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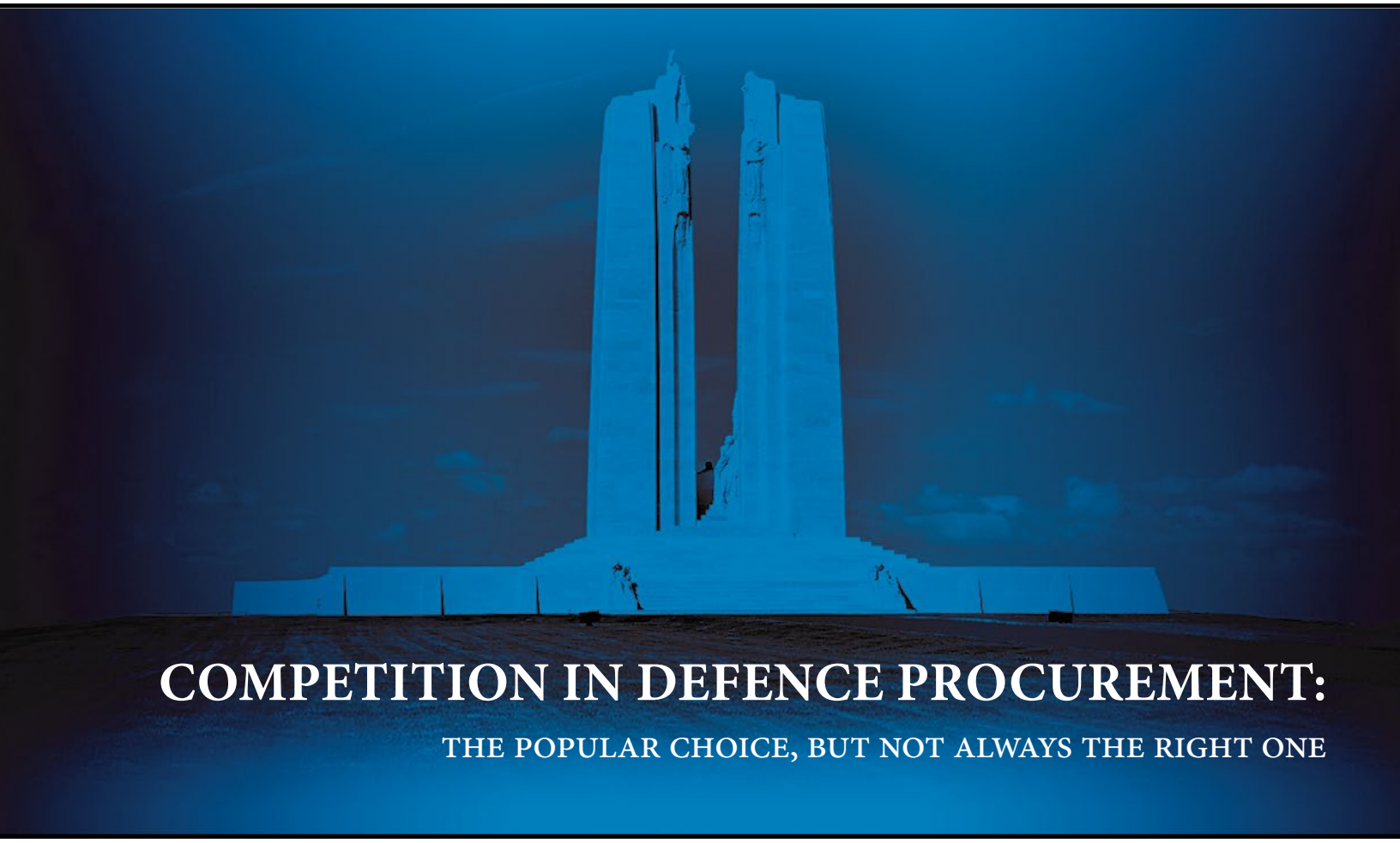

COMPETITION IN DEFENCE PROCUREMENT:

THE POPULAR CHOICE, BUT NOT ALWAYS THE RIGHT ONE

Charles Davies

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Conference of Defence Associations Institute

151 Slater Street, suite 412A
Ottawa, Ontario K1P 5H3
613 236 9903
www.cdainstitute.ca

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Charles Davies

Research Fellow
CDA Institute

EXECUTIVE SUMMARY

There is a deeply ingrained belief in many quarters that virtually all government defence procurement should be done through competitive tendering. There is no deep analysis supporting this belief, little objective research underpinning it, and not much consideration of the possibility that case-specific factors might in some instances lead logically to a different conclusion. This Vimy Paper seeks to encourage a more objective discussion about when the government should meet its requirements through open competitive tendering, and when more restrictive procurement strategies, including sole-sourcing, will provide the best outcome.

The paper begins with an overview of how military requirements are defined and then considers the broader context within which they will be met, including the nature of defence procurement and the legal parameters governing it. The analysis then reviews a number of circumstances where one or other of the four main legal exemptions in the *Government Contracts Regulations* could allow the non-competitive sourcing of certain defence requirements. Having concluded that there are some circumstances when sole-sourcing may be appropriate, the paper briefly examines the very powerful tools provided by the *Defence Production Act* that can be used to ensure that the government gets best price or best value from the contract.

Conventional wisdom sees competitive procurement as the gold standard to be met in government procurement. Therefore, the government is reluctant to use less competitive strategies even when this would save money. The result is that the Department of National Defence may sometimes pay more than it could have, yielding an equivalent net reduction in the defence capabilities the nation can afford to maintain within a limited budget envelope. In order to avoid this, the paper calls for a better informed and more thoughtful public discussion about defence procurement strategies, and a recognition that there will be times when objective analysis will show that a more selective method, including sometimes sole-sourcing, will provide the best outcome for the nation.

SOMMAIRE

Il est difficile d'imaginer l'achat de matériel militaire, toutes catégories confondues, sans appel d'offre. Pourtant, aucune recherche ou analyse en profondeur n'existe qui pourraient nous empêcher de croire que dans certains cas précis, une autre solution soit envisageable. L'auteur de ce 'cahier Vimy' suggère qu'il serait tout à l'avantage du gouvernement de décider entre l'appel d'offre et une stratégie plus restrictive, celle du fournisseur unique, par exemple, afin de rencontrer ses obligations de la façon la plus rentable dans l'achat de matériel militaire.

Comme point de départ, l'auteur énumère les différentes catégories de matériel militaire pour ensuite, dans un contexte élargi, expliquer selon la nature et les paramètres légaux les régissant, la façon que le gouvernement en fait l'achat. Il énumère et explique ensuite les circonstances qui permettent au gouvernement de choisir en toute légalité l'une des quatre raisons pour lesquelles l'achat par l'entremise d'un fournisseur unique est permis. Il poursuit en décrivant les outils puissants que fournit la 'Loi canadienne sur la production de défense' qui permettent au gouvernement d'obtenir le meilleur résultat qualité-prix des contrats.

Il est généralement accepté que l'appel d'offre doit servir de norme d'excellence dans l'achat du matériel militaire. Le gouvernement est donc plutôt réfractaire à l'idée d'utiliser une stratégie plus restrictive, même si cela occasionne au ministère de la Défense nationale des dépenses plus importantes et, par conséquent, une réduction quant à la quantité et la qualité des capacités de défense disponibles. En conclusion, il suggère que dans le but d'éviter un résultat pareil, un débat public et éclairé des enjeux entourant le choix de stratégie à utiliser pourrait conclure que dans certains cas bien précis, une stratégie plus restrictive, celle d'un fournisseur unique, par exemple, serait plus rentable pour le Canada.

INTRODUCTION

There is a deeply ingrained belief in many quarters that all, or virtually all, government procurement should be done through open competitive tendering. There is no deep analysis supporting this belief, little objective research underpinning it, and not much consideration of the possibility that case-specific factors might in some instances lead logically to a different conclusion. The absolute primacy of openly competitive government procurement is widely embraced as conventional wisdom simply because it is an easy idea to understand and 'everyone knows it is true.'

In fact, like the financial consequences that can come from herd investing, selecting a defence procurement strategy based simply upon popular conventional wisdom can often yield unintended negative outcomes. These may range from getting a product or service that is inadequate for the job to – perhaps counterintuitively – overpaying for it. None of these potential outcomes should be acceptable to the government or Canadians, but avoiding them requires sometimes looking beyond conventional wisdom towards politically less popular procurement strategies. This paper seeks to encourage a more thoughtful and objective discussion about when the government should meet its military requirements through open competitive tendering, and when more restrictive procurement strategies, including sole-sourcing, will provide the best outcome for Canadians.

Any decision on a procurement strategy for a given acquisition is driven by many factors, including political considerations, but the main inputs derive from two distinct but interconnected processes: determination of the operational requirement in the context of overall defence priorities and resources; and the procurement planning process. The former defines what needs to be acquired – specifically the operational and technical requirements to be met and the allocated funding envelope. The latter evaluates the relevant marketplace conditions, recommends a procurement strategy appropriate to those conditions, and sets out a plan to execute it.

The primary focus of this paper is the second process, however a short discussion of requirements determination will be helpful in establishing the context.

MILITARY REQUIREMENTS DETERMINATION

Given the small size of the Canadian Armed Forces and wide range of possible missions they are expected to be capable of undertaking, the process of determining what equipment the government should acquire for them can be complex. For major systems in particular, it often involves extensive use of Operations Research tools and simulation environments to study the utility and performance of prospective platforms across a range of potential future mission scenarios. Not surprisingly, multi-role or multi-use

designs frequently emerge from the analysis as providing the most cost-effective solutions.

A multitude of considerations go into this analysis. A major one is of course affordability, not only the acquisition cost but also the whole-life cost of ownership and operation. A second important question is what is available in the market and how closely those existing products meet the Canadian Armed Forces' needs: operational performance in a broad range of climatic and physical conditions; interoperability with existing Canadian and allied systems; maintainability; supportability; and so on. Various additional considerations can also come into play, including government policy direction, domestic industrial interests, and many others.

It is rare to find a single product that optimally meets every aspect of a complex requirement, so trade-offs and compromises are an integral part of the decision process and this can be a source of debate both inside and outside National Defence. Unless an individual has been deeply involved in the analysis, the rationale behind the resulting recommendations (and the perhaps difficult compromises embedded therein) may not be readily apparent to them. Beyond this, the foundations of the requirement itself – the government's analysis of the current and likely future national and global security environment, and the conclusions drawn about Canada's defence needs – may also be challenged in many quarters outside government. It is therefore almost inevitable that there will be controversy around military equipment requirements. In some cases the public debate can become politically debilitating, with occasionally drastic and always expensive consequences for taxpayers.[1]

As a response to this recurring phenomenon, the previous Conservative government sought to strengthen oversight of the process for defining equipment requirements by establishing an independent challenge function to critique the military's operational and technical analyses. The intent was to provide further assurance to the Minister of National Defence, the government, Parliament, and Canadians that this work is being done objectively and under external scrutiny.[2]

The ultimate decision on the requirement will significantly affect the choice of a procurement strategy. If the balance of trade-offs and compromises in the requirements analysis permits enough flexibility so that several products can legitimately be considered to provide acceptable solutions, then a wide open competitive procurement strategy may be entirely appropriate. If, for valid reasons, it is determined that no such flexibility exists, or would come with too many negative consequences, then a more restrictive strategy may be necessary. Options can include limiting the competition to a small pool of qualified suppliers or, in certain cases, sole-sourcing.

DEFENCE PROCUREMENT CONTEXT

Turning now to the selection of a defence procurement strategy, to obtain the best price or best value (which are not the same thing[3]) from a competitive procurement process, several conditions have to be met:

- The requirement has to be clearly defined in a way that gives bidders a common set of measurable parameters to meet in terms of the products or services offered;
- There must be a sufficiently large pool of suppliers demonstrably capable of reliably meeting the requirement. How 'sufficiently large' is defined may vary depending on the technological or other complexities of the purchase, but an appropriately critical mass is necessary for a successful open competitive procurement;
- When buying something that is not a standard product or service, the bid evaluation criteria to be applied in assessing functionally different solutions need to be well defined, defensible, and fair; and
- The government must have reasonable confidence that there will be no collusion among bidders.

These criteria are easy to meet in the vast majority of government procurement transactions, which involve relatively small expenditures on mostly low-cost, widely available commodities or simple services. Office supplies, standard computer equipment, construction equipment, commercial vehicles, temporary clerical services, and so on are all readily available in competitive marketplaces served by multiple suppliers. When purchasing them, traditional open tendering makes eminent sense.

However, the more complex a good or service is, the smaller the number of suppliers likely to be capable of reliably providing it. There are also specialized niche areas where demand is not large enough to support a wide supplier base. At some point in both of these circumstances, the marketplace can no longer be described as truly competitive and different approaches to procurement should be considered.

Defence procurement encompasses both ends of this spectrum. Like other departments of government, the Department of National Defence buys many low-cost, widely available goods and services. However, it also buys very specialized systems with limited availability and, sometimes, unique high-cost goods or services only available from a single source. Selecting the right procurement strategy for each of these situations is critical if acquisition and lifetime system operating costs are to be kept as low as possible.

Looking outside government, modern industry best practices do not emphasize competitive procure-

ment in all circumstances. As far back as 2005, a government report noted that in industry: "[s]ignificant benefits accrue when the corporation enters into long term strategic alliances with a limited number of suppliers."[4] This preferred supplier model was also supported more recently in the 2013 government report by Tom Jenkins, *Canada First: Leveraging Defence Procurement Through Key Industrial Capabilities*, known as the Jenkins Report.[5] Preferred supplier relationships have greater value in situations where the services or technologies involved are more complex, where predictable quality is essential, and/or where success depends upon smooth integration of the elements each player brings to the table, which is often the case with major defence requirements. These kinds of relationships take time and experience to build.

Of course, government procurement is not the same as private sector procurement because many other diverse considerations come in to play, but government cannot afford to ignore these commercial best practices. Indeed, there are several preferred supplier relationships already in place between the Crown and certain companies. Some of these will be discussed further below.

Preferred supplier relationships can be both beneficial and troublesome for governments. The benefits tend to be tangible and measurable – key defence industrial capabilities that are sustained, product quality consistency, supplier responsiveness, price predictability, and so on. The troublesome aspects tend to be political, such as when non-involved companies are dissatisfied or the public perceives the relationships to be unfair or otherwise inappropriate. Overlaying everything, the popular conventional wisdom that government procurements should be openly competed to guarantee lowest price remains a powerful influence that can obstruct rational examination of the arrangements.

Consequently, governments are understandably very cautious when it comes to decisions about procurement strategies other than open tendering, and the policies governing the associated decision processes are accordingly complex and carefully crafted.

GOVERNMENT PROCUREMENT – LEGAL REQUIREMENTS

There are many legal parameters that shape all procurement strategy decisions by the Federal Government. Several international trade agreements apply in principle, however all contain provisions that nations can invoke to exempt defence and other national security procurements from the normal rules for open trade access. Most nations routinely use these exemptions, Canada traditionally less frequently than others.[6] Canada also has a domestic *Agreement on Internal Trade* governing, among other things, purchasing by the federal and provincial governments, and a number of Aboriginal land claim agreements also have legally binding procurement provisions that must be respected.[7] Treasury Board has

incorporated the requirements of these various legal instruments into several directives providing amplifying policy direction.[8]

This is the context for the primary legal document governing federal government purchasing, the Government *Contracts Regulations* under the *Financial Administration Act*. There are only a few specific exemptions to these *Regulations*, including a very recent one approved by the previous Conservative government in June 2015. It exempts "a contract whose purpose is, for operational reasons, to fulfil an interim requirement for defence supplies or services or to ensure defence logistical capabilities on an interim basis, and any related contract."[9] The effect of this is to allow the government to sole-source certain interim defence requirements, and the authority was clearly put in place to enable it to award a non-competitive contract for the lease of a modified commercial vessel to meet the Navy's urgent need for an at-sea replenishment capability pending delivery of the Joint Support Ship.

This new defence exemption to the *Regulations* certainly opens the door for a government to do more non-competitive sourcing, but it is doubtful it will be widely used. For one thing, it only applies to interim requirements and governments will normally be reluctant to spend significant sums on these because doing so may highlight problems with their management of defence capabilities.[10] Secondly, the entire policy framework governing all government procurement is heavily oriented towards competitive sourcing, so departments will continue to face significant institutional resistance to proposed sole-source acquisitions. Finally, above very low dollar levels, it will be Treasury Board ministers who decide whether to apply the exception; given the wide public aversion to sole-sourcing, there is a strong political disincentive to their doing so.

Consequently, the more restrictive legal boundaries of the *Government Contracts Regulations* will continue to apply to the vast majority of defence procurements, and these provide a useful framework for a discussion about circumstances where competition may not provide the best outcomes. Sections 5 and 6 of the *Regulations* state:

> *5. Before any contract is entered into, the contracting authority shall solicit bids therefor in the manner prescribed ...*
>
> *6. Notwithstanding section 5, a contracting authority may enter into a contract without soliciting bids where*
>
> > *(a) the need is one of pressing emergency in which delay would be injurious to the public interest;*
> >
> > *(b) the estimated expenditure does not exceed*

(i) $25,000…[with two very narrow exceptions not normally applicable to defence procurement]

(c) the nature of the work is such that it would not be in the public interest to solicit bids; or

(d) only one person is capable of performing the contract.

In other words, contracts have to be competed – except when they do not for any of the four reasons set out in Section 6. We will consider circumstances where each of these conditions might apply in defence procurement.

COMPETITION IS NOT MANDATORY WHEN:

1. The need is one of pressing emergency in which delay would be injurious to the public interest

This provision is only rarely invoked. It might be, for example, in a disaster response where it has not been possible to anticipate all requirements in advance. Especially in the earliest phases of the relief operation, required goods and services may need to be purchased on the spot where and when they can be found. Other situations may also demand immediate action.

Treasury Board has set financial limits on the emergency spending authorities of individual ministers in its *Contracting Policy* and requires that the circumstances be reported whenever these authorities are used, so there are quite tight controls over the use of this provision.

2. The estimated expenditure does not exceed $25,000

The dollar thresholds set out in this section of the *Regulations* reflect the fact that in some cases the cost of going through a bidding process, for both the government and potential suppliers, may exceed the net value of many smaller purchases. For example, if a fair profit margin for a supplier is 10 percent, then the profit out of a $25,000 contract would be about $2,500 before taxes. Preparing and submitting a formal bid meeting typical government standards for even a simple requirement can easily cost that much or more, and in these circumstances it would be counterproductive for everyone if the requirement were to be competed.

Departments may still choose to competitively source requirements valued below the levels specified in this part of the *Regulations* where it makes sense. In this case, the process may be less formal and less open than for larger acquisitions, for example, the purchasing officer may simply call around to

several suppliers of a standard item to get prices.

3. The nature of the work is such that it would not be in the public interest to solicit bids

The broad wording of this provision reflects the fact that there are many diverse circumstances where the public interest may not be served by competing a requirement. In fact, it can be argued that the decision to exempt interim defence operational requirements from the *Government Contracts Regulations* may have been unnecessary, since a valid public interest argument should be possible to make in most cases of legitimate interim need. Beyond this, there are other circumstances that can arise and a number of these are discussed in turn below.

Existing Equipment

When looking to upgrade or augment an existing system it may be very much in the public interest to go directly back to the original equipment manufacturer (OEM) – for example, when purchasing additional missiles for existing launchers or upgrading the computer software in a complex weapon system. Considering another supplier's product in this kind of situation will often make no sense, given the technical risks and costs involved in trying to integrate a different technology into an existing system.

Going back to the OEM for critical support requirements may also be appropriate for reasons of simple prudent containment of risk by dealing with the proven supplier of an advanced, complex, and expensive platform. Competing the requirement in some circumstances may run the risk of ending up contracted with someone who, though perhaps enthusiastic, is less familiar with the system and therefore more likely to make mistakes that impact its operation, and to run into unexpected and costly difficulties.

In many of these cases, it is worth noting the original procurement of the existing system would have been competed. If so, the follow-on procurement, though sole-sourced in the sense that the additional contract was not competed, derives directly from that original selection process and therefore needs to be looked at differently from a sole-source purchase of a new item. One may choose to either condemn or condone one or the other, or both, but they have to be viewed through different lenses.

Legal and Policy Restrictions on Sourcing

There are some instances where Canadian legislation or government policy requires certain things to be sourced from specified suppliers, in the public interest. For example, most air traffic control services and products used within Canada must be purchased from Nav Canada by law.[11] The Canadian Armed Forces are technically exempt from this requirement, but there are no lawful alternative sources for the

products produced by Nav Canada. As a second example, most conventional military ammunition and small arms weapons must be obtained from specified Canadian-based companies under the government's Munitions Supply Program, which has been in place since the 1970s. The program is intended to provide strategic assurance of supply and quality of key ammunition natures and weapons.

The National Shipbuilding Procurement Strategy has, after an initial competitive process restricted to a very small number of Canadian shipbuilders, created another policy framework under which contracts to build and support major naval and Coast Guard vessels will be sole-sourced to specific companies.[12]

The number of procurements required to be sole-sourced under legislation or policy is not large but the dollar values can be considerable. Ammunition procurements alone have historically been well over $100M a year on average, most of that to preferred suppliers, and the shipbuilding programs will run to tens of billions of dollars over the coming decades.

Cooperative Buys

For complex defence equipment in particular, it may be very much in the public interest for Canada to leverage opportunities that may arise to link in with larger buys by the US, or other allies and partners, to benefit from larger economies of scale.[13] Canadian requirements for complex and expensive systems are typically relatively small and it can be difficult for us in solo procurements to get any meaningful price advantage, or to deal with the technical risks very likely to arise when the program involves significant development work. The troubled Maritime Helicopter Project is a case in point, where the Crown had to provide significant additional funding, adjust aspects of the requirement, and extend contract deadlines to enable the contractor to deliver the system.

Participation in larger collaborative procurements, while not without its own risks, could allow Canada to get the system at a more attractive price as part of the larger buy than it possibly could do so on its own, and to leverage the group's collective ability to better manage technical and other risks. It can also have greater potential to extract high-quality, sustained industrial benefits for Canadian companies as part of the industrial consortium developing, building, and supporting the system throughout its long service life. The same quality and value of benefits simply cannot be obtained through a solo purchase of a small number of platforms.[14] While Canadian involvement in a collective procurement will typically be deemed a sole-source initiative at home, these programs will often be the result of competitive processes led by the major partner or a core group of nations leading the project.

Opportunity Buys

Opportunity buys of complex and unique systems can also merit consideration of a sole-source process in the public interest. The Royal Canadian Air Forces' C-17 strategic airlift fleet was purchased very quickly at an attractive price when production circumstances created a window of opportunity that the government exploited.

Opportunities can also arise to acquire certain needed items such as perfectly serviceable spare parts and test equipment that become surplus in allied or partner nations' inventories at much lower cost than through a commercial purchase.[15] These cases are treated in Canadian policy as sole-source buys.

Transition from Development to Production

In circumstances where the Crown has paid some or all of the cost for a Canadian company to develop a system to meet defence needs, it may be in the public interest to also contract directly with that company to produce and deliver the resulting product. As some Canadian industry groups, Tom Jenkins, and others have commented, a competitive procurement in this circumstance is illogical[16] and would introduce very significant risk that the development investment would be thrown away along with any opportunity for successful international marketing of the product by the company (and resulting royalty payments back to the Crown).

Typically, if the Department of National Defence has paid for the development of a product, it is because there was nothing on the international market that adequately met its needs. Opening a competition for the item in these circumstances almost inevitably means 'dumbing down'[17] the operational requirement so that other, less suitable products can be bid.

The public interest would not be served by either of these outcomes.

Cost of Competition

This is an area that is not well researched and merits further study by government, industry, and academia. The conventional view is that competition always reduces cost to the Crown. However, some knowledgeable observers have questioned this view. A British analysis challenges the assertion that the UK Ministry of Defence saved significant amounts since adopting its current competitive sourcing policy, citing several studies that note the great difficulty of testing those claims and showing that major associated costs have not been factored into the calculation.[18]

The larger and more complex the requirement, the costlier the process of running a competition to meet

it, both for the government and the bidders. The UK study suggests that bidders for complex programs need to spend at least 5 percent of the expected contract value on preparing their bids to have a good chance of winning.[19] The costs of doing business inflate the overhead expenses of all bidders and are ultimately passed on to their customers, which for defence industries means governments. For their part, governments also dedicate very substantial resources to preparing bid solicitations, evaluating returned bids, and assuring integrity of the process when competing large, complex requirements.

If the sometimes substantial combined industry and government costs of complex competitive procurements are considered, open competition may not always be the most cost-effective way to obtain the most military capability and best national outcomes for the lowest overall price.

4. Only one person is capable of performing the contract

Limited Marketplace

As noted earlier, National Defence sometimes needs to buy highly specialized goods or services with limited availability in the marketplace. Markets for defence equipment are shaped by a number of trends that are not necessarily seen in other areas. For example, unlike many commercial technologies, advanced defence systems today have longer service lives than their predecessors, and are produced in diminishing numbers as their costs and capabilities go up. This is a reflection of the very significant technology and other investments that go into their development. Figure 1 illustrates this long term trend for five of the most-produced Western fighter aircraft since 1942.[20]

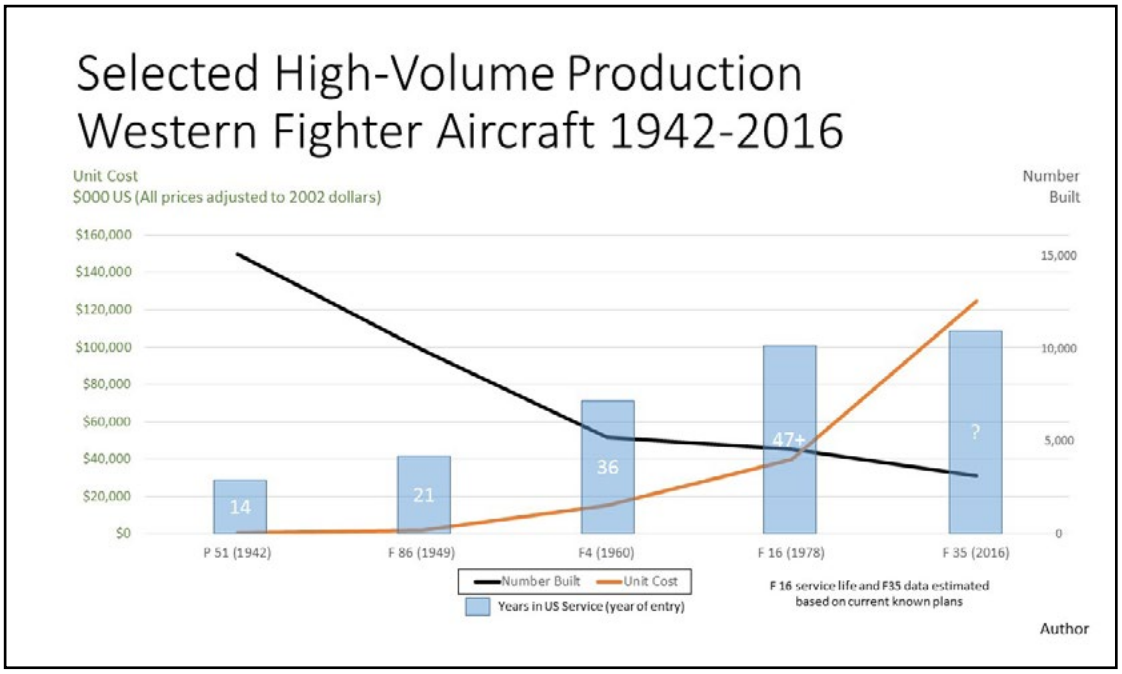

Figure 1: Selected High-Volume Production Western Fighter Aircraft 1942-2016. (Source: Author.)

These high investment costs and lower production runs are driving an ongoing long-term global consolidation of advanced defence system manufacturers,[21] progressively tightening the supplier base as illustrated in Figure 2.[22] Increasingly, for some requirements, only one viable supplier may exist, although others may step forward claiming capacity to be competitive in meeting them. This introduces a potentially significant risk of ending up with a very bad contract for both sides – the Crown teamed with a supplier who cannot actually deliver the promised solution in accordance with the agreed price and schedule, and a contractor who over-optimistically calculated the technical risks, "low-balled" the costs to win the competition, and is facing losing money on the deal. There have even been instances where the contractor eventually just walked away from the contract, leaving the Crown with nothing for the money spent.[23]

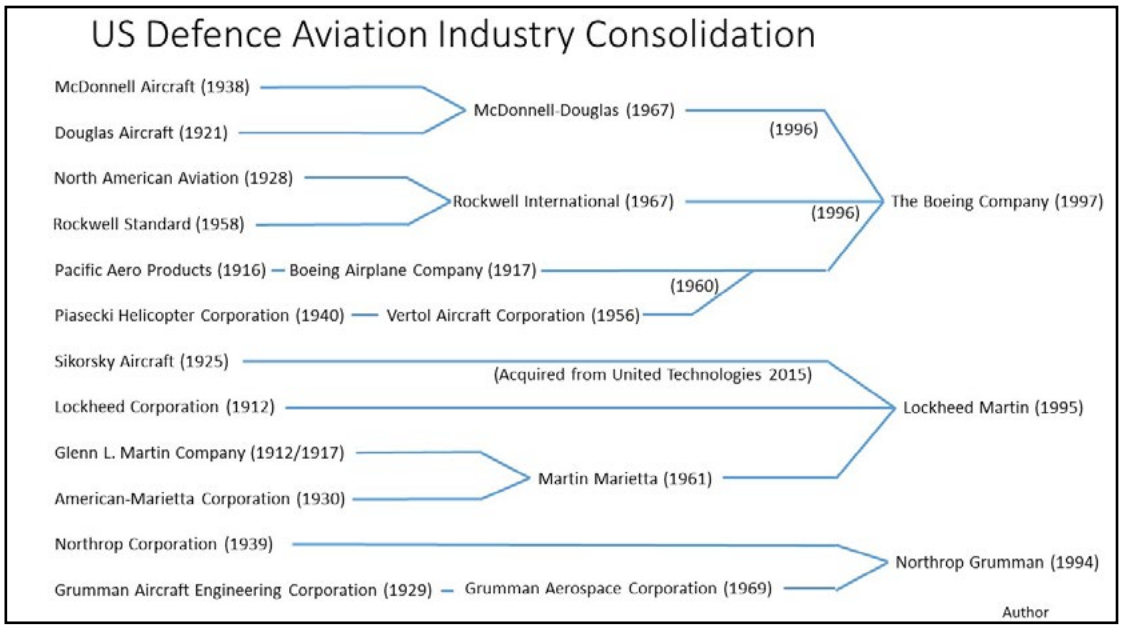

Figure 2: US Defence Aviation Industry Consolidation. (Source: Author.)

These kinds of outcomes are extremely costly to taxpayers, seriously eroding the quality and quantity of defence capabilities received for the money allocated to National Defence. It is therefore important that the marketplace realities be rationally considered when deciding upon a procurement strategy. They cannot be wished away and it is extremely unwise to try to artificially create a competitive market where none naturally exists as it will simply drive up costs. Strategies that try, for example, to broaden the field by encouraging suppliers of more capable and expensive solutions than are actually needed simply allow the supplier of the cheaper, more appropriate, product to bid a higher price and improve their profit, knowing that they will still come in lower than the competing bid.

Conversely, 'dumbing down' the requirement to allow less capable solutions to be bid is both highly irre-

sponsible and likely to incur greater downstream costs to fill the resulting capability gaps. Purchasing lesser defence capabilities than are needed restricts the military options future governments have to deal with crises, and may force later hurried (and expensive) buys to meet urgent operational needs.

The impact of applying any of these market-distorting strategies is insidious because in most cases the additional cost remains almost entirely hidden from public view, and even from government auditors. No one outside the winning company will ever see hard evidence that the Crown overpaid for something in an artificially contrived competition, and the consequences of buying inadequate equipment more often than not get buried in time and lost in the wide mix of elements that make up defence capabilities. The fact that the unnecessary cost is well hidden does not make it any less real, so selecting a procurement strategy based on a rational and objective appraisal of the marketplace is essential if sound value for Canada is to be consistently obtained from defence acquisitions.

Intellectual Property

In addition to the ongoing corporate consolidation of high-end defence equipment suppliers, there is also a trend towards stronger protection of Intellectual Property. As noted earlier, major defence systems now have longer service lives, and are produced in diminishing numbers as their costs and capabilities go up, so system developers are increasingly looking to recoup their very large technology investments by exploiting the resulting Intellectual Property over longer periods.

One major impact of this trend is that it is becoming much more difficult and expensive for the Crown to buy comprehensive Technical Data Packages along with its major systems. In the past, this data would be made available by National Defence to separately contracted, usually domestic, companies providing in-service support services or undertaking modifications to the system. Today, OEMs are much less likely to agree to provide third-party access to their proprietary technical data at an affordable (or sometimes any) price.[24] This may mean that no other supplier has legal access to the technology or design information, and any modification, upgrade or other support for the system can only be done by the OEM or their chosen licensed agent. In this case, competing the requirement may simply not be possible.[25]

The Canadian Armed Forces typically operate their major platforms for a very long time, so eventually Intellectual Property and other constraints to the development of a more competitive after-market may diminish and allow for more sourcing options. However, in the earlier years of ownership sole-sourcing to OEMs will sometimes be a practical and legal necessity.

GETTING BEST PRICE AND BEST VALUE IN SOLE-SOURCE PROCUREMENTS

Assuming that one or other of the above conditions is found to apply for a particular procurement and a sole-source strategy is justified, how does the government ensure that it is getting best price or best value in the process? Conventional wisdom has it that competitive procurements force bidders to sharpen their pencils and so the buyer is sure of getting the best deal. Therefore, how do we assure this in the absence of competition?

The first point to be made is that the latter statement is mostly true, but not always. As noted earlier, if the competitive field has been artificially created or distorted, the buyer is facing considerable risk that price paid will be too high. This risk is greater than it would be under a sole-source strategy because the government uses very different tools in competitive and non-competitive procurements.

Competitive procurements apply various formulas for selecting the winning bidder, but typically it comes down to the lowest cost solution that meets the defined need. The government may negotiate a number of further details before signing the contract, but basically the bid price is the agreed price, and the dynamics of the competition are considered to have generated the best possible outcome for the Crown.

For sole-source contracts, the process is entirely different, especially in the case of defence procurement. Among other things, the *Defence Production Act* gives the Minister of Public Services and Procurement (formerly Minister of Public Works and Government Services) quite remarkable powers to unilaterally set contract terms and conditions, set profit levels, and peer deep into the operations and finances of companies providing supplies and services to the Department of National Defence. For example, Section 23 of the *Act* requires a contractor to maintain detailed records of the cost of carrying out the contract, and to retain them for at least six years after its completion. Section 24 empowers the Minister to determine what is a "fair and reasonable cost" of doing the work and what is a "fair and reasonable profit," and so sets the contract price.

These extraordinary powers are almost always invoked to one degree or another for sole-source contracts with Canadian-based companies, but not in competitive processes as it is presumed that best price is a natural outcome from them. (It can be more difficult to apply these powers to foreign-based suppliers, but in those cases Canada can usually get reasonable assurance of price fairness by other means, and if not retains the option to re-think the requirement.)

The negotiation and administration of sole-source defence contracts in Canada is therefore not necessarily done on a level playing field. If the contracting officer considers it appropriate to invoke all the legal powers available to the Crown, the supplier can be at a distinct disadvantage. More commonly, negoti-

ations are not so invasive but they are very detailed and a lot of work for both sides – sometimes more work than a competitive process. The results are normally balanced and fair to both sides.

It is consequently an absolute myth that sole-sourcing gives suppliers a blank cheque. The hard fact is that, if anything, the powers of the *Defence Production Act* can provide a greater guarantee of obtaining best price and best value for the Crown than may be possible in some competitive processes. We ignore the leverage provided by these Crown powers at our cost.

The choice of procurement strategy is not limited to openly competitive or sole-sourced approaches. There are other options. As briefly mentioned at the outset, the competition can be limited to a smaller number of proven, pre-selected bidders. Another tool available is the Advance Contract Award Notice (ACAN), under which the contracting authority publishes a notice of intent to award a contract to what is believed to be the only qualified supplier of the goods or services. If other suppliers do exist, they have an opportunity to file a Statement of Capabilities indicating that they also are able to provide them. If no one comes forward, the contract can be awarded. If someone does, there are processes for verifying the claim and, if valid, a competition is initiated.

Use of the ACAN process is tightly controlled. It must be requested and justified by the client department and the rationale is independently validated.[26] In negotiating a contract following an ACAN process, the Crown retains the right to exercise any or all of its legal powers under the *Defence Production Act*.

As a final observation, as noted earlier, detailed contract files for all defence contracts – openly competed or otherwise – have to be maintained by the company for six years after completion of the work and these can be audited by the Crown at any time. If overpayments are found in an audit, they can be (and in practice are) recovered. This audit power is routinely exercised for any large contract considered to present a higher risk that overpayments may have been made, providing an additional protection for the Crown in complex sole-source and other procurements.

CONCLUSION

The deeply entrenched conventional wisdom that sees competitive procurement as the gold standard to be met in virtually all government procurement has no basis in rational thought or analysis, and is not necessarily consistent with best practices in industry. However, Canadian governments are highly sensitive to public perceptions and disregard the widespread belief in competition at their political peril. It is therefore not at all surprising that they will go to sometimes great lengths to avoid other procurement strategies in high-visibility acquisitions, and are generally resistant to any other approach to government

purchasing.

This is unfortunate because, while open competition is appropriate for the vast majority of government procurements, there are case-specific circumstances where it will not deliver best price or best value for Canadian taxpayers. Defence procurement has a greater proportion of these cases than most other government purchasing simply because of the technologies and specialized products and services involved. For complex, high dollar-value acquisitions especially, the cost of getting the procurement strategy wrong is also high. When the Department of National Defence pays more than it could have for something there is an equivalent net reduction in the defence capabilities the nation can maintain within a limited budget envelope.

It is therefore important that public and political discourse on defence procurement become better informed about the factors that need to be considered when deciding on a procurement strategy. It is in our collective interest that the government, and Canadians, develop a more cautious perspective about the conventional wisdom around competition as a universal procurement strategy, and recognize that there will be times when objective analysis will show that a more selective strategy, including sometimes sole-sourcing, will provide the lowest price or best value outcome for the nation.

This kind of change in perspective will not be easy to achieve, and indeed is unlikely to ever be fully embraced by all audiences. Consequently, the political sensitivities surrounding less competitive or sole-source procurement processes will remain a factor in these decisions into the future. Indeed, a continuing public debate about how the government does its purchasing is a healthy contribution to our democracy. That debate, however, can only provide real value if it rests upon objective and factual foundations. We can ill afford to keep making defence procurement strategy decisions for high-value systems based on popular 'conventional wisdom' assumptions that lack evidence-based foundations.

In this regard, those who wish to contribute productively to these debates need to do so do so on the basis of a rational view of the limitations, in some circumstances, of open competitive procurement as a strategy. This paper has sought to explain some of those limitations with a view to encouraging the development of more broadly based perspectives on this complex issue. It has also attempted to inject some balance into what tends to be a largely one-sided discussion, by presenting some fact-based perspectives on the less popular side of the question. The hope is that the national conversation on defence procurement strategies can start to be moved, however imperceptibly, towards a more appropriate point of balance that will give Canadians better national outcomes from their substantial expenditures on defence.

Colonel Charles (Chuck) Davies (Ret'd) *is a Research Fellow at the CDA Institute and a former Logistics officer who served for four years as the strategic planning director for the Material Group of the Department of National Defence and three years as the senior director responsible for material acquisition and support policy in the Department. He holds a BA in History from the Royal Military College of Canada and is a graduate of The British Army's Ammunition Technical Officer Course; Canadian Land Force Command and Staff Course; Canadian Forces Command and Staff Course; and Advanced Military Studies Course. He is the author of* Vimy Paper *18: "Defence Transformation and Renewal: Teeth, Tails and Other Myths;"* Vimy Paper *20: "Canada's Defence Procurement Strategy – An End or a Beginning?"*

NOTES

1. The cancelled New Shipborne Helicopter Project, which was eventually succeeded by the woeful Maritime Helicopter Project, was a classic but by no means unique example of this problem.

2. Speech by the then Minister of Public Works and Government Services Diane Finley at the Economic Club of Canada, Ottawa, 5 February 2014.

3. Wikipedia provides a good, concise definition of best value: "Best value procurement is a procurement system that looks at factors other than just price, such as quality and expertise, when selecting vendors or contractors." http://en.wikipedia.org/wiki/Best_value_procurement.

4. Public Works and Government Services Canada, *Report of the Parliamentary Secretary's Task Force: Government-Wide Review of Procurement* (Government of Canada catalogue No. P4-10/2005 0-662-68900-3, 2005).

5. Public Works and Government Services Canada, *Canada First: Leveraging Defence Procurement Through Key Industrial Capabilities* (2013) (2013 Jenkins Report).

6. This issue is also commented upon in the 2013 Jenkins Report.

7. The requirements of all these agreements are spelled out in detail in Treasury Board of Canada, Contracting Policy, http://www.tbs-sct.gc.ca/pol/doc-eng.aspx?id=14494.

8. Ibid., and Treasury Board of Canada, *Procurement Review Policy*, http://www.tbs-sct.gc.ca/pol/doc-eng.aspx?id=12074&section=text.

9. Government of Canada, *Regulations Amending the Government Contracts Regulations, Financial Administration Act* (P.C. 2015-1029, 23 June 2015), published in *Canada Gazette* Vol 149, No. 13 (1

July 2015), http://gazette.gc.ca/rp-pr/p2/2015/2015-07-01/html/sor-dors173-eng.php.

10. Conversely, it may be entirely appropriate to acquire interim solutions for specific missions where existing Canadian Armed Forces capabilities need augmentation. A good example is the interim acquisition of Chinook helicopters for the Afghanistan mission.

11. Government of Canada, *Civil Air Navigation Services Commercialization Act*, http://laws-lois.justice.gc.ca/eng/acts/c-29.7/index.html.

12. See the PWGSC website for details: http://www.tpsgc-pwgsc.gc.ca/app-acq/sam-mps/snacn-nsps-eng.html.

13. For a broader discussion of cooperative programs in the context of a case study of the F-35 program, see Richard Shimooka, "Towards an International Model for Canadian Defence Procurement? An F-35 Case Study" *CDA Institute Report* (Ottawa: The Conference of Defence Associations Institute, 2013), http://www.cdainstitute.ca/images/F-35_Case_Study.pdf.

14. Ibid.

15. The author is personally familiar with cases where the Crown paid more than double, and in one case 45 times as much, for an item through commercial purchase than it could have if a sole-source approval to buy from the allied military organization could have been obtained in time.

16. See, for example, *Industry Engagement on the Opportunities and Challenges Facing the Defence Industry and Military Procurement* (Canadian Association of Defence and Security Industries, 2009). Also see the 2013 Jenkins Report.

17. 'Dumbing down' the requirement means reducing some of the technical or operational standards. This may be to reduce cost or widen the range of potential solutions. Done rationally to deal with affordability concerns, with a clear understanding of the consequences, it may be appropriate. But, if done simply to create a competitive bidding situation, it may be irresponsible.

18. Ron Matthews, *Smart Management of Smart Weapons*, *Claxon Papers* 7, Ugurhan G. Berkok ed. (Kingston: Queen's University School of Policy Studies, 2006).

19. Ibid.

20. Data to create Figure 1 was obtained from Wikipedia and published US and StatsCan CPI data.

21. This phenomenon is also observed by Matthews, *Smart Management of Smart Weapons*.

22. Data to create Figure 2 was obtained from Wikipedia and Britannica.com.

23. The first attempt to upgrade the Canadian Forces Supply System in the early 1990s ended in failure with the contractor walking away financially weakened. It was acquired by a US company shortly thereafter. The project had to be hastily re-launched and a contract for a less capable solution was signed in 1995. Details concerning the second 1995 project are accessible on the Treasury Board of Canada website at http://www.tbs-sct.gc.ca/rpp/2010-2011/inst/dnd/st-ts05-eng.asp#cfssu. Information on the earlier failed program is not readily accessible.

24. This is a global problem. Technology transfer issues continue to impact many procurements, including Brazil's decision to buy the Saab JAS 39 Gripen and India's purchase of the Dassault Rafale.

25. Section 22 of the *Defence Production Act* does give the Minister of Public Works and Government Services (now Public Services and Procurement) the authority to override Intellectual Property rights and protect a third party contractor from Intellectual Property infringement claims if necessary for the execution of a defence contract. However, it also obligates the Crown to pay fair compensation to the Intellectual Property owner. This long-standing authority is rarely, if ever, used today and may not stand up to modern legal challenge. Increasingly, the Crown itself may not have access to certain elements of the technical data for the systems it acquires, in which case the Section 22 authority would have no practical effect.

26. The policy framework is set out in Treasury Board of Canada, *Contracting Policy* and the procedures are defined in the Public Works and Government Services Canada Supply Manual at https://buyandsell.gc.ca/policy-and-guidelines/policy-notifications/PN-39U4.

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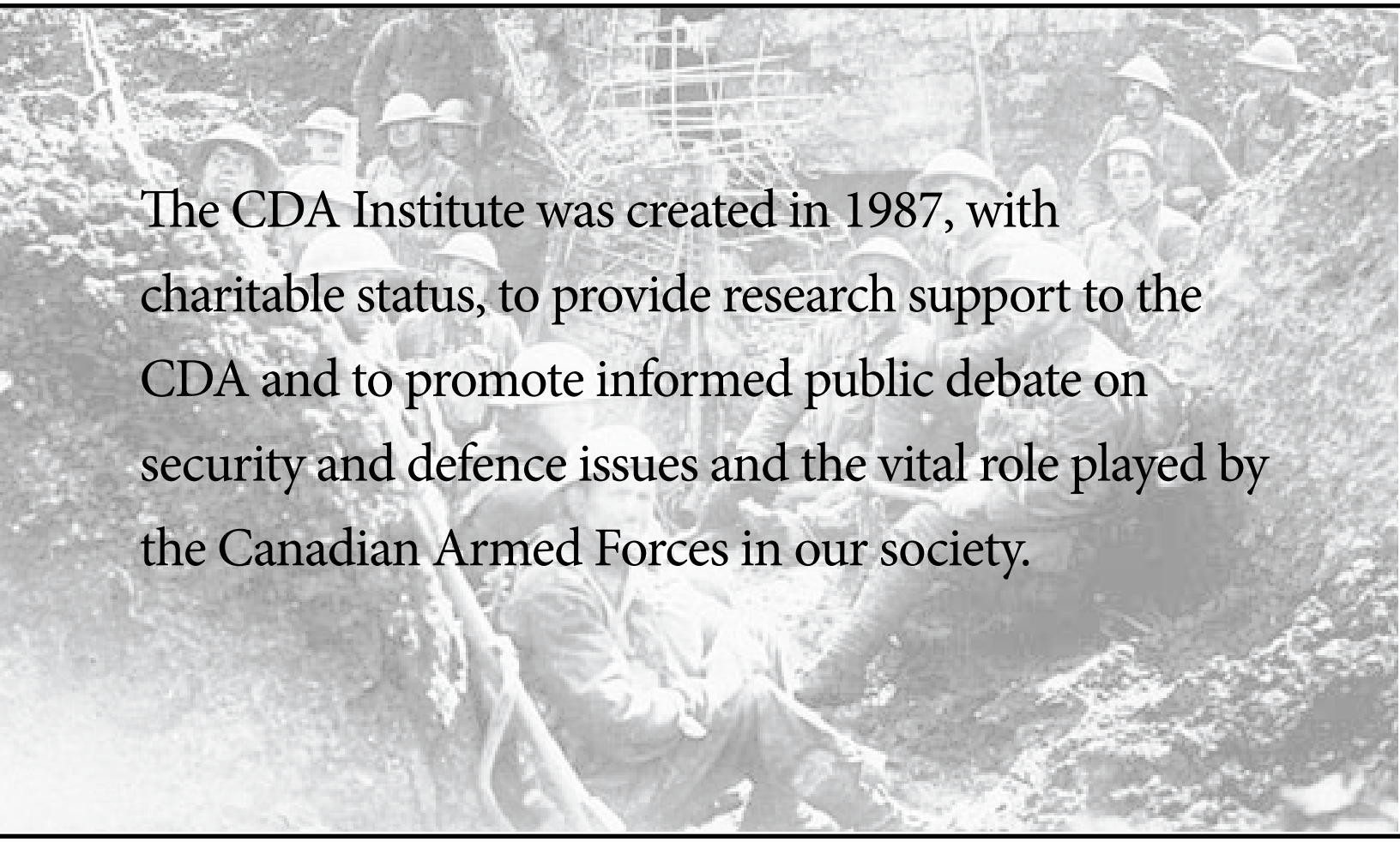

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151 Slater Street, suite 412A , Ottawa, Ontario K1P 5H3
Phone / Téléphone: +1 (613) 236 9903

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