Appendix B

Memo to Senator John McCain
from Mitchell E. Daniels, Jr.,
Director, Office of Management and Budget

May 3, 2002
The Honorable John McCain  
United States Senate  
Washington, DC 20510

Dear Senator McCain:

Thank you for your letter of April 17, 2002 in which you asked us for the preliminary results of our analysis of the following areas related to the Air Force’s tanker fleet.

**Air Force tanker analyses related to KC-135E replacement and tanker requirements**

The Air Force has recently completed two studies of its tanker fleet and tanker requirements – the KC-135 Economic Service Life Study (ESLS) and the Tanker Requirements Study 05 (TRS-05). The ESLS and TRS-05 were both large, detailed, computer-based analyses of the fleet and tanker requirements of which OMB does not have intimate knowledge. However, we are aware of the major conclusions of these studies.

The ESLS looked at the projected cost of maintaining the current fleet of KC-135 tankers (both the ‘E’ and the ‘R’ models) and at the availability of the aircraft as they age. The study concluded that maintenance costs would rise by $23 million/year over the next 40 years. In terms of aircraft availability, the ESLS concluded that there would be a gradual decline as the aircraft age. However, the study determined that only six aircraft would have to be retired before 2040 because they would exceed their airframe life. The TRS-05 examined force (in this case tanker) requirements in various strategic scenarios (the TRS-05 was based on the same scenarios and assumptions as DoD’s Mobility Requirements Study 05). We understand that TRS-05 identified tanker capacity shortfalls under some specific (classified) circumstances.

The Air Force proposes to replace the entire KC-135E fleet with 100 Boeing 767 tanker aircraft. Although the ESLS and TRS-05 did not examine the question of replacing aircraft in the existing fleet, they are pertinent to the issue since:

- the current fleet consists of about 410 KC-135Rs and 126 KC-135Es in good condition, providing a total KC-135 tanker capacity of about 105 million pounds of fuel;
- upgrading 126 KC-135Es to the ‘R’ model would result in a total capacity of over 106 million pounds of fuel - an increase of around 1.7 million pounds over existing capacity. The estimated cost of converting the 126 ‘E’ models to ‘R’ models to get this increase would be about $3.2 billion. However, the Air Force has chosen not to pursue this route;
replacing 126 KC-135Es with 100 Boeing 767 tankers, while maintaining 410 KC-135Rs, would result in an overall tanker fleet capacity of about 103 million pounds of fuel— a decrease of almost 2 million pounds (because the larger capacity of a B-767 would not be enough to compensate for the less than 1:1 aircraft replacement rate). The estimated cost of the B-767s would be between $18 billion and $26 billion (the difference between direct purchase and leasing due to the cost of money).

In other words, replacing the KC-135E fleet would not solve, and could exacerbate, the shortfalls identified in the TRS-05. It is quite possible that greater operational availability of the new B-767 aircraft could mitigate the impact of such a reduction in total fleet capacity. We will continue to assess these issues as the Air Force develops its proposal.

A cost comparison between possible alternatives for improving the tanker fleet

The Air Force's discussions with Boeing regarding leasing 100 B-767 tankers are still ongoing. We, therefore, have no basis to change our previous cost estimates for leasing or direct purchase of B-767 tanker aircraft. We believe, however, that there are four options for the tanker fleet:

Do nothing. This is the path analyzed by the Air Force in its two studies. It results in increased long-term costs of $23 million/year paid out over 40 years, accepts the risk of shortfalls in certain scenarios, but avoids potentially large up-front costs of $3-26 billion depending on the option.

Convert 126 KC-135 'E' tanker models into KC-135 'R' models. The AF has already conducted a re-engining and upgrade program for most of its KC-135s, to convert them to the 'R' model, which the Air Force plans to keep in service until perhaps 2030 or 2040 depending on usage. In all, the Air Force has already re-engined 410 aircraft, leaving only 126 'E' aircraft in the Air National Guard fleet with older engines that could also be converted into an 'R' model. Such an option could be achieved for an estimated cost of about $3.2 billion spread over a period of 6 years (about $525m/yr). The advantages of this option are that the fuel offload capacity of each aircraft would be increased and the total fleet capacity increased to solve some of the shortfalls identified in the TRS-05. Moreover, maintenance costs of the current aircraft would be reduced. In addition, this option would increase the capacity of the fleet sooner than other alternatives (all converted aircraft could be delivered by 2009).

Direct purchase of 100 Boeing 767 tanker aircraft and retirement of the KC-135E fleet. Based on a price of $150 million per airplane, which we understand is a reasonable possibility, and including required military construction, this option would cost approximately $18 billion and would not be complete before 2011/12. The Air Force would have to fully fund these aircraft in its budget request. New B-767s would provide the Air Force with all the advantages of a modern aircraft with greater availability and a potential life longer than that of converted KC-135R aircraft. However, because 100 B-767 aircraft would replace 126 KC-135Es, the total tanker fleet capacity would be reduced and would not solve any of the shortfalls identified in TRS-05.
Lease 100 Boeing 767 aircraft in accordance with section 8159 of the FY2002 Defense Appropriations Act. We understand section 8159 to mean that the lease would cover the aircraft in its basic, or transport, configuration, which the Air Force would then modify into a tanker configuration. At the end of the 10 year lease period the Air Force would de-modify the aircraft and return them to Boeing in their original transport configuration. In this way the Air Force could meet the criteria of an operating lease. The Air Force believes that the base aircraft cost is $90 million with tanker conversion and de-conversion costs adding $60 million to the price. As we indicated to you in our letter dated December 18, 2001, we believe that the total cost of this option would be $26 billion in then-year dollars. This option would provide aircraft on the same schedule and have the same tanking capacity as the direct purchase option with lower near-term costs, but would require that the Air Force return the aircraft after 10 years, meaning that they would have to develop an alternative for the tanker fleet by that time.

We have no basis at this time to change our $26 billion estimate, since discussions between the Air Force and Boeing to determine the possible lease arrangements for such an aircraft are still ongoing. However, we understand that the Air Force interprets section 8159, together with a colloquy reported in the Congressional record on December 20, 2001, to mean that a B-767 tanker is a general purpose aircraft. In an exchange involving Senators Stevens, Roberts, Inouye, and Murray, the Members stated they believed a converted 767 qualified “as a general purpose aircraft.” This position presumes there is an active commercial market for tankers which would therefore relieve the Air Force of costs associated with conversions.

Clearly, this interpretation would make it financially easier for the Air Force to meet the conditions for an operating lease imposed by section 8159 because they could amortize the costs of tanker conversions over ten years instead of paying for conversions up front. While we are currently unaware of any commercial buyer or interest in purchasing 100 tankers, OMB will provide its views on the Air Force interpretation to you in the next few weeks.

The Air Force’s tanker RFI process

OMB did not conduct a detailed analyses or audits of the Air Force’s RFI process for tanker aircraft. However, our overall impression of the Air Force’s tanker RFI process is that it was done in a reasonable and fair manner. From what we know we have no reason to believe that the outcome would have been any different had another entity evaluated the two proposals, given the Air Force’s requirements. Boeing simply appears to have more experience in air-to-air boom refueling than Airbus. Regarding other potential companies, we do not know of any other companies that were both capable of, and interested in, responding to the RFI.

Leasing policy

You asked us to examine the policy of leasing major defense programs and to evaluate the role of DoD’s recently established Leasing Review Panel. When analyzing capital leases, we believe it is critically important to compare the full cost of the lease with other methods of acquiring the capital assets, including direct purchases. We also believe that the President and the Congress should consider the full cost of capital acquisitions when they make budget decisions to allocate resources to Federal agencies and programs. For that reason, we strongly
support the budget scoring rules for leases, which were agreed to by the Congress and the President as part of the Budget Enforcement Act of 1990. The rules distinguish operating leases from capital leases and address the fact that some capital leases are virtually equivalent to the purchase of a capital asset, with most or all of the benefits and risks of ownership transferred to the government, while others are more like rentals. They require agencies to fund the full cost of purchases, lease purchases, and capital leases up-front in the first year of the transaction. In this way, the full cost is recognized at the time when decisions are made to incur that cost, regardless of the source and form of financing, so that Congress and the President have the incentive and the information necessary to make the most efficient use of taxpayers’ money.

The Defense Department’s Leasing Review Panel, of which OMB is a member, has not yet met because the Air Force has not yet completed its proposal to lease B-767s and B-737 executive jets.

**Infrastructure costs**

As we indicated in the attachment to our December 18, 2001 letter, we believe the infrastructure costs associated with the purchase or lease of Boeing 767 aircraft to be approximately $1 billion.

Sincerely,

Mitchell B. Daniels, Jr.
Director