Aerospace

Friday November 15 2013

www.ft.com/reports | @ftreports

Gulf carriers destabilise alliances

Inside »

Merger could be stuck on taxiway
US watchdog has acted to stop a proposed tie-up
Page 2

Gulf states push ahead
Dubai, Abu Dhabi and Qatar seek to increase capacities
Page 2

Manufacturers jostle for lead
Boeing and Airbus focus on widebody jets
Page 3

Satellite sale offers insight
UAE agreement to buy French kit could be revealing
Page 4

Emissions deal hard to reach
How much and how fast are still at issue
Page 4

Traditional groups are under threat from fast-growing players, writes *Andrew Parker*

Global links: dignitaries gather at Hamad International airport to celebrate Qatar Airways' membership of Oneworld, which connects it to 883 destinations AFP/Getty

The great and the good of the aviation industry gathered in Doha last month to celebrate an unusual event.

With much ceremony, Qatar Airways became the first of the large Gulf-based carriers to enter a global airline alliance by joining Oneworld, led by American Airlines and British Airways.

"Becoming a member of Oneworld is one of the most significant landmarks in Qatar Airways' history," declared Akbar Al Baker, the airline's chief executive.

This move highlights how the fast-expanding, state-controlled Gulf carriers – Emirates Airline, Etihad Airways and Qatar Airways – are no longer viewed with universal hostility by western airlines.

But Emirates and Etihad are unlikely to be joining one of the three global airline alliances – Oneworld, SkyTeam and Star Alliance – in the near future. These two carriers, based in Dubai and Abu Dhabi, respectively, are pursuing their own partnerships – actions that are destabilising the alliances and could play an influential role in reducing the importance of these groups.

The alliances were established in the 1990s because foreign ownership rules often prohibited carriers from combining via cross-border mergers. Even the biggest carriers knew they could not fly to all big cities, so airlines formed alliances that in effect bolted their networks together to offer destinations worldwide – notably to business travellers.

These alliances were supposed to be clubs that looked after their respective interests, but last year Qantas – a founding member of Oneworld – sent shockwaves through the industry by agreeing to form a far-reaching partnership with Emirates.

Founded in 1985 and now flying to more than 130 destinations with the world's largest fleet of wide-body passenger jets, Emirates has inflicted financial pain on long-haul carriers in the US, Europe and Asia – including Qantas. But the Australian carrier is hoping the collaboration with Emirates will play a key role in restoring its international operations to profit.

At the heart of the partnership is a code-share that gives Qantas passengers a much greater choice of routes between Australia and Europe, the Middle East and Africa because they can fly on Emirates' jets.

The main casualty of the deal was Qantas' 17-year-old partnership with British Airways although the Australian carrier, which is still a Oneworld member, continues to fly to London's Heathrow airport.

Tim Clark, president of Emirates, says the Qantas partnership is providing the Gulf carrier with additional revenue, because it is now flying more higher-spending business travellers based in Australia and New Zealand. He adds that Emirates has no interest in joining one of the global alliances, because it does not want to be "beholden" to some of the most powerful carriers within these groupings.

"Emirates, if it wants to make its way against a very strong competitive force, must be smarter . . . It was within our DNA to chart our own destiny," says Mr Clark.

Etihad, the youngest of the big Gulf carriers, also has no plans to join one of the alliances – and arguably is doing more than Emirates to destabilise these groupings.

For the past two years, Etihad has been assembling its own mini-alliance by buying minority stakes in five airlines, including Air Berlin, Germany's second-largest carrier, which is a Oneworld member. It is close to finalising the purchase of a 24 per cent stake in Jet Airways, the Indian airline.

More than $750m will have been spent on equity stakes in these partner airlines once the Jet deal takes effect, and Etihad is also providing some carriers with loans to support network expansion.

Continued on Page 3

Aerospace

Airlines merger could be stuck on the taxiway

Regulation US watchdog has taken legal action to prevent a proposed tie-up between US Airways and American Airlines, says *Robert Wright*

As Doug Parker, US Airways chief executive, and Tom Horton, his counterpart at AMR Corporation, the owner of American Airlines, negotiated plans for a merger last year, they mostly kept quiet.

But they were voluble on one point: that by reducing cut-throat competition, previous US airline mergers had hugely benefited the industry.

Yet there were those who did not agree. The US Department of Justice (DoJ) cited the executives' arguments for a combination of the two companies when it filed a legal action in August seeking to block the merger, arguing it would push up fares.

The DoJ's action is currently at a critical stage. With the legal action due in court this month, talks about a possible settlement are under way.

The outcome of the talks – or the court case, if it goes ahead – could dictate whether the steady consolidation of the industry, which has been cruising along for the past decade, can continue or whether it will be forced into an emergency landing.

Events in the US are critical to how the market develops worldwide. The US remains the world's largest civil aviation market. There has also been a significant amount of merger activity there.

In the European market, mergers are complicated both by political sensitivities and rules that demand control of each country's flag-carrier airline must lie within the country concerned.

Experts believe the DoJ has assembled some impressive arguments. "Based on the publicly available information, I think the odds are in the DoJ's favour," says Jonathan Lewis, antitrust partner for Baker-Hostetler, the law firm.

Michael Carrier, a professor in antitrust law at Rutgers University in New Jersey, agrees. "I think the DoJ has a strong case and I believe the DoJ has worked at its complaint, dotting Is and crossing Ts," he says.

The core of the dispute between the airlines and the DoJ is the outcome of a recent series of mergers of other airlines.

Among the largest were the 2008 merger of Delta and Northwest Airlines and the 2010 merger of United and Continental Airlines. Those two mergers created the US's two biggest airlines by sales.

US Airways and AMR have argued that they need to merge to provide a strong counterbalance to those two behemoths of the airline scene. Some labour unions backing the deal have argued there is a fairness issue – if the other mergers were allowed, why not this one?

Mr Lewis points out, however, that the previous transactions have already considerably consolidated the industry.

The DoJ says that, if the latest merger goes ahead, only four airlines – Delta, United, the new American and Southwest, the budget carrier – will account for 80 per cent of US passenger journeys.

Mr Lewis says: "It is always better if you are going to do a transaction to be one of the first movers, rather than being at the end of the line, when the industry has become more concentrated."

The chief executives also regularly discussed, before the merger announcement in February, how previous mergers had made the airline industry healthier by preventing the vicious undercutting that they said had marked earlier periods of weak demand and high fuel prices. The implication was that the US Airways-AMR merger was necessary to complete that process.

> Labour unions ask: if other mergers were allowed, why not this one?

Prof Carrier points out that arguments on this point could be complicated by the scope under antitrust law for a "failing firm" defence – that a merger should be allowed because one party is so financially weak it will otherwise leave the market, reducing competition.

AMR could have some scope to use such a defence since it has been in bankruptcy protection since November 2011. However, according to Prof Carrier, AMR has insisted throughout that it could emerge from bankruptcy as a viable independent company.

It has also turned robustly profitable in the past year, as new staff and leasing and financing arrangements negotiated during bankruptcy have turned round its fortunes.

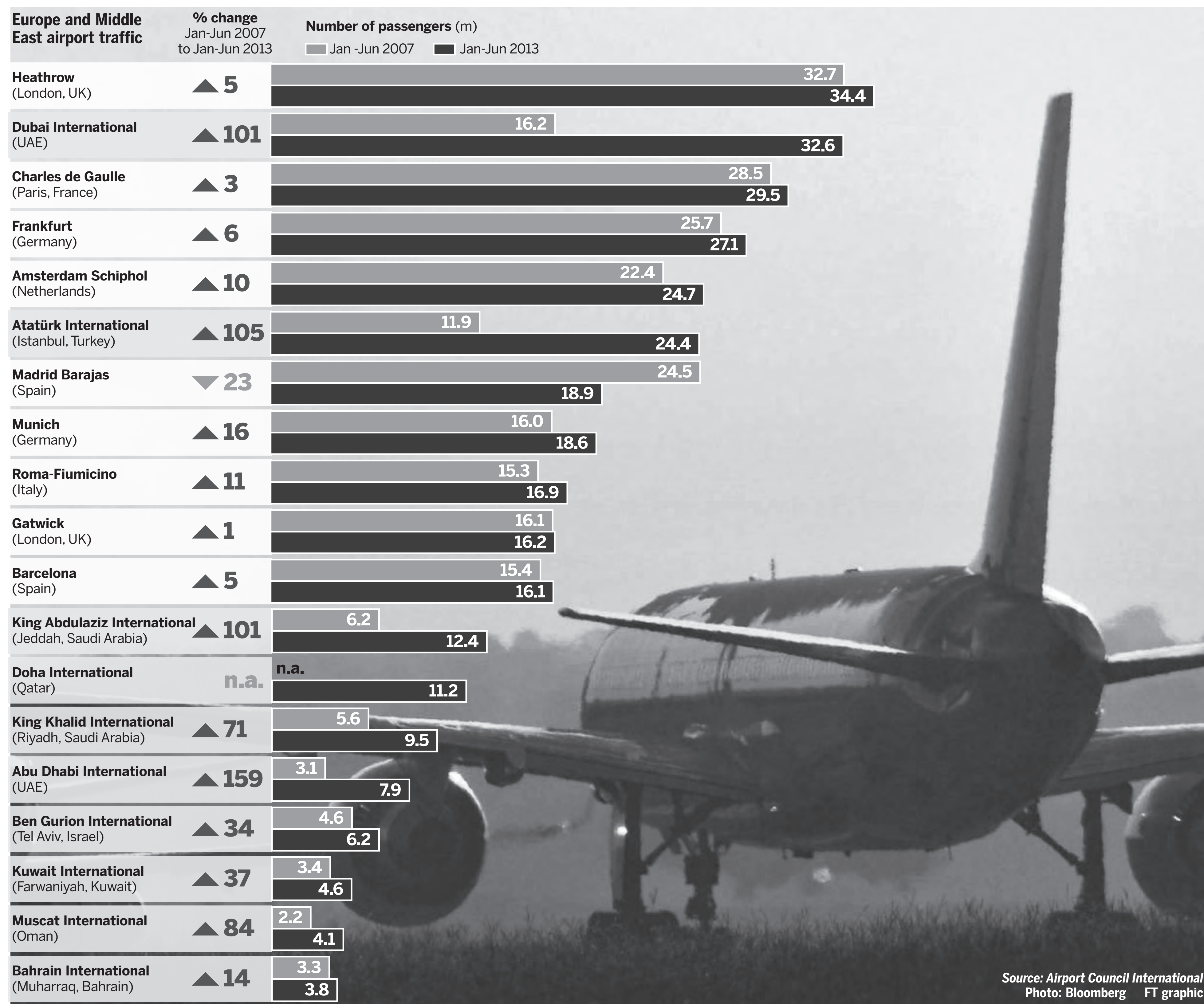
"When you look at how well AMR is doing in terms of profits, I do not think that argument would work," Prof Carrier says.

After Eric Holder, US attorney general, said on November 4 that he hoped to resolve the issues "short of trial", the most likely outcome is that the DoJ and the airlines will agree significant divestments of routes, primarily at Washington's Reagan National Airport.

Nevertheless, Mr Lewis calls the DoJ's effort to block the US Airways-AMR deal a "significant development".

Anyone seeking a merger in future would have to be able to argue convincingly that their deal would preserve or strengthen competition in the airline market.

Even if US Airways and AMR are not the last big US airlines to pursue a merger, they may well be the last to discuss its advantages in the frank terms they used.



National carrier experiences rapid expansion

Turkey

Growth is in step with diplomatic aims, writes *Piotr Zalewski*

It has been quite a decade for Turkish Airlines. In 2003, the carrier, still a relative unknown, flew 65 aircraft, racked up less than 90m air miles, and carried about 10m passengers to 104 destinations, 76 of them international.

Today, its fleet has increased to 233 aircraft, overall passenger numbers have more than quadrupled, and the number of international destinations on its departure boards has reached 197. Turkish Airlines now flies to more countries than any other carrier – 104 at last count.

At the 2013 Skytrax World Airline Awards, passengers also voted it the best airline in Europe for the third consecutive year.

With much of Europe within three hours by air from Istanbul, Turkish Airlines has traditionally been wedded to the continent. Yet that, too, is changing.

Over the past decade, the share of European passengers on its international flights has dropped from 70 per cent to below 60 per cent. The share of African and Middle East passengers, meanwhile, has risen from 4 to 8 per cent, and from 11 to 16 per cent, respectively.

The foray into new markets has paid off. With a 2012 operating margin of 7 per cent, Turkish Airlines has become Europe's third most profitable carrier, behind Ryanair and easyJet, according to the Capa Centre for Aviation, a think-tank.

Turkish Airlines expects revenues of $9.8bn this year, a 17 per cent increase on 2012.

However, with a host of new destinations on the way, including long-haul flights to the US and Asia that will drive up competition with Gulf carriers, Turkish Airlines is rapidly outgrowing its Istanbul base. For an airline that expects to carry 120m passengers by 2023, Ataturk International airport, which last year handled 45m travellers, simply will not do.

That is where the Turkish government, keen to boost Istanbul's status as an international hub, is lending a hand.

Istanbul's third international airport, which officials expected to reach a capacity of 90m passengers by 2018, is in the pipeline. According to Binali Yildirim, Turkey's transportation minister, construction is due to begin in the next few months.

Where governments might sometimes get in the way of a carrier's growth ambitions, Turkey's administration, which owns 49 per cent of Turkish Airlines shares, is doing its best to stoke them.

Take Africa. Here, Turkey's economic and diplomatic expansion has been in step with that of its national carrier. In 2009, Turkey had 12 embassies across the continent. Today, that number is 35.

The nation's exports to Africa, which were roughly $2bn in 2003, reached $13bn last year and Turkish Airlines' growth has been similarly rapid. From four destinations in 2003, the carrier has expanded to 34 today, including 15 last year, says Ali Genc, a company representative.

In March 2012, following on the heels of Turkish aid organisations, the airline became the first European carrier to launch direct flights to Mogadishu in Somalia. Ten further African destinations are in the works.

"It's been something of a rule of thumb," says Serhat Guvenc, an associate professor at Istanbul's Kadir Has University, "that wherever there are Turkish schools, Turkish investments and interests, Turkish Airlines should fly to that destination."

(The opposite also appears to be true. While Turkish Airlines flies to three destinations in Azerbaijan, two in Georgia, and six more in Iran, in the case of Armenia, which Turkey is yet to restore normal diplomatic relations, it has none.)

Strategy: Temel Kotil, chief executive of Turkish Airlines

Temel Kotil, Turkish Airlines chief executive, is the first to acknowledge the overlap.

"[Our] strategies and operations are strongly correlated with Turkey's foreign and trade policy. We are working in great harmony with our government to realise our growth strategy," he says.

With a few exceptions, Turkish businesses have followed where their national airline has led.

"Turkish Airlines has opened the doors of new markets to business people," says Rizanur Meral, president of the Turkish Confederation of Businessmen and Industrialists.

Without Istanbul's backing, Turkish Airlines would probably have had to chart a more moderate course, says Jonathan Wober, senior analyst at Capa, the think-tank.

"It's only a government that would initiate that kind of aggressive, potentially high-risk expansion . . . because a government may choose to take lower returns on its investment . . . if it is generating economic benefits elsewhere for the nation."

Kadir Has University's Prof Guvenc adds: "Most of these flights to these unorthodox destinations have become profitable."

The "if you build it, they will come" approach, he says, "seems to have worked".

Gulf states push ahead with growth plans to realise potential as global passenger hubs

Middle East

Dubai, Abu Dhabi and Qatar are all seeking to increase airport capacities, writes *Simeon Kerr*

The opening of Al Maktoum International, Dubai's second airport, to passenger traffic in October laid down another challenge to the global aviation market.

The trade and tourism-focused emirate has been joined by Abu Dhabi and Qatar in expanding airport capacity, as the trio position themselves as global hubs for air traffic.

Dubai's government will soon announce plans for a second phase of development at Al Maktoum International, as the projected volume of passengers at Dubai International airport in the city centre rises rapidly towards the 90m mark it was designed to accommodate.

Less than 80km away from Al Maktoum, Abu Dhabi International airport in the capital of the United Arab Emirates is increasing capacity from 12.5m to 47m passengers by 2017.

The $15.5bn airport nearing completion in Doha, Qatar's seat of government, is 15 times bigger than the nearby airport in the city, where passenger numbers increased last year by 17 per cent to 21m.

The new facility, with a capacity of up to 55m passengers, is scheduled to open in 2014 after years of delays.

This would allow it to be operational before fast-growing Qatar Airways takes delivery of its first A380 aircraft in spring. The older airport is not equipped for the Airbus superjumbo.

Regional airports are growing to meet the demands of the oil-rich economies, which want to position themselves as intercontinental hubs linking Asia, Africa, Europe and the Americas.

As airports in western Europe and North America have difficulty expanding, the Gulf airports seek to meet the rising demand for intercontinental flights.

John Strickland, director at JLS Consulting, says: "All these airports are hub airports. In the early 21st century, they are perfectly positioned geographically for the growth economies."

Paul Griffiths, chief executive of Dubai Airports, says Dubai, Doha and Abu Dhabi are competing for the "world market".

He says: "We [Dubai] are emerging as the world's pre-eminent intercontinental hub. And, as others such as Hong Kong and Frankfurt run out of the ability to service connecting traffic, we will take on that mantle."

Dubai, where about half of passengers are in transit, is seeking to realise its ambition of becoming the first true "aerotropolis", an urban centre focused in air traffic.

Since 1960, its airport has grown at 15.5 per cent a year. Traffic reached 57.7m passengers last year and is forecast to hit 65.4m by the end of 2013.

Dubai, which hosts 140 airlines flying to 260 destinations, has leapfrogged Hong Kong and Paris and its international passenger traffic could surpass slower-growing Heathrow, London's leading airport, next year.

As Dubai International expands its city-centre airfield, the emirate might attract 100m passengers, the "absolute limit" of its capacity, earlier than the original forecast of 2020 – hence the expansion of Al Maktoum International.

> Dubai's passenger traffic could surpass Heathrow, London's leading airport, next year

Mr Griffiths says: "We need to come up with a master plan to stop airports becoming 'ex-growth'.

"That's a perilous situation . . . When other airports have spare capacity, and if we can't accommodate growth, it will go somewhere else and be difficult to get back."

Options being considered in the plan for Al Maktoum International's second phase include a rise in capacity to 100m passengers by 2020 to accommodate a wholesale move of Emirates Airline and Flydubai to the desert location.

A significant challenge is that air traffic control has emerged as a serious bottleneck to growth, Mr Griffiths says. The UAE will need more co-ordination among its seven emirates and greater co-operation between civil and military aviation to minimise holding delays as flights increase.

Tony Douglas, chief executive of Abu Dhabi Airports, says the region's strategic location is driving double-digit growth in passenger numbers in the Middle East, specifically the countries in the Gulf Co-operation Council – UAE, Bahrain, Saudi Arabia, Oman, Qatar and Kuwait. This growth allows the expansion of multiple hubs, he says.

Bernardo Gogna, project director of the new Doha airport's steering committee, says: "The focus is on getting the airport compliant as per Fifa's [football's governing body] requirements for hosting the 2022 World Cup Finals."

The concentration of swelling airport capacity could become exposed to regional or international risks.

Mr Strickland at JLS warns: "At the end of the day, it is important to realise you can't count on forecasts. There are surprises upward and downward, such as 9/11 or Sars or the financial crisis."

The only time that Dubai has seen passenger traffic fall on a cumulative basis was in the aftermath of the 1990 Gulf war, which broke out seven years after the launch of Emirates Airline. "Random acts do tend to have a big impact on the growth graph," Mr Strickland says.

The long-term patterns of rising middle class travel and increasing regional low-cost flying remain strong, as does the need for connecting flights.

"All things being equal, given the region's geography, modern aircraft, good networks and serious pricing", Mr Strickland says, "we expect these trends to continue".

Incident: emergency workers attend a fire in a 787 Dreamliner at Logan airport in Boston. There were no passengers on the aircraft, but the blaze had serious implications for Boeing Getty

Manufacturers jostle for lead with widebodied jets

Rivals Setbacks have dogged Boeing and Airbus, which both hold hopes for their latest offerings, the 777X and the A350. *Andrew Parker* reports

For many in the aerospace industry, one of the most memorable images of 2013 will be January's television footage of firefighters rushing to deal with a blaze inside a Boeing 787 Dreamliner at Boston's Logan airport.

Boeing was rocked by the battery fire on the empty Dreamliner, operated by Japan Airlines. In a rare move, regulators ordered the temporary grounding of the worldwide fleet of 787s while Boeing fixed the problem.

The Dreamliner, Boeing's newest and most sophisticated passenger jet, is setting new standards in fuel efficiency – it is made mainly from lightweight carbon composites rather than traditional aluminium.

But Boeing's first-time use of lithium-ion batteries resulted in two cases of overheating – including the one at Logan airport.

Will 2013 end on a better note for Boeing, with the launch of a planned upgrade to its twin-engined 777 long-haul jet at the Dubai air show that begins on Sunday? And will this demonstrate that Boeing has made better bets than Airbus, its arch-rival, in the lucrative widebody jet market?

Boeing is proposing a new version of its popular 777 jet, featuring more fuel-efficient engines and carbon composite wings, in a project dubbed the 777X.

Emirates Airline is considering becoming a 777X launch customer by buying as many as 100 of these jets – a deal that could give Boeing a $30bn-plus record-breaking order.

"I think, whatever happens, there will be a substantive order for the new 777," Tim Clark, Emirates Airline's president, said last month, although he stressed at the time no deal had been finalised.

Boeing's plans for the 777X highlight how it is trying to outmanoeuvre Airbus in the widebody, twin-engined market by having more next-generation models than its European rival.

The US manufacturer aims to have five such jets: three versions of the Dreamliner plus two 777X models, carrying between 210 and 400 passengers.

By contrast, Airbus is only proposing one new widebody jet – the A350, with plans to make it available in three versions, which will carry between 270 and 350 passengers. The A350 will compete with both the Dreamliner and the 777X, suggesting the European manufacturer would not have Boeing's breadth of coverage.

However, Fabrice Brégier, Airbus' chief executive, said last month the company could potentially build a fourth, enlarged version of the A350 by stretching its fuselage.

Analysts say Airbus' notable success last month in securing its first order from Japan Airlines for 31 A350s, worth $9.5bn at catalogue price, might partly have been the result of problems with the Dreamliner – although the Japanese carrier's management insisted the deal had nothing to do with the 787 issues.

Jim McNerney, Boeing's chief executive, said last month the Japan Airlines order with Airbus was "a campaign we did not want to lose".

"We will take it as a sign to do better and work harder," he added.

He tempered Boeing's disappointment in Japan by highlighting that Lufthansa had, in September, placed its first order for widebody, twin-engined aircraft with the US manufacturer, by proposing to buy 34 777X jets.

> Boeing's plans highlight how it is trying to outmanoeuvre Airbus

Airbus is playing down the threat of the 777X by making an unflattering comparison with its initial proposal for the A350.

The original plans for the A350 involved attaching the aluminium fuselage of an Airbus A330 widebody jet to new carbon composite wings – but airlines did not rush to buy the aircraft because its operating costs were inferior to those of the Dreamliner.

"The modified older aeroplane like [the original A350 proposal] can never have the same economics as the clean sheet of paper aeroplane," says John Leahy, Airbus' chief operating officer for customers, adding pointedly: "And that is what [Boeing] are running into right now [with the 777X]."

The final proposal for the A350 was a new design made principally from carbon composites. Airbus is aiming to deliver the first A350 to Qatar next year.

While keeping the A350 plans on track will be a big challenge, the most glaring issue for Airbus this year has been the lack of orders for the A380 superjumbo – which entered service in 2007. Doric Lease Corp has made a preliminary commitment to buy 20 A380s, and Airbus is hoping this will convert into an order before the end of 2013.

Randy Tinseth, a Boeing marketing executive, says Airbus overestimated the size of the market for large widebody jets with four engines, such as the A380. Last month, Boeing reduced production of the 747-8 – the latest version of its 44-year-old jumbo jet – for the second time this year, blaming the move on reduced demand.

Zafar Khan, analyst at Société Générale, the bank, says: "The A380 has a future, but more as a niche player in the market, and the A350, the 787 and 777X are likely to be the workhorses in the widebody segment."

Gulf carriers destabilise alliances

Continued from Page 1

In part, Etihad benefits from some of the six airlines' passengers helping to fill its jets, because the Abu Dhabi carrier has code shares with those airlines.

James Hogan, Etihad chief executive, says its stakes in other airlines have put the 10-year-old carrier on a stronger competitive footing. "The only way we can build the scale we need to compete effectively is through strategic partnerships. These enable us either to access markets we do not serve in our own right or to build our presence in areas where our competitors have advantages," he adds.

So, against this backdrop of Emirates and Etihad pursuing bespoke partnership strategies, why is Qatar joining Oneworld?

Qatar, which flies to 131 destinations, highlighted at last month's joining ceremony how it would be able to offer its customers access to Oneworld's global network.

The 13 airlines in Oneworld, and their affiliate carriers, fly to 883 destinations in 151 countries.

Qatar's choice of Oneworld seems partly based on the strong working relationship between Mr Al Baker and Willie Walsh, chief executive of International Airlines Group, parent of British Airways.

Mr Walsh highlighted last month how British Airways' customers would benefit from the opportunity to fly with Qatar to smaller cities in India and other parts of Asia that the UK carrier does not reach.

"Qatar has a fantastic network from Doha . . . into areas we would not be able to serve directly," he said.

Agreement: IAG boss Willie Walsh (left) with Akbar Al Baker of Qatar Airways AFP

Mr Walsh's self-confessed admiration for the Gulf carriers contrasts with concerns expressed by Lufthansa, which last year complained that it was not competing on a level playing field with these airlines, partly because they benefit from government-funded airport infrastructure.

Mark Schwab, chief executive of Star, the alliance that Lufthansa helped to found, says the grouping did not seek to woo Qatar because of the risk that the Doha carrier would end up diverting flying passengers currently with its member airlines.

"We can see lots of value being transferred from our members to one of the Gulf carriers, but it's really hard to see what they get back in return," he adds.

In truth, it is not just Emirates and Etihad that are putting pressure on the global airline alliances.

> Airlines in the alliances but outside joint ventures risk being reduced to minnows

There is the potential for significant tension inside the alliances, because, in recent years, some of their members have formed joint ventures. For example, American Airlines and British Airways began a transatlantic partnership in 2011 that is broadly similar to joint ventures involving Air France-KLM and Delta Air Lines, and Lufthansa and United Airlines.

These partnerships are more important than the broader alliances, because they are focused on the most lucrative long-haul markets and the partners share profits. Airlines in the alliances but outside these joint ventures therefore risk being reduced to minnows.

But Bruce Ashby, chief executive of Oneworld, insists the alliances are not facing obsolescence because of the quasi-industry consolidation unleashed by joint ventures.

"Two airlines may merge, but you are not going to merge with all of the Oneworld partners into some sort of mega-Godzilla airline," he says. "There's still a pretty big role for the general concept of alliances."

However, Rigas Doganis, visiting professor at the UK's Cranfield University and a former head of Athens-based Olympic Airways, says the global alliances are "very unstable" because of the airline joint ventures and the strategies of Emirates and Etihad.

"The partnerships being made by the Gulf carriers are destabilising the alliances by changing loyalties; and loyalties within the alliances are being undermined by joint ventures which create a two-tier membership structure," he says.

Contributors

Andrew Parker
Aerospace correspondent

Jane Wild
Transport reporter

Robert Wright
US industry correspondent

Simeon Kerr
Gulf correspondent

Carola Hoyos
Defence correspondent

Piotr Zalewski
Freelance journalist, Istanbul

Sash Tusa
Partner, Echelon

Adam Jezard
Commissioning editor

Andy Mears
Picture editor

Steven Bird
Designer

For advertising details, contact: **Tom Shepherd**, +44 (0)207 873 4406 and tom.shepherd@ft.com, or your usual FT representative.

All FT Reports are available on FT.com at ft.com/reports
Follow us on Twitter **@ftreports**

All editorial content in this supplement is produced by the FT. Our advertisers have no influence over or prior sight of the articles or online material.

THE WORLD IS COMING
17-21 NOVEMBER 2013
Dubai World Central, UAE
DUBAI AIRSHOW
The Dubai Airshow opens on 17 November, register now for your opportunity to network with the leading figures in the global aerospace industry
www.dubaiairshow.aero/register

Aerospace

Satellite sale could offer more than just a view over Iran

Procurement UAE agreement to buy French kit could be revealing, writes *Carola Hoyos*

Can a military satellite sale offer a glimpse into the future?

In July, the United Arab Emirates signed a deal worth more than €700m to buy two high-resolution Helios military satellites from France. They will give the UAE the ability to look deeper into Iran than any of its Arab neighbours.

The deal, which was quickly followed by a French radar sale, has a second significance – it could herald the thawing of relations between France, the world's fourth-largest military exporter, and the UAE, one of the fastest-growing importers of defence equipment.

The win by Astrium, the satellite subsidiary of EADS, the pan-European defence and aerospace company, and Thales Alenia, a partnership of French and Italian defence contractors Thales and Finmeccanica, has given French analysts and executives a shot of cautious optimism that France could still win a far bigger prize: the $10bn sale of 60 fighter jets to the UAE.

Jean-Yves Le Drian, France's defence minister, described the satellite deal as having put his country's relationship with the UAE back on track after negotiations broke down with the previous French administration over the price and technical capabilities of Dassault Aviation's Rafale fighter jet.

"Trust was broken. Nothing was happening . . . This evening we reached a milestone, which is the building of trust," he told reporters on the flight back from signing the satellite deal.

Hints of whether the thaw will last could come as early as this month's Dubai air show. Statements by Emirati officials that Rafale was again in favour would suggest a big turnround for Dassault.

In November 2012 – after years of negotiating with the UAE failed – French executives and politicians looked on in dismay as David Cameron, Britain's prime minister, secured a "defence industrial partnership that involves close collaboration around Typhoon", in the words of the communiqué issued after his trip to mend shaky trade relationships around the Gulf.

Britain was more than happy to share the details of its Eurofighter Typhoon, which is made by EADS, BAE Systems and Finmeccanica and backed – financially and politically – by the governments of Britain, Germany, Spain and Italy.

A win in the UAE would be sweet revenge for Eurofighter, which lost the last round of a similarly sized Indian tender to Dassault's Rafale last year, although that deal has yet to be finalised. More seriously, a win for Eurofighter would extend work for the partners building Typhoons well beyond 2017, when orders are expected to dry up.

The UK hopes that securing the UAE as a customer could result in sales around the Gulf. Britain has already won orders from Saudi Arabia and Oman and interest from Bahrain. Optimistic executives believe a win in the UAE could improve its chances in Kuwait – a stronghold for US companies – and speed up a second order from Riyadh. A loss would be made less painful by the fact that until recently not even BAE thought it stood a chance in the UAE.

Deal: Jean-Yves Le Drian (left) with Abu Dhabi crown prince Sheikh Mohammed bin Zayed AFP/Getty

Indeed, Dassault has been the clear favourite in the UAE, especially after France's significant efforts to deepen its military ties.

For Rafale therefore, the potential downside from a loss is greater than the upside from a win.

Rafale has France as its only firm customer. The cash-strapped French government this summer slashed the number of Rafale jet fighters it would buy and final contract negotiations with India are proving difficult, prompting some to warn they could take a decade or more to conclude.

Charles Armitage, analyst at UBS, warns that a Eurofighter win in the UAE could lead to a spiral of unfortunate events by putting pressure on India over the Rafale fighters.

"Nobody likes being the only export customer for a programme, as it tends to reduce flexibility and increase the upgrade and maintenance costs," he says, adding that this "could bring Typhoon back into the picture".

Several analysts have suggested that recent political developments, including Paris's professed willingness to hit Syria with a military strike and its continued hawkishness against Iran, may have helped it win further favour in the UAE.

But Francis Tusa, an independent defence analyst, warns that even cautious optimism surrounding Dassault and Rafale may prove misplaced.

"Why would the UAE go back after having very publicly backed off, unless there had been some incredible lobbying behind the scenes," he asks, suggesting that those who see France's recent satellite and radar win in the UAE as a predictor of good news for the Rafale, could be hopelessly lost in translation.

"Actually, what the Emirates may be saying is: 'We won't buy Rafale, but we will buy some satellites as a consolation prize.'"

If so, French executives will have to accept that Helios satellites may be good for spying on Iran, but do not offer a view of the future after all.

Agreement on emissions hard to reach

Environment

There is consensus that action is needed, but how much and how fast are at issue, writes *Jane Wild*

A global agreement on limiting airline carbon emissions has been 16 years in the making but, even after a definitive step forward last month, the goal still seems far off.

After the assembly of the International Civil Aviation Organisation in Montreal in October, the UN agency responsible for standards in aviation hailed a breakthrough: its 191 member countries had endorsed the creation of a global measure to tackle airline emissions from 2020.

Yet that commitment – to work out a deal over the next three years – was not enough for those who said it merely deferred real action.

"We have to temper enthusiasm with a heavy dose of scepticism," says Bill Hemmings, programme manager for aviation and shipping at Transport & Environment, a lobby group.

"All the hard questions – which mechanism, when (and indeed whether) to implement, who to exempt, how to measure and, last but not least, who pays and who receives – are still to be addressed."

The other key resolution to come out of Montreal was controversial, in that it limited the EU's own aviation emissions scheme, creating uncertainty over that.

Observers present at the meeting said the mood had been tense and there had been much resentment towards the scheme.

Developing countries such as China, India, Brazil and Russia, and some developed countries, including the US, argued that flights landing within the EU should not be caught by its scheme.

They say that the European plan to make airlines pay for their carbon pollution, even if the international flight originated far away, is a unilateral breach of their sovereignty.

Some have raised fears of a trade war. Last year, Airbus said that it was unable to complete orders with Chinese airlines because of Beijing's opposition to the EU scheme.

However, despite the weakening of its scheme, the EU painted the decision positively.

Siim Kallas, EU transport commissioner, said that the agreement avoided "a damaging conflict among trading partners".

But, in revised proposals for its scheme a few weeks later, the European Commission again caught foreign airlines within its net, prompting them to hit back.

The International Air Transport Association, the global aviation industry body that represents 240 airlines, said that it was concerned the commission was pursuing action that had the potential to undermine the goodwill that achieved a consensus in Montreal.

It has pushed for a global response to aviation emissions, to avoid distortions created by a patchwork of policies.

Achieving a global system to regulate emissions is possible, agrees WWF, the conservation group. Nevertheless, the Montreal deal was "the smallest of tiny steps forward", says Jean Leston, WWF transport policy manager, and the progress would be problematic.

"It could be quite a difficult few years ahead, and it will depend on the goodwill of aviation industry, if we're going to see anything emerge in a few years' time," she says.

The ICAO's governing council is now working to formulate plans for a global market-based mechanism by 2016. That could take shape as an offset scheme, whereby airlines can buy permits for carbon that is offset elsewhere.

Steven Truxal, lecturer in aviation law at City University in London, says: "It's been a long time, but there is now a global consensus, which is that something needs to be done." The variety of backgrounds and legal frameworks of the countries coming together at the ICAO table highlighted how complex a process reaching an agreement will be, he says.

The EU had moved faster and its emissions trading scheme had "effectively given the US and others a green ultimatum, by saying 'the global aviation sector, anyone who uses our airports, will have to play by our rules'".

> EU scheme had effectively given the US and others a green ultimatum

After Montreal, the EU scheme could be viewed as an interim measure before global action was achieved, he says.

But Mr Hemmings, of Transport & Environment, says the "rush to crush" Europe, supported by the US, has serious implications. "The G77 [group of developing countries], with American support, has clearly shown it has the votes in ICAO," he says.

He warns that the balance of power could tip further towards countries that wanted to constrain the EU scheme with forthcoming changes of leadership – a new council president will take over from January and the next secretary-general will come in 2015.

"With a new Nigerian council president and the next secretary-general potentially coming from China, the chances of any ICAO outcome having a meaningful impact on aviation emissions would seem to be receding," Mr Hemmings says.

"The whole of the ICAO negotiations remain very difficult and I think it's going to take a complete rethink of established positions if we're going to see anything constructive come out of it," says Ms Leston.

Groups all choose the same alternative strategy

Austerity tactics

As budgets are cut, suppliers' attempts to diversify look remarkably similar, writes *Carola Hoyos*

In 2012, global military spending fell for the first time in 15 years to $1.7tn.

The main drivers were the winding down of the wars in Iraq and Afghanistan; the continued decline in European spending and the start of budget restraint by the US, the world's biggest defence spender by far.

All three factors hit western defence groups and have prompted executives to devise strategies for coping with what most believe will be a 10-12 year downcycle.

The problem is that companies are adopting very similar solutions, making it difficult for all to succeed.

Defence company executives have set three objectives: to grab a bigger slice of the service sector; move more aggressively into cyber security; and expand into developing markets.

Almost all of them confidently assert these three factors will make up for the deepening cuts in defence spending in the US and Europe. Few observers are convinced.

Defence services involves helping governments outsource what men and women in uniform have done in the past – from running bases and training helicopter pilots to equipment maintenance, even at war.

The margins are strong, risks low, the work predictable, and the chances of adding business during a downcycle good.

With less new equipment being bought, the argument goes, there is more to maintain and service.

Half of BAE Systems sales already come from this area, and smaller companies, such as Babcock of the UK, are also benefiting.

In outsourcing, the UK government is ahead of its peers. It has put out to tender the £4.4bn job of maintaining its facilities.

It is even considering handing over to the private sector the £14bn a year task of buying its weapons – although for conflict of interest reasons big defence suppliers have not been allowed to bid.

In the US, BAE is maintaining the navy's ships, but there is still room for more service business to be thrown the defence industry's way, analysts say, especially as the fiscal squeeze forces the Pentagon to find savings.

But while defence companies have an advantage in taking over the servicing of equipment that no other industry knows as well, cyber security is different.

Growth prospects are good, but the base is small, the margins not particularly high and other industries – especially security vendors – such as Symantec and Dell SecureWorks – and systems integrators – such as Atos and Wipro – have as much of a claim to the territory.

AlixPartners, a consultancy, warns in a recent report: "When targeting the right applications, defence companies need to recognise that they almost certainly do not possess all the skills and capabilities necessary for success."

Analyst Zafar Khan

That is why BAE bought Detica, a cyber security company, in 2008. Analysts thought the £531m price tag was high and other acquisition targets in the sector have become dearer.

Defence companies' best claim is that they already have the security clearance to handle the most sensitive government projects. Lockheed Martin has been the US government's biggest cyber security provider for years. But that will not be enough to capture the wider civilian market, including banks and utilities.

As AlixPartners puts it: "Companies must beware of the potential to take a me-too approach to strategy. Although first movers don't always win, not all can apply the same strategy and succeed at the same time."

The same holds true for the rush to find customers in developing countries.

Until now, US companies such as Lockheed Martin, Boeing and Northrop Grumman, have had the luxury of supplying their government, whose defence spending boomed after the terrorist attacks of September 11, 2001 and the subsequent Iraq and Afghanistan wars.

BAE, which years ago outgrew its UK home market, and Raytheon, America's most international defence group, are better positioned.

But with all the suppliers now trying to capture international markets, the field is crowded.

And defence sales have as much to do with politics as products.

Zafar Khan, an analyst at Société Générale, the bank, says: "If I were a betting man, I would put money on the company with the stronger political connections, rather than the one with the superior, technical product."

In southeast Asia, US companies have the upper hand, while in the Middle East the UK is helped by its colonial history. The French and Italians enjoy better luck in north Africa.

The next test of those ties will probably be the UAE's $10bn fighter jet purchase.

Dassault of France has offered its Rafale, chosen as the preferred candidate to provide India's fleet. The UK is touting Eurofighter's Typhoon, built by a consortium of the BAE, EADS and Finmeccanica.

Whichever company wins, it will be nowhere near enough to counter the deep cuts in the west's military spending, for which no company appears to have found a remedy.

Dubai air show offers opportunity to assess the state of the industry

Opinion
SASH TUSA

An air show is not an ideal place for contemplation: a stream of order and product announcements, the heady aroma of jet fuel and the noise and sights of a daredevil flying display are powerful distractions.

But the 2013 Dubai air show is a better venue than most from which to assess the shifts in the aerospace and defence industry.

And it is becoming apparent that, as global demand continues its drift towards Asia, the two sides of the industry have radically different drivers.

In large civil aircraft, the Middle East is the main growth market, along with the Asia-Pacific region. Asian demand is driven by a combination of large population centres and long distances, while Middle East demand reflects the region's establishment as the hub centre of choice for global air travel.

Of the region's four potentially world-scale airlines – and their associated hub airports – only Turkish Airlines has the domestic population to support its ambitions. The others – Emirate Airline in Dubai, Etihad Airways in Abu Dhabi, and Qatar Airways – exploit their geographical locations.

But a paradox of the civil aerospace market is the degree to which manufacturing and research and development look set to remain firmly seated in North America and western Europe.

Attempts to develop broad-based aerospace manufacturing and services in the Middle East have stalled, notwithstanding the efforts of state champions such as Mubadala in Abu Dhabi.

And the travails of UAC in Russia and Comac in China, with their Airbus A320/Boeing 737 lookalike projects, emphasises the high barriers to entry in the jet airliner market.

These barriers are characterised less by "hard" aircraft characteristics, including passenger capacity, range, speed, and more by "soft" attributes, especially reliability, economic performance, and ease of maintenance.

Decades of intense competition between Airbus, Boeing, and their suppliers, as well as producing more than 1,000 large jets annually, have honed their capabilities.

But US and European industrial dominance in defence is by no means as certain. The Dubai air show coincides with the apogee of US defence spending: procurement outlays are likely to fall by at least a third by 2016-17.

European companies lacked the boost that their US competitors enjoyed from Afghanistan; their restructuring has been accentuated by the financial crisis.

For the leading US and European defence companies, exports have become the priority, both to keep domestic production lines flowing, and to part-fund the development of products.

The challenge is that export customers increasingly not only require extensive "offsets" to accompany orders for western defence equipment, but also are focused on developing indigenous defence industries.

Nations with large and educated populations and sufficient economic growth can now consider domestic production of armoured vehicles, weapons, defence electronics and warships.

Turkey, Korea, Japan and India all have credible ambitions to join the US, western Europe, Russia and China as producers of locally developed combat aircraft in the coming decades.

> For the leading US and European defence companies, exports have become the priority

Of the US companies, Lockheed Martin, maker of the F-35 Joint Strike Fighter, looks secure, as that aircraft enters service and higher-rate production. The challenge for the company and its partners is to make the F-35 far more affordable than it is at present.

Elsewhere, the expansion of the US defence base that accompanied programmes such as the Littoral Combat Ship and MRAP armoured vehicles looks set to reverse; the LRS-B bomber competition could even see Northrop Grumman squeezed out of the aircraft segment.

But it is European defence companies that probably have the greatest challenge: to retain, by exports and residual domestic demand, a credible technological position and manufacturing base into and beyond the 2020s.

A handful of export competitions over the next five or so years is likely to decide which, if any, of BAE Systems, Dassault Aviation, EADS, Alenia or Saab survive to lead any next generation European combat aircraft programme, whether manned or remotely piloted, in the 2020s.

The author is aerospace & defence partner at Echelon, an independent research & advisory company