Appendix 4
A Comparison of Direct Commercial Sales and Foreign Military Sales for the Acquisition of U.S. Defense Articles and Services

Introduction

This appendix provides an overview of issues, policies and considerations that should be evaluated by the foreign purchaser of U.S. military articles and services in making a decision as to which method of acquisition best suits the purchaser's needs.

At the end of this appendix are three listings of advantages, considerations and misperceptions regarding Foreign Military Sales (FMS) and Direct Commercial Sales (DCS).

Forward

This appendix presents an objective and systematic comparison of the two systems by which foreign governments may acquire U.S. defense articles and services; i.e.;

- Contractor-to-government or Direct Commercial Sales, and;
- Government-to-government or Foreign Military Sales.

Both systems have been designed to achieve a common result, the enhancement of mutual security objectives through the provision of U.S. military items and services to allied and friendly foreign governments.

The two systems may differ in style and substance, but they share important similarities which sometimes go unnoticed. For example, weapon system acquisitions made through either system require U.S. government approval. Similarly, both systems are governed by the *Arms Export Control Act (AECA)* and related legislation. When viewed superficially, there appear to be vast differences in these systems, primarily because one involves a business-to-government association, and the other a government-to-government relationship. Upon closer examination, many similarities as well as differences in the two systems emerge. From the marketplace viewpoint of a foreign purchaser dealing with the multidimensional features of both systems, a variety of perceived advantages and disadvantages are seen to rest in the choice of either acquisition system. These differing system features are often made difficult to assess, sometimes because of misinformation stemming from erroneous impressions, and sometimes because of shaded or prejudiced evaluations of each system's relative merits. Every effort has been made herein to ensure that the differences and similarities between the two systems are objectively described.

The choice of either FMS or DCS is driven by the special circumstances of the foreign purchaser, rather than by substantive differences in the two systems. In either case, it is important to note that the identification of materiel requirements, as well as procurement planning and the choice of acquisition method should be done systematically. When a foreign country's Ministry of Defense (MoD) works together

with the in-country U.S. security assistance organization (SAO) in the development of a three-to-five year procurement plan, both the U.S. Department of Defense (DoD) and commercial sources can be better prepared to process sales requests in an expeditious method as soon as financing becomes available. This is particularly true when countries have requested price and availability (P&A) data, and also because SAOs have pricing data available to assist the country as it is developing its annual and multi-year budgets.

This appendix proceeds on the assumption that a foreign government has already surveyed the international marketplace, and has decided to purchase equipment of U.S. origin. The government must then decide whether to contract to buy the equipment directly from a commercial source or to employ the FMS system for the acquisition. A general summary of the major issues associated with such a decision is provided below. This is followed by a series of sections (Parts 1-12), which focus on specific features of the two systems (e.g., contractual, logistical, financial, etc.) which the purchasing government should consider in making a choice of acquisition methods. The appendix also includes a list of general "pros and cons" regarding the advantages and disadvantages of each system (Annex A). This is followed by an analysis of common "misperceptions" regarding each system (Annex B).

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. Subsequent sections of this pamphlet provide a more expanded discussion of these considerations.

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 cost and price negotiations; the purchaser's responsibility is limited to agreeing to requirements and estimated costs as they are stated in U.S. government 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 required quality at the lowest feasible price, from qualified sources. Under the FMS system, the U.S. government, 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 U.S. government logistics inventories and training facilities. Under a Cooperative Logistics Supply Support Arrangement (CLSSA), most of the DoD inventory and contracting system 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.

Nonstandard item support can be provided through both commercial and FMS channels. Under FMS, DoD has established special systems for acquiring nonstandard items. Nonstandard items, as they relate to FMS, may be defined as any items or equipment not included in the DoD inventory or not purchased for regular use by DoD.

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 judgment as to the degree of U.S. military advice and assistance which will be needed during the procurement planning phase.

This judgment, in turn, depends primarily on the complexity of the defense article or system being purchased. Planning and purchase considerations may involve a complex weapon system configuration, undetermined levels of spare parts and support equipment, operational and logistics support, training requirements, selection of the 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 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 binominal 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. 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 familiar with the products they sell directly to foreign governments. Thus, the types of assistance and advice, which are furnished through the FMS system, also can frequently be provided by contractor personnel.

Price of Item or Service Purchased

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 that must be undertaken by the contractor (e.g., late delivery penalty charges, warranty maintenance, etc.), and the presence of commercial competition. For a weapon 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 U.S. government contract cost and other management costs that 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

As indicated in the Foreword to this appendix, 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 that 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 type 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 U.S. government 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.

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 that, once the delivery period in a commercial contract has been established, it seldom can be changed. In cases of an 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 weapon system acquisition requirements beyond those available through FMS. For example, arrangements involving co production 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 co production agreements without some level of U.S. government involvement. The U.S. government will not finance or guarantee offset agreements. The purchasing country must assume full responsibility for negotiating the offset provisions and assuring the contractor has fulfilled all offset obligations. The *Defense Federal Acquisition Regulation Supplement (DFARS)* allows the recovery of industry offset administrative costs associated with FMS LOAs and there have been many successful co production 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 provide a mix of materials, workmanship, and performance warranties to fit the customer's needs and financial capabilities. Under FMS procedures, the U.S. government 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.

The preceding discussion has summarized the various and complex considerations which enter into a purchaser's procurement decision. In the remainder of this pamphlet, these considerations will be examined in greater detail.

A Comparison of Foreign Military Sales and Direct Commercial Acquisition Methods

Part 1 - First Considerations

The basic distinction between the FMS system and the direct commercial acquisition system is that they are simply different contracting methods which a foreign government may employ for the purchase of U.S. defense articles and services. In the commercial case, a U.S. contractor and a foreign government enter into a direct contract in accordance with U.S. law and regulations, as well as applicable foreign laws and regulations, and provisions of international commercial law. The U.S. government is not a party to these commercial contractual transactions. The foreign

government has the responsibility in such purchases to select the source and manage the awarded contract directly with the U.S. contractor.

Under the FMS system, the U.S. government and the foreign purchaser enter into and sign an agreement (the FMS LOA) which specifies the terms and conditions of the sale. Thereafter, except for items supplied directly from DoD inventory, the U.S. government buys the desired item or weapon system from the U.S. manufacturer on behalf of the foreign government, employing essentially the same procurement criteria as if the item/system was being purchased for U.S. needs. The U.S. government, not the foreign government, selects the source and manages the awarded contract, consistent with the provisions of the FAR and the LOA.

The major issues involved in selecting either one of these two procurement systems, apart from considerations regarding bi-national military relationships, may be concisely described by examining three fundamental questions.

First, there is the question of cost; i.e., how much will a desired weapon system cost on the first day it is deployed with the purchaser nation's defense forces? This cost must include the total charges for all contractor/subcontractor costs and profits, to include manufacturing, delivery, training, and support. Under the FMS system, this represents the final cost to DoD of all acquisitions made for the purchaser under the total package approach, and this cost is estimated on the bottom line of the LOA.

There are certain instances where a commercial acquisition may be faster, cheaper, or simpler than FMS. This is generally a result of the more complex system safeguards and lengthier processing time associated with FMS. Indeed, if the foreign government believes its equipment does not need to be built to U.S. military specifications (MILSPEC) or standardized with DoD equipment, DoD may encourage the acquisition to be made through commercial channels. MILSPEC items can be sold through commercial channels; however, only a few contractors are capable of duplicating from their in-house resources the total service provided by DoD under FMS. Contractor limitations include smaller staffs, a lack of dedicated stockpiles for follow-on support, shortages of transportation during contingency situations, and a lack of access to U.S. military personnel and facilities. Nevertheless, where it is appropriate and when the foreign government desires a direct commercial purchase, contractors can and will assemble, at additional cost to the purchaser, the necessary total service by hiring additional personnel with the required expertise.

In addition to a commercial purchase of MILSPEC items, a foreign government may wish to procure follow-on support via FMS. Because such items are often nonstandard or have nonstandard components, DoD has had mixed and sometimes unsatisfactory experience with the use of FMS to support items procured commercially.

A second key question involves time; i.e., how long does it take from the first day of sales discussion until the equipment is deployed in the field? For most major weapons systems, the total time involved under FMS procedures equates to the time required for LOA negotiations, plus contract negotiations, production lead time, delivery, and training. Commercial contractors may provide some of these services faster than the FMS system.

The third and final question that should be asked is -- how much support will be available when the country must have the items? This question involves a highly scenario-dependent situation. During a period of crisis, or in a major contingency, the U.S. government is authorized by law to make the final allocation of U.S.

materiel resources, regardless of the type of procurement contract (FMS or commercial). If the situation involves a purchaser country and U.S. forces in a coalition effort, it is much easier for the USG to provide support if the items are carried in the U.S. inventory. In a limited conflict, commercial sources will probably prove adequate. In either case, pre-positioned stockpiles of assets maintained in country are the only real guarantee of providing for country requirements for national defense.

In reviewing the pertinent factors associated with the two procurement systems, one should bear in mind that unless the Department of State (DoS) has determined that a specific item or service will only be offered via FMS, there are few absolutes which dictate that all countries should select exclusively either FMS or commercial channels for a given purchase requirement. Rather, there are many considerations, unique both to the individual purchaser and to the items being procured, that are involved in such a choice. The final decision on purchasing channels varies from country to country, and even from purchase to purchase. Given the variety of factors involved, it is important that the purchasing government's decision encompass as many factual considerations as possible.

Part 2 - System Considerations

There are several U.S. sources available to provide information regarding the purchase of U.S.-manufactured weapon systems. These include the marketing representatives of the various U.S. defense industries that produce most of the items being sold, and representatives of the U.S. government; primarily personnel assigned to security assistance management positions.

Most foreign governments are well informed as to what weapon systems are available for acquisition. In addition to industry or U.S. government furnished information, other sources include periodicals, journals, and observations of U.S. armed forces that may be stationed in country or nearby within the region. Manufacturers and exporters may provide general marketing information abroad to promote their products; however, they must insure that any technical information disclosed to prospective customers is in the public domain; further, they are restricted from making any specific proposals sufficient to form the basis of a purchasing decision involving the licensed production of significant military equipment (SME) as defined in the *International Traffic in Arms Regulations (ITAR).*

Any foreign acquisition of U.S. defense items requires prior approval by the U.S. government. A variety of procedural regulations govern the manner in which both marketing and sales approval must be obtained. For example, with respect to a contract for an item of SME valued at $14 million or more which has not been previously approved for export, before a commercial company can make a sales proposal to a prospective foreign purchaser, approval must be obtained from the DoS. This requirement does not apply to North Atlantic Treaty Organization (NATO) governments or to Australia, New Zealand, or Japan. A favorable decision would permit a contractor to conduct unclassified discussions and to make a sales proposal involving the sale of a specific item of SME to a particular country. An approval, however, is not required if the specific item of equipment has been previously approved for export to any foreign country. Where such export has been previously approved, the DoS must be notified in writing thirty days in advance of the intended presentation or proposal. Approval must also be obtained for any proposal to enter into a manufacturing license agreement (MLA) or technical assistance

agreement (TAA) with any foreign government for the production or assembly of SME.

It is important to understand that neither DoS approval nor the fifteen or thirty-day congressional notifications authorize the actual export of defense articles or services, including technical data. Such exports are authorized only after a munitions export license is obtained from the Directorate of Defense Trade Controls (DDTC) within DoS. An application for such a license must be accompanied by a copy of a purchase order, letter of intent, or other appropriate document describing the proposed sale. Normally, an FMS does not require a munitions export license if the foreign diplomatic mission in the U.S. or a properly registered freight-forwarding agent has filed the required advance documentation with the Directorate of Defense Trade Controls.

In reviewing the request for either approval of a sales proposal or presentation or a munitions export license, the following factors are examined by DoS: U.S. government willingness to release the technology to the foreign government requesting the item, the security capabilities of the contractor, the foreign government's willingness and ability to provide security for the technology and hardware which would be obtained through a sale, and the validity of the foreign government's need for the item. Both commercial sales, as well as FMS, must be consistent with U.S. national disclosure policy requirements, as well as with all releasability and technology transfer criteria.

The U.S. Congress must be notified of all cases for which the Directorate of Defense Trade Controls intends to issue an export license for the sale of any defense articles or services which meet or exceed the statutory dollar value thresholds established in the *Arms Export Control Act (AECA).* This notification requirement applies to proposed FMS cases as well as direct commercial sales. The AECA requires that Congress be provided a total of thirty days notification prior to the authorization to export by either FMS or direct commercial sale any major defense equipment (MDE) valued at $14 million or more. The statutory notification period is fifteen days for NATO, NATO member countries, Japan, Australia, or New Zealand. The MDE value for notification to Congress for NATO countries, Japan, Australia, and New Zealand is $25 million or more as opposed to the $14 million for all other countries. MDE is defined in the ITAR as any item of significant military equipment (SME) identified on the U.S. Munitions List (USML) as having a nonrecurring research and development cost of more than $50 million, or a total production cost exceeding $200 million. This notification requirement also applies to the sale of any defense articles or services with a total value of $50 million or more and to military design and construction service sales with a total value of $200 million or more. These notification values for NATO countries, Japan, Australia, and New Zealand are $100 million and $300 million, respectively. In addition to the above, all requests to commercially purchase firearms controlled under category I of the USML valued at $1,000,000 or more must also be notified to the U.S. Congress.

Before an export license for classified material may be granted, security agreements establishing appropriate security measures must be executed between the purchasing government and the U.S. government. The requirement for a security agreement is determined during the DoD review of the license request.

It should also be noted that the U.S. government always reserves the right to terminate a munitions export license and to halt the actual export of the previously licensed items when it is determined to be in the U.S. national interest. This termination authority applies for both direct commercial contracts and FMS

agreements, and it may be exercised at any time - in peacetime as well as during a crisis.

As a matter of national U.S. policy, the U.S. government encourages government-to-government consultations regarding the defense planning requirements of allied and friendly countries. During such consultations, and as part of the FMS process, both classified and unclassified information can be provided, within the aforementioned general marketing guidelines. The FMS process assures that all security provisions are in place for sales of classified items, and it also provides for required purchaser agreements to protect U.S. concerns and to assure the proper use of the article or service. Required security agreements and inspections, may be mandated by the U.S. government before negotiations in support of either a commercial sale or an FMS agreement can be approved.

Government-to-government consultations occur regularly in the many countries in which the U.S. government maintains an SAO. An essential function of the SAO is to assist, when asked, in the evaluation and planning of the host government's military capabilities and requirements. SAO activities, of course, must be in consonance with U.S. government approved guidance and policy.

A third party, such as a freight forwarder, is frequently involved in the shipment/export of U.S. defense articles. In such cases, prior to the export from the U.S. of any purchased defense materiel, the purchasing government (or its representative) must file documentation with the DoS Directorate of Defense Trade Controls assuring and assuming full responsibility for compliance with the ITAR. This requirement applies equally to FMS and direct commercial sales export shipments.

This discussion of export controls highlights an essential characteristic of military export sales. Whatever the procurement choice, whether commercial or FMS, the two governments must agree on a wide variety of issues. Except where the DoS has determined that an item must be sold via FMS, neither government can direct the transaction and either government can shape it by withholding approval. Sales are negotiated from the standpoint that both the buyer and the seller must be satisfied before the sales transaction is consummated.

Part 3 - Contractual Considerations

Whichever procurement system a foreign government decides is best for its situation, some basic form of legal agreement is required. In a direct commercial sale, the agreement normally is a fixed-price contract for specified articles and services. Negotiations between the purchasing government and the contractor permit the incorporation in the contract of the purchaser's specific desires and requirements. The fixed price will not vary in such contracts unless provision is made in the contract to permit price changes or the contract is renegotiated to accommodate changes. In the FMS case, the LOA provides an educated best estimate of the final price for items which are to be purchased from procurement. For such items, the U.S. government must subsequently negotiate prices with the individual contractors associated with the items. Such negotiations must be conducted on the basis of the same procurement provisions used for DoD purchasers. Also, the tailoring of an FMS item to specific country requirements, particularly regarding spares and support equipment, often will not occur until after the LOA is signed. In a small percentage of FMS cases, the final price may exceed the original LOA estimate, and additional charges must then be assessed to reflect

the actual costs to DoD. However, in most cases the final FMS price is lower than the LOA estimate and the country will pay only the costs associated with the sale, even if the original LOA estimate was higher.

The fact that the final LOA cost is generally lower than the initial LOA price estimate is a distinctive feature of the government-to-government FMS agreement. The LOA negotiators for both governments are impelled to agree on a safe estimated price that has to be faced by the purchasing country's finance ministry only one time. Some governments believe it is better to overestimate rather than underestimate the price and then be faced with the need for developing a supplemental budget justification for additional funding. Similarly, the U.S. personnel who prepare LOA estimates have experienced the various problems resulting from underestimated prices; therefore, they tend to introduce a safety factor in their estimates for unanticipated increases in labor or raw materiel costs, higher than projected inflation rates or other increases.

A multi-year DoD analysis of LOA prices revealed that final LOA costs generally fall below initial LOA estimates. The analysis reflected a range of such decreases, averaging about 11-13 percent. This finding can be misleading since it tends to mask those cases in which final prices exceeded the original estimates. Also, the decreases which occur are not always due to high-side estimates, for other factors may be involved. As an example, the purchaser in many instances will choose to decrease the quantity of an individual line item in an LOA, thereby resulting in a corresponding price decrease. Naturally, this will be reflected in the final reduced cost of the LOA. Similar quantity and resultant price adjustments can also occur in direct commercial sales if the contract permits such an arrangement. Notwithstanding such similarities, the direct comparison of LOA and commercial contract prices is difficult since they employ quite dissimilar pricing structures.

For both FMS and direct commercial sales, many contractors and subcontractors may be involved in supplying a weapon system, since no single contractor can normally provide a total major system. Governments with extensive business ties to the West, and which are knowledgeable of U.S. law and financing, may perceive certain advantages in direct commercial sales. They may wish to participate actively in tailoring the procurement process by fixing delivery schedules, negotiating fixed prices, and insuring that designated penalties are stipulated for contractor failure to comply with the contractual agreement. The necessary commercial procurement experience which would permit a foreign government to play an effective role in such contracts may be available as a result of previous commercial purchases of other types of items. For commercial contracts, it is very important for the purchasing government to assess the total resources it must maintain in order to monitor production, evaluate modifications, provide for improvements, assess contract compliance, etc. A large number of highly educated personnel, well trained in international commerce, may be required to perform such functions.

Governments with a lesser trading capability and international contracting experience may choose to purchase through the FMS system where purchases on their behalf involve the entire DoD contracting network. Under FMS, there is no direct foreign purchaser involvement in DoD contract cost and price negotiations. The purchaser negotiates directly with DoD in establishing and agreeing to the various requirements specified in the LOA. Once the FMS purchaser signs an LOA, DoD is committed to procuring the FMS items under the same basic contractual provisions which are used for its own procurement.

In order to make a direct commercial purchase, a purchasing government need not duplicate the DoD contracting network. Nonetheless, the greater the size, experience, and skill level of the purchaser's contracting staff, the more likely the purchaser is to match, or even occasionally exceed, DoD contracting terms.

The FMS system encompasses the same competitive procurement philosophy as the DoD system. Both systems are designed to procure quality defense items and components at the lowest feasible price, from qualified sources. The U.S. government, rather than the foreign purchaser or a contractor, assumes responsibility for the procurement of FMS items. The ability of the purchasing government to maximize competitive procurements under direct commercial contracts may be considerably less than that of DoD, and is dependent on its willingness and ability to accept contractual responsibilities or to contract to hold the prime contractor accountable for workmanship, quality, price, delivery, and other contract terms.

The purchaser's ability 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 with various suppliers, 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 in procurement requirements 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.

Some common contract administration services which a foreign government would likely seek in support of a direct commercial contract include quality assurance, inspection, and audit services. These services are provided routinely under FMS, and are components of the overall FMS cost. For direct commercial procurements, the purchasing government may choose to place its own personnel at the various contractor facilities to perform such services. However, it is more cost effective in most cases to obtain this support from U.S. government personnel who are already assigned to defense contractor and subcontractor facilities. The costs for these services are not a part of a commercial contract. Rather, these U.S. government services would be provided in support of a direct commercial purchase on a fully reimbursable basis, funded under a separate FMS agreement. Any unique purchaser service requirements should be defined in advance and would increase costs under either the FMS or direct commercial systems.

Part 4 - Logistics and Training Considerations

An important consideration in the purchase of U.S. defense equipment is the nature of follow-on support and training which will be required from U.S. sources. If the end item being purchased is in use by the U.S. military, an FMS procurement might prove most desirable since the purchaser could thereby capitalize on U.S. experience and existing U.S. government logistics inventories. Under a CLSSA, most of the DoD inventory and contracting system 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 system

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.

Follow-on support is linked directly to weapon system operations and maintenance crew training. It is important to identify the extent to which the purchasing government will need to provide training assets, and to determine whether the training will be provided by either the contractor or the U.S. government through FMS, or through a combination of both. Similarly, the purchaser must understand exactly how much logistics support will be required and how it will be provided.

Prior to the consummation of a specific FMS agreement, the cognizant U.S. military service is responsible for determining the extent to which it can support, through FMS procedures, the training and logistics requirements of the FMS case. Also, the U.S. military service, when asked, may review its ability to provide such support for a commercial sale. The timing of the support requirements (i.e., when they will be needed) may limit the ability of the service to support the proposed acquisition under a direct commercial sale.

The ability of the U.S. military services to support commercial sales is also limited where equipment may not match the support capabilities available through the normal logistics systems of the services. For example, if the manufacturer only employs commercial stock numbers to identify items, without providing cross-references to the national stock numbers (NSNs) employed throughout DoD, U.S. government support will be greatly complicated and delays will ensue in responding to purchaser support requests. The problem can be overcome if the purchaser is able to obtain contractor agreement to the use of NSNs to catalog all system items. The purchaser benefits when commercial stock numbers are converted to NSNs, for he then gains access to both U.S. government support and contractor support. Such dual access might well be operationally significant in a crisis situation.

For some procurements, training and follow-on support for standard equipment may be required from both DoD and the contractor. DoD itself employs contractor support and training for a number of weapon systems, particularly when a new weapon system is being introduced into the DoD inventory. Thus, as with other considerations involved in procurement choice, the issues of logistics and training requirements are tied to purchaser requirements and U.S. government and contractor capabilities.

Part 5 - Involvement of U.S. Military Personnel

A purchaser's judgment as to the degree of U.S. military advice and assistance that may be needed during the planning phase of a new procurement will often condition the decision as to which acquisition system will be employed. This, in turn, is dependent primarily on the complexity of the item or system to be purchased.

Planning and purchase considerations may involve a complex weapon system configuration, undetermined levels of spare parts and support equipment requirements, 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 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 bi-national consideration which is most often conditioned by the degree of other associations between the two military establishments.

Inter-military contact is frequently facilitated by the FMS purchaser's ability to use DoD information and data transmission systems such as Defense Switched Network (DSN) and the International Logistics Communications System (ILCS), Supply Tracking and Reparable Return/Personal Computer (STARR/PC), AFSAC On Line, Navy E-Business Suite, and the Security Assistance Information Portal (SCIP). Commercial customers must rely on commercial telecommunications systems. DoD also has security assistance dedicated staffs who furnish direct support to in-country SAOs for the administration of the FMS program.

It is important to recognize that whatever level of continuing inter-military contact is maintained, the FMS process creates a government-to-government relationship in the defense field. This is true regardless of whether or not more formal relationships (e.g., alliances) have been established.

Part 6 - Pricing and Financing Considerations

The price and method of financing of defense purchases is a function of several variables, one of which involves urgency of need. The question here is whether a foreign government has a perceived immediate requirement for a specific item or weapon system or whether it is involved in the routine upgrading of its defense capabilities. If the latter, the purchaser must assess its own fiscal budgeting cycle and the level of funds that are likely to become available. If the government can wait to obtain the items under either normal FMS procurement or as an add-on to a U.S. government purchase, cost savings will be achieved through the economies of scale resulting from such purchases. In the commercial marketplace urgency of need reduces competition and decreases the purchaser's leverage in price negotiations.

In some instances, a commercial contractor may have a sufficient quantity of an item in his inventory, and thereby would probably be able to fill a purchaser's order faster than would be possible under the FMS system. In such cases where rapid delivery is desired, it is also often possible to purchase items at a standard catalog price without incurring any price penalties for expedited delivery. Contractors normally do not produce items in anticipation of sales and generally do not maintain an extensive inventory of defense articles. To do so would incur risk and very high sunken costs; yet, on occasion even major items are built at risk.

For its part, the U.S. government is precluded by the AECA from incurring losses. This normally prevents buying in anticipation of a foreign sale, except for items provided under a CLSSA. In emergency situations, the U.S. government can assist foreign governments with FMS purchases by withdrawing materiel from the DoD inventory, or diverting and shipping defense articles from resources on hand or under earlier procurement. Such emergency responses are possible since the items being procured for the foreign purchaser can subsequently be used to replenish the DoD inventory. If commercial procurement channels had originally been selected and then an emergency subsequently ensued, there is much less flexibility available to the U.S. government to provide the needed supply assistance.

It should be noted here that the acquisition of nonstandard equipment through direct commercial procurements may negate the military training and logistics support advantages inherent in the FMS system. On the other hand, neither acquisition system may be able to meet a required level of production on short notice. Response to such a purchaser requirement is dependent on the exact item/system configuration, the quantity desired, and the point at which the manufacturer is in his normal production cycle. These factors affect not only the final price, but the timing of delivery, especially if re-tooling is required for production.

The issue of the total costs of an FMS procurement in comparison to a direct commercial acquisition is frequently a factor considered by the purchasing government. When a weapon system with associated follow-on support is purchased entirely via FMS, the total acquisition cost is generally somewhat less than if the same package is purchased entirely from commercial sources. However, this generalization may not 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 to employ the FMS system or direct commercial channels. This is especially true in those cases where the items or systems 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 or system being purchased, the extent to which other U.S. and foreign requirements may be combined into a more economical order quantity, 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, the FMS system provides for procurements directly from as many original manufacturers as possible, thereby minimizing the purchase price. If a country's purchasing 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 mark-ups 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 of like items which are produced by two or more manufacturers often can be made at less than FMS prices. Items sold under intense competitive circumstances may occasionally be obtained at fixed prices which are below cost/profit margins allowable under DoD contracting regulations, especially when both U.S. and non-U.S. suppliers are in competition for the sale, proposing items that are competitive but not identical. Price advantages under direct commercial sales also may be possible during times of rapid inflation in the United States, especially if the contractor has the ability to make quick deliveries from off-the- shelf inventories or rapid new production.

In the absence of an approved waiver, the AECA requires a charge for a proportionate amount of any nonrecurring costs of research, development, and production of major defense equipment sold pursuant to Sections 21 and 22, AECA, through foreign military sales. The purchaser can request a waiver, in accordance with the above law, when:

- Imposition of the charge or charges would likely result in the loss of the sale; or

- In the case of a sale of major defense equipment that is also being procured for the use of the U.S. Armed Forces, the waiver of the charge[s] likely would result in a U.S. savings (due to economies of scale) that substantially offsets the revenue foregone by reason of the waiver.

Waiver requests must be made by the country on a case-by-case basis and must be submitted prior to acceptance of the FMS LOA amendment for increased quantities. If recent history is used as an indicator, the waiver has a high probability of approval.

The above waiver does not affect the current waiver authority for sales to NATO or NATO member countries, Australia, Japan, and New Zealand in connection with co-production arrangements; or sales wholly financed with Foreign Military Finance Program (FMFP) grant funding. The broader waiver applies to all countries authorized to make purchases through FMS.

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. It will be determined by actual U.S. government contract cost and other management costs required by U.S. law and regulation. The final price may be more or less than the estimated price. Higher prices are the exception.

One special feature of the FMS system involves the use of cross-leveling agreements. Such agreements allow country funds which are on deposit in the FMS Trust Fund to be moved to and from special holding accounts, or moved between separate FMS cases, thereby maximizing the use of country funds. This practice is in contrast to direct commercial contracts, which stand alone and typically provide for fixed prices, with fixed payment schedules, but with no provision for the movement of funds between individual contracts. In short, cross-leveling under FMS provides the advantage of flexibility to the purchaser to meet changing requirements, whereas commercial sales offer the advantage of providing a final price at the time of contract signature.

These differing contractual pricing and financing approaches make comparisons between FMS estimates and commercial prices quite difficult. Under the FMS system, the U.S. government responds to foreign government requests for system sales, and then enters into contracts to meet U.S. military specifications. Recommendations for support and ancillary equipment, plus provisioning and publications, are included in such FMS cases. The resulting total list of articles and services on an FMS case will likely differ from a similar commercial contract, even where both involve sales for MILSPEC items. The bottom lines obviously will be different. It should also be noted that the U.S. government does not compete with U.S. industry for foreign sales. Moreover, as a matter of policy, the U.S. government normally does not knowingly provide foreign governments with comparison pricing information, especially in those instances where it is known that a direct commercial contract is already being negotiated. An exception to the policy of not providing comparison pricing information can be made if the country has a national policy requiring both FMS and commercial data be obtained.

The issue of so-called “hidden costs” in both commercial contracts and FMS agreements also requires clarification. The FMS administrative surcharge and contract administration costs that are added to the basic price of an FMS agreement are obviously functional costs of the FMS procurement process. Except for specific statutory exemptions, all U.S. government expenses for FMS program implementation must be recovered from the purchaser. The administrative

surcharge insures recovery of such costs as those involving sales negotiations, case implementation, contract negotiation, contract management, financial management, certain reports of discrepancy, etc. Contractor profits are also included within the final FMS price, but are limited by the provisions of the FAR. Conversely, the profit ceiling for commercial contracts is established by the marketplace. The purchasing government will not normally have access to information which reveals how much G&A cost or overall contractor profit is included in either a direct commercial contract or in a DoD contract which includes FMS requirements. U.S. firms typically add administrative costs as part of their equipment unit prices, whereas FMS administrative costs are identified as a separate line item on the FMS agreement.

Direct commercial contracts generally require a relatively large down payment, payable at the time of contract signature. The size of such down payments varies with circumstances and the level of contractor risks. For FMS cases, the initial deposit required at LOA acceptance is generally somewhat lower than commercial contract down payments. For items which have a substantial production period, the phased progress payment system used for FMS may stretch out the payment burden beyond the payment schedule requirements of commercial contracts. Further, it is possible that commercial contracts may be made more expensive by the cost of money required to fulfill advance payment requirements, as well as other lost opportunity costs, since the money will not be available for other financial requirements. Such possible differences in payment terms, therefore, should be evaluated as part of the purchaser's procurement decision.

Most contractor selling costs represent allowable charges under FMS; however, there are limitations on agent fee costs (i.e., agent selling charges which are established as a set fee or as a percentage of contract costs, for which payment is contingent upon completion of the sale of an item). Such agent fees may be treated by a commercial contractor as part of its normal overhead, and thus would not appear on the direct commercial contract as a separate cost element. On the other hand, under the FMS system, agent commission fees must be specifically identified and accepted by the purchaser, and are limited to $50,000 for a DoD contract. This dollar limitation also applies to any direct commercial contracts which are financed with repayable FMS credit loans. U.S. government funded FMF cannot be used to pay commissions, agents or contingent fees. Under FMS procedures, the purchaser will always be notified by the U.S. government of any agent fees and must agree to pay for them. Conversely, it is the purchaser's responsibility to determine the specific costs of a direct commercial contract financed with its own national funds.

Part 7 - DoD Production and Control Considerations

DoD is generally neutral regarding whether a weapon system is sold through either FMS or direct commercial sales. In some instances, however, the DoD position concerning the channels of sale is influenced by factors such as releasability criteria, the extent to which DoD controls a production facility, or whether components of the system are produced in DoD-owned facilities.

In limited instances, technology or security concerns may require that sales of specific items be restricted to FMS only. Also, some manufacturers which produce defense items for DoD do not wish to sell such items on a direct sales basis to foreign purchasers; rather, they prefer that international sales be made only through FMS channels.

Additionally, there are many defense articles which are produced by U.S. industry either using production equipment provided by DoD or in U.S. government-owned facilities. Such production equipment and facilities are made available to the contractor to fulfill DoD requirements, including foreign requirements under FMS. Contractors may use such facilities for direct commercial sales only with U.S. government approval of such use, and only when there is no adverse impact on DoD requirements. Except in times of crisis, the prioritization of the use of such equipment or facilities generally is not a problem. During a crisis, however, DoD can be expected to place emphasis on the use of its equipment or facilities to fill its own total requirements.

Another consideration involves components produced by DoD facilities which are provided under DoD contracting procedures to defense contractors as government-furnished equipment (GFE) or government-furnished materiel (GFM). Such items are generally incorporated by the contractor into larger systems which are then sold by the contractor to either DoD or a foreign government. U.S. law limits the sale of GFE or GFM to only certain eligible contractors. Therefore, the extent of DoD-produced components in a system could have a significant impact on the capability of a contractor to make a direct sale. If DoD-produced components are not available to a contractor, the foreign purchaser could acquire them under FMS procedures, and then provide them to the contractor for incorporation in the end item. This procedure, of course, would make a commercial acquisition more complex for the purchaser, and would require his careful coordination of both the commercial and the FMS transaction. By contrast, under the FMS system, DoD provides GFE or GFM (whether produced commercially or in U.S. government facilities) directly to the prime contractor on an equal priority basis for both U.S. and foreign requirements, and DoD coordinates the production of the end item.

If a standard system is obtained commercially, follow-on support may be provided through the FMS system. Also, DoD-produced components for follow-on support are made available to contractors on the same basis as GFE or GFM components required for end item production.

U.S. firms can request that military items that they manufacture be sold to foreign purchasers only by direct commercial sales. Such requests should be sent to the Defense Security Cooperation Agency (DSCA). When approved these DCS Preference requests will be honored for one year. Where the U.S. contractor has been approved for contractor preference, DSCA policy requires that prospective purchasers be informed of the contractor's preference for commercial sales. If after such notification the customer still wishes to purchase through FMS, he must provide justification to DoD for an FMS procurement.

Part 8 - Procurement Lead Time Considerations

Generally speaking, defense articles from production may 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 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 proposals more quickly than the U.S. government 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.

As a further consideration, protracted commercial negotiations are often required to achieve an agreed upon price. The length of the contract negotiations 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 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 procurement. 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.

Part 9 - Flexibility in Contracting Considerations

Governments, with their own cadre of acquisition professionals with extensive international business experience, may determine that the more flexible possibilities offered by direct commercial contracts provide benefits to their weapon system acquisition requirements beyond those available through FMS. For example, arrangements involving co production 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 co production agreements without some level of U.S. government involvement. Nevertheless, there has been many successful co-production and commercial offset programs conducted for sales under FMS procedures even though the U.S. government will not finance the offset whether the sale is commercial or FMS. Also, direct sale arrangements may be more suitable for international competitions where products from several countries are to be considered.

Another factor deserving of purchaser consideration is associated with the restrictions placed on commercial sales involving classified components that may need to be procured through a separate FMS case. In this regard, the U.S. National Disclosure Policy sets forth the levels of classification for which specific countries are eligible. Regardless of the purchasing method chosen, the purchasing government must meet these criteria if a sale involves classified items or technical data.

Many classified shipments of FMS material are made through the Defense Transportation System (DTS). Other DoD-arranged transportation modes may be used which will provide the required security, and enable DoD to maintain control and custody of the material until delivery is complete. The Military Assistance Program Address Directory (MAPAD) lists shipping addresses for country freight and

freight forwarding agents who have been cleared to receive classified material and who therefore may handle the transportation of such material for the purchaser. The MAPAD can be found at the following internet address: https://day2k1.daas.dla.mil/dodaac/mapac.asp.

In all of these considerations, it should be recognized that the unique requirements of a specific sale might rule out the use of the FMS system. Examples of such cases might include a used aircraft trade-in, or a sale involving a barter arrangement as partial payment. Finally, if a purchasing government has its own audit and self-insurance capabilities, this would enhance its overall commercial contracting flexibility.

Part 10 - Purchaser Government Participation

For most weapon systems, DoD strives to maintain viable production bases in the U.S. to support current DoD needs and mobilization requirements. The production base for a specific weapon system might consist of a single U.S. government-owned facility, or a single U.S. contractor-owned industrial facility, or dual or multiple sources. However, certain foreign sources may also qualify. U.S. production agreements with Canada and industrial cooperation agreements with certain other countries enable such foreign sources to bid (usually as sub-contractors) for DoD production contracts. To compete with U.S. sources, these foreign sources must not only meet U.S. specifications, but also must be competitive in terms of both price and quality. Other foreign sources, for whom there are no industrial cooperation agreements, may attempt to bid for DoD contracts, but in addition to meeting specification and competitive requirements, they must also meet the additional criteria established by the *Buy America Act of 1933.*

Under FMS procedures, the DoD procures for foreign requirements on the same basis that it procures for U.S. military requirements, and therefore, qualified foreign producers may provide some components of U.S. systems within the purview of industrial cooperation agreements. Presently, a number of foreign countries are requesting some form of compensation from the U.S. as a condition of purchasing a U.S. system. The most common form of compensation is an offset, or an arrangement to include industrial participation or counter trade as a condition for the sale. DoD policy precludes the direct use of offset under FMS and provides that an offset is best left to direct negotiation between U.S. industry and the foreign country. Policy also precludes DoD from guaranteeing contractor performance under a foreign country-to-U.S. industry agreement.

DoD normally procures items at the most economic price, based on competitive contracting under the specified contracting requirements of the *Federal Acquisition Regulation (FAR)* and the DoD FAR Supplement (DFARS). Accordingly, countries desiring indirect offsets cannot do so under the FMS system; however, except for any offsets, the remainder of a transaction may be accomplished through FMS procedures. Moreover, all of the elements of such a transaction, aside from the offsets, will receive all of the benefits and protection of the DoD procurement system as mandated by the FAR for FMS purchases.

Direct commercial sales, on the other hand, enable a foreign purchaser to exercise a greater degree of flexibility in contracting with U.S. industry than is possible through FMS. This is true because U.S. industry has no structured, regulatory guidance, such as the FAR, which must be followed in direct contracts with foreign governments. Such flexibility extends beyond imaginative financial arrangements to

include such areas as industrial participation, counter trade, or offset. The degree of success the purchaser may achieve in attaining his contract objectives is subject only to the skill of his negotiators, the level of his need for a particular item, the contractor's resources, and the level of the contractor's need for the purchaser's business.

Direct offsets or coproduction usually result in a higher overall cost to the foreign purchaser. Since contractors do not intentionally operate at a loss, the additional costs of implementing offset or counter trade arrangements becomes a part of the overall contract cost. For certain countries, and under certain conditions, the economic spin-offs of industrial cooperation may justify the higher price of acquisition when an offset agreement is involved. This applies to either FMS or direct commercial sales. Even though some countries may pursue direct commercial arrangements to advance their goals of industrial participation, nothing precludes similar procurements under FMS procedures, with the accompanying negotiation of an offset arrangement directly between the U.S. contractor and the purchasing government.

In considering the utility of an offset arrangement in connection with a particular system procurement, the purchasing government must examine its overall objectives. If it wishes to acquire the system in the simplest manner and possibly at a lower price, the purchaser will probably forego the offset option. Conversely, if the purchaser has other goals, such as industrial participation, an offset might prove a viable choice, even with the additional administrative effort and costs which are involved and the uncertainties inherent in most such arrangements. However, it should be noted that unless a government-to-government agreement has been effected, the U.S. contractor with whom an industrial agreement has been made may be unable to assure the foreign purchaser that the foreign production effort will be used to meet future DoD requirements.

Part 11 - U.S. Industrial Priorities

Contractors occasionally find themselves in competition for limited components, raw materials, U.S. government facilities, or tooling. The resultant conflicts may affect production requirements, causing delays and increased costs. To resolve such conflicts in production schedules, the U.S. government has established an industrial priority system. Each U.S. defense program is assigned a specific priority based on the program's relative importance to the U.S. government. Thus, the U.S. government uses its relative need for a system to settle production conflicts, rather than leaving such resolution to the discretion of contractors.

Foreign military sales equipment normally is purchased together with U.S. equipment, and thereby shares the U.S. industrial priority. Direct commercial sales, however, involve independent contracts, and do not automatically enjoy the same production priorities as DoD procurements. Priorities and allocation criteria for commercial contracts must be reviewed and allocated by the U.S. government. The contractor must separately request an industrial priority for a commercial contract. The request is submitted to the Office of the Under Secretary of Defense for Acquisition, Technology and Logistics [USD (AT&L)], along with a copy of the contract or proposed contract. There is no assurance that a priority equal to that applying to U.S. government procurements will be granted. Thus, the issue of industrial priorities is a further variable the purchaser must consider in choosing between FMS and direct commercial channels for defense acquisitions from the United States. It should be expected, though, that delivery lead-times quoted by

U.S. contractors for direct commercial sales have taken this factor into account. Hence, if the quoted lead-time is satisfactory, only very rarely will the industrial priority system subsequently be applied to revise it.

Part 12 - Use of Foreign Military Financing Program Funding

Foreign Military Financing Program (FMFP) funding, which is granted or loaned to the customer by the U.S. government, is most often used to finance FMS purchases. However, under some regulated circumstances, specific countries may use their FMFP funding to pay for DCS contracts. Please refer to SAMM, C.9.7.4.1.1, for further details concerning this topic.

Annex A to Appendix 4
Foreign Military Sales

Potential Advantages	Considerations
1. Total package approach based on U.S. military experience.	1. Purchaser must decide whether the total package may exceed his needs or financial capabilities.
2. U.S. government uses its own procurement procedures and acts as procurement agent for foreign countries.	2. Sophisticated foreign purchasing staff may (or may not) be able to achieve better overall deal by negotiating directly with contractor.
3. Proven and established logistics support for items common to DoD.	3. It occasionally is possible to achieve a full range of contractor logistics support.
4. *Federal Acquisition Regulations (FAR)*, economic order quantity buys, use of GFE or GFM, and competitive procurements tend to reduce price.	4. Compliance with DoD procedures also tends to increase lead times, thus emphasizing need for country planning to start procurement process earlier.
5. Facilitates establishment of design configuration and enhances potential for standardization.	5. Purchaser must decide on the degree of standardization required for a particular purchase.
6. Purchaser pays only the actual cost to DoD (including management expenses), with profits controlled by FAR.	6. While initial LOA estimates tend, in the aggregate, to be considerably higher than final LOA costs, final costs fluctuate (both up and down), making purchaser funds

			management more difficult.
7.	Cross-leveling in the FMS Trust Fund can maximize use of country funds.	7.	Firm fixed priced contracts and fixed payment schedules can be obtained under direct commercial contracts.
8.	Quality control to assure item meets MILSPECs is done by U.S. government personnel.	8.	This service can be purchased under FMS for certain commercial contracts
9.	Items may be available from DoD stocks in times of emergency.	9.	Availability is significantly dependent on DoD's own priorities and inventory positions.
10.	Government-to-government obligation, assuring involvement of DoD personnel in military planning, deployment concepts, operational planning, etc.	10.	If closer military-to-military relationships are a purchaser objective, FMS provides one avenue toward achieving them.
11.	Better access to training at U.S. military schools.	11.	Purchaser can procure hardware under commercial contract, and generally obtain associated training at U.S. military schools via FMS.
12.	Purchase of end item facilities maintenance of design configuration, provision of technical data, modifications, and catalog information.	12.	Arrangements for continual configuration commonality with DoD are an integral objective of the FMS system.
13.	FMS customers can use ILCS system.	13.	Commercial customers must rely on the commercial telecommunications system.

Direct Commercial Sales

	Potential Advantages		Considerations
1.	Potential for fixed delivery or fixed price, with penalty if contractor fails.	1.	Requires considerable experience and sophistication by country negotiators.
2.	Business-to-business relationship allows country to negotiate cost and contract terms.	2.	Closer military-to-military relationships are a purchaser's objective; FMS provides an avenue to achieve this objective.

3.	Direct negotiations with contractor can result in a quicker response.	3.	Requires considerable experience and sophistication by country negotiators.
4.	Sometimes the only source of logistics support for items not included in U.S. inventory.	4.	Purchaser must decide upon desired degree of standardization with U.S. forces.
5.	More capability to tailor package to unique country needs.	5.	Tailored” package may detract from standardization desires.
6.	Continuity of personal contacts with contractor technical personnel.	6.	Generally, also can be arranged via FMS.
7.	New equipment directly from production line.	7.	Generally, also can be arranged via FMS, although some spares may come from DoD inventories.
8.	Lower prices possible under certain circumstances.	8.	Significantly dependent on item or service involved and sophistication of country negotiators.
9.	Generally fixed payment schedule which eases budgeting problems.	9.	Preponderance of payment schedules is more front-loaded than under FMS.
10.	Purchaser can include offset provisions in one contract.	10.	Purchaser can negotiate offsets (directly with contractor) and still procure under FMS.
11.	FMS administrative surcharge and DoD management costs can be avoided.	11.	Purchaser must consider entire cost of transaction, including his contracting staff costs and possibly increased contractor administrative costs.
12.	Commercial purchase of some types of items could help to create and develop a procurement capability.	12.	Scarcity of resources and time may not allow for this type of on-job training for procurement staffs.

Annex B to Appendix 4
Common Misperceptions of FMS or Commercial Sales

	Misperceptions		Facts
1.	FMS prices are cheaper.	1.	Depends on item being purchased, negotiating skills, and many other variables.
2.	Commercial prices are cheaper	2.	Depends on item being purchased, negotiating skills, and may other variables.
3.	FMS offers better assurance for approval of transfer of technology.	3.	Technology release considerations are identical for FMS and commercial sales.
4.	Commercial sales offer a better assurance for approval of transfer of technology.	4.	Technology release considerations are identical for FMS and commercial sales.
5.	FMS is unreliable during hostilities involving either the user or the U.S. government.	5.	Foreign policy or DoD military priority decisions affect the flow of supplies to a country and can be expected to relate to the resource involved. FMS orders may still be filled depending on the nature of the hostilities.
6.	Commercial sales are unreliable during hostilities involving either the user or the U.S. government.	6.	Foreign policy or DoD military priority decisions affect the flow of supplies to a country and can be expected to relate to the resource involved. There may be a tendency to fill FMS orders first, depending on the nature of the hostilities.
7.	FMS provides slow or slack delivery schedule, with frequent slippages.	7.	The numerous built-in FMS system safeguards do slow the procurement process sometimes, although there seldom are slippages once delivery schedules are established. However, in a contingency situation where a USG decision is made to divert items from service stocks and expedite delivery, service is exemplary.

8.	Nonrecurring cost (NC) recoupment charges for Major Defense Equipment is always accessed on FMS sales.	8.	Nonrecurring cost (NC) recoupment waivers may be authorized for FMS on a case-by-case basis. Recent history indicates a high probability of waiver approval.
9.	A country cannot have an offset arrangement when they have an FMS case.	9.	A country may leave an offset arrangement in an FMS agreement, but the U.S. government will not be the enforcer of offset arrangements between the country and the commercial contractor.
10.	No purchaser control or participation is permitted in FMS.	10.	Selection of configuration, range and depth of spares, support equipment, etc., remains in control of purchaser. Program management review conferences are held as necessary to assure purchaser needs are met. Under certain circumstances, the purchaser may observe selected contracting proceedings.
11.	FMS system is characterized by a lack of continuity of personnel contact due to military personnel rotations.	11.	While this may be true for some cases, there are many DoD civilians who do not rotate. Also, military tour is normally three to four years about equal to commercial executive transfer patterns.
12.	No offset arrangements or coproduction programs are possible under FMS.	12.	Not true. These are common to many FMS LOAs. However, offsets must be negotiated separately by the purchaser with the contractor.
13.	Only FMS required U.S. government approval and congressional notifications [Section 36(b), AECA], if necessary.	13.	All items meeting AECA notification thresholds require notification under both sales systems. Section 36(c), AECA, applies to commercial sale notifications to Congress.
14.	U.S. government reserves the right to terminate an FMS sale in the U.S. national interest.	14.	Applies equally to both FMS and commercial sales systems.

15.	Quality control is not assured for items bought commercially.	15.	Contractor sales depend on product reputation. Also, USG quality control procedures may be purchased for standard items.
16.	Contractor involvement stops once an end item is sold.	16.	Contractor participation in follow-on support and maintenance programs is common under either commercial or FMS.
17.	U.S. government controls third country sales only for items sold under FMS.	17.	Criteria and policy are the same for items purchased through either commercial or FMS.