



Aerospace Industries  
Association of Canada

## **Priority Issues Requiring Immediate Policy Development and Implementation by the Federal Government**

*Background Paper and 'Call for Action' from the  
Aerospace Industries Association of Canada*

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## Executive Summary

Canada's aerospace industry comprises more than 400 firms that directly employ 75,000 highly skilled Canadians. It is Canada's advanced technology exporter with 85% of its annual output destined to customers around the globe. The industry is a significant contributor to local economies in all regions of the country.

Aerospace is a global, intensely competitive industry. With a new global aerospace investment cycle underway, Canada must take action to ensure its aerospace investment climate remains competitive, so that Canada remains a location of choice for serving global aerospace markets. The window of opportunity to capture vital investment is limited.

This 'call to action' paper highlights important competitiveness issues confronting Canadian aerospace companies, and identifies three priority areas for urgent Federal Government leadership and action:

- Aerospace technology development and commercialization
- Defence and national security procurement
- Aircraft sales financing

Four recommendations are put forward for early action, with further details offered on implementation parameters:

- Establish a new aerospace technology investment program to succeed Technology Partnerships Canada
- Provide universal access to refundable SR&ED investment tax credits
- Adopt a strategic approach to defence and national security procurement that includes a predisposition to Canadian solutions
- Establish a stand alone aircraft sales financing framework

Industry is committed to working closely with relevant Ministers, their staff and their officials to develop and implement productive solutions that deliver mutually desired outcomes.

## **Priority Issues Requiring Immediate Policy Development and Implementation by the Federal Government**

### ***Background Paper and ‘Call for Action’ from the Aerospace Industries Association of Canada<sup>1</sup>***

#### **1. Purpose**

This ‘call to action’ paper identifies critical issues confronting Canadian aerospace companies, that require an immediate response by the Federal Government in order to secure a globally competitive Canadian aerospace industry that can remain a key contributor to Canada’s economic and social prosperity and national security.

#### **2. Canada’s Aerospace Industry**

Canada’s aerospace industry comprises over 400 firms that directly employ 75,000 highly skilled Canadians. These firms span a wide range of Original Equipment Manufacturers (OEMs), suppliers (direct and indirect) to OEMs, and firms that provide comprehensive life cycle support services. They are integral elements of a complex global network of aerospace product and service providers that serve customers in the commercial aviation, defence and space market segments. With annual industry sales totaling \$22B, it is the fourth largest national aerospace industry in the world. The industry’s contribution to Canada’s GDP is comparable to that of the mining, forestry and electrical & electronics industries. Aerospace is also a Pan-Canadian industry with firms located from Halifax to Vancouver, with clusters of aerospace capability making major contributions to local economies in all regions of the country.

Canada’s aerospace industry is also its leading advanced technology exporter with 85% of its annual output destined to customers around the globe. In fact, unlike other important advanced technology sectors such as information and communications technology and pharmaceuticals, the aerospace industry generates consistent annual trade surpluses – cumulatively, over \$30B in the last 10 years alone.

Annually, Canadian-based aerospace companies invest \$1B in Research & Development, with one firm consistently placing in the top five of all Canadian industrial R&D performers, and two others are in the top ten<sup>2</sup>. They have built strong relationships with Canada’s research universities and government research organizations that lever this aerospace R&D relationship to strengthen their overall research capabilities.

The top tiers of Canada’s aerospace industry comprise Canadian based multi-national firms and important subsidiaries of US and European multinationals that possess world product mandates. In contrast to other manufacturing and service sectors in Canada, the loci of corporate decision-making resides substantially in-country, and not in foreign boardrooms. Individually, these companies chose to invest in and serve world markets

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<sup>1</sup> AIAC is the national voice of Canada’s aerospace Industry representing 400-plus high technology firms operating in the civil, military and space sectors.

<sup>2</sup> Firms are Pratt &Whitney Canada, CAE and Bombardier. Source: Re\$earchinfosource.

from Canada. Their continued commitment to do so will depend on the existence of a competitive Canadian investment climate that is supportive of their business needs - from investing in technology development, to participating in meeting Canada's defence and national security needs and, selling their solutions in world markets. Governments in Canada can have great influence in creating a globally competitive business climate. With the right policy and program 'tool kit', the Federal Government, in particular, can play a key role in supporting the business case for firms to continue to choose to operate in Canada, and for attracting new investment.

### **3. The Global Aerospace Industry: The Role of Government**

Aerospace is a global industry in terms of both demand and supply. All modern aircraft and aerospace systems contain parts made by specialized suppliers from many countries. The high up-front costs to develop a new aircraft or complex integrated system and the very long product life cycles - higher and longer than in other sectors such as automotive and information technology – have encouraged a trend towards fewer, larger multinational development programs.

The global aerospace industry is also intensely competitive. There is competition for market share between aircraft manufacturers and other integrated systems suppliers and among lower tier firms in securing successful supply relationships. And there is competition for jobs and capital investment between the growing number of governments that aspire to have internationally competitive aerospace industries of their own<sup>3</sup>. The trend towards fewer, larger development programs has raised the stakes and intensified this competition.

***“... there is correlation between the pecking order of national Aerospace industries and the level of government support they receive. Moreover, it's not possible to compete unilaterally without it”***  
**Counterpoint Market Intelligence<sup>4</sup>**

Governments “invest” in their aerospace industries in recognition of the benefits to be reaped. First, they know that trade follows investment – firms are either in one of the few supply chain loops for new programs or they are out of business. They also know companies with a long-term role in an aircraft or aerospace system supply chain are stable foundations for growth of their national and regional economies.

The global aerospace industry does not operate in a laissez-faire market place. It is subject to extensive government control and influence, with the realities of national security and politics often trumping international trade theory. Much aerospace technology has both civilian and military applications. Governments, particularly in the US and EU, use their defence programs to support cutting-edge R&D in order to provide military superiority for their armed forces<sup>5</sup>. Through ‘first-use’ and follow-on support for the commercialization of defence technologies, governments also give their firms a

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<sup>3</sup> The Governments of the US, UK, Australia, Japan, Singapore have recently promulgated policy frameworks to enhance the competitiveness of their aerospace industries.

<sup>4</sup> “Who pays, who wins – trends in government funding of aerospace” – Counterpoint Market Intelligence, January 2006, page 5

<sup>5</sup> The US Air Force alone spends US\$20B annually on R&D compared to total EU spending on all form of aerospace R&D and Canada's C\$300M.

competitive advantage in global commercial markets<sup>6</sup>. Similarly, their expenditures on space technology and projects through organizations like National Aeronautics and Space Administration (NASA) and the European Space Agency (ESA), develop and sustain competitive, advanced technology industrial capabilities that serve national objectives and grab a significant share of the global space market.

The reality of today's complex global market in which Canadian aerospace firms operate is that investors seek to optimize the return on their investment and national governments intervene to advance their national interests. These factors must be clearly understood and addressed if Canada is to remain a world leader in aerospace. Government and industry must move forward in partnership to balance and achieve their individual and collective interests.

***“Governments can create significant aerospace capabilities ...  
the Canadians have been conspicuously successful”  
Counterpoint Market Intelligence<sup>7</sup>***

#### **4. The NADSF**

The National Aerospace & Defence Strategic Framework (NADSF) was promulgated by the Federal Government on November 23, 2005 to provide a blueprint for working in partnership with other stakeholders to enhance the global competitiveness of Canada's aerospace industry. In large measure, the NADSF serves as the Federal Government's response to the agenda set out by the Canadian Aerospace Partnership (CAP)<sup>8</sup> – a non-partisan, multi-stakeholder forum created in April 2005 to bring together senior leaders from industry, various levels of government, labour and academia to achieve consensus on, and to respond to, the challenges and opportunities confronting Canadian aerospace companies in a rapidly transforming global marketplace.

The NADSF takes a long-term, comprehensive perspective to Federal Government policy and program initiatives aimed at creating the right conditions that will make Canada a preferred location from which to serve global aerospace markets. It identifies seven areas where the Federal Government can take a leadership role in working with other stakeholders to achieve this outcome:

- Strategic Initiatives and Major Platforms
- Technology Development and Commercialization
- Human Resources and Skills Development
- Trade Development and Market Access
- Sales Financing
- Security and the Environment
- Public Procurement

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<sup>6</sup> A European Commission Report – “The 2002 Annual Report on US Barriers to Trade and Industry”, indicated that the benefits of US Government defence R&D support to Boeing amounted to US\$2B and on average the US engine sector benefited from support at US1.2B annually.

<sup>7</sup> “Who pays, who wins – trends in government funding of aerospace” – Counterpoint Market Intelligence, January 2006, page 5

<sup>8</sup> CAP comprises 18 industry CEOs, the Federal Industry Ministers and colleagues from B.C., Man., Ont, P.Q, and N.S, the heads of the CAW and IMAW, and representatives from Canadian universities and technical colleges.

AIAC members unanimously endorse the Canadian Aerospace Partnership (CAP) as a forum for industry, labour, academia and government to address issues of critical importance to the Canadian aerospace industry and by extension to the economic well-being of Canada. Furthermore, AIAC members unanimously endorse the National Aerospace and Defence Strategic Framework (NADSF) as a mechanism for documenting the Federal Government's objectives and policy intentions with regard to support of the aerospace industry in Canada.

## **5. Urgent Aerospace Priorities for the Federal Government**

Full implementation of this comprehensive approach to securing the long-term competitiveness of Canada's aerospace industry will take time. All stakeholders have important roles to play in implementation. However, urgent Federal Government leadership and action is required in three priority areas:

- Levering Industry Investments in Technology Development, Product Mandates and Strategic Platforms
- Levering Procurement to Capitalize on the Capabilities of Canadian-based Firms
- Providing Adequate Export Financing under Appropriate Terms & Conditions

The 'window of opportunity' for this leadership and action is short. Global aerospace markets have entered a new growth cycle. A concomitant investment cycle is now underway. Many firms face imminent decisions on where to place substantial new aerospace investments. The aerospace investment opportunity (in new technology, products/services and strategic platforms) for Canada over the next five years is estimated at more than \$6B.

To choose Canada as the location for these investments, firms need to be assured that adequate and competitive investment leverage will be provided by the federal government. Large military aerospace procurements will also proceed in the near term as the Federal Government begins to provide much needed new capabilities to the Canadian Forces. The 'business case' for companies with a defence/dual-use focus to continue to invest and grow in Canada will also be highly influenced by whether there exists a clear commitment by the Federal Government to draw upon their advanced technology, market-proven, and globally cost competitive solutions. Similarly, for firms in the space sub-sector, the directions Canada will take in developing new space capabilities to meet Canadian security and other needs will influence their investment decisions. Finally, a surge of orders for new commercial aircraft is occurring. Customers will be drawn not only to those suppliers having the best aircraft and large integrated solutions to meet their needs but increasingly to those that can provide access to financing to support their purchases.

### **5.1. Levering Industry Investments in Technology Development, Product Mandates and Strategic Platforms**

The Federal Government can effectively tailor and apply its policy and programs to provide for both direct and indirect support to securing investment decisions in Canada's aerospace industry. Both types of support are required to meet the differing needs of Canadian-based aerospace companies – there is no 'one size fits

all' solution, and one form is not a replacement for, but is complementary to, the other.

### **5.1.1. Direct Leverage**

Federal Government direct support in co-investing with Canadian-based aerospace firms generally takes two forms. First, to support the development, integration and commercialization of new technologies; second, to share the costs and risk of launching major new aerospace platforms and solutions.

**Technology Development/Product Mandates:** The primary existing Program by which the Federal Government co-invests with Canadian firms to develop and commercialize new technologies is the Technology Partnerships Canada program, created in 1996. In 2005, the Federal Government announced its intention to terminate TPC and replace it with new policy instrument(s) for stimulating private sector technology development. The aerospace and defence component of TPC will terminate on December 31, 2006 (its capacity to make new investments may cease much earlier, as remaining unallocated funds are extremely limited).

In taking its decision on TPC, the Federal Government, through the NADSF, committed to establishing a new, more effective mechanism for supporting Canadian-based aerospace firms to develop and bring to global market leading edge technology solutions. It is imperative that this new mechanism be established quickly so that companies posed to make sizable technology investments are influenced to make them in Canada. Uncertainty caused by undue delay in establishing the new program risks the loss of such substantial investments to other countries. It is also imperative that the new mechanism be structured and operated in a way that:

- provides support comparable (mandate, type of activities covered, level of support e.g. sharing ratio, terms and conditions e.g. repayment conditions) to similar programs of aerospace competitor nations.
- flows financing in a way that remains off the balance sheet - i.e. repayment be contingent on success of the project.
- ties repayment obligations directly to the success of the technology developed with the Federal Government's investment support (as opposed to being tied to total company revenues/profits).
- meets the differing, yet in some cases, interdependent needs of the full spectrum of aerospace firms irrespective of size, ownership and market segment.
- addresses a full continuum of activities from basic research, through early stage technology collaboration and technology development, to commercialization and post market entry life cycle support.
- targets a broad range of investment objectives.

- aligns to the business decision-making cycle/timeframe of companies (i.e. applications can be submitted at any point in time (not a start/stop auction system) and that assessments be completed and decisions rendered within one calendar year).
- supports technology priorities developed through industry and government consensus.
- conducts assessment of proposals submitted by companies based on clear project assessment criteria transparent to the companies and others (with external ‘transparency respecting the proprietary/business confidentiality of proposals submitted by companies).
- provides for predictable funding over the life of (approved) technology development projects (i.e. multi-year approval/flow of financial support).
- works in a complementary fashion with other policies and programs (both domestic (federal and provincial) and foreign) aimed at supporting technology development and commercialization by industry.

It is industry’s view that this can be best accomplished through the establishment of aerospace technology development support mechanisms encompassing five components of investment support, each with differing levels of government investments and conditions on repayment.

- **Strategic Investments** (capturing/sustaining global technology mandates)
- **Technology Collaboration** (multi-stakeholder early-stage research)
- **Technology Demonstration**
- **Proprietary Technology** (near market development/after market technology insertion)
- **Supplier Development** (manufacturing and business process enhancement)

The near-term investment opportunities confronting Canadian firms suggest that a total 5-year funding commitment between \$1.5B and \$2B is required for this new program, if Canada is to fully capture potential investment opportunities.

Since much of the technology development work of Canadian firms is of a defence/dual-use nature, the Federal Government should consider flowing a portion of its technology development investment through current, or newly created defence R&D programs. Doing so would better align its overall policy objectives and its technology investment expenditures, and provide more flexibility in the terms and conditions under which such support is provided, by exempting this investment from international trade disciplines.

The provision of technology development support under the defence umbrella would reduce, if not eliminate, Canada’s exposure to a repeat of its experience at the WTO over Brazil’s challenge of the TPC program, and that now underway between the United States and the European Union over their claims and counter claims that support for their respective commercial transport aircraft industries

constitute prohibited subsidies. Defence R&D support is exempt from these trade disciplines and processes.

**Strategic Platforms:** From time to time, significant, strategic investment opportunities arise. These can be in the commercial, defence and/or space market segments, and they present opportunities for Canada to take a leadership position, or participate as a major partner in an international platform. While these platforms are infrequent, difficult to predict, and often unique, the Federal Government, in recognition of the importance and value of seizing these opportunities, has in the past participated as an investment partner. This includes investment to: a) secure the establishment in Canada of operations of foreign multinationals (e.g., Bell Establishment Agreement); b) help launch and secure the final assembly of aircraft in Canada (e.g., Bombardier's C-Series); and c), secure the participation of Canadian aerospace firms on major international development programs (e.g., International Space Station, Joint Strike Fighter).

The financial demands of these large and infrequent investments outstrip the capacity of programs like Technology Partnerships Canada, and/or require a direct government investment. Foreign governments are increasingly making similar investments and at much higher levels of support e.g. European governments' investments with Airbus, Japan's and Italy's investment with Boeing on B787, Italy's investment on Russian Regional Jet Program. Canada must continue to have a willingness and capacity to make strategic investments that provide growth opportunities for Canadian aerospace companies and in turn to capture the substantial economic return.

### ***5.1.2. Indirect Leverage Through the Tax System***

Tax policy is an instrument used by most nations to provide investment incentives to their industries. The provision of research and development tax credits that encourage companies to undertake technology development is one such policy tool; Canada's Scientific Research and Experimental Development (SR&ED) Income Tax Credit program provides companies tax credits for their expenditures on eligible R&D work performed in Canada.

The SR&ED Program has been an important stimulus to R&D in Canada. It does, however, exhibit a number of weaknesses from both a general and aerospace-specific perspective. First, the program treats companies differently based on their ownership. Canadian-controlled private corporations (CCPC) are treated more favourably than publicly traded corporations. Specifically, a CCPC can benefit from: a) a higher level of tax credit (35% vs 20% for publicly traded firms); and b) the refundable nature of the tax credit (a CCPC can receive a cash refund of the unused portion even though the credit exceeds the amount of tax payable). Tax credits earned by non-CCPC are not refundable, they can only be used to reduce income tax payable.

Many Canadian-based aerospace companies that invest in R&D are publicly traded. A combination of the substantial cash outlays required to support their R&D programs (often years before realizing a profitable return) and their

performance during market downturns often means that their SR&ED credits far exceeds their tax payable. As a consequence, they are not able to fully utilize their credit, and accrue little or no financial benefit.

Subsidiaries of foreign firms operating in Canada – 8 of the largest 14 aerospace firms – are required to consolidate their corporate earnings for foreign tax reporting purposes. The complexities of tax policy across international borders often mean that the value of the SR&ED credits get lost in the machinations of the international tax treatment of firms.

The SR&ED Program needs to be improved to provide equal benefit to all firms conducting R&D in Canada. This can be achieved by providing for a refundable tax credit to all companies on their eligible R&D expenditures in Canada.

To remain competitive in serving global supply chains, small and medium-sized (SMEs) aerospace firms must quickly augment their capacities and capabilities. However, they face daunting challenges in financing the acquisitions of state-of-the-art manufacturing and test equipment. The Federal Government can facilitate SME investment in new manufacturing equipment and machinery by allowing the immediate expensing of the first \$75,000 of such investments. Additional investment incentives would be provided by raising the small business tax rate threshold to \$400,000.

## **5.2. Levering Defence/National Security Procurement**

Most national governments seek to maximize the economic benefits of defence/national security procurement to bolster their own industries and give them a leg up in selling to other nations – this often extends beyond the procurement of goods and services for their military forces to include their national police forces, Coast Guards and their national space entities/agencies. The exclusion of defence/national security procurement from international trade disciplines (e.g. WTO, NAFTA) is an explicit recognition of national governments' desire to use defence/national security procurement in a strategic way to achieve broader national objectives.

Many countries set domestic content levels. For example, 50% of American defence procurement content must be of US-origin, and certain types of commodities or services (e.g.: aircraft maintenance, repair and overhaul) must be sourced only, or predominately from firms in-country. European governments have also traditionally been very proactive in supporting their aerospace industries, and today this has carried over to pan-European defence programs that are generally not accessible, at any sizable level of participation, to suppliers from other nations. Recently, Australia has implemented integrated government/industry 'capability teams' to ensure an "Australian-industry first" bias in its defence procurement. The United Kingdom Defence Industrial Strategy White Paper, published in December 2005, seeks to establish a deliberate link between its defence capability requirements and its defence industry.

The actions of these governments are no doubt driven by a desire to reap the technological and economic stimulus that flows from large development programs.

They recognize that not doing so would weaken their industrial and technological base and constrain the creation of highly skilled jobs. In sharp and puzzling contrast, in Canada, mandatory domestic content provisions are now the exception rather than the general rule. Perhaps more important and appropriate, there is no stated commitment in policy that in conducting its defence procurement, Canada will be predisposed to draw upon market proven, technically sophisticated and globally cost competitive solutions offered by Canadian-based companies.

The ability to participate in domestic defence procurements can have a major influence on the 'business-case' for Canadian-based aerospace firms to grow and prosper in Canada, and for others to decide to establish operations here. For some firms, a single procurement by DND may have a direct and significant impact on its revenues and profitability. Alternatively, this defence business may provide the essential investment leverage to develop and commercialize a product or service for commercial markets. For others, 'first-use' procurement by DND may be crucial in giving them the 'multiplier' credibility in selling to export markets. When high value, high technology defence procurements go to off-shore firms in instances where proven, cost-competitive Canadian solutions exist, this can significantly impair the chance of Canadian aerospace companies attracting future export business. The socio-economic loss of such circumstances must be given more consideration in how Canadian defence procurements are conducted.

The absence or minimal level of Canadian content required on many defence/national security contracts is weakening the motivation of Canadian-based aerospace firms to maintain operations in Canada given their ability to supply the relatively small domestic demand from another country. This is accentuated by increasing pressures on them to relocate capability or establish operations in other countries as a necessary step to remain viable business entities and to access these markets (i.e. to meet domestic ownership/sourcing requirements). Importantly, the dual-use nature of much technology (often produced on a single product line) can mean that relocation of commercial capabilities will also occur.

Industry calls on the Federal Government to take a strategic approach to defence and national security procurement, and adopt a clear policy that it will draw on the capabilities of Canadian-based firms, large and small, to the fullest extent possible in meeting its defence requirements, and that it will utilize defence procurement to develop/retain in Canada technologies deemed important to supporting national economic, security and defence objectives.

In calling for such a policy, industry is not advocating that industrial development take precedence over meeting, first and foremost, the capability requirements of the Canadian Forces. Nor is it calling for the enactment of overt 'protectionist measures' such as a broad mandatory 'Buy Canada Policy' (notwithstanding that many competitor nations continue to employ such measures). Both of these actions would be counterproductive. Rather, industry advocates a more rigorous recognition, and a predisposition to utilization, of the world class capabilities resident in the domestic industrial base, in meeting Canada's defence procurement requirements. They ask for a 'level playing field' whereby, when appropriate, Canada fully exercises its negotiated rights to exempt defence procurements from international trade disciplines, and procures from Canadian sources to achieve other 'whole of

government' objectives, including its technology, industrial and trade development objectives.

Tangible measures that would achieve this are:

***Developing and promulgating a Defence Industrial Strategy that clearly identifies those strategic technologies and industrial capabilities Canada wants to develop and/or sustain in Canada:*** No country can afford to rely exclusively on its domestic capabilities to deliver all of its defence technology, equipment and life cycle support needs. Canada, in particular, with its relatively small defence budget, will always need to work with foreign suppliers in meeting its defence equipment and service needs. However, for reasons of strategic assurance/access, operational independence/sovereignty, strategic influence or to support strategic national economic, security and defence objectives, Canada must retain control of certain technology/industrial capabilities. These capabilities should be clearly articulated and nurtured.

***Adopting a Capabilities-based Procurement Approach:*** To ensure that the Canadian Forces acquires the equipment it believes is best suited to a particular mission, it has traditionally stated its requirements by setting out stringent design and operating specifications of the desired equipment. This approach largely predetermines how a platform must be designed to provide a capability, what it must do, and the way it must be done. Such a detailed, specification-driven approach to procurement discourages innovation and often limits the range of solutions proposed by industry; resulting in the exclusion of more cost effective, but equally capable or better ways of fulfilling the mission objectives. National Defence must consider alternative strategies for acquiring capabilities needed to meeting its overall defence and specific mission objectives.

Capabilities-based procurement (CBP) sets out the mission goals to be accomplished and the general capabilities needed to achieve them. CBP avoids unnecessary equipment design specifications and allows a number of potential solution providers to propose creative and cost-effective ways of delivering capabilities to meet mission objectives.

CBP can also lead to more competition and therefore lead to better 'value for money' in the Federal Government's procurement spending. CBP has the benefit of being more transparent, and by eliminating non-essential qualifications, it reduces any real or perceived bias to a predetermined outcome. In short, CBP focuses on results and not process. This gives the government a better solution in the end but also allows it to move the programs forward faster with less resistance from companies that feel disadvantaged by narrow, mandatory equipment specifications, because there is a more objective basis for the Crown to defend its actions.

***Encouraging Canadian Companies to Lead not just Follow:*** As acknowledged above, Canada cannot supply all its major defence capabilities from the domestic industrial base. However, there is a general tendency for Federal Government procurement offices to overlook Canadian capability and to proceed directly to foreign OEMs without considering ways in which Canadian companies can participate. Particularly on major programs that involve a complex mix of product

acquisition, systems integration and in-service support, qualified Canadian companies should be encouraged to bid as primes. This will foster the development and retention of “high value” skills that will allow these Canadian companies to sell full solutions in the international marketplace, rather than just niche support services. Implementing CBP as described above would create more opportunity for Canadian companies to act as primes in marshalling, from both domestic and foreign sources, including Canadian SMEs, the capability assets that enable achievement of mission objectives.

***Adopting a More Strategic Approach to Securing Canadian Industrial Benefits/Participation:*** When contracts are awarded to foreign primes, the Federal Government requires some industrial return to Canada (offset). Most other countries, including the U.K., Norway, the Netherlands, and Australia, have similar offset policies. The policy instrument used by Canada is the Industrial and Regional Benefits (IRB) Policy, which was introduced in 1986 and is administered by Industry Canada. The IRB Policy requires prime contractors on major defence/security procurements to place a level of activity into the Canadian economy, usually an amount equal to (100%) the contract value.

While the IRB Policy has helped ensure that Canadian defence spending provides an economic stimulus to Canadian industry, the outputs it derives can be enhanced through several changes to the Policy’s design and delivery. Given the critical importance of export sales to the Canadian aerospace industry, the overarching objective of the IRB program should be to improve Canadian firms’ access to and participation in global supply chains. The emphasis should be on the **quality** of the benefits secured, not solely the **quantity**. Specific actions that would help achieve this include:

- in the assessment bids, assign a rated value be assigned to the IRB components of bids in place of the current simple pass/fail methodology.
- Set higher levels of Direct Benefits (participation by Canadian companies directly related to the equipment/service being procured) and Semi-Direct IRBs (other benefits flowing to companies in the Canadian aerospace and defence sector) be required in fulfilment of a prime contractors IRB obligations<sup>9</sup>, with a focus on accessing and/or developing strategic technologies. The 100% of contract value requirement should be reassessed.
- allow prime contractors and their major industrial team partners on international projects be allowed to gain IRB credit for activities directed at involving Canadian companies before any Federal Government decision to procure a capability is made (commonly referred to as ‘banking’). This change would help Canadian companies in gaining greater access at an early stage to key international programs.
- manage IRBs in a more strategic and holistic manner as opposed to managing each program as an independent ‘stovepipe’. For example,

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<sup>9</sup> Currently benefits can be put in place by prime contractors in manufacturing and industrial sector beyond aerospace and defence – such benefits generally do not have a lasting/sustaining economic impact. The value of these offset is diluted because of their dissipation over several industry sectors. Achieving greater levels of Direct Benefits will require much earlier engagement by prime contractors and Canadian industry, facilitated by the Federal Government in the early stages of procurement planning.

leveraging the totality of IRB obligations that a prime contractor may have over several programs, and also leveraging benefits over the entire scope of the prime contractor's global business operations, as well as their relationships with their significant partners on international development programs.

- Canadian SMEs face unique challenges in accessing procurement opportunities. Ongoing procurement reforms like DND's implementation of OWSM increase the potential for SME disenfranchisement. As part of the implementation of a more strategic approach to defence and national security procurement, the interest and views of SMEs must be considered. Establishment of a Government of Canada/SME consultation group to ensure that the needs of small companies are fully reflected in changes to procurement policies, approaches and processes is recommended.

The proposed acquisition of new airlift assets for the Canadian Forces is a 'once in a generation', near-term opportunity for the federal government to **strategically** use its procurement power to stimulate Canadian job and wealth creation, and accelerate the pace of innovation and technology commercialization in Canada.

### 5.3. Export Sales Financing

Sales financing capacity is an important competitive discriminator in global aerospace markets. National governments, through their export credit agencies, play a vital role in this activity. Canada must continue to provide flexible sales financing capacity, that addresses a broad range of needs and circumstances, on appropriate terms, to purchasers of Canadian aerospace goods and services.

Sales financing capacity is particularly important for the sale of aircraft, which are unique, 'big ticket', low volume products, with extremely long service lives (20+ years). Financing for aircraft is provided by a combination of commercial market lenders and government export credit agencies, for example the Eximbank (US), Export Development Canada (EDC), and similar entities in Europe (COFACE in France) and Brazil. Governments do so to reap the rewards of high skilled, high paying employment and the positive impact on their balance of trade accounts and overall economy. EDC's aerospace/aircraft sales financing activities have also been a major source of sustained profits for the corporation.

The role of export credit agencies like EDC is especially important in periods of market turmoil like that experienced in the post-September 2001 period. In such turbulent market conditions, the commercial financing market quickly evaporates, and what little capacity remains becomes more expensive in response to lenders' aversion to perceived higher risk. In the absence of commercial financing, governments play a critical role in assisting the sales efforts of manufacturers. Absent this sales financing support, continued production is unsustainable. The demise of aircraft manufactures (or their exit from the commercial aircraft manufacturing business) such as Fokker, Fairchild, Dornier, Saab, and BAe provide ample evidence of this.

A review of EDC's aerospace mandate to ensure adequate financing support on equitable terms is critical in the face of expanded demand. This should include a

confirmation that EDC aerospace support is competitive with the export credit financing agencies of the US, the EU and Brazil, who have all continued to provide financing to their aerospace/aircraft industry at historic highs, especially in the post-September 2001 period.

While competitive export credit agency support was prevalent in this challenging period, EDC risk management policies on individual airline exposures limited new EDC Corporate Account aircraft financing support in the period of 2003-2005, thereby putting increased pressure on other government financing vehicles, such as the Canada Account and the Regional Aircraft Credit Facility, both of which are more reactive, complex and time consuming channels, with greater uncertainty and delay in the assessment and decision-rendering process.

Although recent EDC policies and their record profitability suggests that this Crown Corporation is prepared to re-emerge and leverage its balance sheet to provide competitive aerospace financing, urgent implementation action is required to respond to the NADSF commitment to establish a stand-alone Aircraft Sales Financing Framework to provide competitive and defensible sales financing. This new Aircraft Sales Financing Framework must:

- ensure adequate capacity to meet market demand.
- provide a clear policy framework and supporting criteria for assessing financing requests.
- allow for flexibility as the financing markets evolve.
- be consistent with manufacturers' sales strategies and align at an early stage with future order commitments.
- identify and clearly explain internal Government capacity constraints.
- provide Canadian aerospace companies with a level international 'playing field' while not distorting international trade.

To best achieve these outcomes, industry calls on the Federal Government to mandate the merger of current aerospace financing instruments into one structure (EDC is the most appropriate entity to take leadership of this unified program), with multiple facets that provide for:

- a long-term, permanent export financing program, which allows for different types of financing structures and vehicles, including interim financing.
- 'market-based' financing terms.
- OECD-type consensus financing, as appropriate.

To ensure optimal effectiveness of this new Aircraft Sales Financing Framework, the management of individual transactions should be delegated to the entity charged with Framework implementation.

Early establishment of a new Aircraft Sales Financing Framework, as described above, will fully exploit EDC's financing capacity as an instrument of public policy to address 'capacity gaps' in the commercial banking sector.

## **6. Conclusion**

Global aerospace markets are rebounding, driven by solid demand and major programs in the commercial and defence market segments. New opportunities are emerging, but global competition for market share is intensifying. Canada's future success in this fast paced, technology intensive, export driven and high value business cannot be assumed solely on the basis of past performance.

The future of Canada's aerospace industry and the economic benefits it delivers to Canadians lies in the outcome of investment decision making that will occur in boardrooms in Canada, the US and Europe over the coming weeks and months. The NADSF lays a solid foundation for a winning business case for those investments to be made in Canada. However, this foundation, on its own, is insufficient to secure and sustain those investments.

The urgent challenge for the Federal Government is to deliver quickly on three key implementation priorities that build on that foundation:

- Levering Industry Investments in Strategic Platforms, Product Mandates and Technology Development
- Levering Procurement to Capitalize on the Capabilities of Canadian-based Firms
- Providing Adequate Export Financing under Appropriate Terms & Conditions

Aerospace industry leaders call on the Hon. Maxime Bernier, Minister of Industry, and his Cabinet colleagues Hon. Michael Fortier, Hon. Gordon O'Connor, Hon. David Emerson, Hon. John Baird and Hon. James Flaherty, to implement, on an urgent basis, policy and program responses to address these priorities.

Industry is committed to working closely with Ministers, their staff and their officials to develop and implement productive solutions to these challenges, that deliver the mutually desired outcomes.

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