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## A COMPARISON OF DIRECT COMMERCIAL SALES AND FOREIGN MILITARY SALES FOR THE ACQUISITION OF U.S. DEFENSE ARTICLES AND SERVICES

[The following is an extract of the general summary of a pamphlet, entitled as above, which has been prepared by the Defense Security Assistance Agency, and will soon be distributed throughout the security assistance community.]

### GENERAL SUMMARY OF MAJOR ISSUES

Unless an item or service is available only via FMS, there are few absolutes which dictate the selection by a foreign government of either FMS or commercial channels for any given requirement. Moreover, the selection of one system for a particular acquisition does not require the exclusive use of that same system for subsequent purchases. Rather, there are many considerations involved in such acquisition decisions which are unique to the individual purchaser, as well as to the articles being purchased. The final decision on procurement channels tends to vary from country to country, and even from purchase to purchase. From the foreign purchaser's perspective, the most important of these considerations are summarized below.

#### PURCHASER CAPABILITY TO NEGOTIATE A DIRECT CONTRACT WHICH WILL ASSURE TIMELY DELIVERY AT A FAIR PRICE

Under the FMS system, purchases for foreign governments are made by a well-established DOD contracting network. There is no foreign purchaser involvement in contract negotiations; the purchaser's responsibility is limited to agreeing to requirements and estimated costs as they are stated in USG Letters of Offer and Acceptance (LOAs). DOD is committed, in general, to the procurement of defense articles through the FMS system under the same contractual provisions used for its own procurements. For the contracting and administrative services provided by DOD, the foreign purchaser is charged an appropriate fee in the LOA, just as commercial contractors include appropriate General and Administrative (G&A) costs in their direct commercial contracts.

It is not necessary for a purchaser to duplicate fully the DOD contracting network in order to make a wise commercial purchase. However, the greater the experience and skill level of the purchaser's contracting staff, and the greater the level of competition the purchaser can generate, the more likely the purchaser is to obtain the best possible commercial transaction to meet his objectives.

The FMS system is based on the same competitive procurement philosophy as is the DOD system, which is designed to assure maximum quantity purchases at the lowest feasible price, from either the original item manufacturer or the prime weapons system contractor. This approach minimizes the price markup, thereby reducing the contract cost to the USG. Under the FMS system, the USG, in lieu of the purchaser, assumes primary responsibility for

acquiring items at the best possible price (quality and other factors considered), and for providing the essential contract administration. Often, FMS and DOD orders are consolidated to obtain economy-of-scale buys, and therefore, significantly lower unit prices.

In addition to accepting the management responsibility and associated management costs of direct commercial contracts, the ability of the purchaser to enter into favorable and successful competitive contracts for a given program is also greatly dependent on the scope and complexity of the program; i.e., the more contracts that have to be entered into, the larger and more skilled must be the purchaser's contracting staff. At one end of the spectrum of complexity is the procurement of a complete weapon system involving a great many end items, a multiplicity of components from numerous suppliers, support equipment, technical assistance, training, etc. At the other end of the spectrum is the procurement of an individual end item requiring little or no follow-on support or services. Such variables are considered automatically in the FMS system. They may also be addressed within a direct commercial contract for a total system purchase from a prime contractor which possesses the capacity to furnish such support.

#### LOGISTICS AND TRAINING SUPPORT NEEDS

An important consideration in the purchase of U.S. defense articles involves the nature of the follow-on support and training which will be required from U.S. sources. If the system or items being purchased are being used by the U.S. military, and are known to require substantial logistical, technical, and training support, an FMS purchase might prove the desired form of procurement, for it would permit the purchaser to capitalize on U.S. experience and existing USG logistics inventories and training facilities. Under a Cooperative Logistics Supply Support Arrangement (CLSSA), the entire DOD inventory and contracting systems can be drawn upon in support of the purchaser's requirements; and this can be accomplished simply by the submission of requisitions for individual parts. In effect, the DOD logistics structure serves as a procurement staff for the purchaser by procuring his required individual items from the current U.S. sources.

There are some U.S. contractors who also are capable of providing full logistics support for the items which they sell. Corporate reputations depend on good performance; and where contractors have the capability of furnishing such support, the results can be expected to be as stated in their contracts.

To the extent that an item provided directly by a contractor is standard and meets USG military specifications (MILSPEC), a CLSSA can be established via the FMS system. However, DOD has had mixed and sometimes unsatisfactory experience with the use of CLSSAs to support items which have been procured through commercial channels, because such items are often nonstandard or contain nonstandard components. Direct commercial sales are encouraged by DOD when the purchaser requires an item which is not supportable by the DOD logistics system, or when the item is not in the DOD inventory.

## DEGREE OF PURCHASER NEED AND DESIRE FOR THE INVOLVEMENT OF U.S. MILITARY PERSONNEL

The choice of FMS or direct commercial procurement channels by a foreign government is often conditioned by its judgement as to the degree of U.S. military advice and assistance which will be needed during the procurement planning phase. This judgement, in turn, depends primarily on the complexity of the defense article or system being purchased. Planning and purchase considerations may involve the following: a complex weapons system configuration; undetermined levels of spare parts and support equipment; operational and logistics support training requirements; selection of suppliers' advice in deployment doctrine and tactics; and a perceived need for military-to-military contact throughout and beyond the procurement period for the item. The FMS system inherently engages the military personnel of the purchasing government and U.S. military personnel in a joint problem-solution process designed to procure, deploy, and support the item involved. Whether this ongoing contact between the military services of the two countries is necessary, or even desirable, is a binational consideration which is most often conditioned by the degree of other associations between the two military establishments. Whatever level of continuing inter-military contact is maintained, it is important to recognize that the FMS process creates a government-to-government relationship in the defense field; and this is true regardless of whether or not more formal relationships (e.g., alliances) have been established.

For their part, contractor personnel can be expected to be fully familiar with the products they sell directly to foreign governments. Thus, the types of advice and assistance which are furnished through the FMS system, also can frequently be provided by various contractor personnel.

## PRICE OF ITEM OR SERVICE PURCHASED

When a foreign government purchases a weapon system and associated follow-on support entirely via FMS, usually the total acquisition cost will be somewhat less than if the same package was purchased entirely from commercial sources. However, this generalization does not necessarily apply with respect to the specific purchase of a given defense article or service.

It is difficult to predict for any particular acquisition whether it would be less expensive for the customer to employ the FMS system or direct commercial channels. This is especially true in those cases where the items/systems and related services to be purchased are not fully equivalent. The likelihood of price differences between FMS and commercial procurements depends on such significant variables as the specific item/system being purchased, the risks which must be undertaken by the contractor (e.g., late delivery penalty charges, warranty maintenance, etc.), and the presence of commercial competition. For a weapons system purchase involving a multitude of manufacturers [i.e., government furnished equipment (GFE) manufacturers], the FMS system provides for procurements directly from as many original manufacturers as possible, which minimizes the purchase price. If a country's procurement staff is sufficiently large and skilled, a comparable procurement approach can be duplicated in commercial purchases. However, such purchases often are based on the procurement of all system items and components from a single prime contractor. Since the prime contractor must procure various items from

subcontractors, this results in prime contractor markup costs which are passed on to the purchaser, thereby possibly increasing the total cost above that which might accompany a similar FMS acquisition.

Direct commercial purchases often can be made at prices below those of FMS when similar versions of the purchased items are produced by two or more manufacturers. This is particularly true when both U.S. and non-U.S. suppliers are in competition for the sale and are proposing items which are competitive but not identical. Items sold under intense competitive circumstances occasionally may be obtained at fixed price quotes below cost/profit margins allowable under DOD contracting regulations. Price advantages under direct commercial sales also may be possible during periods of rapid inflation in the U.S., especially if the contractor has the ability to make quick deliveries from off-the-shelf inventories or rapid new production. Under this circumstance, direct commercial sales may keep total costs at an amount lower than is possible under the DOD contracting system.

As a further cost consideration, the FMS system provides for an estimated price, with estimated payment schedules. The final price of an FMS item or service generally will not be known until after it is delivered. The final price is determined by actual USG contract cost and other management costs which are required to be charged under the provisions of U.S. laws and regulations. Although the final FMS price may exceed the estimated price, this would be an exception, for most final prices fall below the original estimates. Commercial prices, on the other hand, typically provide a fixed price, with fixed payment schedules, thereby enabling the purchaser to know the final price at the time of contract signature.

#### PROCUREMENT LEAD TIME OF ITEM PURCHASED

Advance planning is the key to assuring that items can be delivered from production at the time they are needed by the purchaser. The purchasing government must first review the threat to its security and then carefully determine the military capability it must develop to meet the threat. Such determination must be made both in terms of materiel requirements and the time when they are needed. Early efforts should be made to obtain procurement planning data from either FMS or commercial sources. This will permit firm decisions to be made, with appropriate consideration for procurement lead times. In sum, timely planning is crucial in order to obtain the required military capability when it is needed.

Generally speaking, defense articles which are in production can be procured more quickly via commercial channels than through the FMS system. The FMS acquisition process involves the development, review, and acceptance of the LOA, plus the assembling of requirements for economic/consolidated purchasing cycles, as well as contract negotiations, and production lead times preceding item availability; the commercial system, however, involves only the latter two time requirements. Although LOA acceptance can be delayed by purchaser requests for amendments or extension of the LOA expiration date, similar purchaser requests may also occur for commercial contracts. In general, industry prepares its proposal more quickly than the USG prepares and processes LOAs.

It is also quite possible that governments with a well-developed purchasing capability can negotiate competitive commercial sales contracts more quickly than DOD. The more detailed the competitive contract negotiation process, the longer the purchaser must wait for the product, unless the contractor proceeds at risk, i.e., produces items in anticipation of future contracts. Such an inventory of at-risk-produced items might be readily available through commercial contracts, but would not be available to DOD except in cases of national emergency.

As a further consideration, protracted commercial negotiations are often required to achieve an agreed upon price. The length of the contract negotiations, however, is independent of the time for actual production and delivery of the equipment. In both FMS and direct commercial sales, the delivery time clock starts when an LOA or commercial contract is signed. Prior extensive planning will minimize delivery time, regardless of which system is used.

It is important to understand, however, that once the delivery period in a commercial contract has been established, it seldom can be changed. In cases of emergency for the purchaser, and assuming the materiel is available in DOD inventories, it may be possible for the FMS purchaser to achieve faster delivery through shipment from DOD stocks or through the diversion of items that are under production for DOD procurements. This is true because DOD can subsequently replenish its inventory with the items that are being procured for the purchaser. The possibility of such diversions or withdrawals from DOD stocks in bona fide emergencies should be weighed carefully by a purchasing government before a choice is made between commercial or FMS procurement.

#### FLEXIBILITY IN CONTRACTING

Governments with extensive business ties to the West, and which are equipped to undertake direct commercial contracts, may determine that the terms of sale and greater flexibility offered by direct commercial contracts provide benefits to their weapons system acquisition requirements beyond those available through FMS. For example, arrangements involving coproduction in the purchaser's country, as well as flexible offset terms (whereby the contractor agrees to make offsetting purchases from the purchasing country), may be negotiated more readily in direct contracts than under FMS. However, few U.S. firms can enter into licensed production or coproduction agreements without some level of USG involvement. It is true that the USG will not finance or guarantee offset agreements, and thus the contractor must assume full responsibility for negotiating and fulfilling all offset obligations. Nevertheless, there have been many successful coproduction and commercial offset programs conducted for sales under FMS procedures.

As noted previously, there are other areas in which commercial sales may provide greater flexibility for the purchaser than does FMS. These instances normally include cases which require special equipment configurations tailored to the purchaser's particular needs, and special warranty provisions. Nevertheless, both the FMS and direct commercial sales systems can each provide a mix of materials, workmanship, and performance warranties to fit the customer's needs and financial capabilities. Under FMS procedures, the USG will act as the negotiating intermediary when the purchasing government wants something beyond the DOD standard materials, workmanship, and design warranties which are provided to the U.S. military services.