Asia Pacific Aviation Summit
Keynote Address by Peter Gregg, Qantas CFO
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Thank you and good morning. I'm pleased to be with you today to speak about a topic that certainly resonates with the management team at Qantas and, I'm sure, with most of you here: 'Keeping the momentum going'.

What does that mean? For us, it's not necessarily about continuing to do what we've always done, no matter how well we might do it. For 85 years, Qantas has been – and remains – a great airline. But as one of the world's few truly commercial full service airlines, we must also be a great business.

That means we need to respond quickly to rapidly changing market conditions in order to remain competitive and to retain our capability to reinvest and grow. That requires a clear set of objectives and robust strategies to achieve them. It's this strategic momentum to which we are directing enormous effort, and that is what I'd like to talk about today.

Challenges

In the airline industry, it's easy to feel as though you are a victim of forces beyond your control. We have faced serious adversity in recent years, from terrorism to disease outbreaks and other crises.

Now, the price of fuel is changing the dynamics of an industry that was already in acute financial distress. World-wide losses for the industry are estimated by the International Air Transport Association (IATA) to exceed US$42 billion for the five years to 2005. The entire forward curve for crude oil has recently traded at more than double the long term average price. While Qantas' hedge cover remains amongst the best in the world, as old hedges roll off the cost of new cover is obviously more expensive while fuel prices remain at current levels.

But it's not just the cost impact that is hurting airlines. Higher oil prices are also putting the brakes on demand and economic growth as consumers take less change from the petrol bowser and the cost of moving people and goods rises.

This creates a major dilemma for Qantas, as it does for all airlines. At current prices, our fuel bill is set to rise by $1.2 billion this year. While hedging and surcharges will partially offset this, we still face a $600 million shortfall to last year.

We are cautiously considering a fifth surcharge to recover some of this. However any decision will have to take account of the demand impact, which we've seen with previous surcharges, particularly in price-sensitive leisure markets. We are also accelerating reforms to reduce costs in other areas, which I will discuss shortly.

At the same time, we continue to face the business-as-usual challenges of relentless competition, ever increasing customer expectations and a maze of policy and regulatory settings around the world that often distort competition and limit the reforms that need to take place to ensure this industry's future economic viability.

In our markets, we've faced some specific challenges. The domestic industry structure has changed considerably as a result of the collapse of Ansett in 2001, the subsequent expansion of Virgin Blue to become Australia's second airline and Jetstar's successful launch, which I will discuss shortly. While we think the current domestic industry structure is a viable one that delivers world's best service and value for money to customers, it faces further change. Virgin Blue is making adjustments to its business and Ozjet is planning to start a new domestic operation some time later this year.

We've also witnessed significant increases in capacity from foreign competitors on international routes. This has been made possible by the Australian Government's liberal approach, by world standards, in granting access to Australian international markets.

We do not shy from competition. But we believe the pace and sequencing of this liberalisation needs to be considered carefully in light of the different approaches that Governments around the world apply, and the substantial structural advantages enjoyed by many of our competitors as a result of this.

Free of commercial constraints, many foreign competitors have been able to increase capacity at rates well above market demand growth to support other economic objectives of their home states. Together with the historic restrictions on consolidation in this industry, this has resulted in a situation of chronic over-supply.

Take for example Emirates, which is owned by a Government whose policy is to bring people through Dubai. The more people that go through Dubai, the more successful is the development of policies of the state. This is evidenced by the massive infrastructure investment – more than $US60 billion - being undertaken by Dubai to attract the inflow of these passengers. Therefore, the profitability of the state comes before the profitability of the airline.

State-controlled carriers like Emirates and Singapore Airlines benefit from an aggressive corporatist approach by their Governments that is aimed at promoting growth through their hubs. Among the advantages this bestows are favourable accelerated tax regimes and lower cost of debt financing, by virtue of their near-sovereign risk status, that make it cost effective to continually acquire aircraft to keep their fleet age down and to increase capacity.

Moreover Emirates in particular, as an instrument of an oil-based state, has an additional advantage when oil prices are high. That is because, from an overall economic perspective, the higher revenues from oil help to offset any additional costs incurred by the airline.

What's the bottom line impact of these structural inequities? I'll stick for a moment with the examples of Singapore and Emirates – two of the world's most profitable airlines and toughest competitors to Qantas. If you were to take their reported 2004 profits and apply the same corporate and personal tax rates, accelerated depreciation regime and cost of debt financing that Qantas operates with, it would wipe hundreds of millions of dollars off their significant reported profits.

We are acutely aware that there is no such thing as a level playing field – at least in aviation. But we do believe that a considered approach by Government to industry policy and regulatory settings – that takes into account the real inequities that exist - is critical to the future of Australia's international aviation industry. To this end, we welcome the Australian Government's broad review of industry policy and we will continue to cooperate in any way that we can.

To succeed in the rapidly evolving environment that I've just touched on, we need to have a broad perspective and be willing to make some tough – sometimes very tough - decisions.

Qantas has a key financial objective of improving Group returns to a position where we generate a positive spread to our cost of capital. That is the minimum of what our shareholders expect of a successful industrial company.

I will turn now to some of our key strategies to achieve this.

Sustainable Future Program

Cost reduction and efficiency improvement has never been so imperative. We are making significant progress through our Sustainable Future Program, which was established two years ago to achieve savings, primarily through step-change in operational efficiency.

The initial phase of this program targeted $1.5 billion of savings by June 2006. We are set to exceed this target, with more than $500 million of savings identified to be delivered this year. But, in an environment such as we face, with sustained higher fuel prices representing a much greater portion of our cost base and a shortfall of the magnitude I've just mentioned, we must go much further. We are targeting an ongoing reduction in unit costs of 5 percent a year, excluding the impact of fuel. That is very aggressive, and in recent months we have been looking closely at how we can do things differently to drive greater efficiency through our entire business.

Clearly we need to explore all options to produce our services more efficiently and to protect the vast majority of our staff, of which we have more than 38,000. While we are, and will remain, one of Australia's most important employers, in some areas the Australian cost structure is simply not competitive with those enjoyed by the hub carriers. In those cases, we must look at opportunities in lower cost jurisdictions.

To this end, we will have completed by the end of this month a 15 percent reduction in our management numbers. This has been done through a combination of redundancies, attrition and not filling vacancies. We have done this because we believe management should lead the way in this difficult process.

Scale is also important. Given our end-of-line position and relatively small home market, we need to assess carefully whether we have the necessary scale to compete with powerful foreign players in some parts of the business. Where we do not, we will look at whether we can achieve necessary scale, and what the alternatives are.

Fleet

In 2000, we embarked on an ambitious $18 billion capital investment program over 10 years for new aircraft. This was to replace ageing aircraft and to maintain our competitive position and critical mass by growing as the market grows.

We are continuing to look at options to drive efficiencies through our fleet management. Qantas faces two major fleet decisions over the next five to seven years, to replace its B747 and B767 fleets. This involves more than 60 wide body aircraft.

For long haul flying, the A380 is a natural fit for Qantas, and will allow us to achieve operating cost advantages on thick routes to slot constrained ports such as London and Los Angeles. The delay to the Airbus A380 program, which has deferred the delivery of our first aircraft by six months until April 2007, is disappointing, but we are working with Airbus to ensure we are not competitively disadvantaged.

In the future, we believe there is an opportunity to take advantage of the step change in operating costs promised for new aircraft types such as the B787 and A350. We are assessing these aircraft, for their potential to allow us to serve point to point markets more cost effectively.

We are increasingly focusing on growing point to point flying as we believe these markets represent a major opportunity for Qantas, as an end-of-line carrier. We believe significant potential exists to develop new and fast growing point-to-point routes, thereby strengthening our network offering to our core customer base. We also believe that by taking advantage of technology developments to bypass hubs, we can offer a very competitive alternative to the hub carriers, whose business models require customers to transit through their home ports.

I will stress at this point that we remain confident we can fund this investment through cashflows from our business rather than new equity.

We will also continue to carefully monitor the relative benefits of buying versus leasing aircraft. Debt market trends, the tax depreciation regime and deterioration in aircraft residual values may increase the relative attractiveness of leases, which also provide fleet flexibility.

Value-based airline models

While we are continuing to strengthen our core operations, we believe there are exciting opportunities to expand our presence in value-based segments under the Jetstar brand.

Jetstar in Australia has been a resounding success. It has built a level of brand awareness that is remarkable for an airline little over one year old, and is proving a very effective competitor. Jetstar currently has a fleet of 20 aircraft, including 10 A320s, with another 13 A320s to be delivered by the middle of next year to give a fleet of 23. Jetstar has provided improved profitability on routes that Qantas used to lose money on, and has allowed us to increase services on the fastest growing leisure markets.

Importantly, Jetstar has also challenged many of the assumptions we might once have held about the way we do business. Critical to its success has been the excellent job Alan Joyce and his team have done to meet their target of having the lowest unit costs in the domestic industry. On our numbers, we believe that Jetstar achieved this goal in the second half, particularly when adjusting for average sector length.

At the same time, the Qantas brand has been successful in consolidating its leading position on the main trunk and business-purpose routes.

We've been careful to manage connectivity between the two brands so, from our customers' perspective, the integrity of our network is preserved and they get the best value for money whether they fly for work or for leisure.

We also remain enthusiastic about the opportunities to extend the value-based brand in Asia. The launch of Jetstar Asia has provided a good platform to participate in the rapid growth of a region of more than three billion people.

In its infancy, the airline has suffered a number of setbacks, including regulatory difficulties. These have arisen due to the complexity of dealing with many different Governments, some of which are much less willing than ours to expose their national carriers to new competition. The competitive environment has also been challenging, with several start-ups and few constraints on the competitive response of incumbents. There is no equivalent of our own very vigilant ACCC in many of the countries in our region!

But our recently announced deal with Valuair, which brings both brands under one company, provides some constructive consolidation and gives the combined entity greater scale to pursue the many growth opportunities that we believe exist. For a modest investment, we believe we are now well positioned to expand the model in the region.

Product and customer service

While we are seeking greater efficiency across the Group through improved processes and new business models, we remain committed to investing in our core product and customer service to maintain competitive advantage.

This investment, in particular the rollout of Skybed, has been very well received by our customers. We are proud to have been voted the number two airline in the world this year – up from fourth position the previous year - in the 2005 Skytrax World Airline Awards, which is the largest passenger survey globally.

This excellent result is supported by our internal research, which shows customer satisfaction levels have improved steadily in recent years. We are achieving very good satisfaction levels domestically and international customer satisfaction is at an all time high.

Other portfolio diversification opportunities

In addition to expansion of our value-based brand, we believe there are significant opportunities to diversify our portfolio of businesses to achieve growth and to reduce our exposure to the cyclical risk inherent in the airline business.

The acquisition of Startrack Express two years ago, in joint venture with our partner Australia Post, has strengthened our domestic freight operations and we will continue to look at opportunities to build our presence. We have also increased international freight capacity.

Beyond this, we will explore other opportunities to selectively expand into businesses where we can add value by leveraging the strength of the Qantas brand.

Capital management

To retain the capacity to cope with the inevitable volatility of the airline industry, and to maintain flexibility to reinvest and grow clearly requires careful capital management. Our capital management strategy is aimed at improving shareholder value and we believe the optimal structure to achieve this is one that supports an investment grade credit rating. We remain committed to this, which is indeed a rarity in this industry – we are one of only two investment grade-rated airlines in the world.

Government

To come finally to another issue that has received significant press attention recently; as I mentioned earlier, we are very pleased that the Government has seen fit to conduct a broad-based review of its policy in relation to the airline industry. We will continue to – as indeed will our competitors – provide input to this process. Many areas of Government policy and regulation impact directly on our business, from approaches to liberalisation and foreign ownership restrictions under the Qantas Sale Act, to industrial relations and tax. We have been open about where we believe reforms would assist in providing a framework to ensure Australia can retain a competitive international aviation industry, and we look forward to the outcome of the review later this year.

Industry consolidation

Industry consolidation has similarly been topical. We have long stated that we believe consolidation is necessary for the future viability of this industry. We are now seeing this start to occur in other parts of the world, with Air France/KLM, Lufthansa/Swiss and

US Airways/America West, where the financial imperative is perhaps particularly acute. In broad terms I'll just say that, in the long term, we must be part of this process. The rejection of our previously proposed alliance with Air New Zealand ignores the reality of this industry's economics and our geographic position. As to what form our future participation in the process might take, and when it will occur, that will depend on many factors yet to play out.

In summary

To summarise, we have a lot of work to do to secure Qantas' long term success – both as an airline and a business.

We also acknowledge that change, while necessary, can be very uncomfortable, and can involve significant risks that must be managed carefully.

But, we'd like to think that we have a pretty good track record. After all, Qantas was a pioneer of civil aviation. In its 85 year history, it has mastered many periods of enormous change and has grown to become a very successful national carrier of which all Australians can be proud.

Critical to its success has been – and continues to be - the incredible spirit of our people in both responding to crises and seizing new opportunities, while continuing to deliver outstanding customer service. We think that places us in good stead to 'keep the momentum going' in the future.

Thank you. I’ll now take any questions.