



National Security and
International Affairs Division

B-282718

May 13, 1999

The Honorable William S. Cohen
The Secretary of Defense

Subject: Defense Trade: Decision to Lower FMS Administrative Fee is Premature

Dear Mr. Secretary:

At the request of the Chairman, House Committee on International Relations, we are reviewing the structure and resources of the Foreign Military Sales (FMS) Program. Among the specific objectives of our review are to assess how the FMS program recovers its costs, as required by the Arms Export Control Act, and how projected sales levels made through the program will affect cost recovery in the future.

On May 7, 1999, the Defense Security Cooperation Agency (DSCA), which administers the FMS program, recommended that the Department of Defense (DOD) Comptroller reduce the FMS administrative fee from 3 percent to 2.5 percent. The administrative fee is the major source of revenue for program activities not directly related to individual FMS sales. We believe a decision to reduce the administrative fee at this time is premature.

Our analysis of the assumptions that underlie DSCA's recommendation follows:

- As part of a plan to streamline the FMS process, DSCA has a specific initiative to substantially reduce program operating costs below current levels.

Although streamlining initiatives have begun, DSCA has not yet identified specific cost-cutting measures or developed plans to implement them, once identified. In fact, DSCA does not know the current level of its operating costs. In one of its efforts to identify costs, DSCA has contracted with the Institute for Defense Analyses to measure the cost, workflow, and productivity of the FMS program. In addition, the military departments are engaged in their own, separate reengineering efforts, which have not been coordinated with DSCA. DSCA budget projections already include a decline of 12 percent in funding to be available for administering the program between now and fiscal year 2003 at the current 3-percent administrative fee level.

- DSCA expects FMS sales to exceed current projections because fiscal year 1999 sales to date have exceeded the sales as of the same period for the last 4 years and higher sales are likely to result in part from the Balkan conflict.

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DSCA has not updated its projections for future sales since last fall. Therefore, no analysis supports this assumption. However, increased sales that may occur will also generate additional administrative costs. Depending on the type of equipment and services sold, the additional fees collected may not offset the additional costs. In addition, although DSCA assumes that any increased sales from the Balkan conflict will benefit the FMS program, this assumption may be incorrect since those additional sales may occur directly between U.S. manufacturers and foreign customers, bypassing the FMS program and resulting in no additional fees for that program. Although a lower FMS administrative fee may provide additional incentive for customers to use the FMS program instead of the direct commercial route, DSCA has not analyzed the likelihood of foreign customer choices, or the impact such choices might have on FMS program operations.

- DSCA cites the current balance in the administrative cost account as unusually large and estimates that the reduced fee level will, when combined with logistics support charges, continue to keep the balance above \$250 million between now and fiscal year 2003.

A balance of \$250 million represents about half of the current balance. And after 2003, the balance turns sharply down, according to the DSCA model, falling to a negative in 2007. By law, the FMS Program must fully recover its administrative costs. Beyond that, DOD has no formal guidance on the appropriate level of funding required. Our analysis of historical trends shows that significant or fluctuating sales in any given year and administratively determined cost avoidance initiatives, as well as the lack of requirements-determined basis for DSCA's annual budget allocations affect the balance in the FMS administrative cost account.

In recognition of the global environment within which the FMS Program must operate, which is significantly different from the one for which the FMS Program was created, DSCA and the military services have launched wide-ranging evaluations of their structure, their operations, and the resources they need. Changes in the current administrative fee structure may emerge as a viable recommendation from those evaluations. However, to date there has not been sufficient analysis of either the need for or the impact of such a change. Accordingly, we believe that changing the fee structure is premature and may jeopardize the fiscal soundness of the program.

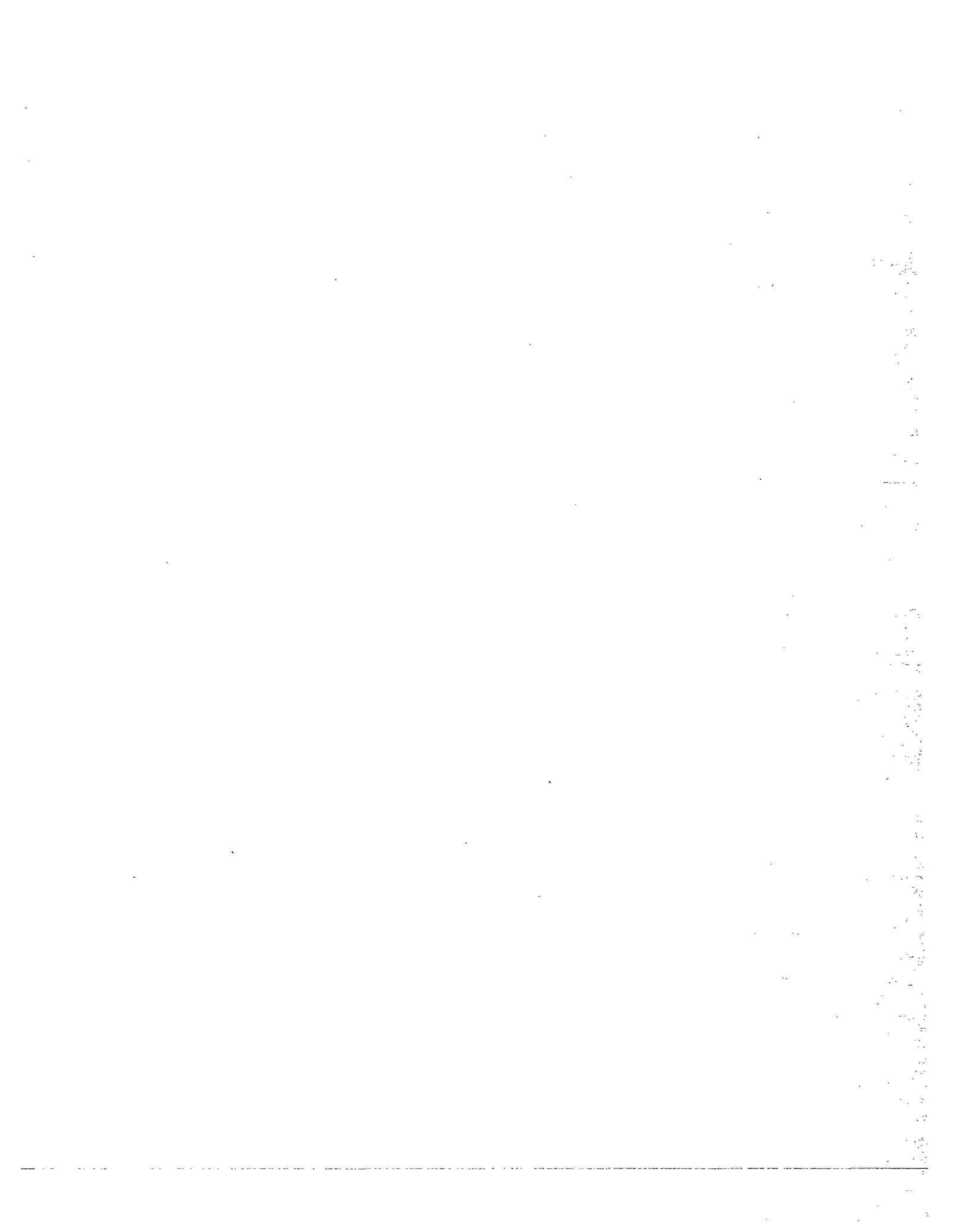
We would appreciate your response to the issues discussed in this letter within 30 days. We are sending copies of this letter to Senator Jesse Helms and Senator Joseph Biden, Chairman and Ranking Minority Member, respectively, of the Senate Foreign Relations Committee, and to Representative Benjamin Gilman and Representative Sam Gejdenson, Chairman and Ranking Minority Member, respectively, of the House Committee on International Relations. Please contact me on (202) 512-4841 if you or your staff have questions concerning this letter.

Sincerely yours,

A handwritten signature in black ink that reads "Katherine V. Schinasi". The signature is written in a cursive style with a large initial "K".

Katherine V. Schinasi
Associate Director, Defense Acquisitions Issues

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