
Contractor Recovery of Offset Administrative Costs

By

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Last year, the Defense Acquisition Regulations (DAR) Council issued an interim rule which revised the Defense Federal Acquisition Regulation Supplement (DFARS) to permit U.S. defense contractors to recover offset administrative costs under U.S. Government contracts for foreign military sales (FMS) requirements. The interim rule became effective on July 15, 1991, and became final on December 31, 1991. This new rule, which appears at DFARS Section 225.7303-2(a)(2)(iii), was the outgrowth of a recommendation made by the Defense Policy Advisory Committee on Trade (DPACT), a group of senior officers of U.S. defense industries who provide independent defense policy advice to the Secretary of Defense and the U.S. Trade Representative.

Offsets are the range of industrial or commercial compensation a defense industry offers to provide to a foreign government as an inducement to purchase the industry's defense articles and services.¹ Today, they are commonplace in the military export environment. Many foreign government purchasers routinely expect offsets to be part of a defense sales transaction. Consequently, offsets play an important role in influencing the purchaser's selection of a defense system. The foreign government often relies on the offset arrangement, and its promise of generating business for domestic industries, to quell the negative political connotations that are associated with government spending off-shore.

In response to the requirement of Section 825 of the National Defense Authorization Act, Fiscal Year 1989, (10 U.S.C. § 2505), President Bush issued his Policy on Offsets in Military Exports on April 16, 1990.² It clarified the role of the U.S. Government in offset arrangements. Based on the belief that offsets distort free market principles, and therefore are economically inefficient, the policy dictates that no U.S. Government agency may encourage, enter directly into, or commit U.S. industry to an offset arrangement in connection with the sale of defense articles or services to a foreign government. Accordingly, the decision whether to engage in offsets, and the responsibility for negotiating and implementing any arrangements therefor with a foreign government, rest entirely with industry.

Prior to the new DFARS rule, costs associated with the administration of offset agreements between industry and foreign governments were allowable costs under U.S. Government contracts. However, these costs were recoverable only when they were associated with a DoD-approved offset agreement. This occurrence, as one would suspect given U.S. offset policy, happened "very infrequently".³

¹ A thorough definition of the term "offset" as used in connection with defense trade is found in *Offsets in Military Exports*, April 16, 1990, pp. 7-9, a report prepared by the Office of Management and Budget pursuant to Section 309 of the Defense Production Act (50 U.S.C. § 2099).

² The Presidential Policy on Offsets in Military Exports was reprinted in *The DISAM Journal*, Summer, 1990, page 46.

³ 56 Fed. Reg. 34,031 (1991).

In accordance with the new rule and the Security Assistance Management Manual (SAMM),⁴ a defense contractor may recover costs incurred to implement specific requirements of an offset arrangement with a foreign government or international organization when the FMS Letter of Offer and Acceptance (LOA) contains the following note:

DoD policy authorizes administrative costs associated with the implementation of offset agreements between the U.S. contractor and foreign customer to be included in the price of the items offered in this LOA. The price of FMS contracts awarded in support of this LOA may include administrative costs associated with implementation of the customer's offset requirement from U.S. industry. DoD is not a party of such offset arrangements and assumes no obligation to satisfy the offset requirement or to bear any of the associated costs.

Further guidance on recovering offset administrative costs is found at SAMM Section 140107. The prospective U.S. contractor or subcontractor(s) for the item the foreign government has requested to purchase through FMS should inform the DoD contracting officer as early as possible of any anticipated offset administrative costs resulting from discussions with the foreign government concerning offset arrangements. This information on offset administrative costs will be included in the estimated unit price for the item in the LOA when the LOA is presented to the foreign government. The above note must appear in the LOA if estimated offset administrative costs are included in the LOA price. This means that a contractor's offset administrative costs are not allowable under the contract if the LOA does not contain the note, and the note or estimated offset costs may not be added to the LOA after DSAA countersignature.

The offset note may only appear in LOAs which are wholly funded by the foreign purchaser with cash or with Foreign Military Financing (FMF) repayable loans. In other words, no FMF grant funds may be used to finance an LOA in whole or in part that includes offset administrative costs.

Administrative costs arising from the contractor's offset arrangement with the foreign government, like other contractor costs, must be reasonable, allowable, and allocable. The DoD contracting officer, when considering the contractor's proposed offset administrative costs, should use the reasonableness, allowability, and allocability standards set forth in procurement regulations.

Some examples of offset administrative costs are given at DFARS Section 225.7303-2(a)(2)(iii)(C). They are:

- (1) In-house and/or purchased: organizational, administrative and technical support, including offset staffing; quality assurance, manufacturing, purchasing support; data acquisition; proposal, transaction and report preparation; broker/trading services; legal support; and similar support activities;
- (2) Off-shore operations for technical representative and consultant activities, office operations, customer and industry interface, capability surveys;
- (3) Marketing assistance and related technical assistance, transfer of technical information and related training;

⁴ DOD 5105.38-M, Section 70103.H.2.w.

(4) Employee travel and subsistence costs; and

(5) Taxes and duties.

Since it is DoD policy to provide a single unit price for an item offered under FMS,⁵ DoD personnel should not "break-out" (i.e., specify) for the foreign purchaser the offset administrative cost component of an LOA item's estimated price. Any foreign purchaser inquiries concerning costs of offset administration should be directed to the contractor.⁶

ABOUT THE AUTHOR

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⁵ SAMM, Section 130701.B.

⁶ SAMM, Section 140107.B.4.