

Section 2 Initiatives for Increasing the Efficiency of Procurement and Improving its Fairness and Transparency

In light of this situation, the Ministry is striving to ensure the effective, efficient acquisition of defense equipment, as well as the maintenance and strengthening of defense production and technological bases through initiatives aimed at increasing the efficiency of procurement and improving its fairness and transparency.

1 Basic Initiatives by the Ministry of Defense

1 Initiatives Aimed at Increasing the Efficiency of Procurement

Despite that the MOD has been endeavoring to increase the efficiency and rationalization of equipment procurement to date to achieve cost reductions to some extent, further efforts to increase the efficiency of procurement will be essential to the upgrading of defense capabilities, in light of the harsh situation surrounding the defense budget and equipment procurement at present.

Based on this awareness, since March 2013, there have been several meetings held by the “Project Team for Promoting Comprehensive Acquisition Reform” which is headed by the Parliamentary Senior Vice-Minister of Defense, and considerations are now proceeding for the advancement of acquisition reform in a robust manner through, amongst other things, reflecting acquisition efficiency policies that incorporate approximately 66 billion yen of economizing in the FY2014 budget.

2 Efforts to Increase Fairness and Transparency

The MOD aims to increase fairness and transparency in relation to the acquisition of equipment and materials, and has thus far implemented a variety of measures from the perspective of making contracts more appropriate, and strengthening checking functions respectively.

Recently, as a part of the effort to make public procurement more appropriate across the whole government, the MOD has been working on a number of measures, including the introduction and expansion of a comprehensive evaluation bidding system¹, the increase of multiple-year contracts, making bidding procedures more efficient, and reviews of single-tendering contracts.

¹ Unlike the automatic bid system, which focuses only on price, this is a system in which the successful bidder is determined on the basis of a comprehensive evaluation that includes both the price and other elements, which is used in cases in which it is appropriate to carry out such procedures as evaluating the technological elements.

Alongside these measures, a deputy chief in charge of auditing was assigned at the Equipment Procurement and Construction Office, and an auditing division was established in the Internal Bureau respectively, working toward strengthening checking functions.

However, because it emerged that in 2012 there was a violation of the Act on Elimination and Prevention of Involvement in Bid Rigging, etc. and Punishments for Acts by Employees that Harm Fairness of Bidding, etc. (commonly referred to as the “Bid Rigging Prevention Act”), in relation to a project to develop a new multi-purpose helicopter for the GSDF that had been contracted out to Kawasaki Heavy Industries, and that Mitsubishi Electric and four of its subsidiaries and affiliates, and Sumitomo Heavy Industries and a subsidiary² had engaged in overcharging, in December of the same year, the MOD announced measures to prevent recurrence, centering on the strengthening of system investigation, the revision of penalties, and the establishment of guidelines concerning bidding suspensions.

Furthermore, in June 2013, Sumitomo Heavy Industries reported to the Equipment Procurement and Construction Office that they had delivered “12.7 mm heavy machine guns” having falsified the results of product testing on them. The MOD is working to prevent recurrence, while implementing five months of bidding suspension measures against Sumitomo Heavy Industries.

2 Achieving Further Efficiency in the Acquisition of Equipment

1. Introduction of an PM/IPT System

Previous project management for equipment by the MOD has given jurisdiction for each stage of the life cycle, from conception and development, through mass production, to maintenance and upkeep, to the respective applicable bureau separately, making it difficult to respond to cost increases in a consistent and prompt manner. Therefore, a PM/IPT system is under development in which a cross-organizational Integrated Project Team (IPT) headed by a Project Manager (PM) is established for major projects, so that the project can be managed, in terms of cost, performance and schedule, in a unified way throughout the life cycle of the equipment product.

2 Promoting Standardization of Equipment and the Development of Product Families

The MOD and the SDF are endeavoring to promote the standardization of equipment and the development of product families, in order to achieve efficient procurement. As well as having endeavored to procure common equipment and supplies across the GSDF, MSDF, and ASDF, with a primary focus on small arms, vehicles, and chemical supplies (e.g. 5.56 mm machine

² Mitsubishi Electric, Mitsubishi Space Software, Mitsubishi Precision, Mitsubishi Electric TOKKI Systems, Taiyo Musen, Sumitomo Heavy Industries, and Sumiju Tokki Service.

guns, trucks, protective masks, etc.), the Ministry is striving to achieve reductions in the unit price of acquisition through curbing development expenses and achieving economies of scale, by such means as standardizing some components of short-range surface-to-air missiles used by the GSDF and ASDF, and the development of product families for anti-ship missiles used by all three branches of the SDF.

3 Efficiency by Intensive Procurement and Integrated Procurement

The MOD has endeavored to implement intensive procurement, which seeks greater efficiency by budgeting and entering into contracts for equipment, supplies and components based on the approach of consolidating the quantities required for several years into a single specific fiscal year. In addition, it has pursued integrated procurement, which involves the consolidated implementation of budgets for equipment used across multiple different organizations, or for components that are common to different types of equipment. For example, in the FY2014 budget, intensive purchasing of defense equipment such as the surface-to-ship missiles required to strengthen the defense structure of the southwestern region, saved approximately ¥33 billion on a contract base.

3 Effective and Efficient Maintenance and Replenishment

In order to deal with the increase in expenditure on the maintenance of defense equipment, initiatives focused on effective and efficient maintenance and replenishment are required. To date, the MOD has been endeavoring to achieve greater efficiency by extending the interval between periodic maintenance and to implement and expand the use of PBL (Performance Based Logistics), which is a new form of contract.

1 Greater Efficiency by Extending the Interval between Periodic Maintenance Checks

Having made adequate efforts to ensure that safety is not compromised, greater efficiency is being sought by extending the interval between periodic maintenance checks of defense equipment such as fixed-wing aircraft, helicopters, and Patriot missiles. For example, cost reductions have been achieved by extending the interval between overhauls for ten types of gas turbine engine on naval vessels from 8,000 hours, as it was prior, to 10,000 hours; and increasing the interval between progressive aircraft reworks of P-3C maritime patrol aircraft (P-3C) from 40 to 48 months.

2 Introduction of PBL

PBL, which involves paying compensation for achieving equipment performance in terms of availability ratio and safety, is a contract method that has achieved positive outcomes when

applied to the maintenance and servicing of equipment in Western countries. The MOD is getting down to its introduction of PBL from the perspective of maintaining and improving the equipment availability ratio and safety, while seeking long-term cost reductions. PBL contracts were concluded in FY2013 on some of the components of the ASDF initial training aircraft (T-7) and some of the engine components of a fighter (F-15). Survey and research will be conducted in FY2014 to contribute to the expansion and deepening of PBL method application.

4 Improving the Contract System

1 Background to the Review

In order to cope with the increasingly harsh environment surrounding the procurement of equipment and materials, the MOD is faced with the growing necessity to accept new ideas and promote the reform of acquisition in a more forceful way.

Against this background, the MOD has been holding meetings of the Contractual Systems Study Group of experts since 2010 to consider new measures.

In its deliberations concerning such matters as contracts relating to equipment procurement, the Contractual Systems Study Group has not only curtailed procurement costs from the government's point of view, but has taken a medium-to long-term perspective, keeping in mind efforts to improve the advantages of companies' participation in the defense business and build "win-win" relationships to reward those who have made efforts to improve efficiency.

2 Measures to Improve Systems Relating to Contracts for Defense Equipment

(1) Improvement of the Provision Requiring the Return of Excessive Profit

The provision requiring the return of excessive profit is a contract provision which stipulates that, in the event of any excessive profit remaining after the execution of a contract, companies must return this to the government. For the government, this provision is not only aimed at preventing the counterparty of the contract from generating excessive profits; it also has the advantage of enabling the collection of cost information through an audit after performance of the contract, as well as the advantage for the company that, because cost is allowed by the government, it forms the basis for the prices of similar contracts concluded in the future.

On the other hand, with contracts that include this provision, factors including cost reductions due to the companies' efforts have led to excessive profits generated which are subject to return, diminishing the effectiveness of cost reduction incentives for the company. Furthermore, careful evaluation is required concerning the appropriateness of imposing the excessive profit return

provision in regard to projects with multiple bidders, where substantial competitiveness is acknowledged to exist.

Accordingly, in March 2012, the MOD improved the regulations, as a result of which, this provision is not applied in the case of competitive contracts in which real competitiveness is ensured. At present, efforts are continuing to accelerate the pace of deliberations. The objective of this is to achieve a transition from cost audit contracts incorporating a provision requiring the return of excessive profit (contracts with a special provision stipulating that an audit of the actual costs incurred will be conducted and that the final amount paid will be established based on this) to an ordinary final and binding contract that establishes the contract sum from the time of concluding the contract, without any special provision concerning the amount to be paid and irrespective of any increase or decrease in the actual cost of manufacture.

(2) Improvement of the Contract System to Generate Cost Reduction Incentives

The MOD has undertaken a variety of initiatives in order to produce cost reduction incentives for companies to date, including the operation of an Incentive Contracts System³. Since being introduced in 1999, however, these incentive contracts have only been used for four projects. Furthermore, the rationalization of public procurement now requires that competitive procedures, such as an open tender, be conducted for each contract. However, in terms of the results, most cases are application by single entry, and these procedures have effectively lost all substance.

Accordingly, the Ministry of Defense made improvements to the System to Promote the Streamlining of Work Processes⁴ in April 2012, creating a system that, under certain conditions, accepts as an incentive fee an amount equivalent to 50% of the man-hours reduced, in the event that a company makes a commitment to reduce costs by achieving greater efficiency in its work by eliminating losses such as those arising from tasks in the manufacturing process. Furthermore, in April 2013, a system entered into force whereby contracts covered by this system (contracts concluded within a maximum of five fiscal years of the decision to apply the system) became single-tendering contracts, in the event that a company made a commitment to

³ A system aimed at motivating companies to reduce costs, whereby a certain proportion (rate) of the cost reduction effect is added as an incentive fee to the price calculated on the basis of the estimated price, in the event that the company proposes and employs cost reduction measures, such as technologies not envisioned at the time the contract was concluded.

⁴ A system jointly involving the public and private sectors to investigate whether there is room for streamlining work processes in which a fact-finding survey and analysis of work processes is performed by the MOD utilizing consulting companies, in order to raise the efficiency in the execution of contract counterparty duties.

use the system and achieve substantial cost reductions. At present, deliberations are underway with a view to the system attracting further initiatives for the cost reduction by reviews, such as diversifying the object to which incentives fees are to be given and reduction of rates⁵.

(3) Reducing Procurement Costs further through Multiple-year Contracts that Actively Utilize the PFI (Private Finance Initiative) Promotion Act⁶

In order to reduce costs, long-term contracts that are consolidated to a certain degree are essential. However, the upper limit for acts resulting in Treasury liability is five years, and it does not make business sense for companies to invest in such short-term contracts; thus, it appears that they refrain from investment that could lead to cost reductions and, furthermore, do not accept orders, in order to avoid risk.

Accordingly, by realizing the planned acquisition and execution of budgets using standardized investment amounts, it is anticipated that implementing long-term multiple-year contracts through the active utilization of the PFI Act and the Public Service Reform Act⁷ will give rise to such benefits as cutting equipment procurement costs by reducing risks for those accepting orders, and promoting the entrance of new suppliers. From this perspective, in regard to the project focused on the enhancement of the X-band communications satellite, which makes use of the PFI Act, the MOD concluded the contract for the project in January 2013.

3 Matters Relating to Measures to Prevent Recurrence of Overcharging

In order to unravel the motivation behind the series of cases of overcharging involving Mitsubishi Electric and other companies involved with defense, the MOD progressively began to conduct investigations and analysis of the motives of the companies in question, and compiled and published measures to prevent recurrences in December 2012.

Against the background of overcharging through the inflation of the number of man-hours involved in projects, the results of the investigation exposed the closed nature of defense-related divisions, which arises from the specific nature of the products (equipment and materials) that they handle. On the other hand, it emerged that the terms of trade unique to the procurement of equipment and materials – in terms of the fact that it is difficult to manage profit and loss, and to achieve sales in the same way that private sector companies usually expect to do – significantly influence their motivation.

⁵ The rate applied to the cost reduction effect as an incentive fee added to the calculated price is currently 50%.

⁶ Act on Promotion of Private Finance Initiative.

⁷ Act on Reform of Public Services by Introduction of Competitive Bidding.

Such background factors are not particular to Mitsubishi Electric and the other companies involved in these recent cases, but are considered to be a common challenge faced by the majority of companies involved in defense production. The measures to prevent recurrences seek to enhance and strengthen measures to alleviate the closed nature of those involved in defense production and increase transparency, as well as reviewing the measures toward the impartial evaluation of the costs and risks borne by companies. In March 2013, the Investigative Committee on Cases of Overcharging, chaired by Parliamentary Vice-Minister of Defense Sato, began deliberations concerning the specific implementation of these measures, with some of these measures entering into force the following month.