



Tankers Back to square one

When the Government Accountability Office upheld Boeing's contract protest in June, it effectively halted the USAF KC-X air-to-air refueling tanker program until a new competition is held. The planned recapitalization of the Air Force's 500-aircraft KC-135 fleet will be delayed, as Boeing and the Northrop Grumman/EADS team continue to refine their proposals and bolster their competitive positions.

The contract itself is of significance: 179 aircraft worth over \$30 billion. It is also the only open and funded U.S. fixed-wing military aircraft contract for at least the next five years. But there are also much broader implications for the Air Force and for the companies involved in the program.

Tanker context

Aside from 54 KC-10s, the USAF's air-to-air refueling tanker fleet consists of over 400 KC-135s, a four-engine jet last built in the 1960s. The average age of the fleet is about 47 years. For several decades, the service has explored replacement options. However, after the Cold War procurement surge collapse in the early 1990s, the Air Force continued to prioritize tactical fighter aircraft for its increasingly scarce procurement resources.

After the September 11, 2001, terrorist attacks, the defense budget increased at a remarkable growth rate. The FY01 procurement budget was a mere \$54 billion; five years later it was twice that. But the money continued to go to fighters and transports; tanker recapitalization money was absent. However, the post-9/11 budget environment involved considerable sums in O&M (operations and maintenance) money added by Congress for military action. The Air Force decided to tap that funding stream for tankers.

In 2002, the USAF initiated a tanker lease deal involving Boeing's KC-767. The



The selection by the Air Force of a replacement for the KC-135 is now on hold.

plan was to lease 100 of these to replace older KC-135Es. Unlike most of the KC-135 fleet, which has been reengined with new turbofans, the E models use 1950s vintage engines and are tremendously expensive to operate. An aircraft lease deal, unlike a direct procurement program, would take money from the O&M account. Lease costs would be balanced by O&M savings from the retirement of the older planes. Also, the Air Force could buy new planes without threatening its highest procurement priorities.

Within two years, this deal was dead. In addition to the unconventional use of operations money for what was essentially a procurement effort, the deal was also connected with the

Darleen Druyun corruption scandal and other related matters that resulted in the removal of Air Force Secretary James Roche and Boeing's CFO Michael Sears.

In the aftermath of the tanker lease debacle, the USAF decided to prioritize cash for an actual procurement account program. Thus, KC-X was born. Research and development funding was first provided in the FY05 budget, with the stated objective of using an off-the-shelf jetliner



The 2002 deal for the KC-767 was dead two years later.

adapted for the tanker role. Boeing, of course, decided to bid a variant of the 767 jetliner originally selected for the lease program. EADS, the only other manufacturer of large jetliners in the world through its Airbus unit, decided to team with Northrop Grumman, giving it a U.S. prime contractor.

The Air Force also plans to follow on the 179-aircraft KC-X program with KC-Y and -Z competitions, which have not been defined.

In March 2008, the USAF selected the Northrop Grumman/EADS team. The winning plane, the KC-30, is a variant of the Airbus A330-200F and uses General Electric CF6-80E1 engines. The service designated the plane the KC-45. Plans call for the aircraft to be built at EADS/Northrop facilities in Mobile, Alabama. Airbus also plans to move A330-200F freighter final assembly from Toulouse to the new facility. The first four KC-30s will be converted to cargo configuration at EADS's Dresden facility. EADS's CASA unit will install the first aircraft's centerline refueling boom at its facility in Spain. The air refueling boom system will be built in West Virginia.

Until the protest, plans called for the first test aircraft to fly in February 2010, with the first Mobile-built aircraft to enter final assembly in September 2011. The first squadron was to be fielded in 2013.

Italy and Japan have signed orders for the KC-767, so at least eight of these will be built. Meanwhile, EADS's KC-30 has been firmly ordered by Britain's RAF, tentatively ordered in February 2005 under a private finance initiative program. Australia also ordered five, followed by the UAE in February 2007.

Impact on the companies

In the immediate aftermath of the contract award, the USAF implied that there was relatively little doubt about the outcome. The KC-30 was the clear winner, by a wide margin. Boeing immediately filed a protest with the GAO, insisting that the competition was far closer, and that the KC-767 was a better performer than the Air Force implied.

The GAO ruled that the service made "significant errors" that could have affected its choice. The Air Force has 60 days to respond, but the ruling endorsed almost all of Boeing's protest points. In one point the GAO indicated that the Air Force was biased against the Boeing bid:

"The Air Force conducted misleading and unequal discussions with Boeing, by informing Boeing that it had fully satisfied a key performance parameter objective relating to operational utility, but later determined that Boeing had only partially met this objective, without advising Boeing of this change in the agency's assessment and while continuing to conduct discussions with Northrop Grumman relating to its satisfaction of the same key performance parameter objective."

This part of the GAO ruling implies that both sides do in fact have a respectable chance of winning a new com-

Dreamliner. With a longer contract delay, Boeing will need to use company resources to keep the 767 line open. Unfortunately, it would take even greater resources to transform the 787 into a tanker-suitable design, and any kind of KC-787 would almost certainly not be available until 2014.

Boeing's protest suggested that it would have bid its 777 if the company had been informed by the Air Force that the service wanted a larger aircraft. Yet while the KC-30 is about 20% larger and heavier than the 767, the freighter version of the 777 is about 40-45% larger than the KC-30. A KC-777 would be considerably more expensive to buy and operate than its competitor.

However, it is also important to note that 179 tankers over 15 years is a mere drop in the bucket for Boeing's commercial unit, whose annual production rate will exceed 200 widebodies and 300 nar-



petition. With the ruling, both contractors have little choice but to continue refining their products and honing their marketing efforts. The competition is effectively back to square one.

In terms of product offerings, Boeing is in a somewhat difficult position. If the recompeted KC-X contract is awarded within two years, the 767 production line will be intact. But after that, the supplier base will begin to erode as commercial demand for the 767 migrates to the 787

rowbodies within a few years. By contrast, these tanker orders would be a major plus for Airbus. The company's current widebody product line is in jeopardy.

Airbus widebodies include the A340, which is dying, the A380, which has been delayed and has only received modest commercial interest, and the A330. Right now, the A330 is in good shape, but airliner demand for this jet will decline sharply as deliveries of the competing 787 ramp up. Airbus' response, the A350, will

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bolster the company after 2014. But between 2010 and 2014, Airbus faces a widebody deliveries trough. A successful KC-30 bid would provide revenues to help bridge that gap.

Also, for EADS and Airbus, much was riding on this contract. While European politicians and unions continue to act against company plans to move production outside Europe, the tanker deal allowed EADS to source from a lower cost area. The company had agreed to build the planned A330-200F freighter version of the A330 in Alabama as well, dealing with the strong euro by creating work in a dollar-based economy.

This Alabama plant would also facilitate EADS's pursuit of its highest priority: greater access to U.S. defense spending. Building a larger industrial footprint in the U.S. would establish strong relations with local politicians, helping to lobby for future program wins and funding.

Fortunately for EADS/Airbus, despite Boeing's protest victory, the U.S. company enjoys no special advantage in a KC-X recompet. It is quite possible that the Air Force, despite its missteps, chose the KC-30 for valid, nonpolitical reasons. The A330 is larger, offering additional lift capability beyond its tanker role. It is also a more modern plane.

Boeing's competitiveness largely revolves around the company's superior air-to-air tanker history and experience. While the KC-767 costs less to operate than the KC-30, the KC-30 acquisition price reflected a considerable discount, making it quite competitive. Most of the other competitive discriminators between the two planes—airport access, required military construction, etc.—are the subject of ongoing contention and debate. They are unlikely to play a material role in the selection process.

But the implication of the GAO ruling is that these aircraft competitive features will play a limited role in the new competition. Assuming that the GAO was right about service bias, it is likely that politicians, especially Sen. John McCain (R-Ariz.), have played a role in politicizing the selection process. It is also certain that this ruling will lead to even greater politicization of the contract, especially as the new competition will likely start a few months before the 2008 election. Political meddling will be magnified by the parti-

san nature of the contest—the KC-30 is largely built in Republican political districts, while the KC-767 is mostly built in Democratic states.

Impact on the service

From the Air Force's standpoint, the GAO ruling could not come at a worse time. Leadership at the top is in a state of transition. On June 5 Defense Secretary Robert Gates fired Gen. Michael Moseley, the chief of staff, and Air Force Secretary Michael Wynne for their "poor performance" in handling nuclear weapons materials. The Air Force's procurement office has also been tainted by several high-profile contract stumbles. The most notable of these, a protest upheld by the GAO involving the service's next combat search and rescue helicopter contract, has also been recompeted.

As a result of the USAF's weakness, its ability to argue for its highest priorities has been badly damaged. This does not bode well for Lockheed Martin's F-22, which needs additional procurement money if it is to survive beyond FY09 funding. However, the Air Force's weakness helps the company's F-35, which competes for Air Force money with the F-22 and is more of a top-level multiservice program than an Air Force one.

The Air Force's changing circumstances are likely to be good news for Boeing's C-17 transport, which depends on additional post-FY08 funding for its survival. Since KC-X program funding will be delayed, the near-term money could go toward a different airlift aircraft program. Also, the new Air Force chief of staff, Gen. Norton Schwartz, is the first top service leader to come from Transportation Command, rather than a fighter or strategic bomber background.



The one certainty is that the decades-old concept of recapitalizing the Air Force's tanker fleet will continue to get older still. But the KC-X program is hardly a massive effort at taking remedial action; the maximum funding level was set to provide for 14 planes per year. So, when the KC-X program finally results in procurement money, it will take over 30 years to fully replace this fleet, given envisaged acquisition plans.

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