Booming commercial demand and escalating pressures on U.S. defense spending were among the key topics at the annual Reuters Aerospace and Defense Summit. Airlines and aerospace companies are riding high while defense companies are girding for sharp cuts in the Pentagon’s $500 billion plus core budget. Top industry and government officials mapped out what challenges and opportunities the current environment presents for industry, government and big-ticket arms programs such as the $392 billion-plus F-35 fighter aircraft, the Pentagon’s costliest weapons program. The Pentagon’s top weapons buyer was among the high-level guests who helped Reuters subscribers make sense of the expected impact of a decade of mandatory U.S. budget cuts, joined by top executives from Lockheed, Boeing and more. On the commercial side, senior executives from United Continental and JetBlue weighed in on changes in the airline industry and the consequences of U.S. Justice Department’s attempt to block the planned American-US Airways merger.
The Pentagon would have to slash its budget by about $20 billion in fiscal 2014 from a year earlier if mandatory budget cuts remain in effect, the chief arms buyer for the U.S. military said on Wednesday, calling that an increasingly likely scenario.

Frank Kendall, U.S. undersecretary of defense for acquisition, technology and logistics, said the cuts would fall disproportionately on the Pentagon’s procurement and research and development accounts, since it was difficult to harvest savings from personnel accounts on short order.

He told the Reuters Aerospace and Defense Summit that an “awful lot of smaller programs” faced delays, cuts and even cancellation if the cuts stayed in effect, while fewer of the big-ticket weapons programs would be affected.

He underscored the Pentagon’s support for its biggest weapons program, the $392 billion Lockheed Martin Corp (LMT.N) F-35 Joint Strike Fighter, calling it the military’s highest priority conventional warfare program.

The Pentagon must cut its base budget by $500 billion over the next decade from planned spending levels under the process called “sequestration”—cuts that come on top of $487 billion in reductions already planned. Military leaders have urged Congress to reverse the cuts, but lawmakers have failed to reach agreement on alternative ways to reduce the federal deficit.

Kendall said he had experienced previous downturns in defense spending, but the current gridlock in Congress was unprecedented, and the resulting uncertainty was wreaking havoc on the ability of the military and industry to do any planning.

He declined comment on the possibility of U.S. strikes on Syria, but said the budget cuts would limit the military’s ability to respond to natural disasters like the 2010 earthquake in Haiti or the 2011 earthquake and tsunami in Japan.

“As we design our budgets to be tighter and tighter because of sequestration, we’ve given up our ability to absorb that type of thing,” he said.

He said big contractors like Lockheed, Boeing Co (BA.N) and General Dynamics Corp (GD.N) would weather the downturn, but he worried about smaller suppliers which are finding it difficult to secure capital for investments in the current market.

The Pentagon is keeping a close eye on the health of such smaller firms and has small pots of money available to help them with cash or programs under certain conditions, he said.

If the budget cuts stayed on the books, Kendall said the U.S. military would likely end up with tiered system that provided some military units with very good equipment, and others with older, less capable equipment.

Given the uncertainty about future budget levels, Kendall said he was deferring some commitments on acquisition programs. He declined to name specific programs, or estimate how many programs could face delays or cancellation.

“Depending upon how long this lasts, there’ll be more on the list as time goes on,” he said. “Until we can go through the fiscal year 2015 planning process and do some more detailed analysis on what long-term sequestration might look like, we don’t really want to make major commitments that we might have to defer.”

Editing by Ros Krasny, Andre Grenon and Edwina Gibbs
F-35 fighters still highest priority despite budget cuts: Pentagon

BY ANDREA SHALAL-ESA
WASHINGTON, SEP 4, 2013

The Pentagon’s chief arms buyer on Wednesday said he did not expect the U.S. Navy to significantly change its plans to buy F-35 fighter jets built by Lockheed Martin Corp (LMT.N), despite mounting pressure on the U.S. military budget.

Frank Kendall, undersecretary of defense for acquisition, technology and logistics, told the Reuters Aerospace and Defense Summit that the $392 billion F-35 Joint Strike Fighter was the U.S. military’s highest priority conventional warfare program.

He said the Navy needed the added capabilities that the F-35 offered, noting that other countries were developing their own radar-evading fighter planes, advanced electronic warfare capabilities and other advanced weapons that threatened the U.S. military’s ability to “control the air.”

“I don’t see any indication that the Navy is going to change its plans in any fundamental way,” Kendall told the summit.

The Navy and other branches of the military have been mapping out their options if lawmakers fail to reverse mandatory budget cuts and they are forced to implement an additional 10 percent budget cut in fiscal 2015.

One possibility under discussion has been a two-year pause in orders for the F-35C carrier variant, a move that could increase the cost of the remaining aircraft to be bought by the Marine Corps and the Air Force, according to four sources familiar with the issue.

Kendall’s strong endorsement of the added capabilities of the F-35 marked a setback for Boeing Co (BA.N), which is offering the Navy upgrades of its F/A-18 Super Hornet fighter in the hopes that it can sell more of those planes.

“The F/A-18 is a great airplane, but it’s a fourth generation fighter. The F-15 is a great airplane, the F-16 is a good airplane, but they’re fourth generational fighters, and you get a quantum improvement in capability out of the F-35,” Kendall said.

Lockheed is building three variants of the F-35 for the U.S. military and the eight partner countries that are helping fund its development: Great Britain, Australia, Canada, Norway, Italy, Turkey, Denmark and the Netherlands. Israel and Japan have also placed orders for the new jet.

Kendall said Pentagon leaders next month would assess a new lower estimate of the long-term operating and maintenance cost of the jets recently prepared by the F-35 program office.

He said he expected a drop in the previous estimate of $1.1 trillion, but perhaps not one quite as steep as the projection by the F-35 program office, which now estimates it will cost $857 billion to maintain a fleet of 2,443 jets for 55 years.

He acknowledged that a decision to reduce the size of the U.S. military spurred by the budget cuts could lead to a reduction in the total number of jets to be purchased, but said those decisions were still several years off.

In the meantime, he said the Pentagon was focused on increasing the production rate so that the price of each airplane would come down.

Kendall said the F-35 program was making progress, as was the complex pilot helmet built by a joint venture of Rockwell Collins (COL.N) and Israel’s Elbit (ESLT.TA), which fuses data from the many sensors on board the plane.

He said the Pentagon hoped to be able to use the primary helmet, but it was continuing to fund work on a less capable alternative being developed by BAE Systems (BAES.L) in case the other helmet did not advance quickly enough.

He said he also remained concerned about bringing the cost of the primary helmet down.

Additional reporting by Paige Cance; Editing by Ros Krasny, Lisa Shumaker and Edwina Gibbs
Travel to suffer as defense industry cuts budgets

BY NIVEDITA BHATTACHARJEE AND KAREN JACOBS
WASHINGTON, SEP 4, 2013

Having enjoyed a relatively strong summer travel season, U.S. hotels and airlines face a potential hit this autumn as the nation’s defense industry and government departments rein in travel spending.

Officials at the Pentagon and top U.S. defense companies told the Reuters Aerospace and Defense Summit this week that they are cutting travel by double-digit percentages to deal with the latest round of automatic spending cuts caused by sequestration. The reductions could create a replay of cuts in the spring that reduced airline revenue when sequestration first hit U.S. government spending.

“I get a list of the top 10 violators” of travel spending, said Dale Bennett, executive vice president for Lockheed Mission Systems and Training. Emphasizing the attention paid to travel, he said he now carries this list along with monthly travel reports in his briefcase.

His division, with 18,000 staff, is cutting travel 10 percent to 15 percent compared with last year. His unit oversees the company’s execution of programs for the U.S. Air Force, Navy, Army, Coast Guard and Marine Corps.

He and others are using more teleconferences to stay in touch with customers. Frank Kendall, the Pentagon’s top arms buyer, said his department has cut back on travel “a lot” as part of 20 percent reductions in headquarters budgets.

Travel cuts do little to close the large Pentagon budget gap, Kendall said, but they are weighed against staffing cuts.

“When we furloughed people ... we all took a hard look at what we were doing,” he said. “Do I want to take this trip or do I want to have somebody work for another day?”

GOVERNMENT EFFECT

Overall corporate travel appears to be recovering with the economy. And defense officials and executives said they still must make trips to work with companies and governments around the world. Many in-
International deals depend on handshakes and personal contacts.

Linda Hudson, outgoing chief executive of the U.S. unit of Britain’s BAE Systems, said employees must still make trips.

“And if we put people on long overseas flights, we’re going to put them in a cabin where they can be comfortable and work,” she said.

But weapons makers and suppliers like Lockheed Martin (LMT.N), BAE Systems (BAES.L), Boeing (BA.N) and EADS North America (EAD.PA) told the Reuters Summit they are reducing travel in an effort to contain costs as sequestration casts uncertainty over the weapons industry. Some are even asking their clients to put caps on travel expenses.

The unanimous caution by defense industry officials and executives at the Reuters Summit suggests continued weakness in government spending, which accounts for 3 percent to 4 percent of airline revenue. Many companies told this Summit, held in Reuters’ Washington office, that 2014 could be worse, with more cuts to come as sequestration continues.

The automatic budget cuts known as sequestration took effect on March 1 and defense spending has taken the single biggest hit from the cutbacks, with a $46 billion reduction through the September 30 end of the fiscal year.

Janus Research analyst Kristopher Kelly said he did not expect the budget cuts to be “a big deal” for airlines. But after sequestration reductions took effect US Airways Group (LCC.N) and Delta Air Lines (DAL.N) said the cuts reduced revenue from government customers in the first half.

Unit revenue, a measure of pricing power and how full planes are, fell in April as U.S. carriers also grappled with sequestration-related furloughs of air traffic controllers. Delta and US Airways reported drops of 2 percent and 4 percent, respectively, for April.

For hotels, business travel and leisure travel have mostly recovered but one area that is still lagging is group meetings and conventions, said Patrick Scholes, a hotel analyst with Suntrust Robinson Humphrey.

Kelley said he now expects government cuts to affect airlines this fall, despite a “decent summer” season.

David Fitzpatrick, managing partner at AlixPartners, an aviation consulting firm, said that if travel falls, airlines are likely to respond by cutting capacity, so that they can keep planes full and profitable.

Hudson of BAE Systems said customers were very creative in 2013 in tapping into resources they had available. “In 2014 most of that’s going to be gone,” making companies look harder for ways to cut expenses.

For airlines and hotels, the dire outlook could foreshadow future hurt as travel goes into its autumn slump. Airlines have already seen a sequestration-related hit earlier this year, when a fall-off in government demand hurt travel revenues.

US Airways, which has a dominant share of takeoff and landing slots at Washington’s Reagan National airport, said U.S. spending cuts reduced revenue from government customers by 30 percent in March. Delta joined in, saying reduced last-minute bookings by government workers cut its unit revenue in March.

‘ATTACKING TRAVEL’

In July, Southwest Chief Executive Gary Kelly said traffic from government spending was “down dramatically.”

“Ttink we all know that sequestration is real,” the CEO said on a call with analysts.

Hudson said BAE System’s U.S. unit was “attacking travel in particular” by negotiating price discounts with airlines and urging more teleconferencing. The unit pared travel spending by 11.9 percent in 2012. Through July 2013, such expenses are down about 20 percent from a year earlier, she said.

At EADS North America, Chief Executive Sean O’Keefe, a former NASA administrator, said that although travel spending at his company was down “easily in the range of 15 to 20 percent” this year, it was not the main focus when it came to cost cuts.

O’Keefe said his company was paying more attention to items such as hiring when it came to cutting costs.

Boeing is also putting a key focus on travel costs, said Dennis Muilenburg, president and chief executive officer of Boeing Defense, Space & Security. He added that “in some cases, travel, spending time with our global supply chain, spending time with our global customers, is an investment in the future.”

Reporting by Nivedita Bhattacharjee and Karen Jacobs in Washington; Additional reporting by Andrea Shalal-Esa and Paige Cance; Editing by Alwyn Scott and Chris Gallagher
EADS (EAD.PA) is opting out of bidding on some U.S. weapons programs as it adjusts to cuts in U.S. defense spending, and it expects flat to lower revenue in defense business in coming years as the cuts deepen, a senior executive said on Wednesday.

“There’s no doubt that the government sector is flat to declining and we’re forecasting the same,” Sean O’Keefe, chief executive of EADS North America, told the Reuters Aerospace and Defense Summit.

International sales may compensate somewhat, he added. The company is gearing for a tough year for its defense business even as its Airbus commercial jetliner business books a record backlog of orders, including a sale of 40 jets to Delta Airlines (DAL.N), announced Wednesday, a deal worth $5.6 billion at list prices that ends nearly two decades of exclusive Boeing (BA.N) sales to the U.S. airline.

O’Keefe, speaking at the Reuters office in Washington, D.C., said the U.S. bidding process has slowed in response to budget cutting and sequestration, which he called “a self-inflicted fiscal challenge that nobody’s ever seen before.”

He said EADS is targeting defense contracts that allow it to build on core strengths, while avoiding far-reaching programs that might not pay off. For example, the U.S. Army’s vertical lift aircraft program.

“I wouldn’t say that we’re walking away from things, we’re just being much more specific about the core competencies,” he said.

EADS’ defense-related businesses represent about 30 percent of overall revenue with the remainder from Airbus commercial aircraft.

In July the company said it would restructure and rebrand itself under the Airbus name, a shift caused in part by its failed effort to merge with BAE Systems PLC (BAES.L) earlier in the year. EADS had long sought to establish a defense-business identity separate from the Airbus brand, which had links to the longstanding rivalry and trade dispute with Boeing.

The attempt to merge with BAE Systems “opened up a whole new strategy” from its previous goal of balancing the size of its aircraft and its defense businesses, O’Keefe said.

The failed merger “gave us an opportunity to rethink what our strategic objectives are,” he said.

O’Keefe said the company isn’t concerned that using the Airbus name would put it at a disadvantage in bidding for U.S. defense work. The competition with Boeing to supply aerial refueling tanker aircraft, he said, showed that EADS can compete on equal footing in the United States, and that buyers don’t need to accept sole-source suppliers. Boeing ultimately won the $35 billion tanker deal on its lower price in 2011. Airbus won an earlier round in 2008 with partner Northrop Grumman (NOC.N).

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Reporting by Alwyn Scott; Editing by Phil Berlowitz and Andrew Hay
Boeing defends work on U.S. missile defense system

BY ANDREA SHALAL-ESA
WASHINGTON, SEP 4, 2013

The head of Boeing Co’s (BA.N) defense business defended his company’s work on a U.S. ground-based missile defense system even though it failed to intercept a missile during a test in July, and called for more frequent testing in the future.

Dennis Muilenburg, president and chief executive of Boeing Defense, Space & Security, told the Reuters Aerospace and Defense Summit that the Pentagon should complete its review of the failed July 5 intercept within a few weeks.

Reuters reported on July 12 that a faulty battery may have prevented the interceptor’s separation from the rocket, an account confirmed by multiple sources since then.

Officials, speaking on background, said the lithium oxyhalide battery made by privately held Eagle Picher flickered off just before the planned separation. It was not immediately clear if the problem was caused by the battery itself or the electric circuits controlling it, they said.

Eagle Picher has declined comment.

U.S. defense officials have said only that the test involved an “anomaly” that caused the interceptor, which is built by Raytheon Co (RTN.N) to separate from the third stage of the rocket, which is built by Orbital Sciences Corp (ORB.N). Boeing is the prime contractor and integrator for the overall system.

Muilenburg declined to give details about the likely cause of the test failure, but said the Missile Defense Agency and Boeing still learned a lot from the wide range of sensors and systems used in the test, even though the missile interceptor did not hit its target.

“The reason we do these test shots is to push the system to demonstrate the integration capability, and to take on new and more difficult targets and challenges,” Muilenburg said.

He called for further, increased testing of the system. “We see a need to continue to test that program ... on a regular basis. That’s what will drive the reliability of the system.”

Muilenburg bristled at comments from missile defense experts who say the Boeing system has been plagued with quality issues, noting that it was the only system defending the United States against a missile attack.

But he said Boeing would invest in a targeted way to improve the reliability and quality of the system.

Once the Pentagon completed its review, Boeing would work with the government to address quality and reliability issues, Muilenburg said.

“We’ll get to the bottom of what happened and we’ll continue to invest in the system in a way that makes it reliable for the country,” he said.

Editing by Stephen Coates
JetBlue not interested in merger, acquisition: CEO

JetBlue Airways aircraft are pictured at departure gates at John F. Kennedy International Airport in New York June 15, 2013. REUTERS/FRED PROUSER

JetBlue Airways Corp (JBLU.O), mentioned as a possible takeover candidate if the proposed merger of US Airways Group Inc (LCC.N) and American Airlines (AAMRQ.PK) collapses, is not interested in a merger or acquisition, its chief executive said on Tuesday.

Speaking at the Reuters Aerospace and Defense Summit, CEO Dave Barger said JetBlue had an interest in assets such as airport gates that become available as a result of mergers. “But mergers and acquisitions: just not of interest to JetBlue. Independence into the future is our plan,” Barger said.

The Justice Department and several U.S. states sued last month to block the merger of American parent AMR Corp and US Airways, saying it would hurt consumers by raising airfares and leading to service cutbacks. A federal trial to determine whether the two carriers will be allowed to form the world’s biggest carrier is set to start November 25 [ID:nL2N0GV0Q].

Barger, who spoke by phone to the summit being held in Washington, also said that the carrier is on the right track and focused on increasing its footprint this year and into 2014, despite some on Wall Street being skeptical about its positioning between full service airlines like Delta Air Lines (DAL.N) and no-frills carriers like Spirit Airlines (SAVE.O)

JetBlue shares have risen 7.52 percent since the beginning of the year, while Delta has risen 66.2 percent and Spirit is up 75.8 percent.

“I know we are penalized because we are growing. I know that we are and at the same time it is so important for us to continue to grow our network,” Barger said.

The CEO also said the combined American-US Airways should not get more slots at Reagan National, and the combined airline would control 69 percent of slots there, the Justice Department stated in its complaint.

“US Airways is already in the No. 1 position at our nation’s capital,” Barger told the Reuters summit. “We actually think that they should remain at the level that they’re at.”

Barger added: “When you think about access into our nation’s capital — we’ve worked for over 10 years to gain access into Reagan National.”

Barger said New York-based JetBlue, which is growing in markets such as Boston and Fort Lauderdale, Florida, and is trying to gain more business passengers, wanted to get more slots at Reagan National.

JetBlue shares closed down 0.8 percent at $6.10 on Nasdaq on Tuesday.
Boeing, Airbus face new threat: low jet sales

BY ALWYN SCOTT
NEW YORK, SEP 3, 2013

With U.S. military spending in decline, Boeing and Airbus investors have been counting on record commercial aircraft sales to keep profits rising.

Now some industry experts are voicing concern that jetliner sales are at risk as economic conditions shift and smaller airlines that placed big orders take on bigger rivals.

The issue is among those to be addressed at the Reuters Aerospace and Defense Summit in Washington, D.C., September 3-5, which gathers top decision makers from the industry.

High fuel prices have spurred massive orders for new fuel-efficient planes. An era of low interest rates and export credits have made the new jets unusually affordable.

Boeing Co (BA.N) and Airbus (EAD.PA) have nearly 10,000 orders - about seven years of production - their biggest backlogs ever, and are building jets at historically high rates.

Boeing is on pace to produce up to 645 jets this year, more than at any time in its history. Airbus delivered 295 jets in the first half, up 6 percent from a year earlier.

The prospect of rising interest rates that would make it harder to finance sales and steady or lower fuel prices that would lessen the need for fuel efficient jets could trigger a sea change. Industry experts warn that new orders could taper off sharply and cancellations and deferrals could rise.

A slowdown could affect not just plane makers and the tens of thousands of workers they employ, but the global network of suppliers, including engine makers in the United States and Europe.

Shareholders could suffer a sharp reversal in Airbus and Boeing shares, whose prices have soared 48 percent and 38 percent, respectively, this year. Investors are counting on high production to bring the long-awaited cash payback from the heavy investments both companies made in new planes over the last decade.

Some airlines already are positioning to capitalize on the global shakeout.

Emirates Airline, the fast-growing carrier that connects Asia, Europe, Africa and the Americas through Dubai, said it aims to grab market share as weaker airlines struggle and fail in the next few years. Those airlines without large networks and without the focus of super-discount carriers, will be squeezed, it said.

“The gap between the winners and losers - or between the customer focused and the less customer focused airlines - will increase,” Thierry Antinori, chief commercial officer of Emirates, said in an interview.

“So we see opportunity.”

DOUBLE COUNTING

Boeing and Airbus predict the number of jets flying travelers around will double over the next 20 years to more than 30,000, worth some $4 trillion at list prices. This is just normal industry growth that has averaged about 5 percent a year historically, supporting demand for travel and planes.

“All of the data points to a strong and resilient airplane market,” said Boeing spokesman Marc Birtel, noting that plans are full and airlines are making modest profits.

“There’s no indication that the market is slowing down or that there’s overcapacity.”

Airbus says the current upswing in the cyclical aircraft business will lead to an “inevitable change in business plan for more than one carrier, ultimately resulting in order changes.” Airbus and other forecasters already factor in lost orders, Airbus spokeswoman Mary Anne Grezin said.

Some airlines see a rich opportunity to grow in the space between big carriers and super discounters.

“You can live in the so-called middle,” JetBlue Airways (JBLU.O) CEO David Barger told the Reuters Aerospace and De-
fense Summit on Tuesday.

“There are a lot of companies that are just terrific companies today that grew up in the middle, stayed in the middle and now are really market leaders,” Barger said at the summit, held at the Reuters office in Washington.

Yet some experts say the airlines themselves have been double-counting the demand for travel, and basing massive orders on faulty assumptions.

Boeing predicts, for example, that air traffic in the Asia-Pacific region will increase 6.3 percent a year over the next 20 years, driven by 4.5 percent annual economic growth in China and India and rising middle-class incomes.

But if each airline expects 6.3 percent growth and buys planes accordingly, they quickly create an oversupply of seats. While that’s good for travelers, who will pay lower fares as airlines battle on price, it spells trouble for airlines.

“Expectations of unlimited growth are going to have to come down to earth,” said Richard Aboulafia, an analyst at the Teal Group, a consulting firm in Virginia. “There just isn’t that much traffic to go around.”

He said the industry is unlikely to have another decade like the last one, with cheap financing, high fuel prices, a new crop of efficient planes, the rise of Middle Eastern carriers and strong growth in Brazil, India and China.

Middle Eastern carriers, leasing companies and many other airlines have been ordering jets to meet demand, said Adam Pilarski, a senior vice president and economist at Avitas, a consulting company near Washington.

“But they forgot to tell all the other airlines to stop buying because they’ll be carrying their traffic,” Pilarski said.

Emirates, for example, notes that two-thirds of the world’s population is within eight hours flight of its Dubai hub. It has 193 aircraft on order, including 55 A380s, adding to 35 A380s already in its fleet.

Other Middle Eastern carriers such as Qatar Airways and Etihad Airways are ordering jets to serve the same market.

ORDER CANCELLATIONS

Airlines typically put a token amount down when they place an order and pay the bulk on delivery. The large production backlogs at Boeing and Airbus mean airlines must wait years to receive the planes. In that time, interest rates are likely to rise, increasing the overall cost.

Airlines won’t begin receiving the new fuel-efficient Airbus A320neo and Boeing 737 MAX, the popular narrow-body planes, until 2015 and 2017, for example.

“Just as the airplane is going to become more expensive to finance, the people buying plane tickets are going to have more demands on their pocketbooks for basics” like housing and cars, due to higher interest rates, said George Hamlin, president of Hamlin Transportation Consulting in Fairfax, Virginia.

Airlines jumped to buy new planes that offered 15 to 20 percent fuel savings when oil prices were soaring five or six years ago, and again when the new MAX and neo variants were launched in 2010 and 2011.

The need for fuel savings may not be as great two to four years from now when the planes are delivered and payment is due, Hamlin says.

So far this year, airline cancellations are holding steady at about 9 percent of orders, in line with the average since 2000, according to Boeing and Airbus numbers. Cancellations spiked to 28 percent in 2009 during the financial crisis.

Barger at JetBlue said it has the flexibility to defer deliveries if the unexpected happens, such as a spike in fuel prices.

Pilarski at Avitas said Airbus and Boeing likely booked more orders per year than they can produce, and expect some to be canceled without cutting production. Much depends on when and on how quickly the capacity bubble bursts.

For Emirates, the prospect of some failed airlines in Asia or elsewhere only enhances its outlook. With a fleet of A380 and big Boeing 777s, Antinori said Emirates can afford to take 50 seats on an aircraft and “play the game” with low-cost carriers in India and elsewhere because the costs per seat on a big plane are so low.

Other big airlines with good brands that can offer low-cost and premium service also are likely to succeed in the years ahead, as are true low-cost carriers that have experience in running lean operations.

“The loss,” he says, “will be in the middle.”

Editing by Andrew Hay and Phil Berlowitz
Top U.S. weapons makers on Tuesday said the crisis in Syria showed the need to halt more than $500 billion in mandatory defense spending cuts and ensure that the U.S. military is sufficiently funded to deal with such contingencies.

The executives told the Reuters Aerospace and Defense Summit they expected cuts and cancellations to big weapons programs in 2014, unless Congress acted to reverse those cuts, which are being implemented under a process called sequestration.

They said President Barack Obama’s push for a limited strike on Syria for its use of chemical weapons, now being debated by Congress, showed how important it was for the U.S. military to be ready for actions around the globe at any time, something that will get increasingly difficult as budgets shrink.

“It brings back to the forefront the fact that our customers are facing global, evolving threats,” said Dennis Muilenburg, who heads the defense unit of Boeing Co (BA.N).

“It should cause us all to take a look at sequestration and how it’s being implemented.”

The Defense Department must slash its planned spending by $500 billion over the next decade, or about 10 percent a year, after lawmakers failed to find alternate ways to reduce federal deficits. Military officials have repeatedly warned that those cuts, which come on top of $487 billion in cuts already being implemented, will reduce the military’s ability to respond to crises around world, such as the situation in Syria.

Arms makers have been scrambling to cut costs by laying off workers and consolidating facilities to stay ahead of the budget cuts and maintain earnings, but executives say they have nearly exhausted those possibilities now.

Linda Hudson, who heads the U.S. unit of BAE Systems Plc (BAES.L), said the Pentagon had found pockets of money and other ways to fund programs in fiscal 2013, which ends September 30, but her company and others were bracing for more significant cuts and cancellations next year.

“2013 has not been as bad as many of us anticipated it would be. I think 2014 is likely to be much worse,” Hudson said, adding that the defense industry needed greater clarity about future budget levels so it can make critical investment decisions.

She said the country also needed to re-think what she described as an “irresponsible” blunt approach to defense spending, noting that the across-the-board nature of the cuts meant they were out of synch with the Pentagon’s strategy.

“The indiscriminate nature of the cuts associated with sequestration have not only had an impact on our industry, but it’s had an impact on our customers’ ability ... to make sure we have the right capabilities when our country needs them,” she said.

Dale Bennett, who heads the Missions Systems and Training division of Lockheed Martin Corp (LMT.N), the Pentagon’s biggest supplier, said the Pentagon was facing tough decisions that “could become a disaster” if they eroded the military’s ability to handle future conflicts.

“We do find ourselves in a world that continues to be complex and that continues to have security issues, so we need to keep our readiness up,” Bennett said. He added that the industry also understood the need to reduce U.S. deficits.

Boeing’s Muilenberg said the wide range of possible risks to the nation’s security demanded that leaders chart a steady course that allows companies to invest in developing necessary equipment and technologies.

“From cyber threats to actions like those we see in Syria, we have an important national responsibility and it’s one that demands a defense budget that’s solid and stable,” he said.

“We recognize the defense budget is part of the overall fiscal solution for the country, but it should be done in a way that allows long-term planning and stability and allows the country to invest effectively.”

Reporting by Andrea Shalal-Esa; Editing by Alwyn Scott and Lisa Shumaker
Budget cuts squeezing smaller defense firms

BY ANDREA SHALAL-ESA
WASHINGTON, SEP 5, 2013

Small companies that make components for everything from tanks to fighter jets and satellites are bearing the brunt of cuts in U.S. military spending with the first casualties already showing up, top U.S. industry and government officials told Reuters this week.

“The small companies don’t have the same access to capital, they don’t have the strong internal financials,” Marion Blakey, president of the Aerospace Industries Association trade group told the Reuters Aerospace and Defense Summit on Thursday.

“We’ve had a couple say that they are going out of business,” she told the summit.

Linda Hudson, chief executive of the U.S. unit of Britain’s BAE Systems (BAES.L), said her company is keeping closer tabs on its suppliers than ever before, and has already stepped in to acquire one company to ensure an uninterrupted supply of cathode ray tubes for its electronics sector.

“We are monitoring our suppliers in a way we have never monitored our suppliers,” Hudson told the Reuters summit, noting that her company was willing to invest in certain cases to “make sure a critical hole doesn’t develop in our supply chain.”

In June, BAE spent 1 million pounds to buy certain assets from Brimar Ltd, a Manchester, UK-based firm that entered bankruptcy proceedings in Britain in November of 2012.

U.S. industry executives and government officials have been warning for over a year that cutting $500 billion from U.S. defense spending over the next decade – on top of $487 billion in reductions already planned – would hit smaller players in the defense industry particularly hard.

Frank Kendall, the Pentagon’s chief arms buyer, said the Defense Department had compiled a large, detailed database identifying suppliers by sector and tier that was helping track problems, especially among companies that produced critical technologies that needed to be preserved.

He said the Pentagon had a small amount of funding - just tens of millions of dollars - to intervene in specific cases, and was also careful to assess the fallout of its budget decisions on smaller firms.

“There are two or three separate accounts that we can draw from that give us some opportunity to protect people that we think are critical to us,” Kendall told the summit.

Blakey said 88 percent of smaller suppliers surveyed earlier this year were feeling the effects of U.S. budget cuts.

Scott Thompson, who heads the aerospace and defense practice of PricewaterhouseCoopers, said uncertainty about U.S. military spending was taking a toll on the overall sector, and had stalled merger and acquisition activity for about two years.

He said there had been about $4.5 billion in deals in the global defense sector in the first six months of 2013, excluding the merger of two Chinese companies, which was about 50 percent below the rolling 10-year average.

Thompson said a slowdown in contracts was already putting pressure on smaller companies that had narrower margins, many of whom were sole source suppliers for bigger programs.

He said he expected more vertical integration in the lower tiers of the sector in coming years, with small and medium-sized firms acquiring even small “mom and pop” companies affected by declining volumes.

Executives at Lockheed Martin Corp (LMT.N) and Boeing Co (BA.N) echoed those concerns at the summit, saying there were keeping a close eye on their key suppliers, and had already helped some firms facing cash flow issues.

“We have a robust process to evaluate the health of our supply chain,” said Dale Bennett, who heads Lockheed’s Mission Systems and Training business, adding that his firm stood ready to buy a company’s technology, inject cash or even acquire firms to safeguard the health of suppliers of key components.

Dennis Muilenburg, chief executive of Boeing Defense, Space and Security, said his company preferred to help suppliers with capital injections or even management help, rather than outright acquiring companies that were in trouble.

“Acquisitions for the sake of supply chain health is not something we try and do,” he said.

Additional reporting by Paige Gance; Editing by Tim Dobbyn

Aerospace Industries Association CEO Marion Blakey attends the Reuters Aerospace and Defense Summit in Washington September 5, 2013. REUTERS/GARY CAMERON
Failed US Airways-American merger will hit foreign flights

BY ALWYN SCOTT, KAREN JACOBS AND NIVEDITA BHATTACHARJEE
WASHINGTON, SEP 6, 2013

The U.S. government’s effort to prevent US Airways and American Airlines from merging could hurt the carriers’ ability to compete on increasingly international routes, and that would probably mean fewer options for business travelers.

In an antitrust lawsuit filed last month, the Department of Justice focused on competition in the United States, arguing the $11 billion combination of US Airways Group and American’s parent AMR Corp would harm consumers by leading to higher domestic fares.

While the suit mentioned international routes that US Air, American and competitors United and Delta fly, it cited no international service in more than 1,000 routes that it said would be “presumptively illegal” if the merger went ahead.

By leaving international routes out, the lawsuit overlooked the fiercest arena of airline competition these days: long-haul international flights that are vital to airlines’ financial success.

Overseas routes are the most lucrative because airlines can charge higher fares and typically carry more customers willing to pay extra for business or first class seats. United Airlines, which has the largest international route among U.S. carriers, gets half of its revenue from international service. For American the figure is 40 percent and for US Airways 25 percent.

Not surprisingly, airlines have been adding flights and amenities in a race for market share on these routes.

Carriers in Asia, Europe and the Middle East in particular have increased overseas flights to U.S. cities and plan to add more. They have added cushy comforts: lie-flat beds, spacious first-class cabins, cocktail lounges, even showers. U.S. carriers are rushing to catch up.

Industry experts say that by preventing the merger, the Justice Department would handicap US Air and American in that race—a move that would eventually doom them.

Business customers would lose out because instead of getting four U.S. competitors on international flights, or three under the merger, the market for international flights would collapse to a United-Delta “duopoly.” Companies often negotiate preferred fares in exchange for giving an airline most of their travel business, and would prefer a third big player, analysts say.

“A stalled merger would harm the two potential partners on their international routes by robbing them of capital to spend on cabin and service upgrades in their international markets,” said David Fitzpatrick, a managing director at AlixPartners.

Fitzpatrick said he recently returned from Asia on a flight operated by a U.S. carrier with an old and tatty plane, a sharp contrast to the flight out on Singapore Airlines.

“They needed to fix that airplane, nothing worked,” Fitzpatrick said at the Reuters Aerospace and Defense Summit. “It’s no fun to fly on a bankrupt airline, or one that’s on the verge.”

US Airways and American are still large domestic carriers and presumably would have the ability to borrow money, buy jets and compete. But they won’t draw the best-paying customers.

“They’re not counted out, but they’re clearly not as large as Delta or United,” said Kristopher Kelley, an analyst at Janus Capital in Denver.

“If you’re a New York investment banker, or a pharmacy company out of New Jersey, perhaps there’s no reason to use American,” he said, because those aren’t American hub regions.

And if the airlines have trouble earning money on domestic routes, they won’t have the money to invest in the lucrative overseas routes. And “the profits that they might experience with New York to Heathrow won’t fund the whole airline,” Fitzpatrick said.

WEAKNESS IN PROFIT

From a distance it may appear that US Airways and American could compete as separate airlines, including internationally. The Department of Justice used the airlines’ own statements about their profitability to argue that they are strong enough to compete as independent entities.

“We certainly don’t need to merge with another airline,” the lawsuit quotes US Airways CEO Doug Parker as saying in mid-2012, as the airline posted record second-quarter financial results.

Both airlines have relatively strong profit margins. In the second quarter, US Airways posted an operating margin of 8.4 percent, just below Delta’s 8.7 percent, which led the industry, according to Robert Herbst, a founder of AirlineFinancials, an analytic service. American’s margin was 5.5 percent, better than United’s figure of 5.2 percent.

And American had $5 billion in cash and had just ordered 460 new jets, the largest order in history, when it entered bankruptcy in 2011. Through bankruptcy, it cut labor costs sharply and posted record profits in August.

But those strengths overlook the size and scope of United and Delta, which also have lowered costs through bankruptcy and merged with other airlines in the last five years.
years, giving them more time to integrate and build their routes and customers.

The two are particularly strong on international routes, controlling 71 percent of capacity in 2012, compared with 29 percent for a combined US Airways and American, according to Herbst’s data.

“There’s no question that over time Delta and United will clean their clocks,” Herbst said, referring to US Airways and American.

United and Delta also have a time advantage. If the merger is stopped, American would need to renegotiate its labor contracts, which were worked out in anticipation of a merger. Similarly, US Airways had planned to join its two pilot groups, themselves a product of a merger, in a single contract through the merger process.

Herbst said that Delta and United have become so dominant on international routes and the domestic routes that feed travelers to international travel that US Airways and American will struggle to attract business passengers who want to stay with one airline for the whole trip.

Eventually, he said, the two erstwhile partners “will have to pull out of international markets.”

Editing by Lisa Shumaker

U.S. air traffic control overhaul at risk— aerospace trade group CEO

BY ALWYN SCOTT
WASHINGTON, SEP 5, 2013

A

n overhaul of the U.S. air traffic control system that would help airlines navigate crowded air routes is likely to be further delayed by U.S. budget cuts, the head of the nation’s chief defense and aerospace industry lobbying group said on Thursday.

NextGen, a staged program that will shift air-traffic control systems to global positioning satellites from radar, requires about $1 billion a year in federal investment and is expected to be completed in 2025, Marion Blakey, chief executive of the Aerospace Industries Association, said at the Reuters Aerospace and Defense Summit.

It is the biggest aviation infrastructure upgrade since radar in the 1940s, she added.

However, budget cuts required by sequestration—a procedure in U.S. law that limits the size of the federal budget—may prompt the Federal Aviation Administration to raid money set aside for infrastructure projects and use it to pay for ongoing expenses, Blakey said.

“The chances are excellent that the investment accounts will be hit much the hardest,” she said, speaking at the Reuters office in Washington, D.C. Blakey is also a former FAA administrator.

“The investment that’s required can be derailed in the course of a single year—2014—by the sequestration cuts.”

When the government is faced with curtailing current operations, which is felt immediately, “usually what has to go is the R&D, the investments,” she said. “That’s what we very much fear because it’s eating this country’s economic seed corn in a terrible way.”

Delay of the NextGen system could affect the capacity of the U.S. air system, which is projected to handle 1 billion passengers in 2015, up from 780,000 in 2010. The impact could be felt especially at congested hubs where airlines already are “bumping up against” system capacity. That means a tiny hiccup in the system can cause many canceled flights at a hub.

Earlier on Thursday, United Continental Holdings Inc’s (UAL.N) chief financial officer said the airline is using new slim seats and other measures to both upgrade planes and allow them to carry more passengers efficiently. John Rainey said he was concerned about sequestration’s effect on air traffic control and towers.

“The more important thing for us is really the air traffic control situation,” he told Reuters. “I’m glad it was rectified quickly” when the FAA got authority to shift money and end the furloughs, he said. “I hope that we would have a thoughtful approach to sequestration, not have any type of capricious cuts like that which would certainly hurt a particular segment of the economy more than others.”

Aerospace and airline executives expect U.S. air travel to increase about 5.5 percent a year. But some have raised concerns that growth could falter if the FAA is not able to keep control towers open or has to furlough air-traffic controllers once again, as it did earlier this year, because of budget cuts.

Blakey said she will leave soon for a conference in China to discuss airport infrastructure development there. The system is undergoing rapid growth and had large delays this summer.

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