

World Low Cost Airline Congress 2007

Peter Gregg, Qantas Chief Financial Officer and OrangeStar Chairman

Good morning.

Qantas is 87 years old and can rightly be called a legacy carrier, but Qantas owns and operates Jetstar, one of the youngest and most profitable low cost airlines in the world. Both Qantas and Jetstar are profitable, Qantas since it went public in 1995 and Jetstar since it was launched 3 years ago.

This is unique in the aviation world a successful and profitable legacy carrier starting and operating a successful and profitable low cost carrier. Conventional wisdom says this can not occur, but the fact that it does, represents an enormous challenge to low cost carriers and offers a way forward for legacy carriers in the current operating environment.

At Qantas, we are three years down the track of a strategy to develop and grow two strong and distinct airline brands. The first, of course, is Qantas, which is internationally recognised as one of the world's leading full service airlines and an iconic Australian brand. It is in its 87th year ...and it is highly profitable, growing and setting new standards in premium product and service. Alongside Qantas, our value based airline Jetstar has grown from its start-up three years ago to be a very successful airline with a network that spans domestic Australia, intra-Asia and now long-haul routes to Asia Pacific. Its operations have been profitable from year one and it was this year voted the World's Best Low Cost Airline in the benchmark Skytrax survey.

Qantas and Jetstar enable us to profitably meet different customer needs. Our main domestic competitor, Virgin Blue, calls itself a 'new world carrier'. At Qantas, we think that having an older and a newer airline gives us the best of both worlds.

I will spend a few minutes on why we embarked on the two brand strategy. As you know Australia has one of the most liberal aviation markets in the world. In 2000, Virgin and Impulse Airlines began low cost operations in the Australian domestic market. Prior to their entry, we had faced other entrants in the decade since deregulation, and we knew we had to compete aggressively to defend our market position. The battle was short but brutal. Within months, Impulse nearly went broke and we acquired it. It was clear one of the remaining airlines would also not survive. The airline with the poorest handle on its costs – Ansett – then collapsed and its owners and the Australian government let it go.

Ansett's grounding coincided with the events of September 11. As international travel halted, we were able to redeploy aircraft quickly into the domestic market to carry travellers that were otherwise stranded by Ansett's demise. Our domestic market share increased dramatically overnight and we acquired more aircraft to meet the demand. After dealing with the initial

chaos, we knew we had a major opportunity, but also some big challenges. We worked out that a market share of around 65% would enable us to optimise our profitability. Our new competitor, Virgin, was still small but had a much lower cost base and big ambitions to take half the domestic market. We realised that defending our target market share with Qantas' cost base could be very expensive.

So we started Jetstar. Jetstar would have a much lower cost structure this would enable it to sustain head to head competition with Virgin Blue in low yielding leisure routes and to provide profitable growth for the Qantas Group in those markets. There were many doubters. After all, a number of European and American full service airlines had tried to start low cost subsidiaries. All had failed. Why would we be different?

We studied the failures. We had vigorous internal debates about the approach we should take. Then we agreed some principles on which we would not compromise.

First, Jetstar would have separate operational management and industrial arrangements. We could not allow the Jetstar cost base to be influenced by the "full service" way of doing things. We had previously started an international leisure carrier, Australian Airlines, that was a hybrid between a full service and low cost airline and we knew we needed a purer low cost model to achieve our objectives in the Australian market.

In the domestic market, Jetstar has successfully established a cost base around 15 percent below Virgin Blue on a like-for-like basis, while we estimate its international cost base to be approximately 20 percent below its nearest competitors.

It has achieved efficiencies by simplifying its product and overheads, using direct distribution channels and establishing workplace structures to suit its style of operation. For example:

- The hourly rate for narrow body pilots is 30 percent below Qantas and the wide body hourly rate is 40 percent below Qantas. Rostering, allowances and superannuation are also significantly better;
- It has a simpler industrial relations structure with two union and three non-union collective agreements; and
- It is hiring all new employees on Australian Workplace Agreements.

The second principle was to maintain Group oversight of Qantas and Jetstar's strategy and network decisions to optimise returns for the Group. This was critical. We had seen from the experiences of our peers that, without controls, low cost carriers could and would attack and damage their parent. So we established a senior flying committee to coordinate decisions. Differences of opinion between Qantas and Jetstar would be resolved by Geoff and myself. We initiated regular route by route margin analysis to determine which operator would deliver the best result for the Group.

But I need to emphasise that there are competitive tensions between Jetstar and Qantas, this is a good thing and in the end they make their own pricing decisions based on their respective cost bases, competition and what the market will bear.

The third principle was to continue to invest in our premium product and service. Qantas is by far the biggest part of the Group and its success underpins that of our other businesses. It is one of only two airlines in the world that has ranked in the top five airlines in the world for customer service for the past five years in the Skytrax survey. That reflects the investment we have made in our product and in training our staff to deliver top quality service.

There is a lot of discussion about the commoditisation of air travel. While that is true of some markets, it is not true of all. As with clothes, cars, wine or hotels, while some people want a basic product at a low price, others want more luxury and are prepared to pay for it. In the domestic market, Qantas has approximately 50 percent market share and generates a 35 percent-plus yield premium over Virgin Blue, which more than compensates for its higher cost base. Internationally, Qantas is one of a handful of top airlines that earns a premium because of the superior quality of its product and service. So, success for us as a group is not only about costs, it is about the relative margins our flying brands can generate.

That said, to justify our investment in Qantas, we need to take costs out and improve efficiency, which is the fourth important point about our two brand strategy. International aviation is not a level playing field. Low cost competition does not only come from the 'no frills' type of low cost carrier. We also face increasing lower cost competition from quality full service airlines in the Middle East and Asia, which enjoy structural advantages that substantially lower their overall cost base. These benefits include: low or no corporate and personal income tax; favourable depreciation regimes that allow them to rollover aircraft faster and benefit from the efficiencies of newer aircraft; lower infrastructure costs as a result of cross-ownership of airlines and airports; and marketing support from their governments.

For this reason, and to address cost pressures such as higher fuel prices, we undertook the Sustainable Future Program with a target of \$3 billion of cost and efficiency benefits over five years. We are in the final year of that program, having accrued \$2.3 billion of benefits and we are on track to achieve our goal.

Our two brand strategy is working well. For the 2006/07 financial year, Qantas and Jetstar achieved a combined profit before tax of \$861 million, up 56 percent on the previous year. The strategies we have put in place over the past seven years have positioned us to benefit from the positive operating conditions that the industry is currently enjoying.

We estimate that the strategy has improved domestic profitability by \$250 million, while maintaining a group market share of 67 percent. That improvement includes the \$112 million contribution from Jetstar's A320 operations in 2006/07, and the money that Qantas used to lose on routes that Jetstar now flies. We do not have the benefit, as Asian and Middle Eastern airlines do, of being able to hub traffic through a single point. However, we believe that the strong structural position we have established in the domestic market gives us an important competitive advantage against the hub carriers.

We are seeking to replicate the domestic success of the two brand strategy in international markets, and are off to a good start. Excluding start-up costs, Jetstar's international operations made a profit of \$3 million for the first seven months of operation – a great achievement.

Despite the benefits of the two brands, we have encountered opposition to Jetstar from some unions, who see it as a 'Trojan Horse' to take jobs from Qantas and erode pay and conditions. At times, when Jetstar has taken over from Qantas on a route, we have also faced resistance from some communities and politicians.

This negativity ignores some important realities. Had we not started Jetstar, and turned unprofitable routes into profitable ones, we would have been forced to cease those services and terminate the jobs of the staff that provided them. Instead we have grown domestic seats since Jetstar's launch and staff.

The two brand strategy works because Qantas and Jetstar 'have each other's backs'. Both are now heavily dependent on each other. Qantas is able to consolidate its position on premium routes where it can generate a sufficient yield, and therefore nearly all its domestic routes are now profitable. Jetstar benefits from Qantas' reputation for quality and safety, as well as corporate support and scale benefits in areas like fuel and currency hedging and aircraft acquisition.

The combination of Qantas and Jetstar puts us in a much stronger position to address competitive challenges, manage the business cycle and withstand shocks.

Our competitive challenges include:

- Tiger's entry into the domestic market;
- Virgin's product adjustments, introduction of regional jets and commencement of trans-Pacific services;
- Emerging low cost long haul models;
- Hub carrier expansion; and
- Airport Privatisations.

While we see no deterioration in the current strong demand environment both domestically and internationally, inevitably there will be periods of weaker economic growth.

Our two brands give us great flexibility to manage these realities:

- We can transition routes to a lower cost structure through Jetstar if yields decline;
- We can switch capacity between the domestic and international networks; and
- Jetstar can compete as low fares leader.

So what does the future hold for our two brands?

Qantas will continue to grow and add new destinations. We estimate it will have approximately 10 percent more aircraft, 25 percent more international capacity, 35 percent more domestic capacity and 50 percent more regional capacity in five years' time.

Qantas will take delivery of the new flagship of the premium fleet – the A380, which will have the next generation of premium product – in August next year, the same month Jetstar is scheduled to receive the first of our B787 aircraft.

From Australia, Jetstar now flies to eight international destinations in Asia Pacific. It will take the first 15 of the Group's Boeing 787 aircraft to expand its network. We think Jetstar is the right vehicle to go back into continental European markets such as Athens and Rome that Qantas has had to withdraw from in the past because they were not profitable with its cost structure. By 2010/11, Jetstar will grow to approximately 10 times its launch size, and around 70 percent of its operations will be dedicated to international and intra-Asian flying.

Another element of our two brand strategy is geographic diversification. We now have investments in Singapore and Vietnam that give us a good platform to participate in the rapid growth of intra-Asian traffic. Our Asian value-based investment strategy has three aims:

- Develop the Jetstar brand throughout Asia Pacific;
- Improve the Group's network reach; and
- Strengthen our distribution footprint by building overseas point of sale presence.

Jetstar Asia, our Singapore joint venture, has had some challenges. Competition has been fierce and the incumbents in its markets have been allowed to engage in practices that would be illegal in Australia. However, its performance has substantially improved. Two years ago, we merged Jetstar Asia with Valuair. While the two brands have been retained, the consolidation has enabled them to realise significant operational synergies. Jetstar's Australian based operations have also been working more closely with Jetstar Asia and have moved to a single brand and distribution approach.

More recently we acquired an 18 percent stake in Pacific Airlines, which will increase to 30 percent over the next three years. This is a relatively modest investment to participate in a large growth opportunity. Consider that Pacific Airlines is the second carrier in a country of 84 million people and currently

has just three Boeing 737-400s. For our investment, we will have a high degree of management influence and we currently have a team working with Pacific Airlines to harmonise its operations with Qantas standards. We will assist its transformation to become Vietnam's low cost airline and help it realise its growth potential. Pacific has extensive opportunities in both domestic and international markets. The Vietnamese domestic air market is expected to grow around nine percent and inbound tourism at between eight percent and 12 percent a year. The Government is investing \$US5.5 billion over the next five years to develop its tourism industry, including upgrades of the major airports, and Pacific's Ho Chi Minh base is within a few hours of the fastest growing markets in Asia. Our partnership with the Vietnamese Government in this investment could also open other opportunities in areas such as freight, flight operations training and airport infrastructure.

We will continue to evaluate other opportunities to expand the Jetstar brand in the region. Markets of interest include Indonesia, Thailand and the Philippines. Across Asia, foreign ownership restrictions require that we have local partners. In order to be an attractive investment proposition, any existing operation must have a strong safety culture, a good distribution presence and a partner that adds value beyond a financial contribution.

We are supporting the growth of our flying businesses with a major investment in aircraft. We currently have \$25 billion of aircraft on order at list prices, including the largest order of Boeing 787s and the second largest order of A380 aircraft.

We will need more aircraft, on top of existing commitments, to maintain our domestic market share target of 65 percent, replace older aircraft and provide long-term growth.

We are finalising a major order of new narrow-body aircraft, which we expect to announce in the next couple of months. We are also considering replacement options for our international fleet of Boeing 747-400s. This decision does not have to be made immediately but we have begun work on it.

To sum up, the Qantas Group's fundamentals are the strongest they have ever been. We made a record profit last year and have forecast a 30 percent improvement this year. We have two dynamic, customer focused airlines. One to compete with 'new world' carriers and make flying accessible to all and one that will keep the higher levels of service and products desired by travellers seeking a premium travel experience. We do believe that is the best of both worlds.