FEATURE ARTICLE

Changes to Foreign Military Sales Administrative Surcharge Structure and Rate

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Background

On 15 March 2006, the Defense Security Cooperation Agency (DSCA) announced a package of reforms aimed at ensuring the continued solvency of the foreign military sales (FMS) Trust Fund Administrative Account. Included in these changes is an increase to the FMS administrative surcharge rate assessed against all FMS and FMS-like cases. The surcharge rate, 2.5 percent since 1999, will be 3.8 percent effective with cases or new case line items accepted on or after 1 August 2006. Other changes in the package include elimination of the Logistics Support Charge in fiscal year (FY) 2008, a requirement to collect a minimum amount against all FMS cases, and a commitment to clarify and consistently implement the standard level of service covered by these charges. This total package of reforms represents some very significant changes that will have both short-term and long-term benefits to the security assistance community. This article discusses the history and factors behind the decision to implement these changes and the overall impact they will have on our programs.

Why Change Now?

The *Arms Export Control Act* (AECA) mandates that an administrative surcharge be assessed on FMS cases to ensure we recover the full estimated U.S. government costs incurred to administer, execute, manage, and oversee these programs. The administrative surcharge is assessed as a percentage of the value of articles and services on each FMS and FMS-like case, e.g., pseudo cases, and other security cooperation programs.

In 1987, a Logistics Support Charge (LSC) was implemented to recover additional costs incurred to provide logistics-related support. The LSC rate is 3.1 percent and is assessed on deliveries of specific logistics articles and services. The combined revenues generated from the FMS administrative surcharge and the LSC are deposited to the FMS Trust Fund Administrative Account and are used to pay for U.S. government administrative expenses related to FMS programs. These expenses include costs to provide U.S. government management of individual FMS cases as well as services that are of benefit to the entire FMS program, infrastructure and information technology investments.

Unfortunately, income from these two charges is currently not sufficient to cover our expenses. Our analysis shows that if we continue with the status quo, (e.g., maintain our current level of expenses, keep the existing rate structure, and achieve forecasted estimates for new sales) the balance in the FMS Trust Fund Administrative Account could reach $0 by FY 2009.

In February 2005, DSCA established an internal group to look at the overall health of the FMS Trust Fund Administrative Account. This team, known as the DSCA Fees Group, was tasked to develop possible solutions to the steadily declining balance in the account, looking both at ways to reduce expenses and increase our income to ensure we recover our costs (as required by law). DSCA recognized that the time to determine a course of action and begin implementation is now! We cannot

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afford to wait until the balance reaches $0 if we want to maintain the solvency of the Administrative Account.

Analysis Behind the Decision

During an extensive five month study, the Fees Group researched past files to understand the history of the administrative surcharge and LSC, particularly how these charges were implemented and assessed, what rate changes have been made and why, the amount of revenue generated from each charge; by country, by case, by military department, and by fiscal year. The group wanted to fully understand how we arrived where we are today so they could apply lessons-learned to any future actions. To look forward, the Fees Group used statistical models to estimate future revenues based on historical case life cycle revenues and estimated future sales. The group also reviewed previous, current, and planned efforts to reduce expenses. Some of the key findings of this five month research and analysis effort included:

- Approximately $250M is needed for a healthy balance in the FMS Trust Fund Administrative Account. This is sometimes referred to as the reserve. The $250M amount is based on first quarter requirements, considerably higher than any other quarter of the year, and the buffer needed to pay expenses independent of revenues from new sales.

- Historically, any changes to the administrative surcharge have been prospective and only applied to new cases and/or new line items. In contrast, implementation of the LSC in 1987 was effective on all deliveries reported after the implementation date of the charge, even for those cases that were already in existence.

- Implementation of the 1999 administrative surcharge rate reduction from 3.0 percent to 2.5 percent was flawed. Although the decision was sound based on the data available at that time, the implementation strategy called for not only reducing the administrative surcharge rate but also reducing budgets, implementing initiatives to save expenses, and reviewing the rate annually for possible change. The only part of the implementation plan that was successfully implemented was the rate reduction, unwittingly ensuring a downward trend in the account balance that now requires corrective action.

- Revenues from the LSC make up 13 percent of the total income. Any decision to reduce or eliminate this charge must consider the need to recover this amount, approximately $40M annually. Additional analysis to determine what an optimal, single rate might be showed that a .5 percent increase to the administrative surcharge would be needed to eliminate LSC and maintain the current income levels and account balance.

- 56.6 percent of new FMS cases implemented in FY 2004 were for less than $600,000. The surcharge collected on each of these cases at the 2.5 percent rate will be less than the minimum $15,000 the Fees Group estimates it costs to write and implement a case. Bottom line, 56.6 percent of our sales did not cover costs

- The military department administrative surcharge-funded workforce is the lowest it has been in FMS history, under 40 percent of the levels funded in 1979. The Fees Group also reviewed recently implemented cost-saving measures as well as current plans to achieve further efficiencies. In an effort to reduce community-wide costs, DSCA capped FY 2006 spending at FY 2005's level and reduced FMS budgets by $18.6M through FY 2009. DSCA also created a new contracting office to internally manage headquarters' contracts and avoid contracting fees. $2M in savings were achieved in FY 2005 as a result of this effort. The Business Efficiencies and Action Team (BEAT) was established in April 2005. This team, led by DSCA with military department participation, is chartered to identify security assistance business process efficiencies that will save the community resources without compromising service. Their first approved initiative is the consolidation of casewriting functions into a single Department of Defense (DoD) office that is estimated to save $5.6M by FY 2010.

Even after these savings measures were factored into the budget outlook by the Fees Group, there remains a budget deficit that must be addressed by an increase in revenues which necessitates an increase to the administrative surcharge rate. Based on their research and data analysis, the Fees Group developed eight possible alternatives that would ensure full recovery of costs. These eight options were narrowed to four that were explored in even greater detail. The analysis included several "what if" scenarios for each different option using different rates, various implementation dates, different estimated new sales, and reduced costs. By June 2005, the group was ready to present their analysis and recommended solution to senior leadership for approval.

Journey to a Decision and Approval

On 21 June 2005, the Fees Group presented four options and a recommended solution to DSCA senior leadership. The proposed solution included seven specific actions to be taken and a timeline for implementation. The DSCA Director and Deputy Director concurred with the recommendation and the briefing was presented to the senior leadership of the Military Department International Program/Affairs Offices of Deputy Under Secretary of the Air Force for International Affairs (SAF/IA), Deputy Assistant Secretary of the Army for Defense Exports and Cooperation (DASA-DEC), and Navy IPO, on 24 June and 6 July 2005. These organizations also agreed with the proposal and the Fees Group was tasked to move forward and obtain interagency approval of the plan.

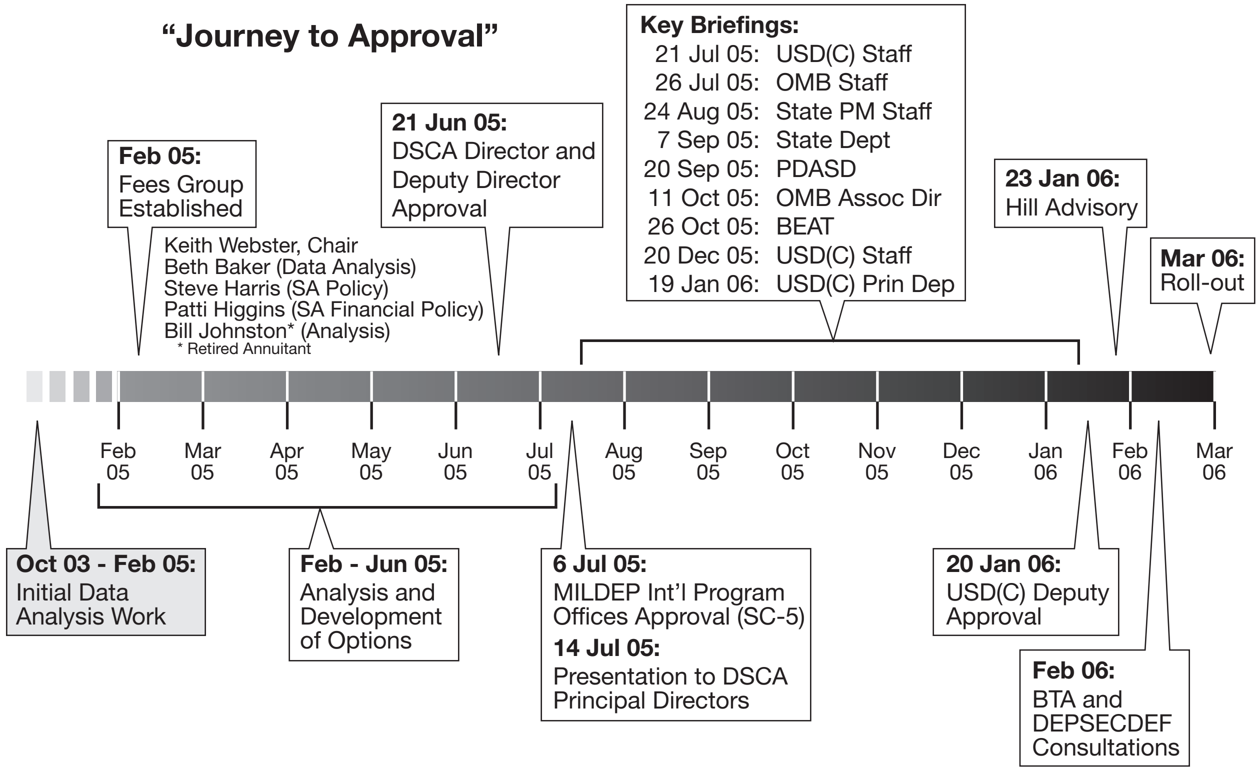
From July 2005 to January 2006, the Fees Group briefed and obtained support from key U.S. government organizations to include USD(Comptroller) staff, Office of Management and Budget (OMB) (Associate Director, National Security Programs), and Department of State (Political-Military Affairs) staff. Over the course of several meetings, DSCA consulted with these offices, responded to their questions, and provided additional data as requested on each of the seven recommended actions. These organizations reviewed the historical data specific to sales and revenue; assessed the current modeling for future sales, projected revenue, and costs; studied the other alternatives that were considered and why they were rejected. Significant time was spent on the math behind the work of the Fees Group and the conclusion reached in all instances was that the approach used by the group was thorough and verifiable.

In accordance with DoD regulations, DSCA obtained Principal Deputy, USD(Comptroller) approval for the rate increase on 20 January 2006. Appropriate Congressional committees were notified on 23 January 2006 of DSCA's intent to implement these changes effective 1 August 2006. In February 2006, the Fees Group worked with the DoD Business Transformation Agency (BTA) to get their perspective on the proposed plan. The BTA agreed with the proposed changes and promised to work with DSCA to explore additional opportunities for savings and/or alternative funding options.

Seven Actions/Changes

The seven actions included in the plan are detailed as follows:

- **Action 1.** Increase the administrative surcharge rate to 3.8 percent. The Fees Group analysis shows that this new rate will cover our costs and allow us to simplify the surcharge fee structure by eliminating the higher non-standard rate (currently 5 percent) as well as the LSC. At our current operational tempo, the administrative surcharge rate would need to be raised to at least 4.8 percent to ensure the balance of the FMS Trust Fund Administrative Account does not reach $0. DSCA did not want to focus only on revenues, however, and recognized the need to reduce expenses as well. By instituting budget cuts and working process reforms, we were able to justify the lower rate of 3.8 percent. The new administrative surcharge rate will be effective on all new FMS and FMS-like e.g., pseudo, security cooperation program, cases accepted on or after 1 August 2006.



Any cases accepted prior to 1 August 2006 will continue to be assessed the rate that was in effect at the time they were implemented, with the exception that any new lines added to these cases via Amendments accepted on or after 1 August 2006 will be charged the new rate. Our estimates show that implementation of the new rate, combined with the other initiatives detailed below, will bring the FMS Trust Fund Administrative Account balance back to a healthy level which should allow decisions in approximately FY 2010 regarding additional funding of community-wide initiatives, such as IT investments.

- **Action 2.** Better define the standard level of service. Table C5.T6. in the *Security Assistance Management Manual* (SAMM) provides information on what FMS case-related activities are covered by:

  - The administrative surcharge;
  - FMS case program management lines (PMLs); or
  - Other lines on the FMS case.

Activities with an X in the administrative surcharge column of this table reflect the standard level of service to be provided on each FMS case. This table is being updated to clarify proper funding sources and ensure consistent application of the standard level of service to all cases. One specific change in the revised table will be the elimination of PMLs. New cases accepted on or after 1 August 2006 may still include valid U.S. government program management services, but these services will be included as separate, well-defined lines on the FMS case, providing more detail and transparency to our purchasers. PMLs implemented prior to 1 August 2006 will continue to be executed as written.

- **Action 3.** Charge any levels of service that are higher than the standard directly to the customer on the case: Our current policy already allows customers to purchase varying levels of services and support directly on their FMS cases. As the U.S. government strives to consistently enforce the standard level of support, some customers may desire higher levels of service on specific cases. This additional support, over-and-above that covered by the administrative surcharge, may be obtained and funded on separate line items on the FMS case. In determining what the appropriate administrative surcharge rate should be, we used the standard level of service as our guide. While we understood some customers might desire additional services and support for specific cases, the administrative surcharge rate to provide this support to all cases would be very high. By setting a standard and keeping it consistent, we were able to keep the rate increase to a minimum, allowing customers to only pay for additional types of support on those individual cases where the customer determines that additional support is necessary. Simply put, why pay a higher rate on all 100 cases, when you really only need the higher level of support on one case?

- **Action 4.** Establish a small case management line requirement. All cases accepted on or after 1 August 2006 must collect a minimum of $15,000 in administrative charges. This is necessary to ensure we recover U.S. government costs to prepare and implement the case. We are currently not recovering these costs on cases that are written for small dollar values or on cases which are closed after implementation without delivery of any articles and/or services. 56.6 percent of all new cases implemented in FY 2004 are scheduled to collect $15,000 or less in total administrative surcharge throughout their life. For cases accepted on or after 1 August 2006, if the case value is so small that the administrative surcharge amount calculated is less than $15,000, a separate line will be added to the case so that the administrative surcharge and this new line combined total $15,000. The value of this line will be adjusted as necessary to allow for changes in case value if the case is amended or modified. A minimum of $15,000 will be retained by the U.S. government when the case is closed. When purchasers use foreign military financing (FMF) to wholly fund their case and received between $1 and $400,000 in FMF monies in the previous FY, the minimum charge will be covered by FMF administrative monies and will not be included on the FMS case.

- **Action 5.** Eliminate the 5 percent administrative surcharge currently charged for non-standard items. Effective 1 August 2006, the 5 percent administrative surcharge currently assessed for provision of non-standard support will be eliminated. Any line items for non-standard articles or services included on cases accepted on or after 1 August 2006 will be charged the standard, 3.8 percent, rate. Any line items that already exist prior to 1 August 2006 and are being charged the 5 percent rate will continue to be assessed that rate. This new policy does not affect the supply support arrangement surcharge for Foreign Military Sales Order (FMSO) I cases which continues to be 5 percent in accordance with the *Financial Management Regulation*.

- **Action 6.** Eliminate the logistics support charge (LSC) effective no later than FY 2008. Effective 1 October 2007, the 3.1 percent LSC will be eliminated. Any items delivery reported on or after 1 October 2007 will not be assessed the LSC, even if they were originally priced to include this charge. Please note that the effective date for this change is FY 2008 vice FY 2007. Delaying the implementation of this change until after the new rate has been in effect for a short period allows for a stronger recovery of the Administrative Account balance. The LSC may be eliminated earlier than FY 2008 if it is determined that the account balance has sufficiently recovered to an upward trend.

- **Action 7.** Review the administrative surcharge and the small case management line value requirements annually for possible changes and publish results. The administrative surcharge rate is not locked-in-stone and should be reviewed frequently to ensure it is allowing us to collect the appropriate amount of revenue to ensure full cost recovery. If the annual review shows that our current cost recovery is not where it needs to be (either too high or too low), DSCA will consider options for correcting the problem. Those options may include a rate change, additional process reforms, or changes to the way we collect the surcharge e.g., the requirement to collect 50 percent of the administrative surcharge funds upon case implementation may require adjustment. We do not envision an annual rate change, but we need to do more frequent, widely-published, analysis to ensure we can identify problems, and make decisions in a timely manner.

Roll-out and Implementation

In four separate meetings held in Washington D.C. on 14 and 15 March 2006, DSCA officially announced these new policies. During these briefings, DSCA provided detailed information to representatives from DSCA, the Military Departments and other implementing agencies, our international customers, and industry. DSCA wanted to ensure these groups heard first-hand the rationale behind these decisions and had an opportunity to ask questions directly to the Fees Group. The briefings were comprehensive and covered key historical events, the current financial situation, steps taken to correct our financial problems, the process by which interagency coordination was achieved, and detailed guidance on the seven actions.

In anticipation of the roll-out, DSCA prepared and distributed several products to assist the community in preparing for these changes. A handout of answers to frequently asked questions was provided to all participants. A more detailed response to query handout was also given to U.S. government personnel. Both of these documents provide useful information in understanding and explaining these changes. A side-by-side comparison of cost impacts to a sampling of FMS cases and a listing of upcoming changes to the Defense Security Assistance Management System (DSAMS) were also provided. The roll-out and implementation products are available on the Security Assistance Network (SAN) website in the DSCA library section. The frequently asked questions have been posted to the DSCA website for community-wide use.

	Required Action	Effective Date
1	Increase the administrative surcharge rate to 3.8%	Case and lines accepted on or after 1 August 2006
2	Better define the standard level of service.	Standard level of service already in-place (SAMM Table C5.T6.) - Current Policy. New clarifying matrix effective 1 August 2006 program management lines not allowed on cases accepted on or after 1 August 2006.
3	Charge any levels of service that are higher than the standard directly to the customer on the case.	Immediately - current policy
4	Establish a small case management line requirement.	Case accepted on or after 1 August 2006.
5	Eliminate the 5% administrative surcharge currently charged for non-standard items.	Cases and lines accepted on or after 1 August 2006.
6	Eliminate the logistics support chart.	All deliveries no later than 1 October 2007 (FY 2008).
7	Review the administrative surcharge and the small case management line value requirements annually.	Immediately

As indicated previously, not all seven actions are being implemented at the same time. The preceding chart shows the effective date for each action:

In implementing these changes, DSCA's goal is to ensure stakeholders have several months to prepare. For U.S. government personnel, there are specific requirements for how letters of offer and acceptance (LOA) must be written not only after 1 August 2006 but also for cases already offered that have offer expiration dates (OEDs) that fall after 1 August 2006. Detailed implementing guidance has been published in DSCA Policy Memorandum 06-19 to ensure all cases are written in compliance with these new policies. This guidance was distributed during the roll-out sessions and is available on the DSCA website www.dsca.mil in the policy memoranda section. For our international customers, time is needed to understand these changes and what choices are available e.g., consolidate requirements on a single, larger case to avoid multiple small case management line thresholds, and adjust purchasing timelines to ensure acceptance before rate change is effective.

There are also several data automation system changes for DSAMS as well as the Defense Integrated Financial System (DIFS) that must be made to ensure successful implementation. These changes are underway and will be completed by the effective date of the changes. To ensure more consistency in implementing the standard level of service we are also encouraging more use of the Security Cooperation Information Portal (SCIP) by both U.S. government personnel and our international customers.

Impact - What Next?

During the course of developing these changes and obtaining interagency approval, one of the most frequent questions posed was whether the new administrative surcharge structure and rate would drive customers away from FMS. Our answer to this question is no. There are many reasons why our partners choose FMS. While cost is certainly a consideration in any procurement strategy, we believe that it is not the only factor. Customers choose FMS to allow the U.S. government to bring the full weight of the DoD community and our leadership into the execution and performance of the sale. Others desire to further their military-to-military relationship with the U.S. government through FMS. In some instances, U.S. industry may also regard FMS as the preferred method of sale. These reasons remain constant regardless of surcharge changes.

While we have not tried to make direct comparisons between FMS and similar support provided by U.S. industry or other defense agencies, our research did show that the FMS program is competitive when compared to similar activities e.g., the Defense Logistics Agency Defense Working Capital Fund (DWCF) and the Office of Management and Budget Most Efficient Organization (MEO) benchmark rates. Even with an administrative surcharge rate of 3.8 percent, we believe we continue to be good value for the money and are confident our customers will continue to agree.

This initiative **does not** stop with implementation. DSCA is committed to reviewing these policies for compliance and effectiveness. In accordance with action number 7, we will be conducting an annual review of the health of the FMS Trust Fund Administrative Account. This review will be published and will include recommendations for what adjustments might be needed to the rates and/or collection methods.

In addition to this review, DSCA will continue to review LOA documents to ensure consistent application of the standard level of service. We will make site visits and perform spot checks to ensure these policies are being implemented consistently.

This initiative is not just about a rate increase. Although the rate increase is perhaps the most visible and emotional part of this effort, it should be remembered that it is only one part of an entire package of reforms designed to ensure we are recovering our costs as required by law. We are committed to working on the expense side of the equation as well as the revenue side. To that end, cost-saving measures will continue to be pursued. The BEAT has been tasked to identify $36M in savings for implementation by FY 2009. We will continue to work on these and other efforts and collaborations designed to save resources across our community.

Questions?

If you have any questions regarding the policy changes related to the administrative surcharge, please contact DSCA-FMSSurcharge@dsca.mil. This e-mail address has been set up specifically to record questions and/or comments regarding these changes. Use of this address will help us ensure consistent responses to your queries and allow us to track questions and answers that might require more formal updates to the community as a whole.

About the Author

Beth M. Baker is a Security Assistance Data Analyst for the Directorate of Business Operations at the Defense Security Cooperation Agency, Arlington, Virginia. She earned a Bachelor of Science degree from Wright State University, Dayton, Ohio, in 1981 and a Master of Public Administration (International Affairs) degree from George Mason University Fairfax, Virginia, in 1994. She also earned a certificate in Legislative Studies from the Government Affairs Institute at Georgetown University, Washington, D.C., in 2002. In her current position, she is responsible for researching and analyzing historical security assistance data to make recommendations for policy and procedure improvements. While at DSCA she has worked a variety of positions to include financial and security assistance policy development. Prior to DSCA, she worked for the Deputy Under Secretary of the Air Force, International Affairs as the chief security assistance policy focal point and for the Air Force International Logistics Center (now the Air Force Security Assistance Center) in a similar capacity.