

Global Pressures Challenge IRB Success

The fundamental principle of the Industrial and Regional Benefit (IRB) policy is that Canada's domestic industry should enjoy the economic benefits that are derived from its investment in large scale defence procurement programs. As such, the IRB policy is a key stakeholder and implementation tool of Industry Canada's *National Aerospace and Defence Strategic Framework*.

Intense competition in global defence, aerospace and security (DAS) markets has led other countries to adopt aggressive strategies to promote and support their own domestic industry – using IRBs (commonly known as Offsets) as a condition of market access. In comparison, Canada's IRB policy seems under-utilized as an economic tool. Coordinated and complimentary action by the defence industry and Industry Canada is recommended to preserve and expand the economic development potential.

Canada's DAS industries are among the most cost competitive, dynamic and innovative countries in the G7. The export market represents approximately 80% of Canadian DAS revenues, with the lion's share to the United States. In the absence of a comprehensive Canadian defence industrial strategy, the IRB policy is a primary vehicle for support of domestic DAS industries, which employ more than 70,000 people, and annually generate more than \$7 billion in the Defence and Aerospace Sector, and approximately \$10 billion in the Security sector.

Under the U.S. *Defense Production Act*, an interagency team was established in 2004 to "Consult with Foreign Nations on Limiting the Adverse Effect of Offsets" on the US defence industrial base. Preliminary results indicate that U.S. defence contractors find **short timeframes in which to perform offsets** as one of the most adverse offset provisions. A projected reduction in US defence budgets is anticipated to increase US political protectionist pressures, and it is in the best interests of Canada to be prepared to respond.

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The global defence industry recognizes that IRBs/Offsets are an inherent cost of doing business within the host country, and continually re-evaluate their material supply strategies to optimize source selections where industrial benefits will be recognized. The outcome is that Canadian DAS industries must continuously compete, to develop new supply relationships, and *retain* existing supply chains relationships. The Canadian IRB policy encourages the development of new economic activity, but provides little incentive to maintain existing supply relationships that are continually faced with increasing global competitive pressures from other nations, and foreign protectionist measures.

While the IRB Policy does permit the claiming of "incremental purchases," the reward and incentive to retain supply relationships with Canadian industry is only applicable in growth markets, or early phases of the product life cycle where growth in the purchasers market; hence increases in incremental purchases, can be assured.

Within the Global Offset community, Canada has a reputation of being a *challenging* country in which to perform offset programs. This would appear

inconsistent with the openness and flexibility of Canada's IRB policy. Canada has one of the most flexible programs where economic support is broadly targeted to "knowledge based" industrial sectors. There are literally tens of thousands of companies in the knowledge-based sector, which includes in excess of 2000 Defence, Aerospace, and Security organizations.

The *challenge* referred to earlier is due, in part, to the need to synchronize the procurement practices of a company with an existing or anticipated obligation to Canada with IRB policy requirements – specifically the IRB Achievement Period. This requirement can create a Catch-22 situation that serves as a disincentive to doing business with Canadian DAS companies. It also places the SMEs (Small and Medium Enterprises) in particular risk as primes face increasingly competitive global economic pressures to move small material supply requirements to other nations in response to an offset requirement.

The establishment of a new material supply chain relationship is complicated by a myriad of sound governmental best practice requirements. Over and above the quality, price, capabilities, experience, and business practice analysis that should be conducted to ensure a viable mutually beneficial relationship can be established between the purchaser and the Canadian supplier (commonly known as the IRB Recipient). The cost, complexities and time required to confirm quality certifications, secure ITAR licensing approvals, and/or conduct Canadian Controlled Goods registrations, US Department of State, Directorate Defense Trade Controls (DETC), etc. is significant. ITARs registrations and clearances currently take nine months at best – effectively eliminating Canadian participation in numerous American contracts.

Simply put, viable new supply relationships often take years to establish and are costly to develop. Security requirements are often not as stringent in the non-DAS or other knowledge-based commercial industry sectors; thus the IRB policy could be viewed as favouring non-DAS industrial support, due to bureaucratic differences in the sectors.

The Canadian IRB policy was established to serve as a stimulus and encouragement for companies to create new supply relationships. Industry Canada has demon-

strated a propensity for establishing the start-date of an IRB Achievement Period as close as possible to the release date of a competitive RFP. Rarely is the IRB Achievement Period start-date established concurrent with the Definition Phase of a defence procurement program (during which, participation and input from industry is requested to ensure the technical requirements can, in fact, be achieved). Industry, and potential sub-contractors play a pivotal role in this consultative process, and an effective IRB program should address program requirements at the Definition Phase, including, identifying Direct participants where TAAs, ITARs, etc. will need to be established. In its current form, the IRB Policy does not recognize this effort and timeline. In fact, should business activity be undertaken with the Recipient, in advance of the IRB Start-date, credits may be lost or discounted through the application of the three-year averaging (incrementals) rule. This produces a strong disincentive for doing business with Canadian industry until the IRB Start-date has been established.

The question is – how do we enhance the support of Canadian DAS industry within the confines of the IRB Policy? Cooperative action between the defence industry and Industry Canada could go a long way towards answering this question.

From the defence industry side, organizations with, or anticipating, future economic obligations to Canada need to improve their understanding and advocacy role for Canadian industry. A Canadian Champion resource is recommended to be established with the authority and support of senior management to investigate and promote company-wide opportunities for Canadian economic development across all corporate divisions, product lines, and programs.

A significant barrier to market, particularly for SMEs, is finding the right contact and niche within a large defence contractor's corporate labyrinth. The Champion is encouraged to work in concert with regional agencies to identify organizations, and assist in establishing connections to the appropriate supply chain decision makers. This activity should be conducted on an ongoing basis to establish sustainable, long-term advocacy support for Canadian DAS on a global basis. Moreover, the Champion

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should explore opportunities to develop or expand operations in Canada that offer cost competitive, world class resources, skills and capabilities where significant productivity enhancement can be achieved.

Companies planning to compete for Canadian defence procurement programs should assume that IRBs will be required, and take a proactive approach to developing a comprehensive IRB development strategy including securing or developing in-house a resource with an in-depth understanding of the IRB policy. Our experience has shown that much of the IRB Policy reputation perception as being “challenging” is due to a lack of understanding of the rules, and how they impact upon supply chain and business case decisions. Revenue Canada expects corporations have the resources to understand Canadian taxation policy; similarly working with Industry Canada is easier when all parties have a common understanding of the rules governing IRBs.

From Industry Canada's side, problems stem directly from the IRB Policy's disconnect with the defence industry's supply chain management best practices. The cost and resource commitment required to establish a Canadian Champion or Advocate for ongoing identification and development of IRBs is significant, however, this investment in for the long-term should be recognized as an integral support mechanism for the DAS industry.

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Global opportunities for Canadian industry are not necessarily in sync with Canadian defence procurement cycles, and the IRB Achievement period restrictions that accompany them.

In the absence of a comprehensive Defence industrial strategy, the IRB Policy could be expanded to provide incentives to support Canadian DAS on an ongoing basis. To clarify, incentives are not punitive and are recommended to reward increased Canadian DAS IRB opportunities participation. As a starting point, this could be achieved through more closely tying the IRB Start-date to the Definition Phase of the defence procurement program where direct industrial participation should logically be initiated. Long-term relationships, teaming agreements, and security approvals cannot be established within a 90 day RFP response period. This in turn would be a major competitive benefit to Canadian DAS who are continually competing for a larger role in Canada's defence procurement programs, and establish a more secure market share on a global basis.

In summary, the objectives of the stakeholders of the DAS industry need not be mutually exclusive. Better utilization of the Canadian Industrial and Regional Benefits Program can be achieved through recognizing a linkage between IRB support and the practicalities of defence procurement programs, material supply chain processes and rewarding of organizational changes that support ongoing long term development of opportunities for Canadian industry.

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