An Analysis of the Special Defense Acquisition Fund

By

Thomas M. Meagher

The Special Defense Acquisition Fund (SDAF) is a vehicle for the procurement of defense articles in anticipation of their sale or transfer to foreign governments. Basic objectives of the fund are to facilitate delivery of materiel in advance of normal procurement lead times and establish a readily available source of selected items of materiel. The SDAF enhances the U.S. government's capability to satisfy urgent military requirements of allied and friendly forces while avoiding diversions from production for U.S. forces or withdrawals from U.S. stocks.

The SDAF is a revolving fund originally capitalized with collections received for the following charges on export sales by the U.S. government and its contractors: collections from sales of defense articles not intended to be replaced in stock; collections from sales representing the value of asset use charges; nonrecurring RDT&E charges; nonrecurring production charges; and contractor rental payments for the use of U.S. government plants and equipment together with such funds as may be authorized and appropriated or otherwise made available for the purposes of the fund. No appropriations have ever been requested for the fund. By statutory restriction, capitalization has been limited to $1.07B since Fiscal Year 1987, and no obligations may be made without prior Congressional approval of an obligation limitation obtained through the annual budgeting process in appropriation acts. [E.g., for FY 1991, the obligation authority for the SDAF of $350 million is contained in Title III, P.L. 101-513.]

The SDAF operates much like a Wall Street futures fund. Traders accumulate inventory positions in various agricultural commodities yet to be produced. At some future date, when these products come to market, traders are contractually bound to take physical possession of whatever inventory they currently hold. The trader's object is to profit from selling the rights to these commodities without ever taking possession. In other words, the trader is gambling that in buying lead time rights to the commodity, he will be able to sell that right for a higher price in the future than what he paid initially.

In much the same way, the U.S. is able to buy lead time towards meeting allied requirements. While much of the equipment produced for the SDAF would fulfill U.S. requirements, the fund's objective, like that of the commodities trader above, is to never actually take delivery of the items. The task of the SDAF is to forecast as accurately as possible these needs such that as equipment is produced, it is moving out the door to the customer. In the event that items are not immediately sold, they are stored by the military departments, in some cases at SDAF expense.

Current SDAF policy requires foreign customers to pay the same price as the U.S. for equipment purchased in any fiscal year. Since the foreign government is buying lead time, the possibility exists that the price might be higher or lower when that equipment is finally delivered some years after the initial order. This would seem to imply that the U.S. government has been placed in a "profit or loss" situation. Here the analogy to the commodities trader ends; the SDAF as a government entity is not interested in "profit or loss" from a financial standpoint. The purpose of the fund is to provide a qualitative return to the U.S. in terms of improved national security both for ourselves and our allies utilizing the fund.

HISTORY

The SDAF was established in Fiscal Year 1982 to remedy a long standing weakness in U.S. security assistance policy. This weakness related to the need and desirability to supply major defense equipment to U.S. allies on an emergency basis. Although such actions contributed positively to U.S.-allied relationships from a foreign relations viewpoint, the unintended side effect could be large diversions from U.S. stocks that impacted upon the readiness of American forces such as we saw during the October 1973 Middle Eastern conflict. When combined with the long lead times associated with the production of modern military equipment, policy makers found themselves in the position of having to make unenviable choices between allied and American requirements. However, by U.S. law, both payments in advance of purchase and full cost recovery were required; thus it was illegal to spend funds on a procurement for a foreign buyer before a sales agreement was consummated.

U.S. policy makers began to look for a system that could satisfy domestic legal requirements while at the same time provide the administration with flexibility regarding the needs of foreign allies. At first the Reagan administration ran into Congressional resistance on the grounds that any special fund would divert scarce resources from U.S. forces. In addition, there was suspicion on the part of some members that the SDAF would become a "stockpile" for U.S. forces and provide the Pentagon with a means of obtaining defense articles in excess of appropriation limits. However, the massive resupply effort to the Israelis in 1973 vividly demonstrated the need to fix the system to prevent a repeat occurrence at some point in the future, such as we are seeing now in the Desert Shield operation in Saudi Arabia.

As a result, the SDAF was authorized in 1981 by the addition of Chapter 5 to the Arms Export Control Act. The AECA was amended to include this change by Section 108(a) of the International Security and Development Cooperation Act of 1981 (Public Law 97-113, dated 29 December 1981). Operational management of the fund is conducted by the Defense Security Assistance Agency (DSAA) with input from the military departments. Centralized accounting and disbursement responsibilities lie with the Security Assistance Accounting Center (SAAC), a U.S. Air Force activity in Denver, Colorado.

METHODOLOGY

The following analysis compares by Fiscal Year: Requested Obligation Limit, Enacted Obligation Limit, Cost of Goods Bought (total obligations) and Value of Goods Sold by Item and Region. Requested and Enacted Obligation limits were taken from U.S. government budget documents for the fiscal years 1982—1991.

End item obligations were supplied by the DSAA Management Information System. End items are obligated in accordance with an annual procurement plan developed by DSAA in consultation with the military departments, the JCS, and the Department of State. Items designated to be procured should:

- be those which, based on experience, judgement, an analysis of the historical data and a projection of needs, are most likely to be needed to meet foreign requirements in less than normal procurement lead times;

- be those which withdrawal from active or reserve force inventories, or diversion from production dedicated to active or reserve forces, would result in adverse impact on the combat readiness of U.S. forces;

- be capable of being produced from existing or expanded production lines;

- if not transferred to meet foreign requirements, be required to meet established acquisition objectives of U.S. forces;
- have significant anticipated FMS demand;
- be those with long procurement lead times, particularly over 24 months; and/or
- have the capability of being approved for foreign sale under current National Disclosure Policy.

Throughout the years, the SDAF has obligated funds for items ranging from night vision goggles to M60A3 tanks. In order to analyze both the mix and timing of equipment purchases, all Fiscal Year obligations (referred to as Value of Goods Bought) and sales (Value of Goods Sold) were arranged into four major categories: Ordnance, Combat Systems (weapon platforms), Command Control Communication and Intelligence (C^3I), and Other Equipment. Each category had anywhere from zero to five subcategories of equipment. These subcategories were then summed by year in order to provide some insight into each obligation and compared with the actual obligation limit for that year. Value of Goods Bought reflects the actual year of obligation. Value of Goods Sold by country relates the sale of the item to whatever Fiscal Year the sale actually occurred. Sales often trail obligations by several years, as indicated in the graphs which follow.

The Congressional Presentation Document for Security Assistance, which reports current and proposed assistance levels by region, provided the format for individual country sales analysis. In addition, several countries that typically do not qualify for U.S. assistance (West Europe, Japan, and Australia) but have also utilized SDAF over this period were analyzed. Once individual country analysis was complete, each subcategory for that country was combined into regional subtotals and world totals.

FINDINGS

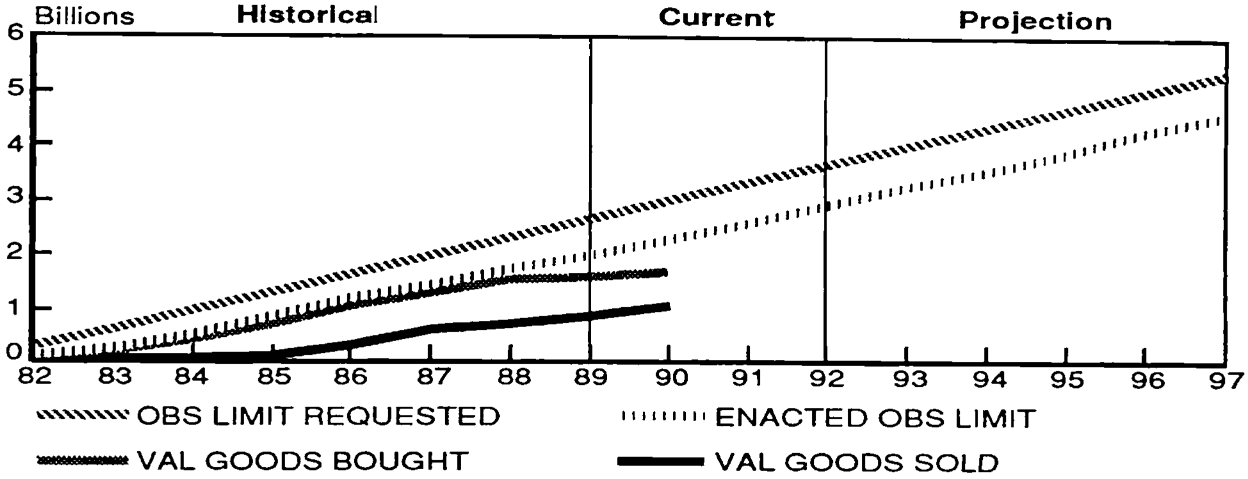
As of July 1990, some $3B in obligational authority had been requested since the inception of the SDAF. This amount on a yearly basis has ranged from $300M in Fiscal Year 1982, the first year of the program, to $350M per year for fiscal years 1987-1989. The most recent request for Fiscal Year 1990 was $325M.

Initially, the administration requested capitalization levels of $300M for fiscal years 1982-1984 with no obligational limitations. However, Appropriations legislation restricted the amount that could be obligated in each Fiscal Year to $125M for 1982 and 1983 and $225M for 1984. Beginning in fiscal 1984, however, the administration began requesting (and was granted) higher obligation limits.

Total enacted obligational authority (limits) for the period contained in appropriations bills totalled some $2.2B or approximately 74 percent of requests. Authority ranged from $125M in Fiscal Year 1982 to $325M in both Fiscal Year 1985 and 1986. The most recent obligational limit for Fiscal Year 1990 was $275M. Since Fiscal Year 1989, obligational authority has been spread over three years as in a normal procurement. Prior to this time, obligational authority was available for only one year.

Value of Goods Bought total some $1.6B since Fiscal Year 1982. This amounts to approximately 73 percent of the appropriated obligational authority of $2.1B and includes some $113M in investments [military department related contract administration charges ($15.5M), Defense Logistic Agency stock supplements ($50M), and export related equipment modifications ($47.5M)].

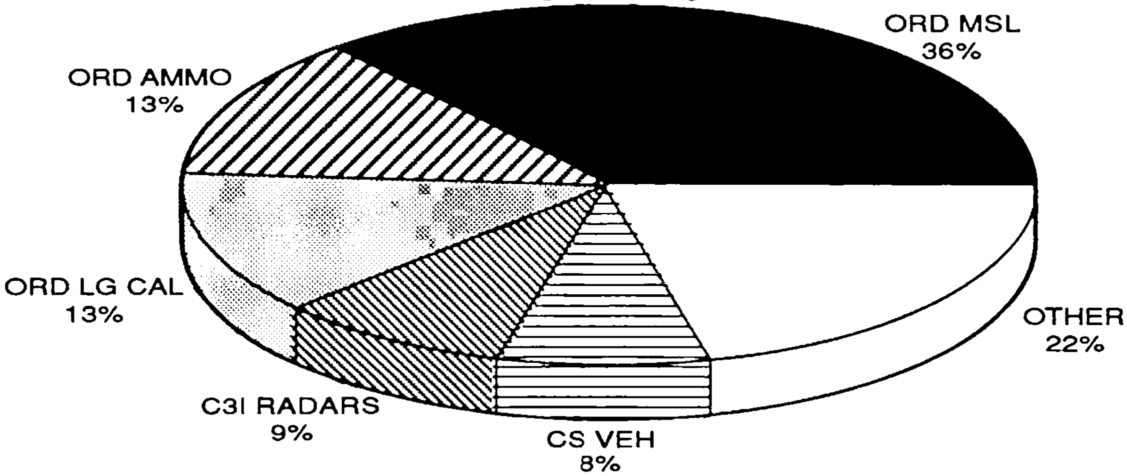
Obligation Requests, Enacted Obligation Authority, Value of Goods Bought and Sold



However, since the adoption of the three-year window beginning in fiscal 1989, obligation rates have slowed considerably. As of the end of fiscal 1988, the last year of the one-year authority, this percentage was close to 87 percent of the obligational authority granted up until that time. Value of Goods Bought (as of July 1990) ranged from $51M in Fiscal Year 1990 to $285M in Fiscal Year 1985. Since the beginning of the Gulf crisis an additional $28M ($19M in FY89, $9M in FY90) has been obligated. These figures are not reflected in the charts and graphs.

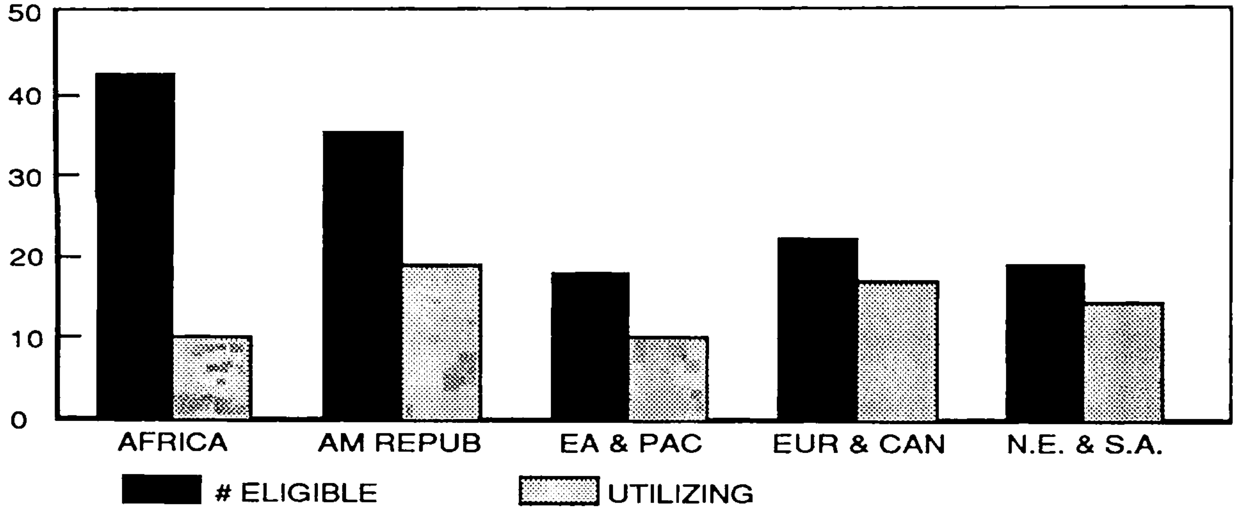
The Value of Goods Sold by country totalled some $1B throughout the period. Some $839M of this amount was in SDAF cases only; the remaining $170M in SDAF sales were consummated as part of military department FMS sales cases. Actual dollar cost of goods sold ranged from $37M in Fiscal Year 1984 (the first year of significant sales) to $210M in Fiscal Year 1987. Value of goods sold by region totalled approximately 63 percent of the $1.6B actually obligated through fiscal 1990. Of the remaining $600M ($113M of which is investment related), approximately 42 percent or $250M is currently pending in ongoing sales cases.

Product Category Obligations



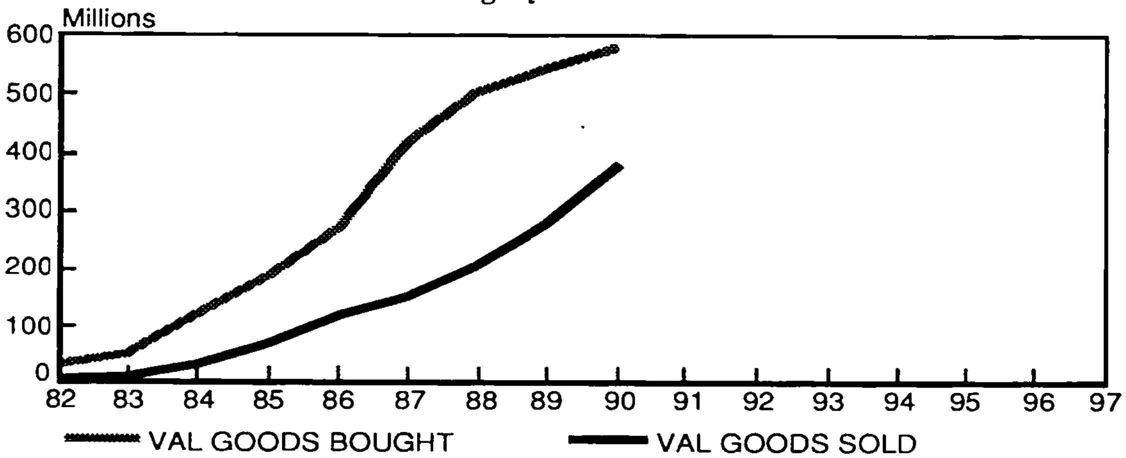
Missiles accounted for over 36 percent of the $1.6B of goods bought (Stingers – 10 percent, Sparrow – 7 percent, TOW – 5 percent, Sidewinder – 4 percent). Other major subcategories with significant purchases include: Ordnance Large Caliber (13 percent total; Phalanx – 4 percent, M198 Howitzers – 3 percent, MLRS – 2 percent, TOW Launchers – 2 percent); Ordnance Ammunition (13 percent total, equally divided between a number of different rounds); C31 Radars (9 percent total; TPQ-37 – 5 percent, TPQ-36 – 2 percent, TPS-70 – 1 percent); and Combat Systems Vehicles (8 percent total, M60A – 4 percent). All other subcategories (including investments) totalled some 22 percent of purchases.

Participation by Region



Based on the Congressional Presentation Document, 136 countries were eligible to purchase equipment through the SDAF during this period. Of the 136 (which included a classified line as well as some countries not normally eligible for U.S. assistance), 71 countries or 52 percent had utilized the fund. This ranged from a high of nearly 77 percent of European countries participating to a low of 26 percent for African countries. This distribution is reflected in the discussion of Value of Goods Sold by region. European and Near Eastern/South Asian countries (74 percent participation, includes all Middle Eastern countries) accounted for two-thirds of all SDAF purchases.

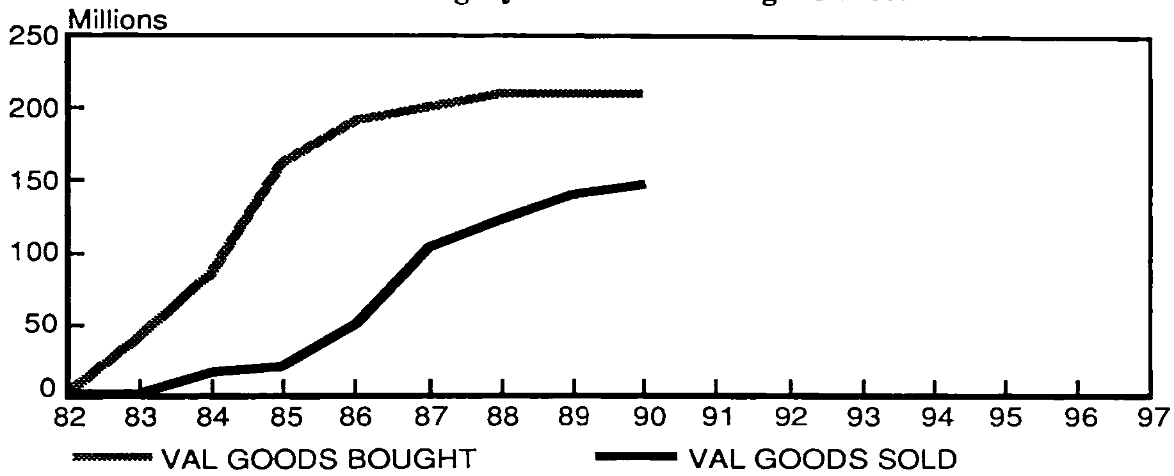
Product Category Ordnance: Missile



Near East and South Asian countries accounted for 34 percent (or approximately $338M) of the $1.0B actual value of goods bought that left DSAA inventory as value of goods sold. Europe and Canada accounted for an additional 33 percent followed by East Asia and Pacific (19 percent), American Republics (12 percent), and Africa (2 percent).

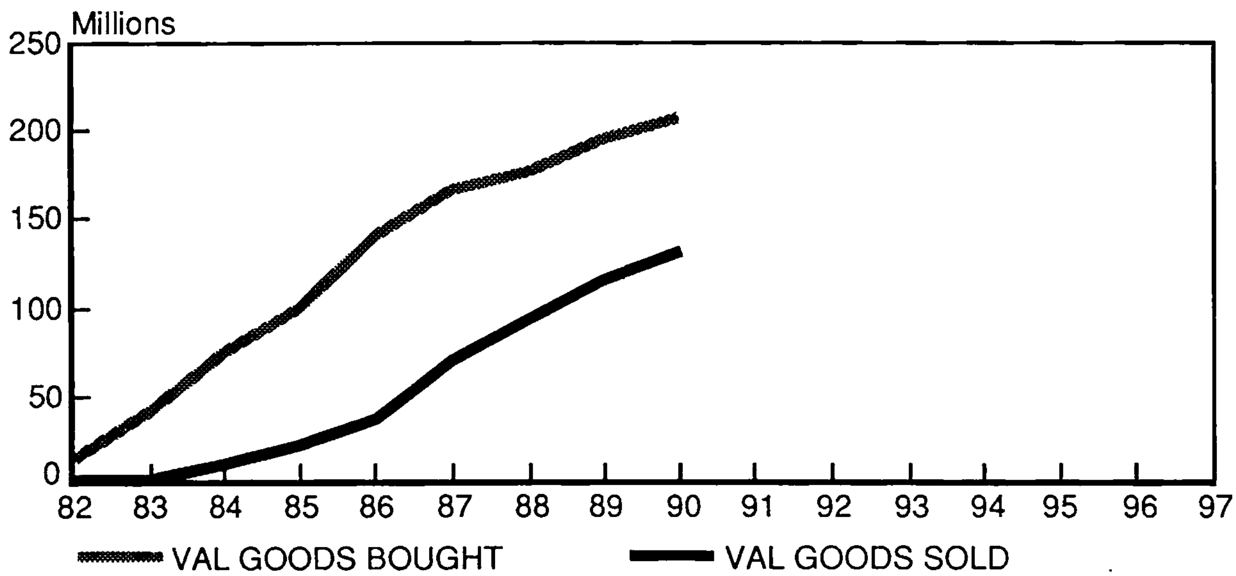
On a product line basis, 37 percent or $378M was accounted for by missile sales, the majority of these being purchased by European countries. East Asian and Near East countries accounted for most of the remaining sales.

Product Category Ordnance: Large Caliber



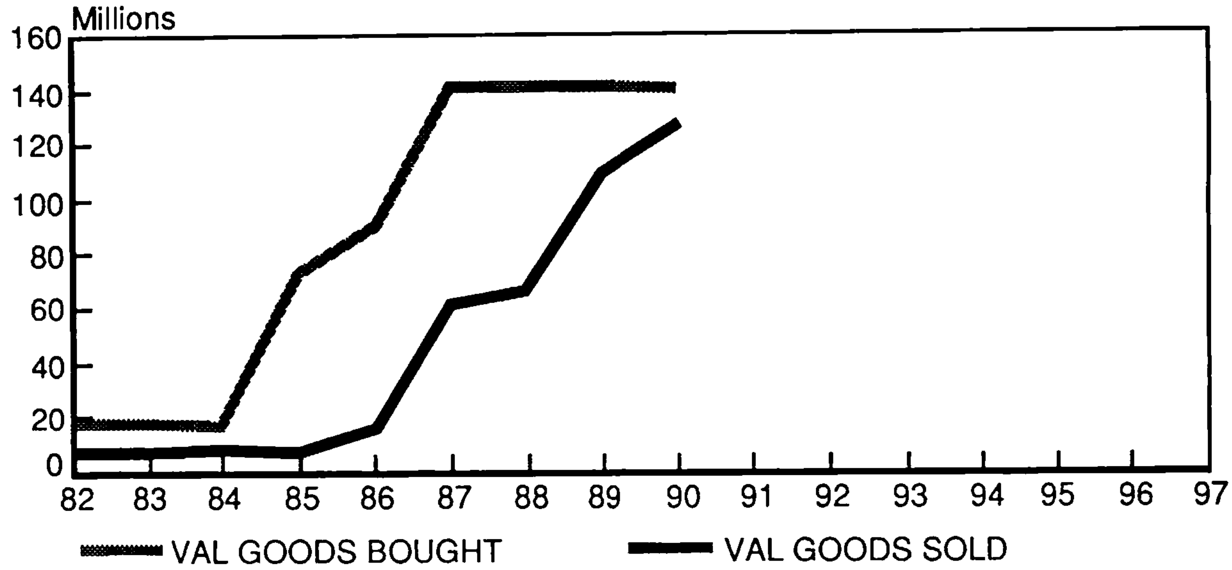
Large Caliber Ordnance was the next largest area of sales (14 percent or $146M). These sales were divided evenly between Europe and the Near East.

Product Category Ordnance: Ammunition



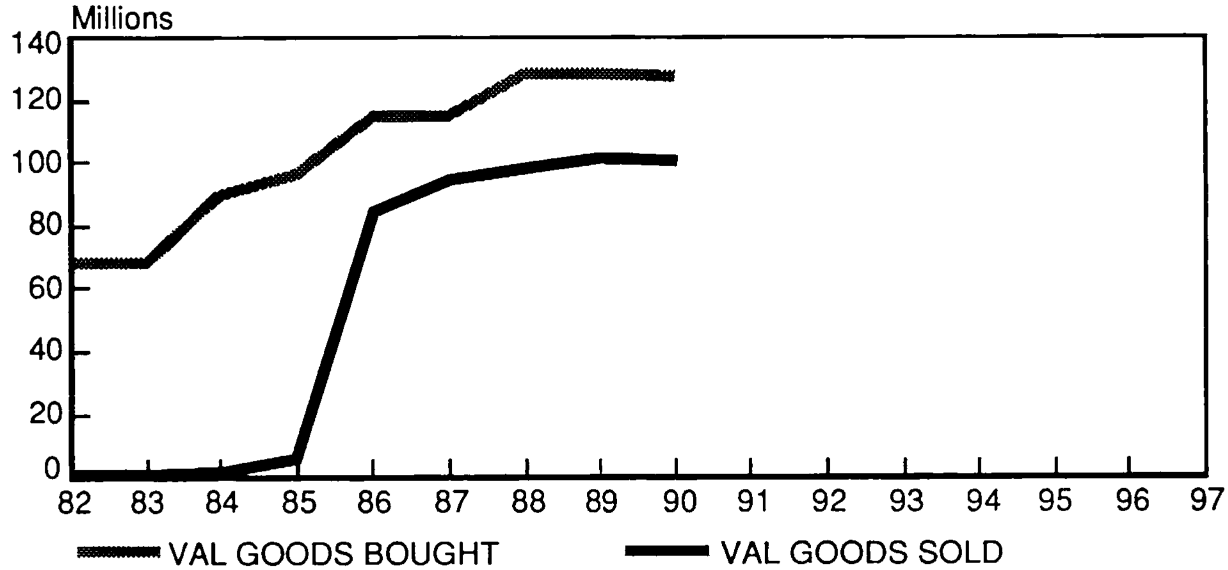
Ammunition COGS totalled some 12 percent (or $126M) of actual obligations. Nearly half of these sales went to the Near East with the remainder divided almost evenly between East Asia, the American Republics and Europe.

Product Category - C3I: Radars



Radar Sales accounted for nearly 13 percent (or $127M) of actual obligations. These sales were divided evenly between East Asia, the Near East, and Europe.

Product Category - Combat Systems: Vehicles



The last major category of cost of goods sold was vehicles (nearly 10 percent of actual obligations or $102M). Nearly all of these sales took place in the Near East with the remainder divided equally between other regions.

CONCLUSIONS

Although the SDAF obligated some 87 percent of the available monies through fiscal year 1988 (the last year for one-year obligational authority), it is important to note that the fund was established first and foremost as a foreign policy tool. A major aim of the fund is to make prudent procurements in support of these foreign policy objectives. This does not equate necessarily into procuring the maximum amount of equipment possible under the current ceiling. The flexibility afforded to the U.S. through the use of the SDAF cannot necessarily be judged strictly in financial terms. As an example, sales agreements concluded in Fiscal Year 1989 have helped to support our foreign policy objectives throughout the world.

Among the highlights from 1989:

- SDAF sales of various types of ammunition (from rifles to howitzers), vehicles (jeeps and trucks), and light arms (rifles, machine guns, and mortars) have greatly reduced pressures on the Army to withdraw on-hand Service stocks for sustainment of the counterinsurgency and border safeguarding missions of friendly governments. Examples of these efforts are programs with Honduras, El Salvador, Peru, Pakistan, Tunisia, Thailand, and the Sudan.

- SDAF has continued to support the National Security Agency (NSA) in implementing more orderly planning and management and stabilizing procurements to foster interoperability of U.S. security communications (COMSEC) with NATO, Australia, and Japan.

- In NATO's Southern Flank, SDAF procurements and sales help force modernization planning and accelerate deliveries of selected items. The sale of Stinger manportable ground to air missiles to Greece, the sale of MLRS and TOW-2As to Turkey, and assorted equipment sales to Portugal are examples of these efforts.

- Readiness and interoperability with NATO, Australia, and Japan have also been sustained and improved by sales and deliveries of such items as TOW-2A anti-tank missiles to the Netherlands and Italy, Stinger missiles to Germany, Sidewinder air-to-air missiles to the Netherlands, and varied communications equipment to Australia and Japan.

- In the midst of the ongoing Gulf crisis, the fund is being tapped to provide extra equipment that will be used to bolster the collective defenses of U.S. allies in the region.

As the SDAF enters the 90s, what changes might occur that would alter the previous obligational patterns we have seen over the previous decade? Among the questions to be answered:

1) Should the capitalization limit be raised in order to allow for the purchase of larger, more expensive systems?

   There is no need to raise the capitalization limit. Simply raising the limit will not appreciably speed the delivery of larger more complex items such as vehicles. Although one objective of the fund is to maintain open production lines, to use the SDAF as an alternative means of stockpiling equipment would not be appropriate under this statute.

2) What changes in the SDAF can be expected in the 1990s?

   These consist of both reductions as well as additions in the types of equipment to be funded by the SDAF

Reductions

Over $50M worth of COMSEC equipment was purchased by European and other technologically advanced allies. Since much of this gear is now being produced by these countries, this area will probably not receive as much attention in the future.

In addition, many new technologies such as the Advanced Medium and Short Range Air to Air Missile systems (AMRAAM and ASRAAM) are being developed in cooperation with European allies. Given the development cost of military technology, such cooperation appears to be desirable and necessary for the future. In the future it is likely that these countries will produce these systems domestically as opposed to buying them through the SDAF.

Technology transfer could also have an impact on the fund. As an example, the development of the AMRAAM might result in the transfer of older technology (such as the Sparrow and Sidewinder) to foreign countries. These countries would theoretically have the capability of producing these systems through their own domestic sources and would have no need to purchase replacements through the SDAF except in extreme emergencies.

The end of dual production, particularly in the missile area, might significantly impact SDAF sales as well. The move to single production lines could eliminate duplicate costs, thus eliminating the desire to use the SDAF to maintain open production lines.

Additions

The recent crisis in the gulf illuminates the continuing threat faced by non-NATO countries despite the wind down of the Cold War. Therefore, it seems fair to assume the use of the fund by Middle and Far Eastern countries, where tensions remain high, will continue to grow while European utilization will remain relatively level or decline in the next decade.

Some $47M in investment monies have been used to modify weapons systems for export. Modified systems include Harpoon and Sidewinder missiles, MK46 torpedoes, and M60A3 tanks. This trend could very well continue and have a marked impact on SDAF sales.

Another major change in emphasis could take place as a result of the increased attention to low intensity conflict, specifically the anti-narcotics and anti-terrorism programs. Legislative authorization for procurement of military equipment to support these programs is contained within Title IV — International Narcotics Control, International Security and Development Cooperation Act of 1985 (Public Law 99-83, dated 8 August 1985). These efforts are oriented primarily towards the Americas and the Middle East. We can probably expect to see increased buys of smaller, lighter, low technology equipment such as small caliber weapons, ammunition, and communications gear at the expense of larger, more technically advanced systems.

Despite the prospect of significant change, the SDAF has proven to be a useful foreign policy tool and should continue to be funded at current levels. The post cold war world does not appear to be a safer place; if anything the world has become less stable. The need to respond to a crisis, much like the one we are witnessing in the Gulf presently, requires that the U.S. be able to do so quickly and with sufficient assets. The SDAF has provided this capability in the past and if sufficiently capitalized should continue to do so in the future. However, the downturn in U.S. defense spending and the resultant effect on the industrial base will continue challenging DSAA managers to provide cost effective equipment in a timely manner to U.S. allies without any degradation and of our own defense readiness.

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ABOUT THE AUTHOR

Mr. Thomas M. Meagher was working as an intern with the International Security Affairs Branch, International Affairs Division, Office of Management and Budget during the period of this analysis. He spent three years on active duty as a U.S. Army officer serving in both artillery and staff assignments. He has a B.A. degree in History from UCLA and an M.B.A. from Southern Methodist University. In addition, he has attended program management courses at the Defense Systems Management College and the Defense Institute of Security Assistance Management. He spent the last four years working in a number of financial and marketing assignments with FMC Corporation Defense Systems Group, San Jose, California, before returning to Washington, DC, to pursue an M.A. degree in National Security Studies from Georgetown University.