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“The Aviation Industrial Base and Department of Defense Rotorcraft Programs”
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The Role of the Department of Commerce

Good morning Mr. Chairman, Mr. Ranking Member and Distinguished Members of the Subcommittee. Thank you for the opportunity to share the views of the U.S. Department of Commerce on the aviation industrial base. I am Joe Bogosian, and I serve as a Deputy Assistant Secretary within the Department’s International Trade Administration (ITA). In this capacity, I manage the Office of Aerospace, as well as the Office of Automotive Affairs and the Office of Machinery. These industry offices focus on competitiveness issues for their respective industries, including trade policy activities.

In cooperation with other agencies and offices, including the U.S. Trade Representative and the State Department, my office seeks to ensure open and fair competition in world markets for U.S. civil aerospace products. Working with the Department of Transportation and the Federal Aviation Administration, we monitor foreign regulations and specifications to ensure that they do not prejudice imports of U.S. aerospace products. With the assistance of our U.S. Export Assistance Centers and our overseas Foreign Commercial Service Officers, our office undertakes trade promotion activities through the organization of trade missions, conferences and participation at air shows worldwide.

At the Department, we also advocate on behalf of the sale of U.S. military goods through the Bureau of Industry and Security (BIS) and on behalf of commercial goods through the Advocacy Center. These offices have helped U.S. companies win billions of dollars of awards in overseas procurement competitions by effectively marshaling the full resources of the U.S. Government in their support. We also host the Trade Promotion Coordinating Committee, which helps to coordinate interagency cooperation and consistency on a host of issues. The BIS also regulates dual-use export controls on the Commerce Control List in parallel with the State Department’s administration of the U.S. Munitions List.

Mr. Chairman, as you are aware, over the past five years, about 80 percent of U.S. helicopter production served military needs. (Of the total helicopter revenue of \$7.1 billion from 1998-2002, 81.3 percent was military.) As such, the government’s portfolio for the helicopter industry has resided primarily at the Department of Defense, NASA and the FAA, while the Commerce Department has helped the industry with specific export control, procurement advocacy and general competitiveness issues. I was asked to provide a high-altitude context for this hearing by discussing some of the larger issues confronting all U.S. manufacturers, some aerospace-specific global competitiveness

issues, and then allow my fellow panelists from industry and other federal agencies to delve into their portfolios of the helicopter industry.

The Manufacturing Initiative

Starting from a high altitude but a very important area, I would like to review some critical factors regarding the U.S. manufacturing sector. U.S. manufacturing is generally experiencing a strong rebound from the recent economic downturn, which hit the sector particularly hard. From the peak of manufacturing production in June 2000 through January 2004, the number of manufacturing jobs in America dropped from 17.3 million to 14.3 million, a 17 percent decline. U.S. manufacturing was further struck by the stock market decline due to the bursting of the technology bubble, and the corporate accounting scandals. Aerospace manufacturing was additionally hit by the SARS epidemic which drove down tourism, the airline industry and the entire supply chain of aerospace manufacturers, as well as by the tragedy of September 11th and the ensuing war on terrorism.

The President acted to strengthen job creation in America and his policies are working. The U.S. economy grew at an 8.2 percent clip in the third quarter of 2003 – the strongest growth in 20 years – and continued at an over 4 percent growth rate in the most recent quarter while the unemployment rate was beaten back to 5.6 percent -- below the average of each of the decades of the 1970s, 1980s, and 1990s. Over the past five months, 366,000 new jobs were created – with 112,000 of those in January 2004 – and more manufacturers are reporting increases in production than at any time in the past 20 years. Our manufacturers still need us, and there is still more to do.

In March of 2003, Secretary Evans announced a Manufacturing Initiative to develop a strategy designed to ensure that the Government does all it can to create the conditions necessary to maximize U.S. competitiveness in manufacturing. To maximize our understanding of the issues and garner industry recommendations, the Commerce Department convened over 20 public roundtable events nationwide with manufacturers from the aerospace, automotive, semiconductor, chemical, plastics, and machinery sectors, among others. The manufacturers attending these roundtables represented a broad mix of small, medium-sized, and large companies, as well as minority-owned and women-owned enterprises.

Regardless of their individual sector, manufacturers identified common problems challenging their competitiveness. They asked for government to eliminate the indirect costs imposed on them due to high health care costs, litigation costs, energy costs and regulatory costs. They asked that tax policies promote competitiveness and innovation. They identified the need to address education, workforce and training challenges. And they asserted that U.S. manufacturers can compete with anyone in the world, so long as they are competing by the same rules.

Our collective findings and recommendations are contained in an 88-page report released in January by the Commerce Department entitled, “Manufacturing in America: A

Comprehensive Strategy to Address the Challenges to U.S. Manufacturers.” The report spells out an entire range of recommendations that federal agencies and Congress should consider and pursue to improve the competitiveness and health of U.S. manufacturers. These recommendations include and build on the six specific steps that President Bush has identified as priorities: making health care costs more affordable and predictable, reducing the burden of lawsuits on our economy, ensuring an affordable, reliable energy supply, streamlining regulations and paperwork requirements, opening new markets for American products, and enabling families and businesses to plan for the future with confidence by making tax reductions permanent.

One of these recommendations calls for the creation of an Assistant Secretary of Commerce for Manufacturing and Services within ITA -- to whom I will directly report -- to develop, advocate, and help implement policies that will improve U.S. manufacturers’ competitiveness. Our new Manufacturing and Services Division will focus on domestic issues, as well as foreign market obstacles, that impair U.S. manufacturing and industry competitiveness. As government advocates for the manufacturing sector, we will work concertedly within the policy-making process to address the needs of U.S. manufacturers.

The Commerce Department is also working on other recommendations in the report, including negotiating the elimination of trade-distorting subsidies, promoting global use of U.S. technical standards, reviewing dual-use export controls, and developing a new Office of Investigations and Compliance and an Unfair Trade Practices Task Force to help enforce trade agreements and combat unfair trade practices.

Our manufacturing report also calls for permanent income tax cuts, permanent research and experimentation tax credits, and a reduction in tax complexity. It recommends a review of burdensome regulations, the promotion of health care reforms, tort reform, a stronger U.S. patent system, an appropriate focus on federal research and development programs to advance innovation and productivity-enhancing technologies, the establishment of cooperative research programs between universities and small businesses, and a review of the existing vocational-technical education system to determine if it meets the needs of the manufacturing sector. It also calls for greater assistance for manufacturing-dependent communities in transition and programs to enable workers to develop the skills necessary for employment transition to emerging and growing industries.

Overview of the Aerospace Industry

Actions at the federal, state and local levels of government in response to these recommendations will directly help the aerospace industry as much as any other sector.

As we all know, aerospace is one of America’s leading industries, generating high technology capabilities and conveniences, and hundreds of thousands of high-paying jobs. The continued growth of high-paying jobs, an efficient transportation system, the economic well-being of our nation, and indeed our national security are dependent on a healthy and robust U.S. aerospace industry.

The aerospace industry sector is also America's largest net exporter of manufactured goods, helping to redress our trade imbalance more than any other industry sector. Of the total output in 2003 of an estimated \$122 billion, about \$51 billion, or approximately 41 percent, was exported. In 2003, the industry recorded a trade surplus of about \$27 billion.

Aerospace is comprised of many sub-sectors, including large civil aircraft, general aviation (including small private planes, business aviation, and commuter aircraft), rotorcraft, military aircraft, spacecraft, launch vehicles, missiles, aircraft engines, aircraft maintenance equipment, air traffic management systems, and airport equipment. In 2003, military aircraft production led all other sectors accounting for 26.9 percent of total aerospace industry revenue, the space sub-sector stood at 23.9 percent, civil aircraft at 22.9 percent, related civil products added another 17.6 percent, and missiles at 8.8 percent (with rounding errors). It is important to note that roughly 72 percent of total U.S. aerospace industry output is procured by federal, local, and foreign government entities.

The economic and security climate of the last few years have impacted the sub-sectors in various ways. U.S. military aircraft, which includes helicopters and missiles, have benefited from increased defense spending in the United States, while orders for commercial aircraft, general aviation, civil helicopters, spacecraft, and launch vehicles, have decreased.

The performance of the commercial aircraft sub-sector, which dominates the civil aerospace sector with its high unit costs, has led to overall revenue growth stagnation for the U.S. aerospace industry over the past few years. Declining tourism and travel by the business community threw international airlines into financial distress, with a number of top U.S. carriers flirting with bankruptcy. The decline of the market for new large civil aircraft, coupled with the ascendancy of Airbus via aggressive pricing and the financial support of European governments, have compounded Boeing's continuing decline in aircraft deliveries.

The United States is no longer the world's predominant supplier of large civil aircraft, having lost that mantle last year when Airbus delivered more aircraft than Boeing after three consecutive years of winning the majority of new aircraft orders. Our current status in the large civil aircraft business is a far cry from the days when we had two and three U.S. manufacturers fully supplying Western markets.

In 1988, during the final spike in Cold War spending, U.S. military aircraft accounted for 69 percent of total U.S. aircraft sales (by revenue) despite the predominant position of U.S. civil aircraft manufacturers in global markets. By 1999, at the height of the economic boom, the pendulum swung to U.S. civil aircraft sales, which then accounted for 60 percent of total revenues. Currently, according to Aerospace Industries Association (AIA) estimates, the two sectors have reversed prominence again, with the

military aircraft sector recording an estimated \$40 billion in sales, compared to the \$34 billion logged by civil aircraft sales in 2003.

From 1990 to 2003, the number of workers producing all aircraft and aircraft parts fell from 672,000 to 369,000, a decline of 45 percent. If we exclude the massive restructuring of the industry that followed the conclusion of the Cold War, and concentrate only on the last five years (from 1998 through 2003), employment still declined by 25 percent – contributing sharply to the 17.6 percent total loss of manufacturing jobs over that same period that I referenced earlier.

While the United States has been dislodged for the time being as the top supplier of large civil aircraft, the U.S. aerospace industry is still the best in the world by virtue of its leading positions in the supply of military aircraft, general aviation aircraft, spacecraft, and missiles. While, according to AIA estimates, general aviation sales and space launches remained in decline during 2003, U.S. civil helicopters rebounded from only 318 units delivered in 2002, to 507 deliveries in 2003. Revenue more than doubled from \$157 million to \$348 million. Constant vigilance and active policies are needed to build upon any good news.

Aerospace Industry Trends and Strategies

In the rotorcraft industry, the French-German Eurocopter and the Italian-British firm Agusta Westland are the world's first and third-largest producers, respectively, competing largely against U.S. manufacturers Bell, Sikorsky, and Boeing. To an interesting degree, the successful market strategy of Airbus is similar to Eurocopter, and we can draw important lessons by reviewing both sub-sectors in the same historical context.

As the U.S. defense industry consolidated in the early 1990s in response to reduced market demand following the end of the Cold War, many aerospace companies diversified into both the civilian and military sub-sectors to help offset cyclical markets. These companies also recognized that certain manufacturing processes and basic product technologies can benefit both the military and commercial sectors. Increasingly, we are seeing military procurements satisfied by variants of products previously developed for the civilian market.

In reaction to U.S. industry consolidation and similar market conditions, European aerospace and defense companies merged in the latter 1990s, culminating in the creation the European Aeronautical Defense and Space Company (EADS), which is Europe's largest aerospace conglomerate. EADS essentially mirrored Boeing's strategy by incorporating military assets, including partnerships in the Eurofighter and Dassault Rafale fighter aircraft, to counterbalance its 80 percent shareholding in Airbus.

EADS also wholly owns Eurocopter, which, according to the company, captured 45 percent of the 673 new civil and military helicopters ordered by the global market in 2003. This market share contrasts sharply with Bell, Sikorsky, and Boeing, which

captured only 14 percent, ten percent, and three percent, respectively. Eurocopter also claims to hold a 48 percent share of the U.S. civil helicopter market, which includes civil defense procurements.

In 2001, the newly formed conglomerate, EADS, depended on Airbus for nearly 88 percent of its earnings (before interest and taxes, EBIT). With great success already achieved in the large civil aircraft and civil helicopter sectors, their unfortunate consequence is the increasingly flat growth curve of market shares in those modestly growing sectors. EADS understands that substantial upside potential and future corporate growth will depend on larger defense markets for its diversified military offerings.

For market growth and revenue stability, EADS apparently believes it must look beyond Europe's relatively small defense market and penetrate the crucial U.S. defense market. It wants to emulate the success of the UK's BAE Systems, its primary competitor in European defense markets (and 20 percent shareholder in Airbus). As you are aware, BAE Systems, through investment and acquisition, has become a leading prime contractor for the Pentagon.

While pursuing the lucrative U.S. defense market, Europe continues to follow a parallel, equally critical strategy: support and increase the competitiveness of its civil aerospace sector. Both the military and civil strategies are described in Europe's Vision 2020 report, the STAR-21 report, and their Sixth Framework research program.

Airlines and industry analysts tell us that competing models of Airbus and Boeing aircraft offer similar performance and operating costs, and that any variation can be factored into the initial cost of acquisition, which essentially drives the final purchasing decision. Airbus claims it can price lower than Boeing because it is more cost efficient. The United States maintains that fungible European government subsidies provided for the development of new aircraft models, over and above their indirect supports, permit Airbus to discount prices and win market share from Boeing. This is a similar pattern to the UK's subsidies to Rolls Royce aircraft engines that distort the market and take away market share from U.S. engine manufacturers, Pratt & Whitney and GE.

European governments justify nearly \$4 billion of launch aid for the new super jumbo A380 aircraft by alleging comparable levels of indirect U.S. Government support to Boeing through NASA and Defense Department research and development contracts. The U.S. Government notes that most defense research is mission-specific and does not benefit civil aircraft programs to a substantial degree, and further notes that comparable levels of research support is provided to Airbus parent companies EADS and BAE Systems. The U.S. Government does not provide launch aid to Boeing.

A number of other factors are also likely to be important determinants in the future direction of the U.S. aerospace industry. In the civilian sector, future demand by passengers and shippers for air transportation services will be key. Historically, the single most predictable gauge of this demand has been fluctuations in Gross Domestic Product (GDP). While we are a long way from achieving the level of record jet liner

deliveries experienced in the late 1990's, continued GDP growth in the United States and other countries, most notably Asian markets like China, bode well at least in the short term for this important aerospace sector. Unfortunately, demand for airline service and the aircraft to meet that demand remains vulnerable to episodic shocks like the 9/11 terrorist attacks and the SARS epidemic that resulted recently in such devastating effects on aerospace manufacturers.

In the military sector, U.S. Defense Department expenditures will continue to dominate future U.S. aerospace industry trends. The modest defense budgets of U.S. trading partners play a secondary role. Given the charter of your subcommittee, Mr. Chairman, and the witnesses here today from the Defense Department, there is little that I could add on this topic.

In both the civilian and military sectors, a significant factor on the future growth of U.S. aerospace manufacturers will be the extent to which their competitors from abroad are able to capture market share, here at home as well as in markets overseas. The most important competition to the United States comes from Europe. A host of factors bear on the competitiveness of U.S. aerospace manufacturers in the global market place. These include economies of scale, private as well as public investment in aeronautical R&D, differences in export control regulations between the United States and our trading partners, tax issues, trade preferences, and international political relationships.

The Commission of the Future of the U.S. Aerospace Industry

Many of these issues were identified and addressed by the *Commission on the Future of the United States Aerospace Industry*, which published its full report in November 2002. I am proud of the contribution my staff at the Commerce Department made in preparing that report, especially in connection with the material on "Global Markets."

The Commerce Department played a leading role in helping to shape the Administration's response to the Commission's recommendations. Shortly after the report was issued, we led an interagency effort aimed at sharpening a public-private focus on the needs of the U.S. aerospace industry. Today, with the exception of the international trade portion of the Commission's report (in which we play a leading role), we are supporting other agencies that have the lead on the various issues addressed by the Commission.

For example, in the area of modernizing the U.S. air traffic management (ATM) system, a number of offices in the Commerce Department are contributing economic and analytical expertise to the Federal Aviation Administration. Our work will help to increase understanding of the economics that underpin the aviation industry and how changes in the current ATM system can produce benefits for the business community, not only in the aviation industry but in other industries as well.

In the area of workforce development, my staff is working with the Department of Labor and an industry committee with the aim of addressing the Commission's

recommendations in this area. In the area of export licensing, we are working with the Commerce Department's BIS and the Departments of Defense and State to help ensure an appropriate balance between the safeguarding of U.S. defense technology and the business needs of U.S. exporters. In the area of aeronautical research and development, my staff is assisting an interagency group that has begun a review of federally funded research and development with a view toward facilitating its dissemination to the private sector.

Mr. Chairman, you chaired a hearing on March 12, 2003, regarding the U.S. rotorcraft industrial base. At that hearing, Mr. Flater commented on the applicability of the Commission's recommendations to the helicopter industry. As you know, the recommendations impacting the helicopter industry focused on the portfolios of NASA, the Department of Defense, the State Department and the FAA.

The area of the Commission's report in which the Commerce Department is most involved concerns global markets and the need for free and fair trade in aerospace products. To an extent not seen in many industries, governments are a significant factor in the aerospace marketplace. Governments play two crucial roles: first, as customer, either of defense products or of civil aircraft (given governmental ownership or control of many non-U.S. airlines); and second, as a stakeholder in the economic well-being of their domestic aerospace manufacturers.

For many governments, including those of Europe, aerospace manufacturing is a strategic industry. The governments of the competitors of U.S. aerospace manufacturers intervene in the marketplace in various ways to support their domestic producers. As I mentioned earlier, this intervention can involve subsidies to produce new products, the creation of technical standards that favor domestic products, the offering of incentives to aircraft purchasers to boost the sale of domestic products, and tax and export financing programs that assist domestic producers in reaching markets abroad. Given this active role of other governments, the U.S. government is challenged to ensure that U.S. producers remain as competitive as possible in the global arena. Similarly, U.S. industry is challenged to work closely with the U.S. government to help address issues that arise. At the Commerce Department, one of our key responsibilities to meet this challenge is monitoring foreign government policies and pursuing appropriate action to promote a strong U.S. aerospace industry.

Concluding Remarks

In conclusion, Mr. Chairman, we know that there are many challenges confronting the U.S. manufacturing industry. Our Manufacturing Initiative report provides a comprehensive survey of policy recommendations that will benefit all U.S. manufacturers including the helicopter industry. We are working concertedly on the range of issues to support U.S. manufacturing and create jobs.

I would again like to thank you, Mr. Chairman, and all the Committee Members for this opportunity to express our views. I will be happy to take your questions.