



September 27, 2010

Letter from Washington

There have been significant developments in the defense procurement realm since the last letter.

Defense Secretary Gates announced a major initiative designed to wring savings out of the acquisition process by developing new guidance that will make affordability a requirement and a key performance factor for the first time.

"Managers will ensure that a program's initial designs are constrained by its ultimate schedule and cost. Implementing this guidance will enable this department to make programs more affordable without sacrificing important capabilities and prevent us from embarking on programs that have to be canceled when they prove unaffordable," Gates said.

The new acquisition guidance is part of a broader efficiency initiative announced last summer to find \$100 billion in overhead savings.

The 23 principal actions contained in the guidance fall under five broad categories:

- affordability
- incentivizing productivity and innovation
- competition
- improving services acquisition
- reducing bureaucracy.

The new rules will apply to all future weapons purchases, and the focus on affordability already is being applied to the next-generation ballistic missile submarine for the Navy. Estimated costs for a single boat had risen as high as \$8.2 billion, but after applying the new standards, the costs are now closer to \$5 billion -- a significant reduction even in a program expected to cost more than \$100 billion.

"Designing to affordability and not just desire or appetite is critical," Gates said.

Much of the focus on acquisition reform has been on weapons procurement programs, but half the \$400 billion the Pentagon spends annually on contracts is for services such as technology support, facilities maintenance,

weapons upkeep and transportation.

"There are a lot of different kinds of services; they all require different managerial structures, they all have a different industrial base. This is a very rich area and because there is so much money, we really do believe we can do a lot better for the taxpayer," Gates said.

Meanwhile, defense industry observers are standing by for another major consolidation after a bomb dropped by Dennis Muilenburg, CEO of Boeing's defense, space and security division that the company was looking at a merger with Northrop Grumman.

"We continue to see acquisitions as an opportunity area for us," Muilenburg said. "It's one of the tools that we use to grow."

He indicated that Boeing was targeting acquisitions in several sectors including unmanned aircraft, cybersecurity and intelligence and surveillance systems, markets in which Northrop is the dominant player.

"I'm not going to rule out or rule in any options," said Muilenburg on Tuesday. "Obviously, as we see defense budget pressure, that does at times lead to potential consolidation."

Industry watchers believe that a Boeing-Northrop Grumman merger would make sense since projected defense spending cuts usually generate talks of industry consolidation. The size of the cuts anticipated in the industry in the next several years almost mandate the necessity for one of the major players to be absorbed, with BAE Systems a likely target as well due to its low share price.

Federal antitrust regulations will be the major hurdle for a Boeing-Northrop merger, since they are the number two and three defense contractors in the United States, which would put almost half of all defense work in the hands of one huge entity. To fly with regulators, such a merger would require major divestitures by both companies in strategic growth areas, which would make the transaction less attractive to either company's board.

But, despite all these potential hurdles, Boeing is still a motivated buyer, since SECDEF Gates recently cut 330 billion from future defense spending plans. The major prize for Boeing in a Northrop merger is Northrop's defense aircraft business. Northrop already subcontracts on the F/A-18 and the E/A-18 electronic warfare aircraft, and almost all of Northrop's business units have a position on the Joint Strike Fighter

While the Northrop-Boeing merger has been the major topic, Lockheed announced a move in the other direction, trimming its executive workforce by almost 25% and cutting almost 10,000 total jobs.

On another front critical to the US defense industry, Congress' failure to

reauthorize the law behind the Export Administration Regulations has resulted in ineffective and decentralized authority regulating dual-use items. The lack of cooperation and coordination between the U.S. State and Commerce Departments has created jurisdictional confusion and overly stringent regulation of purely commercial items, with questionable regulation of key military technologies. There have been several attempts at reform over the last 25 years that have made only minor changes on the margins. The inability of the Congress to implement meaningful reforms has kept U.S. manufacturers at an increasing disadvantage in a competitive environment in which advanced technologies are no longer the exclusive territory of U.S. industry. At the same time, many long-term foreign customers are turning to non-U.S. sources to avoid "contaminating" their products with ITAR-controlled items.

In August 2009, President Obama mandated a broad-based review of the export control system with the intent of identifying those technologies that really are critical to national defense --- the crown jewels --- and erecting higher walls around them, while relaxing the onerous regulations on less important items. Specifically, the goal was to create a single controlled items list, single licensing and enforcement authorities, and a single information system linking them all together in a coherent way. While industry remained skeptical, having traveled down this road several times before with no tangible improvement, there was genuine promise of a sea change in the export control system.

In March 2010, President Obama signed an Executive Order implementing the National Export Initiative, ordering a comprehensive plan to implement export reform within 180 days. Congressional resistance, coupled with the inability of the Senate or House to do anything substantive has crippled the effort. Bottom line: nothing will happen this year and unfortunately not in the Obama administration's next two years.

The President is in an unsustainable situation, having expended all of his capital in the first year and a half of his administration on his legislative priorities, he has nothing left in the bank for things like export reform.

In perhaps the most bizarre twist so far, Forbes magazine, a respected business publication, carried an article psychoanalyzing the President and determining that his policy motivations come from his African father's anti-colonial orientation.

Coupled with the persistent innuendo that Obama is not really an American citizen, is a closet Muslim bent on imposing sharia law on the US, and a variety of other charges, all have kept the administration from focusing on its priorities. What's important for Republicans isn't the accuracy of the assertions, but rather that they resonate with conservative constituencies who haven't always been able to find common ground but whose turnout in November will be crucial.

Going back to the Eisenhower years in the 1950's, the conservative movement has been made up of three very separate and distinct groups: the free enterprise/free traders; the anti-communist foreign policy types more recently known as neoconservatives; and the social issue-focused conservatives. The fear of communism kept all of these groups in the boat during the cold war years, but the Republicans have struggled to keep these groups engaged since the fall of the Soviet Union. Ultimately the war in Iraq and soaring deficits undid the conservative coalition and led to the Democratic takeover of the Congress in 2006 and the White House in 2008.

If the Republicans have difficulty articulating what they are for, they have no problem with what they are against. The battering of the President based on his cultural background, the implication that he is neither sufficiently Christian nor American in his values, provides an ominous undertone to the arguments against his economic policies. It implies that Obama doesn't care about the effect of his policies on ordinary Americans because he doesn't share their values.

The President's sympathy for radical Muslims who would defile the World Trade Center site, his socialist African ancestry and his years in Indonesia, create a shadowy and sinister figure that every conservative faction, fiscal, foreign policy and religious, can find a reason to dislike.

You can undoubtedly expect these attacks to grow more intense as 2012 approaches and the Republican presidential hopefuls start the cycle of courting activists in Iowa and the other early primary states.

The irony is that given the mood of the country the Republicans could win the debate on the basis of policy and ideas and don't need to create any more doubt about the President and his programs. Nevertheless, the President always seems to remain one step behind those who define him negatively, always having to prove what he is not and never revealing what he is.

In the near term, the November Congressional elections are about six weeks away, and the constant innuendo about the President's beliefs and allegiances may be energizing the grass roots in the way the Republicans need and a purely policy debate will not.