

Prepared Statement to the
COMMITTEE ON ARMED SERVICES
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by

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Chairman Hunter, esteemed Committee members, my name is John Plueger, and I am the President and Chief Operating Officer of International Lease Finance Corporation (known as “ILFC”), a commercial airliner operating lease company based in Los Angeles, California. ILFC is wholly-owned by American International Group (known as “AIG”), a worldwide insurance and financial services company traded on the New York Stock Exchange and based in New York. With me today I have also brought Mrs. Julie Sackman, ILFC’s Executive Vice President and Chief Legal Counsel.

Chairman Hunter invited me to testify before you today on the subject of commercial airline operating leases in order to assist you in considering the United States Air Force’s proposal to lease 100 Boeing 767 air refueling aircraft, designated as the KC-767A. In essence, I was asked to provide a short course on commercial airline operating leases and industry practices.

Before I begin, I would like you to clearly understand that I am not qualified to comment on government or military procurement practices or programs, as I have no experience in this area and have never been involved in any military procurement, nor has my company. I am also not qualified to comment on the

technical aspects or financial costs of converting or building a Boeing 767-200ER (on which the tanker platform is based) into a military air refueling aircraft. My knowledge of the KC-767A leasing program is limited to what I've read in the "Report to the Congressional Defense Committees on KC-767A Air Refueling Aircraft Multi-Year Lease Pilot Program" attached to the Secretary of the Air Force's letter to Chairman Hunter dated July 10, 2003, which was provided to me by Chairman Hunter's office. But I do know something about commercial airline operating leases, which I have been doing for the past 17 years at ILFC.

ILFC was founded in 1973 and many people in our industry credit ILFC as the pioneer of the operating lease for commercial jet airliners when we leased our first aircraft, a DC-8, to Aeromexico in that same year. Today, ILFC has a fleet of more than 600 jet aircraft on lease to approximately 160 airlines worldwide. Our leasing fleet includes almost all models of jet aircraft offered for sale by Boeing and Airbus. Our lease fleet specifically includes sixty (60) B767 aircraft, so that aircraft type accounts for almost ten percent (10%) of our total fleet.

As measured by firm order backlog (meaning aircraft that have been ordered but not yet delivered), ILFC is the largest single customer of both Boeing and Airbus. Specifically with respect to Boeing, ILFC today has 148 aircraft on firm order for deliveries scheduled through 2009. Many people find it hard to believe

that a leasing company, as opposed to an airline, is actually the largest commercial customer for Boeing and for Airbus, but it reflects the dramatic growth and importance of the operating lease as a financing, aircraft procurement, and flexibility tool for many, if not most, airlines today.

I would like to begin this “Operating Lease 101” discussion, as Chairman Hunter called it when I spoke with him by telephone, with a review of the general structure, pricing, and financial parameters of commercial airline operating leases. Let me stress that these are generalizations -- each operating lease deal is heavily negotiated and customized. Furthermore, in the highly competitive operating lease industry that exists for commercial airliners today, there are many variations and differences offered by a variety of excellent companies. I specifically do not and cannot speak for any of my competitors and, in this context, I do not see myself here today as a self-appointed industry spokesperson, but rather as simply one of its members who was invited to speak before you.

In an operating lease, the leasing company, referred to as the Lessor, purchases and retains ownership of the aircraft throughout the lease period. The Lessee has complete use of the aircraft, maintains and insures the aircraft at the Lessee’s expense, and makes lease payments (also called rental payments) to the Lessor for the use of the aircraft over a fixed period of time called the lease term.

In this context it is quite similar to leasing a car. And just as with a car lease, at the end of the lease, the aircraft must meet certain minimum return conditions or else extra lease charges or penalties are incurred.

Because the Lessee simply rents the aircraft, and ownership stays with the Lessor, the Lessee does not show the aircraft as an asset on its balance sheet, nor does it record a liability on its balance sheet for the lease payments. Instead, the Lessee simply records the rental expense for the lease payments in its Income or Profit and Loss Statement as each payment is made, along with a footnote disclosure in the financial statement notes as to the future payment obligations under the lease. Therefore the operating lease becomes a method of so-called “off-balance sheet” financing for commercial aircraft. Because the airline does not borrow money to purchase the aircraft, there is no debt associated with the aircraft and therefore the airline does not “leverage” or add debt to its balance sheet, thus providing a benefit to today’s over-leveraged airlines that face mountains of debt.

In order to obtain an aircraft under operating lease, an airline negotiates a lease agreement that usually (but not always) includes some form of security deposit (generally cash but sometimes a letter of credit or bank guarantee). The security deposit paid is a heavily negotiated aspect of the lease transaction. Security deposits can range in amount anywhere from one to three months’ worth

of lease rental payments. The security deposit provides added financial security to the Lessor for the Lessee's performance of the lease obligations. At the end of the lease, if all lease obligations have been satisfied (including the aircraft being in the proper condition at return), the security deposit is normally returned to the Lessee.

Whatever the amount of the security deposit, however, it is a small fraction of the amount that an airline would otherwise have to pay in progress payments to the airframe manufacturer if the airline were purchasing the aircraft new. Such progress payments can amount to as much as 30% or more of the total cost of the aircraft during the period of time that the aircraft is being built. To use an example, if an airline were purchasing a new \$100 Million aircraft, the airline might have to pay as much as \$30 Million in progress payments to the aircraft manufacturer while the aircraft is being built. In contrast, the same aircraft obtained from a leasing company might only require a security deposit payment of as low as \$1-3 Million. When the aircraft is completed, an airline buying a new aircraft has to pay the balance due of the purchase price (the amount still owing after progress payments are made), whereas nothing more is due under the operating lease except for the rental payments which are usually made monthly or quarterly.

This points out an obviously attractive aspect of operating leasing -- you need only a small fraction of the cash or financing to obtain an aircraft under an operating lease versus purchasing the aircraft. It is for this same reason that many of us lease cars instead of buying them. Leasing requires less cash and the monthly payments are lower.

This brings us to aircraft and lease pricing. In the case of ILFC and several other major leasing companies, aircraft purchase agreements are negotiated directly with the aircraft manufacturer for a specific quantity of aircraft and model types to be delivered over a future period of time. Most of these aircraft orders are speculative, meaning that not all of the aircraft being ordered have necessarily been placed on lease to an airline. However, since cost is the number one issue of airlines today, speculative aircraft orders are necessary in order to generate the pricing levels that only large aircraft orders provide.

Aircraft prices are, of course, a matter of extreme sensitivity to everyone in the industry today, and therefore pricing is closely guarded because it is a main factor that determines competitive advantage or disadvantage for airlines and for leasing companies. In every major competitive aircraft campaign at an airline or aircraft leasing company, there are wild stories about concession levels and discounts, most of which are pure speculation or competitive bragging. In truth,

ladies and gentlemen, most of the time you only know for sure what YOU paid for an aircraft, not what anyone else pays for an aircraft. Only one thing is for certain - that discounts and concessions are, in fact, given. And an order for 100 or more aircraft by the most creditworthy buyer would certainly command the highest concession levels offered by any aircraft manufacturer for commercial / civilian airliners.

Aircraft prices are quoted on an escalation basis from a specific month and year base to the actual date of delivery. Each airframe and engine manufacturer has its own escalation formula that takes into account governmentally determined labor and material cost indexes. For example, based on information provided to me from Boeing, the list or catalog price for a B767-200ER, the platform base aircraft for the KC-767A program, delivering in October 2003 (after escalation from the base of year of January 2002) would be approximately \$104 Million. Depending upon the specific airframe manufacturer, discounting or concession levels anywhere from 15 to 30 percent or more from the published catalog price would not surprise me in the civilian/ commercial world for an order of 100 aircraft.

In the commercial world, an order of 100 widebody aircraft (also called twin-aisle aircraft) such as the B767, regardless of whether the order is by an

airline or by a leasing company, would normally command a heavily fought commercial campaign between Boeing and Airbus. Such a large order, particularly in these extremely difficult times for the airlines and airframe manufacturers, would be highly coveted. The competition, however, is not limited just to Boeing and Airbus. There is an equally brutal campaign fought by the engine manufacturers for the order. The B767, for example, can be powered by engines manufactured by Pratt & Whitney, General Electric, or Rolls Royce. The percentage of discounting of engine prices can far exceed that of the airframe. Avionics (which is a term generally used to include aircraft communication and navigation radios, autopilot, radar, global positioning systems, ground proximity warning systems, and other cockpit electronics) represents another area of competitive bidding and negotiation, as are other components such as wheels, tires, brakes, and the auxiliary power unit (APU).

Normally, in a commercial aircraft operating lease structure where the Lessor purchases the aircraft directly from the manufacturer, the Lessee does not know the actual price paid by the Lessor for the aircraft. The commercial airline operating lease industry is highly competitive and, as most of the Committee members are probably aware, there is an over supply of commercial airliners today as the airline industry worldwide, and in particular the United States, suffers the

most severe financial losses in its history. In this environment, lease rates (the actual lease price or payments made by the Lessee to the Lessor) are largely market driven. The lease rate is obviously the most heavily negotiated factor in virtually all operating lease deals. However, there are factors that influence lease rates generally. These factors include:

1. The duration or length of the lease term. Generally, the longer the lease term, the lower the lease rate. So a six year lease (as is contemplated for the KC-767A aircraft) would generally have a lower lease rate than a four year lease, but would have a higher lease rate than a ten year lease. ILFC's average lease term for a new widebody or twin-aisle aircraft is seven years; however, we have a wide range of lease terms on used widebody aircraft (from one year to eleven years) as a function of today's stressed marketplace.
2. The creditworthiness or perceived financial risk of the airline.
3. The customization costs of the aircraft for the airline. Generally speaking, specification and configuration costs that are attributable to a specific airline are priced into the lease rate by amortizing the costs of such customization over the lease term. Therefore, a longer lease

term helps lower the lease rate (lease price) because there is a longer period of time over which the customization costs can be spread.

4. Other cash inflows to the Lessor provided by the terms of the lease, such as security deposits and maintenance reserves (which I will discuss shortly) and whether the Lessor retains the interest earned on these amounts.
5. Other cash outflows made by the Lessor, such as engine or spare parts financing or the purchase of used aircraft from the airline in order to make room for the new aircraft.
6. The strategic importance of the customer to the leasing company and the future business potential of the customer.

In the marketplace today there is a wide variation of lease rates as a function of the supply and demand of each particular aircraft model and the factors such as lease term that I just mentioned. In today's world, however, lease rates on new widebody or twin-aisle aircraft currently range from about .5% to about .8% (five tenths to eight tenths of a percentage point) per month multiplied by the cost of the aircraft. Therefore, a \$100 Million aircraft might lease for about \$500,000 to \$800,000 per month depending on the model aircraft and a variety of factors and market pressures as previously mentioned.

Lease rates themselves can be structured in different ways, depending on the transaction. For example, lease rates can be quoted on a fixed basis (that is, each payment is the same amount through the entire lease term). Alternatively, lease rates can be quoted on a variable rate based on financial interest rates such as LIBOR or Prime. Under a variable rate, the lease payments fluctuate based on the interest rate index being used. There are a variety of other lease rate structures such as “stair-step” lease rates that start out low and then step up gradually over time. Multi-currency lease payments can be structured. Seasonally adjusted lease rates can be structured to match the cash flow of the airline. This is only a sample of the structuring flexibility inherent in the operating lease.

Additional flexibility in operating leases may include lease extension options, early termination options, options to rollover into other aircraft types, and purchase options.

There are many other considerations and issues regarding the operating lease for commercial airliners. I alluded to some of those considerations earlier -- specifically aircraft maintenance, insurance, and return conditions, which are all the responsibility of the Lessee under traditional operating leases.

After the lease rate itself, the maintenance and the return condition sections of an operating lease are the most heavily negotiated, simply because there are

millions of dollars at stake for each aircraft. The aircraft must normally be maintained pursuant to a maintenance program that is approved by the aircraft manufacturer and the aviation authority under which the airline operates such as the Federal Aviation Administration in the United States. Many operating leases contain maintenance reserve charges for major airframe and engine overhauls, the use of life-limited parts on engines, the landing gear and the auxiliary power unit. Under these provisions, the airline pays either to the Lessor or to a third party maintenance provider (with respect to engines, the third party maintenance provider is often the engine manufacturer) a fixed charge for each hour or for each cycle (one cycle equals one takeoff and landing) that the aircraft flies. A fund or savings account is built up that is then used for major overhauls and maintenance, which can amount to millions of dollars on both the airframe and engines. The airline draws on that fund when such major maintenance expenditures are incurred. Such maintenance reserves provide the Lessor with additional security that the airline will have the funds available when needed for major maintenance work. Any money left in these maintenance funds usually stays with the Lessor at the end of the lease.

The return conditions that the aircraft must meet at lease expiry are of pivotal importance and it is often said that profitability in operating leases can be

made or lost in the return conditions of the lease. Generally speaking, in addition to meeting all airworthiness requirements of the aviation authority under which the airline operates, the aircraft must usually conform to one of two broadly accepted standards -- the United States FAA, or alternatively the European Joint Airworthiness Requirements. There is usually a requirement that the aircraft, engines and components be in a “half life” condition at return, meaning that the aircraft, engine and critical parts are half-way between major overhauls. Analogizing again to the car situation, if a car goes into the shop every 10,000 miles for major work, the car would be returned with at least 5,000 miles to go until it has to go into the shop. The engines must meet certain performance standards. The airframe must be delivered fresh from its 15 month inspection (usually called a “C-check”). All Airworthiness Directive must be complied with. An Airworthiness Directive (called “A.D.”) is a specific repair or modification that is required to be performed on the aircraft in order for it to be deemed airworthy and legal to fly. There are many other technical matters dealing with return conditions, but suffice it to say that it is an area where both Lessee and Lessor have major financial exposure.

Closely related to aircraft return conditions are issues regarding the unique specification requirements of the airline. Some airlines, for example, have a

unique audio/video passenger entertainment system or proprietary interior layout which must be removed at aircraft return. Removing such items at the end of the lease can also lead to large financial costs which are normally the responsibility of the Lessee. This may or may not be a significant issue in the KC-767A program.

Aircraft insurance coverage has been another area of increasing consideration and review in the operating lease structure. Under the terms of an operating lease, leases, the Lessee (airline) is responsible for all insurance coverage as dictated by the terms of the lease. Terrorist events, declining aircraft values, and increasing liability exposure have elevated insurance costs and therefore the insurance provisions of operating leases have been opened to new levels of scrutiny, cost analysis, and negotiation. ILFC, for example, generally requires minimum liability coverage of at least \$1 Billion in its aircraft leases as well as aircraft hull values that decline over time as the aircraft depreciates. Other insurance issues addressed in the operating lease usually include war risk, confiscation, deductible levels, and more. Particularly since September 11, the Lessor may accept government guarantees in lieu of commercially-purchased third party and war risk liability insurance.

When an operating lease terminates normally (i.e., the lease contract has run and all contractual obligations, including return conditions, have been satisfied) the

aircraft is returned to the Lessor and the security deposit is refunded to the Lessee. The Lessor may have lined up another follow-on lease customer for the aircraft, or the Lessor may sell the aircraft. There is normally no further requirement or financial obligation on the part of the Lessee to the Lessor once the aircraft has returned. For example, the Lessee does not normally guarantee or pay a fee towards the residual value of the aircraft. The Lessee has no exposure to the aircraft residual value. This illustrates another benefit of leasing versus owning. During periods of economic stress such as we see today in the airline industry and the commercial aircraft marketplace, the Lessor takes all the residual value risk. The Lessee simply walks away. In this way also, the airline is not burdened with a particular aircraft type or size when a different one may then better fit the airline's operational needs.

The Committee should be aware that, in order for a lease to be considered an operating lease, as opposed to a financial lease (which is reflected on the balance sheet of both the Lessee and Lessor), the Financial Accounting Standards Board has set forth four general requirements in its Statement 13, as follows:

1. The present value of the minimum lease payments must not exceed 90% of the value of the aircraft at lease inception.

2. The lease term cannot be greater than 75% of the economic useful life of the aircraft.
3. There can be no “bargain purchase option” at the end of the lease.
4. Title to the asset (aircraft) cannot transfer to the Lessee at the end of the lease.

It appears to me that these requirements may be mirrored in governmental accounting by OMB Circular A-11.

Although I am not here to comment on the K767A program, it would be interesting to know whether it is possible and cost effective to convert existing B767-200ER aircraft into aerial refueling aircraft. The same question applies to converting existing DC-10 aircraft into KC-10 aerial refueling aircraft. Given the K767A projected utilization rate of 750 hours per year (normal commercial airline utilization levels exceed 3,000 hours per year), the current oversupply of aircraft and the resulting depressed market prices, and the ready supply of both aircraft types in the marketplace for many years to come, it might be a way of adding incremental units to the Air Force fleet as needed if a cost effective conversion program existed. Conversely, it would also be interesting to know if the KC-767A could be de-modified back into a passenger or freighter aircraft without significant operational or weight penalties. If so, the aircraft has the potential for a higher

residual value since it would not be limited to the aerial refueling mission, which might result in lower lease pricing over the long term.

Thank you, Chairman Hunter, and Committee members for giving me the opportunity to speak with you today. I hope you find this background information on commercial airline operating leases useful, and I would be happy to answer any questions the Committee may have.