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PRESENTATION

Operator

Welcome to the Air New Zealand 2019 Annual Results Call. (Operator Instructions).

And with that, I'll turn the call over to to Air New Zealand's General Manager of Investor Relations and Financial Planning, Leila Peters.

Leila Peters - *Air New Zealand Limited - Head of IR & Financial Planning*

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/investor-centre. Also on the website, you can find our annual results presentation, shareholder review, financial report, media release and relevant stock exchange disclosures.

Speaking on the call today will be Chief Executive Officer, Christopher Luxon; and Chief Financial Officer, Jeff McDowall.

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. In addition, within the presentation, there is a supplementary information section that includes slides that we will not be specifically addressing, but that do provide key financial and operational details, and we recommend that you take the time to review that information.

Before I hand over to Christopher to discuss the results, I would like to acknowledge that this will be his last earnings call as CEO of Air New Zealand after spending 8 years with the airline. If I could, I would like just to personally thank you, Christopher, for your leadership and tremendous contribution over that time, and I wish you the very best for the future.

With that, I will now turn the call over to Christopher.

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

Well, thank you, Leila. Kia ora, and good morning, everyone, and thanks very much for joining us on today's call. Earlier this morning, we released to the market Air New Zealand's financial results for the 2019 financial year. And those results demonstrate the resilience of our business of $374 million in earnings before taxation achieved despite the challenges we faced with fuel prices, the global Rolls-Royce engine issues and the slowing demand environment which we talked about back in January. While we're clearly not satisfied with that level of earnings, I could not be prouder of our team and the way our people have demonstrated agility and resilience in adjusting to a number of changing external circumstances. It is yet another example, in my view, of a fundamentally sound business with a core foundation that can withstand such challenges.

We discussed in March a series of cost initiatives focused on driving $60 million out of our cost base over the next 2 years. And while it's still early days, we are seeing some good progress across a number of areas. However, I do want to be clear that we are only interested in achieving cost reduction in a sustainable and in a high-quality way, and that's why you'll continue to hear us talk about the importance of customer, cultural and commercial excellence. That's why you will continue to see us to invest in our business and our customer proposition and our people. That is ultimately how we maintain an iconically great business that is around for the long term.

Now I'll briefly touch on the headline financial results before Jeff goes a bit deeper into the details. Our operating revenues were $5.8 billion, which is a record for the airline. Earnings before taxation were $374 million, which was down 31% from the prior year. Net profit after tax was $270 million and despite the decline in earnings, operating cash flow was very strong at $986 million. Now there were 3 main challenges that we faced in 2019, and I'd like to take a moment to go through, firstly, the tactical responses that we made as we were dealing with the issues in real time; and secondly, strategically how we are addressing these issues over the longer term.

And I think the balancing of tactical and strategic is something that Air New Zealand as an organization does extremely well. We have a tremendous amount of industry knowledge that when we're facing a steep and sudden rise in fuel prices as we saw last year, we immediately look to mitigate that risk with changes to capacity and also revenue management. Over the long term, however, we know that it is our investment in a fuel-efficient fleet of 787s and now NEO aircraft that is the best hedge for rising fuel prices. On top of that, we continue to look at ways in which we can improve efficiency with things like flight planning tools and weight reduction programs to ensure that we're actually optimizing our fuel efficiency for the future.

Then if I move on to the issues we faced with the global Rolls-Royce engines, which impacted not only the 787 fleet, but our entire network as uncertainty around aircraft availability had numerous knock-on effects across the business. But unlike other airlines facing a similar situation, we did quickly mobilize to procure 3 dry lease aircraft to keep our customers moving as much as possible. We also increased resourcing in multiple customer-facing areas to ensure better operational resiliency as our customers navigated changes to their bookings. Now those actions came at a cost, but they were the right actions to take to ensure we maintained continued customer trust and loyalty. Now that the issue with the engines is alleviating significantly, the teams are working really hard to regain the operational efficiencies that we expect from the business. We have seen some good progress made on this front and you will see that coming through in our CASK performance, which Jeff will discuss shortly. As just one example, over the past few months, we have seen improved crew rostering as we have been able to schedule certainty in our network. This will drive better operational efficiencies into 2020 and beyond.

And finally, with the slower demand outlook that we highlighted in January, I'm really proud of the way that the team responded to quickly introduce a comprehensive domestic fair restructure that has helped to stimulate leisure traffic, specifically to regional New Zealand. At the same time, Jeff and the team were able to defer approximately $750 million in CapEx by delaying and smoothing our delivery schedule for our NEOs and wide-body replacement aircraft. This was really important as it increases capital efficiency and refits the fleet plan to better match capacity expectations in light of the lower demand growth environment. Then as we look to the next few years, the network growth principles and cost reduction initiatives that we discussed back in the March business review, and then again at our Investor Day at end of May, will certainly help to ensure that our business is set up for success in a slower demand growth environment.

Now I'd like to provide an update on the status of our cost initiative as they encompass various areas of the business and have different drivers and timelines. As you know, we believe that we have consistently demonstrated the right focus on continuous daily cost management. So we already have a really competitive cost space relative to a number of our peers. However, we recognize that we need to maintain this rigor and that we cannot be complacent. Altogether, we're targeting about $60 million of cost reductions by the end of 2021. The first component of that will be regaining efficiencies in our operations following the impact of the global Rolls-Royce engine issues on our network. A large part of that inefficiency was driven by labor costs, specifically having to have high levels of staff and crew available to support our customers and our operations throughout the disruption. While we expect to remove the bulk of this cost in the current financial year, there is likely to be some spillover into 2021, but I would expect that to be quite minimal.

Then turning to the second component which is a 5% reduction in overheads. Now the focus here is to ensure that we have the most efficient and effective cost structure to support the business in a lower growth environment going forward. That includes looking at the mix of centralized versus decentralized support staff, simplification of our digital infrastructure and re prioritization of spend. But I do want to reiterate here that as we said in March, labor costs are one of the areas we expect to be impacted, but on a relatively small basis given the size of our labor base and the fact that the vast majority of changes will be managed through attrition. Our review should be completed shortly with implementation of those actions occurring in the next few months. And we are expecting to deliver on these improvements from an earnings perspective in both 2020 and 2021.

Then we turn to the third component where we have commenced a targeted review of the operations cost base. As mentioned before, this will involve some supply chain consolidation as well as improved labor utilization and optimization of our facilities. What I really want to stress here is that this is a targeted review. We are taking a really structured, almost surgical approach to this. And as such, we're still working through the analysis and determining the specific actions we will take to drive the sustainable outcomes we are looking to achieve. We also expect to deliver these initiatives in both 2020 and 2021.

Now the key takeaway that I want to leave you with here is that we know what we need to do with regard to our cost structure and we are doing it. At the same time, we're not making decisions with a short-term focus that will end up crippling the business in the future. We continue to invest and grow a number of areas across our business, while at the same time recognizing that other areas can work more efficiently. It's a constant balance and I think we do that really well at Air New Zealand.

Now if I can move on to our revenue performance for the year and the changing dynamics from the first half of the year to the second half. And looking at the performance on a quarter-by-quarter basis, you can see the actions we took midyear to adjust capacity in response to demand changes enabled us to manage our RASK and our overall revenue effectively. We started to gain some momentum in terms of the revenue result, especially with strong close-in bookings in the May and June months, which drove a slightly better overall performance than we had expected when we reaffirmed guidance at our Investor Day in May. Areas that demonstrated the strength included domestic as we saw capacity reductions and pricing adjustments start to drive a stronger RASK result. We also saw a good inbound traffic from North America as well as solid performance from the Pacific Islands as we experienced a significant amount of bookings over the April school holidays, which you may remember had Easter and Anzac Day falling on the same week and was considered something of a super holiday for travel. Now that influx of travel demand also meant that the recent July school holidays had less demand, which is reflected in the recent operating stats we released to the market earlier this week. Then cargo was an area which had a relatively good performance in the first half despite our network disruption issues, but in the second half was softer than even our revised expectations due to continued pressure from global macroeconomic conditions. And Jeff will get into more detail on cargo very shortly.

Looking at our forward bookings profile over the next few months, we continue to see a level of demand that is fairly consistent with the second half of 2019, although some markets have some variability. And touching briefly on those, domestic is performing quite well, more constrained capacity driving some good RASK growth, and we are seeing good performance certainly from the business segment. As I already mentioned, the fair restructure that we implemented in February is working well to drive leisure traffic, and we are seeing it come through in the regional markets especially. The Tasman is experiencing increased competition in some markets such as Sydney. However, we are in a strong position with our hybrid customer offering and because we're now flying the more efficient NEOs on some of those routes, our competitive cost base is even stronger. And I would note that on a year-over-year basis, you should expect to see softer unit revenues for the next few months due to the higher level of capacity growth that followed the end of our alliance with Virgin Australia. We will, however, see that roll off from November.

Now turning to Asia, we continue to see good performance on the second daily Singapore service, which will drop back to once daily in the Northern Winter season, as well as Taipei, which will increase in frequency later this year to 5 times per week. Japan is certainly looking stronger here with the Rugby World Cup, and we're really excited about the launch of our newer Seoul service in November. Shanghai is a bit softer and we continue to monitor that closely as well as the current situation obviously in Hong Kong.

And if I can turn to the Americas and Europe, South America continues to be challenging given the weak economic situation in Argentina, although we are getting good demand from Australian and Kiwi outbound traffic. And finally, the weak New Zealand dollar is having some impact on outbound demand to the U.S. in the first quarter, but we are seeing good early bookings for the peak season from Americans coming to New Zealand, so we actually are quite optimistic with regard to this market.

Now I'll hand over to Jeff to discuss the details of the results.

Jeff McDowall - *Air New Zealand Limited - CFO*

Thanks very much, Christopher, and Kia ora to everyone on the call. I'd also like to take the opportunity now, with I still got about a month to go, to thank you, Christopher, for your leadership and also on a more personal note, for the support you've given me over the years and especially the last 2 years as we've worked very closely together.

So turning to our 2019 performance. I'll start by walking you through some of the detail on both the revenue and cost side of our business. There is also a detailed waterfall in the supplementary slides, which shows the breakdown of each component contributing to the overall movement and profitability as well as the movement in our fuel costs expense.

Passenger revenue increased 4.6%, excluding foreign exchange, supported by demand growth of 5.2%, which is well ahead of capacity growth of 4%. RASK increased by 0.6%, excluding foreign exchange, and as Christopher already mentioned, reflected a stronger first half and a more moderate second half as the softer demand environment led to slower rates of growth. Our cargo business has been impacted by global slowdown in freight, with revenues declining 1.8%, driven mainly by macroeconomic and geopolitical uncertainty. As a result, the industry has seen increased competition as demand has slowed, driving pressure on yields and volumes alike. Although our cargo business has been impacted by the global slowdown in freight, we continue to perform better than the market as a result of strong end market execution driving good (inaudible) growth with our partner airlines to expand our market penetration as well as driving better revenue outcomes with the help of an internally developed cargo capacity management tool.

We've summarized the cost performance here, and the next 2 slides go into greater detail on the operating cost performance and the impact of fuel. So turning now to our operating costs. CASK, when adjusted for the impact of fuel price, FX, the third-party maintenance and the temporary impact of the global Rolls-Royce engine issues, improved to 1.2%. This reflects the economies of scale and efficiencies that contributed $113 million to profit in 2019 and partially offset the impact of pricing pressures. At our interim results, we noted that underlying cash could increase as a result of lower levels of economies of scale and efficiencies. This was due to a particularly challenging first half from a network and cost perspective that reflected inefficiencies around our schedule as well as timing related to setting up new routes in the entry of our NEO aircraft into service. We had said at the time that we expected a stronger underlying cash performance in the second half of the year and you can see that clearly here.

Taking a step back from the one-year view and getting some historical perspective, you can see we have a really impressive track record in this area, with almost 6% of CASK improvement when compared to 2015 levels. As I've said before, there are 3 key elements that drive CASK improvement in any given year being efficiencies, economies of scale and productivity. At the Investor Day in May, we set out a target to continue to drive CASK improvement for the next 2 years, and we remain focused on achieving that goal. We've generated strong operating cash flows again this year of $986 million, although this is slightly down compared to the prior year, but reflects strong working capital cash flow offset by lower earnings. Also contributing to our performance was lower cash tax payments in the year, which simply relate to timing. We ended the period with net cash on hand of $1.1 billion. As I mentioned at our Investor Day event, last year, we updated our liquidity target level to be in the range of $700 million to $1 billion and said that we would transition to that level over time, but would aim to stay towards the high end of the range in the near term. The airline continues to maintain a stable investment grade credit rating from Moody's of Baa2.

Gearing was 54.6% and remains in our target range of 45% to 55%. There was a 2.2 percentage point increase in gearing from the prior year, which reflects continued investment in aircraft.

Finally, the Board was pleased to announce the fully imputed final ordinary dividend of $0.11 per share, reflecting the Board's distribution policy that looks through short-term earnings volatility to provide a consistent and sustainable ordinary dividend while ensuring long-term financial resilience.

In the chart on Slide 17, you can see the phasing of our updated aircraft capital expenditures through to 2023, which total approximately $1.9 billion based on an exchange rate of $0.65. This figure in the forecast chart pictured here now reflects CapEx related to the announced deal to purchase 8 Boeing 787-10 aircraft and related assets beginning in the 2023 financial year. As a reminder, the purchase is subject to shareholder approval, which we will seek at our annual shareholders meeting this September. The order is expected to have deliveries of aircraft from 2023 to 2028 financial years and we've reflected the approximate CapEx associated with that program in the supplementary slides of this presentation.

Now turning to hedging and our current profile for fuel and foreign exchange. To be helpful, we've provided an outlook of estimated fuel cost for 2020, with an assumption of average jet fuel at USD 75 per barrel. Based on the makeup of our hedges, we've also provided an approximation of how movement, up or down, on the fuel price would impact our annual fuel cost. At $75 per barrel for jet fuel, our fuel cost for the year would be approximately $1.3 billion, assuming an FX rate of $0.65. I would note that our largest currency exposure is the U.S. dollar, and we currently have approximately 74% of our 2020 exposure hedged to the rate of $0.673.

Now let me turn the call back to Christopher to discuss the outlook for the rest of the year.

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

Thanks, Jeff. Turning to Slide 20, I'll briefly provide some perspective on expected capacity and the revenue dynamics looking out for the rest of the financial year. The chart on this slide shows you our capacity growth for 2020 and it reflects our view that there are still a number of profitable growth opportunities to pursue. This year, demand growth will mainly come from stimulation of new long-haul markets. This view is consistent with the outcome of our business review in March whereby we said that our revised view of capacity growth over the next few years was around 3% to 5%. And as you can see, our expected breakdown for 2020, we do expect capacity growth to be somewhere in the order of 4% to 5%.

So if I start with the green bar, which reflects new long-haul markets, that includes things like the launching of Seoul this November and the ramping up of the frequency to 5 times a week for Chicago and Taipei. It also includes the growth to Singapore coming both from the second daily bank from Auckland and also the new Christchurch service which commences this December. This growth is tapping into pockets of new demand that then you will see that the rest of the long-haul network is essentially flat.

Now if you move to the red bar for domestic, you will see that we expect to contract capacity slightly this year as we made targeted frequency adjustments mainly on the trunk routes. And we are very comfortable with that decision as we have had significant growth into those markets over the past 5 years and we can now fine-tune the schedule to reflect the current demand profile and manage our revenue effectively. And finally, if we look to the blue bar represented in the Tasman & Pacific Islands, I'll say that growth is really a function of the growth from Wellington and Queenstown to Brisbane as well as the A321neo deliveries. That growth comes at really attractive costs, with the A321 having essentially the same trip costs as the original A320s, but with almost 50 more seats. So, in all, I'm really confident that we have the right mix of growth in our various markets to help drive improved profitability in the year ahead, but we are always able to adjust if necessary.

Turning now to the outlook for the year, based upon current market demand and assuming an average jet fuel price of $75 per barrel, the airline is targeting earnings before taxation to be in the range of $350 million to $450 million. This outlook, obviously, excludes the impact of the new accounting standards for leases.

Finally, on a personal note, I'd like to say that it has been a really great honor to have served as CEO of Air New Zealand, and I think it's been an amazing journey the past 8 years and I genuinely feel very privileged to have worked alongside a truly world-class management team. I think, together, we've achieved some incredible things for Air New Zealand and it showed at the strong foundation of competitive advantages that make our airline so special, we'll continue to thrive over the long term. We have an iconic brand supported by 12,500 people who actually care and go the extra mile. We have a domestic network in customer offering that are unmatched, and we've built deep revenue sharing alliances to support our international growth. And finally, we have invested in a simplified and fuel-efficient fleet that provides us with the best cost structure and customer offering for the New Zealand market.

Now you will have seen yesterday we announced that Jeff McDowall will be appointed acting CEO while the final phase of CEO recruitment is completed. Now this will be effective from September 26 and until the successful candidate starts. Jeff, in my view, is an absolutely perfect choice for the role of acting CEO. He's super well-respected within our own business here in New Zealand. He genuinely understands the arc of the business and he has deep commercial and financial knowledge. So I want to say congratulations to Jeff and fundamentally believe the company is in really great hands under his stewardship.

Now as I thank you for listening. I know you'll have some questions. So operator, please open up the line for any questions you may have.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Our first question comes from Andy Bowley from Forsyth Barr.

Andrew James Bowley - *Forsyth Barr Group Ltd., Research Division - Head of Research*

And if I don't have the chance at the end of my questions, Christopher, best wishes for the future.

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

Thanks, Andy. Appreciate it.

Andrew James Bowley - *Forsyth Barr Group Ltd., Research Division - Head of Research*

So a couple of questions from me. First, around capacity growth and reflective of the guidance that you previously provided for the year ahead, can we read anything into now talking about 4% to 5% versus 5% previously? I recognize it's kind of at the margin, but there's a lot of moving parts in this, but it looks like the cuts to domestic may be slightly more than previously guided to in particular.

Jeff McDowall - *Air New Zealand Limited - CFO*

Andy, it's Jeff. Yes, that is right, we have pulled back domestic a little bit more than we'd previously set out from the region of 2% to 3% reduction at the moment.

Leila Peters - *Air New Zealand Limited - Head of IR & Financial Planning*

Yes. If you think about the Investor Day presentation when we first laid out preliminary FY '20 guidance, we were at that time assuming domestic down about 1 point to 1.5 points. We've increased that a little bit so it's now 2% to 3%. The other components of long-haul Tasman & Pacific Islands have not fundamentally changed, so that's just really what's driving the range of 4% to 5%.

Andrew James Bowley - *Forsyth Barr Group Ltd., Research Division - Head of Research*

Great. And then a second question probably to you again, Jeff. How are you thinking about your cost of capital and, therefore, desire to invest in a lower bond yield environment, recognizing that the targeted pretax ROIC hasn't changed in terms of the band of 10% to 15%? We are at the bottom end of that band, but bond yields are substantially lower than when we first started talking about that band.

Jeff McDowall - *Air New Zealand Limited - CFO*

Yes. It's a very timely question, Andy, and it's something about that we've been talking about internally. So one of our priorities over the next few months is to really look at that. So I don't have a kind of conclusion or a direction really for you right now, but it is something we're actively looking at.

Operator

Our next question comes from Owen Birrell from Goldman Sachs.

Owen Birrell - *Goldman Sachs Group Inc., Research Division - Metals and Mining Company Analyst*

Look, just one question for me really just looking at your guidance. The $350 million to $450 million profit before tax is not too dissimilar to what you've just reported. Fuel costs were broadly in line as well, but you're growing your capacity at sort of 4% to 5%, obviously led by what you sort of called out as the profitable long-haul routes, so that's sort of suggesting you're either getting a blowout in your cost potential into the next year or RASK is really coming under pressure. I'm just -- I'm assuming it's the latter. And I'm just wondering if you can give us a sense of what the RASK outlook is looking like for, in particular, the domestic market for next year.

Jeff McDowall - *Air New Zealand Limited - CFO*

Owen, it's Jeff. Yes, so let me just talk you through the ingredients of the outlook for next year because there are some moving parts and then I'll touch on your question about RASK. So as you said, the fuel was -- fuel is actually an improvement next year, but there's a headwind from the changing currency with the U.S. dollar being stronger, so if you look at the impact of those 2 things collectively, it's almost a wash. So that's sort of neutral. Then, as you mentioned, there's some positive margin and revenue growth from new routes and also unit revenue growth particularly on domestic. And we continue to target an improvement in our nominal CASK, so we expect some improvement there both with our normal kind of daily diet of cost efficiencies and the programs, the more transformational programs that we've talked about.

The other ingredient though that does have an affect on our reported earnings is ownership cost and specifically depreciation. Although it's noncash at the reported earnings level, there is quite an uplift level -- uplift there, sorry, as that reflects the aircraft that [we've invested] and also some higher capitalized engine maintenance. So we're looking at, year-over-year, a $70 million to $80 million higher reported depreciation cost. So that's one of the things that we have factored into that guidance level. Domestic RASK is actually looking quite strong. We moved quite quickly after the earnings update we provided in January to kind of reposition for the new demand environment. And if anything, that's worked a little better than we thought. Now if you look at our domestic performance, May, June and into July, that's really starting to give us strong results and strong unit revenue growth and that's one of the things actually that led to our reported profit number this morning being kind of well clear of the guidance floor that we provided of greater than $340 million.

Owen Birrell - *Goldman Sachs Group Inc., Research Division - Metals and Mining Company Analyst*

Okay. Obviously the other thing about interest ownership is how you're funding that. Can you give us any guidance on what you expect your interest costs to be for the next year as well?

Jeff McDowall - *Air New Zealand Limited - CFO*

Well, the new aircraft that we're purchasing and funding are coming at unbelievably competitive funding rates, which is reflective both of the attractiveness of our credit, but also obviously the base rates and some opportunities that we've identified that give us really, really attractive funding rates. So prognosis for our funding costs is very benign over the next foreseeable period.

Owen Birrell - *Goldman Sachs Group Inc., Research Division - Metals and Mining Company Analyst*

So assuming your total net interest is broadly flat?

Jeff McDowall - *Air New Zealand Limited - CFO*

Broadly, yes.

Operator

Our next question comes from Andrew Steele from Jarden.

Andrew Steele - *Jarden Limited, Research Division - VP of Equity Research*

Just the first one is sort of a clarification on the guidance range, appreciate you provided some comments already. Assuming most of the difference between the top and the bottom of the range reflects revenue, could you call out where you are seeing key areas of revenue uncertainty maybe by market, if that's possible?

Jeff McDowall - *Air New Zealand Limited - CFO*

Yes -- no, that's right, Andrew. Definitely, as in a typical year, revenue was the broader -- is the bigger degree of variability, and the $100 million is about 2% of revenues. So at the midpoint, gets you plus or minus so it's a pretty narrow range from that perspective.

In terms of variability, I'm not sure that I would call out any particular area as being more uncertain than the other. It's a reasonably balanced picture. The -- obviously with domestic, it's a market that changes -- can change quite rapidly, but equally, it's the market in which we have the best ability to adapt quite rapidly, and you've sort of seen that in the last few months. So although when we look at the domestic demand at the moment, it's very much in line with what we indicated back in January. We haven't really seen that change much. We're seeing strong corporate booking, still strong unit revenue growth from that segment. Leisure still softer, but growing -- but still positive growth, so broadly, that's in line with what we expected. But it is a short booking window, so we do need to monitor that very closely. But as indicated, the position we have in domestic means we can adapt really quickly if we need to.

Andrew Steele - *Jarden Limited, Research Division - VP of Equity Research*

And I guess just following on from that, just a point of clarification. With the domestic capacity changes that you've highlighted since the -- or for the guidance changes since the Investor Day, I would assume then from your comments that this change is based on revenue optimization rather than any shift in the underlying demand profile of what you're seeing in the forward booking curve.

Jeff McDowall - *Air New Zealand Limited - CFO*

Yes, that's exactly right. So we've looked at the schedule [at a very sort of] micro level and looked at some of the flights that don't perform as well in a lower-demand environment, and that's where the reductions have come from.

Andrew Steele - *Jarden Limited, Research Division - VP of Equity Research*

That's great. And just one last one for me, just on the cost-out targets, it's good to see you've reiterated those. Just trying to gain an understanding of how to think about the phasing of those savings, understand obviously the cycling out of the Rolls-Royce engine issues. Given the comments on that you're still a couple of months away from the implementation of some of the cost-out, how should we be thinking about sort of the quantum of savings into this year and in next year?

Jeff McDowall - *Air New Zealand Limited - CFO*

Yes, so if you look at the $60 million that we talked about back in March with the 3 buckets, one of them, the first one, was the Rolls-Royce efficiencies and they will be much more in 2020 rather than 2021. So we'd look to be at the vast last bulk of that improvement in 2020. The other 2, the overheads and operating cost savings, we'd expect those to be more broadly -- reasonably evenly spread between those 2 years.

Andrew Steele - *Jarden Limited, Research Division - VP of Equity Research*

And so is that on a full year basis? Or are you talking on sort of achieving it on an annualized run rate?

Jeff McDowall - *Air New Zealand Limited - CFO*

On a full year basis. See, I guess what I'm saying is if you take the $60 million, you can bank the first 1/3 pretty much in the first year and take the other 2/3 and split it broadly 50-50.

Andrew Steele - *Jarden Limited, Research Division - VP of Equity Research*

Okay. That's clear. And sorry, one more for me. With the midpoint of the guidance range having some modest growth. [Versus this year] in terms of dividend for next year, should we be thinking about a modest growth of dividends as well into next year?

Jeff McDowall - *Air New Zealand Limited - CFO*

Well, yes, as we've said before, our dividend policy is all about consistently paying a sustainable dividend and so we've set it at a level that we believe is sustainable. We, obviously, will turn our minds toward the dividend for FY '20 as we go through the year, but what will be in our minds is the medium-term outlook for earnings. And as we've been very open in saying, we're not really satisfied with earnings where they are right now and so we're very focused on restoring earnings growth. So that's probably the first thing.

And then obviously, the other 2 key things being the fact that we're coming into a lower-CapEx period, higher free cash flow and the gearing is tracking down. So those will be in our minds as we look at it.

The only other point I'd make actually is if you kind of think back a couple of years, we would have said back then that with the wide-body replacement program coming up in -- from 2023 that we'd targeted gearing below the range as we contemplated that. Now that we've made the CapEx deferral that Christopher alluded to a second ago, that's no longer the case. The CapEx is quite evenly spread. It's quite sort of BAU-like almost as we go through that wide-body program. So we no longer need to get gearing below the range as we contemplate that. So it's another thing that we'll factor into the consideration when we look at the dividends for FY '20.

Operator

Our next question comes from Marcus Curley from UBS.

Marcus Curley - *UBS Investment Bank, Research Division - Executive Director and Head of New Zealand Research*

Could we start with the missing part of the guidance which is the long-haul RASK outlook? Maybe you can give a little bit of comment around demand versus supply. Obviously there's been quite a number of withdrawals from your competitors. It doesn't look like necessarily that's flowed through to higher airfares so far.

Jeff McDowall - *Air New Zealand Limited - CFO*

Marcus, so sure, the long-haul picture, I mean, these are 2 different dynamics going on. I mean one is that we're targeting a stable RASK really on our core existing markets. There are some areas that are a bit stronger, I mean the one that stands out is Japan. We're seeing some really strong uplift, as you'd imagine, with the Rugby World Cup there. But broadly, the capacity settings that we talked about back in March were all designed around giving us a solid RASK outcome, and that's what we're seeing.

We also -- the other leg of that story was that we are looking for top line revenue growth and margin dollars growth through tapping into new markets, and so that's what we've got with Seoul, the extra flights to Taipei, extra flights for Chicago and we've got [flights to] Singapore as well. So those will all deliver incremental profit, but that will bring down the weighted average RASK, which is really more a mix thing than a performance of individual routes thing.

As you say that, thinking about the competitive dynamic for long-haul, it is a fairly benign picture. We've had more capacity being pulled out than has come in. Particularly from China, we've had Hong Kong Airlines come off entirely from previously being 14 flights a week into New Zealand over the summer. Some of the other Chinese airlines have come out as well, like Tianjin, for example, has pulled their services out; (inaudible) has gone pretty stable too. The South American market is going to be affected positively for us by LATAM flying only 4 days -- 4 times a week into Auckland instead of 7. The other 3 flights are going straight to Sydney. The other -- yes, the other -- the only other more competitive market really is Canada, with Air Canada flying into Auckland from Vancouver 4 times a week. But it's only a seasonal service, so -- and with their, Air Canada's, presence in the Canadian market, we'd expect that to come with good market stimulation from Canada.

Marcus Curley - *UBS Investment Bank, Research Division - Executive Director and Head of New Zealand Research*

Any concerns around Qantas and American joint venture on the U.S. routes or more capacity from them on the U.S. routes?

Jeff McDowall - *Air New Zealand Limited - CFO*

No, not really. I mean Sydney wasn't a surprise. It really comes down to what their capacity plans are, and we've seen a very measured response, very measured approach to the market from American Airlines since they've been operating here, clearly playing to their strength, which is inbound demand from the U.S. and which gives us the really strong position for outbound demand from New Zealand.

Marcus Curley - *UBS Investment Bank, Research Division - Executive Director and Head of New Zealand Research*

Right. Just secondly you mentioned that the -- given the engine issues are mostly behind you, I suppose at the Investor Day, you talked about a residual issue on the engines. So could you just confirm that there's no requirement for those engines to go back for further maintenance before?

Jeff McDowall - *Air New Zealand Limited - CFO*

That's right, Marcus. So what we were talking about for the residual issue was really the newer version of the Trent 1000 engine, which is the TEN version. That -- 2 of our aircraft and the one that's about to arrive in October come with those engines and there's an issue with those which means that they will need to be overhauled earlier than originally planned. So although the prognosis then is that we will get all of our aircraft flying again sometime during September, then we think between February, April -- sorry February, March, April, it's likely that we will have 1 aircraft affected as those TEN engines have their work completed, anticipating that we have extended the lease of the EVA 777-300 aircraft out until the end of April to provide us cover for that period.

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

And the other 2 leased 777-200s, we've returned one and we've got the other one going back this month.

Jeff McDowall - *Air New Zealand Limited - CFO*

Yes, that's right. That's right, the second one goes back on 25th of September.

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

A much more stable situation for us, really.

Marcus Curley - *UBS Investment Bank, Research Division - Executive Director and Head of New Zealand Research*

And then just finally, you're obviously doing some incremental hedging in the spread market between -- for jet fuel. Like it doesn't look like there has been a significant expectation of an uplift there in terms of the jet fuel spread. Can you give any color in terms of, does that sort of -- has the change in standards seemed like that's been somewhat blown out of proportion in terms of the impact on jet fuel spreads?

Jeff McDowall - *Air New Zealand Limited - CFO*

Yes. Well, I mean, it's fair to say that there was some dramatic variation in the estimates of people on what was going to happen as we get closer to IMO 2020, from some people saying no impact to some people sort of saying it's going to be $100 a barrel. So we felt, and actually continue to feel, that it's prudent to have some degree of protection because it is still somewhat uncertain and we're seeing [the rates] creep up about at $15, a little over $15 at the moment from kind of $12 a year or so ago. So as you say, we had some protection in place that's reasonably modest. So you as you get closer to the end of the year, it's around 30% and we're not extending it beyond sort of the middle of next year. But I think it's certainly a -- it's probably a lower risk than we thought at the initial period now that we're closer to the time, but there is still some risk there and you're seeing some upward price pressure recently.

Marcus Curley - *UBS Investment Bank, Research Division - Executive Director and Head of New Zealand Research*

And just one final one. Just if you could just call out the underlying labor cost pressure in the business. Obviously, it was yes, within the result; yes, it was relatively missed beyond labor costs with, yes, competing issues. But yes, in terms of sort of the underlying ongoing sort of cost pressure, what would you call out in terms of the number there?

Jeff McDowall - *Air New Zealand Limited - CFO*

Yes, you're right, there were a lot of moving parts in the labor line in the past year. The price element in the past year was around just over 2%. That was actually, for FY '19, entirely offset by lower incentive payments. So the sort of net price effect, if you like, in FY '19 was 0. As you go forward into FY '20, yes, the settlements that we have been making recently have been a tad higher, typically around 3% for the first year. But equally we've got, as we have talked about multiple times, if anything, a heightened focus on efficiencies in the coming year. So despite the labor costs going from [highs] and -- going from maybe 2.2% to closer to 3%, yes, we've got a big, big focus on efficiency. So we're still targeting a reduction in nominal CASK for the year.

Operator

(Operator Instructions) Our next question comes from Nick Mar from Macquarie.

Nick Mar - *Macquarie Research - Analyst*

Most of mine have been asked, but just a kind of high level one. Back in kind of 2017, you talked about the kind of earnings base being a sustainable platform for future growth. How do you kind of view that in light of kind of where earnings are today and what the outlook is for FY '20 and what might have changed structurally versus kind of timing and other issues that you're facing? And what are the other kind of steps to getting it back towards that level and getting it right back up?

Jeff McDowall - *Air New Zealand Limited - CFO*

Yes, I mean that's a good perspective and that's why we're saying so openly that we're dissatisfied with the current level of earnings. Yes, we're not thinking, well, we'll just kind of reset the base lower. We are thinking that, look, $500 million is where we should be and that's what we're aiming towards. So there are a number of things that we've already talked about that will get us towards there. But if I think back to the principles, if you like, on which we based the business review back in March, we are looking actively at the extent to which we can take those further. So for example, from a network perspective, where we're talking about modest and sort of stable growth on existing routes, tapping into new markets for further growth and also improving the way in which we use our aircraft to make that more efficient. And a great example of that was Hong Kong, where we moved to a daytime flight northbound so that we effectively freed up an aircraft. So if you think of those 3 things and as we look at our network, we're very focused on how we can take those principles further and deliver further growth. So I can't give you specifics about what we're looking at or what we're going to do, but we do see potential for further improvement.

Operator

(Operator Instructions) If there are no further questions, I will pass back to Christopher for his closing remarks.

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

Well, can I just say thank you to everyone for listening on the call and just also for your time and interest in Air New Zealand. Can I say, at a person level, just a big thank you to all of you in the investor community because of the support that you've given me, but most importantly, the company over the last 7 to 8 years. We've enjoyed the interactions with you. It's been a pleasure getting to know many of you quite well, and I really do wish you all individually the very best as you go forward. If you would like to schedule a follow-up call or any follow-up questions, please don't hesitate to reach out to Kim and Leila in our Investor Relations team. Apart from that, have a great day.

Operator

Thank you.
