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Protecting the Defense Industrial Base in an Era of Declining Budgets: The Military Takes On Program Cuts, Modernization and Recapitalization

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The Defense industry is entering a new era in U.S. history in which its main patron -- the Pentagon -- has dwindling financial resources because of the country's two protracted wars and continuing economic slowdown. Defense Secretary Robert Gates, meantime, has promised to slash funding for new and even some existing programs. The repercussions for the industry will shape its direction for the coming decades. Knowledge@Wharton's Aerospace & Defense Report turned to Lawrence P. Farrell, the president and CEO of the National Defense Industrial Association, to discuss what will be the likely long-term impact of this new environment for defense companies. Farrell is a retired U.S. Air Force lieutenant general. An edited transcript of the interview appears below.

Knowledge@Wharton: Tell me a little about the National Defense Industrial Association. What's your role in the defense industry?

Lawrence P. Farrell: Our purpose goes back to 1919, with the founding of the old Army Ordnance Association. At the time it was recognized that our industrial response to support our troops in World War I was inadequate. If you recall, when our troops went to war in 1917, basically they took their Springfield rifles and their helmets in their backpack that was about it.

We didn't have sufficient artillery to support our troops. We actually borrowed or bought our artillery from the French and the British. And you might also recall that no American warplanes participated in air battles. We used French SPADs, we used French Nieuport and British Sopwith Camels. We didn't have any combat airplanes and so the association was established at that time to form a partnership between government and industry so that you could have conversations about the best way to support the troops.

Our mission today remains the same. We advocate for the best possible equipment -- world-class equipment for our troops so that we give them the best chance on the battlefield.

Knowledge@Wharton: Defense Secretary Robert Gates recently announced plans to trim the Pentagon's budget and many other jobs associated with the Pentagon. What are your thoughts on the impact this will have on the efficiency of the department and the United States military preparedness?

Farrell: Well, it's hard to say what impact it will have on efficiency. But the country's whole financial situation has forced the Secretary to make some major adjustments. He gave a speech back in May at the Eisenhower Library in which he said that even though President Obama has Defense projected to grow at one to 1.5% a year that is not enough to sustain the existing acquisition programs. He said it would take 2% to 3% real growth to do that, and so he had to find efficiencies somewhere else [to pay the difference].

This is a continuation of the things set in motion in early May. And this is not the last we'll hear this because if you read his speech, he says this is going to continue with 2012 budget and beyond. And he's really looking for efficiencies, by which he means eliminating things that don't add as much value.

Knowledge@Wharton: One of the costs that Secretary Gates is hoping to slash is the expanding number of assessment studies that the DOD does. Just a few months ago, Ashton Carter, the Pentagon's chief weapon's buyer, announced the formation of Joint Estimating Teams or JETs, which will review the program's costs and progress. Carter said he is already seeing what he called "a huge gulf" between the views of the military managers and Lockheed employees for the F-35 program and the JET Assessment. So is it a bad idea to start cutting some of these assessment programs, which supposedly are good at finding some of the runaway expenses or inefficiencies?

Farrell: Well, I'm not sure you can make a blanket statement that all these teams are going to find efficiencies. I think the JET is more of a look directly into the F-35 programs itself. But if you don't have enough money to fund everything in the Defense budget, you have to cut somewhere and somewhere is some of these studies now. If you take all those studies, I don't think the savings are that large. Look at a Defense budget -- it's somewhere north of \$700 billion. So no, it's not going to make a huge impact on the amount saved.

I think it sends a strong signal that he's looking for savings or efficiencies everywhere and 'studies' are one place to start. I don't think you're going to see all the studies go away. I think in his speech, he said, "A certain percentage of the studies will be cut." I think it was 25%, so it won't have a huge impact.

Knowledge@Wharton: The moment Gates made talked of program cuts, various Congressional leaders set about protecting programs in their districts and states. That has always been the case, but is there a greater realization now that these impending cuts are really here and they are financially necessary?

Farrell: Yeah, I think this realization has been dawning for some time. If you go back to 2005, the Congressional Budget Office came to that conclusion under President Bush and he had fairly generous Defense budgets, acquisition dollars and R&D dollars. The CBO said in 2005 that the Defense budget is underfunded by about \$100 billion a year to support the programs then underway. So as far back as 2005 it was recognized that there wasn't enough money to support everything and at some point it would be a reckoning time. I think that point has now come. Gates recognizes, and everybody else realizes, that the country is not in the financial shape to continue to increase the defense budget to support all the programs.

Now, whether or not individual Congressmen realize that stark reality, I can't say. But I do think that they all understand that there will be some cuts and it's obviously their job to support the defense industry in their districts or their states. There'll be a back and forth and pushing and shoving, but I suspect that a lot of what the Secretary Gates has said and done is going to stick.

Knowledge@Wharton: The Pentagon has already cancelled or scaled back dozens of weapons programs. In this atmosphere, what strategy should defense contractors pursue?

Farrell: It looks like the emphasis is on trying to support systems which support the existing wars. Secretary Gates has said this number of times -- and hasn't been contradicted. While he recognizes that the United States needs a full spectrum capability -- from the highest, most demanding aspects of any conflict down to the lowest -- his focus will be on the current fight.

So any system that supports the current fight obviously is something that is going to get a lot of attention. Anything that is an expensive platform that doesn't meet the requirement he sees necessary will probably be under some scrutiny by him.

I think you'll see more money spent on ways to make existing platforms more efficient than they are now. How do you tie them together in an information and intelligence network to increase the capability, for example? A of our platforms need to be integrated across the forces rather than used separately. So I think you'll see a lot of emphasis on communications and intelligence, and surveillance and sensors and things like that.

Knowledge@Wharton: The pace of mergers and acquisitions is also picking me up in the defense sector. What impact will this will have – having a few big players controlling most government contracts and supply chains?

Farrell: That's the case now. There are just a few major contractors. But if you continue to reduce the number of major contractors, you can get to the point where you don't have competition anymore. So I think the great worry is that you won't be in a competitive environment and what you'd like to have is competition.

We all understand -- it's proven -- that competition gives you better quality at a lower cost. You don't want to get in a position where for major weapon systems, and major components, that you don't have, at least two competitors somewhere in the industrial base.

Knowledge@Wharton: The way you win a contract is an established process. Prime contractors know the ins-and-outs of winning contracts. Does this discourage new and perhaps more innovative companies from even entering the space? Does the process prevent them from joining this important industrial base?

Farrell: You've got a lot of small companies forming all the time. Large companies don't form overnight but it is possible for companies to grow up. It still takes a lot of capital to do it but I would say the way is there to do it, if somebody wants to do it. But right now, you have a pretty good group of major players. There are probably five or six, maybe seven major players who do a pretty good job. The competition is pretty good in most areas so I think we're okay for now.

If the number of players got much smaller, it will require maybe a little more management than we have right now. But you have got to keep in mind, too, that most players in the industrial base only do defense. With the exception of Boeing or General Electric and maybe United Technologies, most players don't do anything else. If defense dollars dry up, their business will dry up. So it's important to keep an eye on this thing and to make sure that, as budgets come down, there's some management and some attention paid to what this does to the industrial base capability in defense right now.

Knowledge@Wharton: Those are all the questions I had. Would you care to add anything?

Farrell: I think we need to recognize that the Defense Department budget is under a lot of stress -- that the wars that we're undertaking are consuming a lot of our resources -- close to \$200 billion over the years or about \$60 billion plus a year just for the contingencies.

Our equipment, especially the ground equipment is getting used up and so there's a need to reset, recapitalize and replace some of this stuff. That is going to be the real challenge once these conflicts power down. What decisions are we going to make on recapitalization?

A lot of the ships, the vehicles, the planes, the tanks, they're very old. As you know, the B-52 Bomber is very old, and the KC-135 refueling tankers, their average age is 47 years. These are very old platforms and the question is, 'what do we do going forward?' Do we have a smaller force and recapitalize a smaller force, or do we keep a larger force and try to maintain it well into the future so that we can string the recapitalization out? Those are going to be the major decisions that need to be addressed. We must address the modernization and recapitalization needs of the services that right now have a lot of old iron.