
Foreign Military Sales Offsets and Other Issues Affecting Foreign Military Sales Procurements

[The following information is provided courtesy of the Defense Procurement and Acquisition Policy web site: www.acq.osd.mil.]

What is a foreign military sales offset?

“Offset” means the entire range of industrial and commercial benefits provided to foreign governments as an inducement or condition to purchase military goods or services, including benefits such as co-production, licensed production, subcontracting, technology transfer, in-country procurement, marketing and financial assistance, and joint ventures (*Defense Offsets Disclosure Act of 1999*, PL 106-113, section 1243(3)). There are two types of offsets: direct offsets and indirect offsets.

“Direct offset” is a form of compensation to a purchaser involving goods or services that are directly related to the item being purchased. For example, as a condition of a United States sale, the contractor may agree to permit the purchaser to produce in its country certain components or subsystems of the item being sold. Normally, direct offsets must be performed within a specified period.

“Indirect offset” is a form of compensation to a purchaser involving goods or services that are unrelated to the item being purchased. For example, as a condition of a sale, the contractor may agree to purchase certain of the customer’s manufactured products, agricultural commodities, raw materials, or services. Indirect offsets may be accomplished over an expected, open-ended period of time.

“Offset costs” are compensation practices required as a condition of purchase in either government-to-government or commercial sales of defense articles and/or defense services as defined by the *Arms Export Control Act* and the *International Traffic in Arms Regulations*.

“Offset Agreement” is any offset as defined above that the United States firm agrees to in order to conclude a military export sales contract. This includes all offsets whether they are “best effort” agreements or are subject to penalty clauses.

What is Department of Defense’s general position on offsets in foreign military sales acquisitions?

The general policy of the Department of Defense (DOD) with regard to offsets is that they are market distorting and inefficient. In accordance with an April 16th, 1990, Presidential Policy statement, the decision whether to engage in offsets, and the responsibility for negotiating and implementing offset agreements, resides with the companies involved. The Presidential Policy mandates that “no agency of the United States Government shall encourage, enter directly into, or commit United States firms to any offset arrangement in connection with the sale of defense goods or services for foreign governments.” In compliance with this Presidential Policy, DOD has implemented a “hands off” approach to offsets. *Defense Federal Acquisition Regulation Supplement* (DFARS) 225.7303-2(3)(ii) states that the United States Government assumes no obligation to satisfy or administer the offset requirement or to bear any of the associated costs. This “hands off” approach also extends to a policy of providing no involvement with the negotiation of the offset agreement itself between the company and the foreign military sales (FMS) customer and no role in judging

the merits of these agreements. In addition, the Letter of Offer and Acceptance (LOA) between the United States Government and the FMS customer and the contract associated with that LOA (between the United States Government and the contractor) do not include any of the terms of the offset agreement (such as the delivery schedule, acceptance criteria, etc.) even though the LOA and the contract may include costs associated with the offset. If the FMS customer and the contractor have signed a separate agreement, it remains distinct and independent of the LOA and the contract. This holds true regardless of whether the FMS requirement is purchased on a competitive or sole source basis.

What is the policy on pricing offset costs into our foreign military sales contracts? Is it limited to administrative costs only?

No, we are not limited to including only administrative costs when pricing offsets. Some historical perspective may help to explain why. On 31 May 1995, the Director of Defense Procurement and Acquisition Policy issued a memo clarifying that United States contractors may recover the full cost necessary to implement an offset agreement in connection with FMS purchases. Prior to this, the DFARS language had limited recovery by a United States contractor to the “administrative costs to administer specific requirements of its offset agreement.” The 1995 policy change was deemed necessary because defense companies doing business with FMS countries had the choice of either absorbing the costs for offsets demanded by the countries in return for buying United States defense systems or passing them on to all customers, including DOD, in the form of indirect costs. The United States Government’s position is that the United States taxpayer should not pay any offset costs in connection with a foreign military sale. The new guidance attempted to clarify and broaden what offset costs the contracting officer can allow the contractor to recover from the FMS customer under our foreign military sales contracts and proposed them as direct costs to the FMS customer.

On 13 July 1999, the Director of Defense Procurement and Acquisition Policy signed a subsequent memorandum which clarified the treatment of offset costs. This memo replaced the term “offset implementation costs” with the term “offset costs.” Language was changed in DFARS 225.7303-2(a)(3) as follows:

- A United States defense contractor may recover all costs incurred for offset agreements with a foreign government or international organization if the LOA is financed wholly with customer cash or repayable foreign military finance credits.
- The United States Government assumes no obligation to satisfy or administer the offset requirement or to bear any of the associated costs.

If the LOA is financed with funds made available on a non-repayable basis, a United States defense contractor may not recover costs incurred for offset agreements with a foreign government or international organization.

When the LOA is being written, estimated offset costs are included, if known, in the line item price for the required contracted item. After the LOA is signed and prior to contract signature, the contracting officer (CO) must determine whether the proposed offset costs are allowable and allocable. Often, in a sole source procurement, this means that the CO, in conjunction with the auditor, will need to review the offset agreement. The contractor must make the offset agreement available to the CO upon request when it is needed to evaluate the allowability, allocability, and reasonableness of proposed offset costs.

DOD 5105.38-M, the *Security Assistance Management Manual* (SAMM), is the guidance covering FMS for DOD. Chapter 6, paragraph C6.3.9 of the SAMM also explains this policy for defense contractors' recovery of offset costs.

Can I segregate the costs of the offset as a separate contract line item in the contract?

No. The general policy of the United States Government with regard to offsets is that the contracting officer (and all United States Government personnel) cannot disclose the amount of the offset costs to the foreign government. This policy is based on the fact that:

- Foreign governments as a rule do not want offset costs isolated/highlighted
- United States defense contractors do not want to have the offset costs disclosed because they are concerned that the foreign government may refuse to pay for them

DOD policy, reflected in the *Security Assistance Management Manual* (SAMM) paragraph C6.3.9, requires that offset costs be included within the line item value of the required contracted item on the LOA. The line item containing the offset costs is usually the first major fixed-price type line item in the LOA for the primary defense system being procured. This holds true for the resultant contract as well. In the contract, offset costs should be accumulated, priced, and paid against a single Contract Line Item Number (CLIN) for the FMS customer's deliverable item. In a competitive environment, the contractor must propose any offset costs as part of his proposed contract line item pricing, usually the largest fixed price CLIN for the deliverable end items. Cost and price visibility into the break-out of offset costs is not possible or necessary in a competitive procurement. In a sole source situation, the basis for the offset costs must be disclosed in accordance with the Federal Acquisition Regulation's (FAR's) cost principles. But the sole source negotiated FMS contract must not segregate the offset costs.

What if the contractor can not or will not provide the detailed cost estimate of the offsets to enable me to evaluate the pricing? Can I set the amount aside as an unpriced action to be definitized later?

If the contractor is unwilling or unable to document the offset costs, then the contracting officer cannot allow the offset costs to be charged to the contract. Sooner or later, the contractor must provide a detailed cost estimate for the offset costs for which it wants to be paid. Getting this settled up front in the basic contract is the best approach. Setting aside the amount for the unpriced offset costs would in effect be segregating the costs, which is counter to the SAMM paragraph C6.3.9. guidance. There are several approaches the contracting officer can take in this situation.

One approach would be to figure the offset cost as a percentage of the contract and roll that dollar amount up into the total estimated price of the item associated with the FMS requirement. In using this approach, the contracting officer will likely have to work closely with the contractor to derive an appropriate percentage. However, the contracting officer shall only authorize reimbursement for actual offset costs incurred by the contractor.

Another approach would be to hold back the amount until the contractor can provide the cost proposal information for your analysis. This approach would not hold up the FMS procurement and would put additional pressure on the contractor to provide you the support you need. You will need to take care when adding this amount to the contract, however, not to highlight the amount as being an offset cost, but attempt to work it into other modification actions required on the contract. Your

contracting officer's background documentation can clearly identify the offset cost and the full cost analysis justifying it, but the contract itself cannot.

As the Contracting Officer tasked with negotiating an FMS contract that will include offset costs, am I entitled to see a copy of the offset agreement between the contractor and the FMS customer? Based on what?

Yes, you are entitled to see a copy of the offset agreement if the contractor is proposing costs associated with fulfillment of that agreement. After the LOA is signed and prior to contract signature, the CO must determine whether the proposed offset costs are allowable and allocable. This means that the CO, in conjunction with the auditor, must review the offset agreement and the contractor must make the offset agreement available to the CO upon request. This is based on the fact that the contractor is proposing costs for the CO to review and, in effect, is requesting you to price the offset in accordance with the cost principles in FAR Part 31. Specifically, FAR 31.201-4 provides that a cost is allocable if it is assignable or chargeable to one or more cost objectives on the basis of relative benefits received or other equitable relationship. Subject to the foregoing, a cost is allocable to a government contract if it:

- Is incurred specifically for the contract
- Benefits both the contract and other work and can be distributed to them in reasonable proportion to the benefits received
- Is necessary to the overall operation of the business, although a direct relationship to any particular cost objective cannot be shown

Without understanding the scope and terms of the offset agreement, the contracting officer will not be able to ascertain the acceptability of the costs pursuant to the regulations and therefore will not be able to include those costs in the contract price. The onus is on the contractor to provide the agreement and any detailed justification for the costs to satisfy the CO that meet the FAR criteria for allocability, allowability, and reasonableness.

Can there be just one offset agreement if the United States Government is systems integrator for an foreign military sale?

Sometimes the United States Government may act as a systems integrator for an FMS. For example, a United States contractor may sell a weapons platform (such as an aircraft) to a foreign government via an FMS and another United States contractor (or a separate corporate entity of the weapons platform manufacturer) will sell the platform's armaments under a separate FMS contract. If the foreign government requires a written offset agreement as a condition of buying the weapons platform and the armaments and insists there be only one offset agreement (i.e., an offset agreement with the weapons platform manufacturer), it is appropriate for the contractor selling the weapons platform (e.g., the aircraft) to enter into a written offset agreement with the foreign government that specifically mentions the armaments contractor(s). This arrangement should be recognized by the United States Government in the LOA if:

- The platform contractor's offset agreement expressly states that one or more identified armaments contractors may perform part of the offset obligation
- There is no written offset agreement between the foreign government and the armaments contractor(s)

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- The weapons platform contractor and the armaments contractor(s) enter into written agreement(s) pursuant to which the contractor(s) selling the armaments agrees to perform part of the offset agreement required by the foreign government
 - The weapons platform contractor does not pay or reimburse the offset costs incurred by the armaments contractor(s) and the armaments contractor has no contractual right to recover its incurred costs from the weapons platform contractor;
 - The claimed offset costs are allowable under FAR Parts 15 and 31
 - The weapons platform contractor and the armaments contractor(s) submit to the United States Government certifications and, if requested, satisfactory evidence that they are not both charging for the same offset costs

If offset costs are included in the price of a CLIN in the foreign military sales contract, who is responsible for determining the delivery or completion of the offset arrangement? Who enforces the offset agreement?

The FMS customer is responsible for administering and enforcing the offset agreement. The FMS customer and the contractor have both signed a separate offset agreement which remains distinct and independent of the LOA and the contract. The LOA and the contract associated with the LOA do not include any of the terms of the offset agreement (such as the delivery schedule, acceptance criteria, etc.) even though the LOA and the contract may include costs associated with the offset. If the contractor does not perform the offset requirement in accordance with the terms of the offset agreement, it is the FMS customer's responsibility to enforce it. DOD must not get involved. In accordance with a 16 April 1990 Presidential Policy statement, the decision whether to engage in offsets, and the responsibility for negotiating and implementing offset arrangements, resides with the companies involved. DFARS 225.7303-2(3)(ii) states that the United States Government assumes no obligation to satisfy or administer the offset requirement or to bear any of the associated costs. This is true for both competitive and sole source FMS procurements.

I understand that I should not ask for cost and pricing data if the FMS customer already conducted a competition. If the FMS customer conducted that competition for an all-up complete weapon system (including airplane, radar, missiles, etc.) among a variety of available systems, can I rely on the result for pricing just one of the components, say the missiles alone?

To the extent that the CO concludes that the price for the missiles was a part of the original price competition for the whole program and price was a source selection factor, then no cost or pricing data should be obtained in accordance with DFARS 225.7303(b). The DFARS language is based on a *July 13, 1999 Director, Defense Procurement and Acquisition Policy* memo. In competitive procurements, where adequate price competition has occurred, submission of certified cost or pricing data shall not be required, pursuant to the above 13 July 1999 memo from the *Director of Defense Procurement and Acquisition Policy* and reiterated in a USD(AT&L) (Under Secretary of Defense for Acquisition, Technology, and Logistics) memo of 27 September 2000 from Under Secretary Gansler. This clarification of policy does not waive the requirements of the other parts of the FAR to obtain a fair and reasonable price, to obtain enough information to make that assessment, and to recognize allocable and allowable costs. When pricing sole source contracts, the costs should be treated as any other cost and must be allowable, allocable, and reasonable.

The FMS customer has asked to participate in technical fact-finding and cost negotiations. What is the Department of Defense policy on this?

DFARS 225.7304, “FMS Customer Involvement,” provides the DOD policy. Subparagraph (b) states that FMS customers are encouraged to participate with United States Government acquisition personnel:

- In discussions with industry to develop technical specifications
- Establish delivery schedules
- Identify any special warranty provisions or other unique requirements of the FMS customer
- Review prices of varying alternatives, quantities, and options needed to make price-performance tradeoffs

Subparagraph (d) states, however, that the degree of FMS customer participation in contract negotiations is left to the discretion of the contracting officer after consultation with the contractor. Contracting officers must provide an explanation to the FMS customer if its participation in negotiations will be limited. As always, care must be taken to properly protect contractor proprietary data; so unless the contractor authorizes its release, the contracting officer must protect it (see DFARS 225.7303(c)). This DFARS policy stemmed from a Deputy Secretary of Defense memo dated 9 January 2002, signed by Paul Wolfowitz. The memo states that:

During the contracting process between the contractor and the DOD, the contracting officer shall consult with the FMS customer about major contractual matters, especially any matter that could be perceived as being inconsistent with or significantly different from the LOA. FMS customers are not allowed to observe negotiations involving cost or pricing data unless a deviation is granted in accordance with the DFARS subpart 201.4. FMS customers will be allowed to participate in discussions regarding technical specifications, price performance trade-off decisions, delivery schedules, special warranty provisions, and other requirements unique to the FMS customer. The degree of participation of the FMS customer during contract formation is left to the discretion of the contracting officer after consultation with the contractor. United States Government personnel shall not release any contractor proprietary data except in those limited cases where the contractor authorizes release of specific data. If an FMS customer requests additional information concerning FMS contract prices, the contracting officer shall, after consultations with the contractor, provide sufficient information to demonstrate the reasonableness of the price and reasonable responses to relevant questions concerning contract price. This may include tailored responses, top level pricing summaries, historical prices, or an explanation of any significant initial LOA price.

What considerations bear on a decision to add incentives to an foreign military sales contract?

First, as in any DOD procurement, the customer’s needs and desires are paramount. Second, the risks associated with the contractor satisfying key contract requirements must be considered. Third, contracting officer must consider the value and benefit of these incentives from the customer’s perspective. For example, a schedule incentive might be advantageous if schedule is a risk consideration for the FMS customer. Alternatively, an early delivery is not desirable if the FMS customer will not have the infrastructure ready to accommodate the deliverable end items in advance or funds available/budgeted to cover them. Faster is not always better. The contracting officer should consult with the FMS case manager when structuring any incentives on FMS contracts to ensure the

customer's goals and objectives for the contract's deliverables are achieved. The FMS case manager will consult with the FMS customer on these issues. Keep in mind, however, that there should not be any incentives placed on offset requirements. In fact, the offset requirements themselves must not be identified in the contract or the LOA. The United States Government cannot get involved in any type of contract arrangements affecting offset agreements between foreign customers and defense contractors.

With performance-based contracts being the preferred arrangement for DOD service contracts, the contracting officer may want to negotiate performance incentive arrangements on the FMS contract. There are no unique rules which apply to FMS acquisitions regarding performance-based contracting or incentive contracting. The CO must consult with the FMS case manager to ensure that the FMS customer understands that funds will need to be available at a future date to cover any contingent liabilities associated with incentives provided for in the contract. Sometimes these events occur several years in the future, and the FMS customer needs to be aware and plan its fiscal requirements around when the incentive payments will be earned and awarded to the contractor. If the FMS customer indicates their budget will not accommodate these incentives, the contract should not include incentive arrangements. If incentives and their respective clauses are included, the FMS case manager may consider adding information into the FMS case (via an amendment or modification as appropriate) to make sure the customer agrees to these conditions.