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by Vern Kakoschke and Marcia Mills  
December 2020

# POLICY PERSPECTIVE

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## **FINANCING DEFENCE PROCUREMENT IN CANADA: WHERE IS THE OVERSIGHT?**

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In the Canadian procurement regime for major defence projects, the buck stops at Treasury Board, which has the final say on contract awards that exceed departmental spending authority. Major defence contracts often fall into this category.

Treasury Board (TB) is a committee of the federal cabinet with responsibility for accountability, financial matters and comptrollership, among other matters. Through its administrative arm – the TB Secretariat (TBS) – TB implements cabinet-approved programs and policies into operations.<sup>1</sup> In essence, it is the management arm of the federal government and the keeper of the public purse when it comes to acquiring defence assets or procuring related services.

However, in light of the current project approval processes, including its own contracting policy, when it comes to major defence projects some might argue that the oversight of critical financing aspects is lacking or inadequate. In particular, the TB approval process is arguably too disconnected, too little and too late, leaving serious gaps into which complex procurements are likely to fall. Important financing options (such as the project-financing model) for much-needed capital assets are not being seriously considered, including the public-private partnership (PPP) delivery model.

## Treasury Board's Contracting Policy

Any discussion of oversight in federal government contracting starts with TB's approval process. Currently, TB promulgates guidance to federal departments for their contracting practices in the form of the contracting policy, pursuant to its authority under the *Financial Administration Act*. Operating as the rulebook for government procurement, the contracting policy seeks to achieve multiple and sometimes competing objectives when public funds are spent. These objectives include open, fair and transparent procurements, robust competition, best value in acquisition costs and overall benefit for the government and Canadians<sup>2</sup> (such as, for example, achieving socioeconomic objectives in general or as deemed important by the government of the day).

All of this requires a balance to be achieved between appropriate levels of governmental oversight and there is a risk of stagnation as programs are held up in review cycles that never seem to end. Although not unique to Canada, the criticism is often raised that, by the time a program is finally approved, the original cost submission and the technological requirements are out of date. Woven into this complaint is the issue of determining the appropriate scope of authority approval granted to a particular program. TB needs to approve programs, but providing programs with *carte blanche* to spend billions of taxpayers' dollars without some type of ongoing oversight (or the opposite scenario – requiring ministers to engage in the minutiae of day-to-day management) – is not palatable operationally, functionally and arguably, politically. TB has decentralized

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<sup>1</sup> <https://www.canada.ca/en/treasury-board-secretariat.html>.

<sup>2</sup> Article 1, Contracting Policy.



authority to departments over the years to enable them to be more responsible for their management of taxpayers' dollars. As the auditor general noted in 2007<sup>3</sup>:

[T]here's this sort of pendulum that swings between centralization and decentralization. Given the complexity and the size of the federal government, we have to recognize that this has to be a shared responsibility. I don't think it can be totally decentralized; it would be impossible. There has to be some central function, if not just to produce the financial statements and to issue the policies and the guidance to the departments. To *totally* centralize would also not be functional, given the complexities of these departments in and of themselves. So there has to be a shared responsibility, and what there probably needs to be is more clarity about what the role and responsibility of the central agency is.

The pendulum swings and the tension between centralized authority and decentralization remains, often resulting in significant capital expenditure decisions being made by non-elected officials.

For example, notwithstanding the fact that TB is responsible for ensuring that the federal government in its contracting activities conducts open, fair and transparent procurements that assure robust competition, achieve best value and provide overall benefits to Canadians, government departments seem able to circumvent these objectives. The TB's contracting policy identifies that government contracting must be conducted so as to:

- Stand the test of public scrutiny in matters of prudence and honesty, facilitate access, encourage competition and reflect fairness in the spending of public funds;
- Ensure the pre-eminence of operational requirements;
- Support long-term industrial and regional development and other appropriate national objectives, including Aboriginal economic development; and
- Comply with the government's obligations under Canada's trade agreements.

As noted above, the government must comply with Canada's trade agreement obligations, which at the highest level, require that procurements be conducted in a fair, open and transparent manner. Yet, in 2019, the Department of Finance was able to implement two significant changes

<sup>3</sup> Report of the Standing Committee on Public Accounts, June 2007: 2 .  
[https://www.ourcommons.ca/Content/Committee/391/PACP/Reports/RP2997457/391\\_PACP\\_Rpt19/391\\_PACP\\_Rpt19-e.pdf](https://www.ourcommons.ca/Content/Committee/391/PACP/Reports/RP2997457/391_PACP_Rpt19/391_PACP_Rpt19-e.pdf).



to regulations impacting procurement that have a direct and profound impact on federal government suppliers.

First, the department amended the Canadian International Trade Tribunal (CITT) procurement regulations, to remove procurements from trade agreement coverage and the CITT's review authority.<sup>4</sup> This regulatory change put in place the tools by which a federal procurement could be removed from timely and cost-effective oversight by an expert tribunal, forcing procurement disputes into the already over-burdened court system. Second, the Department of Finance amended the government's contracts regulations to fundamentally shift access to natural justice for government suppliers.<sup>5</sup>

These two changes place additional discretion in the hands of the public service and are indicative of a pendulum swing towards less oversight by elected officials and more opportunities for public servants to implement and exercise arbitrary decision-making in their procurements.

While, from a public policy perspective, too much regulation and oversight may not be ideal, neither of these changes rebalances that concern nor do they address the fundamental issues that plague procurement – long delays in seeking approvals for major projects and inadequate oversight over the spending of taxpayers' dollars on such projects. One of the root causes is in the TB approval process itself and the rigid compartmentalization for approving certain major projects that involve both the delivery of services and capital assets.

## **When is it a Goods Contract and When is it a Services Contract?**

The contracting policy sets out various definitions intended to distinguish between “goods contracts” and “service contracts”. Different rules apply depending upon whether a contract is considered a contract for goods or a contract for services. This bright line distinction creates various issues, particularly for major defence procurements; even though they may be characterized as services contracts, these procurements often necessitate the use of significant capital assets in order to provide the required services. As the services are unique to the Canadian Forces and its requirements, no bidder possesses the necessary capital assets when they bid for the contract. Moreover, such specialized assets are difficult to finance given that they have limited, if any, collateral value.

For example, contracts for pilot training, long outsourced by the Department of National Defence (DND) to private-sector service providers, are typically characterized as service contracts even though they require the contractor to obtain the use of hundreds of millions of dollars of specialized equipment in order to deliver the services. As a result, the procurement process risks treating the capital asset acquisition as an ancillary aspect of the procurement if it is characterized as a services contract, when, in fact, it is no less important, forming the fundamental basis from which the services are able to be delivered. Constructing capital-intensive procurements based

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<sup>4</sup> See: <https://www.fasken.com/en/knowledge/2019/07/van-removing-the-citt-from-the-review-of-canadas-national-security-exception>.

<sup>5</sup> See: <https://www.fasken.com/en/knowledge/2019/08/procurement-bulletin-guilty-until-proven-innocent>.



only upon outcomes is a recipe for disaster for Canada and the bidder; it limits the number of potential bidders who can participate to those with strong balance sheets, as opposed to those who may be best suited to achieve the outcomes desired.

The ongoing procurement for future aircrew training (FAcT) is a case in point.<sup>6</sup> Various letters of interest have been issued since 2013 with a draft RFP expected to be released in late 2020, followed by a formal RFP in 2021.<sup>7</sup> The program is described as the “delivery of pilot training, as well as aircrew training.” No mention is made in the publicly available documents of the significant capital assets that will be required to deliver these services. Indeed, a senior DND officer has said, “it is not an aircraft acquisition program, it is a training service, [and] what we are contracting for is output. How a successful supplier gets there, I am not that fussed. What I care about is the output.”<sup>8</sup>

What this particular view overlooks is that the quality and value of the output rely entirely upon the input, and the input is absolutely linked to the underlying asset financing. Recent estimates of the cost profile of this project set the value of the training services as “\$10 billion over 20 plus years” with the required capital assets likely exceeding \$1 billion when one considers the past costs of pilot training programs in Canada.<sup>9</sup>

None of the RFIs the government has issued to date considered the financing aspect of the FAcT procurement.<sup>10</sup> This raises a critical question that is unanswered: Who is expected to pay for the specialized aircraft, simulators and infrastructure required for the FAcT program and how will they be financed?<sup>11</sup>

The Canadian approach stands in stark contrast to that taken by other countries with similar air force training programs. For example, earlier this year, Australia released a request for information for a refresh relating to its lead-in fighter training (LIFT) system (comparable to the fighter lead-in training program (FLIT) that is part of the NFTC program in Canada). In its call for responses, rather than ignoring the capital asset financing issue, the Australian Department of Defence has specifically requested that respondents address a public-private partnership solution and a leasing solution as possible procurement delivery models for its LIFT program.<sup>12</sup> Singapore and the United Kingdom have also successfully adopted the public-private partnership model for their similar defence programs.<sup>13</sup>

<sup>6</sup> The project was initially referred to as the future pilot training program and then the interim FPT program prior to its current FAcT acronym.

<sup>7</sup> <https://www.tpsgc-pwgsc.gc.ca/app-acq/amd-dp/air/snac-nfps/ffpn-fact-eng.html>.

<sup>8</sup> Col. Pete Saunders, quoted by Chris Thatcher in “Next-Gen Aircrew Training,” *Skies*, July 23, 2019. <https://www.skiesmag.com/features/future-aircrew-training-program-next-gen-aircrew-training/#:~:text=Future%20Aircrew%20Training%20%28FAcT%29%20is%20an%20ambitious%20program,training%20technologies%20and%20teaching%20methodologies.%20Mike%20Luedey%20Photo>.

<sup>9</sup> *Ibid.*

<sup>10</sup> Various letters of interest were published by PSPC starting in 2013. See <https://buyandsell.gc.ca/procurement-data/tender-notice/PW-NF-006-25754>.

<sup>11</sup> Vern Kakoschke, “Financing Capital Assets in a Defence Procurement: The Missing Link in Defence Procurement,” Canadian Global Affairs Institute, February 2020.

<sup>12</sup> ASD/RFI/14004/1 <https://www.tenders.gov.au/>.

<sup>13</sup> In the U.K., the military flight training system (UKMFTS) was financed under a private finance initiative (different name for PPP). See [https://en.wikipedia.org/wiki/UK\\_Military\\_Flying\\_Training\\_System](https://en.wikipedia.org/wiki/UK_Military_Flying_Training_System).



Why hasn't a PPP approach been considered for the FAcT project? There does not appear to be a clear explanation apart from DND's insistence that the procurement is solely a service contract. The well-known advantages of the PPP model for appropriate projects that have been screened may not have been considered.<sup>14</sup> It is unknown whether the P3 screening test<sup>15</sup> was ever applied to the FAcT project. Such a screening test was mandated in 2011 with the following guideline:

Going forward, federal departments will be required to evaluate the potential for using a P3 for large federal capital projects. All infrastructure projects creating an asset with a lifespan of at least 20 years, and having capital costs of \$100 million or more, will be subjected to a P3 screen to determine whether a P3 may be a suitable procurement option. Should the assessment conclude that there is P3 potential, the procuring department will be required to develop a P3 proposal among possible procurement options.

Departments will also be encouraged to explore the potential of P3 approaches for other types of projects and procurements of services.<sup>16</sup>

The P3 screening test continues to apply to federal projects notwithstanding that it was developed by PPP Canada, a Conservative-created Crown corporation which was disbanded in 2017. Although PWGSC is responsible for the screening of federal projects, the TB secretariat has an advisory role.<sup>17</sup> The question remains how the secretariat has been exercising its advisory role and if it has meaningful input into major capital expenditure decisions that are solely within the ultimate purview of TB.

## **TB Approvals: Too Little, Too Late**

PSPC must obtain TB approval for contracts that exceed certain prescribed limits: for the procurement of goods, \$75 million is the limit for competitive contracts and \$3.75 million for non-competitive contracts. Lower limits apply to the procurement of services: \$37.5 million and \$5.75 million respectively. As a result, most if not all major defence projects will require TB approval. The TB approval process is conducted in phases, beginning with program approval in the early stages of procurement prior to the development of an RFP. At this early stage, it is likely that, absent a fulsome statement of requirements and a fully developed program-costing model, little if any information would be available to TB in respect of the magnitude of possible capital commitments by the government or otherwise.

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<sup>14</sup> The Canadian Council for PPPs has published nine myth-busters, one of which declares that "Canada is considered a world leader in public-private partnerships. The procurement process has become very well refined and is viewed globally as one of the shortest and most efficient." See [https://www.pppcouncil.ca/web/P3\\_Knowledge\\_Centre/About\\_P3s/Myths.aspx](https://www.pppcouncil.ca/web/P3_Knowledge_Centre/About_P3s/Myths.aspx).

<sup>15</sup> The P3 screen is a detailed spreadsheet that considers various relevant factors and assigns a rating for each factor. Projects that result in a total rating over a certain level are considered to be suitable for the PPP model.

<sup>16</sup> "Guideline to Implementing Budget 2011 Direction on Public-Private Partnerships" (updated 2012-03-12): <https://www.tbs-sct.gc.ca/pol/doc-eng.aspx?id=25576>.

<sup>17</sup> See the supply manual on mandating P3s at <https://buyandsell.gc.ca/policy-and-guidelines/supply-manual/section/9/60>.





At the final stage, TB approval is sought prior to entering into any such major contracts. In accordance with the contracting policy,<sup>18</sup> PSPC<sup>19</sup> typically seeks TB contracting approval following the selection of a successful proponent and just before the final contract award is made.

Following this procurement model, TB does not have the opportunity to provide strategic direction or input to PSPC until the conclusion of the process, when it may well be too late. The final package is presented to TB only after a long and costly procurement process, which, if approval is withheld, would result in the process having to start over again and possibly placing the provision of critical services (and the output – qualified pilots) at risk.<sup>20</sup> The pre-eminence of operational requirements as an objective may be lost.

PSPC hopes to award the final FAcT contract in 2023, at which time it will seek TB approval.<sup>21</sup> This approval would come 10 years after the first letter of interest for the FAcT program was published by PSPC and may still leave questions unanswered, such as how the necessary capital assets are to be financed.<sup>22</sup>

If the TB approval process unfolds in this manner, the outcome could well be a failed FAcT procurement. A reasonable position that TB could foreseeably take would be to direct PSPC to start the procurement process over again based on more realistic financing assumptions. Another possibility could be for TB to direct that the contract award be made conditional upon proof that the successful proponent has raised the necessary financing on its own. This approach would have some historical precedent as the CFTS contract award in 2005 was made conditional on financing.<sup>23</sup> Such an alternative could, however, be challenging to implement if the essential terms and conditions of the proposed service contract cannot support a project financing model (as in any PPP financing transaction). It may also be exacerbated by the large transaction size for the FAcT capital assets, which may be beyond the reach of those bidders who do not have a strong enough balance sheet to support a multi-billion-dollar financing. TB may well question why the PPP model was not considered early on in the procurement process, which would have relieved the pressure on the federal treasury.

Ultimately, accountability and oversight must be balanced with the very real requirement for timely project execution. Perhaps the pendulum needs to swing back towards the former public policy goal.

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<sup>18</sup> Section 4.1.6 of the contracting policy only requires a TB submission “prior to entering into contracts or contractual arrangements”. There is no requirement for PSPC to seek TB approval prior to proposing capital commitments on the Crown’s behalf.

<sup>19</sup> Public Services and Procurement Canada, which is the working name for Public Works and Government Services (PWGCS) Canada.

<sup>20</sup> Canada is already facing a shortage of military pilots. See “Contractors to Help Air Force Manage Shortage of Experienced Pilots, Technicians - RCAF Turns to Contractors amid Pilot Shortage,” Canadian Press, December 20, 2019.

<sup>21</sup> In a letter of interest dated March 15, 2016, PSPC announced its intent to seek TB approval for the FAcT program in conjunction with a contract award at the very end of the procurement process. See:

[https://buyandsell.gc.ca/cds/public/2016/03/15/acbe4d21db83b06c9d8b5a49cf321496/ABES.PROD.PW\\_NF.B006.E25754.EBSU000.PDF](https://buyandsell.gc.ca/cds/public/2016/03/15/acbe4d21db83b06c9d8b5a49cf321496/ABES.PROD.PW_NF.B006.E25754.EBSU000.PDF).

<sup>22</sup> Canada did not finance the predecessor programs. The NFTA assets were financed under an off balance-sheet financing structure known as the milit-air bond program without a Crown guarantee. The successful proponent privately financed the CFTS assets.

<sup>23</sup> The CFTS contract was awarded in 2005 “after confirmation of financing” by the successful bidder. See: <http://forces.gc.ca/en/news/article.page?doc=contracted-flying-training-and-support-cfts%2Fhnocfoke>.





## Making Defence Procurement More Accountable

What could be done to ensure that elected officials at TB still make procurement decisions without jeopardizing the public service's ability to get projects approved in a timely manner? Some suggestions for a more accountable and disciplined process would be:

1. *Timely Disclosure and Phased Approvals.* Set approval requirements in a manner that requires TB approval well in advance of contract award. If oversight is necessary, ensure that phased approvals are properly timed to coincide with major milestones in requirements development, including asset-financing decisions. Provide rapid and more frequent access to TB for changes made to major projects such as, for example, scope changes of a material nature.
2. *Update Contracting Approaches.* Amend the contracting policy to acknowledge reality and establish a new category of government contracts for blended arrangements that involve a significant capital component in addition to the provision of services. Look to the well-developed processes and documentation already used in PPP transactions for guidance to develop a unique set of contractual terms and conditions that apply to this new category.
3. *Don't Treat Financing Matters as an Afterthought.* The financing aspects of any major procurement are a critical aspect that should not be left to the 11th hour. Retain subject matter experts who have current project-financing experience when defining requirements and developing RFPs. Bidders need to know early on and with certainty if they will be expected to raise significant capital in connection with their bid.
4. *Keep Financing Options Open.* Provide TB with realistic financing approval options as between Crown capital commitments and private-sector financing. Avoid pre-determined TB decisions such as setting the term of a service contract in a manner that is inconsistent with long-lived assets.<sup>24</sup> If an asset has a long economic useful life, the length of the contract needs to be aligned so that it can attract financing. Consider the PPP financing option by applying the federal P3 screening test.
5. *Align Interests.* Accountability doesn't mean that the eventual contractor holds unwarranted risk under a one-sided contractual arrangement that only protects Canada. Contractor performance may be better secured if the resulting contract involves a commercially reasonable and balanced risk allocation and if the successful contractor's interests are more closely aligned with Canada's interests. Having its own capital at risk in the same project will likely have a strong motivational effect on the contractor when it comes to the delivery of services.

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<sup>24</sup> For example, aircraft typically have an economic useful life of 25 years or more and attract financing arrangements of up to 18 years. Service contracts with shorter terms, or option periods, may not be financeable.



Sound procurement decisions can only be made based on full, timely and relevant disclosure by senior public servants to the final decision-makers. All possible procurement options, particularly financing options such as the PPP model, should be considered, screened and disclosed earlier in the process, and provided to TB for an ultimate decision (and not as a foregone conclusion) so that the project can then proceed. A well thought-out procurement approach, including consideration of any capital asset financing, and which appears less of an afterthought, would be better positioned to withstand public scrutiny and protect Canada's financial interests and those of the Canadian taxpayer.

## ► About the Author

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**Marcia Mills** is the Co-Leader of the Fasken National Security Group and Counsel for Fasken's Procurement & Government Contracts, Technology, Media & Telecommunications and International Trade & Customs Law groups. Marcia has practiced for over 20 years in private and public sector, in technology, defence and security, including a decade with Public Services and Procurement Canada. While with PSPC, provided the federal government with strategic legal advice for major Crown defence acquisitions, including the Canadian Surface Combatant acquisition project. Marcia is a Fellow with the Canadian Global Affairs Institute.

<https://www.fasken.com/en/marcia-mills#sort=%40ofclientworksortdate75392%20descending>

**Vern Kakoschke** is Managing Director of Gothic Strategic Solutions Inc. ([www.gothicsolutions.com](http://www.gothicsolutions.com)). He provides strategic consulting services in the aerospace and defence sector and advises on complex structured financings and on major procurements. Vern has 30+ years experience practising law as a partner with a major firm in Toronto, working in aerospace finance in the investment banking industry and managing a private family office. He was actively involved in several large defence procurements, and has structured and arranged numerous private equity transactions, including aircraft leasing ventures in Ireland. Over the years, Vern has completed many novel financing transactions (including tax-advantaged transactions) for various capital assets involving aircraft, rail and infrastructure assets. He can be reached at [vkakoschke54@gmail.com](mailto:vkakoschke54@gmail.com).

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