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CANADA

**CHAPTER 2, REPLACING CANADA'S FIGHTER  
JETS, OF THE SPRING 2012 REPORT OF THE  
AUDITOR GENERAL OF CANADA**

**Report of the Standing Committee on  
Public Accounts**

**David Christopherson, MP  
Chair**

**NOVEMBER 2012**

**41st PARLIAMENT, 1st SESSION**



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**41st PARLIAMENT, 1st SESSION**

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# **THE STANDING COMMITTEE ON PUBLIC ACCOUNTS**

has the honour to present its

## **NINTH REPORT**

Pursuant to its mandate under Standing Order 108(3)(g), the Committee has studied Chapter 2, Replacing Canada's Fighter Jets, of the Spring 2012 Report of the Auditor General of Canada and has agreed to report the following:

## **INTRODUCTION**

In April 2012, The Office of the Auditor General (OAG) released a performance audit on the governmental processes associated with replacing Canada's fighter jets. Canada's current fleet of CF-18 Hornet fighter jets was purchased in the 1980s, with an original estimated life expectancy to 2003. In the early 2000s, the Department of National Defence undertook a major modernization of the CF-18s that extended the life of the aircraft into the 2020s. The OAG examined whether National Defence, Industry Canada, and Public Works and Government Services Canada (PWGSC) exercised due diligence in managing Canada's participation in the Joint Strike Fighter (JSF) Program and in managing the federal decision-making process to acquire the F-35 as a replacement for the CF-18.<sup>1</sup>

Given the importance of this acquisition and concern over the audit's findings, the Standing Committee on Public Accounts (the Committee) held several hearings on the audit. This report represents the Committee's observations and recommendations on its study.<sup>2</sup>

## **INDUSTRIAL BENEFITS**

In his report, the Auditor General stated that for most defence acquisition contracts, the federal government's Industrial Regional Benefits Policy applies. In effect, this policy guarantees work for Canadian companies, usually equivalent only to the acquisition cost of the contracts awarded. For the JSF Program, on the other hand, industrial benefits are not guaranteed or limited to the value of the acquisition. Rather, companies from partner countries are eligible to obtain contracts on a "best-value" basis. The benefits, though, are merit-based and contingent on remaining a partner country in the JSF Program. The JSF Program is led by the United States and involves

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<sup>1</sup> Auditor General of Canada, "Replacing Canada's Fighter Jets," Chapter 2 of the *Spring 2012 Report*, Ottawa, April 2012.

<sup>2</sup> For this study, the Committee held hearings on April 26, 2012 (meeting 40), May 1, 2012 (meeting 41), May 3, 2012 (meeting 42), and May 15, 2012 (meeting 45). The witnesses at each of these hearings are listed at the end of this report.

eight international partners—Canada, Australia, Denmark, Italy, Netherlands, Norway, Turkey, and United Kingdom.

The OAG found that National Defence and Industry Canada developed an effective collaborative arrangement for managing industrial benefits. Their efforts to secure industrial opportunities for Canadian companies through the system development and demonstration phases of the JSF Program were significant and successful. The Auditor General stated, “We found that National Defence and Industry Canada did a good job of managing Canada's participation in the US-led Joint Strike Fighter, or JSF, program to design and develop the F-35 aircraft.”<sup>3</sup>

Simon Kennedy, an Assistant Deputy Minister at Industry Canada, spoke of the contracts that have been awarded to date, “Canadian companies have done well. Since Canada joined the joint strike fighter program in 1997, 70 Canadian companies have received \$435 million U.S. in contracts. Participation in the JSF program provides the opportunity to compete for billions more over the program's lifetime.”<sup>4</sup> As of September 2011, the government had spent \$335 million as part of its contribution to the costs of developing the F-35 and to provide support to Canadian industry.<sup>5</sup>

Simon Kennedy also told the Committee of the total expected contracts for Canadian firms:

The estimate right now for the potential opportunities for Canadian firms is \$9.85 billion U.S.; that's for the production of the aircraft and does not include sustainment and some of the service. For the actual manufacture, if we have the 3,100 or so planes that are estimated to be produced, it's just under \$10 billion in terms of opportunities for Canadian companies.<sup>6</sup>

Mr. Kennedy explained how his department arrived at its estimates:

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<sup>3</sup> Meeting 40, 845.

<sup>4</sup> Meeting 41, 905.

<sup>5</sup> Chapter 2, paragraph 2.23.

<sup>6</sup> Meeting 42, 1005.

Very briefly, the government receives, twice a year, from the prime contractors a very detailed list of all their requirements for the manufacture of the aircraft and a detailed list of all the Canadian companies that they believe can play a role. We sit down with the prime contractors twice a year to go through that list, discuss it, and validate it.<sup>7</sup>

However, the OAG found that the government's estimated forecasted value for industrial benefits for Canadian companies has fluctuated from \$5.2 billion to \$16.6 billion. Additionally, the estimates were based on projections by the prime contractors, which were not independently validated. The information put forward to decision-makers did not explain the limitations of the projections and only included the most optimistic scenario. The Auditor General told the Committee that "we felt it would have been appropriate that the industrial benefit numbers coming forward should have included a range of the estimated industrial benefits rather than just an absolute number."<sup>8</sup>

Mr. Kennedy acknowledged that improvements could be made, "I think we would agree, certainly in hindsight, that we probably could have provided more detailed information and perhaps presented the information differently."<sup>9</sup> The Committee recommends:

## **RECOMMENDATION 1**

**As the government committed to doing in its seven-point plan, that by February 7, 2013, Industry Canada provide to Parliament an update explaining the industrial benefits consistent with the Auditor General's findings.**

## **DUE DILIGENCE**

For large military acquisitions, several departments are involved. As discussed above, Industry Canada has a role to play with respect to industrial benefits. Both National Defence and Public Works and Government Services Canada (PWGSC) are involved in the procurement process. The Deputy Minister of PWGSC, François

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<sup>7</sup> Meeting 41, 955.

<sup>8</sup> Meeting 40, 955.

<sup>9</sup> Meeting 41, 955.

Guimont, described the roles and responsibilities of his department and National Defence:

Our colleagues in the Department of National Defence are the program and technical authority and as such have duties that include, for example, the definition of operational requirements, the preparation of technical evaluations, and the responsibility for associated budgets. With regard to PWGSC, the Defence Production Act provides the minister of Public Works and Government Services with the exclusive authority to buy or otherwise acquire defence supplies required by the Department of National Defence. As such, the department is the contracting or acquiring authority for these types of acquisitions.<sup>10</sup>

An important step in the procurement process is the selection of a procurement strategy, including whether a competition is possible. An exception to the competitive process must be justified and is normally accompanied by a statement of operational requirements and an options analysis. PWGSC is responsible for approving the procurement strategy and upholding the integrity of the procurement process.

The OAG expected the departments involved to exercise due diligence in their support of key decisions and related management activities; that is, that the departments:

- performed and documented analyses (of benefits and risk, operational requirements, options, and costs);
- clarified rules, roles, and responsibilities;
- consulted with other entities; and
- obtained approvals and provided oversight.<sup>11</sup>

The OAG found that in May 2008, National Defence identified 14 draft high-level mandatory capabilities for the replacement of the CF-18s. Also in 2008, National Defence conducted an options analysis of three contender aircraft against these

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<sup>10</sup> Meeting 41, 900.

<sup>11</sup> Chapter 2, paragraph 2.15.

capabilities and concluded that the F-35 offered the “best value.” However, there was little documentation supporting the analysis and conclusion.

National Defence recommended to central agencies, other departments, and its minister that Canada commit to buying the F-35 through the provisions of the 2006 Memorandum of Understanding (MOU). This decision process was put on hold until 2010. As National Defence intended to recommend the purchase of the F-35 without competition, it had to justify an exception to the *Government Contracts Regulations*.

National Defence preferred the exception that “the nature of the work is such that it would not be in the public interest to solicit bids.” As use of this exception was not supported interdepartmentally, National Defence decided to use the exception that “only one [contractor] is capable of performing the contract.” In order to support this exception, National Defence had to provide its operational requirements and its justification to PWGSC. However, National Defence did not provide a statement of operational requirements to PWGSC until *after* the government had announced its decision to purchase the F-35s. PWGSC accepted a letter prior to the announcement from National Defence confirming that the F-35 was the only aircraft meeting its requirement for a fifth generation fighter aircraft.

The OAG found that National Defence officials engaged PWGSC officials late in the process, and, at the same time, PWGSC officials relied almost exclusively on assertions by National Defence officials. The Auditor General, Michael Ferguson, summarized the audit’s findings in this regard:

[S]everal of the usual steps associated with procurement were taken out of sequence, and important documents were prepared out of sequence, rendering them of little consequence. Key decisions were not always supported by adequate analysis or documentation, and did not receive required approvals. Public Works and Government Services Canada was not engaged in its role as the government’s procurement authority until late in the process, and it endorsed the decision to sole-source the acquisition of the F-35 jets without required documentation or completed analysis.<sup>12</sup>

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<sup>12</sup> Meeting 40, 850.

The OAG concluded that PWGSC officials did not demonstrate sufficient due diligence in their role as the government's contracting authority and National Defence officials did not exercise sufficient due diligence in managing the process to replace the CF-18s.

The departments did not agree with this conclusion, as they felt that the level of due diligence was appropriate within the time frame covered by the audit. The Deputy Minister of PWGSC provided his department's position, "Public Works and Government Services feels that it exercised due diligence commensurate with the current stage of the project. In fact, in his appearance here last week, the Auditor General noted that we did exercise some due diligence. However, he deemed it insufficient."<sup>13</sup> The Deputy Minister also said:

I feel very comfortable with the statement made by the OAG; that is, some due diligence was exercised, but it was not sufficient. I accept that. I accept it in the sense that on a going forward basis, as explained by Madame d'Auray, this has not yet reached the preliminary program approval stage. ... Looking back, we should probably have taken a different look at how to undertake that ongoing due diligence, but the seven-point action plan does that on a go-forward basis.<sup>14</sup>

The Deputy Minister explained that PWGSC had engaged in discussions with National Defence on the high-level mandatory requirements to determine whether a competitive process could be conducted. PWGSC considered National Defence's market analysis and met with another potential aircraft manufacturer to discuss their ability to meet the mandatory requirements. This was done after National Defence officials had met with several aircraft manufacturers to review market options. PWGSC determined that the procurement strategy was in accordance with the Treasury Board's contracting policy and requested written confirmation from National Defence that the F-35 was the only aircraft that met the high-level mandatory requirements. Tom Ring, an Assistant Deputy Minister at PWGSC, told the Committee that his department had followed the proper steps, stating:

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<sup>13</sup> Meeting 41, 900.

<sup>14</sup> Meeting 41, 935.

The role of Public Works is to work with the client department in making sure that the justification and rationale for an exception to the government contracting regulations is fully justified. The client department must provide that rationale as to why they are seeking an exemption. In fact, there is quite an extensive checklist in our Treasury Board guidelines that must be filled out. The Department of Public Works works with the client department to make sure this justification is extensive, is on file, is available, and can support the rationale for justifying that only one supplier can do the work. That was all done in this particular case.<sup>15</sup>

Nonetheless, the Auditor General maintained that PWGSC should have received more information earlier. He said:

We certainly saw instances where Public Works was trying to get the information from National Defence. Public Works was trying to do due diligence. However as we state in the chapter, they were hampered by the fact that they were brought in late to the process. But then also, even though they had been asking National Defence for information around operational requirements and hadn't been receiving it, at the critical point, they did sign off on the sole source on the basis of a very short letter.<sup>16</sup>

The Auditor General also noted that “we would have expected that Public Works and National Defence would have gotten together very early on in this process to try to identify what steps, procedures, roles, and responsibilities were required to bring this type of complex acquisition to its end.”<sup>17</sup>

The Committee agrees that in order to ensure better due diligence going forwards, the government needs to clarify roles and responsibilities involving procurement contracts, as well as what steps need to be taken, and in what order. The Committee notes that the government released a comprehensive response to the audit, including a seven-point action plan.

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<sup>15</sup> Meeting 41, 1015.

<sup>16</sup> Meeting 40, 910.

<sup>17</sup> Meeting 45, 945.

## ACTION PLAN

The government has indicated that it agrees with the recommendation and conclusions of the OAG. It released its seven-point action plan on the same day as the report was tabled:

- The funding envelope allocated for the acquisition of the F-35 will be frozen.
- The Government of Canada will immediately establish a new F-35 Secretariat within the Department of Public Works and Government Services Canada. The Secretariat will play the lead coordinating role as the Government moves to replace Canada's CF-18 fleet. A committee of Deputy Ministers will be established to provide oversight of the F-35 Secretariat.
- The Department of National Defence, through the F-35 Secretariat, will provide annual updates to Parliament. These updates will be tabled within a maximum of 60 days from receipt of annual costing forecasts from the Joint Strike Fighter program office, beginning in 2012. The Department of National Defence will also provide technical briefings as needed through the F-35 Secretariat on the performance schedule and costs.
- The Department of National Defence will continue to evaluate options to sustain a Canadian Forces fighter capability well into the 21st century.
- Prior to project approval, Treasury Board Secretariat will first commission an independent review of DND's acquisition and sustainment project assumptions and potential costs for the F-35, which will be made public.
- Treasury Board Secretariat will also review the acquisition and sustainment costs of the F-35 and ensure full compliance with procurement policies prior to approving the project.
- Industry Canada, through the F-35 Secretariat, will continue identifying opportunities for Canadian Industry to participate in the F-35 Joint Strike Fighter global supply chain, as well as other potential benefits for Canada in sustainment, testing, and training, and will provide updates to Parliament explaining the benefits.<sup>18</sup>

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<sup>18</sup> National Defence, "Government of Canada announces comprehensive response to Chapter 2 of the 2012 Spring Report of the Auditor General of Canada," News release, April 3, 2012.

According to the government's news release, the action plan is intended to improve governance, due diligence, and transparency with respect to the decision-making process to purchase new fighter aircraft to replace the fleet of CF-18s. The Deputy Minister of PWGSC described the actions that will be taken as part of this plan:

The government action plan announced on April 3 clearly frames how due diligence will be applied as we move forward with replacing Canada's fighter jets. These seven action points identify the respective roles of key departments, including my department. A secretariat will be led by Public Works and will ensure the delivery of the government's seven-point action plan. The terms of reference governing the committee structure are being drafted, and we are also active in staffing and defining priority tasks for actions. The secretariat will focus on the following outcomes: first, governance and coordination through collaborative arrangements with the key departments involved; second, strengthened due diligence through increased oversight and third party involvement; finally, openness and transparency through clear articulation of timelines, expectations and timely communications.<sup>19</sup>

The Deputy Minister of National Defence, Robert Fonberg, expressed his support for the plan, stating, "We are confident that the government's seven-point plan sets out a strong footing to move forward on the AG's concerns."<sup>20</sup>

On June 13, 2012, the government announced that the National Fighter Procurement Secretariat was operational and released its terms of reference, which set in place the Secretariat's governance and coordination structure. On September 7, 2012, the government announced that KPMG had been awarded a contract through a competitive process to review the acquisition and sustainment project assumptions and potential costs for the replacement of the CF-18s; to develop a framework to assess the life-cycle cost estimate of a fleet of F35As through its expected operational life; and to provide an independent verification of the 2012 annual update to Parliament.

The Committee recommends:

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<sup>19</sup> Meeting 41, 900.

<sup>20</sup> Meeting 41, 850.

## RECOMMENDATION 2:

**That by February 7, 2013, as part of the government's seven-point plan, the government table independently verified updated cost estimates to the Standing Committee on Public Accounts.**

### COST ESTIMATES

The OAG indicated that it had issues with the assumptions used to arrive at cost estimates, as they did not include estimated operating, personnel, or ongoing training costs. This led to a discrepancy of over \$10 billion in the information reported publicly and that used internally. The Deputy Minister of National Defence, Robert Fonberg, said that his department was following established practices in its reporting methodology:

I would note that the approach we took for costing the F-35 is exactly the same approach—and the same 20-year timeframe—that has been taken with all our air asset procurements going back at least to 2004: for the maritime helicopter project, the Chinooks, the Hercules J models, and the new C-17 Globemasters. In each case, announcements and communications focused only on the costs of acquisition and sustainment.<sup>21</sup>

The Office of the Auditor General's expectations were found not to be in full agreement with the Treasury Board policy directives followed by National Defence, specifically the traditional costing of air assets over 20 years. Michelle d'Auray, Secretary of the Treasury Board of Canada, told the committee that:

“[W]hen we have received submissions from the Department of National Defence concerning the timeframe for the costing of a life cycle, 20 years has been deemed to be an appropriate timeframe. It is set by the Department of National Defence. Going beyond 20 years is considered too high-risk to ensure that the value in contracting with industry would be sustained, or the costs would be going beyond the 20-year mark. So that, for us, is considered to be reasonable, and as the Deputy Minister of National Defence indicated, all of the submissions to date that have been presented to the Treasury Board have used a 20-year cost estimate.<sup>22</sup>

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<sup>21</sup> Meeting 41, 855.

<sup>22</sup> Meeting 41, 935.

The Committee acknowledges that in Chapter 6 of the *Fall 2010 Report*, the Auditor General recommended full life cycle costing on major military procurement projects. However, this recommendation was issued after this audit period had already been completed in July 2010. The government has agreed to the Fall 2010 recommendation as outlined in paragraph 2.77.

As part of the Committee's study, the Committee invited the Parliamentary Budget Officer (PBO), Kevin Page, to discuss his previously released report on the F-35.<sup>23</sup> The March 2011 report used a top-down, parametric model based on the weight of the aircraft and using historical trends of the production and sustainment costs of previous fighter aircraft by weight.

Using his cost by weight method, the PBO noted in his March 2011 report that there has been an exponential increase in the cost to manufacture one kilogram of fighter jet aircraft over the last six decades. The cost per kilogram has risen at a rate of approximately 3.5% per year, while the average weight of fighter jet aircraft has increased by about 0.5% per year. Relying on these historical trends and applicable cost drivers, the PBO forecasted that total ownership costs of the F-35, including acquisition and long-term sustainment, would be US\$29.3 billion for 65 aircraft over 30 years, as outlined in the following table.

**Table 1 – The Components of the PBO's Forecast of the Total Ownership Costs of the F-35**

<b>Component</b>	<b>Cost (US\$ billions)</b>
Acquisition, i.e., production	9.7
Initial logistics and set-up	1.7
Operating and support	14.0
Overhaul and upgrade	3.9
Subtotal: ongoing sustainment	19.6
<b>Total: production + ongoing sustainment</b>	<b>29.3</b>

Source: Parliamentary Budget Officer's report.

<sup>23</sup> Parliamentary Budget Officer, *An Estimate of the Fiscal Impact of Canada's Proposed Acquisition of the F-35 Lightning II Joint Strike Fighter*, Ottawa, 10 March 2011.

When asked about the PBO's methodology, the Deputy Minister of National Defence, Robert Fonberg, criticized the measuring of cost by weight. "He took a top-down approach. He used what is called parametric analysis, generally deemed to be not appropriate or suitable for a project in this state of development."<sup>24</sup> In fact, Kevin Lindsey, CFO of National Defence, went on to say:

Mr. Chair, as the deputy has pointed out, the PBO used this parametric modelling, which is normally reserved for projects in the conceptual stage of development where there's very little cost data available to do a bottom-up analysis. In doing so, the PBO estimated the acquisition price of the aircraft at \$148.5 million each, and all of his subsequent costs derived from that. Because that acquisition price is significantly inflated above what we understand the cost to be from the joint project office at the time, all of the subsequent data and costs estimated by the PBO are similarly inflated, by significant amounts. If the PBO had used what we understood the acquisition price of the aircraft to be at the time—that is based on SAR 2009, \$75 million—then the PBO's estimate, other things being equal, would have been about \$17.2 billion over his 30-year timeframe rather than the \$29 billion. That difference is entirely attributable to the PBO's assumption about the acquisition cost of the aircraft.<sup>25</sup>

In response to the PBO's March 2011 report, National Defence provided to Parliament at that time its own estimate of the costs associated with the acquisition and sustainment of the F-35. According to National Defence's information, the total capital acquisition costs would be \$9 billion and the contracted sustainment costs would be \$5.7 billion over 20 years, for a total of \$14.7 billion.<sup>26</sup>

However, there was considerable disagreement among witnesses over how to present information in a number of important areas, namely, acquisition costs, operating costs, and life-cycle costs. The OAG's expectations were not found to be in full agreement with the Treasury Board's policy directives followed by National Defence, specifically the traditional costing of air assets over 20 years.

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<sup>24</sup> Meeting 41, 910.

<sup>25</sup> Meeting 41, 915.

<sup>26</sup> As outlined in Chapter 2, exhibit 2.6.

## A. Acquisition Cost

As Canada is participating in the JSF Program as a partner country, the cost to acquire the F-35s is set by the United States' government. In effect, Canada would be a price-taker.<sup>27</sup> To determine the unit price of the F-35, Canada relies on information provided by the JSF Program Office in its annual Selected Acquisition Reports (SAR) to Congress. The OAG noted in its report that the costs had increased considerably from 2001 to 2009.<sup>28</sup> In 2009, the predicted average unit recurring flyaway costs for Canada was US\$75 million. The Deputy Minister of National Defence told the Committee that the predicted cost had increased:

The joint project office's number, which they send to Congress and which has been consistent, for the variant we would buy in the years we would buy it, was \$75 million, the unit recurring flyaway cost in the SAR 2009, in that report. That number in the latest report, which we'll build our estimates off, is up around \$85 million.<sup>29</sup>

The Deputy Minister stated that this increase was manageable due to the \$830 million that had been set aside in the budgeted amount for contingency and inflation.

The JSF Program Office also provides a projection for the average procurement unit costs. The Committee acknowledges it is difficult to compare the average unit recurring flyaway costs and the average procurement unit costs because they include different elements. Regardless of which number is used, it is important to be clear about what is, and what is not, included in the amount, and to develop a common and consistent definition of acquisition costs. This is important not just for the sake of clarity, but also the Committee notes that the acquisition budget for new fighter aircraft has been frozen at \$9 billion. The Committee recommends:

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<sup>27</sup> Dan Ross, Meeting 41, 930.

<sup>28</sup> Chapter 2, exhibit 2.2.

<sup>29</sup> Meeting 41, 925.

### RECOMMENDATION 3

**That by February 7, 2013 the Department of National Defence return to the Public Accounts Committee with what elements are, and are not, included in the estimated acquisition cost of fighter aircraft to replace the CF-18s.**

#### **B. Operating Costs**

Once replacement fighter aircraft have been acquired, it is important that National Defence have sufficient funds in its budget to operate them. Failing to do so could result in National Defence experiencing operational and budgetary issues.

The OAG noted in its report that National Defence had informed decision-makers that the cost of operating and sustaining the F-35s would be covered by existing funds. This is because National Defence officials are working on the assumption that average annual maintenance and repair costs for the F-35 fleet would be the similar to that of the CF-18 fleet. The Auditor General pointed out that this assumption had led to problems in the past. He said:

We reported on a similar situation in chapter 6 of our fall 2010 report on the “Acquisition of Military Helicopters”. Specifically we noted that national defence initially assumed that the personnel, operating, and maintenance costs for the new Cyclone maritime helicopter would be the same as those for the legacy Sea King it was replacing. National Defence later realized that these costs would exceed those associated with the Sea King by \$1.1 billion over 20 years.<sup>30</sup>

Additionally, the Auditor General and the PBO noted that there may be reason to believe that the cost to operate the F-35 may be higher than anticipated.

Sahir Kahn, Assistant Parliamentary Budget Officer, provided a more precise estimation of the differences in operating costs between the F-35 and predecessor aircraft. He told the Committee that:

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<sup>30</sup> Meeting 45, 850.

The [United States'] Department of Defense says that the operating and required personnel costs associated with the F-35s is higher than the costs associated with the aircraft they are replacing. This information is on page 84 of the report that was published four or five weeks ago. The figures provided indicate a cost for an F-35 of \$31,000 per hour compared to \$22,000 per hour for an F-16.<sup>31</sup>

He continued, "The original hypothesis was that this aircraft would cost more or less the same as the aircraft it replaced. The United States Department of Defence has concluded that this aircraft is quite costly in comparison to the aircraft it is replacing. This aircraft has more capabilities, but, in financial terms, it costs \$10,000 more per hour to operate."<sup>32</sup> In response to comparisons between DND's numbers and the PBO's, Robert Fonberg said:

In this regard, in posting a comparison of the department's estimates and the Parliamentary Budget Officer's estimates on our website, we used the same average price per aircraft as all nine partners are using and have received from the joint project office, and, on a good-faith basis, we presented our estimates on the understanding that the Parliamentary Budget Officer did not include operating costs in his calculations.<sup>33</sup>

It is important to note that deputy ministers rejected the suggestion of the PBO that there was any inappropriate accounting.

In testimony before the Committee, there appeared to be a lack of clarity within National Defence on this issue. In his opening statement, the Deputy Minister of National Defence said, "For decision-making purposes, we have assumed that the operating costs of the F-35s will be similar to those being incurred in our base budget for operating the CF-18 fleet."<sup>34</sup> However, when asked about the hourly cost to fly the F-35, Dan Ross, an Assistant Deputy Minister at National Defence, replied, "We've always expected that the F-35, due to its complexity, would cost more. And as I testified here last year, knowing that we'd spent about \$200 million annually for the F-18, I'd

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<sup>31</sup> Meeting 42, 915. The Committee notes that Canada does not own or operate any F-16 fighter aircraft.

<sup>32</sup> Meeting 42, 915.

<sup>33</sup> Meeting 41, 855.

<sup>34</sup> Meeting 41, 855.

estimated \$250 million to \$300 million in my last testimony. So we expect that it will cost more.”<sup>35</sup>

The Committee believes that National Defence needs to clarify the definitions and calculations of operating costs and recommends:

#### **RECOMMENDATION 4**

**That by February 7, 2013 the Department of National Defence provide a workplan to the Public Accounts Committee which would allow it to provide the estimated operating and sustainment costs of the F-35A.**

#### **C. Life Cycle Costing**

Not only is it important that National Defence estimate the operating costs associated with new fighter aircraft, it is also important that National Defence estimate these costs over the predicted life cycle of the aircraft. This ensures that adequate funds are budgeted to support the aircraft over the long term.

The Auditor General told the Committee that:

Life cycle costing is required by Treasury Board policies and is also included in National Defence's own project approval directive. This directive states the following: "The life cycle cost estimate includes estimates of the total cost of the resources needed to complete project activities and deliver the product system infrastructure, i.e. project acquisition costs, as well as the cost of the resources needed to operate, maintain, and dispose of the product system infrastructure, i.e. ownership costs." While we believe in and support life cycle costing, it is not a requirement established by the Office of the Auditor General.<sup>36</sup>

Despite agreement over the importance of life cycle costing, this issue led to considerable disagreement among witnesses before the Committee because it was not clear over what duration National Defence should estimate life cycle costs.

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<sup>35</sup> Meeting 42, 1000.

<sup>36</sup> Meeting 45, 850.

The OAG indicated in its report that National Defence had not fully presented costs in relation to the life of the F-35 aircraft. According to the OAG, the United States' estimated life expectancy of the F-35 is about 8,000 flying hours, or 36 years on projected usage. The Auditor General told the Committee that:

Really we would have felt that because this was life cycle costing—the way to do life cycle costing is based on the estimated life of the particular asset to sort out what all those costs were going to be and then to include those costs over that full life cycle, rather than choosing a period of 20 years. I think that was where the first primary discrepancy came in. It was the fact that National Defence chose to present this information on a 20-year basis rather than on the full life of the assets, which they knew to be longer than 20 years.<sup>37</sup>

The Committee also notes the OAG's recommendation:

National Defence should refine its estimates for complete costs related to the full life cycle of the F-35 capability, and provide complete estimated costs and the supporting assumptions as soon as possible. Furthermore, National Defence should regularly provide the actual complete costs incurred throughout the full life cycle of the F-35 capability.<sup>38</sup>

National Defence responded by indicating its agreement to implement the recommendation, stating, "Agreed. National Defence will continue to refine its full life-cycle cost estimates for the F-35 capability and commits to making the estimates and actual costs of the F-35 available to the public." The Committee recognizes that the government has committed to do this through the National Fighter Procurement Secretariat.

The Deputy Minister of National Defence was able to confirm for the Committee that "Our approach to costing has never been characterized as "full-life cycle". Our approach has been consistent and compliant with Treasury Board policy and

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<sup>37</sup> Meeting 40, 905.

<sup>38</sup> Chapter 2, paragraph 2.77.

guidance.”<sup>39</sup> His testimony was reinforced and confirmed by Michelle d’Auray, the Secretary of the Treasury Board of Canada.

The Auditor General continued to maintain that full life cycle costs were important. He said, “When we raised the issue of life cycle costing and the fact that it was not complete, I don't believe we were nitpicking in any way. I think that we were saying that there were some significant elements that were missing.”<sup>40</sup> At a subsequent hearing, he indicated, “I don't know whether that is a Treasury Board responsibility, a National Defence responsibility, but the fact that there's still confusion about life cycle costing and how it should be applied, I think is indicative of the fact that it needs to be re-examined to determine the best way to apply it.”<sup>41</sup>

The Committee agrees and recommends:

#### **RECOMMENDATION 5**

**That by February 7, 2013 the Treasury Board of Canada Secretariat provide a workplan to the Public Accounts Committee which would allow it to clarify what is meant by full life cycle costing; and that National Defence indicate the period over which it is estimating life cycle costs, as well as the expected life cycle of the F-35.**

#### **RISKS**

The OAG noted that the JSF Program has experienced cost increases, schedule delays, and technological problems. These issues are not uncommon for a major development program. It has been subject to several major reviews – the latest began in 2010 and is likely to affect unit cost, sustainment costs, and the delivery schedule.

The OAG found that National Defence had not informed decision-makers of the risks relating to costs, schedule or technological difficulties of relying on the F-35 to replace the CF-18s, which are approaching the end of their life cycle. The OAG

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<sup>39</sup> Meeting 41, 855.

<sup>40</sup> Meeting 40, 920.

<sup>41</sup> Meeting 45, 925.

concluded that National Defence had been overly confident in its risk mitigation strategies, especially as the F-35 is still under development and behind schedule.

According to the OAG, there is a risk that the budgets established for acquisition, \$9 billion, and for operations and sustainment, \$16 billion, may not be sufficient as many costs are not yet reliably known. The budgets also do not include costs for the anticipated life expectancy of the F-35, attrition aircraft, upgrades, and weapons.

The Auditor General acknowledged that anticipating future costs involved estimation, but it also involves risks. He said, "Certainly, again, looking at costs into the future is an estimate process. That's why it's important not only to provide estimates but to provide things like ranges and sensitivity analysis around those estimates and to prepare risk mitigation strategies, in case those types of estimates are not accurate."<sup>42</sup> The Committee believes that National Defence needs to be more explicit about how it is planning to mitigate the risks associated with its plans to replace the CF18s. It recommends:

## **RECOMMENDATION 6**

**That the Department of National Defence provide a workplan to the Public Accounts Committee which would allow it to specify in its information to Parliament how it intends to mitigate the risks associated with replacing the CF-18 fighter aircraft fleet.**

## **CONCLUSION**

The Committee notes that while the government has announced its intention to purchase 65 F-35s, it has not yet made the final decision to acquire the jets and has not placed a procurement order or spent money on acquisition. As the Auditor General indicated, "Going forward, it is important that the process to replace Canada's CF-18 fleet reflect principles of due diligence, scrutiny, rigour and transparency."<sup>43</sup>

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<sup>42</sup> Meeting 40, 1010.

<sup>43</sup> Meeting 40, 850.

The Committee believes that creating the new secretariat within PWGSC is an important first step, but it is also vital to clarify what options are being considered and steps remain to be taken. Additionally, the Committee heard considerable differences of opinion with respect to a number of aspects related to the proposed acquisition of the F-35. In order for parliamentarians and Canadians to fully understand the costs and benefits of the F-35, the Committee believes that Industry Canada should provide the range of estimated industrial benefits for Canadian companies participating in the JSF Program, and that National Defence should clarify the elements included in its acquisition cost estimate, and the estimated operating cost of the F-35. The Treasury Board will need to work with the Auditor General to establish a mutually acceptable definition of life cycle costing.

The Committee recognizes that it is vital that the government replace the CF-18 fleet in a timely manner, but it believes that maintaining the public's trust in the process requires a transparent and accountable process that provides full and complete information to Canadians.

# APPENDIX A LIST OF WITNESSES

Organizations and Individuals	Date	Meeting
<p><b>Office of the Auditor General of Canada</b>  Jerome Berthelette, Assistant Auditor General  Michael Ferguson, Auditor General of Canada  John Reed, Principal</p>	2012/04/26	40
<p><b>Department of Industry</b>  Simon Kennedy, Senior Associate Deputy Minister</p>	2012/05/01	41
<p><b>Department of National Defence</b>  André Deschamps, Commander,  Royal Canadian Air Force  Robert Fonberg, Deputy Minister  Kevin Lindsey, Assistant Deputy Minister,  Chief Financial Officer, Finance and Corporate Services  Dan Ross, Assistant Deputy Minister,  Materiel</p>		
<p><b>Department of Public Works and Government Services</b>  François Guimont, Deputy Minister,  Deputy Receiver General for Canada  Tom Ring, Assistant Deputy Minister,  Acquisitions Branch</p>		
<p><b>Treasury Board Secretariat</b>  Michelle d'Auray, Secretary of the Treasury Board of Canada</p>		
<p><b>Department of Industry</b>  Simon Kennedy, Senior Associate Deputy Minister</p>	2012/05/03	42
<p><b>Department of National Defence</b>  André Deschamps, Commander,  Royal Canadian Air Force  Robert Fonberg, Deputy Minister  Kevin Lindsey, Assistant Deputy Minister,  Chief Financial Officer, Finance and Corporate Services  Dan Ross, Assistant Deputy Minister,  Materiel</p>		

Organizations and Individuals	Date	Meeting
<b>Department of Public Works and Government Services</b>		
François Guimont, Deputy Minister, Deputy Receiver General for Canada		
Tom Ring, Assistant Deputy Minister, Acquisitions Branch		
<b>Library of Parliament</b>		
Mostafa Askari, Assistant Parliamentary Budget Officer, Economic and Fiscal Analysis, Office of the Parliamentary Budget Officer		
Sahir Khan, Assistant Parliamentary Budget Officer, Expenditure and Revenue Analysis, Office of the Parliamentary Budget Officer		
Kevin Page, Parliamentary Budget Officer		
Peter Weltman, Senior Director, Expenditure and Revenue Analysis, Office of the Parliamentary Budget Officer		
Tolga Yalkin, Financial Advisor-Analyst, Expenditure and Revenue Analysis, Office of the Parliamentary Budget Officer		
<b>Treasury Board Secretariat</b>		
Michelle d'Auray, Secretary of the Treasury Board of Canada		
<b>Office of the Auditor General of Canada</b>	2012/05/15	45
Jerome Berthelette, Assistant Auditor General		
Michael Ferguson, Auditor General of Canada		

# REQUEST FOR GOVERNMENT RESPONSE

Pursuant to Standing Order 109, the Committee requests that the government table a comprehensive response to this Report.

A copy of the relevant Minutes of Proceedings (41st Parliament, 1st Session: [Meetings Nos. 39 to 42, 45, 55 to 60 and 62 to 64](#)) is tabled.

Respectfully submitted,

David Christopherson, M.P.

Chair

## **DISSENTING OPINION – NEW DEMOCRATIC PARTY OF CANADA - Chapter 2 of the Spring, 2012 Report of the Auditor General of Canada**

The sole-sourced procurement process of the F-35 Lightning II Fighter Jet managed by the Harper government has proven to be the largest military procurement debacle in Canadian history. Both parliamentarians and Canadians continue to be kept in the dark regarding acquisition costs, life-cycle costs, capabilities and process to select a replacement for our aging CF-18s.

New Democrats feel strongly that the Committee's report does not accurately reflect what the committee heard from witnesses on Chapter 2 of the Auditor General of Canada's Spring 2012 Report, "*Replacing Canada's Fighter Jets*". The NDP remains deeply concerned that this study did not allow parliamentarians to shed light and complete the inquiry on this very important matter. Only seven hours of testimony were dedicated to this study, and no responsible ministers appeared during the inquiry.

### **1. Failure to Follow the Procurement Process**

When spending taxpayer money to acquire military equipment, it is vital that the process be open, fair and transparent. In this way, the military gets the best equipment, Canadian taxpayers get the best price and Canadian industries get the best industrial benefits. In the case of the government's decision to acquire the F-35, the process has been flawed, manipulated and not transparent. Important testimony on these issues emerged that is not adequately captured in the Committee's report.

#### **A) SOLE SOURCING**

An open and fair competition would require that the Statement of Operational Requirement (SOR) be made public and used as the basis for bids from suppliers. In the case of the F-35, the complete opposite happened. The government hid the SOR behind the guise of "National Security" and the requirements were written in such a way that only the F-35 could meet them.

The only justification to sole-source the F-35 was based on a one page, 60 word letter classified as secret from the Assistant Deputy Minister (Material) at the Department of National Defence (DND) addressed to the Assistant Deputy Minister of Acquisitions at the Department of Public Works and Government Services (PWGSC) on June 1, 2010. This was only two weeks before the government announced it had selected the F-35 to replace the CF-18 fighter jets. The term "Fifth Generation" was used four times in the letter; it is important to note that the AG said in his report that those terms are not a description of an operational requirement.

An exception to the competitive process must be justified and is normally accompanied by a SOR and an options analysis. However, National Defence did not provide a SOR to PWGSC until after the government had announced its decision to sole-source the F-35.

During testimony on April 26, 2012, the AG strongly recommended "What's important right now for the new committee that's going to be looking at this is, number one, to have very clear direction about whether the F-35 is the only option." We agree with the AG that it is important to clarify what options are being considered to replace the CF-18 fleet and feel this should be reflected in the Committee's report. We also strongly feel that a true open competition is possible only if the New Fighter Procurement Secretariat is clearly mandated to review and change the SOR to replace Canada's Fighter jets so that other options can be considered.

#### **B) INDUSTRIAL BENEFITS**

The government's failure to follow an open and transparent competition also had a negative impact on securing industrial benefits for Canadian companies. Under the Joint Strike Fighter (JSF) Program, industrial benefits are not

guaranteed. Canadian companies must first compete with companies from other countries in order to win contracts. In contrast, an open competitive process requires all bidders to guarantee industrial regional benefits (IRBs) equal or greater to the value of the contract. In the case of the F-35, where the total cost is projected to be in the area of \$40 billion or more, guaranteed IRBs would equal that same amount.

The government has steadily lowered the amount Canadian industry could benefit from the JSF program from \$16.6 billion in 2009 to \$9.85 billion earlier in 2012. The Auditor General noted in his report that “only the most optimistic scenarios were put forward” and that “the estimates were based on assumptions about the type of work that may be performed in Canada.” In testifying before the committee on April 26, he said he was “concerned that those estimates did not include a potential range. They included what really seemed to be just the best estimate of industrial benefits.”

## **2. Lack of Transparency and Misleading Canadians**

The Conservative government misled parliamentarians and the Canadian public by saying before the last election that the cost of the F-35 was over \$10 billion less than what they actually knew to be true.

### **A) TWO SETS OF BOOKS**

It is clear from the AG’s report and ensuing testimony at the Committee on Public Accounts that key decision makers in Cabinet were presented with a cost for the F-35 of \$25 billion in June 2010, but presented a cost to the public of \$14.7 billion in March 2011. This double accounting created two sets of books: one for the government and another for the public and parliamentarians.

The AG made it very clear both in his report and at committee that he had significant concerns with the completeness of the information provided to parliamentarians, as it did not include estimated operating, personnel, or ongoing maintenance costs, even though this information was included in estimates provided to Cabinet.

During committee testimony on April 26, 2012, the AG stated “We identified that there were some significant things were missing from the life cycle costing—for example, attrition, upgrades, and the fact that these aircraft were going to last for 36 years, not just 20 years. When we raised the issue of life cycle costing and the fact that it was not complete, I don't believe we were nitpicking in any way. I think that we were saying that there were some significant elements that were missing.”

He went on to articulate that cabinet approved both a \$16 billion budget designated for operating costs over 20 years, and a \$9 billion budget designated for the acquisition of the F-35 fighter jet: “The number of \$25 billion was a number that was established by Defence that included both the purchase and the maintenance cost, and the budgets were approved through normal process.”

On that same day, the AG spoke to the media, and further clarified these statements:

“I can't speak to individuals who knew it, but it was information that was prepared within National Defence...and it's certainly my understanding that that would have been information that, yes, the government would have had.” When pressed, he said “...certain members of the executive.”

It is important to note that under questioning at the committee on May 1, 2012, the Deputy Minister of Defence clearly contradicted the AG when stood by the assertion that DND never had an estimate of \$25 billion in 2008.

### **B) NOT DISCLOSING THE FULL COST OF THE F-35**

Despite an abundance of reports from the US Pentagon, the US Government Accountability Office, partner nations in the JSF Program and the Parliamentary Budget Officer (PBO), the Conservative government ignored the rising cost of the F-35 and decided to make only the acquisition and support costs public.

The government's cost estimate of \$5.7 billion for the support cost is based on the assumption that the operating cost for the F-35 will be similar to the current operating cost of the CF-18. However, the Pentagon's latest SAR report has estimated the operating cost of the F-35 to be \$32 000 per flight hour, as opposed to \$18,900 for the F-18. Under questioning at the Committee on May 1 and May 3, 2012, the Deputy Minister of National Defence, and Assistant Deputy Minister (Material) at DND presented conflicting views regarding these average annual maintenance and repair costs. No valid explanation was given as to why operating costs of the F-35 would be similar to those of the CF-18.

Second, the government chose to ignore repeated requests from the House of Commons and the PBO to provide full life-cycle costs for the F-35. On May 3, 2012 the PBO told the committee "The government's public figures did not include all components of full life-cycle costs, as required by the House finance committee motion of March 2010."

Third, both Treasury Board Policy and DND's costing handbook stress the importance of including full life-cycle cost. Treasury Board guidelines state: "Inherent in procuring best value is the consideration of all relevant costs of the useful life of the acquisition, not solely the initial or basic contractual cost." Furthermore DND's costing handbook states that life cycle costs "must be assessed in order to develop a full appreciation of the differences between options under consideration."

Fourth, the AG's fall 2010 report on the Acquisition of Military Helicopters recommended that "National Defence should start estimating full life-cycle costs in the options analysis phase of its project management process and present these costs to decision makers at subsequent steps in the process as the estimates evolve." In response to questioning at Committee on May 1, 2012, the Deputy Minister of Defence confirmed that he had indeed read chapter 6 of the AG's Fall 2010 report and was therefore aware of the recommendation to include full life-cycle costs. Consequently, the NDP is very concerned that there is no reference to these guidelines in the Committee report despite being raised during testimony.

#### **Conclusion:**

In light of the evidence heard in committee, the NDP is deeply concerned about the government's failure to follow a fair procurement process, provide plausible cost estimates according to Treasury Board policy and be transparent with Canadians on the true cost of the F-35. It is clear from the Auditor General's report and ensuing testimonies that the government failed to exercise due diligence.

Furthermore we are also concerned that the government's proposed seven-point plan under the New Fighter Procurement Secretariat (initially named the F-35 Secretariat) has no intention to examine alternatives to the F-35. The government has chosen PWGSC to oversee the new secretariat despite the fact that the AG said PWGSC did not fully carry out its role as the government's procurement authority and failed to demonstrate due diligence. Moreover, the government has yet to provide updated cost information to parliament in accordance with point three of the seven-point plan despite having obtained updated costing information from the JSF program seven months ago. Lastly, it does not appear that the NFPS will be mandated to review or change the SOR making it simply impossible to examine options other than the F-35. In light of this, we feel that the government has lost all credibility in managing this procurement.

**Liberal Supplementary Report on “Replacing Canada’s Fighter Jets”  
Chapter 2 of the Auditor General of Canada’s Spring 2012 Report**

The process to replace Canada’s Fighter Jets has been a disaster from the beginning. In the House of Commons on May 27, 2010, Defence Minister Peter MacKay stated, “this next generation fighter, again, will be an open, competitive, transparent process...” Despite this promise, the Conservative government decided to proceed with the purchase of the F-35 without following a competitive process. Furthermore, National Defence did not provide a statement of operational requirements necessary to qualify for an exception to the *Government Contracts Regulations* until after the government announced that it was purchasing the F-35. One of the largest procurements in Canadian history was justified as a sole-source contract based on a flimsy one page letter from National Defence to Public Works and Government Services.

Much like the process to procure Canada’s next Fighter Jet, the committee’s study of Chapter 2 of the Auditor General’s Spring 2012 Report has not been transparent. Despite years of precedence at the Public Accounts committee that the first witness on an Auditor General’s report is the Auditor General, the Conservative majority sought to block his appearance before the committee. It was only after the Opposition Chair of the Committee threatened to resign his position, that the Conservative majority relented and allowed the Auditor General to testify.

Similarly, the witness list for the study was controlled exclusively by the Conservative majority to limit the committee’s ability to fulfill its Parliamentary obligation to conduct an in-depth and constructive examination of the report. On April 19, 2012, the Liberal Party put forward a motion to hear from a list of relevant witnesses and to have them appear in an orderly manner as panels so that each witness would have the opportunity to answer the committee’s questions. The motion was not presented as a final list, and allowed for other witnesses to appear. The Conservative majority defeated this motion. When the Liberal Party raised the

concern at this meeting that the government will try to swamp the committee's ability to effectively question witnesses by having too many appear at one time, Conservative committee Member Daryl Kramp stated the following, "The last thing we need is to have a whole group of witnesses coming in here, eight or nine witnesses at one point, and not be able to dig down and drill down when we should and when we need to." Despite this statement, as a result of a Conservative motion, on May 1, 2012, the committee heard from exactly eight witnesses at once, and for a mere hour and forty minutes. This type of self-contradiction clearly demonstrates that the Conservative majority was not sincere about effectively studying this important report.

The response by the Conservative government to the Auditor General's report is troubling. For perhaps the first time in Canadian history, we have a situation where Deputy Ministers and departments are saying one thing, and the Minister is saying something completely different. While the government claims that it has accepted the findings of the Auditor General and his recommendations, National Defence and Public Works and Government Services continue to reject the conclusions of the report.

Ministerial accountability is not a "pick and choose" issue for a minister. The Minister is responsible for every action of his ministry. It is shocking for a Minister to say in the House of Commons that he accepts the Auditor General's report and recommendations only to have his Deputy Minister state at committee that this is not the case. How can the Minister and the department have different views on something of such paramount importance? This issue has clearly demonstrated that the concept of Ministerial Accountability under this Conservative government has died.

The Conservative government has refused to address the root problems identified in the Auditor General's report, and instead they have chosen to re-arrange the deck chairs on the

Titanic. They have removed the file from National Defence and handed it over to Public Works and Government Services. They initially referred to this new secretariat as the “F-35 Secretariat,” which provides further proof that they are 100% committed to the F-35 to the exclusion of other aircraft. It was only after public ridicule that the name was changed to the “National Fighter Procurement Secretariat”.

The Conservative government has touted their “seven-point action plan” to address the issues raised by the Auditor General, but this plan will only achieve the same results because they are working with the same “Statement of Operational Requirements” that was produced to select the F-35 in 2010. Furthermore, it was Public Works who wrongly accepted a one page letter from National Defence as a reason for the sole-source purchase, contrary government rules, and it is this same department that is now in charge of this procurement. Albert Einstein once said that the definition of insanity is doing the same thing over and over again and expecting different results. This is a fitting description of what the government is doing with the procurement of Canada’s new fighter jets.

The Parliamentary Budget Office and the Auditor General have both stated that the government has failed to provide accurate costing information on the F-35, and despite promising this information to Parliament, the government is already many months behind their self imposed deadlines on providing this information.

### **Recommendation**

**That the government send the “Statement of Operational Requirements” for review to the National Research Council like they have done for the Fixed-Wing Search and Rescue Program and proceed with a new open and transparent acquisition program to replace our aging CF-18 fighter jets.**