ATTACHMENT B
FAA FINANCIAL FEASIBILITY REVIEW

The City of Chicago (the City or Sponsor) is requesting federal assistance in the form of a Letter of Intent (LOI) for a multi-year commitment of Airport Improvement Program (AIP) grant-in-aid funding for airfield projects at O'Hare International Airport (the Airport or O'Hare) as part of Phase 1 of the O'Hare Modernization Program (OMP-Phase 1). The request is for $300 million in AIP discretionary grants over a 10-year period with the City committing $56 million of its AIP entitlement grants. The LOI would help pay the costs of certain projects in the OMP-Phase 1 (the Phase 1 LOI Projects). The Phase 1 LOI Projects include:

- New Future Runway 9L-27R
- Extension of Future Runway 10L-28R (Existing Runway 9R-27L)
- Future Runway 10C-28C (Relocation of Existing Runway 18-36)
- Associated runway enabling projects, generally including associated taxiway systems, navigational aids installation and upgrade, site utilities construction, and existing facilities relocation.

Section 47106(a)(3)) of Title 49 United States Code provides that the Secretary of Transportation may approve an application for a project grant if, among other things, the Secretary is satisfied that “enough money is available to pay the project costs that will not be paid by the United States Government under this subchapter.” In addition 49 USC 47110(e)(2)(B) requires that an LOI project must meet the criteria of 49 USC 47115(d). That provision, in turn requires, among other things that the FAA consider the “financial commitment from non-United States Government sources to preserve or enhance airport capacity.”

We have, with the assistance of an outside contractor\(^1\), reviewed the City’s financial plan for OMP-Phase 1. For reasons presented below, we find the financial plan for OMP-Phase 1 is reasonable.

The Office of Inspector General has recommended that the FAA “should consider not only the stability of the financial plan for Phase 1 but also the reasonableness of the overall OMP financial plan, which includes Phase 2.” The OIG has encouraged the FAA to act “like any prudent investor” and to ensure that the financial plan for the full OMP is “reasonable, credible, and executable.” The City intends to submit another LOI request for OMP-Phase 2 projects at a later date. At that time, we will review the feasibility of the City’s financial plan for OMP-Phase 2 for compliance with the statutory requirement. In the meantime, however, we have, with the assistance of the outside contractor, also reviewed the financial plan for both the full OMP (Phases 1 and 2) and the Master Plan. We find that at this time in the development process the financial planning for OMP-Phase 2 and the Master Plan represents appropriate disclosure for the FAA.

---

\(^1\) John F, Brown & Co. (Brown). See footnote 9 below for a more complete description of Brown’s role in assisting the FAA in this financial review.
BACKGROUND

Airports use various sources of capital funds to finance the cost of their improvement programs including federal and state grants, passenger facility charges, bonds, and internal sources such as retained earnings. For large capital programs, airports must rely to a significant extent on debt in the form of general airport revenue bonds because federal grants and other funding sources are not adequate. The debt is secured by and payable solely from airport revenues. Most airports have no taxing power. Moreover, the credit and taxing power of airport owners (often cities and counties) is typically not pledged to secure airport debt. Thus, the ability of an airport to borrow money in the bond market is entirely dependent on its ability to generate sufficient revenues to service the debt; that is, its creditworthiness. A financial plan is feasible if it is reasonable to expect that the airport can incur and service the required level of debt.

In a large debt-financed program, revenues from airline rents, fees, and charges typically constitute the largest source of incremental revenue to service the debt. Thus, such airline revenues constitute a key source of security for the debt and an important credit factor. When these revenues, which are a cost to airlines for use and occupancy of the airport, are divided by enplaned passengers, the result is a ratio known as airline cost per enplaned passenger (CPE). CPE represents the average unit cost to airlines to access the aviation market served from the airport.\(^2\) Airline consent to an airport development program indicates that collectively the airlines find the value of the proposed improvements is commensurate with the added costs and that increases in CPE are not excessive in relationship to the value of the aviation market. For various reasons, an acceptable CPE at one airport may not be acceptable at another.

CPE, of course, is only one of many factors when evaluating the credit of an airport. Airport credit ratings are developed on a case by case basis but are generally based upon similar considerations including the size and strength of the service area economy; location and role in the national air transportation system; the level of indigenous demand; the strength and volatility of historical traffic trends; intra-regional and inter-gateway competition; the mix of connecting and origin-destination traffic; hub status (primary or secondary); airline market shares, including concentration in financially weak hubbing carriers; debt service coverage and other financial performance measures; legal provisions in bond documents; contractual provisions in airport use and lease agreements; and various other factors such as airport ownership structure, management team, and facility controls.

Airports are relatively strong credits compared to other industries. Notably, airports are significantly better credit risks than airlines. The credit strength of airports is generally attributable to the essential nature of commercial air service, the strong competitive position of most airports, and the relatively small proportion of overall airline costs represented by airport rents, fees, and charges.

---

2. Variance around the average CPE can be significant. In effect, individual airlines may pay substantially more or less than the average due to a number of factors.
The credit performance of airports after 9/11 is indicative of their strength and resilience.

**THE AIRPORT**

O'Hare is the second largest airport in the national air transportation system in terms of passengers. There were 650 million passengers enplaned at the nation’s 427 primary airports in 2003. The 34 large hub airports accounted for 368 million (57 percent) of these enplaned passengers and, O'Hare accounted for 33 million (9 percent) of the large hub total. O'Hare is also key component of the national air transportation system, and it serves as a major connecting hub for the two largest airlines in the world—American and United.

All of the Airport's bonds enjoy favorable ratings from the three major rating agencies. Moody’s and S&P maintain a stable outlook on the Airport credit. Fitch, however, maintains a negative outlook.

<table>
<thead>
<tr>
<th>O'Hare International Airport Bond Ratings (as of June 2005)</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Fitch</strong></td>
</tr>
<tr>
<td><strong>Rating</strong></td>
</tr>
<tr>
<td>First Lien Chicago O'Hare Revenue Bonds</td>
</tr>
<tr>
<td>Second Lien Chicago O'Hare Revenue Bonds</td>
</tr>
<tr>
<td>Third Lien Chicago O'Hare Revenue Bonds</td>
</tr>
<tr>
<td>First Lien Passenger Facility Revenue Bonds</td>
</tr>
<tr>
<td>Second Lien Passenger Facility Revenue Bonds</td>
</tr>
</tbody>
</table>

Sources: Fitch, Moody’s, and S&P websites.

The credit strengths of O'Hare include its role in the national air transportation system given its strategic mid-continent location; the size and growth of its service area, which support a strong origin-destination air travel demand; its established status as a two-airline hub; its residual rate-making methodology contained within its long-term airline leases; and its growing role as an international gateway.

The principal long-term rating concerns specifically for O'Hare are the increasing level of connecting traffic and the possibility of substantial additional debt to finance the cost of the Airport capital program. These are addressed below.

---

3 The Airport has no taxing power. Neither the credit nor the taxing power of the City is pledged to secure the debt of the Airport.

4 For example, in July 2004 Standard and Poor’s cited specifically for O'Hare that “the City’s ability to contain project costs and the extent to which it can provide further details regarding its additional debt needs will be important credit factors going forward” and Fitch currently maintains a “Negative Outlook” for O’Hare citing “the financial difficulties experienced by the nation’s airlines, particularly United...as well as the rising fixed costs associated with the airport’s capital initiatives.”
Connecting Traffic

Connecting hub airports like O’Hare are reliant on the strategic network and routing decisions of individual airlines, which is a credit weakness relative to airports that primarily serve an origin-destination passenger market. However, certain connecting hub airports “that are served by financially strong carriers and/or provide a geographic advantage, having a sizeable O&D passenger base, stand a greater likelihood of sustaining passenger levels than hubs served by weaker carriers and/or in smaller markets.” O’Hare is generally viewed as one of the airports that “stand a greater likelihood of sustaining passenger levels.”

Cost of the Program

Credit concerns about the cost of the program are mitigated in part by the airline support for OMP-Phase 1 and by the phased nature of the development program.

The right of airlines to review and approve capital investments is typical at airports using a residual rate-making methodology. Rating agencies generally consider the rate methodology to be a neutral factor, except in circumstances where the airport is a connecting hub, and in those circumstances a residual methodology is preferred. At O’Hare, the major airlines operate under a residual Airport Use Agreement and Terminal Facilities Lease (Lease) that effectively guarantees that net revenues will be not less than 110 percent of debt service on revenue bond obligations until the Lease expiration in May 2018 and, according to Fitch, “substantially insulates the airport from airline industry volatility.”

Except for certain limited exceptions under the Lease, the City can only include the costs of capital projects in the airline rate base after receiving the approval of a majority-in-interest (MII) of the airlines that are signatory to the Lease. The Lease basically precludes the possibility that the City could undertake a major capital program without the approval of the signatory airlines.

A majority-in-interest of the signatory airlines have approved OMP-Phase 1, subject to the award of a $300 million LOI from the FAA. The LOI Application states that “[For Phase I] the financing plan requires a minimum $300 million LOI commitment by the FAA as a condition to the airline funding commitment.” The LOI Application further states that “If an LOI request is not approved, an alternative method for funding the LOI Projects would be to attempt to secure additional airline MII approvals to issue additional GARBs to finance the construction costs previously identified as being funded with an LOI grant. Estimated debt service payments resulting from an additional $300 million GARB issuance would be approximately $24 million annually.”

6. Ibid.
The OMP is divided into two independent phases, whose estimates of scope, schedule, and costs represent the City’s best estimates to date. With respect to OMP-Phase 2, the City might chose to modify the scope (and cost) or defer the schedule for development of projects within each phase in order to secure MII approval of the signatory airlines or to address other interests or concerns of the City. The functional independence of the two phases (and their component projects) is of significant value to the City in its financial planning. It provides options, allowing the City to flexibly manage the program of development to insure overall financial feasibility.8

**O’HARE FUNDING PLAN**

The City has developed a financial plan for each respective and discrete component of future capital investment including OMP-Phase 1, Full OMP, and the Master Plan. The aggregate plans are presented in the table below. The financial plans generally rely upon federal funding to the maximum extent available including AIP entitlement, discretionary, and letter of intent (LOI) funds, as well as passenger facility charge (PFC) pay-as-you-go funding and leveraged PFC bonds backed by future PFC collections. A small amount of third-party financing is used for certain projects. General airport revenue bonds (GARBs) are then used to fund the net remaining project costs, after the application of all other funding sources. The method of funding being applied, though much larger in scale, is common practice at airports.

**Financial Plan**

**O’Hare International Airport**

<table>
<thead>
<tr>
<th></th>
<th>OMP Phase 1</th>
<th>% Total</th>
<th>Full OMP</th>
<th>% Total</th>
<th>Master Plan</th>
<th>% Total</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>AIP</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Entitlement</td>
<td>$56</td>
<td>1.9%</td>
<td>$60</td>
<td>0.8%</td>
<td>$64</td>
<td>0.4%</td>
</tr>
<tr>
<td>Discretionary</td>
<td>5</td>
<td>0.2%</td>
<td>45</td>
<td>0.6%</td>
<td>191</td>
<td>1.2%</td>
</tr>
<tr>
<td>LOI</td>
<td>300</td>
<td>10.4%</td>
<td>600</td>
<td>7.5%</td>
<td>706</td>
<td>4.6%</td>
</tr>
<tr>
<td><strong>PFC</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>PAYGO</td>
<td>51</td>
<td>1.8%</td>
<td>130</td>
<td>1.6%</td>
<td>566</td>
<td>3.7%</td>
</tr>
<tr>
<td>Bonds</td>
<td>599</td>
<td>20.8%</td>
<td>1,597</td>
<td>20.1%</td>
<td>2,743</td>
<td>17.8%</td>
</tr>
<tr>
<td>GARBS</td>
<td>1,869</td>
<td>64.9%</td>
<td>4,731</td>
<td>59.4%</td>
<td>9,614</td>
<td>62.3%</td>
</tr>
<tr>
<td>Third Party Financing</td>
<td>-</td>
<td>0.0%</td>
<td>796</td>
<td>19.0%</td>
<td>1,552</td>
<td>10.1%</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>$2,880</td>
<td>100.0%</td>
<td>$7,959</td>
<td>100.0%</td>
<td>$15,438</td>
<td>100.0%</td>
</tr>
</tbody>
</table>

**OMP-Phase 1**

The OMP-Phase 1 projects include new future runway 9L-27R, extension of future runway 10L-28R, future runway 10C-28C and proposed west satellite

---

8. “While this plan [the OMP] suggests the city will issue a considerable amount of additional GARBs over a relatively short time frame, the financing plan remains flexible.” Per “Chicago O’Hare International Airport – Revenue New Issue” November 12, 2004, Fitch IBCA.
concourse, all to be completed in 2009. The funding plan relies primarily upon bond funding, with proceeds from PFC Bonds and GARBs comprising 85 percent of the total funding sources. The City projects that the maximum PFC charge level will increase from current $4.50 per eligible enplanement to $6.00 starting in 2011, however this assumption is not a critical component of the OMP-Phase 1 funding plan as the City’s current PFC collection level is able to meet the debt service requirements on both outstanding PFC bonds and projected future PFC bonds for the OMP Phase 1 projects.

**Full OMP and Master Plan**

The OMP-Phase 2 includes the extension of future runway 9R-27L, future runway 9C-27C, future runway 10R-28L, west terminal building/concourse and noise mitigation. The Master Plan includes the remaining projects planned over the time horizon, which are known as the Capital Improvement Program and the World Gateway Program. The quality of information to support the financial plans for the Full OMP and the Master Plan is, as expected, substantially “softer” and more subjective than the financial plan for OMP-Phase 1. For example, the programs reflect planning-level cost estimates, which are inherently less precise than final design estimates. Moreover, the programs do not reflect the changes that may be necessary to secure MII consent.

To fund the costs of OMP-Phase 2, the City generally plans to pursue a second LOI in the amount of $300 million, to issue PFC-backed bonds using the additional bonding capacity created from the increase in PFC levels to $6.00, and to issue GARBs to cover the remaining costs. To fund the Master Plan, the City generally plans to use any remaining PFC bonding capacity and to issue additional GARBs to fund the remaining costs.

**AIRLINE COST PER ENPLANED PASSENGER**

The agency’s contractor developed a model to compile financial projections of the effect of proposed development plans on CPE and other financial variables. The model uses base scenario assumptions developed by the City and its financial consultants and sensitivity scenario assumptions defined by the FAA. The results cover the period through 2015 and are presented in nominal dollars. We believe that the assumptions reasonably reflect expected conditions and the City’s expected course of action. However, events and circumstances frequently do not occur as expected, and differences between actual and projected results may be material.

**OMP-Phase 1**

The base scenario for OMP-Phase 1 followed the financial plan of the City set out in the LOI in all respects including estimates of costs, schedule, and funding. Funding assumptions for the base scenario included, among others, a

---

9. The FAA contracted with John F. Brown Company, Airport Management Consultants, to develop the financial model and compile the financial projections. The contractor also reviewed and commented on this report.
$300 million LOI; unconstrained passenger growth consistent with the projection set out in the draft Environment Impact Statement; AIP entitlement grants according to existing passenger formulas, decreasing to zero in 2011 when a $6.00 PFC is implemented; and 83.5 percent of enplaned passengers are PFC eligible. It was projected that CPE would increase from about $9.00 in 2004 to $13.19 in 2015.10

The sensitivity scenarios evaluated the effect of increases in project costs (+15 percent), schedule delays (12 months), decreases in LOI amounts, extensions in LOI payment schedules, and no increase in PFC levels above $4.50. The most significant effect on CPE was caused by increases in project costs. A 15 percent increase in the costs of OMP-Phase 1 caused the CPE in 2015 to increase 6.4 percent from $13.19 to $14.04.

**Full OMP and Master Plan**

The base scenarios for Full OMP and Master Plan also followed the financial plan of the City set out in the LOI in all respects including estimates of costs, schedule, and funding and the passenger projection set out in the EIS. For the Full OMP and the Master Plan, it was projected that CPE would increase to $20.52 and $30.43, respectively, in 2015.

Similar sensitivity scenarios were employed for the Full OMP. The most significant effect on CPE was the 15 percent increase in project costs which produced an 11.8 percent increase in CPE from $20.52 to $22.94 in 2015. The projected Master Plan CPE ($30.43 in 2015) was tested for its sensitivity to a $4.50 PFC, which caused the projected CPE for 2015 to increase to $31.05.

**Effect of CPE on Airport Activity**

Will airlines reduce service levels at the Airport because of the CPE cost burden? We believe that airline service decisions will be largely unaffected by the projected levels of CPE arising from OMP-Phase 1. And, we believe that, between the City and the airlines, the CPE levels from OMP-Phase 2 will be managed to mitigate potentially adverse effects on airline service decisions at O'Hare.

First, through their MII rights under the Lease, the signatory airlines have substantial control over future CPE levels at the Airport. MII approval of OMP-Phase 1 represents the views of most of the affected users that the value of the proposed improvements—from savings in aircraft operating costs, improved passenger convenience, and other tangible and intangible benefits—is commensurate with the added costs and that the future CPE is not excessive in relationship to the expected value of the aviation market at O'Hare. Similarly, OMP-Phase 2 cannot move forward without an MII review of the projects for their benefits and costs (including CPE levels). Thus, projects in OMP-Phase 2 must

---

10. The City estimated that the CPE would be $9.24 in 2003 and $8.89 for 2004. (See Master Plan, Table VII-9.)
undergo a vetting process in which the City and the signatory airlines come to terms on scope, cost, schedule, and other factors affecting CPE levels.

Second, the City has disclosed in bond offering documents its plans to undertake the Full OMP as well as other capital improvements at the Airport, which would be financed through various future issues of airport revenue bonds. Each future issue will be evaluated in terms of the circumstances, management plans, and future expectations that exist at the time of such bond issue. Through bond ratings, insurance premiums, and interest rates, the City will receive independent feedback on the creditworthiness of the Airport and the ability of the City to service its existing and proposed debt. The City can use this feedback to modify its development plans, if appropriate.

Third, airline costs that are represented by airport rents, fees, and charges account for 4 to 7 percent of the total operating expenses of major U.S.-flag airlines. Fuel and labor, by contrast, account for about 17 percent and 30 percent, respectively, of airline operating expenses.\textsuperscript{11} Because airport charges are a relatively small share of airline operating expenses, they do not exert significant influence on airline service decisions, except when there is a substantially less expensive alternative airport that can work as an effective substitute for serving an airline’s target aviation market. While O’Hare competes with Midway and Milwaukee for local passengers, with other mid-continent hubs for domestic connecting traffic, and with other gateways for international traffic, it holds a relatively strong competitive position. We believe the disparity in CPE would have to be significant in order for the risk of diversion from O’Hare to be material.

Finally, both CPE and CPE as a percentage of average airfares at the Airport are within the range currently experienced at other large hub airports.\textsuperscript{12} Future CPE levels projected for OMP-Phase 1 are also within this range. Future CPE levels projected for the Master Plan are high, but not unprecedented; however, these CPE projections are not really comparable to CPE levels currently experienced at other large hub airports to the extent that other airports do not reflect the effect of capital plans on future CPE levels. In this regard, it is also important to note that CPE levels typically peak at the time that a large capital program first comes into service (upon expiration of the capitalized interest period and the step-up in operating expenses); thereafter, CPE levels moderate and even decline as costs stabilize, passenger levels increase, and non-airline revenue sources increase faster than costs.

\footnotesize
\begin{itemize}
  \item \textsuperscript{11} Form 41 data for the 12 month period ended June 30, 2004.
  \item \textsuperscript{12} Rating analysts and others recognize the inherent limitations of using CPE ratios as a basis for comparing airports. For example, some airports provide “turn key” facilities while others rely on airlines to finance some or all of their terminal improvements. Other things being equal, CPE would be significantly higher at the “turn key” airport. Despite these limitations, CPE is the most readily available measure of airline unit costs represented by airport charges.
\end{itemize}

September 28, 2005

-8-
CONCLUSION

Based on its review of the City's financial plan, on its understanding of airport finance, and on discussions with its contractor, the FAA believes the financial plan for OMP-Phase 1 is realistic, reasonable, and credible, and executable. Accordingly, the FAA is satisfied that enough money will be available to pay the costs of OMP-Phase 1 that will not be paid by AIP grants.