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IMPROVING ARMY-INDUSTRY
COOPERATION IN DEFENSE
SALES ABROAD

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April 1987

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19. ABSTRACT (Continue on reverse if necessary and identify by block number) The U.S. Army and U.S. industry are partners in furthering U.S. security objectives through sales of defense equipment and services to friendly foreign nations. These sales have major military and economic impacts on both the United States and the foreign countries involved and are also an important component in the U.S. balance of trade. Improving cooperation between the Army and industry in making these sales is becoming increasingly important, particularly in an era when the international arms market is becoming more competitive. At a recent conference, industry representatives made 21 recommendations for improving Army industry cooperation in defense sales abroad. These are discussed in detail. LMI evaluated these recommendations, and recommended that the Commanding General of the Army Materiel Command should take the following actions: • By expanding their charters, make the materiel program managers responsible for developing, early in the acquisition process, integrated production plans for both U.S. needs and foreign sales.						
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Executive Summary

IMPROVING ARMY-INDUSTRY COOPERATION IN DEFENSE SALES ABROAD

For the past two years, Army and industry representatives have been discussing ways to improve cooperation in defense sales abroad. Industry spokesmen believe that some current policies and practices need improvement because they put U.S. industry at a disadvantage in relation to foreign competitors or in an adversary position with respect to the U.S. Government. We agree that constructive change is called for. Further, we believe it is possible.

We recommend that the Commanding General of the Army Materiel Command:

- By expanding their charters, make the materiel program managers responsible for developing, early in the acquisition process, integrated production plans for both U.S. needs and foreign sales.
- Require for each weapon system that its full-scale development plan spell out the Army position on future foreign sales and release of associated technology.
- Direct that a price disclaimer, including the date of last procurement on which published prices are based, be added to the *Army Master Data File Price Report*, which is sometimes used by foreign purchasers to compare offered prices for foreign sales with the listed prices.
- Sponsor an annual conference in which the Army and industry exchange ideas for improving cooperation in U.S. defense sales abroad.

In addition, we recommend that the Commanding General seek support of Headquarters, Department of the Army and the Office of the Secretary of Defense to:

- Remove the \$50,000 limit on the allowable agent fee for a foreign sale and make the fee a function of sale size; e.g., set the fee at 5 percent for sales up to \$1 million and 0.5 percent for sales above \$100 million, with fees in-between growing linearly with sale size while the percentage decreases.
- Reduce or abolish the 3 percent administrative charge now added to Government-furnished equipment procured by industry for foreign sales.
- Restructure the calculation of the recoupment charge for nonrecurring costs (for research, development, test, and evaluation and for production investment), reduce it, and allow it to be waived altogether when there is price competition.

The actions we urge are not as dramatic or sweeping as some that industry has sought. Their advantage is that they are clearly achievable.

There is little to be gained in putting effort into pursuits that offer no chance of success in the near future. The policy of allowing overseas marketing costs to be allocated only to foreign sales, for example, may be debatable. However, the Congress has recently confirmed that policy

and the Secretary of Defense has accepted it. Similarly, many of the charges that must be applied in foreign sales may be vestiges of a time when competitiveness was not a serious problem for U.S. business. Nonetheless, wholesale elimination of them is not now a realistic prospect.

Our recommendations promise, in our judgment, the greatest improvement consistent with a high probability of success in implementation. We urge their adoption.

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CHAPTER 1

INTRODUCTION

PURPOSE

This report summarizes and evaluates recommendations arising from an Army/industry conference sponsored by the U.S. Army Security Affairs Command (USASAC) on 15-16 May 1986. The theme of the conference was cooperation between the Army and industry in security assistance and defense trade. Its objective was to solicit industry views on how cooperation could be improved and to obtain industry recommendations for changes in policies, procedures, regulations, and laws in this area.

BACKGROUND

For the past decade, U.S. sales of military materiel and services for ground forces have averaged more than \$3 billion a year. These sales have contributed to U.S. foreign policy objectives and have also lowered U.S. unit costs, increased defense industrial activity, and contributed to reducing the balance of payments deficit.

Now, however, changes are taking place that affect the stability of the worldwide military market and the U.S. share of it. Some, such as the drop in value of the U.S. dollar with respect to many foreign currencies, could be expected to have a positive effect on all U.S. export sales. Others, such as the growing surplus of production facilities for military equipment and ammunition in both developed and developing countries, will have a negative effect. Still others, such as lower world prices of

commodities, including oil, will have mixed effects.

In view of these uncertain economic trends, the prospect of lower funding levels to support military sales credits, and perceived conflict between foreign military sales (FMS) and direct commercial sales (DCS), USASAC solicited industry views concerning the U.S. military sales posture. USASAC administers the Army portion of FMS and advises the Department of State (via OSD) on the granting of export licenses for ground forces materiel, services, and technology by DCS. The conferees discussed both systems authorized by law for the international sale of U.S. armaments and technology.

The conference grew out of a series of visits by USASAC officials in 1985 to industrial firms involved in military exports. On the basis of information obtained during those visits, the conference agenda presented in Appendix B was developed. Issue papers, prepared for distribution before the conference, are included in Appendix C.

There were four working groups at the conference:

- A) Recovery of Cost of Sales to Industry and Government)
- B) Security Assistance Organizations, Military Attaché, USASAC, Program Management Office, and Major Subordinate Command Support to Industry)

C) Foreign Competition and How the United States Should React to It

D) Impact of Licensed Production/Coproduction Benefits and Costs.

Participants in the conference are listed in Appendix D.

ORGANIZATION

Chapters 2 and 3 discuss in detail the recommendations and rationale offered by industry, our evaluations, and the actions we recommend. Chapter 2 consists of recommendations that fall within the scope of responsibility of the Army

Material Command (AMC); Chapter 3 of those that fall outside the scope of AMC's responsibility, but for which AMC can, nonetheless, urge initiatives for change at higher organizational levels.

SUMMARY

Of the 21 recommendations from the conference, we recommend that action be taken to implement 7, that 6 be partially implemented, and that no action be taken on the remaining 8. Tables 1-1 and 1-2 list the industry recommendations discussed in Chapters 2 and 3 respectively, as well as our recommendations to AMC.

*requests foreign
sales; terminate
international*

TABLE 1-1

INDUSTRY RECOMMENDATIONS WITHIN THE SCOPE OF AMC'S RESPONSIBILITIES

Recommendations by industry representatives	Recommendations by LMI
2.1 Expand the charters of program managers (PMs) to include planning for foreign sales and production cooperation, early in the acquisition cycle, as well as publication of goals and milestones and reports of progress toward those goals.	Implement.
2.2 Determine policies on sales and release of technology at the beginning of full-scale development.	Implement.
2.3 Include the date and quantity of last procurement and economical order quantities for new procurement in the <i>Army Master Data File Price Report (AMDFPR)</i> .	Implement.
2.4 Reduce the number of licensed production cases where memoranda of understanding (MOUs) are used.	Take no action.
2.5 Establish means for forecasting when MOUs will be required.	Take no action.
2.6 Develop a better system for paying foreign marketing costs when materiel is sold through FMS from U.S. production or from materiel stockpiled by the Special Defense Acquisition Fund (SDAF).	Implement in part.
2.7 Inform potential purchasers fully of their rights to choose among sources in FMS cases.	Take no action.
2.8 Release Technical Data Packages (TDPs), whose release is authorized by MOUs, through industrial rather than Government channels, except in unusual cases. Contract with industry to meet foreign customer requests for TDPs for maintenance and repair purposes.	Implement in part.
2.9 Test and certify "export" versions of equipment, as well as equipment the Army acquires for its own use.	Implement in part.
2.10 Provide a regular forum for exchanges of views between Government and industry concerning U.S. defense sales abroad.	Implement.

TABLE 1-2

INDUSTRY RECOMMENDATIONS OUTSIDE THE SCOPE OF AMC'S RESPONSIBILITIES

Recommendations by industry representatives	Recommendations by LMI
3.1 Make the allowable agent fee a varying percentage of sale size – e.g., 5 percent for sales up to \$1 million, decreasing to 0.5 percent for sales over \$100 million.	Implement.
3.2 Discontinue the 3 percent administrative charge on Government-furnished equipment (GFE) items procured by U.S. industry for foreign sales.	Implement: reduce or abolish.
3.3 Reduce or eliminate the nonrecurring cost (NRC) recoupment charge and add price competition as grounds for waivers.	Implement: restructure and reduce.
3.4 Allow adequate compensation under normal accounting practices for developing foreign markets.	Take no action.
3.5 Allow recovery of costs of administering offsets from a firm's total pool of defense overhead.	Take no action.
3.6(a) Make Export-Import (Ex-Im) Bank loans available for defense sales.	Implement in part.
3.6(b) Allow the Overseas Private Investment Corporation (OPIC) to insure military investments and letters of credit.	Implement in part.
3.7 Apply commercial credit terms to defense sales.	Implement in part.
3.8 Provide information on letters of offer and acceptance (LOAs) to industry and suspend LOAs and LOA activity when notified of commercial negotiations.	Take no action.
3.9 Require security assistance training for all Security Assistance Organization (SAO) personnel unless previous experience clearly makes it unnecessary. Some portion of that training should be devoted to relations between SAOs and U.S. industry.	Take no action.
3.10 Increase Government support of military sales efforts.	Implement in part.
3.11 Define "foreign availability" in terms of performance instead of the specific technology used to attain performance and the available foreign production base. Expedite license approval where foreign products are available.	Take no action.

CHAPTER 2

INDUSTRY RECOMMENDATIONS CONCERNING THE RESPONSIBILITIES OF THE ARMY MATERIEL COMMAND AND MAJOR SUBORDINATE COMMANDS

INTRODUCTION

The industry recommendations discussed here fall within the scope of responsibility of AMC. Each recommendation is discussed in turn, and the disposition recommended by LMI is presented.

The first five recommendations deal with acquisition policy and management and emanated from working group B on Support to Industry and working group D on Licensed Production/Coproduction.

RECOMMENDATION 2.1

Expand the charters of program managers (PMs) to include planning for foreign sales and production cooperation, early in the acquisition cycle, as well as publication of goals and milestones and reports of progress toward those goals.

Background

The industry working group said that the responsibilities of PMs for planning foreign military sales and industrial cooperation are not explicit enough in their charters.

Rationale

Project management offices have often waited until the production base was in danger

of "going cold" before considering foreign sales seriously. Delayed efforts in support of foreign sales (i.e., those undertaken only 2 or 3 years before termination of U.S. production) have caused problems of synchronization with the planning, programming, and budgeting schedules of potential foreign customers. Such problems may result in a break in production, with attendant delays in delivery and increases in unit costs (for restartup), resulting in the loss of both a sale and a "warm" production base from which a competitively priced foreign sale could be made. In the view of the industry participants, this situation is brought about principally because the PM's charter and efficiency report emphasize meeting his service's initial operational capability (IOC) and providing fielded support. But if the developed system is approved for foreign sales, and a warm production base is desired, either to serve as a component of U.S. mobilization capability or to make possible an internationally competitive price, resources and direction must be addressed by PMs much earlier and more vigorously than in the past.

Evaluation and Disposition

We have reviewed a selection of PM charters that describe the major duties and responsibilities of Army PMs; AR70-17, System/Program/Project/Product Management; and a draft version of AMC Pamphlet 5-xxx, Program, Project, Product Manager Materiel System Assessment.

We find that the responsibilities of PMs for foreign sales are strictly limited. Their main responsibility is to make sure that such sales do not have a negative effect on the Army's acquisition plans or result in premature release of U.S. technology. Rather than promoting foreign sales, PMs generally react to foreign sales requirements placed on them by such agencies as the Defense Security Assistance Agency and USASAC.

The responsibilities of PMs for rationalization, standardization, and interoperability (RSI) within NATO (Section V of a typical charter) are described in more detail than responsibilities for relationships outside of NATO. They typically focus on consideration of foreign equipment, e.g., to ensure that foreign components or subsystems are used where appropriate. Planning and promoting foreign sales to increase RSI are not mentioned. When production is discussed, there is no mention of the need to integrate foreign sales into the production stream to achieve economies of volume production. In sum, many of the foreign sales benefits seen by industry are not mentioned explicitly in Army PM charters.

Our review and industry's comments indicate that foreign sales should receive more emphasis in the PM charter. It would be unwise to make PMs responsible for foreign sales planning in the larger sense, i.e., in delegating some or all of USASAC's present responsibilities to them, since they do not – and are unlikely to – have resources to perform this function. However, their responsibilities to USASAC and to the FMS system should be stated more positively. PMs should be tasked to help identify potential foreign customers and assist Security Assistance Organizations (SAOs) in arriving at the best FMS delivery schedule and price feasible in an integrated domestic/FMS production plan. They should also be made the focal point for establishing sales goals and milestones, for recording progress in foreign military sales for both the FMS system and direct commercial

sales, and for seeing to it that volume economies derived from foreign sales are reflected in more affordable Army programs overall.

We recommend that the international programs section of the PM charters, Para. 2-3a. (14) of AR70-17, and AMC Draft Pamphlet 5-xxx be reviewed and modified to reflect more positive guidance to PMs concerning foreign sales.

RECOMMENDATION 2.2

Determine positions on sales and release of technology at the beginning of full-scale development.

Background

This recommendation is closely related to Recommendation 2.1 in making more explicit the obligations of the PM to plan for foreign sales.

Rationale

The time between initial sales efforts and system deliveries to a foreign customer is seldom shorter than 6 years. Therefore, restrictions on release of technical data in support of sales efforts must be carefully planned well in advance of potential deliveries. The Army must avoid past practices of changing positions in midstream, which have resulted in wasted sales efforts, lost sales opportunities, and dissatisfied and frustrated customers.

Evaluation and Disposition

Though it might be difficult to carry out this recommendation at the time full-scale development is decided on (that is, far in advance of production), both industry and the Government would benefit if specific consideration were given, at that point, to the release and sale of technology. Plans for full-scale development should be modified to include a section dealing with these issues.

RECOMMENDATION 2.3

Include the date and quantity of last procurement and economical order quantities for new procurement in the *Army Master Data File Price Report (AMDFPR)*.

Background

Industry contends that outdated price information is being released to foreign governments, causing losses of commercial sales. Unit procurement price information is included in the AMDFPR, which is published monthly. The U.S. Army Catalog Data Agency is responsible for maintaining the data base and publishing the report. The data base is updated annually, and significant price changes are incorporated as they are identified. The report includes 87 data elements, including stock number, sources of supply, price, unit of issue, and related data.

Rationale

This monthly report is provided to potential foreign customers through pinpoint distribution, and they draw on it for market information. The problem is that the report includes pricing information for which the basis is unknown; that is, the order quantity and date of procurement, on which the listed price is based, are not shown. A foreign customer compares these prices with prices in current proposals and is led to conclude that the commercial contractor is overpricing bids. Sales have been lost as a result.

In industry's view, the problem could be resolved by expansion of the report to include the date of last procurement and the procurement quantity. A basis would thus be provided for estimating more current procurement prices.

Evaluation and Disposition

We have discussed the problem with personnel in the Office of the AMC Deputy Chief of Staff, Supply, Maintenance, and Transportation (SM&T) who supervise publication of the AMDFPR. They made the following points about the AMDFPR and its users:

- *The AMDFPR is widely used by the Army in resupply activities. In this use the pricing information is regarded as a "highly variable guide."*
- *Army users have little need for the additional data recommended because:*
 - ▶ *Item managers are on top of the situation and already have the information.*
 - ▶ *Other field organizations can use a "price challenge" system to obtain better data when the published prices appear to be wrong.*
- *Only FMS and DCS customers, therefore, would have interest in the additional information, and the AMDFPR is not published for their benefit.*

The SM&T people made the following points with respect to changing the AMDFPR:

- *Adding data elements would be difficult because of software problems.*
- *For many items, obtaining accurate last-price last-order quantity information would be difficult. This is particularly true of items provided by the Defense Logistics Agency or acquired in initial provisioning buys.*

- *If order quantities were included, the report might become classified.*

After considering both these comments and industry concerns, we make these recommendations:

- *A "price disclaimer" should be displayed prominently on each page of the AMDFPR.*
- *As the date of last procurement (on which the pricing information is based) becomes available, it should be included in the AMDFPR.*

RECOMMENDATION 2.4

Reduce the number of licensed production cases where memoranda of understanding (MOUs) are used.

Background

MOUs are government-to-government agreements. Licenses are industry-to-industry agreements. The MOU, it is contended, sometimes involves a lengthy and cumbersome governmental process that appears to add little value to a well-drafted licensing agreement.

Rationale

The working group argued that, in the majority of cases, controls that are desired or needed by the U.S. Government could all be achieved through the licensing agreement, and that requiring an MOU can add as much as a year to the time needed to negotiate an agreement.

Evaluation and Disposition

MOUs have not been used to excess. Because of the extra effort involved, the Government negotiates them only when it has determined that

its interests need protection. In any case, only 45 MOUs involving licensed production have been negotiated in the past 20 years. During the same period, many hundreds of production licenses have been approved. We recommend that no action be taken.

RECOMMENDATION 2.5

Establish means for forecasting when MOUs will be required.

Background

Industry argues that it is frequently surprised to find out that an MOU is required after it has expended time and money in marketing efforts and has begun negotiations toward a licensing agreement. The fact that industry negotiations are taking place is known to the Government, since an export license must first be obtained.

Rationale

Industry sales efforts would be much more efficient if the time to make a sale could be estimated accurately and the ultimate level of government-to-government interest could be made known in a timely fashion. Unexpected MOU requirements add greatly to the uncertainty of time estimates, increase costs, and weaken the ability of U.S. firms to meet foreign competition.

Evaluation and Disposition

It is possible that tentative MOU/non-MOU decisions could be forecast at the beginning of full-scale development. Forecasting for all cases, however, would be a complex process and subject to a high degree of error. The reason is that MOUs are country-specific and are negotiated for different reasons with different countries. In addition, the conditions that influence the need

for an MOU may also change over time with respect to a given country.

For companies negotiating licensing agreements where MOUs might possibly be required, the best guides appear to be common sense and close coordination with USASAC. Industry should not expect a license to be sufficient when political or technical issues suggest reasons for negotiating an MOU. Often, commercial representatives become aware of such difficulties before Government personnel do. In addition, it has been USASAC policy to discuss these factors with industry as much as possible.

No change in Army procedures is recommended.

The next five recommendations deal with a variety of issues and arise from discussions in working group A on Recovery of Costs of Sales, working group D on Licensed Production/Coproduction, and the panel discussion at the end of the conference.

RECOMMENDATION 2.6

Develop a better system for paying foreign marketing costs when materiel is sold through FMS from U.S. production or from materiel stockpiled by the Special Defense Acquisition Fund (SDAF).

Background

The working group contended that sales from option quantities and acquisitions by the SDAF do not compensate industry adequately for costs of foreign marketing efforts that often result in sales from these sources.

Rationale

The Defense Federal Acquisition Regulation Supplement (DFARS 25.7304) allows reim-

bursement of certain foreign marketing costs under procurement contracts for FMS. According to the working group, however, procurements for FMS are frequently obtained from government option quantities on domestic procurement contracts and handled as though they were entirely domestic, without any allowance for foreign marketing costs. In addition, the working group contended that procurements by the SDAF are the equivalent of procurement for foreign purchasers, but they, too, are treated like domestic procurements, without allowance for foreign marketing costs. Failure to compensate industry for legitimate foreign marketing costs is unfair at best and inhibits the sales efforts of U.S. industry.

Evaluation and Disposition

FMS Procurements

DFARS 25.7304 specifies that appropriate foreign marketing costs may be charged to procurement contracts for FMS. Such costs may also be allowed if option quantities on domestic procurement contracts are used to satisfy FMS customers. In this case the contractor is to be informed that the option is exercised for FMS.

The extent to which contracting officers or agencies are failing to follow procurement regulations is not known. Therefore, one of two actions may be appropriate:

- *Allegations of failure to comply with regulations can be investigated further.*
- *A letter can be sent to Army contracting agencies that process FMS contracts, citing industry complaints and drawing attention to the provisions of DFARS 25.7304.*

The latter course of action is recommended.

SDAF Procurements

With respect to sales from SDAF procurements, there appears to be little justification for Government reimbursement of foreign marketing efforts. The SDAF was developed for the Government's convenience to deal with certain emergency situations, and procurements for it should not be regarded differently from general domestic procurement. No action is recommended.

RECOMMENDATION 2.7

Inform potential purchasers fully of their rights to choose among sources in FMS cases.

Background

This recommendation arises from instances where U.S. firms have invested in foreign marketing, only to find that they must make second investments in competitive bids. The working group contended that in some cases this has been a result of the buying country's not being aware of its right to specify the procurement source.

Rationale

This recommendation presents a difficulty. On the one hand, the DFARS 23.7307 and its predecessor, Defense Acquisition Regulation (DAR) 6-1307(a), as well as a 1982 U.S. Comptroller General decision (B-207629), unambiguously affirm the right of the buying country to designate the procurement source. On the other hand, the *Security Assistance Management Manual* (SAMM DoD 5105.38-M, Chapter 8, Section II) limits this right and imposes conditions on a buying country's designation that are not too different from the justification required by a U.S. agency for a noncompetitive award. It is not clear, therefore, what information should be passed on to buying countries.

It was clear in working group discussions that industry representatives believed the DFARS version is valid and ought to control.

Evaluation and Disposition

It is probable that the rationale for the SAMM position is that purchases made through FMS are meant to be made under U.S. procurement regulations and therefore under the implicit – if not expressly applicable – requirements of the Competition in Contracting Act (CICA). If the foreign buyer wishes to use the U.S. procurement system through FMS, he must do so in the usual way, i.e. in accordance with CICA. Also, the Major Subordinate Commands might find it difficult to prepare letters of offer and acceptance without following the manual's instructions with respect to sole-source preference. The foreign purchaser always has the alternative of DCS (using cash or FMS credits) if he finds the justifications of the FMS system onerous or restrictive. Therefore, no action is recommended.

RECOMMENDATION 2.8

Release Technical Data Packages (TDPs), whose release is authorized by MOUs, through industrial rather than Government channels, except in unusual cases. Contract with industry to meet foreign customer requests for TDPs for maintenance and repair purposes.

Background

Until recently, all MOU-authorized TDPs were released through the FMS system, rather than by industry. Releases of TDPs are now decided case by case.

Rationale

Because of its day-to-day familiarity with TDPs, industry is a better transfer medium than

the FMS system. More important, TDPs released for maintenance and repair purposes are sometimes used improperly to support manufacturing activities. The working group said that industry, because of its greater familiarity with these TDPs, is in a better position than Government agencies to release and control them.

Evaluation and Disposition

The mode by which TDPs are released, through the FMS system or under contract by private firms, is now decided case by case. Government policy recognizes that in some cases releases by contract with industry are both safe and efficient.

The Commanding General (CG) of USASAC should instruct his International Industrial Cooperation Directorate to continue analyzing MOU-authorized and customer-requested maintenance and repair TDP transfers on an exception basis and select the most efficient means by which they can be accomplished, taking into account the rights and interests of U.S. defense industry in associated intellectual property.

RECOMMENDATION 2.9

Test and certify "export" versions of equipment, as well as equipment the Army acquires for its own use.

Background

This recommendation reflects a concern raised in several working groups: that is, when the United States does not wish to export first-line equipment and when less-sophisticated and perhaps less-capable equipment would meet the needs of a specific foreign buyer, there is no means of obtaining a "stamp of approval" by U.S. users with respect to the "export" model's capabilities.

This recommendation also reflects a deeper concern by industry that it is not treated fairly by the U.S. testing system. For instance, foreign producers can have their products tested by the United States, and the test results are often used in sales efforts. U.S. materiel that does not precisely meet U.S. requirements or is not precisely responsive to them, it was argued, does not receive the same consideration.

Rationale

The testing situation described above is said to be unfair to U.S. industry in two ways: First, U.S. products that are not adopted by the Army become less competitive abroad; second, in the U.S. market, the result can also be discrimination against U.S. products, in contrast to foreign products that have undergone Government-funded testing.

Evaluation and Disposition

There are two reasons for the existence of export versions of U.S. equipment:

- *U.S. reluctance to export the most advanced equipment*
- *Special (and often cost-reducing) requirements on the part of the buyer, the result being differences between foreign and U.S. versions.*

In the case of alternative equipment designs resulting from reluctance to export advanced systems, the Government is also reluctant to invest in the costly test-and-certification process. Without an assured buyer, there is no way for the Government to recover these costs. A second reason for reluctance is the general policy that the Government does not give logistic support to nonstandard items through the FMS system. Not only is there usually no assured buyer to pay for

the test-and-certification process, but there is also no long-term interest in logistic support.

With respect to items that are modified at the customer's request and that then become export models, the problem is less severe. The buyer either does his own test and certification or reimburses the U.S. Government for the cost. In addition, modified logistic support agreements are sometimes negotiated on a case-by-case basis. In any event, the Government is not dealing with an open-ended commitment of furnishing logistic support on a nonstandard model to an as-yet-unspecified buyer, as would be the case if such commitments were made to an "export model."

There appears to be no good solution to the problem raised by industry. One alternative would be for industry to pay for supplementary tests that would establish export model certification. However, this is likely to be costly.

We recommend that industry be asked for more data as to the need for a Government-conducted export-model testing program and for proposals for funding and conducting it.

RECOMMENDATION 2.10

Provide a regular forum for exchanges of views between Government and industry concerning U.S. defense sales abroad.

Rationale

This conference, the significant industry interest it elicited, the many recommendations

produced by the working groups, and the background noted in Chapter 1 were viewed by panel members as confirming the need for continuing consultation between the Government and industry. The annual AMC-sponsored "Atlanta" conference, which brings together chief executive officers and senior representatives of industry with the senior acquisition leadership of the Army, was cited as a possible model for a continuing forum. In particular, the continuity and follow-up provided from year to year by the CG of AMC were mentioned as being that conference's most important features. It was suggested that a similar forum for U.S. defense sales abroad would be beneficial.

Evaluation and Disposition

Though it may be too early to determine whether a regular forum or annual conference is necessary, it would be useful to have a follow-up meeting, at which the Army could explain its response to industry's present recommendations, and industry could present further data as well as raise new questions. This may be particularly useful at this juncture in international affairs, when U.S. defense sales are volatile and there is greater emphasis on the U.S. Army's use of foreign-developed technology and, in some cases, foreign materiel.

Planning should begin well in advance of the proposed meeting. A good starting point for planning would be when AMC review of this report is complete.

CHAPTER 3

INDUSTRY RECOMMENDATIONS CONCERNING RESPONSIBILITIES AT ORGANIZATIONAL LEVELS ABOVE THE ARMY MATERIEL COMMAND

INTRODUCTION

This chapter covers industry recommendations that fall outside the scope of AMC's responsibility but concern issues that AMC can raise at higher organizational levels. The statement of each industry recommendation is followed by a discussion and LMI's recommendation to AMC for action.

The first seven recommendations deal with financial and accounting issues affecting arms sales abroad. These recommendations emerged from the discussions in working group A on Recovery of Costs of Sales and in working group C on Foreign Competition.

RECOMMENDATION 3.1

Make the allowable agent fee a varying percentage of sale size - e.g., 5 percent for sales up to \$1 million, decreasing to 0.5 percent for sales over \$100 million.

Background

Payment of an agent fee of more than \$50,000 per sale is now prohibited if the sale is made through the FMS system or if FMS credits are used to fund a direct commercial sale. Working group C noted that foreign sales efforts sometimes take as long as 6 years. A \$50,000 fee is not adequate compensation for a sizable sale

that requires a multiyear effort on the part of an agent.

Rationale

The present regulation has three consequences for U.S. industry's sales activities: First, it effectively prohibits small companies or companies with a narrow product line from participating in FMS activities. These companies do not have the resources to maintain representation in foreign countries, and foreign representatives will not undertake to represent them in the absence of large "up-front" retainers or noncontingent fees. Second, larger companies do pay for foreign representation, usually by retaining consultants or assigning U.S. sales staff on a long-term basis to various countries. It is quite possible that those costs might exceed the cost that would be incurred by reasonable contingent fee arrangements. Third, since competitors of U.S. industry are not restricted by the U.S. rule, they can and do obtain better sales representation than is possible for most U.S. firms.

Industry has no wish to support contingent fee abuses and has no complaint against fully informing both the buyer and the U.S. Government of arrangements made in this area, as well as obtaining the buyer's agreement that the fee is reasonable and justified. But present limits invite abuse by depriving both the buyer and the seller of the economic benefit of

contracting and paying for specialized and expert services outside their organizations.

Evaluation and Disposition

A \$50,000 fee limitation on all sales, regardless of their size or complexity, cannot be justified on rational economic grounds. In addition, it discriminates against U.S. firms, particularly against small firms. In combination with the regulation that prohibits charging foreign marketing costs to U.S. defense contracts (see Recommendation 3.4), it excludes many U.S. firms from the FMS market, particularly the smaller and more innovative ones.

The industry recommendation is a reasonable remedy for these inequities, requires little or no extra administration, and is likely to result in benefits rather than costs to the Government. We recommend that AMC support it with the Department of the Army and OSD.

RECOMMENDATION 3.2

Discontinue the 3 percent administrative charge on Government-furnished equipment (GFE) items procured by U.S. industry for foreign sales.

Background

DoD Directive 4175.1, *Sale of Government-Furnished Equipment or Materiel and Services to U.S. Companies for Commercial Export*, enables some U.S. firms to buy GFE directly from commodity commands for incorporation into larger systems for export. Such equipment is obtained either from previous procurements or from Government option quantities on current procurements, or is manufactured at Government facilities. In any case, the U.S. commercial purchaser must pay the full cost of production in advance. In addition, a nonrecurring cost recoupment charge may be assessed. The 3 percent FMS administrative fee is applied

because the ultimate user is a foreign government purchaser.

Rationale

Industry contends that the 3 percent fee, in addition to the requirement for "up-front" cash, is unjustified because the Government provides no definable service. Moreover, the fee constitutes an unwarranted increase in cost that makes the direct commercial sale of U.S. products less competitive with foreign industries. Finally, in industry's view, imposition of the fee discriminates unfairly in favor of the FMS system at the expense of DCS.

Evaluation and Disposition

The terms for purchase of components from the Government for incorporation into equipment to be sold by industry in DCS are: the cost of production, cash in advance, plus a 3 percent fee (and any nonrecurring cost recoupment fee assessed). The rationale for these terms is this: first, the Government does not make a profit; second, it does not take any financial risks; and third, this is a foreign sale, and the administrative fee for Government foreign sales is 3 percent.

The industry complaint is that, in this case, the Government supplies only a small part of the services customarily supplied by the FMS system. In fact, no part of the LOA and Government-administered contracting process is used. Industry therefore thinks the administrative fee should be lower.

We find the industry rationale to be valid but are unable to determine the equitable level for the administrative fee. We recommend that AMC raise this issue with Defense Security Assistance Agency (DSAA) and that lowering or abolishing the administrative fee for this type of sale be considered.

RECOMMENDATION 3.3

Reduce or eliminate the non-recurring cost (NRC) recoupment charge and add price competition as grounds for waivers.

Background

The question of NRC recoupment by the Government from foreign sales was raised several times during the conference, specifically in working groups A, C, and D.

The NRC recoupment charge enables the Government to recover part of its research, development, test, and evaluation (RDT&E) and production base investments from foreign sales. Basically, these investment costs are prorated over the sum of the expected U.S. buy and expected total foreign sales, with foreign sales bearing their share of these costs. The NRC recoupment charge is not a fixed fee assessed on all foreign sales but a variable charge that depends on the nonrecurring costs of a given item and the quantities of that item that the United States and foreign customers buy.

Rationale

The working group criticized the present NRC recoupment system on several grounds. Major objections were:

- Investment costs for U.S. systems are "sunk" costs that the United States would have incurred regardless of whether there were any foreign sales. Therefore, recovery is unnecessary.
- Present means of calculating NRC recoupment charges are inaccurate and arbitrary.
- No good means are available for changing the amount of NRC

recoupment charges when conditions change, e.g., when production numbers change from original estimates.

- Increases in prices resulting from NRC recoupment charges threaten foreign sales.
- Imposition of a prorated NRC recoupment charge ignores the collateral benefits the United States receives from foreign sales, e.g., lower unit costs for its own procurements, longer periods of a warm production base, increased U.S. economic activity, and favorable effects on the balance of trade, downstream logistics, training sales, and military-political ties with friendly nations.

From industry's perspective, this charge represents one more addition to the price of U.S. defense goods that makes them less competitive overseas. Therefore, industry representatives said the charge should be eliminated or at least reduced. A fixed or flat rate rather than a separately computed rate for each item was considered a possible alternative but not recommended.

The second part of Recommendation 3.3 is that, when there is foreign competition for a specific sale, this fact should be considered as grounds for waiving the NRC recoupment charge. This follows from the logic that, given a choice between no sale and a sale with no NRC recoupment charge, the United States would be better off with a sale with no NRC recoupment because of the benefit of jobs, longer production runs, and sales of logistics support.

Evaluation and Disposition

There is no easy solution to the problem of how much to charge foreign government purchasers for RDT&E and production investment costs already paid for by U.S.

taxpayers. The Congress has directed that, except where waived on a reciprocal basis or for compelling national security reasons, foreign purchasers shall bear their fair or prorated share of such fixed (and "sunk") costs as well as pay the same price for recurring production costs as U.S. taxpayers. The problem lies in determining the prorated share when future foreign sales are essentially unknown and unknowable.

Prorated shares are now calculated on the basis of estimates of total U.S. buys and future foreign sales. They may be recalculated as estimates of foreign sales change, but there is no provision for retroactive rebates or recollections. As a result, the NRC recoupment charge frequently appears arbitrary, sometimes inadequately recovering the RDT&E and production investment costs and at other times excessively recovering them.

We think the principle that foreign purchasers should pay a fair and reasonable portion of RDT&E and production investment costs is sound, but shares cannot reasonably be calculated on a simple formula involving estimated future sales. We recommend that the CG of AMC initiate and support efforts within DoD to develop a better basis for structuring this charge – perhaps on the basis of historical cost data with several types of weapon systems – and to add price competition as a basis for waiving it altogether.

RECOMMENDATION 3.4

Allow adequate compensation under normal accounting practices for developing foreign markets.

Background

Before 1977, normal foreign marketing costs were allowed as part of the total defense business overhead pool for U.S. defense contractors. When a restrictive arms export

policy was adopted in early 1977, the pertinent DoD regulation was changed to discontinue this practice and discourage sales. After another change in arms export policy in 1981, efforts were made to return to the earlier practice. However, despite those efforts – which had strong and continuing industry support – the practice of not allowing foreign selling costs to be allocated to a company's domestic defense business base was enacted into law in 1985.

Rationale

The working group concluded that the present regulation dealing with recovery of foreign selling costs has several negative effects. It tends to limit the level of marketing activity abroad that companies are willing to undertake, especially if they have a narrow business base or confront a competitive procurement for an FMS case. At the same time, limiting marketing activity may result in loss of sales, which in turn limits U.S. volume production, the recoupment of nonrecurring costs, and U.S. industrial activity that could reduce trade balance deficits. Finally, new market penetrations and sales initiatives are discouraged in such an environment. Failure to market can also reduce U.S. diplomatic influence with allies or potential allies.

The working group discussed two other possible effects of the present selling-cost regulation, though no final determinations were made. Industry representatives said that the regulation discriminates against the FMS system in favor of DCS, and against small- and medium-sized firms in favor of large defense companies. The argument in the first instance is that the FMS price, already burdened with Government surcharges and other fees, must bear the entire cost of reimbursing industry for its foreign selling costs without those costs being shared by the U.S. Government, even though the foreign customer must pay a portion of the cost of selling to the U.S. Government. In the second

instance, many small- and medium-sized firms have either no foreign sales bases or very narrow ones against which to charge foreign selling costs and hence cannot compete against foreign or large domestic firms, who have foreign business bases sufficient in size to allow them to ensure the recovery of selling costs.

Evaluation and Disposition

This recommendation concerns laws and regulations that have a complex and contentious history. The present policy has been in effect in DoD regulations since 1977 and was enacted into law in 1985 without objection by the Secretary of Defense. It provides that foreign selling costs are allowable as overhead only in U.S. procurement contracts for FMS and not in contracts for U.S. forces even though selling costs to the U.S. Government for procurements for U.S. forces are allowable and allocable to contracts for FMS.

Our analysis leads us to conclude that, though there are valid arguments on both sides of this issue, in the end, the position of the Congress and the Secretary of Defense is correct. The present rule does appear to discriminate to some extent against small defense firms and firms with narrow product lines and, in addition, results in marginal overcharges to FMS customers. However, we believe that proposed alternatives either would be hard to administer or would result in unjustified charges (possibly significant and amounting to extraction of an unintended and indirect subsidy) against continuing U.S. contracts. For these reasons and because the issue has recently been addressed by the Secretary of Defense, we recommend that no new action be taken on this industry recommendation. The issue is discussed in detail in Appendix A.

RECOMMENDATION 3.5

Allow recovery of costs of administering offsets from a firm's total pool of defense overhead.

Background

Offsets are a common feature of many FMS programs. The Government's policy is not to enter into offset agreements, leaving them to industry to work out and guarantee where they are needed.

Rationale

The working group did not object to the Government's "hands-off" policy, but declared that the costs of administering offset programs are legitimate overhead costs that should be an allowable component of a firm's general defense overhead pool. The working group estimated that these costs would amount to 7 percent or less of total offset value.

Evaluation and Disposition

Agreements to compensate foreign countries for military purchases through reciprocal trade agreements, generally referred to as "offset," are a common feature of defense sales. After experimenting briefly with becoming a party to such agreements in the 1970s, the Department of Defense decided not to participate further in them. Since then, offset agreements have been entirely the province of industry. Industry's rationale for this recommendation, given present Government policy, is weak. Though U.S. defense sales are useful to the Government and offset agreements are helpful, the Government's

policy of not being a party is clear and requires no administration. To involve the Government in them, even indirectly, through agreement to fund their overhead costs would require new regulations, controls, and costs without definable benefits. We recommend that no action be taken.

RECOMMENDATION 3.6(a)

Make Export-Import (Ex-Im) Bank loans available for defense sales.

Background

The Ex-Im Bank of the United States is generally forbidden to extend "Loans, guarantees or insurance . . . in connection with the sale of defense articles or defense services."¹ In addition, the Arms Export Control Act (AECA) of 1976 prohibits Ex-Im Bank financing of arms sales to ". . . economically less developed countries."² The former constraint can be waived with Presidential certification that it is in the national interest to do so. There is no waiver authority for the latter.

Since the constraint against defense support was legislated in 1968, the Ex-Im Bank has not financed or guaranteed military programs directly. Before then, the Bank was heavily involved in this area in support of Iranian programs and so-called "country X" loans where, in cooperation with DoD, it would support sensitive programs. The Bank has not requested Presidential waiver of statutory restrictions for developed-country programs since 1968.

Notwithstanding statutory constraints, threats of more restrictive regulation, and a general policy of avoiding overt military programs, the Ex-Im Bank can and does play an important indirect role in support of some

military programs. Typically, these are programs that involve equipment purchases and technology transfers in "dual-use" areas. There is a wide variety of these. In the equipment area, fixed- and rotary-wing aircraft for police use, drug enforcement, and internal communications often differ little, if at all, from their military counterparts. The Ex-Im Bank could therefore support acquisition of a sizable portion of a country's aircraft fleet. In the technology transfer area, a specific example is the establishment of a jet foil manufacturing capability in Indonesia by Boeing Marine Systems. The first two phases of this program will be directed mainly toward establishing a marine industrial capability appropriate to the commercial activities of a developing island nation. The third phase will include military applications. By obtaining Ex-Im Bank financing for the first two phases, Indonesia greatly reduced the need for FMS financing later.

Rationale

Industry's justification for this recommendation is straightforward. Since the Ex-Im Bank provides credits for U.S. exports, the working group believed it should provide them for all exports. This is consistent with the view that the United States should regard and administer military exports more like nonmilitary exports, as major arms sales competitors of the United States are believed to do.

RECOMMENDATION 3.6(b)

Allow the Overseas Private Investment Corporation (OPIC) to insure military investments and letters of credit.

¹Section 635n, Title 12, Chapter 6A, Subchapter 2, U.S. Code 1982 edition.

²Section 32, AECA.

Background

OPIC is a relatively small Government corporation that was established to "... mobilize and facilitate the participation of U.S. private capital and skills in the development of less-developed friendly countries and areas." It is guided by concern for the "economic and social development impact" of the projects for which it provides insurance or financing, gives preferential consideration to projects in less-developed countries where annual incomes amount to no more than \$680 per capita in 1979 U.S. dollars, and restricts its activities with countries whose per capita income exceeds \$2,950. It also gives preference to U.S. small businesses. OPIC is forbidden to use appropriated funds for "military or paramilitary purposes" – a long-standing prohibition that has always been part of appropriations authorizations.

Rationale

Industry's justification for this recommendation is the same as for Recommendation 3.6(a).

Evaluation and Disposition

Discussions with Ex-Im Bank and OPIC personnel indicate that neither of these recommendations would be welcomed by the agencies for which they are intended. Furthermore, Congress is unlikely to change its direction of the last decade and involve these institutions in military activities. However, in the case of the Ex-Im Bank, cooperative and symbiotic (dual-use) commercial/military programs are feasible. USASAC might wish to sponsor a seminar in which successful dual-use programs could be discussed by Ex-Im Bank and industry representatives.

RECOMMENDATION 3.7

Apply commercial credit terms to defense sales.

Background

Most commercial banks, if not all, do not finance acquisition of military materiel or technology by foreign nations. Since the Ex-Im Bank and OPIC cannot lend in this area either, credit at commercial rates is not available. In the absence of U.S. Government-backed credits, which are likely to decline over the next 5 years, or the extension of credit by third parties (e.g., Saudi backing for specific Middle East procurements), which is also likely to diminish, there are no means for making U.S. equipment available to nations that cannot pay in cash.

Recommendations 3.6(a) and (b) are intended to fill this gap, but industry representatives implicitly recognize that implementing them would be difficult. Consequently, this recommendation concerns the need for investigation of credit sources by industry itself.

Evaluation and Disposition

Industry comments on the conference report indicate that this recommendation is misstated. It should read "Obtain commercial credit for defense sales." The problem that the recommendation addresses is, however, correctly stated – that reductions in Government-provided credit for defense sales over the next 5 years threaten to curtail sales to many nations drastically.

This recommendation has to some extent been overtaken by events. After testimony before Congress by the American League for Exports and Security Assistance, DoD began a program

of sales – with Congressional approval – to specific countries, backed by a mixture of commercial and Government credit. These countries are good credit risks, and total loans are tied together in such a fashion that the consequences of nonpayment of the Government-backed portion apply equally to nonpayment of the commercial portion. Thus, the U.S. Government, in an indirect way, is the guarantor of the commercial loan, in that application of government-to-government penalties are automatic and not waivable.

USASAC should closely monitor this mode of financing and provide advice concerning it to industry, either on inquiry or through presentations at future conferences.

The remaining four recommendations in this chapter deal with support of marketing abroad. They include recommendations made by working group B on Support to Industry, and working group C on Foreign Competition.

RECOMMENDATION 3.8

Provide information on letters of offer and acceptance (LOAs) to industry and suspend LOAs and LOA activity when notified of commercial negotiations.

Background

The working group contended that U.S. contractors are often unaware that FMS actions are being processed and declared that the FMS system tends to withhold such information. This fosters competition between the U.S. Government and its contractors. Customers exploit this competition by requesting both LOAs and commercial proposals for comparison purposes. This procedure is harmful to U.S. sales, whether direct commercial or conducted through the FMS system.

Rationale

The working group said these problems result largely from a lack of uniform application of policies and procedures. DSAA reserves the right to evaluate each case individually. Even if notification of significant commercial negotiations is provided, an LOA may still be issued and the industrial firm concerned may not be informed. In addition, if an LOA has already been issued and the customer also requests a commercial proposal, it is unlikely that DSAA will withdraw the LOA. Implementation of this recommendation would require much more open exchange of information between the Government and industry and, if not the abandonment of the case-by-case approach, at least an attempt to systematize the management of Government/industry relationships in most instances.

Evaluation and Disposition

A mixed system of Government-operated and commercial military sales is hard to administer. Although stated Government policy is not to compete with commercial sales, the Government offers prospective customers such a varied mix of sales incentives and benefits that such competition is often inevitable and, from the perspective of foreign purchasers, essential to informed purchase decisions among acquisition strategies. When competition occurs between the two systems, it is usually the result of the buyer's "shopping," rather than any intent on the part of the U.S. Government or the defense industry to compete

The present policies and procedures for responding to requests for FMS information when commercial negotiations are going on appear to be adequate to protect the expressed interests of industry. We think the Government should be open and forthcoming in furnishing

information to U.S. defense industry regarding the status of FMS actions and requests for information from foreign nations, but industry should take the initiative in obtaining the information it needs. We could not determine whether there is a widespread problem in industry's ability to obtain appropriate information, or in suspension of LOA activity when commercial negotiations begin. However, because the perception of industry (as represented at the conference) is that the problem is widespread, we recommend that USASAC and DSAA monitor compliance with policies in this area closely over the next year to determine the extent of the problem and rectify it where warranted.

If another conference is conducted with industry, this topic, a report of the investigation, and follow-up actions should be considered for the agenda.

RECOMMENDATION 3.9

Require security assistance training for all Security Assistance Organization (SAO) personnel unless previous experience clearly makes it unnecessary. Some portion of that training should be devoted to relations between SAOs and U.S. industry.

Background

Members of the working group reported that they have found that many SAO personnel are poorly trained for their positions and are often uncooperative in their dealings with U.S. contractors, frequently failing to acknowledge their responsibilities to assist U.S. contractors as delineated in the SAMM. No specific instances were cited, but this point of view was strongly and generally held.

Rationale

The net effect of the reported deficiencies is an interface with the foreign customer that is disjointed and ineffective and gives the appearance that U.S. industry is not fully supported by the U.S. Government. Since competition from other countries is increasing, all U.S. sales must be a team effort to convince the foreign government to "buy American." The SAO is and should be the leading edge of team sales efforts.

Evaluation and Disposition

DoD Directive 2055.3 prescribes mandatory training requirements for personnel assigned SAO responsibilities. All personnel are required to attend (or to have satisfactorily attended within the 5 years before assignment) appropriate courses at the Defense Institute of Security Assistance Management (DISAM). Only the Director, DSAA, can waive this requirement. It is difficult to propose more specific or stringent regulations concerning SAO personnel training requirements.

With respect to course content, several blocks of instruction provide information concerning relationships with industry. These include:

- *SAO operations overseas*
- *Commercial sales versus FMS*
- *Contractual aspects of FMS.*

In addition, during each course a guest speaker from industry presents an "Industry View of Security Assistance."

Finally, to make sure that industry is fully cognizant of the goals and procedures of U.S. Security Assistance, DISAM offers a course for

times a year for industry representatives. It is designed to meet the educational requirements of U.S. defense industry representatives responsible for or involved in international sales. Since 1982, 283 students representing 75 companies have taken the course.

In view of these efforts on DoD's part to integrate industry into U.S. foreign sales activities, there is no requirement for further regulation or changes in educational content in this area.

RECOMMENDATION 3.10

Increase Government support of military sales efforts.

Background

This is an omnibus recommendation with two explanatory instructions:

- Investigate ways the U.S. Government can better support defense sales efforts.
- Pattern defense sales support after the way commercial sales are supported.

The U.S. Government regards sales of U.S. military goods and services as an instrument of foreign policy. Laws and regulations reflect this view. They, in turn, lead to constraints on DoD in support of military sales efforts. In addition, DoD is committed to the competitive bidding process for acquiring the military goods and services it sells to foreign countries, a constraint that can be waived only when buying countries present convincing justification for noncompetitive procurement. These basic Government positions are not likely to change, and implementation of the recommendation must be considered in this context.

In addition, having two methods of selling U.S. military equipment to other countries – DCS and Government-administered FMS – complicates the problem of determining what kind of Government support can be given to industry. These two sales modes exist side by side, together with a policy that states that the Government is indifferent to the mode a buyer chooses. However, ensuring even-handed treatment and avoiding competition between FMS and DCS is difficult; the problems presented are not likely to change in the near-to-midterm future.

Rationale

The working group was well aware of the background noted above and did not believe that these basic principles can or should be changed. However, it also believed that there is much more latitude to operate within those principles than is now exercised by the Government. The working group saw a continuing influence of what it regarded as the unwise and unnecessary restraints on arms exports policy and operations stemming from the late 1970s. This is why restudy and reconsideration are called for.

Evaluation and Disposition

Industry comments on the conference report indicate that this recommendation should have read "for commercial military sales efforts." If so, this again reflects industry-perceived conflicts between DCS and the FMS system. It also reflects industry concerns about training of SAO personnel, as mentioned in Recommendation 3.9.

Aside from a suggestion that SAO personnel function more like commercial attachés, no specific measures were proposed. In general, industry representatives recognize, when pressed, that SAO personnel's functions are quite different

from those of commercial attachés and that actions that might be appropriate for the latter would be inappropriate for the former.

We believe that better communication between the Army and industry is the best means of implementing this recommendation. We recommend that, before a second conference, industry be asked to propose changes consistent with the requirements of U.S. foreign policy and operational procedures.

RECOMMENDATION 3.11

Define "foreign availability" in terms of performance instead of the specific technology used to attain performance and the available foreign production base. Expedite license approval where foreign products are available.

Background

A major criterion for determining suitability for export is the availability of comparable foreign products. At present, the question of foreign availability is answered in primarily technical – rather than performance – terms. For example, technical assessments of critical technology, prepared for U.S. systems by the AMC Deputy Chief of Staff for Intelligence, consider gross system performance only secondarily. Primary criteria are whether one or more of the technologies used in the system are on the DoD Militarily Critical Technologies List (MCTL), whether this technology is susceptible of reverse engineering by the recipient, and whether export will lead easily to the development of countermeasures. Any combination of the above may lead to the recommendation that export be denied, even though in gross performance terms, a foreign system that does not use that technology (or technologies) may be its equal.

The availability of a foreign production base is a second criterion in the export decision process. If there is little or no foreign production capability, the item is considered not available, and export permission may be denied on those grounds.

Export license procedures have been improved substantially in recent years, and DoD now has only 30 calendar days within which to review applications referred to it by the Department of State. Consequently, the requester may become aware of the disposition of his application – including a negative decision – quite quickly. In industry's view, however, the appeal procedures for negative decisions or decisions that attach unwanted conditions to the license are not defined rigorously enough.

Rationale

The problem of how foreign availability is defined is not only one of developing adverse and unjustified export restrictions, but also of allowing adverse decisions whose appeal is difficult and time-consuming. The resulting unexpected or unplanned delays can give the United States an image of being arbitrary and unreliable to prospective customers.

The working group said that, at a minimum, export license requests that are denied or modified on the above grounds should be studied more carefully by the Government, with industry consultation, and that appeal procedures should have time constraints of the same duration as the original request.

Evaluation and Disposition

Our review shows that this subject encompasses two separate issues. The first is Army reluctance to license technology that it has not employed for its own use and that in its judgment provides capabilities it does not currently possess.

The second consists of rules and regulations flowing from the Export Administration Act of 1979, Reauthorization, Section 107 (Foreign Availability), administered by the Department of Commerce.

At present we do not have enough data on either issue to warrant specific recommendations concerning substantive actions AMC might take.

This is an area where industry should be asked to be more specific in its comments and to

orient them toward Army decision processes and regulations. This is not to say that comments concerning Department of Commerce activities are not pertinent and that AMC should not raise Department of Commerce issues at higher DoD organizational levels, given enough justification. However, in this area, dealing first with issues that lie within AMC's purview is most likely to improve Army/industry relationships.

APPENDIX A

**EXPENSES INCURRED BY U.S. INDUSTRY IN
SELLING DEFENSE MATERIEL ABROAD**

EXPENSES INCURRED BY U.S. INDUSTRY IN SELLING DEFENSE MATERIEL ABROAD

INTRODUCTION

At a recent conference with Army representatives on U.S. military sales abroad, industry representatives made several recommendations to improve the U.S. competitive position overseas. One was that the Government "... allow adequate compensation for the development of foreign markets under normal accounting practices." Here we review the history of the issue and draw conclusions concerning U.S. policy, law, and regulations.

Background

Within specified limits, marketing costs are allowable charges against Government contracts. Until 1977, the costs of marketing to both domestic and foreign customers purchasing through the U.S. Government procurement system were aggregated and evaluated for allowability without distinction.

This accounting convention, however, had been the subject of study and controversy for several years. This was particularly true during the early 1970s, with the rapid growth in both the volume of foreign sales and the costs of the foreign marketing organizations of large U.S. defense contractors. Both Navy and Air Force procurement organizations raised questions as to whether foreign marketing costs should be allocated to domestic contracts. Essentially, their conclusion at the time was that contract

benefits were not tangible or direct enough to justify allowability.

In 1977, partly in response to the deemphasis on U.S. arms exports resulting from the Carter Administration's foreign policy, a distinction was made between foreign and domestic customers. New regulations directed that foreign and domestic selling costs could no longer be accumulated in a single pool and allocated to the entire sales base (i.e., Government plus foreign defense sales), but must be segregated. Domestic costs could still be charged to the entire base, but foreign costs would be charged only against sales made through the U.S. foreign military sales (FMS) system as authorized by the Defense Federal Acquisition Regulation Supplement (DFARS), Section 25.7305. On 5 October 1985, the Secretary of Defense rescinded the regulation. On 10 October 1985, however, Congress reinstated the previous regulation: "... none of the funds appropriated by this act shall be available to compensate foreign selling costs..." (Section 8102). But the conference committee report did indicate willingness to consider a reclama by the Secretary of Defense.¹

The Issues

Two interrelated sets of issues are raised by the 1977 change in regulation and the subsequent change in law. These are: equity,

¹"The conferees feel the issue could be reconsidered ... if the Secretary of Defense certifies the cost effectiveness of a change in existing regulations. ..." FY85 Appropriations Act Conference Report 98 1159, 384.

fairness, and accounting principles on the one hand; and cost effectiveness on the other

Equity, Fairness, and Accounting Principles

Although no study has been made and objective data are not available, the logic of the 1977 change in regulation is that it has more effect on some segments of U.S. defense industry than on others. It discriminates against small businesses and businesses with narrow product lines, hampering their efforts to find new customers through the FMS system. This segment of the defense industry often has no initial FMS business base to which foreign sales costs can be charged. In addition, these sales efforts often require such costs to be spread over several years, and it is impossible for such firms to recover them. The reason is that, under FMS contracts, costs are allowable only if they are incurred during the accounting period in which the sale takes place.

For many small businesses, this restriction effectively prohibits the recovery of all but a small part of marketing costs because, in most cases, these costs are incurred over several accounting periods.

Moreover, direct commercial sales (DCS) may not provide an alternative source for reimbursement. FMS prices form an upper bound that commercial sales prices usually do not exceed. For the products sold by small firms, FMS prices may not reflect foreign selling costs adequately. Thus, the direct sales price may have little or no margin for charging marketing costs. The situation is further exacerbated by FMS limitations that effectively prohibit shifting part of the risks of foreign sales initiatives to foreign sales organizations, thus inhibiting use of foreign sales facilities in cooperation with other small firms.

Large U.S. defense firms, which do the bulk of foreign defense business, encounter little

difficulty in recovering their foreign marketing expenses. Their foreign sales are diversified both by customer and in time, and these expenses are therefore spread over several years of FMS contracts. But, since their FMS contracts also are concluded over several accounting periods, the FMS prices capture those costs. As noted, the FMS price tends to act as the upper bound for the DCS price. Therefore, for large firms there is a margin for recovery of marketing costs in DCS as well as in FMS.

Large firms oppose the unallowability of foreign marketing costs on U.S. domestic contracts for two major reasons: first, the restriction tends to result in more diverse cost pools; second, it increases the cost to their foreign customers. More cost pools mean greater complexity in accounting and auditing. The rewards of this complexity, if any, flow mainly to the Government. As a result, the requirements for more cost pools tend to be opposed by industry in general.

Industry contends that foreign sales prices now include a prorated share of the cost of marketing to U.S. customers as well as all of the expense of marketing to foreign customers. These higher prices put U.S. products at a disadvantage with respect to foreign competitors. The effect of the proposed solution – implementing a single pool – would be to raise domestic prices and reduce FMS prices. As noted above, it might also reduce DCS prices, perhaps by a larger margin than FMS prices.

Cost-Effectiveness

The cost effectiveness question raised by Congress is this: Would pooling foreign marketing costs with domestic costs result in a net loss or net gain for DoD? To be more specific: Have the increased charges to foreign customers and the decreased access to the marketplace for segments of U.S. industry stemming from the

regulation resulted in decreased sales? If so, would the benefits derived from increasing these sales by allowing a single pool outweigh the savings (estimated at between \$70 million to \$240 million a year) that accrue to the U.S. Government from prohibiting the combining of domestic and foreign sales cost pools? The question is hard to answer. Although one can list possible effects of the present regulation (e.g., a decrease in FMS, a decrease in FMS market share worldwide), it is not possible to demonstrate that the regulation was their sole cause, rather than some other factor such as political instability or the sudden increase in oil wealth. Thus, the cost of the regulation is difficult to estimate. At the same time, the estimate of savings from the two-pool arrangement is very uncertain. Taken together, it is, therefore, almost impossible for the Secretary of Defense to certify in any rigorous fashion "... the cost-effectiveness of a change in existing regulation."

The DoD Response to the Conference Committee

After the 1985 Appropriations Act was passed, the Assistant Secretary of Defense (Acquisition and Logistics) [ASD(A&L)] prepared an issue paper concerning the Secretary of Defense's position with respect to Congress' action and invitation for a reclamation. Opinions regarding the cost-effectiveness of allowing foreign and domestic costs of sales to be accumulated in a single pool and allocated across the total defense business base were requested from the Army, Navy, Air Force, Defense Logistics Agency, Assistant Secretary of Defense (Comptroller), Under Secretary of Defense for Policy, and several industry organizations. The issue paper was based on these responses.

In general, the Government responses took the ASD(A&L) inquiry at face value. The issue that a cost-effectiveness analysis of the problem

might be impossible or that applying cost-effectiveness criteria might be inappropriate was not raised. Government responses fell into several categories: that a single pool would be cost-effective if advance agreements could be reached that would limit the maximum level of allowable foreign marketing costs, that a single cost pool would be a giveaway to industry in that foreign sales would occur in any case, that the media would perceive the single pool as an industry giveaway and publicize it as such, and that the single pool might stimulate FMS in ways not intended by Administration foreign policy.

In addition, the issue of the relation between the single pool and DCS was raised to the effect that, if the single-pool allocation were accepted, both U.S. industry and foreign customers might have incentives to prefer DCS over the FMS system, industry because it might be able to increase its profits and foreign customers because they might be able to avoid paying marketing costs at least for U.S. requirements.

DISCUSSION

The negative positions against change taken by Government respondents are discussed below, followed by a discussion of positive responses from industry.

Change Would Mean a Giveaway to Industry

This response suggests confusion about who pays the cost of the double pool arrangement. It is not industry but the foreign customer. In effect, the price is being raised, it is unlikely that industry, in the end, would absorb these marketing costs from its profit margin.

Rises in Prices Have No Effect

It is often said that U.S. defense sales will continue, regardless of increases in price resulting from the policy on the allowability of

marketing costs. The reason is that many sales to cash customers are made because the United States is the only source for the required item and/or the U.S. item is clearly superior to available alternatives. However, the validity of this argument can be determined only after the sale has been lost and the damage done. In addition, it is possible that sales where the United States is the only source may well be of those requiring substantial logistic support. Losing an *initial* sale of equipment foreshadows downstream loss of logistics and support sales, perhaps larger than the initial sale itself, as well as loss of the opportunity for continued influence with the foreign buyer. This longitudinal effect may contribute to an appearance of stability in FMS in the short run, but it is no guarantee against market loss in the long run.

Foreign Policy Implications

Another conclusion was that the U.S. policy toward conventional arms transfers has changed since the preceding Administration, but not much. Case-by-case reviews of all arms transfers are still required, and care is still exercised to avoid any adverse effect on allied or friendly nations. Therefore, the practice of having allied and friendly nations bear a part of the cost of marketing to the United States as well as all of the costs of marketing to them is held to be justifiable.

Aside from the policy implications of having allies and friends bear a portion of domestic marketing costs, there is little or no connection between the handling of foreign marketing costs and U.S. foreign policy. OSD is responsible for advising the Department of State, case by case, regarding FMS cases and the granting of export licenses, including those required for most marketing efforts. No change in this responsibility would be implied by a return to a single marketing cost pool.

Accounting Complexities

Two major points were raised in regard to accounting principles and complexities: first, that DCS may circumvent the purpose of a single pool, and, second, that advance agreements to make allowability of foreign marketing costs in a single pool contingent on the benefits of these sales are not feasible.

The corollary to the possibility that some defense contractors may not be able to recover all foreign marketing costs from FMS contracts in a double-pool arrangement is the possibility that the Government may not receive benefits commensurate with its costs from a single-pool arrangement. The reason is that the product, originally sold through the FMS system, may later be sold in DCS at the producer's current production cost, plus a nonrecurring cost (NRC) recoupment charge paid to the Government, plus a profit. There is no requirement in DCS that foreign marketing costs charged to FMS in prior accounting periods be repaid.

As a result, if the product is not sold through the FMS system, none of the direct benefits (e.g., spreading both U.S. and foreign marketing costs over a larger base) will be realized. Moreover, the marketing cost increment, which in ordinary commercial operations would be a residual cost of sale and would have to be recovered at the time of sale, already will have been paid by the Government.

Given these complexities, the concern about the feasibility of negotiating advance agreements with respect to allowability of foreign marketing costs is understandable. Because of the flexibility enjoyed by industry in being able to sell through either the FMS system or DCS, decisions about allowability would be difficult.

Media Reaction Would be Adverse

The concern evidenced in several Government responses about potential media reaction is probably reinforced by a misunderstanding about who bears the cost of the double-pool arrangement. The concern about media reaction might be different if this arrangement were perceived by allied and friendly nations as a means by which the United States, through the FMS system, imposes a share of U.S. costs on them in contravention of the Government's formal pledge of equal access to the U.S. procurement system – a privilege for which they pay the cost of administration.

A Congressional Budget Office's statement that "... foreign sales are an integrated part of a contractor's business and marketing is not constrained by cost allowability" indicates that this lack of understanding is not confined to DoD. First, disallowing foreign sales costs clearly does constrain marketing for a large segment of U.S. defense industry. Second, though the policy may not constrain marketing by other segments immediately, the higher prices that result may ultimately reduce sales, which, in turn, will certainly affect marketing.

Industry Responses

Industry is strongly opposed to the current regulation. Three kinds of justification for this position were presented. First, it was argued that exclusion of foreign selling costs from an integrated pool with domestic selling costs violates accepted cost-accounting principles, in that it conflicts with the basic principle that prudent industrial managers will control overhead costs in ways that will make their operations most competitive.

The second industry argument is that the current regulation discriminates against small businesses. Its basis is much like that presented earlier.

The third argument is that the current regulations may eventually require industry to set up entirely separate cost pools, segregating foreign and U.S. marketing costs completely. Charging U.S. selling costs only to domestic sales and foreign selling costs only to foreign sales would cause U.S. prices to rise in comparison to the present system.² This, however, is probably not where the Government would permit the argument to end. There is justification for having foreign customers pay some part of U.S. marketing costs: if the United States had not made this investment in selling to itself, there probably would be nothing for the foreign customer to buy. Thus, what is implied is a three-pool accounting system for selling costs: selling costs that benefit both the United States and its foreign customers; those that benefit only the United States; and, last, those that benefit only the foreign customer. This illustrates the cascading effect that the requirement to designate a specialized overhead pool can have and why it is in the interests of both industry and the Government to limit this practice.

Industry goes on to assert that wide proliferation of specialized overhead pools (e.g., class-of-customer-cost pools for other kinds of costs) could result. In industry's view, if this became common practice, hundreds of millions of dollars would be shifted to U.S. Government contracts on an annual basis where the Government now benefits from broad allocations. This may be an empty threat. First, it ignores the fact that DCS can circumvent the entire U.S. procurement process except for NRC recoupment charges. If foreign buyers wish to

²Some examples of rising prices are cited, but no estimate is given of what the aggregate increase might be.

avoid the costs associated with that process, they can do so by negotiating directly with U.S. suppliers. Second, it is unlikely that – to accommodate FMS buyers – industry would open any farther the Pandora's box of more cost pools.

Finally, industry presents no real evidence indicating buyer dissatisfaction. On the basis of experience in the 9 years since foreign sales expenses have not been allowed, some decrease in the ratio of FMS to DCS has occurred. But the decrease has not been large, and an argument can be made, from present evidence, that foreign buyers perceive the advantages of using the FMS system as outweighing its potentially higher cost.

CONCLUSION

The Secretary of Defense chose not to certify to Congress that allowing foreign sales costs to be charged to domestic contracts is cost-effective. If decreases in FMS were to result from this decision, they could have rippling effects on the FMS system. For example, they could reduce U.S. influence and contacts with working-level foreign defense personnel as well as higher-level officials, thus weakening U.S. influence in both the short and long term. Moreover, decreases in sales could result in personnel reductions and other dislocations in the FMS system.

Despite these possible effects, the decision reached by the Secretary of Defense is not necessarily wrong. From the point of view of equity, it may appear that the United States includes some charges in FMS pricing for which customers receive no direct benefit. However, determining the extent of any inequity resulting from these charges is difficult, and it is probably not extensive (e.g., those resulting from allocations of total selling costs minus valid foreign marketing costs and of U.S. selling costs that benefit foreign customers).

Moreover, though small defense firms may have difficulties marketing through the FMS system, it is not clear that the regulation concerning foreign selling costs is a major contributor to this difficulty. The problem might be handled better by liberalizing agent-fee regulations than by returning to a single selling-cost pool.

A primary reason for not changing current law and regulation is the inherent difficulty in administering such a change in a mixed DCS/FMS environment. Were all defense sales abroad DCS, the question would not arise. Were all sales made through the FMS system, a single selling-cost pool would be easy to administer. In a mixed system, neither case obtains.

RECOMMENDATIONS

Despite the recent Secretary of Defense decision concerning changes in present policy, that policy remains at issue. U.S. defense sales abroad do face a competitive environment, and, in this context, the appearance of inequity to the buyer may be more important than the actual financial effect. It is also apparent that some U.S. firms think the present policy is inequitable and will continue to raise the issue.

The Department of Defense, therefore, needs a more acceptable approach on which it can base discussions with Congress, its foreign customers, and U.S. industry. In view of the political sensitivities involved, we recommend that OSD:

- Ask Congress to liberalize agent fee restrictions.
- Consider preparing a white paper that will explain the issue to foreign customers.
- Explore alternative accounting systems and principles to determine if a more equitable means for sharing selling costs among domestic and foreign customers can be devised.

APPENDIX B

AGENDA

AGENDA

USASAC/INDUSTRY CONFERENCE IMPROVING U.S. ARMY/U.S. INDUSTRY COOPERATION IN SECURITY ASSISTANCE AND DEFENSE TRADE

15-16 May 1986

Thursday, May 15

- 0800-0830 – Registration - 2nd Floor Lobby
- 0830-1000 – Plenary Session - Ballroom A
- 0830 – Welcome and Introduction
Major General Edward C. O'Connor, USA
Commanding General, U.S. Army Security Affairs Command
- 0845 – The View from the Department of the Army
The Honorable James R. Ambrose
Under Secretary of the Army
- 0915 – Recent Legislation and OSD Initiatives Affecting Armaments
Cooperation
Dennis Kloske
Advisor to the Deputy Secretary of Defense
for NATO Armaments
- 0945 – Organization of the Conference
Robert A. Gessert
Logistics Management Institute
- 1000-1030 – Coffee Break
- 1030-1200 – Panel Discussion - Ballroom A
Moderator:
Lieutenant General Ernest Graves, Jr., USA (Ret.)
Georgetown University Center for Strategic and International
Studies
Panelists:
Peter Byrne
BMY Corporation
Paul Pearson
Cypress International
Willis C. Robinson
U.S. Army Security Affairs Command
- 1200-1300 – Lunch - The Atrium

- 1300-1500 – Working Group Sessions
- Working Group A: Recovery of cost of sales to industry and Government - **Ballroom A**
 - Working Group B: SAO, military attaché, PMO, and MSC support to industry - **Ballroom B**
 - Working Group C: Foreign competition and how the U.S. should react to it - **Room II**
 - Working Group D: Impact of licensed production/co-production – benefits and costs - **Room V**
- 1500-1530 – Coffee Break
- 1530-1700 – Working Group Sessions continued
- 1700-1715 – Plenary Session - **Ballroom A**
- 1700 – The View from the U.S. Army Materiel Command
General Richard H. Thompson, USA
Commanding General, U.S. Army Materiel Command
- 1830-1930 – Reception (Open Bar) - **The Atrium**
- 1930-2100 – Dinner and Speaker - **Ballroom C**
The Honorable William Schneider, Jr.
Under Secretary of State for Security Assistance,
Science, and Technology

Friday, May 16

- 0800-1000 – Plenary Session - **Ballroom A**
- 0800 – Working Group A Report
Richard Simonsen
Ford Aerospace and Communications Corporation
- 0830 – Working Group B Report
Michael H. Hull
Sikorsky Aircraft Division, UTC
- 0900 – Working Group C Report
Dave Fourney
Texas Instruments, Incorporated
- 0930 – Working Group D Report
Benjamin Forman
LTC Aerospace & Defense Company
- 1000-1030 – Coffee Break

1030-1200 – Summary Panel Discussion - Ballroom A

Moderator:

Major General Edward C. O'Connor, USA
Commanding General, U.S. Army Security Affairs Command

Panelists:

Arthur J. Burros
Avco Lycoming TEXTRON
Martin Suydam
General Dynamics Corporation

Paul Donovan
U.S. Army Security Affairs Command

Willis C. Robinson
U.S. Army Security Affairs Command

1200 – Adjourn

APPENDIX C

ISSUE PAPERS

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Working Group C – Foreign Competition and How the United States Should React to It	C-13 – C-15
Working Group D – Impact of Licensed Production/Co- production – Benefits and Cost	C-17 – C-19

USASAC/INDUSTRY CONFERENCE

ISSUE PAPER

WORKING GROUP A RECOVERY OF COST OF SALES TO INDUSTRY AND GOVERNMENT

ISSUE

Both U.S. industry and the U.S. Government experience costs of selling military equipment abroad and require means to recover them. The means available to industry are restricted by Government policy and considered inadequate by many. The means available to the Government provide mixed benefits and are sometimes considered counterproductive.

REFERENCES

- a. DoD 5105.38-M, *Security Assistance Management Manual* (SAMM), Chapter 7, Section III, "Financial Principles and Procedures"
- b. DoD 7290.3-M, *Foreign Sales Financial Management Manual*, Chapter 7, "Pricing"
- c. DoD Federal Acquisition Regulation (FAR) Supplement 25.7304, "Pricing Acquisitions for Foreign Military Sales"
- d. Army Regulation (AR) 12-8, *Foreign Military Sales Operations/Procedures*, paragraph 4-20, "Case Management Costs."

DISCUSSION

Part 1: Selling Cost Recovery to Industry

The means by which U.S. industry can recover the cost of selling military equipment to foreign governments depend on whether the sale is a direct commercial sale (DCS) or a foreign military sale (FMS) through the U.S. Government. If a sale is made directly on a commercial basis, the selling cost can be included in the price insofar as the customer is willing to pay. If the sale is made through the FMS system, repayment of costs is made on the basis of the DoD Federal Acquisition Regulation Supplement (DFARS), which establishes costs that will be allowed and their extent.

Industry does not have control over whether a sale will be made directly or through FMS. This is the option of the purchasing nation, even when a product has been qualified for direct sales preference (DSP). Industry can influence the purchasing nation's decision by aggressively marketing the product and by proposing lower prices, better terms, or better delivery schedules than the FMS system offers. However, the decision to commit marketing resources in this situation is risky because it is difficult to establish a DCS business base sufficient to

absorb all the selling costs, including those for unsuccessful sales efforts.

Recovering marketing costs for sales made through the FMS system is also uncertain. As in DCS, frequently there is no broad business base to absorb the selling costs for all sales efforts or the general and administrative costs associated with them. Second, when there is a sale, cost recovery tends to be restricted to those costs that would be normal for an equivalent domestic sale. Industry representatives claim that if the procurement is made from option quantities included in domestic buys, U.S. marketing costs are the ones considered allowable; and, even when no options exist, domestic marketing costs still tend to be used as the yardstick for determining appropriate charges to FMS system sales. The referenced regulation, however, does permit reasonable selling cost charges that might be greater than those for equivalent domestic sales. The problem is determining the amount that is "reasonable." While industry generally maintains that foreign selling costs are higher than domestic, there are few if any guidelines for contracting officers to use in determining how much higher.

Industry's exposure to risk is compounded somewhat by the fact that if a foreign nation does make a decision to buy a product through FMS that an industrial firm has been actively marketing, the DFARS prescribes that, where appropriate, competitive bids be solicited for the resultant procurement. This automatically places the marketing firm at a disadvantage, since its competitors may not have incurred marketing costs. Although the DFARS states that the buying nation may indicate a source-selection preference that will be honored by the FMS system, industry representatives claim that Army Materiel Command (AMC) Major Subordinate Commands (MSCs) sometimes ignore the wishes of the buyer.

Another matter of concern to industry is reimbursement of foreign selling agents, whose allowable fee or commission on an FMS case or on any sale where Government-backed credit is used is limited to \$50,000, regardless of the size of the sale. Generally, this limitation results in U.S. firms' not using such agents or representatives in the conventional sense, and it may place them at some competitive disadvantage in areas of the world where this is accepted practice.

Part 2: Selling Cost Recovery to Government

The means by which the Government recovers the costs of sales negotiations, implementation, and other aspects of operating the FMS system that include the equivalent of selling costs include: a nonwaivable 3 percent (or 5 percent, in some limited cases, e.g., for nonstandard items) administrative charge on all sales, and case management and other direct charges.

The 3 Percent (or 5 Percent) Administrative Charge

The basic purpose of this charge, the size of which is reviewed biennially, is to ensure that FMS are not supported or subsidized by appropriated funds. It provides the basic budget for the entire FMS program, from the Defense Security Assistance Agency (DSAA), through the security assistance portion of the U.S. Army Security Affairs Command (USASAC), to the Security Assistance Organizations (SAOs) in U.S. embassies abroad. There are, to be sure, restrictions on the purposes for which funds collected in this way can be used. In theory, if funds collected exceed the costs of administration of the FMS program, the excess would be rebated to client nations. There is, however, no current provision for rebating any excess.

Despite the fact that the entire FMS program budget provided by the 3 percent administrative charge appears to be stable at least in the short run, charges collected for any particular FMS case may not fully cover the general and administrative costs for that case. Some nations require special attention that drives their portion of the FMS budget higher than their pro rata share of the 3 percent administrative charge. For political reasons, it may be especially difficult to limit administrative costs in any given case. Moreover, sometimes the FMS system is used by a potential buying nation to shop competitively with other sources. Here the costs of preparing planning and review surveys, price and availability estimates, or resulting letters of offer and acceptance that are not exercised by the buyer will not be recovered directly. Thus, the FMS system sometimes faces problems analogous to industry's in recovering "marketing" costs.

Case Management and Other Direct Costs

Several other costs to the U.S. Government that are incurred only because of foreign sales administration may be considered directly chargeable and not "indirect" charges. These include, for the U.S. Army, case management costs for particular FMS cases or programs. The intent of case management charges is to charge all costs that can be ascribed to support of a particular case to that case and thereby reduce the burden on the overall FMS administrative fund. Criteria for determining whether case management costs are directly chargeable include the fact that the incremental costs, such as for temporary duty, supplies, and materials, must be incurred solely for the single FMS case,

and that any man-year costs must equal or exceed those for one man-year. Such charges must be clearly defined in the letter of offer. Case management charges in excess of \$100,000 in any FMS case require the approval of the Commander, USASAC or his designee.

SOME ALTERNATIVES

- Develop and publish guidelines for the allowability of industry's foreign selling costs for FMS or for DCS funded with FMS credits.
- Allow industry to allocate at least some foreign selling costs to their overhead base for domestic U.S. defense contracts.
- Expand DCS of major equipment and use FMS more for logistics and support services.
- Fully inform potential buying nations of their right to indicate a source selection preference in an FMS case.
- Encourage greater use of case management charges to limit the burden on the general FMS administrative budget and achieve a more equitable distribution of administrative funds.
- Restrict the application of the 3 percent administrative charge to new and recurring costs for new procurement (i.e., exclude application to nonrecurring research, development, test, and evaluation (RDT&E) and production costs) and adjust the rate as necessary.

USASAC/INDUSTRY CONFERENCE

ISSUE PAPER

WORKING GROUP B

SECURITY ASSISTANCE ORGANIZATIONS, MILITARY ATTACHÉ, USASAC, PROGRAM MANAGEMENT OFFICE, AND MAJOR SUBORDINATE COMMAND SUPPORT TO INDUSTRY

ISSUE

Security Assistance Organizations (SAOs) and military personnel having security assistance (SA) responsibilities in the field are not uniformly knowledgeable concerning U.S. systems and industry capabilities and provide support to U.S. industry that is perceived to be inconsistent or weak. Also, Program Management Offices (PMOs) and AMC Major Subordinate Commands (MSCs) sometimes are perceived to be indifferent or opposed to industry's foreign sales marketing efforts.

REFERENCES

- a. DoD Directive 2055.2, *Manning of Security Assistance Organizations and the Selection and Training of Security Assistance Personnel*, 11 March 1985
- b. DoD Directive 5132.3, *DoD Policy and Responsibilities Relating to Security Assistance*, 10 March 1981
- c. DoD 5105.38-M, *Security Assistance Management Manual (SAMM)*, Chapter 4, Section I, paragraph B.2.a, "Security Assistance Organization Assistance," and Chapter 4, Section II, paragraph A.2, "Limitations to Planning"

- d. Defense Security Assistance Agency (DSAA), *A Comparison of Direct Commercial Sales and Foreign Military Sales for the Acquisition of U.S. Defense Articles and Services*, 15 October 1985.

DISCUSSION

Part 1: Field Support

A frequent industry observation is that the support provided abroad to U.S. industry representatives by SA agencies and personnel at U.S. embassies is highly variable. At times, cooperation appears to be lacking, and information is not shared in a timely manner. At other times, U.S. Government personnel appear to have inadequate knowledge of the systems or services industry representatives are presenting to foreign customers. The reasons cited for such deficiencies include:

- Inadequate policy guidance to field personnel concerning support to industry
- Difficulties in obtaining information on U.S. industry products and services
- Apparent conflicts or competition between FMS and DCS

Another dimension of this problem (which may result in part from the above deficiencies and in part from a reluctance of industry to undertake costly foreign marketing efforts) is that foreign military customers sometimes suggest that U.S. industry's marketing activities are:

- Targeted on the products it has to sell rather than on customer needs
- Uninformed concerning the customer's resource availability
- Uninformed concerning the customer's decision processes.

Industry may expect too much support from SA field agencies. Sometimes the support provided by Department of Commerce attachés at U.S. embassies to commercial marketing is cited as the type of service to be expected from SA personnel for military marketing. It should be recognized, however, that SA and Commerce personnel are not only funded differently, their missions are different as well. Commerce personnel are paid from appropriated funds, and their mission, within very broad limits, is to maximize U.S. commercial activities. SA personnel, on the other hand, are funded by administrative charges on FMS sales paid for by the customer. This creates a special SA/foreign government relationship that is specifically defined in the referenced DoD directives. Within this context, support to U.S. defense industry is a collateral mission that to some extent is complicated by inherent differences and potential conflicts of interest between FMS and DCS.

It is unlikely that the SA field agency mission will change to any significant degree. For the Government, defense sales abroad, whether by the FMS system or DCS, will continue to be important primarily as a means to

further U.S. foreign policy. Nonetheless, where feasible, U.S. friends and allies will continue to be required to pay for the implementation of this policy through fees on FMS sales. Within this context, industrial and commercial considerations will continue to be of secondary importance.

U.S. industry and the FMS system will have to work within the above constraints for the foreseeable future. However, if they recognize and understand these constraints, significantly better performance may be achieved by each in an era of greatly increased competition.

Part 2: PMO and MSC Support

Industry comments also suggest that lack of support and cooperation from PMOs and MSCs is often a serious marketing impediment for both FMS and DCS. Sometimes there is reluctance to supply information, adjust production schedules, institute minor tailoring modifications requested by the buyer, and control prices—all of which are necessary for successful foreign sales but conflict to some degree with the main domestic mission of these agencies.

In the case of the FMS system, PMO and MSC roles in planning and review (P&R) analyses, price and availability (P&A) estimates, and the preparation of letters of offer and acceptance (LOAs) are specific and clear (AR 12-8, paragraphs 1-7). If the complaints above are valid, they are not the result of deficiencies in the regulations. For DCS, on the other hand, PMO and MSC responsibilities are limited largely to recommending approval, disapproval, or modification of export license requests. While there may have been more pressure in the past to disapprove than to approve such requests, current U.S. Government policy recognizes the legitimacy of DCS, and current DoD regulations attempt to make disapproval more difficult. Again, it appears

that the pertinent directives and instructions are adequate.

The underlying problem is the absence of incentives and the existence of disincentives for support of foreign sales by PMOs and MSCs. First, if sales through the FMS system are small, program managers can see little advantage to their overall program but several potential disadvantages, e.g., entering international logistics arrangements of marginal size. On the other hand, if sales are extensive, coproduction and offset agreements will almost always be involved, which, in the view of the PMO and MSC, may threaten the U.S. production base. Also, coproduction and offset arrangements may increase U.S. costs and result in large extra workloads on the PMOs and MSCs that must be handled with only marginal increases in staff.

If major foreign sales through DCS are proposed, problems loom with respect to production coordination, cooperative logistics support arrangements without U.S. Government configuration control, and extra work without extra resources. It seems clear that PMO and MSC tasks of supporting domestic users are easier to accomplish if they do not have to cope with foreign sales, and that support of domestic users is the primary yardstick by which PMO and MSC effectiveness is measured.

SOME ALTERNATIVES

- Modify DoD Directive 5132.3 and Army implementing regulations to include the importance of providing specific types of support to U.S. industry by SA personnel in U.S. embassies abroad.
- Expand the information (e.g., an industrial version of the Military Security Assistance Projection) provided to U.S. industry for better understanding of foreign customer requirements, resources, and decision processes.
- Encourage industry to make better use of information currently available on foreign customer requirements, resources, and decision processes prior to attempting marketing abroad.
- Provide better information to SA field agencies and personnel on the performance characteristics of products of U.S. defense industry and on the technological and production capabilities of U.S. defense industry.
- Provide incentives for PMOs and MSCs to seek more opportunities for their U.S.-developed systems to satisfy the materiel requirements of U.S. friends and allies.

USASAC/INDUSTRY CONFERENCE

ISSUE PAPER

WORKING GROUP C FOREIGN COMPETITION AND HOW THE UNITED STATES SHOULD REACT TO IT

ISSUE

Developed nations use arms exports as instruments of their foreign, military, and economic policy and have become increasingly competitive with the United States as suppliers of military equipment on world markets. Several developing nations have recently entered world markets in the lower technology areas. What used to be a sellers' market for U.S. defense equipment has become much more of a buyers' market.

REFERENCES

- a. DoD 5105.38-M, *Security Assistance Management Manual (SAMM)*, Chapter 7, "Preparation and Processing of Foreign Military Sales Cases," and Chapter 9, "FMS Credit and Guaranteed Loan Financing"
- b. DoD 7290.3-M, *Foreign Military Sales Financial Management Manual*, Chapter 7, "Pricing"
- c. General Accounting Office, *Nonrecurring Costs: Improvements Needed in DoD Cost Recovery Efforts*, April 1986
- d. General Accounting Office, *Cost Recovery: Collecting Research and Development Costs on Commercial Military Sales*, February 1986

- e. LTG Howard M. Fish, USAF (Ret.), "Its Time to Stop Cutting Our Throats: Taxes on Exports Cripple U.S. Ability to Compete in World Market," *Defense News*, 10 March 1986
- f. Unpublished notes on industry attitudes and experience with NRC recoupment.

DISCUSSION

Industry representatives frequently cite four major threats to maintaining or expanding U.S. sales of ground force equipment and services, whether through FMS procedures or DCS. These are:

- Subsidized sales by economically developed nations
- Low-cost sales by developing nations
- Restricted availability of credit for military purchases
- The high cost of U.S. equipment.

Subsidized Sales by Industrially Developed Nations

There is an old arms sales maxim that you can afford to give the rifle away if the recipient will agree to buy the ammunition from you. This is probably the case with subsidized arms

sales; they are not made in the prospect of a long-term loss. Rather, compensation is obtained through political influence, trade concessions, or guarantees of downstream business such as ammunition or logistic support sales.

The United States also subsidizes some sales through the FMS Financing Program and through the Military Assistance Program (these funds can be spent only through the FMS system). Transferring technology may be another way of effectively subsidizing foreign sales on a case-by-case basis. However, U.S. policy clearly states that these means are to be employed in support of foreign policy and are not intended to be economic/commercial mechanisms for avoiding losses of sales to foreign competition.

Industry representatives sometimes suggest that a broader U.S. policy should be formulated that recognizes the problems presented by subsidized foreign sales. Two kinds of policy modifications are possible: first, those that improve our competitive posture by nonprice means and, second, those that lower our prices. Nonprice means might include greater Government support for private military sales efforts or explicit guarantees of long-term logistics support for U.S. goods. Prices could be lowered by changing charges that are applied to FMS and DCS cases. The largest of these is the NRC recoupment charge called for by the Arms Export Control Act of 1976. Unless waived, as it may be under the Act for close allies, the NRC recoupment charge requires foreign buyers to pay a proportionate share of the U.S. RDT&E and production base costs for each item of equipment. However, recent General Accounting Office (GAO) studies have found determining the size of this charge and to which products it applies to be uncertain. They also report that, in some cases, the charge tends to price the United States out of the market, and that collecting the charge from DCS

transactions is difficult. DoD generally concurred in these GAO findings

Instead of assessing a unique charge on each item of equipment, several other countries use a fixed rate: e.g., the Federal Republic of Germany, 5 percent, France, 2 percent, and the United Kingdom, 7.5 percent. The United States also uses a fixed rate of 5 percent for nonmajor defense equipment sales. The GAO has recommended that the United States also adopt a fixed rate for major items. Others have proposed that the NRC recoupment charge be abandoned entirely, on the grounds that it is counterproductive as well as being an unconstitutional tax on exports (reference e). By and large, however, U.S. industry supports the application of some NRC recoupment charge by the Government (reference f).

Developing Nation Competition

Competition from lesser developed countries is concentrated primarily in the lower technology end of the market, where they have a comparative advantage in labor costs and generally can be quite price competitive. In some cases, however, these countries need to import technology to be competitive. This presents the United States with a difficult dilemma when licensed production or coproduction with these countries is proposed. Developing nations that acquire U.S.-designed systems under licensed production or coproduction agreements frequently want to produce for export as well as for their own needs. The United States supports the economic stability of these nations, and their equipment exports, whether civilian or military, contribute to this stability. However, such exports often compete directly with the products of U.S. industry. This can result in loss of U.S. sales, attendant lower U.S. economic activity, and ultimately higher U.S. weapons costs. Also, dependence by developing nations on this kind of

trade is not likely to enhance total world stability.

The United States, of course, is not the only supplier of technology for developing nations' arms industries. If the United States does not provide the necessary technology, other developed nations that do not have as large a stake in either their production base or continued sales, or the same attitude toward world stability, will. Therefore, entering into arrangements whose long-term impact is difficult to foresee and might turn out to be detrimental to U.S. industry may be difficult to avoid entirely. Continued and expanded cooperation between the Army and industry in negotiating licensed production, coproduction, and technical data transfer agreements is in the interest of both, at least in the short term.

Restricted Availability of Credit for Military Purchases

About \$15 billion has been requested in foreign aid for FY87 of which 60 percent is military aid including credit authorization. The request is likely to be reduced, perhaps severely, and there are indications that austerity will extend at least through FY92. These limitations, plus the needs of a few very large recipients of credit, may freeze the United States out of many of its current markets. Providing new sources of arms sales credit is a challenge for both industry and Government.

Other Considerations

Factors that may counteract or mitigate the impact of competition during the next 5 years are:

- The devaluation of U.S. currency *vis-a-vis* that of some of its most aggressive competitors, thus making U.S. equipment more affordable

- The perception that the United States is a very reliable provider of spare parts, logistics, and weapons-upgrade support and a nation that will provide consistent long-term military assistance to its allies and friends
- The reduction in world oil prices.

This last factor, although better allowing many U.S. customers to afford U.S. equipment, will be detrimental to others. The latter nations, some of whom have been cash customers in the era of high-priced oil, may become potential credit customers or be forced to consider other sources of equipment and support.

SOME ALTERNATIVES

- Reduce charges (such as the NRC recoupment charge) that appear to price U.S. equipment out of some markets, and establish uniform rates for such charges.
- Continue to compete in the world market on the basis of the quality of U.S. equipment and long-term support arrangements rather than on the basis of price.
- Encourage greater use of DCS for major equipment to promote direct responsiveness by U.S. suppliers to foreign customers in delivery, acceptance, and establishment of an initial operational capability.
- Develop and encourage private sector financing of selected international sales of military equipment.

USASAC/INDUSTRY CONFERENCE

ISSUE PAPER

WORKING GROUP D IMPACT OF LICENSED PRODUCTION/COPRODUCTION – BENEFITS AND COSTS

ISSUE

Licensed foreign production and coproduction do not support the CONUS production base, tend to erode foreign markets for finished military goods, and may risk loss of critical technology. However, they do result in initial sales of technology and services, often preserve part of downstream industry sales, and promote U.S. foreign policy objectives.

REFERENCES

- a. DoD Directive 4005.1, *DoD Industrial Preparedness Planning*, 26 November 1985 (especially paragraph E.4.e)
- b. Department of Defense Task Group, *International Coproduction/Industrial Participation Agreements*, 15 August 1983
- c. Draft DoD Directive 2000.9, *International Codevelopment, Coproduction and Other Armaments Cooperation Agreements with Other Countries or International Organizations*, undated (1986)
- d. Office of Management and Budget, *Impact of Offsets in Defense-Related Exports*, Report prepared pursuant to Section 309 of the Defense Production Act Amendments of 1984 (P.L. 98-265), December 1985.

DISCUSSION

To some degree, licensed foreign production and coproduction arrangements are inescapable in today's arms market. If they were rejected, sales would be threatened and relationships among friends and allies would be strained. However, for the United States, these arrangements are truly a two-edged sword. On the one hand, they strengthen our ties with friends and allies both politically and militarily; on the other hand, they tend to increase both allied and U.S. costs and may reduce the ability of the United States to support the needs of its allies in emergencies.

Overlapping Interests

No clear distinction can be drawn between industry and Government interests in this issue.

The Government usually adopts policies and supports actions to protect and enhance the CONUS production base. Licensed production and coproduction often do not contribute to this objective. (For certain critical items, DoD Components are discouraged from concluding agreements that will have an adverse impact on the U.S. defense industrial base – see reference a.) However, other military and foreign policy considerations that require such agreements and arrangements often override this objective. U.S. policy is not clearly spelled out in current directives. Coproduction and industrial participation policies were reviewed

by a DoD Task Group in 1981-83 (reference b), but the recommended new directive exists only in draft form (reference c).

Industry tends to favor licensed production or coproduction agreements when they produce larger business volumes in the short run and preserve at least part of the market in the long run. However, particularly when the technology to be transferred belongs to the Government and there are, therefore, no licensing revenues accruing to industry, the prospect of decreased sales and intensified foreign competition militate against licensed production and coproduction. Thus, sometimes the Government is the foreign production advocate and sometimes industry, their roles being easily reversed in particular cases.

Types of Production Partners

Cooperative production agreements are negotiated with essentially two types of partners: industrially advanced nations and lesser developed nations.

In the case of licensed production or coproduction agreements with industrially advanced nations, the U.S. motivation is primarily a desire for standardization of equipment and logistic support. Even though this objective may not be as important for the licensees or coproducers, who tend to be more interested in economic effects than the United States, it is still a significant consideration to them as well. Thus, there is an initial common security objective between the United States and the foreign licensee or coproducer. Moreover, from the U.S. point of view, technology transfer to industrially advanced nations may be a two-way street. For example, while the Army exports coproduction rights for HAWK or the Multiple Launch Rocket System (MLRS), it may import rights to produce foreign-developed machine guns or communications equipment. In addition, there is little concern about

retransfers, since third-party sales agreements usually are observed scrupulously by industrialized U.S. allies. Finally, industry is at home in this environment; many U.S. defense contractors have teaming agreements with their foreign counterparts or subsidiaries in developed countries. In some cases it is difficult to distinguish between their U.S. and foreign business bases.

Licensed production and coproduction agreements with lesser developed nations present more difficult problems. First, although standardization is desirable, it is not the deciding factor. These nations have limited ability to develop and produce equipment on their own, and the United States is often their only source of supply. Thus, the decision to supply finished goods versus licensing production or coproduction is one that the United States makes on other grounds. Second, there is little likelihood of reciprocal technology exchange. Third, sales to other countries may be very difficult to control in the long run due both to economic factors and to considerations of national pride. Finally, such arrangements are usually of limited interest to U.S. industry in that they do not add significantly to their international business base and, in addition, tend to be difficult and expensive to support.

Licensed production and coproduction agreements with lesser developed nations are almost entirely the result of long-term security considerations based on the recipient nation's desire to use such agreements to improve itself industrially and the U.S. decision to assist in this process. For most lesser-developed-nation licensed production programs, lower labor costs may tend to reduce unit costs; but, even so, the need to invest in the production base may raise them above U.S. production costs. As a result, to recover production base costs, the licensee is forced to expand its market beyond those items produced for its own needs. Coproduction agreements encounter fewer difficulties, since

marketing of subsystems or components independently of the United States is often impossible, and the necessary production base investments are smaller. However, such limited arrangements are unlikely to be satisfactory to the foreign coproducer; and offsets, in which the United States gives up part of its domestic or foreign market, are also a common feature of such agreements.

Technology Loss

There is also the problem of potential technology loss to the Warsaw Pact. While it is possible that critical technology may be lost in licensed production and coproduction arrangements, countervailing considerations are that:

- Transfers to developed nations are conducted under mutual security restrictions that must meet established U.S. standards.
- Transfers to lesser developed nations are usually of older, less-critical technology.
- Both kinds of transfers are subject to extensive DoD security controls.

In this connection, it is asserted by industry that overreactions to the possibility of loss of technology sometimes affect legitimate industrial marketing efforts adversely. For

instance, it is claimed that restrictions imposed on the export of radar systems to a Middle Eastern nation were extended inappropriately to sales and coproduction agreements with NATO allies. By the time the problem had been resolved, these nations had made other arrangements and U.S. industry had lost significant sales and probably suffered considerable damage to its long-term competitive position in this area.

SOME ALTERNATIVES

- Accelerate the publication of a new DoD directive on licensed production and coproduction.
- Develop better Army guidelines concerning ways to limit the impact of licensed production/coproduction on the CONUS production base.
- Solicit industry inputs, consistent with appropriate "arms-length" considerations, prior to entering licensed production/coproduction agreements to transfer U.S. Government-owned technology.
- Clarify and publicize rational policies on the control of critical technology transfer in licensed production/coproduction programs.

APPENDIX D

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GLOSSARY

AECA	=	Arms Export Control Act
AMC	=	Army Materiel Command
AMDFPR	=	Army Master Data File Price Report
ASD(A&L)	=	Assistant Secretary of Defense (Acquisition and Logistics)
ASD(C)	=	Assistant Secretary of Defense (Comptroller)
CG	=	Commanding General
CICA	=	Competition in Contracting Act
DAR	=	Defense Acquisition Regulation
DCS	=	direct commercial sales
DFARS	=	Defense Federal Acquisition Regulation Supplement
DISAM	=	Defense Institute of Security Assistance Management
DLA	=	Defense Logistics Agency
DSAA	=	Defense Security Assistance Agency
DSP	=	direct sales preference
Ex-Im	=	Export-Import
FMS	=	foreign military sales
GAO	=	General Accounting Office
GFE	=	Government-furnished equipment
IOC	=	initial operational capability
LOA	=	letter of offer and acceptance
MCTL	=	Militarily Critical Technologies List
MLRS	=	Multiple Launch Rocket System
MOU	=	memorandum of understanding

MSCs	=	Major Subordinate Commands
NRC	=	nonrecurring cost
OPIC	=	Overseas Private Investment Corporation
P&A	=	price and availability
P&R	=	planning and review
PMO	=	Program Management Office
PM	=	program manager
RDT&E	=	research, development, test, and evaluation
RSI	=	rationalization, standardization, and interoperability
SA	=	security assistance
SAMM	=	Security Assistance Management Manual
SAO	=	Security Assistance Organization
SDAF	=	Special Defense Acquisition Fund
SM&T	=	Supply, Maintenance, and Transportation
TDP	=	Technical Data Package
USASAC	=	U.S. Army Security Affairs Command
USD(P)	=	Under Secretary of Defense for Policy

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