Retain Secondary Items for Foreign Military Sales—

A Sound Business Decision

Executive Summary

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For the past several years, DoD's emphasis on material retention has evolved to the point of keeping only the minimal number of assets needed to support the mission. It recently issued a revised and more stringent retention policy for secondary items that directs the DoD Components to dispose of some assets they previously retained. Because of the magnitude of force-level reductions, the inactive inventory, and. other inventory management issues, Congress has imposed restrictions on sales revenues generated by the Defense Business Operations Fund (DBOF) that may be reinvested in the procurement of new inventory.

The Defense Security Assistance Agency (DSAA) and the Military Services are concerned about the effect that this more restrictive policy will have on the support of the U.S. Security Assistance Program. In view of those concerns, DSAA asked the Logistics Management Institute to analyze policies and business practices related to the supply support of foreign country weapon systems, determine whether problems exist, and recommend appropriate solutions.

During FY92 and FY93, DoD averaged $2 billion a year in foreign military sales (FMS) of secondary items other than sales programmed under the cooperative logistics supply support arrangement (CLSSA).

- The DoD disposed of $18.4 billion worth of wholesale secondary item assets in FY93.

- Of the $18.4 billion, approximately $940.6 million or 5.1 percent of the assets are in a "like new" issuable condition and match items with non-CLSSA and CLSSA-nonprogrammed requisitions.

- If DoD were to retain $387 million of those assets (no significant impact on inventory or base closures as it represents less than 3 percent of the disposals and about four average warehouses), it would have a 99 percent probability of their being sold within 13 years based on current demand patterns.

- The net present value of the potential revenue generated after all expenses from *retaining* the materiel for FMS is $252 million. In contrast, the net present value of continuing the current *disposal* policy is $19 million.

- Even if only half were sold, the net present value of potential revenue after all expenses would be $128 million. The *retention* alternative would generate from 6 to 13 times more net revenue than *disposal.*

We recommend that OSD take the following actions:

In order to take advantage of this rare opportunity to increase DBOF revenue, offset costs that need to be recovered through cost recovery rates (approximately 90 percent of the benefit would be to the U.S. forces), and improve support to FMS customers:

Establish an FMS Reserve for the retention of assets solely for FMS in accordance with the concept outline in Appendix A of this report, and revise the related policies as we suggest in Appendix B.

Retention of assets, in general, has acquired a bad reputation—they are looked upon as "unneeded"—because of the perceived lack of management and viable economic basis for retaining billions of dollars in inventory. Thus, to justify retaining materiel for support of FMS, the probability that it will actually be sold must be high.

In order to ensure a uniform, economically viable, and flexible basis for determining the maximum quantity to be retained in the FMS Reserve:

Establish the reserve limit in accordance with the Economic Quantity Limit (EQL) methodology described in this report. That methodology is based on an annual recomputation of each item's FMS demand, demand variance, and at least a 99 percent probability of being sold within a 13-year selling period.

As a part of downsizing and normal weapon system modernization, some models of weapon systems are being phased out of the U.S. forces inventory. The DoD Components are aggressively pursuing the sale and transfer of those weapon systems to authorized foreign countries, and future support for those systems is a factor in the success of their efforts. Present policies require the disposal of all secondary item support assets unique to those systems, normally within one year of elimination from the U.S. forces' inventory (a one year extension can be authorized).

To encourage sales of obsolete weapon systems, provide more responsive support to foreign countries, and increase DoD revenues:

Change the policies as provided for in Appendix B of this report to permit retention on an economic basis of parts peculiar to weapon systems no longer in the U.S. forces' inventory.

Secondary items are being disposed of at an exceedingly high rate. Each passing day may result in the disposal of assets that should be retained to support future FMS.

To implement the FMS Reserve at the lowest possible cost and in the shortest feasible time and to minimize the premature disposal of potential FMS Reserve assets:

Assign initial responsibility, including management and performance reporting, to the inventory control point with integrated materiel management responsibility for all items eligible for inclusion in the FMS Reserve and subsequently explore the feasibility of assigning responsibility to a private-sector contractor for FMS-peculiar items.

Full implementation of the FMS Reserve concept, including management of performance reporting—activities that are critical to the evaluation of the policies and operations—requires changes to computer systems. The inclusion of those changes in the DoD Logistics Corporate Information Management (CIM) program will require time.

In order to implement the total FMS Reserve concept at an earlier date:

Explore the feasibility of developing a "Stand-alone" desktop computer application for use in conjunction with existing inventory control point management systems.