FORTUNE AVIATION SERVICES

Can the commercial aircraft backlog withstand a 50% drop in fuel prices?

The recent dramatic decrease in oil prices has provided an opportunity for improving global economic conditions (except in those countries whose economies are dependent on high oil prices). The outlook from Seattle and Toulouse may be less sanguine since the aircraft manufacturer's revenue stream is dependent in part on a continuation of high jet fuel prices. What will the impact be on existing orders as well as retirements from existing fleets from this unexpected drop in fuel prices?

Every new aircraft presentation from the manufacturer begins with a promise that the newer model will have markedly better fuel burn (usually on the order of 15%) thereby providing operators cash savings on their largest operating expense. For a typical narrowbody aircraft, this represents about a 10% reduction in block hour costs provided fuel costs $4/gallon. However, at $2/gallon, that savings drops to only 5%, not a compelling argument for an airline considering replacing its current generation aircraft. Unfortunately, the fuel cost savings will always be offset by an approximate 30% increase in ownership cost per block hour. Although the manufacturer also promises an improvement in maintenance costs, after a honeymoon period, those costs will often increase back to the level of the older equipment. Regrettably, the ownership cost increase is permanent.

Presumably, there are valid reasons other than fuel burn why an operator would elect to replace an existing low capital cost asset with a significantly more expensive one.

- Technical obsolescence (i.e. IFE, navigation and cockpit related improvements not feasible for existing fleet type)
- Attractive long term engine maintenance contract on new fleet type
- Reduction in ancillary costs associated with newer equipment
- Favorable new equipment financing
- Tax and/or book advantages

The combined benefit from these other items could offset some or all of the higher capital cost.

Given the modest cash operating cost improvement from lower fuel prices, there is unlikely to be a mad rush to defer or cancel existing orders (new orders are a different matter) based on fuel prices alone. Forecasters did not foresee the unprecedented drop in prices and no one can accurately predict if or when they will rise again. A rational buyer would not likely alter a long-term decision based on short-term events. There would be have to be solid evidence of a sustained period of low oil prices to alter behavior or significant change in another block hour expense, such as finance rates.

One interesting question to consider – how will the airlines choose to redeploy their fuel cost savings?

- Lower fares (don't hold your breath)
- Return to the shareholders and/or employees (maybe)
- Buy more coach seats to squeeze into their cabins (probably for some)
- Order more new equipment (John Leahy's prediction)

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