NELSON'S 10 YEAR PLAN 2021-31

A NEW COMPANY MODEL FOR NELSON AIRPORT AND PORT NELSON

Nelson City Council
Te Kaunihera o Whakatū

A New Company Model for Nelson Airport and Port Nelson

Supporting Information

Introduction

Nelson Airport Limited (NAL) and Port Nelson Limited (PNL) are both jointly owned by Nelson City Council and Tasman District Council. NAL is a Council-Controlled Trading Organisation (CCTO) while PNL is a Port Company. The Ministry of Transport also owns one share in NAL, the 'kiwishare'. Both companies were immediately impacted by COVID-19, with NAL particularly affected by the drop in overseas tourist travel into the region. While there has been some improvement in trading conditions, there is still considerable uncertainty in relation to when overseas visitors might return to New Zealand, the level of ongoing internal travel, and what the long-term economic impacts will be for New Zealand imports/exports.

As part of its response to this uncertainty, the PNL Board, with the support of the shareholder Councils and the NAL Board, commenced an assessment of alternative business structures. Given the pressure on both businesses, it was natural that consideration was given to opportunities to find and realise synergies, and financial and business efficiencies. Several options were assessed, and these are discussed later in this proposal.

The Councils' preferred option is to establish a new, jointly-owned Operational Holding Company, the 'proposed Holding Company', as a Holding Company for the assets and operations of Nelson Airport and Port Nelson. The proposed Holding Company will be a CCTO. The shareholding Councils consider that the proposal will provide benefits, to both the companies and to the shareholders. Under Section 56 of the Local Government Act 2002 (LGA02), the Councils are required to consult with their communities before establishing a new CCTO.

The preferred option also involves the transfer of assets from the Councils' direct ownership (of NAL and PNL) to the proposed Holding Company. Under Section 97(1)(b) of LGA02, a decision to transfer the ownership or control of a strategic asset to or from the local authority can only be made if provided for within the Councils' Long Term Plans. Both Nelson Airport and Port Nelson are identified in legislation as strategic assets of the Councils.

This proposal does not result in any loss or dilution of the Councils' overall ownership of Nelson Airport or Port Nelson.

The Proposal

The Councils propose to establish a new Holding Company with Nelson City Council and Tasman District Council as equal shareholders. A single Board of Directors, which will have the necessary range of skills and expertise to operate both the Airport and the Port, will replace the two existing Boards. A single Chief Executive Officer and a single Chief Financial Officer will be appointed to the proposed Holding Company, removing duplication in these roles across the Airport and the Port companies. A Chief Operating Officer (COO) will be appointed to Nelson Airport, mirroring the existing COO role in PNL. All other operational aspects of NAL and PNL will remain structured as they are currently.

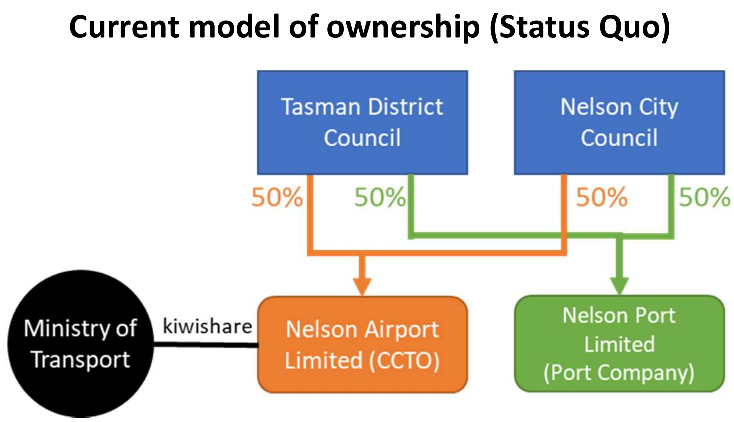
The Councils therefore propose to:

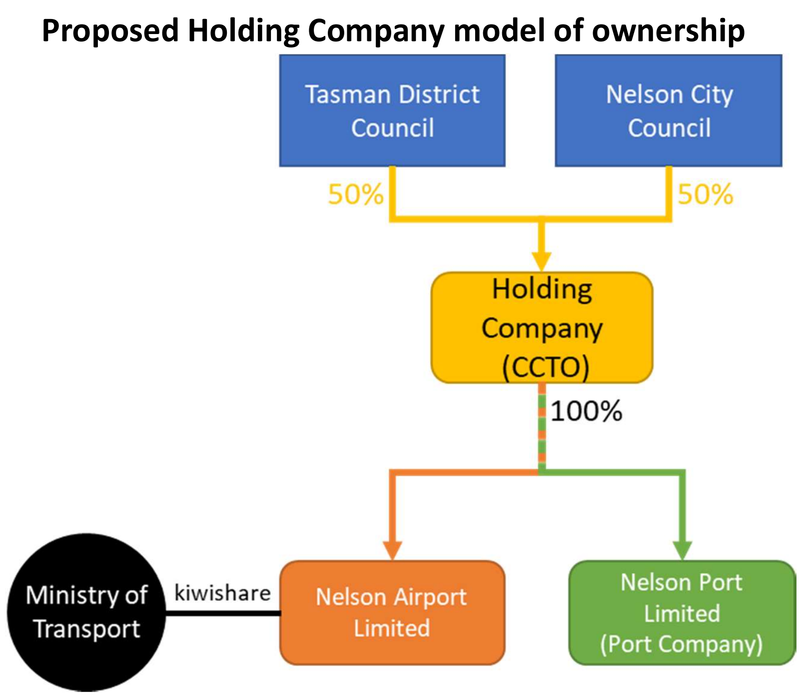
- Establish a new CCTO as an Operational Holding Company, 50% owned by Nelson City Council and 50% owned by Tasman District Council
- Transfer the Councils' shareholding in both Nelson Airport Limited (NAL) and Port Nelson Limited (PNL) to the new CCTO.

This Holding Company proposal is conditional on both shareholding Councils agreeing to proceed.

The current and proposed models are shown in figure 1.

Figure 1: Current and proposed model of ownership of NAL and PNL





The proposed holding company model of ownership above, applies to the proposed operational Holding Company and alternatives Three and Four

Advantages of the Proposed Option

The proposal will result in a number of benefits, advantages and opportunities for the efficient and effective operation of Nelson Airport and Port Nelson. These have been broken down into the following:

Benefits for the companies:

- **Funding benefits** – The proposed Holding Company will be able to access Local Government Funding Agency (LGFA) loan funding directly, and hold its own debt, rather than have the Councils apply to the LGFA and then hold debt on behalf of the companies. This would also result in significantly reduced borrowing costs.
- **Direct operational synergies** – costs that can be removed from either company due to operational efficiencies (e.g. governance, corporate and finance functions).
- **Indirect operational synergies** – improved resilience, risk management and access to stronger capabilities through sharing of expertise across the companies.
- **Taxation efficiencies** – through the formation of a consolidated tax group.
- **Better strategic alignment** – through having a single Board and leadership team.
- **Reduced reporting requirements** – only one Statement of Intent (SOI), Six-Monthly Report and Annual Report.

Benefits for the Councils:

- **Reduced shareholder administration costs** – the Councils have one CCTO to administer rather than two.
- **Potential for shareholders to retire debt** – the scale of the proposed Holding Company may allow it to take on additional debt to repay Council debt.
- **Future opportunity** – to add other entities to the proposed Holding Company to deliver additional benefits and outcomes.

Disadvantages of the Proposed Option

Some risks and disadvantages have been identified with the proposed option. These, along with mitigation, are listed below:

- **Loss of focus** – A combined Board and management team could result in a loss of focus on one or other of the businesses. This risk is thought to be small, given similarities in operational activities between the two companies, including: infrastructure provision, facilities management, cargo and passenger management, property ownership and operating within a strict regulatory framework. Overall, this risk is deemed to be very low.
- **Weakened customer negotiations** – There is a risk that some of the potential savings could be lost through negotiations with key customers. This risk will be mitigated by the increased capacity available within the combined Executive to carry out negotiations. The Holding Company CEO would add to the existing capacity of the NAL negotiating team. Overall, this risk is deemed to be low.
- **Synergistic Savings potentially lost to Commercial Airlines** – If the cost allocation approach does not allocate the Holding Company costs to NAL at a level at least equivalent to the savings that are projected to come from NAL, a proportion of the synergistic savings could be lost to commercial airlines. This risk can be mitigated by ensuring that holding company overheads are reasonably allocated to the airport at an appropriate level.

Accountability and Monitoring Arrangements

Currently, NAL has to prepare a SOI for its joint shareholders. Separately, PNL has to prepare a Statement of Corporate Intent (SOCI) for its joint shareholders. Both companies hold separate Annual General Meetings and both prepare separate Annual Reports.

A new CCTO would need to provide one single SOI, a Six-Monthly Report and one Annual Report for its shareholders. The Councils can still set their expectations for what the SOI should include and the companies should deliver. Overall, monitoring and accountability arrangements would be the same as they currently are, with the main change being that a single, strategically-aligned SOI will be developed instead of a separate SOI and SOCI.

Conflicts of Interest

The transfer of ownership of NAL and PNL to the proposed Holding Company will not create any new conflicts of interest.

Options Considered

A number of options are initially considered as practicable, and were examined in detail by the business case. These were:

1. Proposed option – **Operational Holding Company** – A new Holding Company would be established. A single Board of Directors, collapsed leadership team and shared corporate services, delivered by the proposed Holding Company to the Port and Airport. This is the Port company board's preferred option.
2. **Do nothing** – Retaining the current structure with the two companies remaining independent with their own Boards and Executive, no change to funding structure.
3. **Holding Company as a funding vehicle** – A new Holding Company is established to provide a funding vehicle only for the Port and Airport. All other aspects of the entities remain the same. This is the Airport company board's preferred option.
4. **Holding Company as a funding vehicle plus shared services arrangement** – A new Holding Company is established to provide a funding vehicle only for the Port and Airport. A single Board of Directors and a shared services agreement is established between the Port and the Airport. All other aspects of the entities remain the same.

This consultation is only on the Holding Company options above.

The following options were considered as not practicable given shareholder objectives. On initial analysis, they do not provide the desired outcomes, the risks are significant or they would impact negatively on Council debt.

5. **Changing funding structure** – Retaining company structure as at present, but funding for each entity provided by additional LGFA borrowing through the Councils' balance sheets.
6. **Share transfer** – All shares in one entity would be acquired by the other, except the NAL 'kiwishare' owned by the Ministry of Transport.
7. **Asset transfer –** All assets, liabilities, contracts, staff and licences of one entity would be acquired by the other.

Table 1 shows an initial analysis of the practicable options compared with the 'do nothing' option.

Overall Option **One** is the preferred option as it delivers most benefits, whilst the risks identified are low, and are manageable.

Table 1: Comparison of initial options

Benefits (☑ = elements of benefit potentially apply, ☒ elements of benefit do not apply)				
Option:	2: Do nothing	1: Proposed option: Operational Holding Company	3: Holding Company as funding vehicle	4: Holding Company as funding vehicle plus shared services
Savings through access to LGFA	☒	☑	☑	☑
Direct operational synergies	☒	☑	☒	☑
Indirect operational synergies	☒	☑	☒	☒
Reduced shareholder administration costs	☒	☑	☒	☑
Potential for shareholders to retire debt	☒	☑	☑	☑
Taxation benefits	☒	☑	☑	☑
Risk factors (☑ = elements of risk potentially apply, ☒ = elements of risk do not apply)				
Loss of identity	☒	☒	☒	☒
Access to LGFA funding	☒	☒	☒	☒
Taxation issues	☒	☒	☒	☒
Legal issues	☒	☒	☒	☒
Loss of focus	☒	☑	☒	☒
Weakened customer negotiations	☒	☑	☒	☒
Loss of synergistic savings to commercial airlines	☒	☑	☒	☒
Established relevant precedents	☒	☒	☒	☒

Further Analysis of Proposed Option

The proposed option was preferred because of the funding differential benefits (through LGFA) of $900,000 per year that can be achieved from each of the holding company options and because of the level of operational synergies that could be achieved, estimated at between $592,000 and $942,000 per year as compared with $167,000 per year from Option Four. Operational synergies include: savings in payroll, directors' fees, insurance, IT system and other savings through joint procurement/sharing of services.

Deloitte was commissioned to independently review the direct operational synergies in the proposed option. It found that:

- $592,000 of the annual synergy benefits appear reasonable and likely
- $54,000 of synergy benefits appear possible, albeit with risks of benefits not being able to be achieved
- $250,000 of synergies identified have been assessed as possibly unlikely
- $36,000 of synergy benefits appear unlikely
- Additional synergy benefits relating to cost savings, revenue uplifts and capital expenditure savings have also been identified but not quantified, suggesting the projected savings are conservative.

On balance, the synergy benefits outlined appear mostly reasonable and achievable and should provide material benefit to a combined group. Deloitte also noted:

- Synergies are not effective immediately after the merger takes place. Typically, these synergies are realised two or three years after the transaction. This period is known as the 'phase-in' period, where operational efficiencies, cost savings, and incremental new revenues are slowly absorbed into the newly merged firm
- In the short term, costs may actually go up as the integration incurs one-time expenses and a short-term inefficiency due to lack of history working together and culture clashes. If a culture clash is too great, synergies may never be realised
- Achievement of synergies requires focus from management in order to ensure that the 'status quo' in each organisation is not maintained
- Nelson Airport Ltd is small relative to Port Nelson Ltd (expenditure of approximately 10% of PNL). Therefore, in some cases the benefits from scale might be hard to achieve as the merged entity will not be substantially larger than the Port in its current state
- That they did not assess any flow-on impact on the Airport Landing Charge income (arising from a reduction in the Airport company's costs) but identified that this risk would need to be managed.

Summary of Options

Options: Benefits and disadvantages/costs	
1 - Operational Holding Company (proposed option)	
Benefits	**Disadvantages/costs**
• Funding benefits from Holding Company being able to access Local Government Funding Agency funding • Direct operational synergies • Indirect operational synergies • Taxation efficiencies • Reduced shareholder administration costs • Potential for shareholders to retire debt • Commercial and operational commonalities • Aligned strategic goals • The attraction of higher-level talent and expertise due to scale • Flexibility to introduce other commercial activity to the Group • Net Present Value (NPV) of $18.9 million ($1.3 million average benefit per annum)	• Risk of a loss of focus on one or other of the two companies from having a single Board and single CEO • Possibly weakens negotiating position with larger customers • A proportion of the combined savings may be lost through reduced landing charges income • Risk that realisation of direct operational synergies is not as great as projected
2 - Do nothing (status quo)	
Benefits	**Disadvantages/costs**
• No transitional costs • No uncertainty for customers of NAL and PNL	• Opportunity to realise funding, operational synergies, taxation, administration benefits is lost • Loss of opportunity for shareholders to retire debt • No flexibility to introduce other commercial activity to the Group
3 - Holding Company as a funding vehicle	
Benefits	**Disadvantages/costs**
• Funding benefits from Holding Company being able to access Local Government Funding Agency funding • Taxation efficiencies • Potential for shareholders to retire debt • Governance, CEO and management team structure dedicated to NAL • Flexibility to introduce other commercial activity to the Group • NPV of $7.7 million ($0.6 million average benefit per annum) • Both NAL and PNL retain individual identities and focus	• No direct or indirect operational synergies delivered • Value of savings made is significantly less than for an Operational Holding Company (although more than status quo) • May not deliver strategic alignment between two companies • Councils are one step removed from governance of NAL and PNL meaning community representation may be diluted

4 - Holding Company as a funding vehicle with shared services	
Benefits	**Disadvantages/costs**
• Funding benefits from Holding Company being able to access Local Government Funding Agency funding • Taxation efficiencies • Potential for shareholders to retire debt • Low-risk option still able to achieve the funding efficiencies • CEO and management team structure for both organisations remains largely the same, retaining • Flexibility to introduce other commercial activity to the Group • NPV of $10.3 million ($0.7 million average benefit per annum)	• Value of savings made is significantly less than for an Operational Holding Company (although more than status quo) • Possibly weakens NAL's negotiating position with larger customers • Risk that realisation of direct operational synergies is not as great as projected

Decision Making Process

This proposal to form a new company will only be confirmed if, following hearing of submissions, both Councils decide to adopt the proposal.