COMMENTS BY AER LINGUS ON NOTICE (CP4/2003) ISSUED BY COMMISSION FOR AVIATION REGULATION

Aer Lingus welcomes the Notice by the Commission For Aviation Regulation (the "Commission") setting out the issues to be reviewed relating to its Determination on Maximum Levels of Airport Charges (CP4/2003) and appreciates being given the opportunity to comment on the matters put forward by the Commission for review.

Clearly, conditions in the aviation industry have been extremely difficult in the aftermath of 11th September. As with other airlines, Aer Lingus has had to respond vigorously and creatively to these events, rationalising its fleet and cutting costs and fares substantially. In this context, our view is that the Commission's proposals are unduly generous and provide Aer Rianta with an unjustified degree of insurance from the commercial realities of the aviation business. In the aftermath of 11th September, Aer Rianta should have undertaken measures to improve its efficiencies beyond the targets set by the Commission in its Determination. We do not therefore accept that in such conditions, it is appropriate for Aer Rianta to be allowed to raise its airport charges by 2.9% in real terms next year (even excluding the carry-forward of charges under-recover in previous years).

Our specific criticisms of the Commission's proposals relate to:

- the use of unduly pessimistic demand forecasts;
- security costs that seem inconsistent across the three airports and which are projected to increase inexplicably in the future;
- the upward adjustment in Aer Rianta's Regulatory Asset Base (RAB), which does not seem to be consistent with stated depreciation figures; and
- the lack of any recognition that, in the current commercial climate, Aer Rianta should be expected to achieve greater efficiency gains, or, if they are to be protected from commercial downturns, that their weighted average cost of capital should be adjusted downwards to reflect the fact that they are acting in a virtually riskless environment.

We are also concerned that the Commission has not stated its proposed X for 2005 and 2006, so we have not had the opportunity to comment on this vital calculation.

While we welcome this consultation process, it is difficult for us to comment on the detail of the proposals in a number of respects, either because important information is omitted from the document, or because information is presented in such a way as to make it impossible to verify the Commission's analysis. We comment on these points below.

DEMAND FORECASTS

Aer Lingus notes that the Commission proposes to replace Aer Rianta's centreline traffic forecast for 2000 with its 2002 forecast as the baseline for the price cap from 2004.

First, we welcome the Commission's decision not to adjust traffic forecasts retrospectively. To do so would further weaken efficiency incentives on Aer Rianta by insuring them against the impact of all traffic movements.

However, Aer Lingus considers that Aer Rianta's centreline traffic forecast for 2002 is not the appropriate basis for the Commission's Determination. The 2002 forecast was made in the immediate aftermath of 11th September and represents the most pessimistic scenario for the future, derived at a time when accurate forecasting of future traffic volumes was virtually impossible.

While the aviation sector remains weakened, compared to the pre-11th September period, it is our view that prospects for traffic growth have improved over the last two years. To underline this expectation, Aer Lingus is currently moving to a single fleet type, which will increase our capacity between now and 2006 by 22.5%. This move implies an increase of 1.7 million passengers in 2006 over 2003. This level of growth is not reflected in the 2002 forecasts. When Aer Lingus was asked to participate in the 2002 forecast by Aer Rianta, we did not look beyond a one-year period which we stressed was a year of consolidation in passenger numbers but that we would be undertaking a major review of the network that we would serve.

We believe that the Commission should use Aer Rianta's centreline traffic forecast for 2003, as this forecast is more up-to-date and better reflects current expectations regarding traffic growth at the Irish airports.

SECURITY COSTS

Aer Lingus recognises that the events of 11th September and afterwards place an increasing burden on airport security and airlines must share in this burden. However, in a number of respects we are not happy with the Commission's proposals. Our objections fall into two parts. First, there are a number of matters of principle that we feel the Commission should address in making allowance for higher security costs. Second, we are concerned about some of the figures being assumed for security costs, both now and in the future.

As regards matters of principle we have three main issues:

- Aeronautical services should not bear the whole of the increase in airport security costs following 11th September.
- Airlines should not have to meet the entire security costs associated with the use of Shannon by the US military in the lead up to and during the war in Iraq.
- The Commission's treatment of all security costs should present Aer Rianta with adequate incentives to manage these costs efficiently.

As regards the first point, unless we have misunderstood the Commission's position, it seems that all of the increase in security costs incurred following 11th September are being attributed to aeronautical services for passengers and are to be recovered from airport charges. However, it is clear that airport security relates not only to passenger aeronautical services but is also for the benefit of freight services and non-aeronautical users. As a consequence it is our view that the full brunt of increases in security costs should not be borne through increased airport charges for passenger services. Some reasonable proportion of security costs should be recovered through freight airport charges, car park charges, retail rentals, etc..

As regards the costs incurred by Aer Rianta in connection with the use of Shannon by the US military in the lead up to and during the war in Iraq, we are concerned that these costs are included in the Commission's calculations for 2002/03 and hence contribute to the K factor that raises charges in 2004. We believe these costs should not be included in full because they are not solely related to the provision of the normal aeronautical services. Aer Lingus seeks reassurance that theses costs are not being borne solely by the airlines under the Commission's proposals.

As regards the incentives on Aer Rianta to perform their security function efficiently, we note that the Commission's proposals show security costs increasing substantially in real terms over the period. In particular we note from Table 3A that security costs show a significant increase from 2003 to 2004. Estimating the 2003 calendar year costs as three-quarters of 2002/03 plus Q4 2003, direct security opex rises from €19.2m to €22.5m, a 17% increase. Costs then increase further to 26.5m in 2006, equivalent to a real increase of 8.5% per annum. Although the details have been withheld, it would seem that insurance costs are also being forecast to spiral in real terms.

While there is clearly a need for increased security, we question whether the scale of these increases is justified. In particular, while we can understand increases in security costs in 2002 and 2003 following 11th September, we do not understand the rationale for expecting ever increasing costs in real terms over the next few years, especially to the extent suggested by the Commission's numbers. There are two points we wish to make in this regard. First, if the increased costs relate to additional functions, the Commission should satisfy itself that these additional functions are warranted and are being performed in a cost effective manner. Second, to the extent that security functions are now being carried out by specialised security personnel, the Commission should ensure that the costs related to these personnel are counterbalanced by cost savings achieved as a result of the freeing up of the non-specialised staff who previously carried out these functions.

Furthermore, while Aer Lingus is not in a position to verify whether the level of expenditure proposed by Aer Rianta is reasonable in comparison to other major European airports (and accepts that these figures could be sensitive in nature), we suggest that the Commission conducts such a comparison so as to verify whether the level of expenditure projected by Aer Rianta in this area is reasonable.

We also note that the Commission's original determination contained an assumption of 3.5% p.a. efficiency improvement for opex at Dublin and 4% p.a. at Shannon. We believe that any forecast security costs should be subject to the same efficiency targets as are imposed upon the rest of Aer Rianta's business. We therefore ask the Commission to consider seriously whether the scope for efficiencies within security expenditure has been adequately explored.

In addition to these general points, we have identified a number of points of detail with the numbers on security costs that, in our view, require investigation/clarification:

- Table 2 (Schedules 1 & 2) shows that the cost per FTE of airport police and ASU payroll is lower for Dublin airport than for Aer Rianta as a whole. Can it be correct that Aer Rianta's payroll cost for security is higher (on a per FTE basis) at Shannon and Cork than at Dublin?

  To be specific: in Schedule 1 the Y/E Dec. 2002 FTE's for Dublin are 221, at a cost of €46,799 per FTE, while the total FTE's for Aer Rianta is 321.92 at a cost of €49,436 per FTE. This implies that the FTE's not based in Dublin number 100.92 and cost €55,210 each. In Y/E Dec. 2003 the equivalent figures are 106.02 FTE's not based in Dublin, at a cost of €59,619 each.

  In Schedule 2 the Y/E Dec. 2002 FTE's for Dublin are 314.4, at a cost of €44,822 per FTE, while the total FTE's for Aer Rianta is 435.85 at a cost of €49,892 per FTE. This implies that the FTE's not based in Dublin number 121.45 and cost €63,017 each. In Y/E Dec. 2003 the equivalent figures are 120.2 FTE's not based in Dublin, at a cost of €66,957 each.

- Table 2 (Schedules 4) suggests that the cost of hold baggage screening in Cork is twice that at Shannon (€6.2m as opposed to €3,3m). Why is this the case?

- Furthermore, why is there almost a ten-fold difference in "facilities" costs between Cork and Shannon (2.1m as opposed to €0.28m)?

- Are the fibre-optic ring proposed for Shannon and the energy centre proposed for Dublin related only to security, or should they not fall within general capital expenditure?

- Aer Lingus would prefer the Commission to be specific regarding how much of the expenditure in Schedule 4 is over and above that allowed in the 2002 revised determination.

Finally, we would like to note that Aer Rianta's actual spending on security has, in practice, fallen below the level projected by the Commission in its 2001 determination, notwithstanding the impact of 11th September. We believe that it is usual practice for regulators to assess performance against actual expenditure and ask whether there is evidence that performance has been adequate given actual spending. In this case, we suggest that the Commission should consider whether the level of security achieved by Aer Rianta has been sufficient. If so, and this has been achieved for less than the Commission allowed for in its

Determination, the Commission should consider seriously whether increases in spending above the level set at the previous determination are really justified.

RAB AND DEPRECIATION

We understand that the Commission has carried out a number of changes to its calculation of Aer Rianta's RAB, including:

- changes to the indexation of assets;
- revised asset lives based on additional information from Aer Rianta; and;
- the exclusion of fully depreciated assets from the RAB calculation.

We note, however, that the net result of these changes is to increase Aer Rianta's RAB from September 2003 to January 2004 from c. €660m to c. €860m; an increase of 30%.

Without the provision of greater detail on these calculations it is difficult for Aer Lingus to comment. However, in our view neither changes to indexation nor exclusion of fully depreciated assets from the calculation can explain the sudden increase in Aer Rianta's RAB.

In section 2.2.1, the Commission indicates that it previously assumed an average asset life of 15 years, but that on the basis of more detailed information from Aer Rianta it is now using a range of asset lives from 2 to 50 years. Although the point cannot be proven quantitatively from the data provided, the implication is that the average asset life assumed under the new calculations is likely to be greater than 15 years.

However Tables 4A and 4B appear to show an inconsistent impact of the change in depreciation assumption. The fact that the net asset figure has increased considerably suggests that a significantly greater average asset life has been assumed. However, if that were true then we would also expect to see a substantial reduction in the annual depreciation charge to compensate. This does not seem to be the case, because annual depreciation is only reduced from €58m to €50m.

To illustrate this point in numbers, we set aside the issue of indexing and assume that the change in gross asset values from €1,682m to €1,190m is due to writing off fully depreciated assets. In the absence of any change in average asset life, accumulated depreciation should fall by the same amount (€492m) from €1,020m to €528m. In practice, accumulated depreciation falls to €327m. For the treatment of the depreciation charge in the current year to be the same as for historic depreciation, we would expect the current year charge to fall by the same proportion as the accumulated total, that is from €58.5m to €36.2m. This discrepancy makes a substantial difference to the capital costs that Aer Rianta is allowed to collect from airport charges in 2004. Aer Lingus believes that it is necessary for the Commission to explain this discrepancy.

EFFICIENCY AND THE WACC

We note that the Commission has not adjusted Aer Rianta's efficiency targets since its previous review. Aer Lingus feels that the Commission's approach does not recognise that in the current commercial climate, Aer Rianta should be expected to achieve greater efficiency gains.

To illustrate, we attach a Presentation prepared for Aer Lingus management called "Towards Profitability – Taking A Long Term View". This Presentation shows that from 2001 to 2003, Aer Lingus has reduced average yields by 23%. Aer Lingus, like all its competitor airlines, has had no alternative but to achieve drastic efficiency improvements. To this end, we have reduced our costs per RPK by 35% over the same period. These reductions in both yield and cost are well in excess of the original targets set out in our Survival Plan. Aer Lingus recognises that there is now a fundamental change in the industry. The key to a sustainable and profitable business in this changed environment is aggressive and relentless cost management. It has been stated many times by Aer Rianta (quoting from the Doganis Report) that airport costs are not a significant element in an airline's cost base. To date in 2003, airport charges represent 11.5% of aeronautical revenue while fuel is 10.5%. It has never been suggested that fuel is not a significant cost element of the business. Airport charges are a significant cost and must be subject to realistic commercial pressures. Consequently, we believe the Commission should revisit its efficiency targets to ensure that Aer Rianta shares with the airlines in the necessary response to the aviation downturn. We believe that there is significant evidence supporting a larger efficiency target for Aer Rianta.

We note that in 2001 the Appeal Panel requested the Commission to consider setting more demanding efficiency improvement targets for all three airports, taking into account the need to reduce efficiency differences with peer airports more rapidly. It also expressed concern that the modest efficiency target of 4% set for Shannon did not even meet the Commission's own objective of reducing the existing efficiency gap with peer airports by half during the period of the Determination. Although the Commission responded by accelerating its efficiency targets, it did not change their overall size. This is notwithstanding the fact that Aer Lingus pointed out to the Commission after the appeal decision that both the Commission's benchmarking exercises compared the three Irish airports with an average and not with best practice, and therefore understated Aer Rianta's scope for efficiency improvement.

Alternatively, the Commission may believe that it is not appropriate to increase Aer Rianta's efficiency target. If so, then it should consider the implications of this decision for Aer Rianta's weighted average cost of capital. Such an approach amounts to the Commission providing insurance to Aer Rianta against adverse commercial conditions by allowing it to raise its airport charges at a time when commercial pressures would indicate that a reduction is more appropriate. If this increase is to happen then the implication is that Aer Rianta's WACC should be adjusted downwards to reflect the substantial reduction in commercial risk to which it is exposed. If Aer Rianta is to operate in an almost riskless environment then it should have a reduced WACC that reflects the absence of risk. We consider that 3.5% would be an appropriate level (as opposed to the current level of 6%).

OTHER ISSUES

Finally, there are a number of other issues on which Aer Lingus seeks clarification. These relate to the presentation of the numbers in Table 6A. In particular:

- We recognise that the correct yield figure for 2004 is calculated in Table 7. However, it makes it difficult to follow the Commission's argument that the figures in Table 6A do not add up: for instance see the movement from row 7 to row 10.
- It would be helpful to present a clear calculation of why a yield of €6.29 in 2004 equates to an X of –2.9 (i.e. a real increase of 2.9%).
- What X is the Commission proposing for 2005 and 2006?

Towards Profitability
Taking a Long-Term View

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Traditional Fundamentals of the Industry

- Labour intensive
- Capital intensive
- Low margins
- Boom and Bust cycle
- Complex structures meant high cost base:
  - Network/interlining capability
  - Costly distribution of product
  - Service obsessed to justify high fares
- Based on monopoly style government ownership

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Performance of Traditional Airline Model

- In 2001 airlines lost almost $13 billion
- In 2002 losses exceeded $11.5 billion
- US majors lost $11.4 billion in 2002 following a loss of $7.5 billion in 2001 (after approximately $5 billion in aid)
- Half of 2001 losses occurred before September 11th
- Clearly industry was in serious decline before that tragic day

Fundamentals of the New Industry Model

- Cost obsessed
- Service is a distant second
- Price is the driver
- Available revenue dictates cost base
- Lean structure
- Simple customer proposition
- Financially robust

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Performance of the "New" model

- "Low-cost" became an industry term
- Positions traditional carriers as "high cost"
- Successful "low-cost" airlines broke traditional performance mould:
  - Ryanair 2002 operating profit €263.5m up 61.7% from €162.9m in previous year
  - Southwest operating profit $417.3m in 2002 was 30th successive year of profitability
- Consistent performance regardless of economic conditions

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Aer Lingus performance pre-September 11th 2001

- 2001 Budget

  - Operating Profit of €64M
  - Net cash of €56M
  - CAPEX of €288M
  - 6% increase in average fares
  - 12% growth in passenger numbers
  - 19% increase in transatlantic revenues

- By July, 2001Forecast Operating Loss of €38M and net debt of €22M

- Debt financing negotiated but not in place

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Crisis post-September 11th 2001

- Facing closure: Aer Lingus identified as a likely casualty
- Transantlantic Market in chaos
  60% of ASKs
  40% of revenues
  50% of profit
- Load factors fell to <40% within 2 weeks of 9/11
- Cost base and work practices unsustainable
- Action must be urgent, radical and the change must be permanent

Facing into the Abyss

- First priority was Survival
- Had to be the beginning not the end of change
- Financial stability vital as basis for further progress
- Determined not to succumb to traditional restructuring model:
  - Restructure
  - Profits
  - Relax
  - Crisis

Survival Plan – “does what it says on the tin”

- Reduce costs by €190 million (16%)
- 17% reduction in capacity - mainly transatlantic
- Staff reduction of over 2,000 (33%)
  All areas, all grades and all categories
- Radical changes in work practices
- Pay freeze
- Pricing action, remove restrictions – stimulate traffic
  Transatlantic load factors recovered to >80% by mid October

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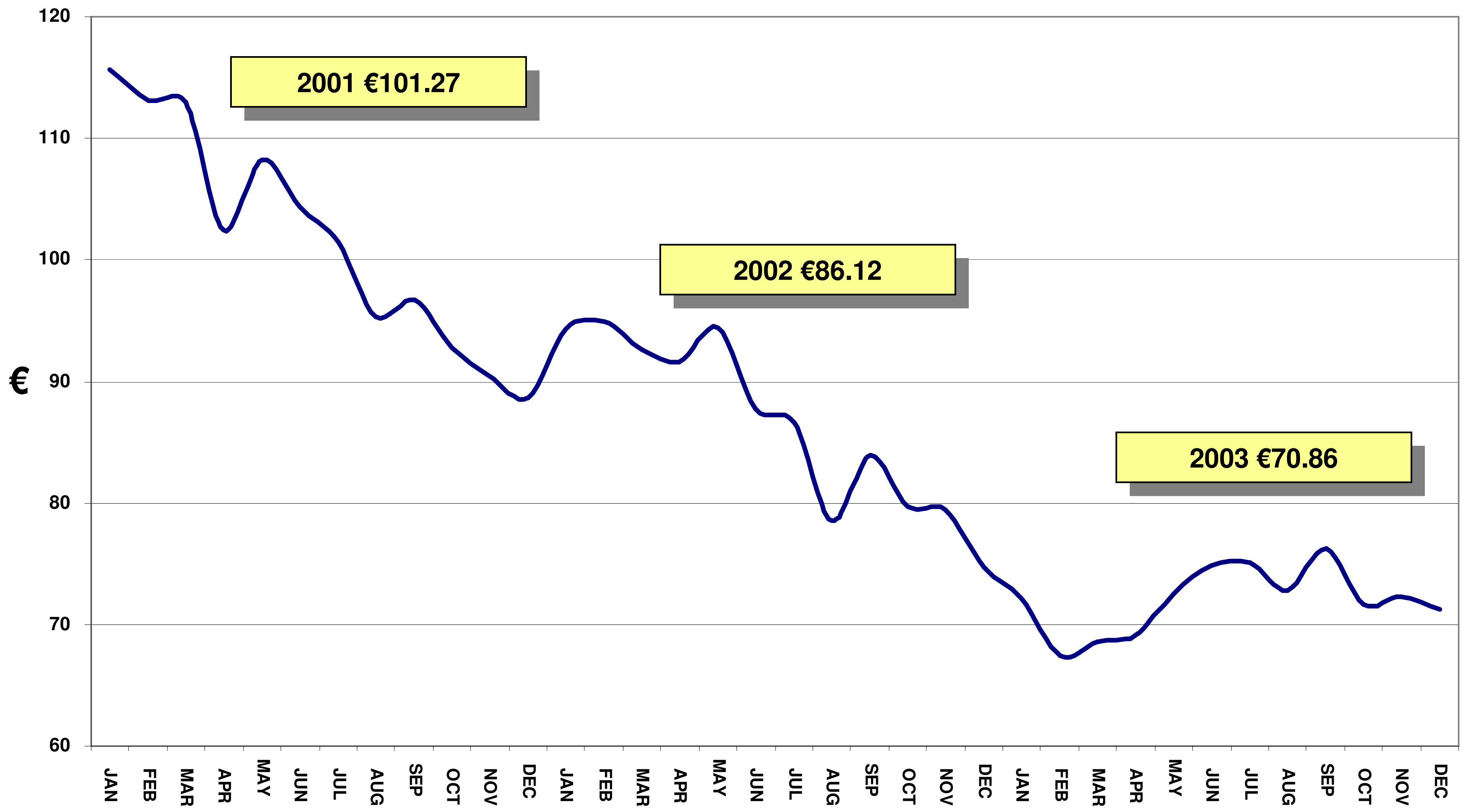
Moving Beyond Survival

- Management group reduced by 55%
- Less bureaucratic, more teamwork
- Simple decision making process – we know what needs to be done
- Not the "normal" cyclical downturn – fundamental change in the business
- Certain assumptions proved invalid:
  - "Recovery" of business traffic
  - Fares levels

Ireland – Heathrow yields 2001 to date



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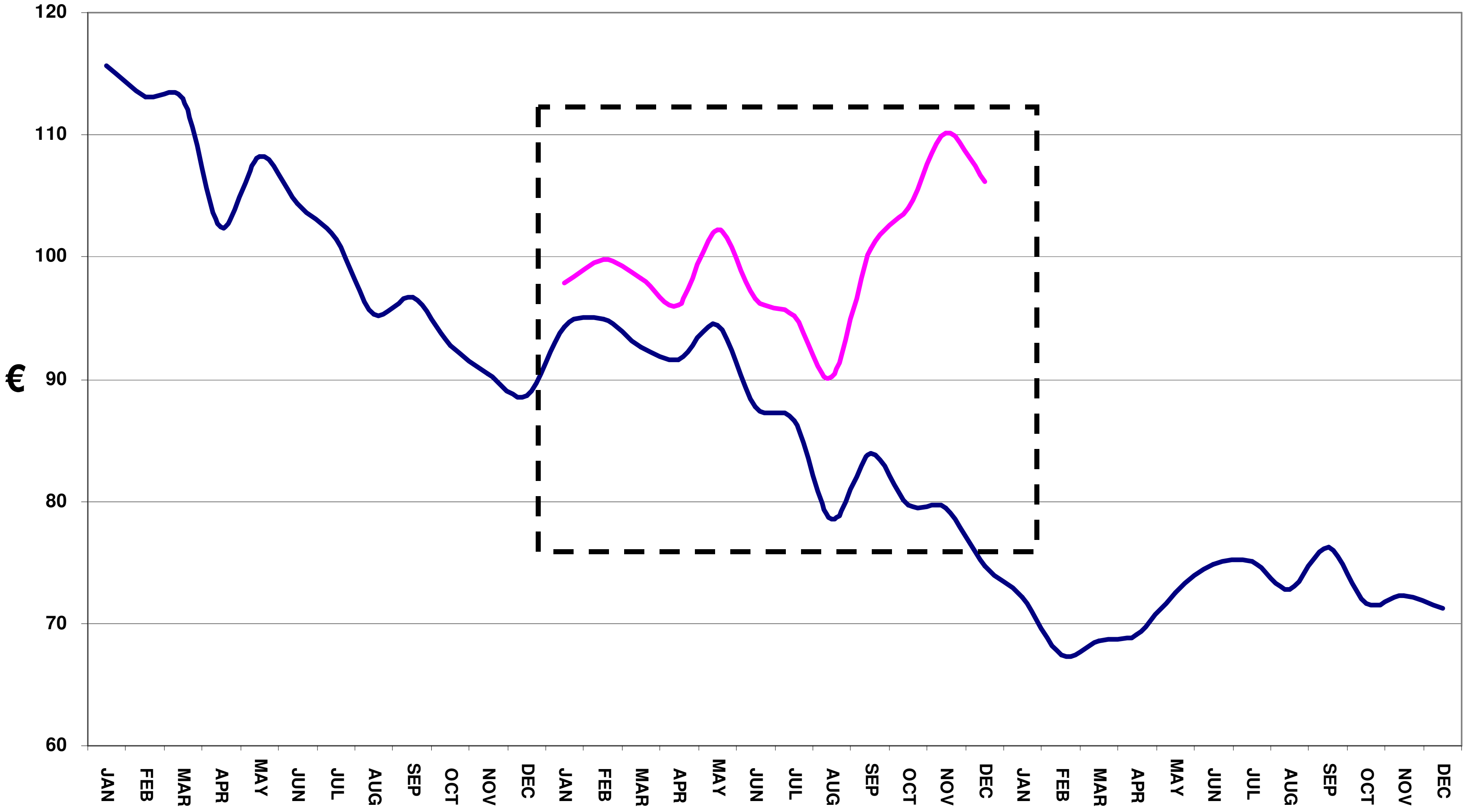
Ireland – Heathrow yields actual versus "plan"



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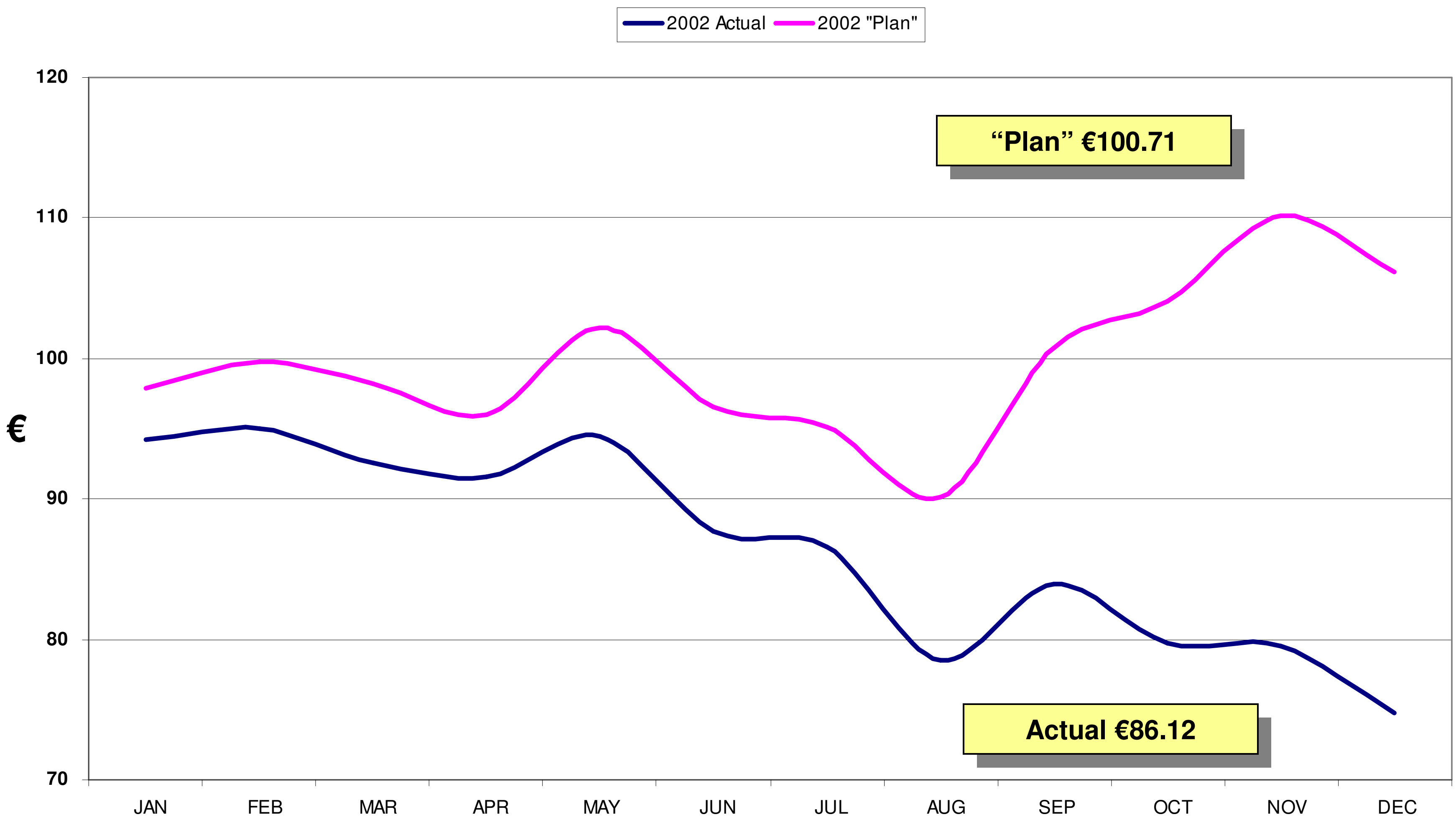
Ireland – Heathrow yields actual versus “plan”



Building a Sustainable Business – Back to Basics

- Become “relevant” in the market
- Millions of cheap seats
- Business fares reduced by up to 60% (7% revenue reduction)
- Add new routes through greater efficiency
- Ease of access through aerlingus.com
- Maintain customer service ethos
- Cheaper fares lead to higher load factors

Cost Base and Price

- The key to a sustainable and profitable business in the changed environment is aggressive and relentless cost management.
- Aggressive cost control means aggressive pricing.
- Aggressive pricing makes you relevant and attractive to the customer.
- Price stimulated air travel after 11 September.
- Aer Lingus
  - costs and prices are down
  - passenger numbers and load factors are up

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Change in business model

2003 Versus 2001	
Change in Overall Capacity (ASK)	-6%
Change in Passenger Traffic (RPK)	7%
Change in Passenger Load Factor	+ 11 Points
Change in Average Yield	-23%
Cost per RPK	-35%

Aer Lingus – The Transformed Business Model

- Simplify the business – less complexity
- Low fares
- Quality service
- More direct routes
- Lower costs
- Profits

Path to Transformation

- Key is Cost:
  - Fleet
  - Distribution
  - Airport Charges
  - Fuel
  - Marketing
  - Product

Fleet – standardise, less complexity

- European fleet – move to single aircraft type
- 17 new Airbus A320 ordered
- Fleet change complete by end 2005
- 10 new routes for 2004
- 30 new routes between 2002 – 2004
- Funding from internal resources without recourse to external investment

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Future Fundamentals

- No return to the old model
- More cost reduction across all cost captions
- More low fares
- More routes
- More aerlingus com
- More technology – e-ticketing, self-service, email and text promotions etc…
- Less complexity!
- More profits

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