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PRESENTATION

Operator

Welcome to the Air New Zealand 2016 interim results call. (Operator Instructions) With that, I will turn the call over to Air New Zealand Head of Investor Relations, Leila Peters. Please go ahead.

Leila Peters - ***Air New Zealand Limited - Head of IR***

Thank you and good morning, everyone. Today's call is being recorded and will be accessible for future playback on our investor centre website, which you can find at www.airnewzealand.co.nz. Also on the website you can find our full interim results pack, media release and relevant stock exchange disclosures.

Speaking on the call today will be Chief Executive Officer Christopher Luxon and Chief Financial Officer Rob McDonald. I would like to remind you that our comments today will include certain forward-looking statements regarding our future expectations which may differ from actual results. We ask that you read through the forward-looking cautionary statement provided on slide 2 of the presentation.

And with that, I'll turn the call over to Christopher.

Christopher Luxon - ***Air New Zealand Limited - CEO***

Well, thank you Leila and kia ora and good morning everyone. Before I begin, I just wanted to take a moment to thank our team of 11,000 Air New Zealanders for their continued dedication and hard work during what's been a really exciting phase of our Company's history.

During the first six months of the year we've seen a number of pivotal route launches and fleet announcements and great strides have been made on the customer experience front too.

We've also rolled out some ground-breaking digital innovations and of course we've seen some changes on the competitive front as fuel prices hit 12-year lows. It certainly has been a really exciting six months that could not have been possible without the dedication and hard work of all of our world-class people.

Moving on to the highlights of our first half performance of the 2016 financial year, we generated strong operating revenue of NZD2.7 billion, an increase of 12% over the prior period. Earnings before taxation were NZD457 million, an increase of NZD260 million or 132%.

After taking into account tax expense of NZD119 million, net profit after taxation was NZD338 million. We generated strong operating cash flows of NZD541 million for the first six months of the year, an increase of 43%.

Now turning to slide 5, I would characterise this interim result as the combination of several positive internal and external factors, all contributing towards a great result for the period. A key contributor to the profit momentum was exceptionally strong passenger revenue growth of 16%.

This was driven by an increase in demand which exceeded the capacity growth across the network. And based on the solid work done by our sales and revenue management teams to stimulate new demand, yields were only minimally impacted from the significant capacity growth, declining slightly by 1.1%.

Cargo revenue continued to be strong during this period, increasing 21%. And on the costs side, a major driver of incremental profitability was the significant decline in fuel prices. Fuel price dropped 44% which more than offset the cost of additional volumes related to the increase in capacity.

And finally, I'm proud to see the meaningful impact the fleet simplification is having on our business. For example, we increased capacity by 16% but fuel consumption only increased 12%, reflecting the excellent efficiencies of our simplified fuel-efficient fleet. In total, economies of scales and efficiencies drove NZD106 million of incremental profitability.

Now, I would like to spend a little time on the demand landscape with respect to certain external factors, and if you could turn to slide 6, I'll start with international long-haul.

The interest and desire to visit New Zealand from overseas tourists continues to grow and we see it as a big driver of demand. 2015 tourism statistics showed a marked increase with 10% volume growth from overseas visitors compared to 5% growth in 2014.

And Air New Zealand certainly plays a very big part in stimulating this tourism demand, bringing 40% of international visitors into New Zealand along with our alliance partners. We saw the New Zealand dollar decline during the first half of 2015 and finally stabilise around the $0.65 level over the past six months. And we expect to see a greater interest in New Zealand as an affordable long-haul vacation destination.

Likewise, if we look at the trans-Tasman sector, Australian tourism into New Zealand grew 6% in 2015 compared to 2% in 2014. With about 51% market share on the trans-Tasman, Air New Zealand was certainly a beneficiary of that growth.

As Australia remains by far the largest source of overseas visitors to New Zealand, our focus on capturing this demand is of the utmost importance as we look forward.

In regard to the domestic market, the fact that the New Zealand economy has remained relatively stable this year has certainly been a contributing factor to strong demand on the main trunk and regional routes.

People continue to travel for both business and leisure and with our expansive network of domestic flights with competitive fares, we are thrilled that they are choosing to fly with Air New Zealand.

Another key factor driving growth within our domestic routes is the strong inbound tourism trends we continue to experience. Overseas visitors are entering New Zealand via Auckland and then transiting from there to a number of destinations across the country.

And we are capturing a significant portion of this demand with market share of 83%, as we continue to grow our domestic and our regional network. We are also seeing strong demand in the Auckland to Queenstown and Auckland to Christchurch routes as well as the domestic dispersal into key regional centres.

Now looking at the potential headwinds that we may face in the near to medium term, with the downward trend of fuel prices and the increasing tourism to New Zealand, we are seeing renewed interest from a number of competitors.

This frankly is simply the return to a more normal competitive environment. We do expect yields in some markets to be under pressure over the short term as the market adjusts to more capacity and a low fuel price environment.

However, we expect this pressure can be partially offset by market stimulation, efficiencies and the economies of scale we continue to capture as we grow our own network with the efficient fleet structure we have put in place.

The changes we have made across our network, our continued improvement in the fleet and our cost structure makes me confident that we have never been better positioned to win against competition and also achieve our over-arching commitment of delivering profitable network growth.

Now, back in August I outlined the five key areas that we are focused on as part of our ongoing strategy to create value for our shareholders. During the first half of 2016 the team has made great progress in many of these areas, as highlighted here on slide 7.

The first priority is to grow and develop our existing markets and to investigate new opportunities within the Pacific Rim, both using our own assets and with alliance partners. We certainly achieved that during this period, growing our capacity 16%, including 11% domestically and over 24% on long-haul international routes.

The impact of the annualisation of the recommenced Singapore route was about 11%. And in December 2015 we successfully launched two new international routes to Houston and to Buenos Aires. The Auckland to Houston route is key to opening up the accessibility of New Zealand to the south and east coast of the US.

A key differentiating factor in launching this new major route is our partnership with United and having access to their expansive US sales and distribution channels to help stimulate inbound tourism. Forward bookings on this route are strong, especially out of the US, and I'm very happy to say that from day one Houston is a positive contributor to our North American network.

Auckland to Buenos Aires represents our first service in the South American market, and while it is still early days I couldn't be more pleased with the flawless operational execution from the team. Sales over the first few months have also exceeded our expectations with a healthy spread of bookings originating from New Zealand, Australia and Argentina.

This new route will also be a positive contributor to our international network. Our close partnership and our codeshare agreement with Aerolineas Argentinas has been instrumental in obtaining the support to stimulate demand from the South American market.

And finally, Auckland to Beijing is a great example of leveraging the strength of our partner Air China to increase the already strong connections that exist between China and New Zealand. New Zealanders now have direct access to Beijing with Air China's daily direct service and Air New Zealand is also benefiting from access to Air China's sales distribution network.

This has resulted in generating even more demand on our Shanghai to Auckland route and China is now New Zealand's second largest inbound visitor market after Australia. And being able to support both the leisure and the commercial growth between our two countries is important, not only to our business but also to the larger New Zealand economy.

Looking forward to the second half of the year, we expect to grow Group capacity approximately 7%, with about 9% on international long-haul routes and about 5% on the short-haul network. With long-haul operations expected to grow faster than short-haul, the higher proportion of long-haul routes is expected to have an adverse impact on overall yield due to the mix change of around about 1%.

Over the course of calendar year 2016 we'll be making changes to the domestic schedule which will reduce complexity for our customers and our own operations. The new schedule will also result in much greater choice and flexibility by improving connectivity, frequency and consistency across the domestic network.

The implementation of the new schedule will see increased capacity for the 2017 financial year, including the addition of night flights in and out of Queenstown. These changes will also improve the utilisation of our existing jet and turboprop fleet and frankly are a win-win for our customers, the regional economies and Air New Zealand.

In November we announced the launch of a new seasonal route to Ho Chi Minh city which will commence from June through October of this year and will run three times a week. We are very excited to offer our customers access to this increasingly popular leisure destination and we hope the direct route to Auckland will stimulate more Vietnamese visitors to come and experience the beauty of New Zealand too.

Our second priority is to grow a simplified, modern fleet of aircraft across our network and in the process, simplify our business to achieve economies of scale, optimise efficiencies and drive down cost. On the wide bodies we received delivery of three Boeing 787s during the period, with the remaining six aircraft on order expected to be delivered over the next three years.

During this period, we also exited the last of our 737s with our narrow body fleet now comprised entirely of Airbus A320s. While the A320 has approximately the same trip costs as the 737, it has 38 more seats, resulting in a lower cost per seat.

For our Tasman and Pacific Island network we have 13 A321, A320 NEO family aircraft on order, with the first delivery expected in late 2017. These aircraft bring with them 17% more fuel efficiency than the current A320 aircraft.

In November we also announced the decision to replace 11 older ATR-500s with 15 ATR-600s which includes four aircraft for growth. This expansion will provide another 600,000 seats on an annual basis into the New Zealand regional market and is a continuation of our strategy to maintain high frequency and low fares to our customers in those regions.

Looking forward, our strategic investment in fleet will provide additional cost advantages beyond fuel efficiencies. For example, reducing the number of aircraft types in our fleet decreases the number of pilot groups and we're beginning to see efficiencies related to crew operations and training.

Additionally, we're seeing lower airframe maintenance costs, although the engine maintenance costs we expect will remain similar. Altogether, our modernisation of the fleet will continue to improve our unit costs, which is especially visible in times of higher capacity growth due to economies of scale.

As I have mentioned over the years, we have many people working to drive an ever improving relationship between our customers and Air New Zealand. I am really proud to say our brand has never been stronger. We continue to receive recognition from the industry. This year we were thrilled to receive the Airline of the Year award for the third consecutive year by airlineratings.com.

In the past six months our customer loyalty program Airpoints exceeded 2 million members with strong growth of 17% compared to 12 months ago. Airpoints members' overall satisfaction has also reached an all-time high in the past six months. We continue to focus on increasing engagement with our high value customers. In the near term you can expect to see announcements on new partnerships that will further strengthen the value proposition for our customers.

Also during the period we completed the upgrade of our flagship lounges at Auckland International airport and Sydney airport. To date we have received a very significant uplift in customer satisfaction regarding the new lounges. We expect this positive feedback to continue with the upcoming upgrades of lounges in Brisbane, Hamilton, Invercargill and Wellington Regional.

Lastly our refurbishment of the Boeing 777-200s was completed in December, which is part of our focus on providing a consistent product and customer proposition across the whole fleet.

Our fourth priority is the commitment to our people. Air New Zealand continues to attract top talent from all over the world. More importantly once we retain that talent they tend to stay with the Company, as evidenced from our low turnover rate of less than 5%. It starts from recruitment.

We certainly are advantaged by having one of the best corporate reputations in Australasia and are fortunate to receive substantially more applications than there are available positions. Once we hire the right person for the job we don't stop there. We spend a lot of time developing our talent and getting their feedback on how we can continue to improve.

A great example of this which I've mentioned before is the High Performance Engagement Charter which has changed the way in which we manage the ongoing relationship between management, our employees and the unions.

During the past six months we were pleased to successfully negotiate 17 collective agreements which covered over 5000 employees or over two thirds of employees who are governed under collective agreements.

This success is a testament to the union leaders and a real credit to their openness to work with us on improving the relationship and a willingness to work collaboratively with management on mutually beneficial solutions.

I am also very pleased that effective next week Jodie King will take over from Lorraine Murphy as our Chief People Officer. Lorraine has contributed immensely to Air New Zealand over the past three years bringing her expertise and leadership skills to elevate the people function of our business to a high calibre.

But it is really exciting for me that the best person for this role was within our own talent pool. This is truly a reflection of both the merits of our people as well as the time and resources that we deploy every year to help with their professional development.

Our final strategic priority is to create a leading digital organisation in Australasia and to be one of the best digital airlines globally. We were really pleased to welcome last month the arrival of our new Chief Digital Officer, Avi Golan.

Avi joins us from Silicon Valley with significant experience in building consumer based digital products across a range of industries. Reporting directly to me Avi's role is critical in developing our technology and digital capability.

During this period we announced the roll-out of two new digital innovation offerings. Firstly our unaccompanied minors wristband with near field communication technology now gives parents peace of mind with real time information on where their children are at each stage of the travel process. It is the first offering of its kind in the airline industry. We pride ourselves at Air New Zealand for thinking outside of the box to improve the travel experience for families with young children.

The other innovation is our biometric bag drop service now available at Auckland International airport. Customers can now scan their passports and boarding passes at self-service kiosks that verify their identity by a biometric camera before placing their bags to be checked in. As the first airline globally to offer such a service we are pleased that Air New Zealand has helped streamline a common pain-point in the travel process.

As we look forward in this area we will continue to develop our digital capabilities with a focus on two main priorities. First, utilising technology to further improve the travel experience for our customers. The second core focus is leveraging technology to make our own staff even more productive and to help free up their time to provide an ever-improving service to our customers at every level.

So we have a lot going on at Air New Zealand. There's still a lot more to be done. Our team is extremely energised and excited about where we're going next. Now let me turn the call over to Rob who will walk through the interim financial results in greater detail. Then I'll come back to briefly discuss the outlook for the business.

Rob McDonald *- Air New Zealand Limited - CFO*

Thanks Christopher. Kia ora and good morning. Before I start my commentary I want to note that with the adoption of the new hedging standard at the start of the 2015 year gains and losses on derivatives recognised within earnings now match the timing of the underlying hedged transaction. Therefore you will no longer hear us refer to normalised earnings.

Moving to slide 14, I will walk through the key movements which affected our performance during the period. Please note that these numbers isolate the impact of foreign exchange and divestments. As Christopher discussed earlier operating revenue was the largest driver of incremental profitability.

Revenue, excluding foreign exchange and divestments, increased by NZD247 million. Passenger revenue increased by NZD232 million largely driven by increased traffic of 17% which was offset by a marginal decline in yield. Cargo and other revenue contributed a further NZD15 million improvement.

Labour costs increased by NZD56 million due to the combination of activity and rate increases. These items were partially offset by improved productivity. Total labour cost, excluding foreign exchange and divestments, increased 9.6% on capacity growth of 16%.

Fuel cost was down NZD184 million compared with the prior period. In the first half of the 2016 financial year the average US dollar fuel price decreased by 44%. Including the impact of hedging fuel price related savings were NZD252 million. These savings were partially offset by increased fuel consumption related to growing our capacity.

Maintenance, aircraft operations and passenger service costs were NZD77 million higher primarily due to airframe and engine costs across the A320-777 and 787 fleets as well as increased landing and in [navigation] charges.

Sales and marketing and other expenses increased by NZD36 million. This increase includes costs relating to the launch of new routes, increased spending on our new brand campaign and higher IT expenditure related to the new digital initiative.

Ownership costs were NZD22 million higher due to increased depreciation and leasing expense relating to the delivery of new aircraft. Associated earnings had a positive impact of NZD36 million relating to earnings improvement from the Company's investment in Virgin Australia and the Christchurch engine centre.

The negative impact of currency movements on revenue and costs, net of increased foreign exchange hedging gains, was NZD9 million while the impact of divestments that occurred in 2015 resulted in a net adverse impact of NZD7 million. The net result of all these movements is an incremental increase in earnings before taxation of NZD260 million.

Looking deeper into our unit cost performance, the cost per ASK adjusted for divestments decreased during the period from NZD0.1058 per ASK to NZD0.0944 per ASK. Looking at the major components there was a modest increase relating to price as well as a negative impact from the weaker New Zealand dollar.

These cost increases were more than offset by the benefit of lower fuel prices which equated to NZD0.0147 per ASK. Economies of scale and efficiencies contributed to a further savings of NZD0.0036 per ASK or NZD106 million. The total reduction per unit cost excluding divestments delivered savings of NZD227 million.

We've done a lot of work to improve our cost structure over the years however this trend is sometimes masked by the fluctuations that occur period-to-period in foreign exchange and fuel price. When we look at our cost per ASK over the past three years and remove the influence of changes and price of fuel and foreign exchange we are able to see an impressive improvement per unit cost of down 7%.

This is driven by economies of scale and efficiencies that Christopher discussed earlier, of which we are seeing a significant impact in the first half of the year due to double digit growth in the network.

Moving to our domestic network on slide 17, this period was a record for Air New Zealand in terms of capacity growth of 11% compared to December 2014. This growth was largely driven by our commitment to simplify and up-gauge the fleet while improving upon the comprehensive network of over 400 daily flights across New Zealand.

We are able to fill those new seats with only minimal impact on load factors, down marginally by 1 percentage point and yields down 3.9%.

We are very proud of our world class domestic and regional on-time performance. Our domestic on-time performance has increased to 91.1%, up 1.5 percentage points. Our regional on-time performance did decrease to 86.2%, down 3.1 percentage points compared to the prior period. However we are confident the new deliveries of ATRs and the revised domestic scheduling will improve this performance.

Moving to the Tasman and Pacific Islands. This network saw a significant capacity growth of 7%. This was mainly due to the increased frequency of wide-body aircraft. In October we introduced the selling of premium economy seats on select routes. Demand for this product has been solid on both the Tasman and Pacific Island routes with little adverse impact on our business class bookings.

Traffic and yield have both increased on these routes with yield increasing 2.7% or 1.6% excluding the impact of foreign exchange. Tasman and Pacific Island on-time performance was strong at 87.1%, up 4.8 percentage points.

Our international network had a fantastic performance during this period with strong capacity growth of 24%. Passenger demand exceeded capacity at 25% with an exceptional response from the Asian routes to our 787 product. Yields were up 2% although adjusting for the impact of foreign exchange, yields declined 5.2%.

Moving to cargo, the business performed very well with revenue up 21%. This was comprised of volume increasing 9%, yields increased 1.6% and the impact of foreign exchange contributing 10%.

Solid execution in this area has led to increased market share on the long haul network from New Zealand. This strong demand was driven primarily from North America, Australia and Asia.

Our balance sheet and operating cash flow continue to be very robust. We ended the period with unrestricted cash on hand of NZD1.4 billion, an increase of 6% on June 30, 2015. As Christopher mentioned at the beginning of the presentation operating cash flow was strong at NZD541 million.

Gearing is 53.8% which remains within our target range of 45% to 55%. The increase is primarily due to the increased debt on new aircraft and the impact of shareholder distributions offset by strong earnings.

Our cash flow generation and healthy balance sheet have prompted the Board to announce a fully imputed interim dividend of NZD0.10 per share which is an increase of 54% on the prior period.

Our simplified fleet not only brings economies of scale and efficiencies to the business, but also allows us to move capacity around the network. The flexibility in our orders and lease arrangements allow us in the medium term to pause or accelerate capital expenditure and the times of changing market conditions.

Based on the current fleet plan, we expect capital expenditure relating to aircraft and associated assets over the next 3.5 years to be approximately NZD2.3 billion based on the US dollar exchange rate of $0.65.

With regard to fuel hedging, in the first half of the year we participated in 82% of the available fuel price decline. That was a great result. We continued to utilise collars for our fuel hedging which we feel comfortably positions us to capture further price falls while protecting us against any potential material spikes.

For the second half of this financial year, we're 71% hedged and for the first half of the 2017 financial year we're currently 56% hedged based on expected fuel consumption. In terms of foreign exchange, our largest exposure is the US dollar.

For the second half of this financial year, we have US dollar hedges in place for approximately $325 million at a rate of $0.73 against the New Zealand dollar and approximately $295 million of hedges at a rate of $0.66 for 2017.

Now let me turn over to Christopher to discuss the outlook for the remainder of the year.

Christopher Luxon *- Air New Zealand Limited - CEO*

Well thanks Rob and turning to slide 25, we have provided our outlook on the full year performance. Based upon current market conditions and assuming current fuel prices and foreign exchange rates, we are targeting earnings before taxation for the full 2016 financial year to exceed NZD800 million.

This outlook excludes equity earnings from our Virgin Australia shareholding. As we start to firm up our network plans for 2017, we are initially anticipating total capacity growth in the range of 8% to 10%.

The majority of that growth will be related to the annualisation of the new routes as well as continued up-gauging in the domestic and regional markets. We'll provide more details in the coming months, but our preliminary indication is that international long haul will grow between 8% and 10% and short haul will grow between 6% and 8%.

In summary, while we're all very proud of the strong performance in the first half of 2016, I am even more excited about what we have yet to do.

Our teams continue to remain focused on executing our growth strategy, maintaining our operational excellence and improving on our world class customer experience that Air New Zealand is so well known for as well as deploying our capital to create strong returns for our shareholders.

Thank you for listening, and now Operator if you don't mind, please open the line for questions.

QUESTION AND ANSWER

Operator

Thank you. (Operator instructions) The first question today comes from Marcus Curley from UBS. Please go ahead.

Marcus Curley *- UBS - Analyst*

Good morning guys. A couple of questions if I can. First Christopher, on the long haul network -- sorry international network I should say, you saw a 5% decline in yields in the first half underlying.

Can you give a little bit of colour in terms of what you're seeing by the key routes and whether you're seeing a lot of change in that at the moment?

Christopher Luxon *- Air New Zealand Limited - CEO*

Yes hi Marcus, how are you? What I can say is -- let me just explain a little bit about how we're thinking about yields. I mean the first thing to say is that we are looking at it through the lens of mix so we're very conscious of yes, obviously we're adding routes that may have slightly lower yields than existing businesses but let's be really clear, are adding a lot to profitability.

So if you just take an example, we've had massive growth in our Asian region and those yields were slightly lower than North America but my goodness, they are incredibly profitable to the network. So there is a mix issue around yields which we've got to be cognisant of as we're growing in the way that we're growing.

I think the second point I'd say is that -- you know, to reassure you is that we are ruthless about revenue maximisation. So we do take a big total revenue sort of approach to maximising revenue by flight and that's working well.

The third thing I'd say is that what we're seeing is remember our unit costs have come down 11% in this last half. Our RASK has stayed pretty much stable and flat, so we're getting huge margin benefit as well.

So I say that to sort of to dimensionalise a little bit about what's going on as we think about yields because we are very -- you know, we're conscious that we've started up new routes like Houston and Buenos Aires.

By definition, they will have lower yields than existing businesses say to North America, but it's such a -- let's be really clear. To have positive contributions from both those routes from day one is a phenomenal achievement and is incredibly profitable for our whole network and for the work that we're doing.

So yes, that's sort of how we're thinking about yields. With respect to long haul, we're actually seeing huge yield -- we're seeing huge growth in capacity but we're actually doing that I think incredibly intelligently. I want to reassure you that we're not doing profitless growth. We're not just growing for the sake of it.

We actually are going into these markets, deeply understand the customer, working really hard on the sales and marketing. We're going into a deep partnership. So if I just take an example, China, we have spent -- been in China since 2006. The last two years we've become profitable in China. A lot of that has been about how we have altered the revenue mix to move to higher yielding, higher value customers that will stay longer, spend more and are more open to us.

We've also changed the aircraft economics but intelligently we've done a really great deal with Air China who obviously are giving us huge sales and distribution reach back in mainland China and now Shanghai services as well as coming on from Beijing. Same if you think about the partnership with Cathay into Southern China.

So I say all that just to sort of give you a sense of if you were in my shoes and to reassure you that we're not being -- we're embracing the growth really intelligently. We are working it through and digesting it very well.

I appreciate that the mix around yields might look and feel different but we're taking a total revenue approach and certainly I can reassure you what we've got is sustainable, profitable growth happening as a result.

Rob, would you have anything else to add?

Rob McDonald *- Air New Zealand Limited - CFO*

Yes I just -- there's a lot of growth in that half for North America, close to 16%--

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Christopher Luxon *- Air New Zealand Limited - CEO*

Compared to 19%.

Rob McDonald *- Air New Zealand Limited - CFO*

So you can see there that -- that a lot of that growth, we'll compete up against indirect -- sorry, direct traffic from Australia, probably the yields there have been -- had some pressure on them.

So that's some of the aspect of where that yield has declined and equally in the US again, just absorbing that amount of growth is -- it just takes some time to consume but what it does do is it positions us extremely well as we look forward into a different environment next year with competition from America.

Marcus Curley *- UBS - Analyst*

So on the international network, you're not necessarily seeing any dramatic impact from competition or the first wave of competition out of Asia at the moment, you know, in terms of the outcomes you're seeing.

Christopher Luxon *- Air New Zealand Limited - CEO*

No, no, that's the short answer.

Marcus Curley *- UBS - Analyst*

Okay and secondly from me, you obviously are getting good leverage out of staff costs but on a per unit basis, they were up quite a bit, probably 6% in the half. Can you give a little bit of colour in terms of, yes, what was happening under the skin of the staff costs?

Rob McDonald *- Air New Zealand Limited - CFO*

Yes so clearly a lot of activity in this half and just reflecting this half is always our sort of build up to growth half. So there's a lot of effectively employment of operational staff, there's a lot of training as we take in new aircraft and things building up largely what --was a launch this year or the past year was, you know, the beginning of December. So that's sort of one aspect to it.

Obviously CPI in there as well and also provisioning for incentive payments.

Christopher Luxon *- Air New Zealand Limited - CEO*

Yes I think Marcus, if I remember correctly I think capacity is up 16%, total labour cost is up 9.5%. As Rob said, a lot of it's about a bubble that we take before we get into our peak season in December-January.

It works itself out sort of in the second half quite nicely and obviously variable Company incentive payments and--

Marcus Curley *- UBS - Analyst*

On the flip side, you're not necessarily employing a lot of additional people if you exclude the disposal.

Christopher Luxon *- Air New Zealand Limited - CEO*

Sorry, say that again?

Marcus Curley *- UBS - Analyst*

It doesn't look like you've employed a lot of people if you remove the disposal of--

Christopher Luxon *- Air New Zealand Limited - CEO*

Yes. So we actually -- on a like-for-like basis we've got about a 2% growth in FTE so we actually are recruiting people and that's a function of that 16% growth but obviously we watch it very closely to make sure it's not anywhere close to the capacity growth that we've got.

Marcus Curley *- UBS - Analyst*

Okay and then finally from me, just a small one. Rob, can you just give us the hedging loss on fuel in the half?

Rob McDonald - *Air New Zealand Limited - CFO*

Yes. The hedging losses in New Zealand dollars was around NZD51 million.

Marcus Curley - *UBS - Analyst*

Okay.

Operator

Thank you. The next question comes from Paul Turnbull from First NZ Capital. Please go ahead.

Paul Turnbull - *First NZ Capital - Analyst*

Hi Christopher and Rob.

Christopher Luxon - *Air New Zealand Limited - CEO*

Hi Paul.

Paul Turnbull - *First NZ Capital - Analyst*

Just a question from me, just domestic yield down 3.9%, with reported RPK growth on the adjusted basis so making it (technical difficulty). So you're kind of getting (technical difficulty)--

Christopher Luxon - *Air New Zealand Limited - CEO*

Sorry Paul, can we just get you to talk up? Can't quite hear you well.

Paul Turnbull - *First NZ Capital - Analyst*

Can you hear me now?

Christopher Luxon - *Air New Zealand Limited - CEO*

Yes, that's much better. Thank you.

Paul Turnbull - *First NZ Capital - Analyst*

Okay. Yes so domestic yield was down 3.9% in your presentation with RPK growth of 6.4% so 2.5% value growth. What are your expectations around second half, given I guess that's a fairly modest growth profile and you've obviously got competition building with Jetstar resuming capacity expansion.

So what's your view around domestic yield and secondly are you seeing within that market any I guess weakening in activity? I just noted some comments from other macro influenced companies this reporting season where they were pointing out a bit of a slowdown they're seeing in air markets.

Christopher Luxon - *Air New Zealand Limited - CEO*

Yes so Paul, I mean the headline is we added 11% capacity. I think yields were just down as you say 3.9%. That's a tremendous amount of growth but importantly a tremendous amount of market stimulation.

So I can tell you from a total revenue point of view it's been incredibly positive but what I'd say is as we go forward, no I mean we're not seeing -- our domestic business is in really good shape. In fact we've held up incredibly well through December-January -- not held up but it's powered ahead and as we look at forwards going forward, we're not seeing obviously what you're seeing with other organisations in New Zealand.

Rob McDonald *- Air New Zealand Limited - CFO*

Yes, certainly see that in the January stats, you know, a really strong performance. So yes, from our perspective we're seeing very good demand.

Paul Turnbull *- First NZ Capital - Analyst*

Yes look I just -- that's for those numbers in January. Just the one thing I need to highlight here though is that the numbers you've provided in terms of ASK and RPK growth are an unadjusted basis versus the actual trading days in July. So you're overstating the numbers when you talk about them. Then on that theme, you've -- what was the benefit to (multiple speakers)--

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Christopher Luxon *- Air New Zealand Limited - CEO*

You're talking about six days Paul, right?

Paul Turnbull *- First NZ Capital - Analyst*

Yes well -- yes, so roughly 3.3%.

Christopher Luxon *- Air New Zealand Limited - CEO*

Yes so bottom line, the way we looked at it was if we look at December to January sort of domestic demand is holding up really well if we add those two months together.

Paul Turnbull *- First NZ Capital - Analyst*

Yes, yes.

Christopher Luxon *- Air New Zealand Limited - CEO*

To get through that adjustment.

Paul Turnbull *- First NZ Capital - Analyst*

If I look at just the cost benefit also from the -- again, you've got fixed costs and variable costs within your overall mix. Can I assume that your fixed costs, they benefit from an additional trading day versus pcp.

So when I think about second half, I need to just consider that there was -- you did additional revenue as such, but the fixed costs don't adjust there?

Christopher Luxon *- Air New Zealand Limited - CEO*

It's not really material, to be honest, Paul. You might well be right, but we're talking not that lot of materiality, to be honest. I mean, what I can tell you is that what's been impressive is that--

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Paul Turnbull - ***First NZ Capital - Analyst***

Arguably -- I was just going to say there is obviously quite a high fixed cost element within, say, labour costs, for example, quite a big cost line. I guess it could be somewhat material, if you look at it on that basis.

Christopher Luxon - ***Air New Zealand Limited - CEO***

Well, yes. I'm not quite sure. The labour cost pieces were sort of explained as largely variable in terms of linked to the growth that we've got going on in the business. As I said, variable Company incentive payments as well, so it's probably not as high as you're imagining. Rob?

Paul Turnbull - ***First NZ Capital - Analyst***

Okay, so can I ask are you paying--

Rob McDonald - ***Air New Zealand Limited - CFO***

We pay to match the revenue and cost. We just don't see it as material.

Paul Turnbull - ***First NZ Capital - Analyst***

Okay. The next question, with the new competition coming along, you had a very big result in cargo. Admittedly, some of it was FX, but it's outstanding, the growth you're getting now there. Do you see potential for, as the new competition ramps up on some of those international routes, for you to lose market share to some of them for your cargo revenue?

Christopher Luxon - ***Air New Zealand Limited - CEO***

To be honest, Paul, our cargo business has done really well, actually, and certainly, as you say, when you look at other airlines and their cargo businesses, we've done exceptionally well over the last four or five years, actually, almost double digit growth in the organic business each year.

So no, the competition, to be honest, we feel like we've got that responded to. I could go through each of the different theatres for you if that was helpful, but we're not seeing any -- our cargo business is in great shape. New Zealanders are exporting well.

We've got really good relationships across New Zealand with those freight forwarders and directly with the exporters themselves, so we're feeling very comfortable and confident with the cargo business. Obviously the lower dollar, frankly, is helping New Zealand exporters, which is really good.

Paul Turnbull - ***First NZ Capital - Analyst***

Absolutely. Final question for me, just getting back to the ramp-up in the international seat capacity coming in to New Zealand. If you look at -- just trying to get more transparency in terms of how you're seeing connectivity as a driver of growth in isolation, and perhaps if you look at other examples in the past where you might have circa 50% uplift in seat capacity into mainland USA, how much can connectivity drive in terms of demand growth by itself?

Christopher Luxon - ***Air New Zealand Limited - CEO***

So what do you mean by -- can you just explain what you mean?

Paul Turnbull - ***First NZ Capital - Analyst***

Just a simple -- Auckland Airport, for example, talk about connectivity, so to increase seats by itself will drive -- will stimulate demand to fly.

Christopher Luxon - ***Air New Zealand Limited - CEO***

Oh, right, I see what you mean.

Paul Turnbull - ***First NZ Capital - Analyst***

Secondly, you've got obviously American Airlines and United with their loyalty programs and all the rest of it, that you'd think would drive it as well. So I'm just interested in how much connectivity.

Christopher Luxon - ***Air New Zealand Limited - CEO***

Maybe I can talk about it a bit, about that North American sell and how we're thinking of that. Obviously yes, we do have American coming into the marketplace. Our view, very clearly, is that they are corporate configured. It's a 230-seater aircraft and it will probably be a lot of their corporate customers burning their Frequent Flyer miles on that trip.

That also is -- I think that's fundamentally a good thing. There's already a large amount of indirect traffic that moves between New Zealand to Australia through to the US that moves through Fiji or other islands, up to the US as well.

And essentially I think North America -- American coming onto the route will take away a lot of that indirect traffic that doesn't currently travel, frankly, on Air New Zealand today, and will also do a good role in terms of actually stimulating demand.

Certainly US visitor numbers to New Zealand are growing very strongly and have been for the last three to four years.

On the other side, just remember that we feel good about our business. We've been there a long time. Over the last few years we've essentially built not just depth but now we've added breath to our network and footprint into North America.

Just remember, United is a partner, not a competitor of ours, so we obviously have a pretty close relationship with them, and the support that we've had going to Houston has been very good.

So net-net it's a resumption of you're seeing essentially a resumption of competitive activity across our network that we've dealt with in the past, but that's the sort of way we're thinking about the North American business, a bit like I outlined the Chinese one to earlier, too.

Rob McDonald - ***Air New Zealand Limited - CFO***

I'll just reinforce Christopher's comment and the example being Shanghai, which I guess again is more about activation and connectivity. We're doing better than we've ever done into Shanghai, and that is in the year that a competitor arrived the whole year.

Paul Turnbull - ***First NZ Capital - Analyst***

Final question for me just quickly. Are you still -- looking at, is it a maximise strategy for you, so you're priced to hold loads around currently within each of your markets?

Christopher Luxon - ***Air New Zealand Limited - CEO***

Sorry, Paul, I missed that question. Can you just take it a bit slower and a bit louder?

Paul Turnbull - ***First NZ Capital - Analyst***

Sorry. In terms of sustaining out load factor around current levels, will you look to price in your markets to hold loads at around where they are currently?

Christopher Luxon - ***Air New Zealand Limited - CEO***

No. So we have a total revenue maximisation strategy. That's ruthlessly ingrained in this business. I can reassure you of that, from our revenue management guidance from the top down. So we don't manage the business for loads at all.

Paul Turnbull - ***First NZ Capital - Analyst***

Okay. Thanks a lot.

Christopher Luxon - ***Air New Zealand Limited - CEO***

We're all about maximising revenue per flight ruthlessly.

Operator

Thank you. The next question comes from Andy Bowley from Forsyth Barr. Please go ahead.

Andy Bowley - ***Forsyth Barr - Analyst***

Thanks. Good morning, Christopher, Rob, and Leila. I'll make an effort to speak slowly, clearly, and loudly. I hope you can hear me.

Christopher Luxon - ***Air New Zealand Limited - CEO***

Sorry, guys. Thank you. How are you, Andy?

Andy Bowley - ***Forsyth Barr - Analyst***

I'm well, thanks. How are you?

Christopher Luxon - ***Air New Zealand Limited - CEO***

Good.

Andy Bowley - ***Forsyth Barr - Analyst***

So look, a couple of questions from me. The first one references a comment you made to one of your earlier slides where you suggested we're now returning to a more normal competitive environment.

So to put that into context, we've had a fair few announcements in recent times from other airlines around capacity additions or new routes, et cetera, and I recognise there's a fair few variable factors at play, but how do you see the competitive environment unfolding over the next 12 months or so, beyond what's already in the public domain already?

Christopher Luxon - ***Air New Zealand Limited - CEO***

Look, I think the big driver of a lot of the increasing competitive activity is the demand for tourism in New Zealand, and let's be clear, Air New Zealand's growth has been very much in line with the potential in the tourism growth that we're seeing in the marketplace. That's really good and really important, that we are on that trend, given we're running 40% of the business here.

So I think certainly tourism seems to be a very big driver of what's attracting carriers in and out of New Zealand. What I meant by that is that we have -- we've seen carriers come and go over a long run over the last (technical difficulty) years, and so we're used to these levels -- we're used to competing, put it that way.

Rob McDonald - ***Air New Zealand Limited - CFO***

The comment I'd make to that also is New Zealand is not alone in this. You only need to look as far as Australia, seeing strong inbound growth going on there now as well. So it's a function of lower currencies. Better fuel prices means that the tyranny of distance gets solved a little bit economically, so that makes it more attractive.

Christopher Luxon - ***Air New Zealand Limited - CEO***

The other thing I'd say is let's be clear that Air New Zealand is on the front foot converting the opportunity, too. So we've dealt with -- we've launched Singapore services, Houston services, Buenos Aires services, Beijing, obviously Vietnam, and they are all really good examples.

Not only that, but we're getting through the -- to get them positively contributing from day one says that we're out in the world, also seeing opportunities and converting those incredibly well. So you've got to just see it as -- there's puts and takes to the whole piece of how we're going about it.

Andy Bowley - ***Forsyth Barr - Analyst***

Recognising the comment you made to the previous question around you're ruthless around revenue maximisation, to what extent can you manage various routes or the business more broadly from a proactive stance around competition?

Is there any revenue management around the prospect of future competition, or is it just today we're trying to maximise revenue on flights as they go out?

Christopher Luxon - ***Air New Zealand Limited - CEO***

Well, we sort of deal with what we're faced with in the here and now, and that's very much what we're fixated on. Obviously we have pretty good revenue management processes that are looking at forward-booking three months, six months, nine months out, and obviously pricing and maximising revenue per flight.

Obviously the other big piece we can do to deal with competition is obviously the big investments we've made in customer experience. A lot of our markets that we're in now, we are competing with and customers are choosing very strongly to stay with Air New Zealand. Our Airpoints program growth was 17% to over 2 million people just in this last half.

Let's be clear, we're in competitive battles. Air New Zealand is more than holding its own, and customers are supporting us and value the customer experience that we have put in place.

Andy Bowley - ***Forsyth Barr - Analyst***

Okay. Last question from me. The capacity outlook. A sustained increased capacity through the next financial year, 8% to 10% for the business as a whole. What are your expectations around aircraft delivery beyond that at this stage? What are you expecting with regards to capacity in 2018 and 2019?

Christopher Luxon - ***Air New Zealand Limited - CEO***

Oh, right. We thought we were doing well trying to give you a read for an indicative on FY17, but to be honest, Andy, I can't give you that level of detail. What I can tell you is that we've had 16% capacity in the first half, 7% in the second half. That follows from 11% the previous half, and as we go into 2017, our initial indications are 8% to 10%.

What I would say to you guys is we are doing that in a very balanced way, and again, we are not interested in growth for the sake of growth. We are interested in profitable, sustainable growth, and so we are being very purposeful about that.

So you look at that 8% to 10% on, say, long haul routes. Probably two thirds of it is dialled in as annualisation of what we've got going on. So we're being very intelligent, we're being very purposeful, we're being very balanced about how we're going about securing that growth.

Your bigger point is, as you can see from the fleet program, by the time we get to 2019, we're starting to taper off our CapEx investment in new fleet, and clearly that has cash flow implications as we go forward.

Rob McDonald - ***Air New Zealand Limited - CFO***

Just some comments from me on that. As Christopher mentioned, the annualisation is the most powerful part of the growth in the coming year. In the coming year, we'll get three 787-9s again, so the fleet will, by November, grow to nine, which will actually, at that point, be our biggest wide-body fleet.

But probably also what we're going is we'll start exiting in the next few months, the start of the exit of the 767 program, so the past year has been very much just -- very much additions of aircraft, but now we're going to see the 767s start to exit, beginning in the next few months as we're just bringing that growth down a bit.

As Christopher mentioned, when you look out to 2018, 2019, 2020, lots of choices then, but we're quite mindful we've gone through quite a big capital program that's still ongoing for the next couple of years, and certainly in the last few years. So as we look towards the latter part of the decade, there's certainly tremendous potential for free cash flow generation.

Christopher Luxon - ***Air New Zealand Limited - CEO***

I think, Andy, the only other thing I'd say about 2018 and 2019 is that we are very dialled into tourism growth in New Zealand, so we want to participate in the tourism growth and obviously contribute, and we think we drive a lot of it, frankly, but when tourism is growing at 10% in New Zealand, the range of that is a good thing.

Andy Bowley - ***Forsyth Barr - Analyst***

Great. Thanks, guys.

Christopher Luxon - ***Air New Zealand Limited - CEO***

Thanks, Andy.

Operator

Thank you. The next question comes from Matt Peek from Craigs Investment Partners.

Christopher Luxon - ***Air New Zealand Limited - CEO***

Hi, Matt.

Matt Peek - ***Craigs Investment Partners - Analyst***

Hi, guys. I just have a couple of questions that were probably best answered by Rob. The first one is in relation to the increases in rental and lease and depreciation and amortisation.

We saw quite a big increase in the first half compared with 2H15, and I was wanting to know if there's -- if you look at it on a run-rate going into the second half basis whether there's much more of an increase there.

Rob McDonald - ***Air New Zealand Limited - CFO***

Just on those, the rentals were up because that was the full period for a couple of 777-300s and the other part of that was currency impacts that as well. Clearly we've got three 787s just arrived and then so the second half obviously depreciation will come up a little as well.

Matt Peek - ***Craigs Investment Partners - Analyst***

Okay, thanks. And then in relation to fuel hedging, I think if you look forward the hedging in place for the first half of 2017 is the highest that a mid first half has been at this time of the year.

Christopher Luxon - ***Air New Zealand Limited - CEO***

Yes.

Matt Peek - ***Craigs Investment Partners - Analyst***

I was just wondering whether you could give us some commentary whether that's because of the volatility that we're seeing or whether you have a house view on where fuel prices might get to in the next six or 12 months.

Rob McDonald - ***Air New Zealand Limited - CFO***

Yes. We did go from our minimum hedging profile literally to our maximum profile during January, in the latter part of January, and that was really I guess an appreciation that we were seeing rent close to or under NZD30. And to us that presented an opportunity, and you've seen in the hedging we've disclosed a use of collars for that.

So we felt we were able to create a pretty -- an environment where we had covered off, at least for the near term, the chances -- helped us against any sudden spikes or strong return. I guess, I think fuel has got longer to go, longer to play out during the course of the year.

Christopher Luxon - ***Air New Zealand Limited - CEO***

But our participation in the first half was really outstanding, in terms of 82% of the price fuel decline we were able to participate in. And then to be -- we're pretty well hedged and then as Rob said, that move from minimums to maximums in January was I think a good call.

Okay, are there any other questions on the line?

Operator

At this time we're showing no further questions.

Christopher Luxon - ***Air New Zealand Limited - CEO***

Okay. Well, if can just say guys, just a big thank you for everyone for listening in and for your time and interest in Air New Zealand.

If you would like to schedule more detailed one-on-one team please reach out to our investor relations team led by Leila and also Julia and I know they'd more than happy to pick it up with you. But again, thanks for all the time and support, we really appreciate it, and we'll talk with you soon. See you.