Chapter

# 9 Foreign Military Sales Acquisition Policy and Process

## Introduction

The Foreign Military Sales (FMS) process fundamentally is an acquisition process. Under FMS, a foreign government or international organization identifies a need for a military-related item or service and chooses to acquire it from the US government (USG). The government-to-government sales agreement governing the 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 FMS customer.

This chapter primarily examines acquisition as it relates to the USG's process for purchasing material or services by means of contracts with industry. The goal is to highlight where and how FMS procurements fit into the normal DOD procurement process. Additionally, 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.

Within DOD, the term "acquisition" may also refer to the entire life cycle process DOD uses to develop, test, evaluate, produce, and sustain weapon systems in order to satisfy formally identified 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.

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: life cycle logistics; auditing; business, cost estimating, and financial management; contracting; facilities engineering; industrial/contract property management; information technology; engineering/technical management; program management; purchasing; science and technology; systems engineering; 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 web site: http://icatalog.dau.mil/onlinecatalog/tabnav.aspx.

## Global Military Marketplace

When an international customer 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 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 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 foreign customer must first determine whether or not to acquire a US system rather than developing an indigenous system or purchasing another country's system. If the foreign customer selects a US 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.

DOD is generally neutral regarding whether a foreign customer chooses to purchase via FMS or DCS. Although officially neutral regarding the procurement method (FMS or DCS), DOD does prefer that friendly nations choose US systems. The reason for the US preference relates to the political, military, and economic benefits resulting from the US 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 DCS Procurements," 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 one primary reason why international customers choose the FMS option is that DOD arranges the purchase on the customer's behalf using the same USG regulations and procedures DOD utilizes for their own procurements. As a result, FMS customers receive the same benefits and protections as DOD. This can be a considerable benefit when the customer may be spending hundreds of millions or perhaps billions of dollars to acquire a military system. This chapter examines how DOD uses its existing acquisition policies and procedures to procure articles and services in fulfillment of LOA agreements.

## Foreign Military Sales Content

Typically, FMS system sales consist of weapon systems 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 which have been approved for full rate production for US forces. The full rate production decision is a key acquisition decision point from the FMS perspective. If a foreign customer requests an LOA for a system that has not yet been approved for full rate production, a policy waiver is required. In this situation, the Defense Security Cooperation Agency (DSCA) will request concurrence from the Joint Chiefs of Staff and the Under Secretary of Defense for Acquisition, Technology, and Logistics [USD (AT&L)] 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 the full rate production decision, there is the risk that the US may decide not to produce the system. This would present an undesirable situation if the US has an LOA commitment to deliver a system to an FMS customer, but decides not to deliver this same system to US forces. The FMS customer would then possess a nonstandard system and have only very limited sustainment options; in addition, the customer could potentially lack interoperability with US 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. This waiver is often referred to as the "Yockey" waiver, named after a former Under Secretary of Defense.

Although some FMS customers may purchase specific items or services independent of a major DOD end item system, most SA 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 FMS customer 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.

Because the FMS process is accomplished using existing DOD procurement regulations and policies, the material and services provided under FMS will generally be US origin products. SAMM C4.4.1 states that DOD will not enter into LOAs that commit to procurement in foreign countries unless the DSCA has approved an exception.

## Contracting for Foreign Military Sales

It is important to recognize that the Arms Export Control Act (AECA) permits FMS from both DOD stocks and by means of DOD contracting to acquire material or services directly for the FMS customer. Generally, DOD inventory levels are established to support DOD's own operations and to provide a contingency reserve of material. When an FMS customer 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 US military readiness. As a result, it may be necessary for DOD to procure the required FMS item by contracting with industry, rather than supplying the item from stock. There is an exception to this policy under a special program called the Cooperative Logistics Supply Support Arrangement (CLSSA). More information on the CLSSA program is contained in chapter 10 of this textbook, "Logistics Support of International Military Sales." In addition, the Secretary of Defense may determine that a release of stock articles to foreign customers under certain circumstances is necessary to support overall national interests even when there is a resulting negative impact on the readiness of US 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 FMS customer accepts an LOA, it enters a government-to-government agreement to purchase military items or services from the USG. In regard to the LOA, the FMS customer 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 customer. In the procurement contract, the USG becomes the buyer and the vendor from industry becomes the seller. The FMS customer is not a legal participant in the procurement contract with industry; instead, the USG acts on behalf of the FMS customer. The vendor is under contract and directly obligated to the USG, and has no direct contractual relationship with the FMS customer. The vendor entering into a procurement contract with the USG (to produce material or provide services) is not exporting their products. For all intents and purposes, the vendor is selling to the USG. The USG is exporting the products under the authority of the LOA.

### Letter of Offer and Acceptance and Contract Relationship

The LOA documents the customer'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 customer's requirements to ensure the LOA addresses all customer needs. Simultaneously, the CM must also ensure any special procurement issues from the Contracting Officer (CO) perspective are adequately addressed with the customer 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 customer'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 customer, 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.

### *Major System Acquisition*

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

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

A PM team will typically consist of a weapon system program manager, supported by personnel from several functional disciplines (engineering, testing, contracting, logistics, and financial management).

When an FMS customer purchases a major weapon system, the same PM office overseeing the DOD acquisition of that system will also manage the FMS customer acquisition. The system PM office may acquire FMS quantities either as individual procurements or by merging FMS requirements with DOD's requirements on the same US contract. The CO within the overall PM office is the only individual granted the authority to enter into contracts on the behalf of the USG. In this role, the CO 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 standard level of service discussed in the SAMM C9.4.2.2. Additional management services will be funded by a well-defined services line on the LOA. The SAMM requires each service line to include a LOA line item note to describe the details of the services provided, and to identify the performance period.

### *Follow-on Support Acquisition*

In regard to standard follow-on support, FMS requirements from the LOA will be routed to the DOD Inventory Control Point (ICP) managing the item for the DOD. ICPs assign an Item Manager (IM) the responsibility for 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 CO 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. 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.

### *Nonstandard Acquisition*

DOD policy is to support all systems sold through FMS for as long as the FMS customer chooses to operate the system. For the FMS customer, the DOD decision to curtail or end operations of a given system may impact support. Many examples exist where DOD currently supports systems operated by FMS customers 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 foreign purchaser plans to continue to operate the system.

Nonstandard requirements are, by definition, items not actively managed in the DOD supply system for US forces. Nonstandard FMS requirements have historically been difficult to support, due to the fact that no supporting management or acquisition infrastructure exists within the DOD. Since no ICP activity manages or purchases these items for DOD, MILDEPs have contracted with commercial buying services (CBS) to procure most nonstandard items in lieu of DOD directly contracting for nonstandard items. More information on CBS is presented in chapter 10 of this textbook, "Logistics Support of International Military Sales."

**Contracting Regulations**

The *Federal Acquisition Regulation* (FAR) establishes a set of uniform acquisition policies and procedures to be used by all federal 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). 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 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 overarching 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 on 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

The CICA requires USG agencies to promote the use of full and open competition in procurements. This legislated requirement is detailed in part 6 of the FAR, which discusses contract competition. In a competitive procurement, the USG makes public notification of its intent to purchase. The USG electronically posts these notifications on its Federal Business Opportunities (FEDBIZOPPS) web site: http://www.fbo.gov. These public notifications are commonly referred to as solicitations. The FEDBIZOPPS web site provides interested vendors an opportunity to submit a bid or proposal to the USG in accordance with the solicitation instructions. Submitting a bid or proposal enables the vendor to be considered in the contract source selection process. 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. 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 seven 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:
  - ◊ 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 involving the federal government
- An international agreement or a treaty between the US 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 US will select the contractor on the same basis as it makes contractor selections to fulfill its own requirements. In other words, the norm for FMS contract awards is for the US to use its competitive contract award process to select the contractor to fill the FMS customer's requirement. The SAMM C6.3.4 states that competitive source selection will be utilized to the maximum extent possible in support of FMS.

**Foreign Military Sales Other Than Full and Open Competition by Customer Request**

Section 1.2 of the LOA standard terms and conditions does permit the FMS customer to formally request a noncompetitive procurement be conducted on its behalf. Within the FMS community, a customer'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 purchaser's representative in the United States may also submit these requests to the IA. A customer's other than full and open competition request should be submitted with the Letter of Request (LOR). FMS customers need not provide a rationale for the request.

Requests for other than full and open competition should be to meet the objective requirements of the purchaser 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 foreign purchaser's request to use other than full and open competition, and DOD contracting agencies are encouraged to defer to a foreign purchaser's requests under the international agreement exception to the extent that they are not aware of any indication that such requests violate US 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 US 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 purchaser must be coordinated with DSCA.

In addition to reviewing the customer's other than full and open competition request, the SAMM also recommends the request be forwarded to the applicable CO for information and advice. Typically, the CO will have previous experience procuring the same or a similar item or service for DOD. 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 customer's other than full and open competition selection may not be a practical procurement choice. In these instances, the CO can inform the CM, who would provide this additional information to the FMS customer for further consideration.

Other than full and open competition requests typically specify a particular prime contractor. FMS customers may also request that specific subcontractors be utilized by the prime contractor. Requesting specific subcontractors limits the ability of 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 customer chooses to request specific subcontractors, the purchaser should be advised of the additional risk as stated in the SAMM C6.3.4.4.

Per the SAMM, section 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 CO to initiate a noncompetitive procurement at the FMS customer'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 CO to permit compliance with the FAR 6.3 requirements for noncompetitive procurements.

As an exception, 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 customer 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 Customer Request**

Although most FMS other than full and open competition procurements originate with the foreign customer, noncompetitive procurements can originate unilaterally with the USG. In this situation, although the FMS customer 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 international agreement).

An other than full and open competition procurement not requested by the FMS customer may include a major system acquisition. For example, if the customer sought to purchase an F-16 aircraft through FMS, the customer would not need to request an other than full and open competition because the F-16 is only available from a single vendor.

**Competitive Source Selection**

Unless the LOA reflects an approved customer request for procurement using other than full and open competition or unless the CO 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 FMS customer to recognize that the competitive process requires time to accomplish. Foreign customers 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 by 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 at up to $150,000 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 at up to $6.5 million. The FAR, part 13, describes this process.

***Sealed Bids***

Sealed bids are used if: time permits the solicitation, submission, and evaluation of bids; if the award can be made on the basis of price and other price-related factors; if it is not necessary to conduct discussions with the prospective vendors; and, if 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:

- ◊ The USG solicits competitive proposals
- ◊ Offerors prepare and submit proposals
- ◊ A competitive range determination is made by the USG to decide with which offerors 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 all federal contracting opportunities valued over $25,000 from a single web site at: https://www.fbo.gov. FMS requirements are also advertised on this website for interested vendors.

### 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

The decision concerning the type of contract to use in an FMS procurement is an internal USG decision. The USG will select the contract type for FMS in the same manner that it selects contract types for itself. Often, the USG will combine its own requirements with FMS requirements on a single contract. Although the USG will select the type of contract used to procure for FMS, the contract type may impact the customer 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. As a result, the type of contract can ultimately impact how long it will take to close the FMS case. More information on FMS case closure is contained in chapter 12 of this textbook, "Financial Management."

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.

### 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 following final delivery.

### Cost-Reimbursement

Cost-reimbursement contracts pay the contractor all incurred costs determined to be allowable 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 on the basis of 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.

## 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 DOD uses in contracting for itself. As may be expected, there are a few peculiarities associated with FMS contracts. The DFARS contains a special subpart that addresses these peculiarities. This subpart is DFARS 225.7300, "Acquisitions for Foreign Military Sales."

### Foreign Military Sales Solicitation and Contract Marking

DFARS states that all solicitations to industry for FMS requirements should separately identify the requirement as being for FMS and also indicate the specific FMS customer. 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 be marked "FMS Requirement" and are to include the FMS case identifier code.

### 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 CO. 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 CO 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 problems arising when the LOA is implemented for procurement can be identified and minimized through close coordination between the CM and the CO. The DFARS states that the role of the CO is to assist the FMS CM by:

- Assisting in preparing the price and availability (P&A) data
- Identifying and explaining all unusual contractual requirements or requests for deviations
- Reviewing sales commissions and other unique fees
- 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:

- 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
- 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 customer 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.

## Sales Commissions

Sales commissions, 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 customer 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 sales commissions 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 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 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.

SAMM C6.3.7.4 states all LOAs which include contingent fees (regardless of value of the case) and all correspondence with a purchaser on the subject of 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.

## Foreign Military Sales Customer Involvement in Contracting

The FMS process primarily involves the foreign customer 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 foreign purchaser involvement. The SAMM, section C6.3.5, states that sufficient details should be included in the LOA to allow the US CO 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 FMS customer involvement in the DOD contracting process, policy in both the SAMM and the DFARS does permit FMS customers to participate in certain elements of the contracting process. This policy supports the overarching intent for the FMS process to provide transparency to international customers. Unfortunately, there can be confusion on the part of employees within the DOD acquisition infrastructure (as well as by international purchasers) regarding the extent of FMS customer participation in the DOD contracting process. To highlight this issue, the DSCA Director issued policy memorandum 09-60 (see attachment 1) that elaborates on the DFARS provisions for customer participation. This memorandum states that many FMS customers with an interest in participation believe they are being summarily shut out of the contracting process, and as a remedy to this perception, it encourages the DOD acquisition community to follow the provisions of DFARS 225.7304 by actively seeking opportunities for customer participation. Additionally, the Director of Defense Procurement and Acquisition Policy (USD/AT&L/DPAP) issued a memorandum (see attachment 2) to the DOD acquisition community reiterating the importance of accommodating FMS customer involvement in acquisition programs. If an FMS customer 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 customer participation.

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

***Source Selection***

Competitive contract awards are the default procurement method for FMS. As discussed above, the FMS process does provide an option whereby the customer 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 request. Unless the customer submits an other than full and open competition request, the customer cannot provide direction regarding source selection decisions. LOA standard term and condition 1.2 states, "The Purchaser 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 FMS purchaser is not permitted to interfere with a prime contractor's placement of subcontracts or to direct the USG to exclude certain vendors from participating in an FMS competitive source selection. Customers may suggest that certain additional firms be considered because this has the effect of increasing competition [see SAMM, section C6.3.5.1 and DFARS, 225.7304].

***Contract Discussions***

Although the USG should be able to accomplish contracting actions without FMS purchaser involvement, the SAMM C6.3.5.2 states that the CO should consult with the FMS purchaser on any matter that could be perceived as inconsistent with or significantly different from the LOA. Per DFARS 225.7304, FMS purchasers 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 FMS purchaser. Additionally, customers may participate in reviewing varying alternatives, quantities, and options needed to make price-performance trade-offs. The degree of participation of the FMS purchaser during contract negotiations is left to the discretion of the CO after consultation with the contractor. USG personnel are not permitted to release any contractor proprietary data unless approved by the contractor. FMS customer participation may be limited in situations where the contract includes requirements for more than one FMS customer, the contract includes unique US requirements, or negotiations involve contractor proprietary data.

***Contract Negotiations***

One area specifically excluded from customer participation is that of negotiations involving cost or price data [DFARS, 225.7304(e.3)]. Under FMS, the foreign purchaser 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 Purchaser agrees that the US 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 FMS customer 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. Per the DFARS 225.7304(e)(3), the FMS customer is not permitted to observe or participate in cost or pricing negotiations between the USG and the contractor unless a deviation is granted. 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 foreign purchaser. As noted in the SAMM, section C6.3.6.2, all pertinent information and contractual obligations between the USG and the foreign purchaser are identified in the LOA. Consequently, there should normally be no need to provide a copy of the contract to the foreign purchaser. 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. 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 CO is ready to accept a contract offer, section A further serves as a contract instrument that the CO can also sign to award the contract. In summary, section A provides the key 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 CO).

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 COs 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 010303 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 FMS customer in the quarterly FMS billing statement. In order to facilitate proper FMS billing, financial reconciliation, and eventual FMS case closure, it is important that COs 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 CO can provide any description or specifications needed to elaborate on the section B information. This section is particularly important when services are being purchased; 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. The 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 and Defense Transportation Regulation chapter 208. See chapter 10 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 DOD will apply the same quality, audit and inspection procedures for FMS procurements as it applies for internal DOD or US military procurements. Also, LOA standard term and condition 5.1 states that the title to FMS materiel transfers at the initial shipping point. DOD will perform inspections according to the requirements in this section of the contract. If the material 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 FMS customer's unique delivery requirements will apply. Delivery information for data is identified on the DD Form 1423 (Contract Data Requirements List—CDRL) and included in the contract.

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); paying office, 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 through the use of 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 CO 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 CO 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 CO 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 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) located at 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 physically located near or at the contractor's facility.

Within DOD, the Defense Contract Management Agency (DCMA) is 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 customer needs. After contract award, DCMA monitors contractor performance and management to ensure that cost, product performance, and delivery schedules are in compliance with 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.dcma.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 web site: http://www.dcaa.mil/.

**Foreign Military Sales Contract Administration**

Contract administration is an integral part of the FMS process. The customer is entitled to this service as part of the FMS purchase. LOA standard term and condition 1.2 states, "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."

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

- Contract administration
- Quality assurance
- Contract audit

When contract administration is performed outside of the US, a fourth CAS fee component 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 US without charge. The SAMM, tables C9.T5, C9.T6, and C9.T7 identify countries, programs, and organizations that have reciprocal CAS agreements with the US. 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 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 material which subsequently transfers to the FMS purchaser 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, "Materiel Inspection and Receiving Report" (see Figure 9-1), 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

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, 90 percent for small businesses, and 95 percent for small disadvantaged 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 FMS customer'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 FMS customer's expectations are based on the LOA. If deviations from the LOA estimates become apparent during contract performance, the customer should be notified and an LOA amendment or modification issued. Early notification to the customer is important to permit the customer 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 FMS customer. 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 US for LOA payments from the FMS customer. Unfortunately, the customer's budget was already established to support the original estimate of payments, and this early delivery decision caused significant problems for the FMS customer.

### Contract Administration of Direct Commercial Sales

Eligible governments purchasing US goods and services via direct commercial sale (DCS) may request DCMA offices and the DCAA auditors to provide contract administration and contract audit functions. To do this, the foreign customer 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 foreign purchaser 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 a foreign customer's request for services that are applicable to a specific contract.

## Offsets

An offset is a package of additional benefits that the seller agrees to provide 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 purchasers. 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."

**Figure 9-1**
**DD Form 250 Material Inspection and Receiving Report**

**MATERIAL INSPECTION AND RECEIVING REPORT**

*Form Approved*
*OMB No. 0704-0248*

The public reporting burden for this collection of information is estimated to average 30 minutes per response, including the time for reviewing instructions, searching existing data sources, gathering and maintaining the data needed, and completing and reviewing the collection of information. Send comments regarding this burden estimate or any other aspect of this collection of information, including suggestions for reducing the burden, to Department of Defense, Washington Headquarters Services, Directorate for Information Operations and Reports (0704-0248), 1215 Jefferson Davis Highway, Suite 1204, Arlington, VA 22202-4302. Respondents should be aware that notwithstanding any other provision of law, no person shall be subject to any penalty for failing to comply with a collection of information if it does not display a currently valid OMB control number.

**PLEASE DO NOT RETURN YOUR COMPLETED FORM TO THE ABOVE ADDRESS.**
**SEND THIS FORM IN ACCORDANCE WITH THE INSTRUCTIONS CONTAINED IN THE DFARS, APPENDIX F-401.**

| 1. PROCUREMENT INSTRUMENT IDENTIFICATION (CONTRACT) NO. | ORDER NO. | 6. INVOICE NO./DATE | 7. PAGE | OF | 8. ACCEPTANCE POINT |
|---|---|---|---|---|---|
| | | | | | |

| 2. SHIPMENT NO. | 3. DATE SHIPPED | 4. B/L TCN | 5. DISCOUNT TERMS |
|---|---|---|---|
| | | | |

| 9. PRIME CONTRACTOR CODE | 10. ADMINISTERED BY CODE |
|---|---|
| | |

| 11. SHIPPED FROM *(If other than 9)* CODE | FOB: | 12. PAYMENT WILL BE MADE BY CODE |
|---|---|---|
| | | |

| 13. SHIPPED TO CODE | 14. MARKED FOR CODE |
|---|---|
| | |

| 15. ITEM NO. | 16. STOCK/PART NO. DESCRIPTION *(Indicate number of shipping containers - type of container - container number.)* | 17. QUANTITY SHIP/REC'D* | 18. UNIT | 19. UNIT PRICE | 20. AMOUNT |
|---|---|---|---|---|---|
| | | | | | |

**21. CONTRACT QUALITY ASSURANCE**

**a. ORIGIN**

☐ CQA ☐ ACCEPTANCE of listed items has been made by me or under my supervision and they conform to contract, except as noted herein or on supporting documents.

DATE SIGNATURE OF AUTHORIZED GOVERNMENT REPRESENTATIVE

TYPED NAME:

TITLE:

MAILING ADDRESS:

COMMERCIAL TELEPHONE NUMBER:

**b. DESTINATION**

☐ CQA ☐ ACCEPTANCE of listed items has been made by me or under my supervision and they conform to contract, except as noted herein or on supporting documents.

DATE SIGNATURE OF AUTHORIZED GOVERNMENT REPRESENTATIVE

TYPED NAME:

TITLE:

MAILING ADDRESS:

COMMERCIAL TELEPHONE NUMBER:

**22. RECEIVER'S USE**

Quantities shown in column 17 were received in apparent good condition except as noted.

DATE RECEIVED SIGNATURE OF AUTHORIZED GOVERNMENT REPRESENTATIVE

TYPED NAME:

TITLE:

MAILING ADDRESS:

COMMERCIAL TELEPHONE NUMBER:

** If quantity received by the Government is the same as quantity shipped, indicate by (X) mark; if different, enter actual quantity received below quantity shipped and encircle.*

**23. CONTRACTOR USE ONLY**

**DD FORM 250, AUG 2000** PREVIOUS EDITION IS OBSOLETE.

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 is a form of compensation provided to a purchaser that involves goods directly related to the item being purchased. As an example, a US contractor may agree to permit the purchaser to produce certain components or sub-assemblies of the weapon system in-country.

An indirect offset is a form of compensation provided to a purchaser that involves goods which are unrelated to the item being purchased. For example, a contractor may agree to purchase, usually for resale, certain manufactured products, agricultural commodities, raw materials, or services produced by the customer country.

**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 US domestic industries. These concerns include the impact of these trade practices on American jobs, the US balance of payments, technology transfer, and the long term consequences for the US 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 US trade. The Secretary of Commerce prepares the report in consultation with the Secretaries of Defense, Treasury, and State, and the US trade representative. A link to this annual offset report to Congress is included in the references section of this chapter.

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.

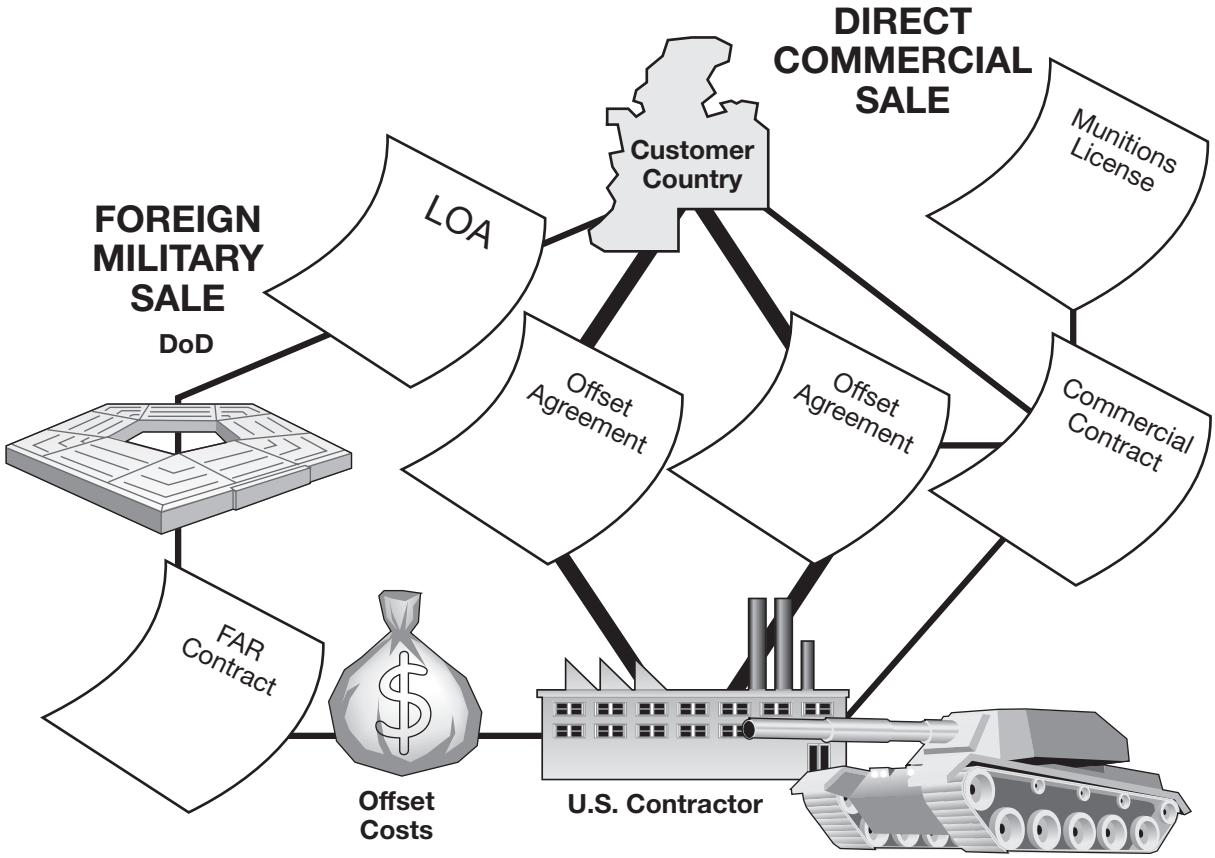
**United States Government Offset Policy**

Offsets are permissible under FMS. However, it must be emphasized that the offset agreement is between the purchasing country and the US contractor. The USG is not a party to the agreement and does not retain any obligation to enforce the contractor's performance of the agreement. Figure 9-2 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 purchasers. If the USG prohibited offsets under FMS, US 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. The key provisions of the policy on offsets are:

- No USG agency shall encourage, enter directly into, or commit US firms to any offset arrangement related to the sale of US defense articles or services
- USG funds shall not be used to finance offsets
- Negotiations or decisions regarding offset commitments reside with the companies involved
- Exceptions require Presidential approval through the National Security Council (NSC)

**Figure 9-2**
**Offset Relationships**




**Offset Costs**

When a customer requires an offset in association with a major procurement, do they actually obtain the offset benefit 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 US firms to successfully compete for international business and permits offset arrangements as a legal business activity. Likewise, the USG wants international customers to have the option to purchase military systems using either the FMS process or the DCS process. Under FMS, the contractor is actually working directly for

DOD, but the USG permits this same contractor to concurrently enter into an offset agreement directly with the FMS purchaser. Although DOD is clearly not a 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 the DFARS considers as allowable. Contractors are permitted to build the cost of performing the offset into the contract price it charges 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 customer 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.

The additional cost to perform the offset generally results in a higher contract cost which, in turn, results in a higher FMS cost under the LOA. Although not a party to the offset agreement, the USG serves as the banker for the offset. Although the DFARS 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 CO to review and determine that the contract costs, to include offset costs claimed by the contractor, are both allocable and reasonable. A recent change to DFARS 225.7303-2 directs that all indirect offset costs are to be deemed reasonable with no further analysis necessary by the CO if the contractor provides the CO a signed offset agreement or other documentation showing that the FMS customer made the indirect offset of a certain dollar value a condition of the FMS acquisition. LOA standard term and condition 2.8 reflects this change by referring to the DFARS but does not make specific reference itself to indirect offsets.

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 customer 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 US contractor. However, the fact that offset costs have been included in the P&A or LOA price estimates 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 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.

> The USG is not a party to any offset agreements/arrangements which may be required by the Purchaser 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. To the extent that the Purchaser requires offsets in conjunction with this sale, offset costs may be included in the price of contracts negotiated under this LOA. Such costs shall be determined or deemed to be reasonable in accordance with SUBPART 225.73 of the Defense Federal Acquisition Regulation Supplement (DFARS). If the Purchaser desires visibility into these costs, the Purchaser should raise this with the contractor during negotiation of offset arrangements.

## Summary

The fundamental principle regarding contracting for FMS requirements is that the USG essentially treats the FMS customer'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 customers 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 FMS customer 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 FMS customers 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 normal DOD business.

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

## References


DSCA Manual 5105.38-M, *Security Assistance Management Manual* (SAMM), chapters 3, 5, 6, and 9. http://www.samm.dsca.mil/.

*Federal Acquisition Regulation* (FAR), parts 6, 14, 15, 16, 25, and 31. https://www.acquisition.gov/Far/.

*Defense Federal Acquisition Regulation Supplement* (DFARS), part 225, Foreign Acquisition. http://www.acq.osd.mil/dpap/dars/dfars/html/current/tochtml.htm.

Department of Commerce. *Offsets in Defense Trade*, Eighteenth Report to Congress. https://www.bis.doc.gov/index.php/other-areas/strategic-industries-and-economic-security-sies/offsets-in-defense-trade.

## Attachment 9-1
## DSCA Policy Memorandum 09-60, dated 22 December 2009

DEFENSE SECURITY COOPERATION AGENCY
201 12TH STREET SOUTH, STE 203
ARLINGTON, VA 22202-5408

DEC 2 2 2009

MEMORANDUM FOR DEPUTY UNDER SECRETARY OF THE AIR FORCE INTERNATIONAL AFFAIRS
DEPUTY ASSISTANT SECRETARY OF THE ARMY FOR DEFENSE EXPORTS AND COOPERATION
DEPUTY ASSISTANT SECRETARY OF THE NAVY FOR INTERNATIONAL PROGRAMS
DIRECTOR, DEFENSE CONTRACT MANAGEMENT AGENCY
DIRECTOR FOR SECURITY ASSISTANCE, DEFENSE FINANCE AND ACCOUNTING SERVICE – INDIANAPOLIS OPERATIONS
DIRECTOR, DEFENSE INFORMATION SYSTEMS AGENCY
DIRECTOR, DEFENSE LOGISTIC AGENCY
DIRECTOR, DEFENSE INFORMATION SERVICE
DIRECTOR, DEFENSE REUTILIZATION AND MARKETING SERVICE
DIRECTOR, DEFENSE THREAT REDUCTION AGENCY
DIRECTOR, NATIONAL GEOSPATIAL-INTELLIGENCE AGENCY
DEPUTY DIRECTOR FOR INFORMATION ASSURANCE, NATIONAL SECURITY AGENCY

SUBJECT: Foreign Military Sales (FMS) Customer Participation in the DoD Contracting Process, DSCA Policy 09-60

In 2002, the Security Cooperation Community led the effort for customer participation and acquisition transparency in DoD contracts awarded on behalf of Foreign Military Sales (FMS) customers. We successfully sponsored the November 22, 2002, Defense Federal Acquisition Regulation Supplement (DFARS) amendment that provided authorization for FMS customers to participate in specifications development, delivery schedule development, identification of warranties, and other contractual requirements unique to the customer.

The DFARS change encourages customer participation in both the acquisition process and discussions with industry. Customers also are allowed to participate in the contract negotiation process within the limitations of the section, to the degree authorized

by the contracting officer (CO). The section specifically protects against unauthorized release of proprietary data and improper influence on the contracting process.

Transparency and cooperation build customer confidence and teamwork. Early dialog with customers on specifications, schedules, and unique requirements, strengthens acquisition planning and provides specificity for scope development. Frank discussion of alternatives and options increases customer confidence in the decision process. Responsible inclusion in negotiations invests our customers with a sense of ownership of the process.

The DFARS empowers the CO to determine the degree of customer participation in the acquisition process. Further it requires the CO to provide the customer an explanation if, and how, its participation will be limited.

We have customers who are interested in actively participating in FMS acquisitions, but believe they are being summarily shut out of the process. I request that you encourage each of your acquisition communities to take up the spirit of DFARS 225.7304 and actively seek opportunities for customer participation in DoD acquisitions for FMS.

**Jeffrey A. Wieringa**
**Vice Admiral, USN**
**Director**

cc:
STATE/PM-RSAT
AFRICOM
CENTCOM
EUCOM
JFCOM
NORTHCOM
PACOM
SOCOM
SOUTHCOM
TRANSCOM
USASAC
SATFA TRADOC
NAVICP
NETSAFA
AFSAC
AFSAT
DISAM

## Attachment 9-2
## OUSD AT&L/DPAP Memorandum, dated 21 July 2011

OFFICE OF THE UNDER SECRETARY OF DEFENSE
3000 DEFENSE PENTAGON
WASHINGTON, DC 20301-3000

ACQUISITION, TECHNOLOGY AND LOGISTICS

JUL 21 2011

MEMORANDUM FOR COMMANDER, UNITED STATES SPECIAL OPERATIONS COMMAND (ATTN: ACQUISITION EXECUTIVE)
COMMANDER, UNITED STATES TRANSPORTATION COMMAND (ATTN: ACQUISITION EXECUTIVE)
DEPUTY ASSISTANT SECRETARY OF THE ARMY (PROCUREMENT)
DEPUTY ASSISTANT SECRETARY OF THE NAVY (ACQUISITION AND PROCUREMENT)
DEPUTY ASSISTANT SECRETARY OF THE AIR FORCE (CONTRACTING)
DIRECTORS OF THE DEFENSE AGENCIES
DIRECTORS OF THE DOD FIELD ACTIVITIES

SUBJECT: Customer Involvement in Foreign Military Sales (FMS) Acquisitions

The Foreign Military Sales (FMS) Program is authorized under the Foreign Assistance Act of 1961 and the Arms Export Control Act as an instrument of United States foreign policy to provide defense articles and defense services to friendly countries and international organizations in order to deter and defend against aggression, facilitate common defense, and strengthen the security of the United States.

In November 2002, the Defense Federal Acquisition Regulation Supplement (DFARS) was amended at Subpart 225.7304 to provide authorization for FMS customers to participate with U.S. Government acquisition personnel in discussions with industry to develop technical specifications, establish delivery schedules, identify any special warranty provisions or other requirements unique to the FMS customer, and review prices of varying alternatives, quantities, and options needed to make price-performance tradeoffs.

Many FMS customers have voiced interest in actively participating in FMS acquisitions. I ask that you seek opportunities to enhance FMS customer involvement in your acquisition programs in order to foster better understanding, strengthen alliances, provide transparency, and build customer confidence and teamwork.

Should you have additional questions on this policy, please contact Mr. Jeff Grover at 703-697-9352 or e-mail address jeffrey.grover@osd.mil.

Richard Ginman
Director, Defense Procurement
and Acquisition Policy