

Power Play: Changing Engines with the Oil

By Don Mitchell

I spoke recently at a conference where the following question was raised: *Should a lessor care whether the same engines installed on the aircraft at delivery are returned at the end of a lease?* There was disagreement on the panel, and in the context of exploring how lessees and lessors can strengthen relationships, perhaps this is an issue ripe for review.


The Lessor's Perspective—What's Mine is Mine: Lessors are primarily concerned with value preservation and predictability. Well-crafted maintenance and recordkeeping requirements and return conditions provide insurance against receiving a boat anchor at return and an engine that can remain on-wing with a follow-on operator for a measurable time after delivery. The engines are the most valuable part of an aircraft, indeed even *exceeding* the value of the airframe as the aircraft ages. Providing the flexibility to exchange engines mid-term, except in the case of a total loss, upsets the negotiated balance that is struck in the lease and fully protects the lessor from the unknowns that may exist with an engine of a different pedigree. Flexibility, which adds uncertainty, may also impact remarketability of the aircraft. As most aircraft are financed, engine swaps can be difficult if not built into the financing from the outset. There are tax, accounting and security issues to consider, including the preservation of the lessor's and its lenders' perfected interests and priorities in the engine. And what about reserves? A lessor won't want to repay reserves before a scheduled maintenance event as an adjustment for an exchanged engine in better condition.

The Lessee's Perspective—What's Yours is Mine: In contrast, lessees are primarily concerned with flexibility. Those with large enough fleets view engines as "plug-and-play" items where a focus on lease restrictions may be sidelined in favor of maintaining a smooth and reliable operation. Engine return minimums are a distraction and complication, requiring a juggling act in the maintenance planning process that is inefficient, time-consuming and costly. And if an engine is below minimums or otherwise fails a return inspection, the lessee is facing a costly overhaul or repair when another suitable engine may be available in the fleet or, depending on market conditions, elsewhere. If the parties have negotiated minimum conditions at return, why does it matter what engine those minimums are on?

The lease, when you look at it, reflects the value of the aircraft at a snapshot in time. The parties should thus be able to easily administer an engine exchange at any time during the lease term.

Managed Flexibility: As a practical matter, the parties have already agreed to engine exchanges in the lease—in the context of a total loss to an engine. In this case, the lessee sources the replacement engine and, subject to the lessor's inspection, the replacement engine is substituted for the destroyed engine. The fundamental objective is that the replacement engine has the same value and utility as the engine replaced at the time just prior to its loss. This well-established practice should translate easily to discretionary replacements. The lease, when you look at it, reflects the value of the aircraft at a snapshot in time. The parties should thus be able to easily administer an engine exchange at any time during the lease term. Essentially the hard asset of the engine plus maintenance reserves held on account (assuming reserves are not at a concessionary rate) should equal the value of a fully overhauled engine. Reserves accounts can be adjusted to account for any differences in residual life.

This becomes more complicated when considering conditions that are difficult to measure objectively. For example, determining "time remaining" is challenging when you consider that engines are maintained "on condition." You can examine trends in other engines in the lessee's fleet, but results may vary. In addition, first-run engines have a longer on-wing time than overhauled engines and therefore have greater value. Lastly, records and pedigree are as important as physical condition. You can have two engines with the same time remaining, yet one operated in a harsh or high-cycle environment, and another not.

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An event of loss causes a forced replacement—it simply must be done and the lessee’s insurers will likely pay the bill. By contrast, the dynamics of a discretionary replacement for the convenience of the lessee are different. The lessor’s veto right given in the context of a loss could unfairly limit the lessee’s ability to conduct a discretionary exchange and having too many restrictions would dilute this right. To address this, the parties can document comprehensive and objectively measurable conditions within which the lessee could have free reign to substitute engines. For example, the selection of candidate engines from within the lessee’s fleet should address the pedigree and recordkeeping issues. Imposing margin requirements could provide a cushion for condition. Lastly, the lease return conditions, ongoing maintenance requirements and existing inspection rights provide backstop protection for the lessor.

In the final analysis, if the parties can agree as a fundamental concept that each maintains an equal footing in the context of discretionary engine exchanges, then there is no cost to providing flexibility—only the benefit of a cooperative and positive working relationship. ▲

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