7th April 2009

Dublin Airport Authority

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Regulatory Proposition Document

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1. Introduction

In its timetable for the 2009 regulatory determination CAR has requested that DAA provide its financial projections for the next regulatory period. In providing the forecast financial outlook DAA would like to take the opportunity to set out its views on the key strategic issues which inform its assessment for the period 2010-2014.

This document provides an overview of the company's strategy together with detailed analyses of the company's perspective on the following regulatory building blocks

- Passenger Traffic Forecasts for Dublin Airport 2010-2014
- Capital Investment Programme 2010 -2014 (an associated dossier which provides details of DAA's consultation with users is also attached)
- Operating Expenditure and Cost Efficiency Assumptions
- Commercial Revenue Forecasts for Dublin Airport 2010-2014
- Cost of Capital for Dublin Airport
- DAA Financial Projections 2010-2014.

DAA has a statutory mandate to manage, operate and develop Dublin Airport. The company's key policy objective is to deliver the facilities at Dublin Airport required by the principal transport gateway to Ireland's 21st century economy. DAA envisages a Dublin Airport managing circa 35 million passengers per annum comfortably and efficiently by 2025. This can be only be achieved if DAA is appropriately incentivised to deliver a quality airport experience to the best possible international standards.

This in turn requires CAR to deliver on commitments made during the 2007 Interim Review and to ensure it takes account of the risk in the company's environment in preparing its assessment of the aeronautical revenue requirement for the next regulatory period.

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2. Transforming Dublin Airport

In recent times, Dublin Airport has experienced serious capacity shortages due to the impact of several years of underinvestment resulting from delayed sanctioning of additional aeronautical capacity. By 2006 the serious nature of this capacity deficit at Dublin Airport was becoming widely apparent. Passengers had increased from circa 3 million per annum in 1982 to over 21 million passengers per annum in 2006. Dublin Airport was exhibiting the effects of exceeding its maximum capacity across a number of different parameters. Departing passengers were in some instances nearly double the terminal's declared capacity in the peak morning flows, arriving passengers exceeded declared capacity at several times of the day and customs, piers, check-in and baggage hall capacity were also at certain times significantly exceeded. This high level of congestion led to much negative airline, public and media commentary. There was a great deal of concern about the potential impact on air transport to and from Ireland and the wider Irish economy of the deteriorating conditions at Dublin Airport.

To address this urgent need for additional capacity, the Government published its Aviation Action Plan on 18 May 2005.[1] This mandated the provision of a new Pier at Dublin Airport by 2007 and the building of a second terminal (T2) by 2009 by DAA.

In response, DAA then sought to develop a capital investment programme to address the requirements of the Government Aviation Action Plan consistent with the Dublin Airport's long term masterplan. In order to do so, DAA asked Pascall and Watson to review and update its masterplan. The company went on to assemble a worldclass team of expert advisors including the consultancy firms, Turner &Townsend, ARUP, Mace and Davis Langdon PKS to advise on the development of T2 and the other elements to form a capital investment programme entitled "Transforming Dublin Airport". This investment was designed to bring about a step change in the capacity and service levels available at Dublin Airport and was envisaged to be undertaken in two phases.

- An investment of €1.2bn in Phase 1 covering the period 2006-2009
- A further investment of €800m in Phase 2 covering the period 2010-2014

In conjunction with its advisors, DAA consulted extensively with the various stakeholders and developed detailed design and costings for the core elements of Phase 1 i.e. T2 and its associated projects. T2 design and costings were also subject to independent scrutiny by the Government appointed independent verifier. This work culminated in the publication in October 2006 of the 2006 Capital Investment Programme (CIP).

DAA is satisfied that its commitment to the delivery of cost efficient infrastructure to resolve the capacity deficits at Dublin Airport was recognised by CAR when it approved the remuneration of over 95% of the DAA's 2006 Capital Investment Programme in its 2007

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1 See Speech delivered by Minister for Transport, Martin Cullen TD, on the adoption of the Government Aviation Action Plan, dated 18 May 2005.

Interim Review Decision. As a company with a fully commercial mandate and with no access to Exchequer funding, DAA was only in a position to proceed with this investment on the basis of the undertaking from CAR that this expenditure would be remunerated in the forthcoming price cap decision. This regulatory commitment must be upheld if Dublin Airport is to remain financially viable and to be incentivised to undertake further investment as and when it is needed by airlines and passengers.

Delivery of T2, Pier E and associated infrastructure provides the capacity to facilitate competition in air services thereby benefitting the consumer. These developments will also allow Dublin Airport to continue developing as the single most important engine of economic activity in the State and as the most important generator of employment and income for the local region. Looking to the future, it will be important that Dublin Airport's new and existing asset base is preserved if it is to continue to facilitate this.

One of DAA's key objectives for the future is to maintain and improve service quality standards at Dublin Airport. It has been DAA's experience to date that there is little consensus on service quality and indeed a significant divergence between the stated needs of airlines and passengers on many service quality elements. DAA believes that the primary emphasis should be on the passenger as the ultimate customer of all parties operating at the airport, while continuing to identify and balance all of its customer requirements. In this context, there is a need for a practical recognition by CAR that existing and future passengers at Dublin Airport have at least an equal voice as airlines in terms of the facilities and services required at Dublin Airport and how they should be funded[2].

DAA's focus on this issue is reflected in the fact that Dublin Airport has been improving its performance on key service metrics over recent years[3]. The company's performance on service quality ensures that Dublin Airport compares favourably with a number of comparable European airports, many of which have higher charges and have invested more heavily in infrastructure and facilities than has been allowed at Dublin. Maintaining this focus does not require a formal link between service quality and the price cap.

3. Impact of Current Economic Environment

There is currently an unprecedented level of turmoil in the Irish and global economies. The OECD has warned that world economies are facing the deepest and most widespread recession in over fifty years, it has forecast that international trade is likely to fall by more than 13% in 2009 with world economic activity predicted to shrink by 2.7%[4].

The aviation sector is particularly hard hit by the economic downturn as demand for air travel is strongly driven by national income. Under the present conditions consumers are cutting back on business and leisure travel and freight trade continues to weaken. This has been further exacerbated by the impact of recent high oil prices and unfavourable exchange rate

[2] DAA notes that the UK government has proposed that CAA be given a primary duty to focus on passengers in regulating the London Airports
[3] As illustrated in DAA's response to CAR's Issues Paper, December 2008
[4] OECD Interim Economic Outlook March 2009

differentials. Those passengers that are travelling have reduced propensity to spend resulting in a downturn in commercial revenue income.

In December 2008, IATA reported a 'precipitous' drop in premium air travel with a 16.3% drop in European travel, while in its most recent projection, it has forecast a 12% decline in airline revenues for 2009. In February 2009, ACI indicated than more than 80% of European airports had registered falling passenger traffic and it is now anticipating a 5% drop in traffic at European airports for 2009.

Dublin Airport is currently experiencing a strong negative impact arising from recession in the world economy and the consequently sharp downturn in the aviation market. This is illustrated by the following

- passenger numbers at Dublin Airport have fallen 12% year-on -year in Quarter 1 2009
- projections are that passenger volumes could fall by [redacted]

The current economic crisis is impacting heavily, [redacted] In addition, in some cases customers are looking hand back properties while the potential for bad debts is an increasing concern for the group as evidenced by the receivership of the Thomas Read Group. It is likely that Dublin Airport will continue to be exposed to volatility in the near future as passenger numbers at Dublin Airport reflect negative trends in national income.

The scale of the deterioration from 2008 performance is unprecedented in terms of the financial performance of the group. Based on a revised passenger traffic forecast of 21m at Dublin Airport and further deterioration at Shannon and Cork Airports, DAA Company now forecasts to record very close to break even position in 2009. When interest on the proceeds of the sale of the Great Southern Hotel Group and Birmingham International airport are excluded in the DAA Company accounts, DAA's three airports combined forecast losses in 2009. Furthermore, at the time of writing the Company only sees downside risk to the forecasts.

This unprecedented fall off in revenue is having a direct impact on DAA's financial ratios and the current forecast is that the group will close 2009 with [redacted]
Financeability is addressed later in this document however ratios at this level would indicate [redacted]
This is substantially less than the A credit rating that DAA has consistently stated it needs to operate in a financially stable manner. Indeed, if DAA had a credit rating below A in 2008 it probably would not have had the capability to raise the €600m in bond debt.

[redacted]

3.1 Passenger Traffic Forecasts 2010-2014

DAA normally updates passenger forecasts annually. The last official forecast was completed in February 2008 (DAPF08/01). Between November 2008 and March 2009, the forecast was iteratively reviewed in light of the current economic difficulties and revised airline plans. Based on the current most up to date information, we have produced a new forecast (DAPF09/04 attached as supporting document I), which underpins the business plan being presented to CAR.

The main drivers of the Dublin Airport traffic forecast are economic growth (in terms of real GDP) and airfare trends. Other short-term adjustments are made based on customer input or local market judgement. DAA has consulted extensively with users in developing the current forecast. Specifically, the passenger traffic forecast takes account of the following important developments for 2009:

[redacted]

- After 2009, the key drivers are economic forecasts and the assumed growth rates are based on:
    - For Ireland:
        - GDP projections provided to DAA by Fitzpatrick consultants
    - For all other countries:
        - The latest IMF World Economic Outlook published in Jan 2009 for 2009 and 2010
        - The NIESR Economic Overview from Oct 2008 for 2011 and beyond

[redacted]

4. DAA Response to Current Environment

DAA believes that as a dynamic and commercially focussed economic entity it must manage the impact of the current economic uncertainty to the greatest extent possible. As a consequence, the company has responded to the current negative environment by

- re-examining its capital expenditure requirement for the period 2010-2014
- instigating a review of its operating costs
- undertaking a careful assessment of the impact of the current market downturn on its commercial revenues with a view to determining the optimum approaches to limit their decline.

4.1 Review of Capital Investment Programme

DAA originally intended that the balance of its €2 billion Transforming Dublin Airport Programme would form the basis of its 2009 CIP for consultation with airport users. However having considered the current unprecedented level of volatility in the aviation market and reflected on recent communications from airline users, the company decided that it was necessary to review the timing of the next phase of its development plans for Dublin Airport.

While mindful of the impact of the current economic climate, it is inappropriate for airport companies to adopt a very short-term perspective as the nature and structure of the airport business obliges them to maintain a long term focus[5]. This means that while it may be advisable to postpone some capital investments, other essential investment must be carried out. The latest EUROCONTROL study on the Challenges of Growth for European Aviation highlights that Europe continues to face an airport capacity crunch. It is predicting that despite the economic downturn and the crisis facing the sector, air traffic will double by 2030. If airports do not provide capacity to facilitate growth there will be substantial congestion going forward and this will potentially restrict competition. This is particularly important for a small island economy like Ireland. It has been widely acknowledged that the country's economic recovery must focus on developing indigenous industry and re-invigorating Irish export performance. This can only be facilitated through the provision of appropriate infrastructure, including airport capacity.

DAA's CIP (supporting document II) represents a balanced approach to addressing capital expenditure requirements for the next regulatory period. The CIP reflects the fact that DAA believes that it currently appropriate to focus on the spend that is necessary in the short term, but it also incorporates triggers for certain 'enabling' projects to enable Dublin Airport to expand in a manner that will facilitate growth in traffic when economic conditions improve.

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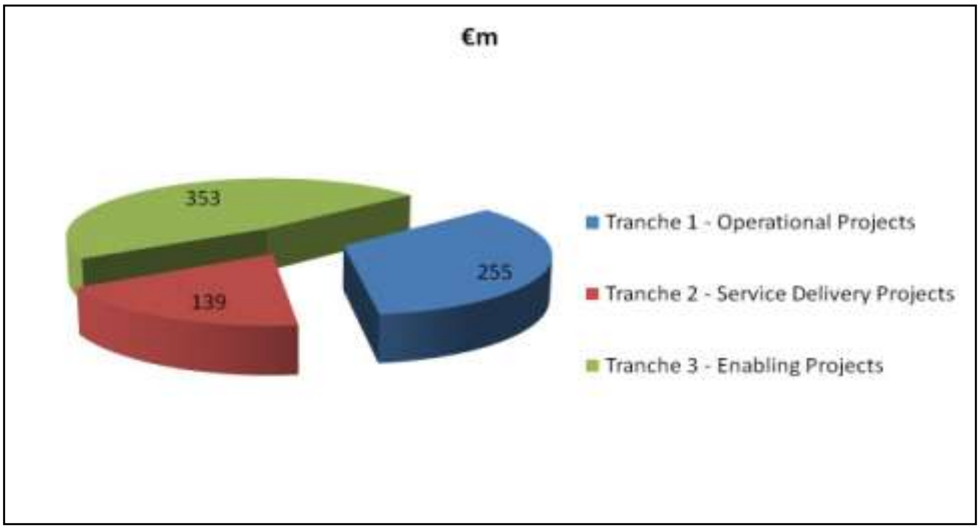
[5] This view has been expressed by Olivier Jankovec Director General ACI Europe in *Dealing for Today While Planning for Tomorrow* in ACI Europe Communique Airport Business December 2008/January 2009

DAA is therefore proposing a significantly reduced programme for 2010-2014, which is divided into tranches as follows:

- Tranche 1: Operational Projects, comprises the minimum investment needed to carry out the economic replacement or upgrade of life-expired assets, and to comply with specific regulatory or safety requirements. These works are valued at circa €51 million per annum, an investment which equates to circa 2.8% of the Regulated Asset Base.

- Tranche 2: Service Delivery, represents the investment required to maintain customer service levels, protect and enhance single till commercial revenues and carry out the planning and design work necessary in order to reduce the lead times required for key items of infrastructure that will form part of future capital programmes.

- Tranche 3: Enabling Projects represents the investment required to enable future growth at Dublin Airport. The timing of each enabling project is determined by reaching certain demand triggers as outlined in the CIP document. DAA is requesting that each is assessed and evaluated by CAR, with the intention of agreeing to their remuneration when the proposed trigger points are reached, without the need for an interim determination.



This CIP is currently the subject of discussion with CAR and airport users as part of the ongoing Commission lead capex consultation process (Supporting Document III sets out the interaction with users on the capital expenditure proposals to date).

4.2 Focus on Keeping Dublin Airport Operating Cost Efficiently

As a company with a strong commercial focus, DAA believes that it is essential for the company to both achieve and demonstrate operational efficiency. In the recent past the company's keen focus on the efficiency of operations at Dublin Airport resulted in total operating costs per passenger declining by 21% in real terms between 2002 and 2007 and payroll costs per passenger reducing by 17% in the same period. It is also important to note that during the last regulatory review, CAR carried out bottom up and top down assessments of Dublin Airport's operating costs and it concluded that existing operations at Dublin Airport were in fact largely operating efficiently.

DAA continues to strive for cost competitiveness and to seek out innovative approaches to its airport operations. This is of vital importance given the negative financial indicators for the forthcoming regulatory period.

It is expected that the introduction of T2 in 2010 will inevitably result in a step increase in fixed costs and an increase in unit variable costs in its early years. However, DAA anticipates that the T2 tender process being led by the Department of Transport and its advisors will ensure the best possible cost outcome is achieved. DAA welcomes the fact that CAR has indicated in its Issues Paper that it will rely on the competitively tendered price as the basis on which to estimate the operating costs for the T2 facility.

In the context of falling passenger numbers, weaker commercial demand, rising payroll costs and an uncertain regulatory and market pricing environment in 2010, it was clear that a review of the risks to the group's immediate and medium-term financial outlook was needed. This process commenced in late 2008. The review established that the Company (the three airports and group & shared services) needs to target sustainable savings in operating costs. A Cost Recovery project team and structure has been established to develop and implement a plan with a view to reducing the cost base of the company through the implementation of short term tactical measures and longer term strategic efficiency measures.

[redacted]

In conclusion, CAR undertook a review of DAA's opex at Dublin Airport in 2005 and assessed it as efficient. Significant real productivity gains have been made between 2002 and 2007 and as is evident from the outputs of the direct benchmarking analysis, DAA remains relatively efficient compared with other airports. The results of the indirect (TFP) benchmarking undertaken by DAA indicate that the scope for further efficiency gains is marginal.

4.3 Projecting Commercial Revenues for Dublin Airport 2010-2014

Dublin Airport earns income from retailing (both Direct Retail and Concession Retail) and commercial (e.g. Car Parking, Property Concessions, Property Rental, Property Advertising) activities. This represented 51% of overall Dublin Airport revenues in 2008. This income is a key component of overall Dublin Airport income under the "single till" arrangement and, as such, mitigates the revenue requirement via airport charges.

DAA is committed to maximising income from retail and commercial activities at Dublin Airport in line with its vision of delivering "a quality Airport travel experience to the best international standards" and in order to meet its statutory duty[6].

DAA commercial revenue assumptions have been developed against a "bottom up" analysis for each of the primary sources of income (presented in Supporting Document V), considering the specific drivers and market trends affecting each. In addition, these assumptions reflect best information on the intentions and plans of Dublin Airport's main tenants and concessionaries.

Following a period of sustained growth in passenger numbers – and in retail and commercial incomes – the forecasts for 2010-2014 are being developed at an extremely volatile time, with a severe contraction within the aviation industry and the economy as a whole. At the time of writing (March 2009) there was still no external consensus as to the likely depth of the "trough" in terms of GDP or retail sales decline, and the views of economists / analysts differ as to the timeframe for recovery.

With evident signs of distress across a range of business sectors (including the aviation, retail, hospitality and advertising sectors), and with continued low levels of consumer confidence, it is clear that both passengers and corporate clients will continue to reduce spending in the near term.

There has been a sharp increase in the rate of business failures, which is likely to continue, with resultant leasehold and contract defaults leading to further loss of income as new operators and tenants are recruited, for example,

- A number of high profile business restructurings have already impacted Dublin Airport, including SR Technics and the Thomas Read Group;
- In particular, retail and hospitality/hotels are seeing high rates of receivership

Passenger volumes have a direct impact on many elements of Dublin Airport income, though this relationship is not always linear. Notable income streams that are heavily impacted by passenger numbers include:

- Direct Retail and Concession Retail;

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[6] Under the Air Navigation and Transport (Amendment) Act, 1998, DAA has a statutory duty regarding revenue generation: "to conduct its affairs so as to ensure that the revenues of the company are not less than sufficient taking one year with another to (i) meet all charges which are properly chargeable to its revenue account, (ii) generate a reasonable proportion of the capital it requires, and (iii) remunerate its capital and pay interest on and repay its borrowings".

- Certain Property Concessions; and
- Car Parking (although this income stream is also strongly influenced by price elasticities, the level of competition, and the availability / marginal cost of alternative modes of transport).

The decline in overall passenger numbers also affects the commercial returns that bidders expect to earn from the concessions and contracts available at Dublin Airport. It is to be expected, therefore, that where negotiations or tendering takes place during a passenger volume decline, terms (rates) will be significantly less advantageous to the airport than those that might be achieved during a period of strong growth. It should be noted that Dublin Airport is required to tender a large number of existing and new concessions within the 2009-2011 period (including approximately 90% of existing T1 food & beverage revenue and 50% of existing T1 retail concession revenue – as well as Car Hire, Foreign Exchange, and Coach Service property concessions).

[redacted]

Dublin Airport Retail & Commercial Income, 2001-2014[7]

[redacted]

[redacted]

The commercial revenue forecasts are set out below.

Dublin Airport Forecast Retail & Commercial Income, 2008-2014

[redacted]

[7] For commercial revenues nominal values are used for both historical and forecast data – unless otherwise stated. All 2009 figures are latest budget (e) and all 2010-2014 figures are latest forecast (f).

The key assumptions in relation to DAA's future commercial revenues are as follows:

- **Retail:** 2009-2010 is forecast to be an extremely difficult trading period, to be followed by growth in retail sales in 2011 with the opening of additional space, improved passenger flows and some return of consumer confidence. Certain "non-core" categories currently sold through "Direct Retail" in Terminal 1 are planned to be transferred to a "Concession Retail" model from 2011:
- **Car Parking:** Though car parking will continue to see increased competition (in Long Term parking) and substitution (in Short Term parking), Dublin Airport will seek to stabilise revenues through the new online booking model – and will benefit from the additional capacity in Short Term car parking provided by the terminal-linked hotel / multi-storey car park development;
- **Property Concessions:** Though the overall decline in economic activity and the resultant impact on passenger forecasts will impact the attractiveness of property (commercial) concessions to operators, the terminal-linked hotel / multi-storey car park development will provide significant revenue from 2011.
- **Property Rental:** Though the property market will see lower occupancy rates and pressure on rents, compounded by changes to our tenants' business models (e.g. web check-in), Dublin Airport will seek to maintain incomes from property through close supervision of our portfolio and by working closely with our tenants.

In real terms, retail and commercial income per passenger in Dublin Airport has been declining during the current determination period. Within DAA's retail and commercial forecasts, the company has projected a stable income per passenger in real terms – despite the challenges that exist in terms of retail spending and consumer confidence.

Retail and commercial income per passenger (PAX) are provided below.

Dublin Airport Retail & Commercial Income per Passenger (PAX), 2001-14

[redacted]

DAA believes that Dublin Airport will continue to compare favourably with other European airports in terms of share of income from retail and commercial activities and income per passenger.

DAA commercial plans allow for, and require, continued and sustained promotion and innovation to ensure that all profitable opportunities are maximised. DAA will continue to focus its activity on those areas that it considers core to the company's income and to the passenger experience.

Dublin Airport's Capital Investment Programme (CIP) proposals are central to driving the available income growth, maintaining customer service levels, facilitating retail and commercial operations and maintaining existing incomes. Notable projects include the terminal-linked hotel / multi-storey car park, T1 passenger processing enhancements, and the ongoing maintenance of the retail and property portfolio.

When Terminal 2 and the other major developments are complete, DAA believes that Dublin Airport will be well positioned to grow retail and commercial revenues into the future.

5. Current Financial Outlook

In the recent past DAA was able to rely to some extent on substantial passenger traffic growth at Dublin Airport to compensate for relatively static airport charges and operating cost growth. Given the economic outlook this will no longer be the case for the forthcoming regulatory period as substantial passenger volume reductions and falling commercial revenues are anticipated for the next two years.

DAA's financial projections indicate a considerable reduction in profitability; and for the first time in its corporate history, at current levels of aeronautical revenue DAA will generate losses from its airport business in 2009 and 2010.

2009/2010 Outlook – Airports

[redacted]

DAA has no recourse to Exchequer funding and its current financial situation is unsustainable and must be addressed. On 3 March 2009 S&P downgraded DAA from A stable to A- negative outlook citing that *"DAA's financial profile will weaken in 2009 significantly more than previously expected".* S&P's negative outlook implies an expectation of a further deterioration in the financial profile and a further downgrade as a consequence.

[redacted]

It is imperative that CAR recognises the gravity of this situation given its statutory obligation to enable DAA to operate and develop Dublin Airport in a sustainable and financially viable manner.

[redacted]

[redacted]

It should be noted that in deciding to leave airport charges for 2006-09 unchanged, the Commission expressly recognised that deferring the recovery of investment costs might affect the financial viability of DAA. However, it was stated that *"the Commission is satisfied that the FFO:Debt ratio should remain above 15% for the remainder of the current regulatory period, even allowing for the proposed additional capital expenditure that DAA proposes to undertake before 2010"*[8].

In relation to the estimated charge of €7.75 in the period 2010-14, it was stated that this price *"yielded an average FFO: Debt ratio greater than 17% during the period".* Furthermore, the Commission reported on sensitivity tests conducted on this price level. *"The effects of changing passenger forecast number (+/- 10%) or the cost of capital (+/- 1%) were reported, with the outcomes showing average FFO:Debt ratios exceeded 15% in all four cases".*[9] This was despite the warning from DAA that *"the average FFO: Debt ratio would be substantially below 15% if average charges were €7.75".*[10]

In the recent past, DAA has been forced to rely on the sale of assets, amounting to circa €0.6 billion, external to the regulated business to assist in financing the delivery of the necessary infrastructure at Dublin Airport. Due to the proceeds from the disposals of assets in recent years outside of the price regulated business of Dublin Airport and the prudent management of funding, available liquidity and credit rating, the Group was able to fund its Capital Investment Programme and put in place significant liquidity to carry it through the completion of the current capital programme and through the initial stages of the most significant recession since the 1930's (a recession that was not foreseen at the time of the sale of assets in question). The continuation of this position will be significantly dependent upon DAA's business at Dublin Airport becoming self funding and achieving a reasonable return on investment on a stand-alone basis.

To the extent that these assets sales have been factored into the Commission's financial viability assessment this is wholly inappropriate. As they are not generated through DAA's return on investment at Dublin Airport, they should not be incorporated in the financeability assumptions or used as a means of allowing income deferral through the regulatory formula. In the forthcoming period, it will clearly not be sustainable to continue to rely upon asset disposals from outside the regulated entity to maintain healthy financial ratios.

The Commission has consistently adopted measures which have variously depressed income and increased risk. These include assuming optimistic and/or inaccurate commercial revenues, taking an asymmetric approach to upsides/downsides thereby increasing risk; deferring revenue through various regulatory approaches; "utilising" revenues from outside the single till; not recognising the Government' requirement for dividend payouts and consistently and unreasonably reducing elements of capex in the RAB. In addition, CAR's policy, in high growth times, of regulatory price caps set well below market norms, and substantially lower than peer airports for what is the 6th largest European and 12th largest World airport in terms of international passengers has been proven to be ill-advised and the most recent regulatory practice of deferring income into the future equally harmful.

[8] P52, CP6/2007
[9] P9, CP6/2007
[10] P41, CP6/2007

Reversing these policies in the 2009 regulatory decision, and addressing the consequent challenges of implementing resulting pricing in more difficult economic times, will be fundamental to the financial health not just of Dublin Airport but of the DAA Group. It is absolutely critical that the price cap for the next determination is set to appropriately compensate DAA for the €1.2 billion capital investment at Dublin Airport it has made in the current regulatory period and to cover the significant financeability risk to DAA's business during the next regulatory period.

5.1 DAA's Future Financial Viability

Financial viability or financeability, as demonstrated by ensuring access to funding as and when required by the business plan, is an increasingly tough test for all borrowers in the new world of debt markets following the onset of the credit crisis. In DAA's case, the opening position for this determination already means that there are significant concerns about financeability. Events have proven that that the Commission's approach to financeability at the last review would not have enabled DAA to fund the required CIP at Dublin Airport.

DAA relies greatly on its credit rating and its key financial ratios to access the debt markets. Currently DAA is precariously positioned in terms of financial viability for the following reasons:

- Given its reliance on passenger numbers and commercial revenues, DAA is perceived to be highly exposed to the economic cycle and in particular concerns about the Irish economy
- In spite of recent activity to raise funds in the bond markets the financing and refinancing requirements are significant over the next review period with the maturity of the €250m bond and the €300m bank facility
- S&P have recently downgraded DAA by one notch from A to A- and have a Negative Outlook on the ratings signifying an expectation that DAA could be downgraded to BBB+
- Airline financial health - several airlines in recent times have gone into bankruptcy e.g. XL and Futura, and IATA expects losses in 2009 of $4.7 billion for the world's airlines due to the "rapid deterioration of the global economic conditions"
- [redacted]
- Regulatory uncertainty

In the course of its forthcoming regulatory review, DAA expects the Commission to demonstrate that it adopts a balanced and realistic approach to risk, and takes full account of all the various potential downsides in its analysis of regulatory outcomes. Furthermore in the light of the current market environment and the rating agencies' recent downgrade of DAA and negative outlook on the company, CAR must consider the financial viability of Dublin Airport in all plausible substantial downside scenarios and to reflect in its decision the need to ensure that DAA will continue to have access to capital markets to finance its activities.

The Commission had previously stated that it seeks to enable the DAA to maintain an investment grade rating for its debt for the purposes of operating Dublin Airport but believes that the availability of adequate finance to DAA does not depend on the DAA maintaining an "A" rating.

The Commission's previous view on rating was formed at the top of an unprecedented credit boom and this view has now been undermined by the evolution of the debt markets since the Interim Review Determination. It is very doubtful that the highs of the 2005-2007 credit boom will ever be reached again. Debt markets have transformed following the credit crisis and have settled at equilibrium where almost all of the previous assumptions made by CAR on financial viability are no longer valid. In particular, access to alternative types of debt such as project finance bank loans has been heavily curtailed as banks withdraw from long term lending and wrapped bond markets have been shut for nearly 2 years with little prospect of recovery as all major monoline insurers have been downgraded and are closed for new business.

The financial turmoil has had a permanent impact on the pricing of debt and led to structural changes in debt and equity markets. Since the onset of the credit crisis bond market conditions have worsened significantly and there have been a number of periods when issuance has stopped completely e.g. post Lehman's bankruptcy. When the markets have been open, investors have placed greater emphasis upon (i) credit quality, preferring issuers in defensive sectors such as telecoms and utilities, (ii) credit ratings, with appetite for A-rating or above and (iii) name recognition by investors. There has been relatively little bond issuance at BBB ratings throughout 2008 and so far in 2009, with investors preferring issuers with at least an A- rating. Where A- issues have occurred they have been at substantial premia and for short maturities.

Furthermore bank market conditions are much more difficult than the bond markets as a result of the credit crisis and its impact on bank balance sheets. Lenders have reported a reduced willingness and ability to lend in each of the past four quarters (compared to the previous quarter) due to concerns about the economic outlook, reduced appetite for risk and decreased availability of wholesale finance.   Lenders have indicated that a further reduction in maximum credit lines, together with a further strengthening of covenants is expected over the next three months. In particular the following features are now common place in the bank markets:

- Most banks are reducing their credit lines in order to conserve capital for potential future losses arising from the economic downturn;

- A number of banks are withdrawing to their 'home countries' following state support which limits borrowers ability to tap a wide syndicate of banks;

- Terms are becoming more expensive with tighter loan covenants and increased collateral and security in order to increase banks' return on capital;

- Banks are typically not lending beyond 3-5 years and many have withdrawn from the long term project finance market which infrastructure companies would typically rely upon in the absence of bond markets;
- Bank syndication markets are closed with most deals done on a 'club' take-and-hold basis;
- Significant new bank commitments are typically only being made on the basis of a bond take-out i.e. on the assumption that the banks can be refinanced in due course though the bond markets (indeed DAA's previous bank facilities were executed on this basis)

Long term funding is the most appropriate funding structure for DAA and in the absence of such funding DAA is exposed to significant refinancing risk. DAA as a business should be looking to fund primarily in the longer term debt markets given its long term asset base and the nature of its deferred revenue profile. The bond market is the most viable and accessible source for long term funding and is ratings driven. In the current debt markets only companies with at least an A rating can ensure continued access to the long term debt markets.

Therefore current market conditions would suggest that DAA could face substantial credit rationing at even a BBB+ credit rating, and would most likely encounter severely restricted access to debt markets at a BBB (or lower) rating. The potential impact of a plausible downside scenario resulting in a credit downgrade to BBB+ (or lower) requires that DAA maintain a credit rating of at least A. An A- rating would allow for insufficient headroom in the event of a downside scenario. Therefore, to ensure Dublin Airport's financial viability the CAR must set a cost of capital consistent with an A rating for the DAA.

DAA's credit rating was recently downgraded by S&P from A to A- with a negative watch.[11] According to S&P a move to stablise the credit rating will be dependant on the assumption that *CAR will increase the average price cap by at least 22% from 2010 onwards*. The rational for S&P's decision is important since the inference is that DAA is reasonably likely to be downgraded to BBB+ (or lower) at some stage if it does not achieve increased airport charges. Given the emphasis investors are currently placing on credit quality DAA is probably now viewed as effectively rated BBB+.

Current financial market conditions and recent comments from S&P relating to the downgrade of DAA to A-, would suggest that an FFO: Interest Coverage of 3.5x and an FFO: Debt of 20% would be required to restore DAA to an A credit rating.

The current market conditions mean that the CAR should interpret its statutory duty to ensure the ability of DAA to operate Dublin Airport in a sustainable and financially viable manner as a requirement to enable DAA to achieve an A credit rating and therefore the ability to secure adequate funding to finance its business. In doing so CAR should test its regulatory determination using a financeability test allowing for appropriate financial ratios

[11] S&P (2009) "Dublin Airport Authority PLC Cut to 'A-' On Expected Financial Profile Weakening; Outlook Negative", March 3.

consistent with an A credit rating. There will be serious financeability risks and implications if DAA were to be downgraded to BBB+. DAA recommends that CAR stress test its regulatory model for plausible downside scenarios. These scenarios should incorporate credit rating downgrades and the associated difficulties with accessing debt markets, as well as any increase in the cost of debt.

5.2 Cost of Capital for Dublin Airport

As part of the process of preparation of this regulatory proposition, DAA commissioned the firm of international economic consultants NERA to advise on an appropriate weighed average cost of capital for Dublin Airport.

NERA has presented a comprehensive assessment of the cost of capital (Supporting Document VI) for DAA based on the company holding an A credit rating. Taking into account all of the available evidence, NERA concludes that its best estimate of the pre-tax WACC for Dublin Airport at this time is 8-9.4%. Noting the uncertainty around some of its estimates and the ongoing volatility in financial markets NERA has not concluded on a "point" estimate of the cost of capital at this stage but recommends that this cost of capital range will need to be reconsidered closer to the publication of the 2010 regulatory determination.

NERA findings are summarised in the following table:

Dublin Airport Cost of Capital

	NERA Estimate 2009 (%)
Gearing	50
Real Pre-Tax Cost of Debt	4.6
Real Post-Tax Cost of Equity	10.0 – 12.5
Tax Rate	12.5
Pre-tax WACC	**8.0-9.4**

In the analysis prepared by NERA, there is clear evidence that the cost of debt rises as credit quality decreases. This is more pronounced below an A rating. Therefore retaining an A rating reduces the cost of capital relative to lower (but still investment grade) ratings and allows CAR to fulfil its statutory obligations to protect the needs of users and enable DAA to operate Dublin Airport in a sustainable and financially viable manner.

CAR must ensure that its assessment in relation to the calculation of the WACC is aligned with the ratios emerging from its price cap calculations and assumptions regarding credit ratings in order to avoid a fundamental disconnect between rating assumptions at a cost of capital level.

6. Conclusion

DAA has a statutory mandate to manage, operate and develop Dublin Airport. The company's key policy objective is to deliver the facilities at Dublin Airport required by the principal transport gateway to Ireland's 21st century economy. DAA envisages a Dublin Airport managing circa 35 million passengers per annum comfortably and efficiently by 2025. This can be only be achieved if DAA is appropriately incentivised to deliver a quality airport experience to the best possible international standards.

This requires CAR to deliver on commitments made during the 2007 Interim Review and to ensure it takes account of the risk in the company's environment in preparing its assessment of the aeronautical revenue requirement for the next regulatory period.

The current market conditions mean that the CAR should interpret its statutory duty to enable the ability of DAA to operate Dublin Airport in a sustainable and financially viable manner as a requirement to enable DAA to achieve an A credit rating and therefore the ability to secure adequate funding to finance its business. In doing so CAR should test its regulatory determination using a financeability test allowing for appropriate financial ratios consistent with an A credit rating. There will be serious financeability risks and implications if DAA were to be downgraded to BBB+.

In its Interim Review decision CAR stated that it envisaged an average price cap of €7.75 (2006 prices) for the next regulatory period. The application of this charge [redacted] yields a result that would be inadequate to secure DAA's financial viability. [redacted] it is absolutely critical that the price cap for the next determination is set to appropriately compensate DAA for the €1.2 billion capital investment it has made in the current regulatory period and to cover the significant financeability risk to DAA's business during the next regulatory period.