Pricing Procurements for FMS

By

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Well, friends and graduates, it's time to review some of those classroom points made during your DISAM block of instruction on acquisition. Granted, the following mini-lecture may be more germane to those in the contracting field, but it should not bore anyone. I recently received the new 1986 issue of the *Armed Services Pricing Manual* (ASPM) and found that the section on foreign military sales (FMS) hasn't changed, but nevertheless,was interesting to review. It starts out with advising Contract Price Analysts, GS-1102s, that FMS has special considerations and is important to our defense.

Under FMS, financially independent countries of the free world can buy needed military equipment and thereby carry a share of the common defense burden. FMS helps a developing nation attain the minimum security and stability needed for its development. Thus, the objective of the United States foreign military sales program is to promote the defensive strength of friends and allies. FMS also can promote the concept of cooperative logistics and equipment standardization, and offset some of the unfavorable balance of payments resulting from U.S. military deployments abroad. For these reasons, it is in the public interest to increase the sale of American-made military items to friendly nations.

THE FMS MARKET ENVIRONMENT

In buying for FMS, you will be half in and half out of a different market, and will need to recognize the characteristics and customs of that market. You may and probably will find yourself buying the same items from a company, some for a DOD user and some for a foreign customer. You probably will be asked to pay different prices for the same item, with a higher price for FMS items. One example of costs used to justify an FMS price would be *selling expenses* for a company that maintains an overseas or export sales organization. Another would be the cost of *post-delivery support services* for which we customarily contract but for which the foreign customer might require as a warranty of sorts without any special arrangement. There is a list of such special costs in the Department of Defense *Federal Acquisition Regulation Supplement* (DFARS) 25.7304(c).

The ASPM goes on to say that foreign nations have been assured that the United States Government will use its best resources to insure that the prices paid for FMS items are reasonable. You must use the same care and diligence and the same techniques in pricing FMS as you would if you were pricing a DOD buy. Although new or unfamiliar areas of cost must be considered, the same requirement for certified cost or pricing data, for principles regarding competition, for price analysis, and for cost analysis apply to these sales to the same extent they apply to sales for DOD consumption. Remember, our international agreement, the DD Form 1513, Annex A, paragraph A.1, provides for the following: "The Government of the United States agrees . . . to procure [defense items] under terms and conditions consistent with DOD regulations and procedures."

Many students think that the contractor does not know that the acquisition is for FMS. Since over 75% of the items delivered under FMS come directly from the contractor, this belief is in error. Also, DFARS requires that price and availability data from a sole source contractor for an acquisition over $10,000 will be based on information requested from the contractor, "and such

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request shall state that it is for information for the purpose of a potential Foreign Military Sale and shall identify the customer." (DFARS 25.7303(b)(1)) The contractor also must be informed because of the different allowable costs that apply, as compared to U.S. acquisitions.

ILLUSTRATIVE PRICING PROBLEMS

The ASPM lists four typical FMS pricing problems. To illustrate these problems, assume you have a requirement and that:

a. **Problem.** "DOD has been the only buyer and user of the equipment and there is only one company that makes it. In the past you have used cost or pricing data and the concept of what it should cost in analyzing and negotiating a fair and reasonable price. Now that you have the FMS quantity, there is to be a second user. Has anything really changed?"

Response. Your answer is "not really." You still look at cost or pricing data and at the effort required to perform the contract. If the contractor is likely to incur added expenses as a consequence of selling to the foreign user, you may consider these in arriving at the price to be paid, as long as this is not limited by the FAR, Part 31.

b. **Problem.** "DOD is one user, but the equipment also has been sold to a commercial user. There is only one company that makes the particular equipment, but three others make and sell products designed to do the same job. Until now, you have used cost or pricing data and priced on the basis of what it should cost. The offeror for the FMS requirement says the equipment is commercial and does not submit cost or pricing data. The offeror does give sales information that identifies quantity, price, and delivery rates for the past year. The commercial price level is 20% over prices you have paid for the same equipment. What's a fair and reasonable price for this FMS procurement? Would it make any difference if the procurement at hand included quantities for U.S. military use as well as FMS?"

Response. The question of the item being commercial versus non-commercial is not dependent on the DOD user--in this case FMS. If DOD has not been satisfied with the contractor's case of commerciality and the data provided on the Standard 1412 forms for its own acquisitions, there is no reason to accept commerciality now for FMS. DOD has promised to use its "best efforts" to obtain the best price and delivery possible. The second question of mixing U.S. and FMS quantities should actually result in a reduced price since larger quantities are to be purchased.

c. **Problem.** "DOD is one user, but the equipment has been sold to the original equipment (end-item) manufacturer (OEM) for both installation and resale, and to parts suppliers and end-item users for replacement. The equipment manufacturer maintains a priced sales catalog regularly and uses it to price orders to commercial customers. The list prices in the OEM catalog are much higher than the prices you have paid, and even when discounted in the proposal for the FMS equipment, they remain higher. What do you do about price?"

Response. We try to continue buying from the equipment manufacturer to avoid the end-item manufacturer's mark up for both our own needs as well as FMS. Under any circumstances, if DOD doesn't accept the commercial catalog price for its own items, it won't accept that price for the FMS customer.

d. **Problem.** "DOD is one user. It had caused the basic system to be developed. Two models of the system also have been sold directly to users, both U.S. and foreign companies. When you have bought for DOD use, the company has submitted cost or pricing data. The company claims the model required for the FMS customer is commercial and does not furnish cost or pricing data. The commercial models differ from the military chiefly in the kinds and numbers of black boxes hung on the basic system. What is a reasonable price and what do you use to figure it out?"

Response. Of course we try to sell the government's version with modification of the black boxes. Again, just because it is FMS doesn't make the item commercial. Commercial models seem hard to sell in this business. Remember the F-16/F-20 controversy? Our friends and allies want what we use in our own military.

The basic problem, as is obvious from these examples, is to determine the true nature of the market. In other words, you find out what has been sold, in what quantities, when, and to whom, and the kind and extent of competition. If sales have been made to foreign customers, you should find out what kind and how much effort the company had to expend to make those sales, the size of any sales office, and the nature, frequency, and cost of post-delivery services that the company has had to supply. These inquiries may be necessary and particularly relevant when the company tries to justify a higher price than you would pay when buying for U.S. consumption.

PRICING BY COST ANALYSIS

Costs may be incurred in the foreign military market that would not be allowed or recognized in the domestic military market. In deciding how to treat these costs, you should understand that in the domestic military market there are two conditions of nonallowability. Certain costs are unallowable because they are held to be unnecessary or not allocable to defense contracts. However, these costs may be necessary and allocable to the contractor's other business, including sales to foreign governments. If so, they should be recognized in costs analyses for FMS.

Other costs may be necessary expenses of doing business that the United States Government, for reasons of public policy, labels unallowable and expects contractors to pay out of their profits. These expenses include advertising, interest, and entertainment costs. These are also unallowable as costs in pricing FMS, but they may sometimes justify higher profit rates on FMS procurements.

You should use weighted guidelines to establish your profit objective, just as you would for any other procurement where cost analysis has been performed. However, you may recognize an added profit on FMS.

The weighted guidelines technique permits you to consider, under contract cost risk, additional risks associated with FMS. To decide how much, you must distinguish among the efforts and risks of contractors. First, you would provide differently for the contractor who establishes and maintains an effective sales force and the one who does not. Second, you would separate the contractor who accepts substantial risks in the foreign military market and the one who doesn't. These risks might include responsibilities for providing a technical cadre to help the foreign customer maintain the equipment, a parts inventory, training, and other post-delivery functions. Another risk might be what follows from the need for large sales promotion efforts, such as advertising and exhibits. However, the total profit under contract cost risk can't exceed FAR limits for different contract types.

RECOVERY OF NONRECURRING AND RECURRING COSTS

A customer (foreign government, international organization, foreign commercial firm, or domestic organization) is expected to pay a fair price for the values of DOD's nonrecurring investment in the manufacture of products and development of related technology. When specified dollar thresholds are met, the DOD sales offer to a customer includes a charge for DOD investment costs.

For purposes of recouping nonrecurring charges, articles fall into two basic categories. The first category is major defense equipment (MDE), which by definition has experienced a nonrecurring research, development, test, and evaluation (RDT&E) cost accumulation of $50 million or more, or a total production cost of $200 million or more. For MDE, nonrecurring cost recoupment charges are assessed on a pro rata basis, by dividing the total cost investment (nonrecurring RDT&E and nonrecurring production costs) by the total estimated number of units projected to be produced over the life of the system. For the second category, non-MDE items, nonrecurring cost recoupment is based on a percentage (5 percent of the item's current DOD inventory price) whenever $2 million in RDT&E funded cost is expected to be incurred on the item. The respective charges for the above two categories of items can be found in the *Security Assistance Management Manual* (SAMM) (DOD 5105.38-M) and the *Foreign Military Sales Financial Management Manual* (DOD 7290.3-M).

The nonrecurring cost recoupment will be added to the price and refunded to the Government. Usually, the system program office will calculate the amount and coordinate with the Director, Defense Security Assistance Agency and the Office of the Assistant Secretary of Defense (Comptroller). DOD Directive 2140.2, *Recoupment of Nonrecurring Costs on Sales of U.S. Products and Technology*, August 5, 1985, contains criteria as to what costs are or are not to be included, when a waiver will be obtained, and how collection will be handled. These too, should be taken up with the Defense Security Assistance Agency.

In addition, DOD 7290.3-M, Chapter 7, specifies that recurring support costs will be allocated to a foreign customer related to the current production contract. These FMS costs include: government-provided material, such as fuel; government-provided engineering services, such as in-house test and evaluation; quality assurance, such as the costs incurred by the Defense Contract Administration Service (DCAS); contract production, testing, destruction, and evaluation, if in another contract or performed by the government; government-provided transportation, packing, crating, and handling, such as government bills of lading; OSD-prescribed administrative charges; recurring costs of technical documentation, such as handbooks and technical manuals; and the cost of contract audit by the Defense Contract Audit Agency. Many of the costs are recovered on a surcharge (percentage) basis.

COUNTRY-TO-COUNTRY AGREEMENTS

Before signing off in a negotiation with an offeror, make sure the agreement is consistent with any agreement, executive or diplomatic, that exists between the United States and the foreign government. If the agreement is different from DFARS or FAR, the agreement takes precedence. While the contractor may know if there is an agreement between the countries, the system manager is the most logical source. If the manager doesn't know, the Director, Defense Security Assistance Agency can provide the information and should be consulted through appropriate channels.

CONCLUDING REMARKS

The pricing of procurements for FMS begins with the general premise that FMS contracts shall be priced using the same principles and with the same care attendant to pricing normal DOD contracts. However, the DFARS does allow the contractor to charge a slightly higher price for FMS to recover costs not otherwise permissible in DOD contracts. This fact notwithstanding, the foreign customer stands to gain from the DOD management expertise available through FMS, and can be assured of paying a fair and reasonable price.

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