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by Vern Kakoschke

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POLICY PERSPECTIVE

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Defence procurement in Canada has had some well-known challenges in recent years. Many commentators have suggested possible strategies for fixing the defence procurement system. The identified problems include overspending on defence programs, unnecessary and undue delays in re-equipping Canada's fleet of aircraft, ships and ground transport, and defence budgets that remain unspent. The problems also include procuring authorities experiencing a shortfall in manpower and expertise, the inability to execute on defence procurements, unjustified sole-sourcing without a proper competition, political interference in selection issues, and the list goes on. The proposed solutions often address process-related matters: establish a single agency responsible for defence procurement or perhaps a cabinet secretariat to manage the involvement of three of four government departments who are often not on the same page.

To date, not much has been written or discussed in public policy forums on a critical question: How should the necessary capital assets be financed? At one extreme, Canada could simply write a cheque and pay for them up front, thereby placing the assets on Canada's balance sheet. At the other extreme, Canada could drop the financing obligation into the laps of private-sector bidders and let them worry about the most efficient way of raising the necessary capital. A middle-ground solution could involve a public-private partnership (P3) structure, a model which seeks to balance the interests of the public and private sectors in a manner that leads to a better solution for all parties.

Any public policy discussion often begins with first principles. What is the government's policy objective? It is to procure the best available equipment, with the most benefit to the Canadian economy or local interest groups and at the lowest possible cost. All three goals must be balanced in a manner that is politically acceptable, meets budget constraints and withstands public scrutiny. In major procurements, capital can be the largest single cost of a defence procurement.

Conventional wisdom is that Crown debt is by far the cheapest financing alternative for any new program that requires the acquisition of capital assets. The Crown issues Government of Canada (GoC) bonds for a term that matches the expected useful life of the capital assets and the interest rate does not include a risk premium or credit spread (often called "Canada's flat"). Canada purchases the capital assets and then, if necessary, makes them available for use by a private-sector operator under a lease or loan arrangement as government-furnished equipment (GFE). The fixed-wing search and rescue (FWSAR) program is an example of a procurement in which Canada simply paid for the aircraft up front with the related maintenance services (in-service support) for the assets being funded over a long period of time.

The government ownership model is simple, straightforward and enjoys the lowest capital cost. But it has two serious drawbacks. First, the GoC bonds are consolidated on the Crown's balance sheet with other Crown debt. This brings them to the attention of the major rating agencies. If the total Crown debt increases beyond acceptable rating norms, rating agencies will typically downgrade Canada's credit rating with the result that the interest rate on future GoC bond issuances will rise. Increased Crown debt may also lead to a politically unpalatable higher budget deficit.

Second, the Crown typically selects the appropriate capital assets, a decision that is fraught with risk and intense public scrutiny. Politicians likely dread having to make such decisions. In a scenario where the capital assets can be bundled with required services, the Crown may prefer to procure only the services and leave the related asset selection up to the successful proponent. If the service provider bears the debt service costs and they are simply embedded into the price for services, then the program's cost can be booked in the Crown's operating budget and not its capital budget. Capital budgeting decisions tend to receive a much higher level of public scrutiny than changes to the annual operating budget. Milestone payments made to the successful proponent that are tied to the delivery of a portion of the capital assets can be buried in operating budgets. Relatively low milestone payments may not attract public scrutiny whereas higher payments in a material amount likely would.

Historical Perspective

The financing for the NATO Flight Training in Canada program (NFTC) can offer some historical perspective. In 1994, Bombardier made an unsolicited proposal to provide contractor-supported jet pilot training in Canada.[1] The proposal contemplated certain novel economies of scale for the high fixed cost of establishing a training program. The acquisition costs and non-recurring charges would be amortized over trainees from the Canadian air force and from the air forces of participating NATO nations, thereby resulting in a lower cost per student. Less well-known was the proposal's financing package: the program's entire capital cost would be financed in a manner that was "off-balance sheet" to Canada and to Bombardier. It became known as the Milit-Air financing as it involved the establishment of a special purpose entity (SPE) called Milit-Air Inc., a not-for-profit corporation. In 1997, the Canadian government awarded Bombardier a 20-year service contract for the NFTC program, valued at $2.85 billion. Under the service contract, Bombardier was responsible for providing fully serviced aircraft, flight simulators, training content, and airfield and site-support services to the Department of National Defence (DND). Milit-Air financed all the capital assets pursuant to a bond issue to institutional investors and then leased them to Bombardier.

The Milit-Air financing was completed in two tranches: the first tranche in the amount of $720 million of amortizing secured bonds was issued in 1998 and the second tranche in the amount of $106 million was issued in 2002.[2] The financings coincided with the obligations to pay equipment suppliers such as Raytheon for the T-6A aircraft and British Aerospace for the Hawk 115 aircraft that were required for the training program. The SPE purchased the capital assets and leased them

[1] National Defence and the Canadian Armed Forces, "NATO Flying Training in Canada: An Innovative Solution for NATO Flying Training Requirements," Sept. 7, 1998. Available at http://www.forces.gc.ca/en/news/article.page?doc=nato-flying-training-in-canada-an-innovative-solution-for-nato-flying-training-requirements/hnlhlxhd

[2] Offering Memoranda dated May 5, 1998 and June 25, 2002 issued by Milit-Air Inc. and its financial advisor and underwriter, Scotia Capital Markets.

to Bombardier who in turn provided services to Canada in exchange for firm fixed fees and variable fees. The fixed portion of the service contract payments were "hell-or-high-water" obligations of Canada and were assigned by way of security to the SPE so that it could service the debt on the outstanding bonds. The complex financing structure is described in detail in a 2002 decision of the Ontario Securities Commission.[3] The OSC concluded that the distribution of the bonds was exempt from provincial prospectus requirements even though the financing did not fall within an exemption for government debt: "the arrangements do not constitute a direct obligation of Canada to make payments on the bonds or a collateral obligation of Canada in the nature of a guarantee." In other words, Canada did not guarantee the payments to bondholders and hence under then-applicable accounting principles, the total debt of $826 million was not consolidated with Crown debt.[4]

The Milit-Air financing was widely considered in financing circles to be an innovative and cutting-edge transaction well ahead of its time. Why was it admired? Standard & Poor's (S&P) rated the Milit-Air bonds. S&P rated most financing transactions involving a service contract structure and an SPE as an accommodation party at one or more notches below the then-current rating of the sponsoring government.[5] Milit-Air was a rare exception. S&P awarded the Milit-Air bonds a AAA rating, the same rating as GoC bonds.[6] In other words, Canada and the procuring authority for the NFTC capital assets could have its cake and eat it too: the Milit-Air bonds were not shown in the consolidated accounts of Canada as Crown debt and yet the interest rate on the bonds was the same as what Canada would have paid if it had issued GoC bonds. This was an impressive result that likely resulted in interest cost savings over the full term measured in the millions of dollars.

Unfortunately, the auditor general of Canada did not see it that way. In his 1999 annual report, the AG found that the decision to award a sole-sourced contract to Bombardier (which contract was assumed by CAE Inc. in 2015) "was not adequately justified". The AG reviewed the financing arrangement and found it to be lacking, primarily due to the fact that Canada was on the hook for the debt servicing charges even if no services were being provided. The risks were not justified in the AG's view: "The main risk is that if Milit-Air Inc were ever to become insolvent, National Defence would face the drastic consequence of losing its access to the planes while continuing to pay the firm fixed fees."[7] Perhaps the AG did not appreciate that the SPE was designed to be bankruptcy-remote and that an insolvency of Milit-Air was highly remote. The AG would have much preferred if Canada had simply purchased the capital assets outright and supplied them to the contractor as GFE. The AG also failed to acknowledge that if Canada had used the GFE approach, it would have been responsible for the debt servicing charges on the GoC bonds in any event. On an incremental risk basis, it may be that the benefits of the financing in terms of lower interest costs outweighed the incremental risks.

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[3] In the Matter of Scotia Capital Inc. and Milit-Air Inc. Available at https://www.osc.gov.on.ca/en/SecuritiesLaw_ord_200220628_2113_scotiacapital.htm

[4] The auditor general concluded in his 1999 annual report that Milit-Air was an independent organization and not subject to the control of Canada or Bombardier. In the result, the debt appeared on the balance sheet of Milit-Air Inc., but not on any other party's balance sheet.

[5] The reason for the lower rating is that the payment stream under the service contract could be caught up in a service provider's bankruptcy and hence the payment flows to the bondholders could theoretically be interrupted.

[6] Standard & Poors Rating Direct Report (Oct. 11, 2007).

[7] 1999 September and November Report of the Auditor General of Canada – Case Study 27.1-NATO Flying Training in Canada.

In subsequent years, the AG continued to criticize the NFTC program and its financing. In 2002, the AG concluded that the profit margin built into the NFTC contract was excessive and could not be justified. In 2006, the AG calculated that the Crown paid about $39 million for training that it could not use. In his 2006 annual report, the AG stated that the Crown was "less than successful in obtaining foreign student commitments". The mandarins at Public Services and Procurement Canada (PSPC) likely got the message: they would probably never again attempt a highly structured financing such as Milit-Air in a defence procurement and risk incurring the AG's wrath. A chill fell on the procuring authority.

In 2003, the pendulum in respect of defence procurement contracts swung in the opposite direction. Canada released a Request for Proposals (RFP) for a contract to provide long-term primary helicopter and multi-engine fixed-wing pilot training at Southport, Manitoba. The RFP incorporated the AG's recommendations that the next training contract should have payments tied to performance and value received. The AG reviewed the draft RFP for the primary training project and found that payments would be based on milestones: "If the contractor fails to achieve the milestones, this could result in payment holdbacks and forfeiture. Incentives are also in place for good performance."[8] In 2005, Canada announced that a relatively unknown Western Canada-based aerospace company was the winner and awarded the contracted flying training support (CFTS) contract, subject to confirmation that the winner (a relatively small private company) could raise the financing.[9] Details of the CFTS financing are not publicly available, apart from the fact that a $137.5-million transaction was concluded at the time of contract award.[10]

The Enron Debacle

The Enron scandal in 2001 changed the landscape for Milit-Air style financings.[11] Enron filed for bankruptcy and its accounting firm, Arthur Andersen, was dissolved. The CFO of Enron went to jail. One of the causes of their downfall was Enron's use and abuse of SPEs that enabled the company to hide hundreds of millions in liabilities from its shareholders and lenders. Largely as a result of the Enron debacle, the U.S. accounting regulator (the Financial Accounting Standards Board) changed the accounting rules to make it more difficult, if not impossible, to use off balance-sheet financing structures.[12] Most large Canadian corporations that had taken advantage of such financing structures promptly reversed course and consolidated their SPEs' debt. It is not clear

[8] May 2006 Report of the Auditor General of Canada.
[9] National Defence and the Canadian Armed Forces, "Backgrounder on CFTS," March 30, 2005. Available at www.forces.gc.ca/en/news/article.page?doc=contracted-flying-training-and-support-cfts/hnocfoke
[10] McCarthy Tétrault LLP. Available at https://www.mccarthy.ca/
[11] Many corporations in capital-intensive industries were taking advantage of off balance-sheet financing structures at that time. In such financings, the debt was typically issued by a special purpose entity that was not controlled (de jure control) by the sponsoring corporation. Hence the debt that the SPE issued was not consolidated with the sponsoring corporation's debt even though the latter was indirectly responsible for the debt servicing, typically through lease payments to the SPE. As a result, the sponsoring corporation did not put any stress on its financial covenants with its lenders and it also avoided the payment of capital tax which was based on the corporation's stated liabilities.
[12] In 2009, FASB issued Interpretation FIN 46(R) entitled "Consolidation of Variable Interest Entities". If an SPE qualified as a VIE under a new substantive test (rather than control test), the VIE's debt would have to be consolidated with the debt of the primary beneficiary (i.e., the sponsoring corporation). The Canadian accounting regulator soon followed suit with the publication of Accounting Guideline AcG-15 (Consolidation of VIEs).

from the public record whether the AG also responded to the change in accounting standards by adding the outstanding Milit-Air bonds to Crown debt in the Crown's audited accounts.

Future Air Crew Training (FAcT) Program

The competition for the next-generation training contract started in 2013. The Crown announced that it would combine the pilot training currently being provided under the NFTC program and the CFTS program together with air crew training for combat system officers and airborne electronic sensor operators into one massive procurement.[13] A RFP is expected to be released in 2020 with a contract award expected in 2021. The Crown has made no mention in its public releases how the required capital assets are expected to be financed under the FAcT program. The four qualified bidders in the FAcT competition may be faced with uncertainty in bid preparation in that they may or may not be expected to provide the financing as part of the bidding process. The amount required to refresh or fund the FAcT program's capital assets will likely be significant: if the total capital cost of the two existing programs approached $1 billion over 20 years ago, the capital cost of a refresh could be well in excess of that amount. Such an onerous financing obligation could put smaller bidders at a disadvantage to larger multinational defence contractors.

Public Private Partnerships (P3s)

The P3 procurement model is an investor-friendly method of transferring risk for public infrastructure projects to the private sector and enabling a private-sector financing at an acceptable risk premium over GoC bonds.[14] It is all about delivering value for money. Cash-strapped provinces have enthusiastically embraced the P3 model for the design, build, operation and maintenance (DBOM) of various projects in the health-care sector, social infrastructure such as hospitals, libraries and prisons, and transportation such as roads and bridges. Relatively few P3 projects have been completed at the federal level: the RCMP headquarters in Surrey, the Gordie Howe Bridge and the Communications Security Establishment Centre (CSEC) in Ottawa. It was unfortunate that the Liberal government in 2017 disbanded PPP Canada, a Conservative-created Crown corporation that encouraged P3s at the federal level.

There is no reason why the P3 model could not be applied to defence projects, particularly if they involve a mix of capital assets and service delivery, as most P3s do. Security concerns can be overcome, as was evidenced in the CSEC project. There is no loss of government control over strategic assets in any P3 deal. Contracting practices for P3 deals have been well developed over the years and the investment community has accepted the risk allocation set out in commonly used P3 documentation. No need to reinvent the wheel with new and complex documentation when preparing a RFP. Other countries, such as the U.K. and Australia, have fully embraced the

[13] FAcT website: www.tpsgc-pwgsc.gc.ca/app-acq/amd-dp/air/snac-nfps/ffpn-fact-eng.html
[14] Many P3 projects have been financed at interest rates based on the then-prevailing applicable GoC bond rate plus a credit spread of 150 -200 bps.

P3 model (known locally as PFIs or private finance initiatives) for defence procurement and yet Canada has not followed their lead, notwithstanding the demonstrable benefits that could be derived from such an approach.[15] P3s are typically built on time and on budget as the risk of delays, cost overruns and non-performance are transferred to the successful proponent in the private sector.

Lessons Learned

When it is released, the RFP for the FAcT procurement will provide an interesting case study for whether Canada has learned any valuable lessons from the predecessor financings undertaken in the NFTC and the CFTS programs. Some shaping principles that could be helpful when designing a defence procurement involving significant capital assets (such as FAcT) include the following:

1. *Contemplate an investor-friendly financing for the capital assets*. Unless Canada prefers to increase its budget deficit by a material amount, the RFP's terms should not scare off potential investors. By adopting best practices in the P3 industry, Canada could level the playing field when it comes to financing. Each bidder should have the same opportunity to raise the capital on the strength of the underlying service contract and not simply on the strength of its balance sheet.

2. *Unwind the Milit-Air financing*. The Milit-Air bonds are nearing maturity but are still outstanding. The original purpose of the financing structure – off balance-sheet accounting treatment – has disappeared. The annual cost of maintaining a not-for-profit corporation cannot be insignificant. This cost could be avoided by unwinding the financing in a manner that involves Canada stepping up to assume the obligations under the bonds as a direct obligation of the Crown. This could well facilitate transition issues between the existing NFTC assets and the refreshed assets.

3. *Involve the auditor general in the RFP design process*. The AG made numerous helpful recommendations in his reports regarding the NFTC program, many of which remain valid concerns today. Has the AG ever followed up and determined the current status of his recommendations? Better transparency would assist the bidders and their investors in risk assessment. Moreover, the expected accounting treatment for all parties concerned could usefully be reviewed by the AG and anticipated in the RFP.

4. *Reconsider the use of milestone payments*. If Canada intends to partially contribute toward funding the capital cost in whole or in part, the contributions could take the form of progress payments rather than milestone payments. The former payments are considered to be earned when paid, whereas the latter are considered unliquidated advance payments (meaning the Crown could claw them back in certain circumstances). No investor will wish to invest in a project where the Crown has a prior claim on the same

[15] The benefits have been well documented by the Canadian Council for PPPs in numerous published studies.

assets funded by an investor. The AG may also consider the accounting treatment of such milestone payments, as they may in some cases be treated as being on capital account rather than on income account and buried in a government department's operating budget.

5. *Provide certainty for bidders in the RFP process*. Uncertainty is the enemy of a cost-effective program. If bidders are given advance notice of the essential terms of a procurement, they can plan accordingly, including preparing for a financing that will likely require substantial amounts of debt and equity from the investment community. Any necessary governmental approvals, including from Treasury Board, would be best sought at the start of a procurement process. Leaving the funding approvals to the end as an after-thought would not be helpful.

Defence procurements are large and complex. Financing considerations should be taken into account as early in the procurement process as possible. The failure to consider the appropriate financing approach for major capital assets could well add millions to an already costly program. Conversely, a properly structured procurement and related financing could save the Crown many millions in terms of the cost of capital.

About the Author

Vern Kakoschke *is Managing Director of Gothic Strategic Solutions Inc. (www.gothicsolutions.ca). He provides consulting services in the aerospace and defence sector and advises on complex structured financings, including tax-advantaged financings. Vern has 30+ years experience practising law in Toronto and in the investment banking industry where he completed several novel financing transactions for major capital assets involving aircraft, rail, power and infrastructure assets. He retired last year from a senior management role at KF Capital (owner of KF Aerospace), including as a director of SkyAlyne Canada LP (one of the bidders for FAcT) and was formerly the finance lead on the SkyAlyne bidding team.*

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