

Chapter

9

SECURITY COOPERATION ACQUISITION POLICY AND PROCESS

INTRODUCTION

Fundamentally, the Foreign Military Sales (FMS) process is an acquisition process. Under FMS, a foreign government or international organization identifies a need for a military-related requirement (material item, service, and/or training) and chooses to have the U.S. Government (USG) acquire it for them. The agreement governing the FMS acquisition is the Letter of Offer and Acceptance (LOA). To fulfill the LOA requirements, the USG may supply items or services from on-hand Department of Defense (DOD) resources, or the USG may purchase from industry for subsequent delivery to the international partner.

Similarly, the Building Partner Capacity (BPC) process is also an acquisition process. Under a BPC program, the USG, in coordination with the benefiting country, identifies a need for a military-related item or service, and then utilizes the Defense Security Cooperation Agency's FMS infrastructure to manage the acquisition. The BPC agreement (e.g., "pseudo" LOA) provides both the authority and funding source for the acquisition.

This chapter addresses acquisition as it relates to the USG's process for purchasing materiel or services by means of entering into contracts with industry. The goal is to highlight where and how Security Cooperation (SC) procurements fit into the normal DOD procurement process. Also, this chapter will discuss the international business arrangement referred to as an offset. The offset concept is defined, the USG policy regarding offsets is presented, and the means to address offsets within the FMS process are explained. This chapter primarily focuses on acquisition in support of FMS, because FMS represents the majority of SC acquisitions. However, this chapter will also identify the differences when acquisition is performed in support of BPC programs.

Within the DOD, the term "acquisition" may also refer to the entire life cycle process the DOD uses to develop, test, evaluate, produce, and sustain weapon systems in order to satisfy DOD military capability requirements. This formalized acquisition process is referred to as the Defense Acquisition System (DAS). Chapter 13 of this textbook, "Systems Acquisition and International Armaments Cooperation," discusses how issues affecting future foreign sales of major systems are addressed within the DAS during the system development process.

The DOD also uses the term "acquisition" to refer to multiple functional career field areas. In fact, the Defense Acquisition University (DAU) offers a number of courses for personnel within these various career fields that support the DAS. Acquisition career fields include the following: life cycle logistics, auditing, cost estimating, financial management, contracting, engineering, facilities engineering, industrial/contract property management, information technology, science and technology management, program management, purchasing, production/quality/manufacturing, and test and evaluation. All of these various functional acquisition disciplines are utilized in the DAS process. To review the courses offered by the DAU, visit their website: <https://www.dau.edu/training>.

GLOBAL MILITARY MARKETPLACE

When an international partner requires a military item or service, it must find a source to fulfill that requirement. From its national perspective, there are many economic and political factors that make acquisition from an indigenous source the preferred choice; however, in today's high technology military environment, a substantial financial investment is usually required to conduct the research, development, testing, and evaluation (RDT&E) and to build the manufacturing or production capability and capacity to field most major military systems. In addition to the financial investment, considerable time is required to accomplish this process. Given these considerations, many nations fulfill certain military needs by procuring military systems from other governments, or from foreign commercial firms that have already developed and fielded a capable system, rather than developing a new, country-unique system.

United States Item Preference

The potential international partner must first determine whether or not to acquire a U.S. system rather than developing an indigenous system or purchasing another country's system. If the international partner selects a U.S. system, they must next decide whether to purchase through the government-to-government FMS process or make the purchase through the government-to-industry Direct Commercial Sales (DCS) process.

The DOD is generally neutral regarding whether an international partner chooses to purchase via FMS or DCS. Although officially neutral regarding the procurement method (FMS or DCS), the DOD does prefer that friendly nations choose U.S. systems. The reason for the U.S. preference relates to the political, military, and economic benefits resulting from the U.S. and its allies using the same military equipment.

Foreign Military Sales Procurement Rationale

Chapter 15 of this textbook, "A Comparison of Foreign Military Sales and Direct Commercial Sales," compares some of the advantages and disadvantages of FMS and DCS procurements. This chapter will not review all the relative pros and cons; however, the Security Assistance Management Manual (SAMM) states that a primary reason why international partners choose to procure through FMS is that the DOD arranges the purchase on the international partner's behalf using the same USG procurement regulations and procedures that the DOD utilizes for its own procurements. As a result, international partners receive the same benefits and protections as the DOD. This can be a considerable benefit when the international partner may be spending hundreds of millions or perhaps billions of dollars to acquire a military system. This chapter examines how the DOD uses its existing acquisition policies and procedures to procure articles and services in fulfillment of LOA agreements.

Foreign Military Sales Content

Typically, major FMS system sales consist of weapon systems that the DOD has already developed, produced, and fielded for its own use. DOD policy states that the USG will only agree to sell systems through FMS that have successfully completed operational test and evaluation. If an international partner requests an LOA for a system that has not yet successfully completed operational test and evaluation, a policy waiver is required. This waiver is often referred to as the "Yockey" waiver, named after a former Under Secretary of Defense. In that situation, the Defense Security Cooperation Agency (DSCA) will request concurrence from the Under Secretary of Defense for Acquisition and Sustainment (USD [A&S]) before offering an LOA for a system that is still under development.

The reason for this policy concerns future supportability and interoperability issues. Prior to successfully completing operational test and evaluation, there is the risk that the U.S. may decide not to produce the system. This would present an undesirable situation if the U.S. has an LOA commitment to deliver a system to an international partner but decides not to deliver this same system to U.S. forces. The international partner would then possess a nonstandard system and have limited sustainment options. In addition, the international partner could potentially lack interoperability with U.S. forces and other allies. If the waiver is approved, the LOA for the FMS case must include a special note identifying the risk that the USG may not place this system into production.

Total Package Approach

Although some international partners may purchase specific items or services independent of a major DOD-end item system, most SC programs are built around the sale of one or more major DOD weapon systems. Under FMS, major weapon system sales are accomplished using the Total Package Approach (TPA). TPA provides the international partner the weapon system as well as all the necessary support elements to operate and sustain the system for an initial period. Subsequent FMS follow-on support cases may additionally be implemented for continued sustainment of the system throughout its operational life. The TPA is also applied in support of BPC programs.

SAMM C4.3.2. Identifies LOAs must be offered reflecting the Total Package Approach (TPA). Major weapon system case development is complex and must reflect international partner desires to achieve a successful TPA. Because the FMS process is accomplished using existing DOD procurement regulations and policies, SAMM C4.4.1 states that IAs may procure from foreign sources as required to conduct FMS acquisitions in accordance with the DFARS under the same acquisition and contract management procedures used for other defense acquisitions to meet U.S. standard inventory requirements. IAs should not enter into such sales arrangements for equipment not in the U.S. inventory unless DSCA (Strategy, Plans, and Policy Directorate [SPP], and Office of the General Counsel [OGC]) have approved an exception.

CONTRACTING FOR FOREIGN MILITARY SALES

The Arms Export Control Act (AECA) permits FMS from both DOD stocks and by DOD contracting to procure the materiel or services from industry for the international partner. Generally, DOD inventory levels are established to support the DOD's own operations and to provide a contingency reserve of materiel. When an FMS partner submits a requirement under the authority of an LOA, the DOD policy is to only use its current inventory for FMS demands if it can do so without negatively impacting U.S. military readiness. As a result, it may be necessary for the DOD to procure the required FMS item by contracting with industry, rather than supplying the item from stock. In addition, the Secretary of Defense may determine that a release of stock articles to international partners under certain circumstances is necessary to support overall national interests even when there is a resulting negative impact on the readiness of U.S. forces. If this decision is made, the President must furnish a report explaining the decision to Congress in accordance with C6.4.6 of the SAMM.

Buyer and Seller Relationship

When an international partner accepts an LOA, it enters a legal agreement to purchase military items or services from the USG. In regard to the LOA, the international partner is the buyer, and the USG is the seller. The USG may provide the articles or services from stock, but often must contract with industry to acquire items or services for delivery to the FMS partner. In the procurement contract, the USG becomes the buyer, and the vendor from industry becomes the seller. The international partner is not a legal participant in the procurement contract with industry; instead, the USG acts on behalf of the international partner. The vendor is under contract and directly obligated to the USG and has no direct contractual relationship with the international partner. The vendor entering into a procurement contract with the USG (to produce materiel or provide services) is not exporting their products. The USG is exporting the products under the authority of the LOA.

Letter of Offer and Acceptance (LOA) and Contract Relationship

The LOA documents the international partner's requirements and provides both the authority and funding to initiate contracting actions. In preparing the LOA, the Case Manager (CM) must clearly understand the international partner's requirements to ensure the LOA addresses all international partner needs. Simultaneously, the CM must also ensure any special procurement issues from the Procuring Contracting Officer's (PCO) perspective are adequately addressed with the international partner and appropriately documented within the LOA. The goal is to have an LOA that can be implemented by means of a procurement contract that both fulfills the international partner's desires and is consistent with all USG contracting regulations. The key to success in this area is clear communication early in the LOA preparation process between the international partner, the CM and the applicable DOD contracting organization.

Department of Defense Infrastructure for Foreign Military Sales Acquisition

Before discussing the contracting process, an introduction to the DOD's structure for FMS acquisition is necessary. The DOD does not maintain a separate acquisition infrastructure solely for FMS. Rather, the DOD supports FMS by exercising the same acquisition infrastructure already established to support its own requirements. The DOD organizations, with acquisition responsibility for the required FMS items or services, will be tasked to, in addition to other DOD workloads, perform the FMS related acquisition activities. This means that the same organizations that procure the same or similar type item or service for the DOD will also be procuring in support of FMS.

Major System Acquisition

For major weapon systems, the Military Departments (MILDEPs) establish Program Management (PM) offices responsible for the following:

- Developing and acquiring the initial system
- Managing all technical aspects of the systems delivered to U.S. forces
- Procuring any additional quantities for the DOD
- Engineering improved or modified configurations

An Integrated Product Team (IPT) will typically consist of a weapon system program manager, supported by personnel from several functional disciplines (program management, engineering, testing, contracting, logistics, and financial management).

When an international partner purchases a major weapon system, the same PM office overseeing the DOD acquisition of that system will also support the management of the international partner acquisition. The system PM office may acquire FMS quantities either as individual procurements or by consolidating FMS requirements with DOD's requirements on the same U.S. contract. The procuring contracting officer (PCO) supporting the PM office is the only individual granted the authority to enter into contracts on the behalf of the USG. In this role, the PCO will be supported by the functional expertise of the members of the PM office team in establishing source selection criteria, evaluating offers, and negotiating the terms and pricing of the contract.

In order to accomplish successful program execution, major FMS system sales may require program office services beyond those provided by the FMS Administrative Surcharge discussed in the SAMM C9.4.2.3. Additional management services will be funded by a well-defined services line on the LOA. The SAMM requires each service line to include an LOA line item note to describe the details of the services provided, and to identify the performance period.

Follow-on Support Acquisition

For standard follow-on support, the same DOD functional organizations that purchase the respective item for the DOD will also be responsible for FMS purchases. FMS requirements from the LOA will be routed to the applicable DOD Inventory Control Point (ICP) managing the item for the DOD. ICPs assign an Item Manager (IM) the responsibility of managing inventory levels for a range of specific standard items. The ICP IM responsible for the requisitioned item will decide whether the FMS order should be supported from on-hand stock, held on back order for support from materiel due into stock, or placed on a purchase request (PR) for procurement. If procurement is required, the IM will initiate a PR identifying items to be procured and the appropriate funding source to finance the procurement. The PR, containing a fund cite from the applicable FMS LOA, will be routed to the ICP's contracting activity. A PCO will follow normal DOD procurement processes to select a vendor and award a contract to fulfill the FMS requirement. Based on the volume of FMS activity, the ICP's manpower may be augmented with additional positions funded by the overall FMS administrative fund.

Nonstandard Acquisition

DOD policy is to coordinate with the international partner to potentially support all systems sold through FMS for as long as the international partner chooses to operate the system. For the international partner, the DOD decision to curtail or end operations of a given system may impact support. Many examples exist where the DOD currently supports systems operated by international partners that the DOD no longer actively retains in its inventory, such as the F-5 and the F-4 aircraft. In these situations, components of the system may transition from being standard to nonstandard items. SAMM C6.4.7 states the MILDEPs should notify foreign users of weapon systems soon to become obsolete to the USG. Foreign users should, then have a minimum of two years to place a final order for secondary support items to sustain the system for the additional period the international partner plans to continue to operate the system.

Nonstandard requirements are, by definition, items not actively managed in the DOD supply system for U.S. forces. Nonstandard FMS requirements have historically been difficult to support, since no supporting management or acquisition infrastructure exists within the DOD. Since no ICP activity manages or purchases these items for the DOD, MILDEPs typically contract with commercial buying services (CBS) to procure most nonstandard items in lieu of the DOD directly contracting for nonstandard items. More information on CBS is presented in Chapter 10 of this textbook, "Logistics Support of Security Cooperation Materiel Transfers."

Contracting Regulations

The Federal Acquisition Regulation (FAR) establishes a set of uniform acquisition policies and procedures to be used by all executive agencies of the USG. The FAR is the primary document governing contracting actions undertaken by the USG. Many of the FAR requirements originate in legislation created by Congress. One of the best-known laws governing contracting is the Competition in Contracting Act (CICA), which requires full and open competition in procurements. Similar to other federal regulations, the FAR is considered to have the force and effect of law. The current version of the FAR is publicly available online. See the chapter references for the web address.

In the LOA, standard term and condition 1.2 states that the USG will follow the same regulations and policies when procuring for FMS as it does when procuring for itself. This condition in the LOA is referring to the FAR. The SAMM (which provides overall policy for the conduct of FMS) states FAR provisions applicable to the DOD will apply to FMS procurements.

Given that DOD procures many unique items, the Defense Federal Acquisition Regulation Supplement (DFARS) was created to supplement the FAR. Each of the MILDEPs and their subordinate commands have, in turn, issued further supplements to the DFARS, to aid contracting personnel in implementing the FAR and DFARS. It is important to recognize the hierarchy in the contracting regulations. The FAR remains the over-arching authority while each subordinate supplement may amplify and expand on the principles of the FAR but cannot contradict it. Accordingly, each supplement issued by the MILDEP can only amplify the principles contained in the DFARS. It is interesting to note that DFARS, subpart 201.104, states the DFARS applies to contracts issued by the DOD in support of FMS. The current version of the DFARS is available online. See the chapter references for the web address.

CONTRACT SOURCE SELECTION

As previously stated, the CICA requires the USG agencies to promote the use of full and open competition for procurements. This legislated requirement is detailed in Part 6 of the FAR, which discusses the contract competition. In a competitive procurement, the USG makes public notification of the intent to purchase. The USG electronically posts these notifications on the SAM.gov website. Per the FAR, all federal agencies are required to use competitive procurement procedures as the normal method of acquisition.

As an exception under certain conditions, the FAR permits procurement on a noncompetitive basis, which is officially known as “other than full and open competition.” In a noncompetitive procurement, the USG negotiates with a single source to the exclusion of all other potential sources. In order to use this exception to normal procurement procedures, a justification must be prepared to document the reasons why a noncompetitive procurement is required rather than conducting a competitive procurement. According to the FAR, noncompetitive procurements are permitted only when justification is provided based on one or more of the following conditions:

- The property or services required are available from only one responsible source and no other type of supply or services will satisfy agency requirements.
- The need for the supply or services is of an unusual and compelling urgency.
- Award of the contract to a particular source or sources is required in order to do the following:
 - ◊ Maintain a facility, producer, manufacturer, or other supplier available for furnishing supplies or services in case of a national emergency or to achieve industrial mobilization.
 - ◊ Establish or maintain an essential engineering, research, or development capability to be provided by an education or other nonprofit institution or a federally funded research and development center.
 - ◊ Procure the services of an expert for use in any litigation or dispute.
- An international agreement or a treaty between the U.S. and a foreign government or

- international organization specifies a source.
- A statute expressly authorizes or requires that the procurement be made from a specified source.
- Disclosure of the agency's needs would compromise national security.
- A head of the agency determines that it is necessary in the public interest to use procedures other than competitive procedures.

Foreign Military Sales Competitive Source Selection

The LOA standard terms and conditions reflect the FAR preference for competition in contract awards as mandated by the CICA. LOA condition 1.2 states the USG is responsible for selecting the contractor to fulfill the LOA requirements. Additionally, condition 1.2 states the U.S. will select the contractor on the same basis utilized to make contractor selections to fulfill its own requirements. In other words, the norm for FMS contract awards is for the U.S. to use its competitive contract award process to select the contractor to fill the international partner's requirement. The SAMM C6.3.4 states that competitive source selection will be utilized to the maximum extent possible in support of FMS.

Sole Source for Foreign Military Sales

Section 1.2 of the LOA standard terms and conditions permits the international partner to formally request a noncompetitive procurement be conducted on its behalf. Within the FMS community, an international partner's request for procurement using other than full and open competition is commonly referred to as "sole source" when the contract to be awarded is expected to exceed the simplified acquisition threshold (FAR 2.101 and FAR part 6). Per the SAMM C6.3.4, an authorized official of the purchasing government may submit a written request, generally through the Security Cooperation Organization (SCO), that the Implementing Agency (IA) make the procurement from a specific organization or entity, or that competition be limited to specific organizations or entities. The Defense Attaché or comparable international partner's representative in the United States may also submit these requests to the IA. An international partner's other than full and open competition request should be submitted with the Letter of Request (LOR). Per DSCA policy 12-15, international partners do not need to provide a rationale for the request.

Requests for other than full and open competition should be to meet the objective requirements of the international partner and not for improper or unethical considerations. USG representatives must remain objective in providing options or recommendations to the partner and may not solicit requests for other than full and open competition. In general, the USG does not investigate the circumstances behind a international partner's request to use other than full and open competition. DOD contracting agencies are encouraged to defer to an international partner's requests under the FAR's international agreement exception to the extent that they are not aware of any indication that such requests violate U.S. law or ethical business practices. The IA must consult with its counsel on cases where facts indicate that granting a request to use other than full and open competition may violate U.S. law or ethical business practices. If the IA determines that a request to use other than full and open competition should not be approved, the memorandum informing the international partner must be coordinated with DSCA.

In addition to reviewing the international partner's other than full and open competition request, SAMM C6.3.4.6 also recommends the request be forwarded to the applicable PCO for information and advice. Typically, the PCO will have previous experience procuring the same or a similar item or service. The DOD maintains data on past procurements and the performance of various vendors in fulfilling previously awarded DOD contracts. The USG may possess additional information indicating the international partner's other than full and open competition section may represent a financial or performance risk. In these instances, the PCO can inform the CM, who would provide this additional information to the international partner for further consideration.

Other than full and open competition requests typically specify a particular prime contractor. FMS partners may also request that specific subcontractors be utilized by the prime contractor. Requesting specific subcontractors limits the ability of the DOD to hold prime contractors to performance and cost parameters. Normally, the prime contractor is responsible for selecting and overseeing subcontractor work to ensure all contract milestones are achieved. When an other than full and open competition subcontractor is specified, the prime contractor will be required to use certain subcontractors. This removes the prime contractor's ability to shift work away from under-performing subcontractors and could relieve the prime contractor from certain contract liabilities. If the FMS partner chooses to request specific subcontractors, the international partner should be advised of the additional risk, as they would bear the additional costs to correct any issues according to SAMM C6.3.4.4.

Per SAMM C6.3.4.5, approved other than full and open competition requests must be documented in an LOA note. The rationale for documenting this approval in the LOA is to ensure compliance with the FAR. The fourth FAR exception for noncompetitive procurement permits noncompetitive procurement based on an international agreement. For FAR purposes, the LOA is considered to be an international agreement. An LOA containing an approved other than full and open competition note permits the USG PCO to initiate a noncompetitive procurement at the international partner's request while remaining in compliance with the FAR. A copy of the accepted LOA containing the other than full and open competition note should be forwarded to the applicable PCO to permit compliance with the FAR 6.3 requirements for noncompetitive procurements.

An other than full and open competition request may be considered after LOA acceptance. The same other than full and open competition review and decision process would occur. If approved, the accepted LOA would require an amendment to document the approval. If the other than full and open competition request is submitted by an official representative of the international partner known to have equivalent or greater authority than the official who signed the LOA, then the other than full and open competition note can be added to the LOA via a modification. LOA modifications are unilateral documents that can be immediately implemented upon issuance.

Foreign Military Sales Other Than Full and Open Competition Without International Partner Request

Although most FMS other than full and open competition procurements originate with the international partner, noncompetitive procurements can originate unilaterally with the USG. In this situation, although the international partner did not have any specific desires for a particular vendor, the USG managers conducting the procurement may determine that the FMS procurement needs to be conducted on a noncompetitive basis. In this case, the USG managers must generate a written justification for the noncompetitive procurement based on one of the other FAR noncompetitive procurement exceptions (i.e., other than the international agreement exception).

Competitive Source Selection

Unless the LOA reflects an approved international partner request for procurement using other than full and open competition or the PCO has justified a noncompetitive award in accordance with another of the FAR exceptions, a competitive source selection process will be conducted. It is important for the international partner to recognize that the competitive process requires time to accomplish. International partners often question why it may take so long to deliver an item under FMS. Part of the item lead-time involves the period necessary to plan and conduct the competitive source selection process.

Per the FAR, competitive source selection can be accomplished using one of three methods: Simplified Acquisition Procedures (SAP), sealed bids, or negotiation. This represents a hierarchy of preferred use. For any given procurement, the first option should be to consider whether the procurement qualifies to be accomplished under SAP. If it does not meet the criteria for SAP, the next option is to evaluate whether sealed bidding criteria can be met. The final option, when the first two methods cannot be applied, is to use negotiation. This hierarchy reflects the degree of difficulty and cost invested by the USG in the procurement. SAP is the easiest and least-costly type whereas negotiation requires the most government resources and incurs the highest cost.

Simplified Acquisition Procedures

SAP is aimed at streamlining government procurement. Price quotes are solicited from vendors, and the government, then, issues an order to the vendor providing the best value for the price. Given the reduced bureaucratic approach, dollar value limitations have been placed on the situations in which this method can be used. Purchases valued up to \$250,000 involving noncommercial items are permitted, and, because of the price regulating influences of the competitive commercial marketplace, this method can be used for purchases of commercial items valued up to \$7 million. The FAR, part 13, describes this process.

Sealed Bids

Sealed bids are used if the following circumstances apply: time permits the solicitation, submission, and evaluation of bids; the award can be made on the basis of price and other price-related factors; it is not necessary to conduct discussions with the prospective vendors; and there is a reasonable expectation of receiving more than one sealed bid. Under sealed bidding, the government advertises its requirements and invites interested firms to submit bids. Vendors interested in competing submit their respective bids in accordance with the invitation for bid instructions. Generally, there will be a deadline date for bid submission and a date established when the government will open the bids. On the bid opening day, the USG will open and review all the bids submitted. The contract will most likely be awarded to the firm that submitted the lowest price bid that was responsive to the requirements. “Responsive” means that the bidder offered what the government requested and not something else. The FAR, part 14, describes this process.

Negotiation

Negotiation is used if any of the above conditions for SAP or sealed bidding cannot be met and when it is necessary to conduct discussions with prospective contractors. The main steps in this process, as described in the FAR, part 15, are as follows:

- The USG solicits competitive proposals.
- Offerers prepare and submit proposals.
- A competitive range determination is made by the USG to decide with which offerers to conduct written or oral discussions.
- USG technical and price evaluation of proposals is conducted. In this process, the USG typically has two evaluation teams separately consider the merits of each proposal. One team will be comprised of specialists capable of distinguishing between the relative

technical and qualitative benefits presented by each proposal; the other team, comprised primarily of financial and accounting experts, will review the price-related factors of each proposal.

- The USG selects and awards a contract to the vendor whose offer is most advantageous to the government. The most advantageous or best value offer is the one determined to provide the best combination of performance and price. It is not necessarily the lowest price offer or the best performing product or service.

Advertising for Competition

The federal government officially advertises federal contracting opportunities on a website described in the “Contract Source Selection” section above. FMS requirements are also advertised on this website for interested vendors. The FAR, part 5, describes procedures for publicizing contract opportunities.

Set Aside Procurements

As previously stated, all procurements for FMS will be conducted in compliance with FAR and DFARS policy and procedures. As such, the potential does exist for certain FMS procurements to be set aside for special categories of businesses to exclusively compete. This is another example of the USG conducting FMS procurements in the same manner as it conducts procurements for itself. The FAR, part 19, describes this process.

Although procurements may be set aside, the FAR also requires contract awards be made to responsible contractors. A responsible contractor is one the government believes to possess the ethics, resources, capability, and capacity to successfully deliver the contract requirements in a timely manner.

CONTRACT TYPES

There are two fundamental categories of contracts used in DOD procurement: fixed-price and cost-reimbursement. Within these two broad categories, there is a wide variation of contract types. The contract type may impact the international partner when it comes to timely case closure. Under FMS, the financial policy is for the USG to recover the total cost of performance against the FMS case. The type of contract used in making FMS procurements can impact how long it will take to determine the total cost. More information on FMS case closure is contained in Chapter 12 of this textbook, “Financial Management.”

Fixed-Price

Fixed-price contracts establish a price that is generally not subject to any adjustment, regardless of the costs the contractor subsequently accumulates in performing the contract. This type of contract makes the contractor responsible for managing costs or dealing with cost risks with little or no cost risk to the government. When a contractor delivers articles or services under a fixed-price contract and the USG accepts the product, no significant further action is required by either party. The government will pay the predetermined fixed price, and the contract can be closed. The FAR standard for closing a fixed-price contract is within six months of final delivery.

Cost-Reimbursement Contracts

Cost-reimbursement contracts pay the contractor all incurred costs determined to be allowable, allocable, and reasonable per the provisions of the contract. These types of contracts are suitable only when the uncertainties involved in contract performance do not permit costs to be estimated with sufficient accuracy to use a fixed-price contract. Under cost-reimbursement contracts, the contractor has less cost risk, whereas the cost risk to the government is higher. Under a cost-reimbursable contract, the contractor will submit contract performance cost data to the USG. The USG must then review this cost data to validate that the costs claimed by the contractor are allowable, allocable, and reasonable.

- Allowable means the cost category being claimed is considered to be a legitimate expense category by the FAR.
- Allocable means the cost is assignable or chargeable based on relative benefits received or another equitable relationship.
- Reasonable means that the amount claimed by the contractor for an allowable and allocable share does not exceed that which would be incurred by a prudent person in the conduct of competitive business.

Due to the time necessary for the contractor to gather and report cost data and for the USG to perform any necessary review and audits of the cost data, it may take a lengthy amount of time to close out a cost-reimbursable contract. The FAR standard for closing cost contracts, following final delivery, is within twenty months for contracts without indirect rates and within thirty-six months for contracts with indirect rates.

CONTRACT OPTIONS

The USG processes and procedures prescribed by the FAR and DFARS to place a requirement on contract often require a significant amount of time to accomplish. In June 2018, the Director of Defense Pricing and Contracting issued a new policy to make contracting practices timelier and more effective. Under the new policy, for major system procurements, contracting officers are encouraged to establish priced options for two years beyond the current procurement year. The FAR, part 2, defines a contract option as a unilateral right in a contract by which, for a specified time, the Government may elect to purchase additional supplies or services called for by the contract, or may elect to extend the term of the contract. This policy will permit contracting officers to exercise these existing priced options for emerging FMS requirements rather than re-accomplishing the entire contract process. It is anticipated that this approach will provide a more timely and responsive outcome in support of FMS partners.

SPECIAL FOREIGN MILITARY SALES CONTRACTING CONSIDERATIONS

Throughout this chapter, it has been emphasized that contracting for FMS will be in accordance with normal FAR and DFARS policies and procedures. As a result, contracting for FMS essentially mirrors the process the DOD uses in contracting for itself. As may be expected, though, there are a few peculiarities associated with FMS contracts. The DFARS contains a special subpart that addresses these peculiarities. This subpart is DFARS 225.73, “Acquisitions for Foreign Military Sales.” The following is a brief discussion of the key unique FMS contracting policies.

Foreign Military Sales Solicitation and Contract Marking

DFARS Procedures, Guidance, and Information (PGI) 225.7301 states that all solicitations to industry for FMS requirements should separately identify the requirement as being for FMS and also indicate the specific international partner. It is important for industry to know this information, because special rules concerning cost allowability for FMS may apply as discussed later in this chapter. Additionally, all awarded contracts containing FMS requirements are to include the FMS case identifier code in the contract.

Contracting Officer Involvement in the Letter of Offer and Acceptance

The only person legally authorized to commit the USG in a procurement contract is a warranted PCO. A warrant is a specific certification provided to a federal employee or military officer that authorizes that person to commit the USG in contracts. The PCO along with other procurement professionals on the team will take the requirement identified on the LOA along with the LOA funding to ultimately award a contract with industry that is compliant with the FAR and DFARS requirements.

Potential future procurement problems can be identified and minimized through close coordination between the CM and the PCO. The DFARS 225.7302 states that the role of the PCO is to assist the FMS CM by doing the following:

- Assisting the Implementing Agency to prepare the LOA or price and availability (P&A) data
- Identifying and explaining all unusual contractual requirements or requests for deviations
- Communicating with potential contractors
- Identifying any logistics support necessary to perform the contract

Contract Pricing for Foreign Military Sales

The FAR and DFARS provisions are intended to ensure procurement at fair and reasonable prices. In addition to protecting the USG interests, the FAR and DFARS also attempt to treat contractors fairly. The provisions of DFARS subpart 225.7303-2 recognize that, in working to fulfill FMS contract requirements, contractors may incur legitimate additional business expenses they normally would not incur in DOD-only contracts. As a result, DFARS subpart 225.7303-2 permits certain types of costs to be allowable for FMS contracts. Although the same pricing principles are used, FMS contract prices are not always identical to the DOD contract prices. This situation is due to slightly different rules regarding cost allowability for FMS requirements than for DOD requirements. Examples of such allowable FMS contract costs include the following:

- Selling expenses
- Maintaining international sales and service organizations
- Sales commissions and fees in accordance with FAR, subpart 3.4
- Sales promotions, demonstrations, and related travel for sales to foreign governments
- Configuration studies and related technical services undertaken as a direct selling effort to a foreign country
- Product support and post-delivery service expenses
- Operations or maintenance training, or tactics films, manuals, or other related data
- Technical field services provided in a foreign country related to accident investigations, weapon system problems, operations/tactics enhancement, and related travel to foreign countries
- Offset costs, which are further defined later in this chapter

Although DFARS 225.7303-2 does permit certain costs for FMS to be allowable, the amount claimed by the contractors must also be determined to be both an amount appropriately allocable to the respective contract and reasonable in the rate charged. DFARS 225.7303-5 limits this special cost allowability provision to procurements originating from LOAs financed with either international partner funds or repayable credits. If the LOA is financed by USG grant funds such as Foreign Military Financing Program (FMFP) funds or Military Assistance Program (MAP), then the cost allowability rules default back to the standard DOD criteria.

Contingent Fees

Sales commissions or agents' fees, referred to in the FAR as contingent fees, are generally allowable if the commission or fee is paid to an employee or a selling agency engaged by the prospective contractor for the purpose of legitimately securing business.

DFARS, 225.7303-4 permits contingent fees to exceed \$50,000 only if the international partner agrees to the fees in writing before contract award. In addition, by exception, the following countries must approve all contingent fees regardless of value before they can be considered allowable FMS contract costs:

Australia	Egypt	Greece	Israel
Japan	Jordan	Republic of Korea	Kuwait
Pakistan	Philippines	Saudi Arabia	Taiwan
Thailand	Turkey	Venezuela	

The SAMM, Section C6.3.7.1, states that, if contingent fees are part of a contract proposal, inclusion should be made known to the purchasing government prior to, or in conjunction with, the submission of the LOA to that government. The notification should include the following: the name and address of the agent; the estimated amount of the proposed fee; the percentage of the sales price; and a statement that appropriate officials of the DOD consider the fee to be fair and reasonable or that the USG cannot determine the reasonableness of the proposed fee. This statement is normally included as an LOA note.

The SAMM C6.3.7.4 states all LOAs, which include contingent fees (regardless of value of the case), and all correspondence with an international partner about contingent fees relative to Price and Availability (P&A) data or an LOA as well as all post-LOA notifications about contingent fees, must be coordinated with DSCA (Strategy, Plans, and Policy Directorate (SPP)).

Foreign Military Sales International Partner Involvement in Contracting

The FMS process primarily involves the international partner in LOA related issues. After the LOA is accepted, internal USG processes are undertaken to fulfill the LOA requirements. Generally, these internal processes are accomplished without direct international partner involvement. The SAMM, Section C6.3.5, states that sufficient details should be included in the LOA to allow the U.S. PCO to negotiate and award a contract without requiring foreign country representation or direct involvement in the formal negotiation process.

Although, traditionally, the norm has been no or very limited international partner involvement in the DOD contracting process, policy in both the SAMM and the DFARS does permit international partners to participate in certain elements of the contracting process. This policy supports the overarching intent for the FMS process to provide transparency to international partners. Unfortunately, there can be confusion on the part of employees within the DOD acquisition infrastructure (as well as by international partners) regarding the extent of international partner participation in the DOD contracting process. If an international partner has an interest in participating in the FMS acquisition process, these desires should be identified early in the LOA development process, preferably in the Letter of Request (LOR), in order that the LOA implementation plans can include international partner participation.

The following outlines the areas, per the SAMM and the DFARS, that the international partner may choose to have greater participation and other areas where international partner participation is not permitted.

Source Selection

Competitive contract awards are the default procurement method for FMS. As previously discussed, the FMS process does provide an option whereby the international partner can request the USG contract on a non-competitive basis with a specific vendor in support of an LOA requirement. This process is referred to as an other than full and open competition (i.e., “sole source” as defined in FMS in SAMM C6.3.4). Unless the international partner submits an other than full and open competition request, the international partner cannot provide direction regarding source selection decisions. LOA standard term and condition 1.2 states, “The international partner understands that selection of the contractor source to fill requirements is the responsibility of the USG, which will select the contractor on the same basis used to select contractors for USG requirements.”

Additionally, the international partner is not permitted to interfere with a prime contractor’s placement of subcontracts or to direct the USG to exclude certain (unless an FMS sole source has been requested and approved) vendors from participating in an FMS competitive source selection. International partners may suggest that certain additional firms be considered because this has the effect of increasing competition (see DFARS, 225.7304).

Contract Discussions

Although the USG should be able to accomplish contracting actions without international partner involvement, the SAMM C6.3.5.2 states that the PCO should consult with the international partner on any matter that could be perceived as inconsistent with or significantly different from the LOA. Per DFARS 225.7304, international partners may participate with USG acquisition personnel in discussions with industry to develop technical specifications, establish delivery schedules, and identify any special warranty provisions or other requirements unique to the international partner. Additionally, international partners may participate in reviewing varying alternatives, quantities, and options needed to make price-performance trade-offs. The degree of participation of the international partner during contract negotiations is left to the discretion of the PCO after consultation with the contractor. USG personnel are not permitted to release any contractor proprietary data unless approved by the contractor. International partner participation may be limited in situations where the contract includes requirements for more than one international partner, the contract includes unique U.S. requirements, or negotiations involve contractor proprietary data.

Contract Negotiations

One area specifically excluded from international partner participation is that of negotiations involving cost or price data unless a deviation from the Director of Defense Pricing and Contracting, Office of the Under Secretary of Defense (Acquisition and Sustainment) is granted [DFARS, 225.7304(e.3)]. Under FMS, the international partner has authorized the USG to solely negotiate the procurement contracts that originate from the LOA requirements. LOA standard term and condition 1.2 states, “The international partner agrees that the U.S. DOD is solely responsible for negotiating the terms and conditions of contracts necessary to fulfill the requirements of this LOA.”

Contract Pricing

SAMM C6.3.6.1 states information concerning FMS contract prices can be provided to the international partner in order to demonstrate the reasonableness of the price and to respond to relevant questions concerning contract price. Pricing information may include top-level pricing summaries, historical prices, or an explanation of any significant differences between the actual contract prices and the estimated contract price included in the initial LOA price. Other FMS unique contract pricing policies contained in DFARS 225.7303 were discussed above in the section titled “Contract Pricing for FMS.”

Contract Release

The issue may arise as to whether copies of the USG procurement contract may be released to the international partner. As noted in the SAMM, Section C6.3.6.2, all pertinent information and contractual obligations between the USG and the international partner are identified in the LOA. Consequently, there should normally be no need to provide a copy of the contract to the international partner. However, if the contract is unclassified and provides only for the requirements of the requesting country without including USG or other country requirements, release can be considered by the PCO. Release of internal pricing or negotiation information is not permitted.

CONTRACT STRUCTURE

Contracts for the procurement of FMS articles or services will be prepared according to FAR, DFARS, and any applicable agency subordinate supplements. The FAR, subpart 15.204-1, outlines a common format or structure to be used in federal contracts. This common contract structure is referred to as the uniform contract format. The ten core sections of a federal contract are differentiated by use of alphabetic section headings. As a result, federal contracts will be structured into ten sections under the headings of Section A through Section J.

Section A is titled “Solicitation/Contract Form.” The reason for this dual title is that the federal government may develop a draft or proposed contract that is issued when seeking offers from vendors. When used in this type application, Section A serves as a solicitation to vendors for contract offers. When the PCO is ready to accept a contract offer, Section A further serves as a contract instrument that the PCO can also sign to award the contract. In summary, Section A provides the cover page for the contract. It identifies, among other things, the contract number, the government procuring office, the contractor awarded the contract, and the government entity that will provide contract administration. Section A also bears the signatures of both the vendor’s representative, or the party making the offer, and the official from the USG that awards the contract (i.e., the PCO).

Section B is titled “Supplies or Services and Prices/Costs.” This section contains a brief description of the supplies or services that may include item numbers, National Stock Numbers (NSNs)/Part Numbers (PNs), article/service nomenclature, and quantities. Because a variety of different items or services can be purchased on the same contract, Contract Line-Item Numbers (CLINs) are used to differentiate between various items or services being procured. If there are multiple requirements for the same item or service, a subordinate indenture structure can be used in the contract breaking down the overall CLIN requirements into sub-CLIN requirements. Use of CLINs and sub-CLINs enables PCOs to differentiate the individual requirements being procured within the same contract. Experience shows implementing separate CLINs or separately identified sub-line items helps to avoid billing errors and facilitates FMS case reconciliation and closure. Use of informational sub-CLINs for FMS requirements (rather than separately identified, scheduled, or priced sub-CLINs) should be avoided as these may increase the probability that payment errors could occur. Additionally, segregating each FMS requirement into its own CLIN or sub-CLIN may be necessary to reflect different FMS prices, which may result from the provisions of DFARS, subpart 225.7303, “Pricing Acquisitions for FMS.” More information on FMS contract pricing is contained in this chapter under the section title “Contract Pricing for FMS.”

The SAMM C6.3.1 states that FMS requirements can be procured on the same contract with DOD requirements. However, the DFARS subpart 204.7104 states that separate contract sub-lines (i.e., sub-CLINs) should be used in contracts where individual contract requirements will be paid by more than one funding source or have different delivery dates/destinations. For FMS contract requirements, the DOD *Financial Management Regulation*, Volume 15, paragraph 010302, states that new FMS procurements should directly cite the FMS trust fund account as the source of contract funding. This approach is known as direct cite funding. The fund cite code structure used in direct cite funding not only identifies the FMS trust fund, but also refers specifically to the purchasing FMS country, FMS case, and FMS line. As a result, when payments are made against the contract requirement, the fund source for those payments will be referenced directly back to the applicable LOA country, case, and line that established the requirement. Contract payments for the applicable FMS CLIN or sub-CLIN will be billed to the respective FMS case and line. This payment information will be reported to the international partner in the quarterly FMS billing statement. In order to facilitate proper FMS billing, financial reconciliation, and eventual FMS case closure, it is important that PCOs follow this process of breaking out each individual FMS contract requirement into its own respective CLIN or sub-CLIN. More information on the FMS trust fund and the quarterly FMS billing statement is contained in Chapter 12 of this textbook.

Section C is titled “Description/Specifications/Statement of Work (SOW).” This is where the PCO can provide any description or specifications needed to elaborate on the Section B information. This section is particularly important when services are being purchased, because those services need to be adequately described. In some cases, this section may reference a separate SOW that is included in Section J, which is a list of attachments. SAMM C5.4.7.8 states that an LOA could potentially reference a separate SOW, memorandum of understanding (MOU), or performance work statement (PWS). Generally, the DOD procuring entity will develop a SOW or PWS based on the LOA requirements and then place the SOW or PWS on contract.

Section D is titled “Packaging and Marking.” This section describes packaging, packing, preservation, and marking requirements. FMS shipments need to be packaged in accordance with SAMM C7.8, requiring not less than Military Level A/B standards as defined in MILSTD-129. FMS requirements will need to be marked according to MILSTD-129. See Chapters 10 and 11 of this textbook for more information on FMS logistical considerations.

Section E is titled “Inspection and Acceptance.” This section covers contract inspection, acceptance, quality assurance, and reliability requirements. LOA standard term and condition 1.2 states that the DOD will apply the same quality, audit, and inspection procedures for FMS procurements as it applies to internal DOD or U.S. military procurements. Also, LOA standard term and condition 5.1 states that the title to FMS materiel transfers at the initial shipping point. The DOD will perform inspections according to the requirements in this section of the contract. If the materiel or service meets the contract requirements, a USG representative, usually from the Defense Contract Management Agency (DCMA), will accept contract performance.

Section F is titled “Deliveries or Performance.” This section describes the time, place, and method of delivery or performance. Delivery schedules for hardware and services may be described in terms of calendar dates or specified periods of time from contract award date. The appropriate regulation clauses from the FAR, DFARS, and other agencies' supplements will be selected and inserted into Section F. Any of the international partner's unique delivery requirements will apply.

Section G is titled “Contract Administration Data.” This section will include accounting and appropriation data and contract administration information or instructions. This may include directions regarding use of Accounting Classification Reference Numbers (ACRNs) and invoicing instructions. ACRNs identify the source of funds to be used to pay for certain CLINS or sub-CLINs on the contract. As identified in the discussion concerning Section B of the contract, the overall contract requirements should be broken down using the CLIN or sub-CLIN structure based on the respective funding sources. As a result, each FMS requirement should be broken out on the contract as its own CLIN or sub-CLIN that references its own unique ACRN. For FMS, the ACRN will identify the source of funding to include the applicable country, case, and case line that will directly fund the contract requirement. Additionally, Section G of the contract will include contract payment instructions. These are instructions selected by the PCO that will be followed by the contract payment office, Defense Finance and Accounting Service (DFAS), in making payments to contractors. In the FMS case reconciliation process, these instructions are used to validate how payments should have been made under the contract. Appropriate use of contract payment instructions, especially when multiple requirements with multiple funding sources (ACRNs) are present, will help preclude erroneous payments and avoid the additional work of payment corrections. The PCO should select payment instructions from the standardized menu at DFARS 204.7108. The payment instructions should be assigned at either the contract line-item level or at the entire contract level, but not at both levels.

Section H is titled “Special Contract Requirements.” This section will include a clear statement of any special contract requirements that are not included in other sections of the uniform contract format.

Section I is titled "Contract Clauses." The PCO shall include in this section the clauses required by law or by the FAR. Most contract clauses are incorporated by reference. This means the full text of the clause is not included in the contract, which prevents the cumulative length of this section from becoming too extensive. The entire text of the standard clauses may be found in FAR part 52 and DFARS part 252. As a result, only the clause reference and title normally appear in the contract.

Section J is the list of attachments. The applicable specifications identified in Section C can typically be unwieldy, and it is common for contract personnel to include such documents as attachments to the contract. Section J simply identifies a list of such attachments. The list of attachments will include a title, date, and number of pages for each. The content of Section J may include the specification, statement of work, statement of objectives, and a list of addressees for Contract Data Requirements (CDRL) exhibits.

CONTRACT ADMINISTRATION SERVICES

The contract administration function is an important part of the acquisition process. The scope of contract administration involves the monitoring of all facets of implemented contracts to ensure complete and effective performance by both the contractor and the USG. Specialists in contract administration, quality assurance, industrial security, financial management, and production management perform contract administration. The FAR, part 42.3, provides a detailed listing of seventy-one contract administration functions.

Normally, there will be a Procuring Contracting Officer (PCO) assigned to the MILDEP or defense agency. The PCO oversees the contract process through the contract award. Since the contractor may perform contract work at multiple geographic locations, it may be impractical for the PCO to perform day-to-day oversight in administering the awarded contract. As a result, the PCO generally delegates contract administration functions to an Administrative Contracting Officer (ACO) who is typically physically located near or at the prime contractor's facility.

Within the DOD, the Defense Contract Management Agency (DCMA) is typically responsible for contract administration services. Before contract award, DCMA provides advice and services to help PCOs construct effective solicitations, identify potential risks, select the most capable contractors, and write contracts that meet international partner needs. After contract award, DCMA monitors contractor performance and management to ensure that cost, product performance, and delivery schedules follow the terms and conditions of the contracts.

The DCMA regional commands (Eastern, Central, Western and International) contain geographically oriented Contract Management Offices (CMOs) that administer DOD contracts. More information on DCMA is available online at <http://www.dema.mil/>.

The Defense Contract Audit Agency (DCAA) provides both pre-award and post-award contract audit and financial advisory services in support of DOD acquisitions for FMS. More information on DCAA is available on their website: <http://www.dcaa.mil/>.

Foreign Military Sales Contract Administration

Contract administration is an integral part of the FMS process. The international partner is entitled to this service as part of the FMS purchase. LOA standard term and condition 1.2 states, "When procuring for the international partner, DOD will, in general, employ the same contract clauses, the same contract administration, and the same quality and audit inspection procedures as would be used in procuring for itself."

In the LOA, the international partner is charged a Contract Administration Service (CAS) fee for FMS materiel and services delivered from procurement. The CAS fee has three primary cost components:

1. Contract administration
2. Quality assurance
3. Contract audit

When contract administration is performed outside of the U.S., a fourth CAS fee component (OCONUS CAS) will be applied. More information on the CAS fee is contained in Chapter 12 of this textbook, “Financial Management.”

In accordance with the Arms Export Control Act (AECA), the cost of quality assurance, inspection, audit, and other contract administration services may be waived for North Atlantic Treaty Organization (NATO) members and for NATO infrastructure programs if a reciprocal CAS agreement exists whereby these same services are provided to the U.S. without charge. The SAMM, Tables C9.T5, C9.T6, and C9.T7, identifies countries, programs, and organizations that have reciprocal CAS agreements with the U.S. A brief description of the content for each CAS fee element is provided below.

- Contract administration includes financial services, contract management, review of contractor systems, price and cost analysis, negotiation of contract changes pursuant to the changes clause, final determination of cost allowability, termination settlements, plant clearance and disposal of contract inventories, and administration of government property.
- Quality assurance consists of inspection, testing, evaluation, and continuous verification of contractors’ inspection systems or quality assurance programs. When unfavorable conditions are detected, requirements for corrective action are initiated by the contractor. All FMS requirements have the same quality assurance processes applied that the DOD utilizes for its own contracts. The quality assurance function includes the USG inspecting and ultimately accepting or rejecting the contractor’s performance under provisions of the contract. At the point of acceptance, the USG takes title to the materiel, which subsequently transfers to the international partner at the manufacturer’s loading facility prior to shipment per LOA standard term and condition 5.1. USG acceptance of performance is documented by either a DD Form 250, “Material Inspection and Receiving Report,” or by generating a Receiving Report acceptance within the Wide Area Workflow system.
- Contract audit consists of financial services provided by DCAA in connection with the negotiation, administration, and settlement of contracts and subcontracts; these include evaluating the acceptability of costs claimed or proposed by contractors and reviewing contractor cost control systems.

Contract Financial Management

The DOD is responsible for making payments to contractors in accordance with the contract. It is common practice to make “progress payments” to contractors prior to delivery. These payments cover a percentage of costs incurred as work progresses. The customary progress payment rates on DOD contracts are 80 percent of the total estimated contract cost for large businesses and 90 percent for small businesses [DFARS 232.501-1]. This rate schedule also applies to contracts awarded for FMS requirements

Progress payments are often predicted in advance, using cost expenditure curves developed from typical DOD contract expenditure rates. Therefore, the anticipated progress payments, plus any hold back for termination costs, form the basis for the international partner’s LOA payment schedule.

It is important that LOA data and the actual contract performance progress be kept in balance. The LOA documents the USG’s best estimate of cost and delivery information. The international partner’s expectations are based on the LOA. If deviations from the LOA estimates become apparent during contract performance, the international partner should be notified and an LOA amendment or modification issued. Early notification to the international partner is important to permit the international partner to decide and exercise any alternate options or to make arrangements to accommodate revised cost or delivery schedules.

Any change from the original LOA commitments may be significant to the international partner. In one case, a contractor offered the USG the opportunity for early delivery of a major FMS requirement. Historically, contract early delivery has generally been viewed as a positive situation, provided there is no increase in total contract cost. In this situation, the PM agreed to the early delivery, because there was no increase in contract cost. However, accepting early delivery generated an accelerated financial demand by the U.S. for LOA payments from the international partner. Unfortunately, the international partner's budget was already established to support the original estimate of payments, and this early delivery decision caused significant problems for the international partner.

Contract Administration of Direct Commercial Sales

Eligible governments purchasing U.S. goods and services via direct commercial sale (DCS) may request DCMA contract management offices and the DCAA auditors to provide contract administration and contract audit functions. To do this, the international partner must submit an LOR for these services to DCMA.

These services for DCS purchases are normally authorized and reimbursed through a blanket order LOA arranged between the international partner and DCMA. Such an LOA would establish an estimated dollar value against which individual contract administration requests could be placed during a specified ordering period. DCMA may also prepare a defined order LOA to respond to an international partner's request for services that are applicable to a specific contract.

OFFSETS

An offset is a package of additional benefits that a contractor agrees to provide to the purchasing country in addition to delivering the primary product or service. Offsets generally apply only to acquisitions of major systems. In the international marketplace, there are numerous armaments producers competing to sell their systems to prospective international partners. When a country makes the decision to procure a major foreign system, significant amounts of national funds flow out of that country's economy. Given the cost of today's modern systems, the cash outflow may involve hundreds of millions or even billions of dollars. As a result, purchasing countries often desire to leverage this huge foreign expenditure to obtain additional benefits for their nation in addition to acquiring the weapon system itself. This package of additional benefits, which is intended to compensate for the huge financial outflow, is referred to as an offset. The term "offset" is derived from the concept that the additional benefits received in association with the procurement create an "offset" effect that counteracts the consequences of the large outflow of national funds for the foreign procurement.

Offsets are recognized as a legitimate, legal business arrangement found in international acquisitions. Offsets in defense trade began in the late 1950s. Today, offsets continue to be an important element in defense trade with the majority of offsets involving aerospace industry sales. Offset requirements may be established in conjunction with either FMS or DCS acquisitions.

Types of Offsets

Various terms are used to describe different types of offset arrangements, including "offsets," "coproduction," "buy-backs," "barter," "counter-purchase," "compensation," and "counter-trade." However, all offsets can fundamentally be categorized into two types: direct offsets and indirect offsets.

A direct offset involves benefits, including supplies or services that are directly related to the item being purchased. For example, as a condition of sale, the contractor may agree to permit the international partner to produce, in its country, certain components or subsystems of the item being sold.

An indirect offset involves benefits, including supplies or services that are unrelated to the item being purchased. For example, as a condition of a sale, the contractor may agree to purchase some of the international partner's manufactured products, agricultural commodities, raw materials, or services.

Congressional Interest and Notification

As the number and variety of offset programs has increased, so has the concern of many government agencies, private industries, labor officials, and the media over the impact of offsets on U.S. domestic industries. These concerns include the impact of these trade practices on American jobs, the U.S. balance of payments, technology transfer, and the long-term consequences for the U.S. and foreign economies. The President is required to submit to Congress an annual report on the impact of offsets on defense preparedness, industrial competitiveness, employment, and U.S. trade. The Secretary of Commerce prepares the report in consultation with the Secretaries of Defense, Treasury, and State and the U.S. trade representative. A link to the U.S. Department of Commerce, Bureau of Industry and Security (BIS), "Offsets in Defense Trade" website is included in the references section of this chapter. The BIS website includes a wide range of offsets in defense trade resources, such as the Offset Reporting regulations, guidance and recommended format for reporting offset activities, frequently asked questions on offsets, and copies of recent reports to Congress and the Presidential Policy on Offsets.

The AECA, Section 36(g), requires congressional notification of proposed FMS and commercial export sales, which include offset agreements. The information provided to Congress includes a general description of the performance required for the offset agreement. This description should indicate if a known offset requirement exists, whether the country has a standard offset requirement, if the offsets provided will be direct or indirect, and the estimated percentage of each. If there is no offset agreement at the time of the notification, that should be so stated. Offset reporting is treated as confidential information that remains classified even after the statutory congressional notification is complete.

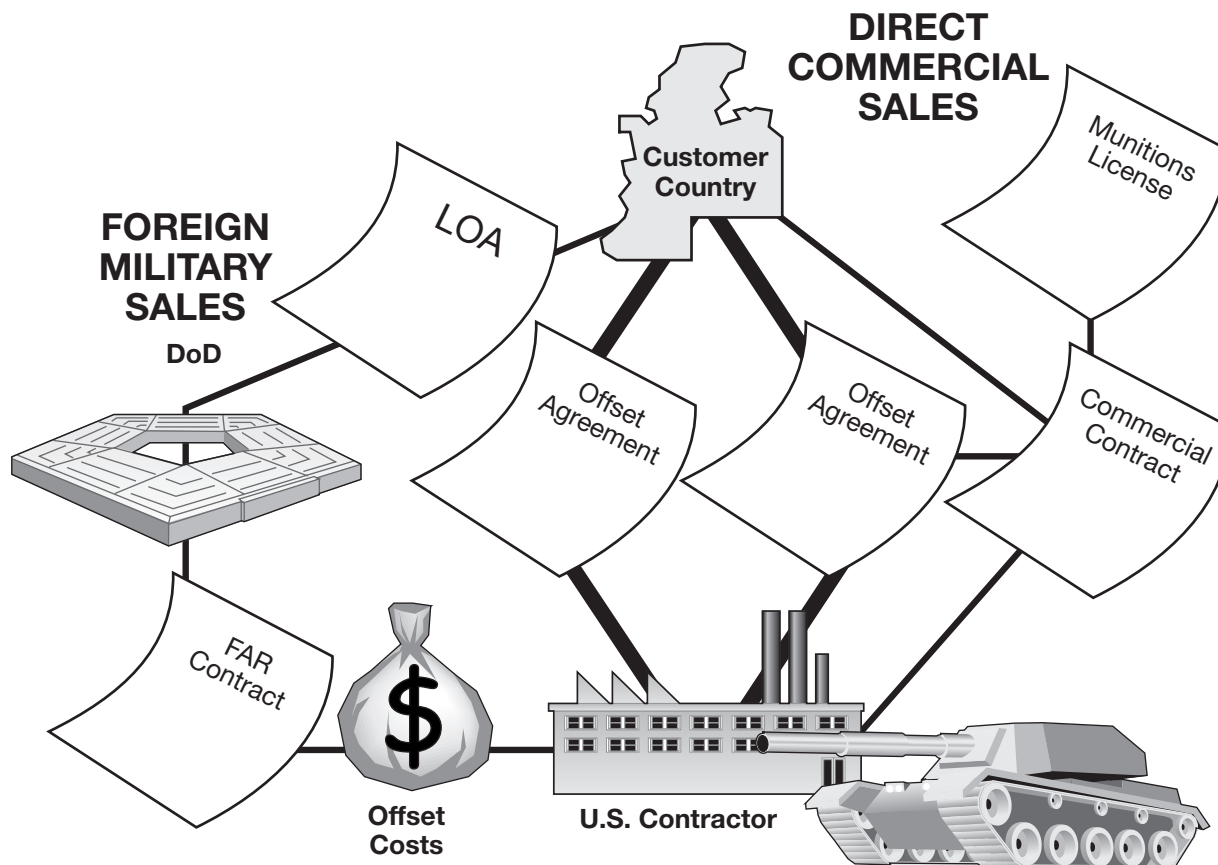
United States Government Offset Policy

Offsets are permissible under FMS. However, it must be emphasized that the offset agreement is between the purchasing country and the U.S. contractor. The USG is not party to the agreement and does not retain any obligation to enforce the contractor's performance of the agreement. Figure 9-1 illustrates the offset relationship. This appears to be, and is in fact, an odd arrangement. In an ideal world, the USG would prefer that offset agreements did not exist; however, the reality of the marketplace is that other countries are competing for international business and are willing to provide offset packages to prospective international partners. If the USG prohibited offsets under FMS, U.S. firms would be at a huge disadvantage in international competition.

The Presidential Policy on offsets in military exports was announced by President George H.W. Bush on 16 April 1990 and was subsequently codified into law by the Defense Production Act Amendments of 1992. This policy is also incorporated within DFARS 225.7306. The key provisions of the policy on offsets are as follows:

- No USG agency shall encourage, enter directly into, or commit U.S. firms to any offset arrangement related to the sale of U.S. defense articles or services.
- USG funds shall not be used to finance offsets.
- Negotiations or decisions regarding offset commitments reside with the companies involved.

Figure 9-1
Offset Relationships



Offset Costs

To an uninformed observer, it may appear that the offset process provides a means to obtain some national benefits at no cost. The fundamental principle of business dictates that any enduring enterprise cannot incur expenses that exceed revenue. This extends to defense sales involving offsets. Firms may agree to perform an offset to win an acquisition competition, but they must recover the cost to perform the offset through the price charged in the primary system contract. In a direct commercial contract, the contractor must build the anticipated cost for performing the offset into its contract prices.

Under FMS, the offset cost recovery process is awkward. The USG wants U.S. firms to successfully compete for international business and permits offset arrangements as a legal business activity. Likewise, the USG wants international partners to have the option to purchase military systems using either the FMS process or the DCS process. Under FMS, the contractor is working directly for the DOD, but the USG permits this same contractor to concurrently enter into an offset agreement directly with the international partner. Although the DOD is clearly not party to the offset agreement, the DFARS, subpart 225.7303-2 recognizes that contractors performing business in support of foreign governments or international organizations may incur certain additional legitimate business costs. Offset costs are one type of cost of doing business with a foreign government that the DFARS considers as allowable.

Contractors are permitted to build the cost of performing the offset into the contract price charged the USG. Under FMS pricing policy, the USG must recover all the costs of conducting FMS. As a result, if offsets are required by the purchasing country, the LOA price will be incrementally higher in order to cover the cost of the offset. So, on the surface, it may appear that the international partner is receiving the offset at no cost, but offset expenses are actually included as a part of the applicable line-item unit cost in estimated prices quoted in the LOAs. It is the contractor's responsibility to inform the implementing agency when estimated offset costs have been included in FMS pricing.

Although the DFARS subpart 225.7303-2 states offset costs will be considered allowable, it does not mean the contractor does not have to exercise fiscal responsibility in offset performance. The DFARS requires the PCO to review and determine that the contract costs, to include direct offset costs claimed by the contractor, are both allocable and reasonable. A change to DFARS 225.7303-2 states that all indirect offset costs are to be deemed reasonable with no further analysis necessary by the PCO if the contractor provides the PCO a signed offset agreement or other documentation showing that the international partner made the indirect offset of a certain dollar value a condition of the FMS acquisition. LOA standard term and condition 2.8 reflects this policy change by referring to the DFARS.

It is important to note that the DFARS provision permits offset costs to be included in the costs billed to the USG under the procurement contract only if the LOA is funded with international partner funds or repayable credits. If the LOA is funded with non-repayable FMFP funds, offset costs are not allowable.

It is inappropriate for USG personnel to discuss with the foreign government the nature or details of an offset arrangement with a U.S. contractor. However, the fact that offset costs have been included in the P&A or LOA price estimates will be confirmed, should the international partner inquire. The international partner should be directed to the U.S. contractor for answers to all questions regarding its offset arrangement, including the offset costs.

Offset LOA Standard Term and Condition

LOA standard term and condition 2.8 addresses offsets. This condition summarizes the USG policy regarding offsets in association with FMS.

Any offset arrangement is strictly between the international partner and the U.S. defense contractor. The U.S. Government is not a party to any offset agreement that may be required by the international partner in relation to the sales made in this LOA. The USG assumes no obligation to administer or satisfy any offset requirements or bear any of the associated costs. Although offsets, as defined in the Defense Federal Acquisition Regulation Supplement, are not within the scope of the DOD contracts entered into to fulfill the requirements of this LOA, offset costs may be recovered through such contracts. Indirect offset costs may be deemed reasonable without further analysis in accordance with the Defense Federal Acquisition Regulation Supplement. If the international partner wishes to obtain information regarding offset costs, the international partner should request information directly from the U.S. defense contractor.

CONTRACTING FOR BPC PROGRAMS

Building Partner Capacity (BPC) programs that are often implemented via "pseudo"-LOAs will utilize the FMS infrastructure for execution. However, due to the different authorities and appropriated funding sources for BPC programs, acquisitions for BPC will not follow the FMS acquisition processes and procedures outlined in SAMM C6.3 and the DFARS Subpart 225.7300.

Instead, acquisition for BPC programs will follow the processes and procedures outlined in SAMM C15 as well as the FAR and DFARS provisions associated with contracts funded by USG-appropriated funds.

A key consideration in conducting BPC acquisitions is to recognize the time-limited nature of BPC funds for both obligation and disbursement purposes. SAMM Table C15.T2 lists the various BPC programs with the associated appropriation authority, fund expiration date and funds cancellation dates. These dates are essential in procurement planning and execution for BPC. Due to the fiscal time limitations, SAMM C15.2.5 outlines the role of a feasibility assessment in planning for a BPC acquisition.

Another major difference for a BPC acquisition is that the benefiting country is not provided an opportunity to request procurement from a specific vendor. The FMS sole source process based on the FAR subpart 6.302-4 international agreement exception is ineligible to be utilized with BPC programs. The other than full and open competition process can be used for BPC programs, but the justification for use must be based on other exception criteria outlined in the FAR, subpart 6.3. SAMM Figure C15.F2 discusses the sole source process that is applicable to BPC programs.

Regarding contract pricing, BPC requirements default to all the normal DOD pricing rules. The FMS contract pricing provisions outlined in DFARS subpart 225.7303 are not applicable to BPC acquisitions. Additionally, offsets as discussed for FMS are not applicable in BPC acquisitions.

SPECIAL DEFENSE ACQUISITION FUND (SDAF)

Background

Acquisition in support of security cooperation programs, both FMS and BPC, can sometimes take a long time. Long acquisition lead times can be caused by several different factors.

First, for SC programs, there is the LOA lead time. The LOA lead time reflects the amount of time from receipt of the request until the LOA is accepted and financially implemented. This lead time can represent several months, depending on the LOA's complexity. For SC programs, the LOA serves as both the authority and funding source for the acquisition. As a result, even though the partner's requirements are known early in the overall SC process, contracting actions cannot proceed until the security cooperation agreement (LOA or BPC case) has been accepted and financially implemented.

Second, there is the contracting administrative lead time. The contracting administrative lead time reflects the amount of time required from when the funded requirement is provided to the respective DOD contracting activity until the procurement contract is awarded to a vendor. The administrative lead time is largely influenced by the time necessary to comply with the many mandatory DOD acquisition policies and procedures. Acquisition in support of security cooperation programs is accomplished using the same acquisition policies, procedures, and management infrastructure that are utilized to make purchases for the DOD itself. Some of the key actions accomplished during the administrative lead time include thoroughly identifying the requirement; performing market research to determine source options; developing clear specifications or statements of work/objectives; identifying an acquisition strategy; formulating a source selection plan and evaluation criteria; advertising/soliciting for offers; allowing time for potential vendors to develop offers; evaluating competing offers; conducting discussions with industry to better understand offers; scoring industry proposals based on strengths/weaknesses/risks; selecting the offer that provides the overall best value; and awarding the contract.

Third, there is the manufacturing or production lead time. The production lead time reflects the amount of time required from date of contract award until the vendor physically delivers the product or service to the USG. This lead time is largely influenced by the nature of the article or service being purchased. Although some articles or services are readily available, others are intrinsically more complex and will require longer times to produce. Some key actions during the production lead time include scheduling new contract work into existing production orders and purchasing raw materials, fabricating parts, assembling components, integrating subsystems, performing final assembly, inspecting, and testing. This period of time can substantially lengthen if the article or service deviates from the DOD standard specifications or configurations which necessitates additional design, integration and testing services.

Fourth, there is the transportation lead time. The transportation lead time reflects the amount of time necessary to physically move the article from the point of origin, typically somewhere within the continental U.S. to the final destination within the partner's country. For services, this increment of time reflects the time for the contractor to select employees, prepare the work team, forward materials, and deploy the team to the partner's country. Depending on the mode of transportation for articles or the availability of personnel for services, this may take several months to accomplish.

As a result, the cumulative lead time for delivery of security cooperation items or services sourced from procurement is driven by the LOA lead time (LOR to LOA financial implementation) plus the contracting administrative lead time (time until contract award) plus the production lead time (time for the vendor to manufacture/assemble article) plus the transportation lead time (time to transport from initial shipping point to final location in partner's country). Together, these can result in a lengthy overall lead time until delivery.

Fund Description

The Special Defense Acquisition Fund (SDAF), authorized in Section 51 of the Arms Export Control Act, 22 U.S.C. 2795, was created to address the issue of long security cooperation lead times. As described in SAMM C11.9, the SDAF is a financially independent, revolving fund that finances the procurement of defense articles and defense services in anticipation of future transfer to foreign countries and international organizations. The SDAF itself is a procurement authority, not a transfer authority. All SDAF assets are transferred to partners using the same laws, regulations, and rules that govern all foreign military transfers.

The SDAF provides both procurement authority and funds availability to engage in procurement actions prior to LOA or pseudo-LOA implementation. The SDAF allows the USG to deliver selected articles and services to partners in less than normal procurement lead-time, and it enhances U.S. force readiness by reducing the need to divert assets from U.S. forces when partners have urgent requirements that cannot otherwise be satisfied.

Account Funding and Capitalization

The SDAF is capitalized using selected receipts on FMS sales, as provided in Section 51(b) of the Arms Export Control Act. The Congress has not appropriated any funds for the SDAF since the account was reconstituted in 2012. The size of the account, which is the sum of the total assets that have been purchased by the SDAF but not yet sold plus the total amount of unencumbered funds in the account, cannot exceed \$2.5 billion, as provided in 10 U.S.C. 114.

Procurement Proposal Submission and Approval Process

DOD components identify the items or services proposed for procurement using the SDAF funds. SDAF procurement proposals generated by Security Cooperation Offices or Geographic Combatant Commands should be coordinated with the relevant Integrated Regional Team at DSCA. DSCA, in consultation with the Department of State, Bureau of Political-Military Affairs, selects the defense articles and defense services to be purchased by the SDAF. The defense articles and services approved for procurement are included in a spend plan that is provided to the congressional committees that oversee the authority. The plans are submitted 30 days prior to the start of each new fiscal quarter.

Procurement Execution

The implementing agencies (IAs) execute the purchases of approved items. SDAF procurements are made in accordance with DOD regulations and procedures, as outlined in the FAR and DFARS. The international agreements exception to full and open contracting competition cannot be used on SDAF procurements.

The IAs are responsible for storing and maintaining accountability of defense articles purchased by the SDAF until the items are transferred to a foreign government, international organization, or Building Partner Capacity program. In addition, the IAs must establish controls to ensure SDAF assets are not transferred to an international partner or used by the military department unless explicitly approved by DSCA.

Allocation Decision

An approved allocation request authorizes the IA to offer the requested item or service to a foreign government, international organization, or Building Partner Capacity program.

The SDAF allocation process begins when an eligible foreign country, international organization, or Building Partner Capacity program requests information on defense articles and/or services, and the articles and/or services are available in the SDAF inventory. When such a request is received, the IA should verify the availability of the requested asset and then submit an SDAF allocation request to DSCA.

SDAF-procured assets are allocated in accordance with the laws, regulations, and policies that apply to all foreign military sales and transfers. The allocation of an asset to support an eligible foreign country, international organization, or Building Partner Capacity program must be approved by DSCA before it can be added to an LOA

Generally, sales are made from assets in the SDAF inventory. In instances where the article or service requested has been purchased by the SDAF but not yet delivered to the USG, the international partner may purchase the equity that the SDAF owns in the acquisition contract.

Role of the LOA

SDAF assets may be offered on a separate LOA or as one or more separate lines on an LOA that includes articles and services that will not be sourced from the SDAF inventory. Sub-lines will not mix SDAF and non-SDAF material and services. Once a case is offered, the SDAF assets on the case will be held in reserve until the offer expiration date (OED) expires.

Pricing

The price for SDAF assets and contract equities sold through the FMS process will be computed by establishing a base acquisition price. The base price is the higher of the SDAF procurement price or the current contract price. Once the base price has been established, additional charges, such as non-recurring costs (NC), contract administration services (CAS), transportation, and proportionate storage fees, will be added to arrive at the SDAF selling price. The payment for defense articles and services sourced from the SDAF must be included in the initial deposit.

When SDAF-purchased assets are transferred to a foreign government or international organization, the proceeds from the transaction are reimbursed to the SDAF and used to finance subsequent purchases.

SUMMARY

The fundamental principle regarding contracting for FMS requirements is that the USG essentially treats the international partner's requirements as if they were USG requirements. In contracting for FMS, the same contracting regulations, policies, and procedures are applied. Per the SAMM, this is one of the principal reasons international partners select the FMS system rather than contracting themselves using direct commercial processes.

The unique aspects of the procurement process that pertain to FMS are few in number, but they have a major impact on the FMS process. Competitive source selection is the norm; however, the international partner has the option to use other than full and open competition if they desire the USG to contract with a specific firm. Under other than full and open competition procedures, the international partners need not provide a rationale for the request.

The USG also has established a comprehensive contract administration infrastructure that will be used to oversee the execution of contracts awarded in support of FMS requirements. Again, the USG uses the same contract administration, quality assurance and contract audit processes for FMS that it uses for DOD procurements.

Offsets are an international market reality. Offsets are permitted in association with FMS when the LOA funding the procurement contract is financed by international partner cash or repayable credit. If the LOA is funded by USG grant funds, offset costs claimed by the contractor will be considered unallowable.

Building Partner Capacity (BPC) programs that are implemented via pseudo-LOAs will utilize the FMS infrastructure for execution. However, due to the different authorities and appropriated funding sources for BPC programs, acquisitions of BPC will not follow the FMS acquisition processes and procedures outlined in SAMM C6.3 and the DFARS Subpart 225.7300. Instead, acquisition for BPC programs will follow the processes and procedures outlined in SAMM C15 as well as the FAR and DFARS provisions associated with contracts funded by USG-appropriated funds.

The SDAF provides a unique potential opportunity to initiate contracting actions in advance of LOA financial implementation, thereby reducing the overall procurement lead-time. DSCA must approve each proposal by the DOD components to procure using SDAF funds. The SDAF-acquired assets are allocated by DSCA and are sold via stand-alone SDAF LOAs or as separate SDAF lines on LOAs that sell other non-SDAF articles and services.

REFERENCES

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