
Foreign Military Sales Contracting: “What’s in a Price?”

By

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Section 22 of the Arms Export Control Act (AECA) of 1976, as amended, allows for the procurement of defense articles and services not readily available in the Department of Defense (DoD) stock systems. The AECA enables the United States Government (USG) to enter into contracts for the procurement of those defense articles and services on behalf of the foreign customer. The Letter of Offer and Acceptance (LOA) is the basic bilateral contractual document agreed upon by the United States and the foreign customer. In signing the LOA, both the United States Government and the foreign customer agree to the terms and conditions of that agreement.

Within the LOA, “Standard Terms and Conditions,” are two specific sections that address the requirements for procurement and the foreign customer. Section 1.2 of the LOA states, “The USG will furnish the items from its stocks and resources, or will procure them under terms and conditions consistent with DoD regulations and procedures. When procuring for the Purchaser, 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, except as otherwise requested by the Purchaser” Section 7.1 states “This LOA is subject to U.S. Federal Procurement Law.” The inclusion of both clauses in the LOA affords the foreign customer the same benefits and the same protection that apply to DoD procurements. However, even though the foreign customer is afforded the same benefits and same protection under the Federal Acquisition Regulation (FAR) and the Defense Federal Acquisition Regulation Supplemental (DFARS), this does not mean that FMS sales prices are identical to prices for other “domestic” contracts. Application of the pricing principles in the FAR Part 15 and 31 and DFARS Part 225.73 can result in differing contract prices for the same item if purchased for domestic usage.

The key to the differing prices is the application of “costs” which are allowable under Foreign Military Sales contracting but may not necessarily be allowable under a domestic contract. Allowable costs can be defined as costs allowed by the contract and by the FAR. DFARS Part 225.7303 lists those costs, which are recognized as reasonable and allocable costs of doing business with a foreign government even though such costs might not be recognized when pricing other defense contracts. This is because additional services, resulting in costs, are being performed with the beneficiary being foreign governments as opposed to the U.S. Department of Defense. These allowable costs are in addition to the normal additive costs associated with the standard LOA (i.e. Nonrecurring Cost, Contract Administrative Services, Logistic Support Charge, Packing, Crating, Handling & Transportation and Administrative charge). “Reasonable” as used in the FAR is defined as costs in their nature and amount do not exceed what would be incurred by a prudent person in the conduct of competitive business (FAR 31.201-3). “Allocable” as used in the FAR can be defined as costs assignable or chargeable to one or more cost objectives based on relative benefits received or other equitable relationship (FAR 31.201-4). The reasonable and allocable costs of doing business with a foreign customer are summarized below. (DFARS Part 225.7303-2) (Note: The listing of allowable costs below are examples and are not all-inclusive.)

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- Selling expenses.
 - Maintaining international sales and service organizations.
 - Sales commissions and fees.
 - Sales promotions, demonstrations, and related travel for sales to foreign governments.
 - Configuration studies and related technical services undertaken as a direct selling effort.
 - Product support and post-delivery service expenses such as:
 - Operations and maintenance training, 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 implementation costs.

A U.S. defense contractor may recover costs incurred to implement its offset agreement with a foreign government or international organization if the foreign military sale Letter of Offer and Acceptance is financed wholly with customer cash or repayable foreign military finance credits.

- Costs that are the subject of advance agreement under the appropriate provisions of the FAR Part 31; or where the advance understanding places a limit on the amounts of cost that it will apply only to DOD contracts for the U.S. Government's own requirements.

(Note: If the funding for the LOA is financed wholly with non-repayable FMFP Credit, pricing will be in accordance with FAR Parts 15 and 31 and will be priced identically as other defense contracts).

Costs not allowable under FAR Part 31 are not allowable in pricing foreign military sales contracts with the exception of the allowability of Independent Research and Development and Bid and Proposal (IR&D/B&P) costs which are limited to the contract's allocable share of the contractor's total IR&D/B&P expenditures.

Sales commissions and fees are allowable under FMS contracts, provided the agent is a bona-fide employee of the contractor for the purpose of obtaining business for the contractor. (No such commissions or fees are permitted for any FMS case that is wholly financed with FMF funds.) A recent change reported in the Defense Acquisition Circular raised the ceiling on contingency fees, which were previously limited to \$50,000 per contract per country to in excess of \$50,000 if the foreign customer agrees to such fees in writing before contract award. (DAC 91-13, March 9, 1998, Vol. 63, No. 45) All LOA's which specify that a sales commission or agent fee is included, must be coordinated with the Defense Security Assistance Agency (DSAA), regardless of the dollar value of the case and prior to submittal of the LOA for signature to the requesting foreign customer. The foreign customer will be notified of the inclusion of commission or agent fees in the price of the LOA and has the option to either accept such fees or reject them. If rejected, the commission or agent fee will not be recognized by the contracting officer, and the LOA will be withheld pending withdrawal of the commission or agent fee from the contractor's proposal. If the contractor refuses to withdraw the sales commission or fee from the contractor's proposal, the contracting officer will notify the agency which, in turn, will notify the foreign customer that DOD will be unable to purchase the item or service. The Security Assistance Management Manual (SAMM) DOD 5105.38M paragraph 80103, and DFARS 225.7303-4 list those countries which prohibit inclusion of sales commissions and agent fees unless the payments have been identified and

payment approved in writing by the foreign customer before contract award. These countries are:

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

Offset implementation costs have recently been given greater emphasis in Foreign Military Sales cases. Inclusion of offsets are not likely to disappear any time soon from system sales and are here to stay (DOD News Vol.12, No.37). An offset can best be defined as follows:

An agreement, arrangement, or understanding between a U.S. supplier and a non-U.S. Purchaser under which the supplier agrees to purchase or acquire, or to promote the purchase or acquisition by other U.S. persons, of, goods or services produced, manufactured, grown, or extracted, in whole or in part, outside the U.S. in consideration for purchases of defense articles or services from the supplier. A U.S. person means an individual who is a national or permanent resident alien of the U.S. and any corporation, business association, partnership, trust, or other judicial entity incorporated, or permanently residing, in the U.S. (SAMM App. B).

Offset arrangements can be grouped into two distinct categories: Direct and Indirect. A direct offset usually results in compensation of related goods, whereas indirect offsets result in compensation of goods unrelated to the defense article sold. DFARS 225.7303-2 allows for offset costs to be included as part of the applicable line item unit cost. After notification of the inclusion of the offset cost by the contractor to the implementing activity, the associated costs are incorporated into the LOA. It is important to remember, even though offset implementation costs are incorporated into the LOA and the contract between the USG and the contractor, only customer funds are used to administer the offset arrangement. Because of the unique relationship between the USG contractor and the Foreign Customer in an offset arrangement,

it is inappropriate to discuss with the foreign government the nature or details of an offset arrangement with a US contractor; however, the fact that offset administrative costs have been included in the P&A or LOA price estimate will be confirmed, should the customer inquire. The customer should be directed to the US contractor for answers to all questions regarding its offset arrangement, including the cost of administering the arrangement. IA involvement in any discussion of these costs with the customer beyond confirmation of their inclusion in price estimates requires case-by-case review and approval by DSAA. (SAMM 140107-B4).

CONCLUSION

The pricing of articles for the FMS customers may differ from that for domestic customers. The price difference between FMS customers and domestic customers is primarily due to the allowability provisions in the FAR and DFARS. These additional costs are the result of additive services being performed for the customer.

ABOUT THE AUTHOR

CDR Hawkins has been an instructor at DISAM since December 1995. He is a graduate of the California Polytechnic State University, San Luis Obispo, California, and holds a Masters of Science in Materiel Acquisition Management from the Florida Institute of Technology. He is the functional coordinator for contracting and acquisition subjects in all DISAM courses.