought that this exchange would build further confidence in the company, that you can be put on—the feet put to the fire, if you like, in terms of parliamentary scrutiny. We're told with the MOM Bill that's all gone, that's out—no scrutiny, no Ombudsman, no OIA, no parliamentary review, no parliamentary questions, nothing. You're a different class of organisation, yet there's going to be a high level of public scrutiny and disclosure of information. What's your view on that?

Palmer There's a number of threads there, Chairman, which I think I should answer. The first is that for listed companies—and if I take the Air New Zealand example—the extent of scrutiny by the market takes several forms. So there are the disclosures by the company, but the particular scrutiny by analysts, who are trying to predict the future performance of the company, requires them to understand in some detail the drivers and the numbers for the company, which means that the intensity of that scrutiny is much greater than you will get in any public forum. So in dealing with the pure commercial issues, I am satisfied that the level of that scrutiny will exceed anything that other forums can do.

If we take the specific issues, for example, that you've raised about the elements around what is and isn't in the MOM process—if we just take the issues of confidential information, then I can tell you from a Solid Energy point of view, the number of requests that that company gets under the Official Information Act are a very serious drain on management time, management effort and management cost. I'm not saying that it's right or wrong, but it is a very, very serious drain. Every time that companies are required to make presentations, whether it is to the board or anybody else, that is a time that is again a serious drain. So I think we've got to have a balance between where is the most effective point of disclosure for these sorts of companies.

The question, then, in a political sense probably becomes, if the Crown is going to be a majority long-term holder of these companies, is there a question around the greater New Zealand and political questions that should be served in a different forum? My answer is, possibly yes, but they are not the same commercial questions that relate to the performance.

Cosgrove I suppose the essence of my question is, do you see a conflict—I presume you don't—between your commercial requirements and the scrutiny that you do have today from all those stakeholders, business analysts and others, and the scrutiny that, if you like, for better or worse, high-quality or low, this forum and the Parliament on behalf of taxpayers can exercise?

Palmer Your question was, do I see a conflict. My answer to that is, no, I do not see a conflict.

Clark Just picking apart the business model a wee bit, if I understand it correctly, the international business must be less profitable because of the greater component of fuel costs in the actual travel, and therefore the loss of a portion of market share as that market has grown is not necessarily all bad news. That's the part of the venture that's riskiest and the hardest to make profit in. Some would argue that kind of coming back to a smaller model that's domestically based is likely to be more profitable and more successful, where you can dominate the market over time. I wondered, really, if you had thoughts about that. Obviously, there are some benefits to scale, and having those international links will be important, and the market may change—fuel may become a different component of overall costs—and you will have some strategic thoughts around that. I guess it's an open question, I'm really asking for comment about that.

Fyfe I would respond in two ways: firstly, if you look at share of inbound long-haul seats coming in and out of New Zealand, actually our share today is about the same as it was 7 or 8 years ago. So, despite comings and goings, we project forward into the current financial year, we see that market share relatively stable. That said, if you look at it from an Air New Zealand perspective, proportionately more of our future investments are going into regional assets than they are going into long-haul assets. So, whilst we've kept our share of that market stable, we've been growing our domestic market, and through our investment in Virgin we've been growing our position in the Australian market.

So we find that we have a far greater ability to compete in those markets to the point that you make, which is that we have greater control of the costs going into the short-haul business than we do the long-haul business. So an aircraft flying to London and back, a triple 7 300—it costs $1¼ million to get that aircraft to London and back, and over 50 percent of the cost is fuel. A 737 flying Auckland-Wellington, about 23 percent of the cost is fuel. So we have a lot greater influence in how we compete in the short-haul markets.

So, as we look forward, our long-haul assets are becoming a smaller part of our portfolio and we are weighting our business to the regional market. Our investment in Virgin Australia was a strategic decision to say we could enter that market in our own right, with our own aircraft, but we would have created a very difficult position. The incumbent players would have responded to that, and we viewed that we would have lost in the near term a substantial amount of money. So buying a 20 percent stake in Virgin was the equivalent of buying effectively 12 aircraft and deploying them into the Australian market without creating that market dislocation. You will see our strategies increasingly orientated towards growing the domestic market.

The final comment I would make is, it's difficult for us to look at our long-haul routes in isolation. A passenger who flies from London to New Zealand on a service that may not be particularly profitable then flies domestically around New Zealand and on profitable services, so the value of that passenger may be profitable in a network sense even though a particular sector is unprofitable, and if you starve that sector away you actually then undermine the profitability of your business here in New Zealand. So we have to look at it in a fully integrated fashion.

Clark On margins that are, what, 1.4 percent, presumably at some point and to some degree domestic passengers are subsidising international passengers in order to keep those options open?

Fyfe So, in a degree, we have routes that subsidise other routes, that's absolutely right. Some of our long-haul routes today are making very good money. Some of our short-haul routes actually lose money today. But net-net today we would have probably 30 percent by number of our current routes in isolation do not return their cost of capital.

Goldsmith You've talked about the quality of your decision-making being the key to ongoing success, and that's not unique to your business but with most businesses, I suppose. We're talking about these institutional arrangements, and the question is, what's going to keep you on your toes best in terms of continuing to make good-quality decision-making? The sense I'm getting from you is that the collective wisdom and scrutiny of the markets, through the mechanism of the share price and the disclosures that you have, is going to be far more effective and has been far more effective than any parliamentary scrutiny and people coming along asking questions at a select committee. Am I correct in giving that assessment?

Palmer My response to the question—a good question—which I hope is predictable, is: in actual fact the scrutiny that matters is the scrutiny by management and the board that we demand of ourselves, rather than anybody else demands of us.

Goldsmith Just a general comment about the mixed ownership model—I mean you are the living example of that at the moment, in the general sense. What would you regard as its strengths and benefits as a model, in your experience of it over the last few years?

Palmer Perhaps—touching on one of the earlier questions—one of the reasons why I have been a strong public advocate for some time about the model is because of a range of experiences in fully listed companies and very large fully listed companies and in companies with the Air New Zealand structure and in SOEs. The reason why I hold that view is that, if we take the Air New Zealand example, we have responsibilities to our shareholders but, both for the board and for the management, we feel, as the national flag carrier, we have some quite specific responsibilities to "New Zealand Inc.", if you like, because we are the national flag carrier. To discharge those responsibilities, we don't always—in fact often—we do not take a harsh commercial view that a pure solely profit-driven organisation would take. We take a profit-driven motive, but we take it in the context of our wider corporate and social responsibilities.

That is helped by having the Crown, where you operate in that sort of environment, by having the Crown as a cornerstone shareholder, and it is helped by the fact that that is balanced by the fact that you have other shareholders and the market to satisfy. So it is a very good balance between, if you like, some substance durability around the nature of your register, so you are not always looking over your shoulder to see who might be taking you over tomorrow, and knowing that you have a responsibility to a wide range of shareholders. That is, in current parlance, often termed as corporate social responsibility. I think it is taken to a slightly different level in these sorts of companies. We have constant discussion around our board table as to how do we balance the peace between our responsibility, specific responsibility, to our shareholders and our wider community responsibility.

Cosgrove Mr Palmer, was the market satisfied, do you think, when Air New Zealand almost went bust prior to the Government intervening and buying it back?

Palmer Was the market satisfied?

Cosgrove I'm using your words, because, you know, the counter-factual is also true. In private sector hands, as you would be aware, before you and your chief executive took over and got the show right again—

? It's not the first business in the world to go bust.

Cosgrove The man's a genius. Well done.

Palmer My answer is that the reason for Air New Zealand getting into the situation it got to with Ansett was the result of, in my view, poor governance and poor management.

Peters I'm looking for some details. Is Air New Zealand guilty of employing Chinese nationals in preference to New Zealanders?

Fyfe I'm probably the best to answer that question. No, we don't employ Chinese nationals in preference to New Zealanders. We do employ—we have a Chinese cabin crew base that operates our service out of Shanghai, where the vast majority of our passengers are Chinese-speaking customers. As a consequence, we made a conscious decision to ensure the vast majority of our crew could communicate with them in their language of origin.

Peters Who is the employer of that crew in Shanghai, Air New Zealand?

Fyfe No, the regulations in China require us under law to employ those crew through a government body so—

Peters That's the foreign aviation service—

Fyfe We contract that government body to employ those crew on our behalf.

Peters Then why did you describe them before Immigration New Zealand as "existing employees"?

Fyfe Immigration New Zealand fully understand the relationship between the employer and Air New Zealand. So in that situation, they wear our uniforms, we treat them totally as our employees and part of our community, as a business, but have fully disclosed to Immigration New Zealand that they are employed through this third party, as required by Chinese regulation.

Peters Either they were employed by FASCO or they were employed by Air New Zealand. Which one was it?

Fyfe As we explained to Immigration New Zealand, and it was fully understood by all the parties, they are employed by FASCO but we treat them as though they were employees of Air New Zealand, because that's the way we treat any of our third party contractors that work in our uniform, supporting our customers.

Peters How you treat them is a matter for, obviously, your company's internal policy. I want to know, who was the employer at the time that application was made for those visas—Air New Zealand or FASCO?

Fyfe Again, if I repeat the question, the employer was FASCO. Immigration New Zealand were fully aware that Air New Zealand have the contract of employment with FASCO for those employees, and they fully understood the relationship between Air New Zealand and FASCO and the employees.

Peters Well, you know, in 2009 you effectively got rid of 36 members who were flight attendants and people like that. Not one of them has been re-employed by you, have they?

Fyfe I don't know the answer to that question.

Peters All 36 say that they have not been re-employed by you, yet you've got people employed under the—

? Did you say all 36,000 said that?

Peters No, I said 36.

? 36?

Peters Yes, lost their job in 2009—on a "first to be employed" arrangement under their contracts, yet none has been employed. Yet we have FASCO, which is a Chinese Government corporation, having people here under visas, under the guise that they are Air New Zealand employees, when they are not.

Fyfe That's a completely different question. The issue that you're raising is a question where, in the time period that you refer to, these existing staff, that were contracted to Air New Zealand's employment through FASCO—we had surplus numbers of these staff in China; we were required to pay their salaries, through our contract with FASCO; and we had an employment requirement for a short period of time down here in New Zealand, a matter of months; so we redeployed some of those staff on a secondment for a short period of months, because we were going to be paying their salaries anyway, rather than incur additional costs by hiring staff short-term here in the New Zealand market.

In relation to whether we will re-employ staff that have previously worked for Air New Zealand, we certainly have re-employed staff that have previously worked for Air New Zealand, albeit, as I say, I can't comment on the 36 flight attendants. We've had many more than 36 flight attendants leave Air New Zealand in the last few years.

Peters All right. If you look at the Cook Islands Government's latest Budget, it has all the big ticket items—for example, education is $9 million - plus, health there is $9 million - plus—but Air New Zealand's subsidy is well in excess of $13 million. If you look—and we've all been involved over the years in working out what a fair support base for Air New Zealand is, when it comes to the Islands, how can you square that figure with any price or inflation index over that time?

Fyfe The situation, in terms of that subsidy on Rarotonga, is the subsidy that Air New Zealand receives to operate a service between Rarotonga and the USA. On a commercial basis, that service is non-viable. So we have an arrangement with the Government of the Cook Islands that they will subsidise that service to allow us, not to make a profit on that service, to get to break-even. We have full disclosure of all the economics of operating that service, and that is the amount of money it costs to cover our costs of operation. The Cook Islands Government have made a decision that that investment is justified by the value of those tourists that are carried on that service into their market place. On a commercial basis, that service is not viable.

Peters That has always been the basis of those negotiations, going back a number of years. What I do not follow is the huge jump in that cost of subsidy.

Fyfe Sure. Well, the jump in the cost of subsidy is not because our cost base has gone up; it's because the actual number of passengers carried on that service and the price they're prepared to pay has gone down. The arrangement is that they effectively cover the losses that we make operating that route.

Palmer Could I just add two comments, because I think this is a classic illustration of the discussion that we are required to have as a company about our corporate and social responsibility in trying to maintain some of these services where we have almost a non-commercial situation. This is one illustration of it. In that period, we should bear in mind that fuel price has doubled.

Hayes Can I also make a comment? I have recently attended the forum of Finance Ministers meeting over in Kiribati, and, absolutely unsolicited, listening to some forum secretariat officials, some Australian officials and some New Zealand officials, they were commenting on the outstanding quality that you guys provide in outlining your costs for those subsidy arrangements for their – So congratulations on doing a great job there—absolutely unsolicited.

Norman Just a few issues: capital raising. If you were to go to the Government now seeking the Government to contribute to a capital raising that you wanted to get engaged in, what do you think your chances of success would be, if you went to the Government now to seek more capital? Has the board considered this issue? If it did consider it, did it think there was a very high likelihood that the Government would come up with large amounts of capital at the moment?

Palmer The reality is, consistent with my earlier comments, that we have run a relatively conservative balance sheet, to make sure that we are in a position both to deal with an economic downturn, which has a significant influence on cash flow, and that we can deal with the capital commitments that we see going forward. The issue has not arisen for Air New Zealand because of the way, I'd like to think, we've managed our business and particularly our balance sheet particularly well.

It's therefore a theoretical question. The theoretical question is: in the current environment, do I think it likely that the Crown would see a new investment in Air New Zealand to expand its operations as a priority, given the other issues? My instincts are: probably not.

Norman The reason I asked the question is in relation to the mixed ownership model debate. As I'm sure you're aware, one of the arguments has been to facilitate the mixed ownership model companies accessing capital. So if you were to issue more equity, or issue more shares, then the Crown would have to buy 51 percent of those shares, if the Crown sold down to 51 percent, in order to maintain it—by law they have to. Would that put a constraint—if you say you want to issue more equity in order to raise more capital but the Crown has to buy 51 percent of all the new shares issued, both voting and non-voting, as the result of an amendment to the bill, does that present an obstacle to you in terms of raising capital through that mechanism?

Palmer Well, if I answer the question in the context in which I think it's been asked: I would have thought that, for the Crown in its current position, fronting up with 51 percent of the capital is a much preferable position to fronting up with 100 percent.

Norman You currently have the option, though, do you not, to issue bonds—to borrow—so you don't have to have equity to raise capital; your other option is debt, effectively. You have that option currently. That option doesn't go away, it's present in either model, right?

Palmer As I've answered in other forums, one of the issues in the global economic crisis—and I say this given my quite considerable involvement in the banking and finance sector—is people who have taken on too much debt, and debt in inappropriate forms is at the heart of the current global economic crisis.

Norman In terms of the tourism strategy that Mr Fyfe talked about, Air New Zealand would have to be one of the biggest players in the tourism space in New Zealand, yet you kind of argue that we essentially haven't had a "New Zealand

Inc." approach. The advantage of having these computers is that you can scan through stuff, and I was looking at some of your earlier reports, where you raised similar issues. Why do you think Air New Zealand hasn't kind of grasped the nettle on that issue?

Fyfe Let me try to answer that question: I think that the challenge for us is, a purely competitive approach to trying to stimulate demand is very problematic in a very high capital-intensive business like the airline industry. So 70 percent of air routes around the world are operated by one carrier, 91 percent of air routes around the world are operated by one or two carriers. So if you stimulate competition on routes that are already competed for, you tend to find yourself as a business competing to maintain your position on that route and distracted from growing new markets and new opportunities. I think, as an airline linked to our airports and linked to Government, we haven't succeeded—and we certainly put ourselves at the heart of not being able to effect this outcome—we haven't succeeded in having a clear strategy of how we deploy our resources in an aligned way to the new markets of greatest opportunity, rather than often trying to stimulate competition on markets that are actually not growing or are potentially even in decline.

Norman My other question is, your comments around Airways and MetService versus the airports I found very interesting. Essentially, they are all monopolies, roughly monopolies of one sort or another, yet Airways and MetService are both SOEs, and in your original statement you said they provide effectively a well-priced service, whereas the private or mixed ownership model airports provide a kind of overpriced service, was what I inferred from what you said. Have I interpreted that correctly?

Fyfe The airport issues that we have, have little to do with a mixed ownership approach. The airport issues that we experience are specifically to the airports that are driven solely by a commercial private sector approach, and we have a situation where they have a statutory right to set prices and earn profits at whatever level they choose, and they are monopolies. In that situation, it is very difficult, in a purely private sector environment, to constrain any abuse of that monopoly. The issue relates to monopoly far more than the ownership state of the business.

Norman Yet the two organisations identified are SOEs that provide a good service.

Peters The nub of this question is in relation to something you said at the start about the cost structure, landing fees, and what have you. You suggested that, well, the system wasn't working. My question is, that's very obviously not just your view, it's the view of others as well. What about a Commerce Commission inquiry, for example? Why don't we do something about this cost regime, rather than just having to wear it and trying to pass it on to passengers?

Fyfe There was a Commerce Commission inquiry back in 2002. It recommended that it got resolved. That recommendation was not pursued by the

Government at the time. There is another review that is now under way, and we hope we get a more satisfactory outcome.

Smith My question is in terms of overall company performance. You rightly observed that New Zealand has a big stake—not just your shareholders—in the success of our airline. Mr Chairman, you are in the position, quite uniquely, of having chaired both a mixed ownership company with Air New Zealand and a 100 percent - owned business like Solid Energy. Is it your view that, in terms of company performance regardless of shareholder, there are benefits to New Zealand in having a mix of both Government and private shareholding in businesses, given that you've had that unique experience in both mixed ownership and 100 percent State-owned businesses?

Palmer Unquestionably, which is consistent with my answer to the earlier question. Can I just use one example: I mentioned earlier that we have just appointed Christopher Luxon as our new CEO. We've attracted him out of a very high-profile international role in Korea. I'm entirely satisfied that SOE companies, given the political issues around that organisation, will not attract those sort of people back to New Zealand in the way that we've been able to do in Air New Zealand.

Smith You're advising the committee that if a company was 100 percent owned, such as Air New Zealand, the quality of chief executive that you would get would be less as a consequence of that 100 percent State ownership?

Palmer I'm satisfied that people with that sort of background will not be attracted to come back to work in a totally Government-owned environment, that are attracted to come back into what they see as a commercial environment with the Crown playing a key shareholder role.

McClay Thank you. We're going to have to finish there. Gentlemen, thank you very much. Rob, just to recognise the work that you've put into Air New Zealand, as the committee has expressed our appreciation to you. We wish to do so again, and we wish you the very best of luck.

conclusion of evidence