

## **How much is the KC-45 tanker award worth?**

It's conventional wisdom—because the figures are what the Air Force said and the media has since reported without question—that the award is worth \$40 billion over 10-15 years. An alternative figure that's also been bandied about is \$30 billion. But it's unlikely that the contract is worth either of these figures. And the direct benefit to Airbus is far less.

Following the Boeing scandal of the 2001-2004 period, in which the price Boeing offered 100 KC-767s to the USAF was criticized as being way too rich—as well as more than EADS offered at the time—the Air Force took a different approach to pricing this time around.

When US Sen. John McCain scrutinized the original tanker deal, his office made a point of going to the commercial market to see how much airlines were paying for the 767-200ER, the model on which the KC-767 is based. McCain discovered, apparently much to the Air Force's surprise, that airlines get big discounts for bulk orders. (How this comes as a surprise to anyone who regularly reads *The Wall Street Journal* escapes us, but the USAF procurement system apparently was, we're told.)

As the Air Force sought bids for this round, officials used the new-found knowledge about how airlines drive down pricing to their advantage.

It's common knowledge in the commercial aviation world that for really big orders, discounts of 30% to list price are not at all uncommon. On occasion, discounts are even greater. Launch customers of a new equipment type often get 40% discounts and sometimes more.

Considering the plum of the KC-X contract and the fact that this time around there was actually real competition, the Air Force was in a position to drive a hard bargain. The Air Force acknowledged last week that pricing was “aggressive.”

Below is our number-crunching. Here are the assumptions:

*Number of Airplanes:* 179.

*Stated Values:* \$40 billion (“Scenario A”) or \$30 billion (“Scenario B”), as publicly reported and accepted.

*Commercial Discounts*, applied to the KC-X program: 30% or 40%.

*Production Rate*: 12 or 18 a year (a figure of 15 has also been reported). This data point allows us to calculate the annual revenue to the winner.

So our calculations give us the “list price” unit cost, followed by the discounted prices and the annual revenue to the winner at production rates of 12 or 18 a year.

Scenario A		Scenario B	
Procurement (000)	Unit Cost (000)	Procurement (000)	Unit Cost (000)
\$ 40,000,000	\$ 223,464	\$ 30,000,000	\$167,598
At 30% Disc.	\$ 156,425		\$117,318
At 40% Disc.	\$ 134,078		\$100,559

Production Per Year	Scenario A	Scenario B	Production Per Year	Scenario A	Scenario B
	Revenue (000)	Revenue (000)		Revenue (000)	Revenue (000)
12	\$2,681,564	\$ 2,011,173	18	\$4,022,346	\$3,016,760
30% Discount	\$1,877,095	\$ 1,407,821		\$2,815,642	\$2,111,732
40% Discount	\$1,608,939	\$ 1,206,704		\$2,413,408	\$1,810,056

The all-in price at a 30% discount from \$40 billion is \$28 billion. A 40% discount is \$24 billion. If \$30 billion is the starting point, a 30% discount means a price of \$21 billion and a 40% discount is \$18 billion.

Recall that Northrop Grumman, when calculating the number of US jobs the KC-30 program would create, used an assumed starting price of \$160 million for the mathematical formula created by the US Department of Commerce. Although Northrop at the time stressed this was merely an example number, it coincides (perhaps coincidentally) pretty close to the 30% discount unit price in Scenario A, above.

**What’s this mean for Airbus?**

It’s important to remember that Airbus doesn’t get all this revenue even though the KC-30 is based on its A330-200. Northrop gets its cut as the prime contractor. The suppliers to the airplane, such as those for engines, avionics, landing gear and so on, are paid out of this revenue stream and unit price. Engines, for example, eat up 25% of the airplane’s cost right off the top. While we don’t have any credible estimate how much the suppliers’ cut is of the remaining 75% of the plane’s price, and we have no way of knowing the

Northrop cut or the cost of the military hardware, by the time it's all said and done, the final revenue stream to Airbus is a sharp discount to the total price paid by the Air Force.

Northrop has said that 58% of the KC-30 by value will be US content. This certainly suggests that of the total price, Airbus will see only 42% of the gross revenue stream, or as little as \$788 million a year before paying its European suppliers under the 30% discount, 12-planes a year Scenario A outlined above.

When you consider that Airbus' estimated revenue last year was around \$44 billion, the gross Airbus cut represents 1.73% of annual revenues at the low-end scenario.

While the contract is considered a plum for the winner, aerospace analyst Richard Aboulafia is correct when he says in the context of total annual production and revenues, the KC-X contract is minuscule. Boeing delivers more than 450 commercial airplanes a year; 12 or 18 don't even make a dent in production rates. Boeing's full year 2007 revenues were \$66 billion; annual revenues, depending on the production rate and pricing, of \$1.8 billion to \$3 billion really wouldn't have amounted to much, less than 5% at the top end of the production rate. EADS hasn't reported full year 2007 results yet but had revenues of \$28 billion (at today's exchange rate) for the half year, or an estimated \$56 billion if this figure is simply doubled for the full year. Airbus, which accounts for 80% of EADS revenues, also delivers more than 450 airliners a year, so the production rate of the KC-X doesn't mean much, either.

None of this means that this is anything to sniff at. And there are larger issues at work here, all of which we've written about many times and won't repeat today.

But this mathematical exercise attempts to put some meaning to the contract.

*By Scott Hamilton, March 4, 2008*