BY THE COMPTROLLER GENERAL

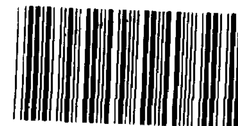
Report To The Congress

OF THE UNITED STATES

A New Approach Is Needed For Weapon Systems Coproduction Programs Between The United States And Its Allies

American industrialized allies increasingly have sought and will continue to seek cooperative production arrangements from the United States for their procurement of weapon systems. It is evident, however, that there is a need to alter the present procedures governing coproduction of weapon systems with foreign countries if the United States is to participate in major new coproduction agreements.

This report examines the present method used to cooperatively produce weapon systems and the difficulties resulting from this method. A number of recommendations are made to alter the way coproduction programs are established and administered. These recommendations relate to contractual relationships, congressional review, procurement legislation, and executive department coordination.



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COMPTROLLER GENERAL OF THE UNITED STATES
WASHINGTON, D.C. 20548

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To the President of the Senate and the
Speaker of the House of Representatives CWO 00001

This report describes a possible new approach to establishing weapon system coproduction programs involving the United States and certain of its allies. Until now such programs have been governed by regulations and procedures applicable to foreign military sales.

Coproduction arrangements involve issues of national sovereignty, international agreements, and governmental relationships with industry not usually present in international sales of weapon systems. Their unique character demands different procedures and contractual agreements to make coproduction programs more effective. The recommendations in this report are intended to accommodate these requirements.

A copy of this report is being sent to the President of the United States. Copies are being sent to the Director, Office of Management and Budget, and to the Secretaries of Commerce, Defense, State, and the Treasury.

Elmer B. Staats
Comptroller General
of the United States

COMPTROLLER GENERAL'S REPORT TO THE CONGRESS

A NEW APPROACH IS NEEDED FOR WEAPON SYSTEMS COPRODUCTION PROGRAMS BETWEEN THE UNITED STATES AND ITS ALLIES

D I G E S T

In the future, the acquisition of major military equipment by United States allies will most likely be based on some type of cooperative arrangement. If the United States chooses to become a partner in such cooperative arrangements, it has become evident from experience gained in the F-16 aircraft and other defense programs that there is a need to alter the present procedures governing coproduction of weapon systems with foreign countries.

Both the United States Government and industry usually define coproduction as an industrial participation effort where a foreign contractor joins with a United States contractor in the production of a system for use by the foreign government or for sale to a third party. There have been many of these "coproduction" efforts, including such programs as the M-113 Armored Personnel Carrier with Italy, the F-104G aircraft with West Germany, and the M-16 rifle with the Philippines. (See pp. 1 to 2.)

This report concentrates on coproduction programs wherein all participants in the coproduction arrangement, including the United States, use the end product.

The present system used to govern coproduction arrangements is the same as that which governs foreign military sales and does not take into account the military, economic, and political arrangements and consequences of doing business on a coproduction basis.

PSAD-79-24

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FOUR ISSUES

To assure sound management of coproduction programs which may occur in the future; the Congress and the Administration need to carefully assess each of the following four matters and GAO's recommendations for improving present procedures.

1. Contractual relationships

The use of foreign military sales procedures in setting up military acquisition programs establishes the United States and the foreign government as the contractual parties. The United States sells the weapon system and manages the program, because it involves U.S. production of a U.S.-developed weapon system. With the emergence of complex industrial coproduction where foreign participants actually build a major segment of the equipment they purchase, and even produce part of a military system which the United States will use, the foreign military sales procedures are inappropriate because they do not reflect the partnership nature of coproduction. (See pp. 5 to 11.)

2. Congressional review

Existing legislation requires a Letter of Offer and Acceptance to be issued by the United States to consummate a sale under foreign military sales procedures. The Congress is given notification of an impending sale at least 30 days before a Letter of Offer and Acceptance is issued. In coproduction programs the participating governments also generally sign a Memorandum of Understanding signifying the agreement of the members. It is with this more detailed document that U.S. commitments are made to foreign governments. Congressional consideration of proposed cooperative arrangements on the bases of limited information contained in Letters of Offer and Acceptance does not appear appropriate. The Memorandums of Understanding provide

a better insight into the nature and extent of the U.S. commitments proposed. (See pp. 11 to 15.)

3. Procurement legislation and regulations

In establishing industrial participation programs with foreign countries, U.S. procurement statutes and regulations have caused difficulties. Their prescribed policies and procedures are not necessarily appropriate for programs involving intergovernmental cooperative ventures. Two general areas where laws and regulations have caused friction and may prove to be troublesome are

--the protection of domestic commercial interests and

--contracting, auditing, and accounting procedures. (See pp. 15 to 17.)

4. Management and administration

In addition to the above, present administrative arrangements may not offer the centralized administration that industrial participation efforts need for making balanced and effective decisions and policy interpretations. (See pp. 17 to 18.)

RECOMMENDATIONS

GAO recommends that the Congress, as part of its assessment of the future involvement of the United States in coproduction programs:

--Consider a direct sale approach as the accepted method for U.S. prime contractors engaged in coproduction programs, thereby removing such programs from foreign military sales procedures. Under the direct sale approach, the U.S. companies would contract directly with a foreign government or consortium buying the product.

--Require that a Memorandum of Understanding be submitted to the Congress for review before the U.S. and foreign participants make a commitment to join in a coproduction program. The Congress would either concur by taking no action or object by disapproving the Memorandum of Understanding.

--Review appropriate procurement legislation and regulations to identify and evaluate the changes necessary to provide the needed flexibility for a realistic and efficient application to cooperative ventures with foreign countries. It is expected that foreign participants will take comparable reciprocal actions when they are needed to facilitate such ventures.

GAO further recommends that the President consider, within the context of his current executive branch reorganization studies, the establishment of an independent interagency administrative or coordinating mechanism to provide balanced policy and management guidance and act as a clearinghouse for industrial participation programs.

The new approach which is proposed should be considered for application to North Atlantic Treaty Organization (NATO) countries, plus Australia, New Zealand, and Japan. All of these countries are exempt from the restrictions imposed by the President's Conventional Arms Transfer Policy.

AGENCY COMMENTS

Copies of the report were submitted to both the Departments of State and Defense for review and comment. Although both agencies declined to provide formal comments, GAO has adjusted the report by considering informal technical comments provided by the staff of these agencies, particularly of the Department of State. Written comments have been received from the Departments of the Treasury and Commerce. (See apps. I and II.) Questions which they raised on issues related to this subject are discussed in chapter 3. (See pp. 21 and 22.)

Comments received directly from individual domestic contractors and two industry associations were generally favorable. Several NATO members were given copies of the report, and their responses were also generally supportive. Comments from these sources were considered in preparing the final draft of this report.

The subject of this report involves many sensitive areas of concern to the U.S. Government and industry. GAO believes its recommendations are responsive to the conditions within which coproduction arrangements would have to operate in the future, but recognizes that further discussions will and should be generated. In this regard, the recent GAO report, "Transatlantic Cooperation in Developing Weapon Systems for NATO--A European Perspective," (PSAD-79-26) will help in understanding the subject area and evaluating many of the issues raised in this report. GAO would be willing to assist the Congress in actions taken as a result of this report.

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ABBREVIATIONS

AWACS	Airborne Early Warning and Control System
GAO	General Accounting Office
MOU	Memorandum of Understanding
NATO	North Atlantic Treaty Organization

CHAPTER 1

INTRODUCTION

The Mutual Defense Assistance Act of 1949 was enacted to enable the United States to provide military aid to our European allies. During the 1950s and early 1960s, military aid to foreign countries principally took the form of grant aid. Under grant aid, the United States provided military equipment, support, or other services without reimbursement.

Beginning in the 1960s, as economic conditions in a number of countries improved, an increasingly larger portion of military equipment was provided through foreign military sales, a reimbursable arrangement involving credit or cash.

In order to provide a formal structure to the foreign military sales program, the Congress enacted the Foreign Military Sales Act of 1968. The act gave Congress explicit authority to disapprove any foreign military sale proposed by the executive branch which exceeded $25 million. The Arms Export Control Act of 1976, which replaced the 1968 Foreign Military Sales Act, specifies the procedural and informational requirements necessary for the Congress to oversee foreign military sales, and for the Government to manage them. This act applies to any government-to-government sale over $25 million and any government sale of major defense equipment over $7 million.

OTHER SYSTEM ACQUISITION METHODS

Direct purchases of substantial portions of military equipment by the more industrialized nations present some drawbacks. To many U.S. allies, direct purchases have an adverse impact on certain political and economic considerations, such as the balance of payments and employment levels. Such purchases may also limit the ability of these nations to develop and maintain a viable defense industry.

To overcome these detriments, foreign countries may consider alternatives when they wish to acquire a U.S. weapon system. One alternative is to secure licenses from U.S. developers to produce the system themselves. In licensing, the foreign country acquires the rights to produce in that country a military item developed in the United States. A second is to enter into coproduction arrangements. The Government and U.S. industry have construed coproduction to include any industrial participation effort where a foreign contractor joins with a U.S. contractor in the production

of a system for the use of the foreign government or for sale to a third party. There have been many of these "coproduction" efforts, including such programs as the M-113 Armored Personnel Carrier with Italy, the F-104G aircraft with West Germany, and the M-16 rifle with the Philippines.

In this report we classify as a coproduction program any type of joint arrangement wherein all participants in the coproduction arrangement, including the United States, use the end product. When the term coproduction is used in this sense, the distinguishing feature is the common usage of the jointly produced item. In contrast, many major past programs that have been classified as coproduction arrangements either more closely resembled a licensing arrangement or found the U.S. selling its share of the production run to a third party rather than including the item in the Department of Defense inventory.

Through these new avenues for military acquisitions, the European members of the North Atlantic Treaty Organization (NATO) see an opportunity to

--lessen the impact of the high cost of new weapons,

--upgrade their military capability,

--provide employment for their populace,

--redress some of their balance-of-payments losses,

--obtain new technology for their industry, and

--gain full partnership in the development and production of their own military hardware.

The first significant multinational coproduction program (as defined above) involving U.S. and foreign contractors was the F-16 aircraft program. Although the F-16 effort involved a partnership arrangement between the U.S. and four European countries, it was nevertheless managed in accordance with foreign military sales laws and procedures which structured the program as a sale by the U.S. to the European participants. As will be demonstrated in chapter 2, such laws and procedures do not deal effectively with the problems and issues which are unique to coproduction. Coproduction necessitates special treatment because it involves issues of national sovereignty and international contractual agreements distinct from those involved in foreign military sales.

Coproduction will likely be a frequent method of weapon system acquisitions in the future, according to discussions with U.S. and foreign government and industry officials. Some of our allies will continue to require costly or sophisticated weapon systems which they would have difficulty producing on their own. Others may wish to codevelop systems in order to share the cost and be in a position to subsequently coproduce them.

These considerations point to the need for offering flexible alternatives to the present method of managing and structuring programs to accommodate the peculiarities of the coproduction arrangement.

PURPOSE OF REVIEW

This report identifies and discusses the conditions peculiar to coproduction programs and recommends possible alternatives for reviewing, contracting, and managing such programs if they are to be established in the future. It deals with two somewhat distinct subject areas relating to coproduction programs. One concerns the complexity and impact associated with such programs; the other concerns the difficulty of using foreign military sales procedures to structure such efforts.

Two of the four recommendations deal with timely and accurate review by the Congress and the need for interagency coordination of such cooperative efforts within the executive branch. The remaining two recommendations concern contractual relationships and the applicability of U.S. procurement laws and regulations. Taken together, these recommendations suggest a redirection of coproduction ventures away from foreign military sales procedures, which have the U.S. Government contracting for a weapon system for sale to a foreign government (along with associated application of U.S. laws) when, in reality, that foreign government is an equal partner with the U.S. Government. In its place, suggestions are offered for more proper allocation of responsibility in such programs which would recognize the national sovereignty of the participants.

The recommended alternatives are intended for application to NATO countries, plus Australia, New Zealand, and Japan. All of these countries appear to be logical choices because of their advanced industrial capabilities, their exemption from the coproduction restrictions imposed by the President's Conventional Arms Transfer Policy, and their preferential status in the Arms Export Control Act. Furthermore, the

policy of the United States (as stated in Public Law 94-361) strongly favors NATO standardization of weapons. Finally, the Congress has encouraged the use of coproduction efforts to achieve NATO standardization and the related goals of economic benefit to our NATO allies.

In assessing the need for a new acquisition approach for coproduction programs, such as the F-16, we divided our efforts into the following four areas.

Contractual responsibilities--This part of our review addressed the contractual aspects of coproduction programs. Analysis was directed at identifying the best way responsibility, authority, and industrial efficiency could be structured contractually to allow a more efficient approach to such programs.

Congressional review--In this area we investigated the present system for congressional review of coproduction programs and assessed its application in the F-16 program.

Procurement practices--This part of our review addressed the difficulties U.S. procurement regulations create when applied to international programs. The report highlights the procurement areas where modification should be considered in the U.S. procurement regulations to eliminate possible future problems.

Management aspects--The final part of our review addressed the handling of policy and day-to-day management concerns for industrial participation programs.

SCOPE OF REVIEW

This review involved discussion with numerous officials in the Departments of Defense, State, Treasury, and Commerce; the President's Reorganization Project; Headquarters, United States Air Force; Headquarters, Air Force Systems Command; European F-16 participating governments and industry; and other NATO governments. We also held discussions with numerous U.S. contractors, including several industrial associations involved in coproduction efforts or who had an interest in any future developments in this area.

CHAPTER 2

A PROPOSED NEW APPROACH

The present methods used in establishing and administering coproduction programs between the United States and its allies should be revised if the U.S. is to participate in major coproduction programs. Present foreign military sales legislation does not reflect the proper relationship of the participants in such programs insofar as their rights and responsibilities are concerned. Furthermore, such legislation does not guarantee the timely involvement of the Congress in establishing such programs. In addition, existing procurement legislation designed to protect domestic interests is incompatible with the nature of such programs. Finally, there is a lack of coordination among the various U.S. executive agencies whose interests are affected by the consideration of issues relating to coproduction programs.

The alternative approach for use in multinational coproduction efforts that is proposed in this report has as its objective the establishment of:

--A proper allocation of responsibility among the governmental and industrial participants in industrial participation programs.

--A procedure by which the Congress can act in a timely manner in approving industrial participation programs.

--A congressional commitment to support an industrial participation program, assuming the program is meeting its objectives, barring any unusual circumstances.

--A realistic acquisition policy and related practices suited to participation programs.

--A representative body of Government agencies to participate in establishing industrial policy and program practices.

STRUCTURING OF RESPONSIBILITIES

With the emergence of complex industrial coproduction programs such as the F-16, where foreign participants actually build a major segment of the equipment they purchase and even produce parts of a system which the United States will use, the foreign military sales procedures are inappropriate.

Coproduction arrangements give the involved parties rights and responsibilities that are different than those found in conventional buyer-seller relationships. Coproduction arrangements are essentially partnerships, while military sales are inherently transacted at arms length. The present foreign military sales procedures do not reflect these rights and responsibilities.

The use of foreign military sales procedures in setting up military acquisition programs establishes the U.S. and foreign governments as the contractual parties. The United States is the seller of military equipment to the foreign country in this government-to-government arrangement. The U.S. Government contracts with the U.S. manufacturer for the item or service. Under this approach the United States must take title to the equipment and then transfer it to the purchasing government.

This approach works relatively well when a country is purchasing an item outright. However, as the trend shifts from outright purchases to coproduction, foreign military sales procedures become less appropriate.

The basic premise of a foreign military sale is that, when selling a specific weapon system to a foreign government, the United States has the responsibility for insuring the delivery date, the quality of the product, and the reasonableness of cost.

In coproduction programs, however, the product's cost, quality, and schedule are greatly affected by each of the participants. Thus, a delay in the production of a component by a foreign contractor could affect the delivery schedule of the overall system. Also, the cost of a coproduced item and its quality are affected by production standards and economic conditions in different countries. Finally, other than what the foreign participants voluntarily agree to, the U.S. Government has no authority to exercise controls or management techniques that may be needed to ensure delivery of a satisfactory product to the foreign government.

The F-16 program offers many examples of the complexities of coproduction efforts and shortcomings of using the traditional foreign military sales procedures in coproduction programs. By examining these problems, possible alternatives to foreign military sales procedures can be proposed. Basically, the F-16 program is a joint arrangement to produce F-16 aircraft in the United States and in four NATO countries (Belgium, Denmark, the Netherlands, and Norway). The coproduction aspects of the effort consist of the fabrication of components by industry in the United States and Europe, the incorporation

of parts built in Europe into U.S. aircraft, and simultaneous assembly of F-16s at three different locations within the consortium.

One of the most important goals of the program is to place production contracts in Europe equal to a certain amount of procurement value of the original aircraft. Through this method the foreign participants hope to compensate for part of the cost of the initial purchase and, in turn, gain industrial technology and obtain a modern sophisticated fighter.

A Memorandum of Understanding (MOU) was signed by the U.S. Secretary of Defense and the respective Ministers of Defense of the European F-16 participating governments, which identified the basic arrangements of the agreements. These documents offered by the United States to each country established the basic legal responsibilities of the United States vis-a-vis its customers. These legal commitments assumed by the U.S. Government included

--furnishing required defense articles and services,

--passing on to the European participants any rights included in the price under any contract connected with the procurement of items on behalf of the purchasing European nations,

--repairing or replacing damaged or defective parts, free of charge,

--providing title warranty to all items sold to purchasers, and

--accepting responsibility for all termination costs of its suppliers resulting from cancellation or suspension of all or part of the order.

The use of foreign military sales procedures thus imposed product responsibility upon the United States, even though the production was to occur in several countries where the United States was powerless to exercise the proper supervision necessary for a reliable product. In light of this situation, the European participants agreed to assume those contractual risks and financial liabilities to the same extent as assumed by the U.S. Government for the production taking place in the United States. Thus, in the F-16 program, which involved a precedent in international industrial defense cooperation, the foreign military sales procedures had to be modified to accommodate the relationships and responsibilities of the participants.

In our opinion, a direct sale contractual arrangement would more accurately reflect the relationships and responsibilities of the participants. Additionally, it would eliminates the U.S. Government as the contractual seller. The approach would overcome conflicts over national sovereignty voiced by American allies.

Because the contracting must be matched to the particular program environment, a number of direct sale approaches could be used to allow U.S. contractors to enter into more direct relationships with the participating foreign governments or contractors. We believe that industry initiative and innovation should be encouraged, and that a direct sale approach would foster such innovation in structuring the relationships in a coproduction program. The following represent possible arrangements for the direct sale approach.

Arrangement "A"

An American prime contractor, linked contractually with foreign subcontractors for the production of a weapon system, would contract directly with the foreign governments or government consortium to produce the weapon systems as agreed in the MOU. There would be no government-to-government contractual relationship beyond an MOU. The prime contractor would bear the sole responsibility for the product. Neither would it be necessary to have direct contractual arrangements between the foreign contractors and their governments. This arrangement can take two forms: contractor to foreign government (A_1) or contractor to consortium (A_2).

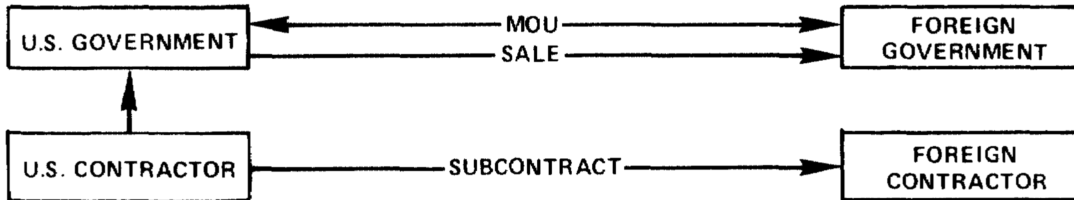
Arrangment "B"

The associated contractors, both U.S. and foreign, would contract directly with their respective governments. This type of arrangement would be applicable in cases where the foreign contractors are producing the end products to be purchased by the foreign governments with the U.S. contractor furnishing parts.

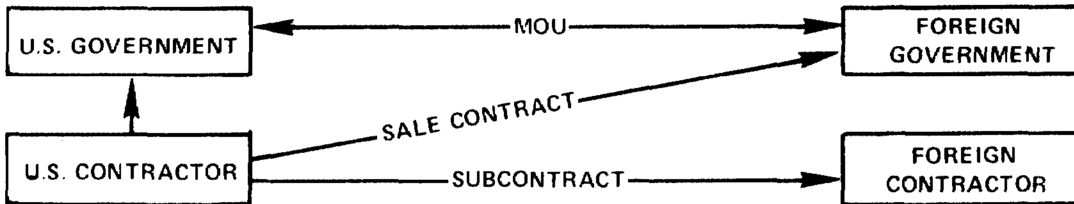
A recent example of one of the possible arrangements (A2: contractor to consortium) is the Airborne Early Warning and Control System (AWACS) which has been primarily structured as a direct sale, with the United States and NATO participating. Aspects of the program including government-furnished aerospace equipment and training services will be handled as foreign military sales cases. A NATO Program Management Organization is to be established consisting

Contrast of the Foreign Military Sales Arrangement of the F-16 Program with Arrangements "A" and "B"

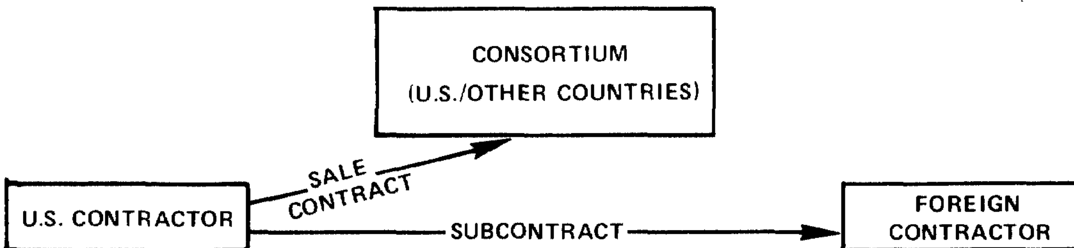
F-16 ARRANGEMENT



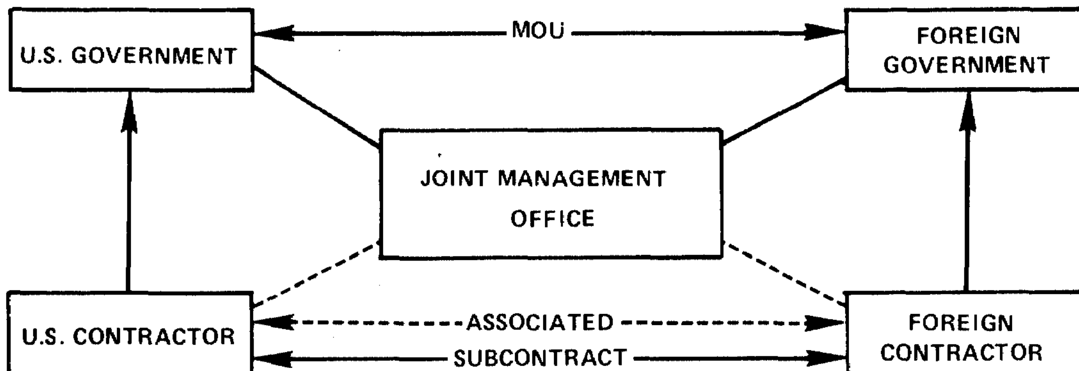
ARRANGEMENT "A_1"
(CONTRACTOR TO FOREIGN GOVERNMENT)



ARRANGEMENT "A_2"
(CONTRACTOR TO CONSORTIUM)



ARRANGEMENT "B"
(NATIONAL CONTRACTOR TO NATIONAL GOVERNMENT)



of all the participating governments. However, since the United States has previous experience in acquiring the system for its own use through the American prime developer and producer, it has been designated as agent to manage the program on behalf of the NATO Program Management Organization. The parties to the contract will be the NATO Program Management Organization and U.S. contractors. U.S. procurement practices will be applied on the program except when they are inappropriate to foreign subcontractors and contracts, and obligation of funds will be in the name of the NATO Program Management Organization.

In the AWACS direct sale approach, the following conditions exist:

1. Sovereign rights are respected as each nation participates and buys a weapon system as one body through a joint organization.

2. Procurement laws and regulations are structured to accommodate the sovereign rights of the participants and the national laws of each participant.

3. Management of the program would still be retained by the national government most qualified to assume this task.

4. Each participant has knowledge of the status of the acquisition and is able to protect its peculiar objectives through established organizational bodies.

The direct sale approach requires that contractors assume greater responsibility than they have had in traditional foreign military sales. Some U.S. firms have had significant experience and will be more easily assimilated into this approach, while others will face a period of education to be sufficiently prepared to enter into major commercial contractual relationships. From our review, it is evident that most major U.S. firms do have the necessary background.

In proposing a direct sale approach for coproduction efforts, it must be pointed out that in some circumstances certain parts of a program may and should be placed under foreign military sales procedures. This might occur when munitions or other sensitive types of equipment or specific services can only be provided by a particular government. Even with the more industrialized and developed countries, certain aspects of major acquisitions may need special support. If such support is needed, separate foreign military sales arrangements can be established to provide the needed expertise.

The approach would eliminate the seller-buyer relationship and foster a partnership element to joint ventures. Since the MOU would be subject to congressional review, U.S. interests would be sufficiently protected. Also, as will be discussed shortly, the establishment of a central U.S. authority for each program would continue to assure a U.S. presence in such efforts. But at the same time, the United States would not be accountable for aspects of the program outside its control and responsibility for the day-to-day industrial efforts would be fully retained by the contractors who are most familiar with the industrial aspects.

Government-furnished equipment

There are many cases where a major end-item is composed of a substantial proportion of government-furnished equipment. Under present conditions, the United States provides this equipment to a contractor for incorporation into a weapon system. In coproduction programs, it may be more efficient to provide such equipment to the U.S. contractor who is establishing a direct sale relationship with a foreign nation or contractor. He in turn would be able to establish a total contractual arrangement with a foreign government.

TIMELY CONGRESSIONAL REVIEW

Under current foreign military sales legislation, the Congress is, at some point in time, officially given notification of an impending sale. Subsequent to that notification, the Congress has a specified period of time in which to object to the proposed transaction. If no objection is forthcoming within the alloted time, the sale may be concluded. This review procedure was designed to deal with rather straightforward sales of military equipment and/or service.

In contrast, in industrial participation programs (like one of the coproduction arrangements described earlier) the participating nations sign an MOU reflecting the agreement of the members to jointly produce a weapon system. It is in this document that commitments are made by the participating governments. In such cases, the application of review procedures designed for foreign military sales is unsatisfactory, as the F-16 case demonstrates.

For the F-16, a letter notifying the Congress of the impending sale of the F-16 to the four participating European nations was submitted as required by section 45(a) of the Foreign Assistance Act of 1974 on April 22, 1975. The letter of notification identified the foreign countries involved in the sale, the dollar amount, description of the article,

and the U.S. armed service that was making the sale. Based upon this notification, the Congress had 20 days to object to the sale. Since no congressional objection was made to the proposed F-16 program and the necessary legal steps had been fulfilled, the United States and the four participating European nations signed an MOU in June 1975. In the MOU, the United States made the following commitments regarding the U.S. Government's responsibilities in the multinational program:

1. Procure 650 F-16 aircraft and base a large number in Europe.

2. Manage the F-16 multinational program.

3. Utilize depot maintenance and overhaul facilities established and funded by the Europeans.

4. Provide for European industrial participation in F-16 production to effect European procurement. Production and assembly contracts were to equal 58 percent of the original European 348 aircraft buy with additional offsets for any future third-country sales.

The European nations made the following commitments for their governments:

1. Purchase 348 F-16 aircraft.

2. Pay for all material and services necessary to their program.

3. Pay a prorata share of U.S. Government nonrecurring costs for development of the F-16 aircraft system.

The congressional notification of the impending F-16 coproduction program met the legal requirements, but it was not made at a point in time when all the pertinent data that was later to be included in the MOU was available for congressional review. Thus, congressional notification was too early to provide the necessary data.

A number of things have happened since the time of the F-16 program review by the Congress. Section 36 (b) of the International Security Assistance and Arms Export Control Act of 1976 has extended the period of congressional review from 20 days to 30 days while still requiring that congressional notification include the data required in the 1974 law. In addition, the Congress may request the President to transmit additional information as specified in the 1976 law. Among other things, the data that the Congress could request includes:

--Impact on U.S. military stock and preparedness.

--Impact on U.S. business concerns which might otherwise have provided such articles or services or equipment which a foreign firm(s) is to provide.

--Economic and unemployment impact to the United States resulting from such a program.

--Analysis of how the proposed program would affect the military strengths of the countries involved in the program.

The data that the Arms Export Control Act of 1976 identifies as appropriate for the Congress to request would not have been available for the Congress when the letter of notification was made in April 1975. In fact, data such as economic or industrial impact or cost of coproduction were not totally available when the F-16 MOU was signed in June 1975.

The MOU generates significant and important activities which are difficult to change. Countries commit themselves to a program, budgets are planned, and schedules approved. In this environment, congressional changes after an MOU has been signed could have an adverse impact on cooperative programs. It is evident that in such cases, emphasis should be placed on obtaining congressional review of the MOU--it being the basic agreement and, in our view, the most appropriate document for the Congress to review. At this time, the Congress should be given a full understanding of the involvement that the United States would assume.

Under present arrangements, congressional prerogatives are significantly restricted after an MOU is signed. In the case of the F-16, the European participants incorporated their F-16 commitments into their long-term budgets with the signing of the MOU. They also had to purchase and install tooling, initiate training programs, build facilities, and in some cases, initiate early production activities to meet the F-16 schedules.

If congressional notification and review occurs before an MOU is developed, it would be made before all the significant data is available. Notification at any time after an MOU is consummated by the United States and foreign countries, that could lead to congressional disapproval, would almost certainly cause political, military, and economic repercussions for the participants.

Proposed changes in congressional oversight

In order to bring the proper congressional oversight into industrial participation programs, the MOU which is negotiated by the United States with the foreign government(s) involved in a coproduction program should be presented to the Congress. Because of the highly sensitive nature that such efforts hold for each participating government, congressional review should occur as early as possible, but not before sufficient data is available to fulfill the present data requirements enumerated in the International Security Assistance and Arms Export Control Act. In this way, the Congress' decisionmaking prerogatives, based on full review of all the facts, is not only protected, but, in fact, greatly expanded.

Preceding the submission of an MOU, U.S. and foreign government officials would take the necessary steps to establish a joint venture program. The MOU would identify the basic agreements reached by the participants and be limited to the necessary data needed to support a congressional decision. Specifically, it would identify:

--The governments which intend to participate in the joint program.

--The type and capabilities of the system being considered. (This may not be limited to a specific type of system like the F-16, but could identify a family of weapons which would meet the requirements and on which industrial participation could be applied.)

--The number of items to be procured and the estimated yearly procurement.

--The estimated cost of the program.

--The planned schedule.

--The corporations involved in the program.

--The participation plan including any offsets 1/ being considered.

1/An agreement which allows a contracting party to be compensated for the costs of procuring a weapon system through some form of economic arrangement such as industrial participation or exchange of goods and services.

--The responsibility and liability of all the participants, including the prime contractors.

--The impact of U.S. and foreign government involvement.

--The conditions governing third-country sales and transfers.

The MOU would be submitted to the Congress as soon as the national participants have decided to enter a joint program, although some of the specific data may not yet be available at this point. In such cases, the MOU would identify the general understanding that the participants have reached. During the review cycle, the Congress would be given the information needed to understand the program's scope and its potential impact. The Congress would have the same 30-day time period to review the MOU as it now has to review foreign military sales programs. If the program is not disapproved, it would be formally initiated, and the MOU would become the binding agreement. During the review process on the MOU, the Congress could request changes which would be renegotiated with the foreign governments.

Such a review procedure tailored to joint venture situations offers several advantages over the continued reliance upon existing procedures which are designed essentially for foreign military sales:

--The Letter of Offer and Acceptance (which is the document through which the U.S. offers to sell a military article to a foreign government) would be eliminated in cases which involve coproduction programs.

--Congressional review authority would be protected by the submission of the MOU.

--The buyer-seller relationship which the Letter of Offer and Acceptance signifies would be eliminated.

--A partnership relationship between the U.S. and foreign governments would be provided and contractual alternatives would be available.

Congressional support

Industrial participation programs, particularly coproduction programs, further the interests of the participating States. In such programs, not only is each State's prestige at stake, but there can be political ramifications if the program were cut back or canceled. These matters are of

concern to the participants. Therefore, all known implications of the commitments and the importance that the participants attach to them should be brought to congressional attention so that the Congress can give due consideration to these concerns before it acts on the MOU.

ADJUSTING PROCUREMENT LAWS

In establishing coproduction and other industrial participation programs with foreign nations, some of the requirements of the U.S. procurement statutes and regulations have caused difficulties. The policies and procedures they prescribe are not necessarily appropriate for programs involving intergovernmental cooperative ventures.

The following briefly summarizes some of the principal procurement laws and regulations whose waiver or modification should be considered if further industrial participation programs are to be encouraged and significant ventures of this kind undertaken. Specifically, there are two general areas where laws and regulations have caused friction in the past and will continue to be troublesome: (1) the protection of domestic commercial interests and (2) contracting, auditing, and accounting procedures.

Protection of domestic commercial interests

Several European governments have indicated great reluctance to accept restrictions imposed by U.S. laws and regulations that are concerned with the protection of U.S. domestic interests. Examples of laws and regulations which can directly affect U.S. and foreign participation in industrial ventures include:

--Prohibitions against purchases of foreign food, clothing, textiles, specialty metals, or construction of naval vessels in foreign shipyards (annual inclusions in Department of Defense Appropriation Acts).

--No research and development contracts dealing with weapon systems may be made with foreign sources when an equally competent domestic source will perform the service at a lower cost (Public Law 92-570, sec. 744).

--Army supplies are to be made in U.S.-owned factories or arsenals so far as can be done on an economical basis (10 U.S.C., sec. 4532).

--No defense funds may be used to buy items other than U.S.-manufactured items without adequate consideration given to U.S. firms in labor surplus areas, U.S. small businesses, and the U.S. balance of payments (22 U.S.C., sec. 2791).

--Defense supplies must be shipped on U.S. flagships unless charges are excessive (10 U.S.C., sec. 2631).

Foreign governments believe that, since industrial participation programs involve sovereign nations, discriminatory national regulations such as these must be adjusted accordingly. Under such circumstances, it would seem expedient to allow waiving of certain clauses if (1) the benefits to the allied defense posture can be identified and (2) U.S. labor and businesses would directly or indirectly benefit. It is expected that foreign participants would make similar accommodations in their laws and regulations.

Contracting, auditing, and accounting procedures

Requiring adherence to prescribed U.S. contracting, auditing, and accounting standards also caused friction among governments participating in past programs. A variety of statutes which prescribe procedures to be followed in the formation of contracts, terms and conditions of contracts, and contract performance, impact upon cooperative ventures. Examples of such statutory provisions include the following:

--Contracts for property and services are to be made by formal advertising (10 U.S.C., sec. 2304-a).

--Contracts are awarded to the lowest responsible bidder on a competitive bid basis (annual inclusion in Department of Defense Appropriation Acts).

--No advance payments by the U.S. purchaser unless determined that such is in the public interest (10 U.S.C., sec. 2307).

--"Vinson-Trammell Act," dealing with excess profits in aircraft and naval contracts (10 U.S.C., sec. 2382).

--Contract warranty that no third-party agent was retained to solicit the contract for a commission or contingency fee (10 U.S.C., sec. 2306-b).

Other troublesome procedures have included the Department of Defense's audit of contractor records, and disclosure of cost and pricing data.

All parties agree that accountability and consistency must be maintained in the accounting practices of each nation, and that program oversight must be maintained. However, attempts to satisfy the accounting and auditing requirements of both the United States and the other participating countries have created significant problems stemming from national sovereignty prerogatives that each wishes to retain.

If coproduction efforts are to be a more frequnt arrangement between the United States and certain of its allies, a thorough review of the appropriate procurement legislation and regulations should be undertaken by the Congress in order to identify and evaluate the changes necessary to provide the needed flexibility. The present efforts by the Department of Defense in reviewing the present procurement constraints for cooperative efforts should offer a valuable source to be used in such a review. The congressional review should stress the impact of such changes and the reciprocal actions required of our foreign allies vis-a-vis these laws and regulations.

ESTABLISHING COMPREHENSIVE COORDINATION

The possibility of increased industrial participation programs will create a tremendous need for close coordination between various branches of the U.S. Government. Affected agencies would include the Departments of State, Defense, Treasury, Commerce, and Labor, as well as the Office of Science and Technology Policy, Council of Economic Advisers, and national intelligence organizations. Present administrative arrangements do not appear to offer the centralized administration that industrial participation efforts need for efficient decisionmaking and policy interpretation as the following examples illustrate.

The Arms Export Control Board, an advisory body with policy-planning and review functions, reviews and controls all applications for arms sales and transfers. Chaired by the Undersecretary of State for Security Assistance, it is composed of representatives from the Departments of State, Treasury, Commerce and Defense; Joint Chiefs of Staff; Arms Control and Disarmament Agency; Agency for International Development; National Security Council; Central Intelligence Agency; and the Office of Management and Budget. Representatives from other agencies attend when matters concern them.

The granting of export licenses for direct commercial sales is the responsibility of the Office of Munitions Control in the Department of State. Functioning mainly as a processor of applications, the Office lacks staff and expertise in many technical areas, relying instead upon the counsel and expertise of other agencies.

The Defense Security Assistance Agency in the Department of Defense is responsible for the supervision and administration of all foreign military sales and security assistance programs. The present foreign military sales system is designed essentially for intergovernmental transactions involving the transfer of arms, other military equipment, and/or various services.

As presently constituted, such organizations possess too parochial a perspective to reflect the scope of expertise and outlook that complex industrial participation programs require for proper evaluation and oversight. They provide minimal or no representation of domestic and international economic, commerce and trade, and industrial and labor interests and perspectives.

Increasing activity in industrial participation programs will require an interagency or coordinating mechanism that would provide policy and management guidance, and act as a a clearinghouse for industrial participation programs. The organization could consist of representatives of the

--Department of Defense--implementation of program,

--Department of State--foreign policy and security objectives,

--Department of Commerce--export control,

--Department of the Treasury--international finances and currencies, and

--Department of Labor--employment issues.

Other agencies should be considered for representation after a complete analysis of the desired makeup of such a unit has been conducted.

The present Department of State and Department of Defense organizations offer a possible foundation from which to create an independent central authority of multiagency representation with an expanded role concerning industrial participation programs.

CHAPTER 3

CONCLUSION, RECOMMENDATIONS,

AND AGENCY COMMENTS

CONCLUSION

It has become evident, particularly from experience gained in the F-16 aircraft and other defense programs, that there is a need to alter the present system used to establish and manage coproduction efforts. The present system used to govern such arrangements is the same as that which governs foreign military sales. The system does not take into account the military, political, and economic arrangements and consequences of doing business on a coproduction basis, and does not allow for effective congressional review of the transactions.

RECOMMENDATIONS

We recommend that, if the United States chooses to become a party to future joint ventures, a new approach be considered to facilitate effective congressional review and efficient administration of coproduction programs with our allies. The approach should be considered for application to NATO countries, Australia, New Zealand, and Japan, since these countries have been exempted from the restrictions imposed by the President's Conventional Arms Transfer Policy.

Specifically, we recommend that the Congress, as part of its assessment of the future involvement of the United States in coproduction programs:

--Consider a direct sale approach as the accepted method for U.S. prime contractors engaged in coproduction programs, thereby removing such programs from foreign military sales procedures. Under the direct sale approach, the U.S. companies would contract directly with the foreign government or consortium buying the product.

--Require that a Memorandum of Understanding, signifying the commitment of the U.S. and foreign participants to join in a coproduction program, be submitted for review as soon as the points of agreement have been identified. The Congress would either concur by taking no action or object by disapproving the MOU.

--Review appropriate legislation and procurement regulations in order to identify and evaluate the changes necessary to provide the needed flexibility for a realistic and efficient application to co-operative ventures with foreign countries. It is expected that foreign participants will take comparable reciprocal actions when they are needed to facilitate such ventures.

We further recommend that the President consider, within the context of his current executive reorganization studies, the establishment of an independent interagency administrative or coordinating mechanism to provide policy and management guidance and to act as a clearinghouse for industrial participation programs.

AGENCY COMMENTS

Copies of the report were submitted on August 31, 1978, to both the Departments of State and Defense for review and comment. Although both agencies declined to provide formal comments, we have adjusted the report by considering informal technical comments provided by staff of these agencies, particularly the Department of State. Written comments received from the Departments of the Treasury and Commerce are included in appendixes I and II, respectively.

The Department of the Treasury emphasized that significant attention should be given to the division of responsibility among participating countries in coproduction programs, questioning whether it would be sound management to divide responsibility for a program among the countries participating. In fact, such an arrangement exists with the F-16 MOU whereby the European producers accept joint product responsibility and liability. Unless such a division of responsibility and liability can be made, coproduction programs would be difficult to establish. The Treasury suggested extending the list of countries to which the new approach would apply to include such countries as Spain, Israel, South Korea, and Taiwan. The arms transfer policy of the present administration precludes this, but it is an area to which congressional attention might be directed. The Treasury supported the recommendation of a proper executive agent to administer industrial participation programs. The Treasury also believed that no consideration should be given to changing present cash management activities. Further, the Treasury would like to be involved in all negotiations in any cooperative production arrangement where the United States will be diluting its control over financial management, especially on the issue of cash flow.

The Treasury agrees that our proposed centralized management organization would allow such participation at the critical points of a program's initiation.

Finally, the Department of the Treasury has concern that any modification of certain laws and procurement regulations to reduce friction caused by U.S. requirements could create a more lenient situation for foreign producers than for domestic producers. We agree that such a situation should not develop and that any modification of U.S. regulations be made only if equivalent actions are undertaken by foreign countries toward U.S. industry and no reduction of procurement standards is created.

Comments prepared by the Department of Commerce centered upon two major items: (1) the replacement of foreign military sales procedures with more direct contractual arrangements and (2) the submission of MOU's to the Congress for review and approval. Concern was expressed that the proposed contractual arrangements would not prove any more satisfactory than the present government-to-government arrangement they are designed to replace and the question raised as to the negotiating position of U.S. companies vis-a-vis foreign governments under a direct sale approach. Commerce suggested instead that contractual obligations might be reallocated without changing the present nature of the agreements. Examples in the commercial sector, such as the aircraft industry, suggest that American firms can successfully deal with foreign governments and industries under a direct sale approach and, therefore, such an arrangement should be equally applicable to the joint production of weapon systems. In discussions with European officials, they indicated that national sovereignty and international contractual agreements call for adjustment to the traditional foreign military sales approach. By eliminating the buyer-seller relationship of foreign military sales procedures, the national sovereignty of each nation is not impacted. Additionally, the MOU still retains the basic government-to-government nature of these programs.

As to the submission of MOUs to the Congress for review and approval, Commerce said that such an arrangement would involve the Congress too closely in the governmental negotiation process, produce delay, expose an agreement to special interest considerations, and raise the issue of foreign parliamentary participation and review. Subsequent conversations with other government agencies, congressional personnel, and affected industries revealed an equal concern as to the most satisfactory position of the Congress in the MOU process. On this basis, we have amended our position to that

of congressional disapproval to keep such a relationship more in line with existing legislative practices.

Comments received directly from two industry associations and individual domestic contractors were generally favorable. Several NATO members were also given draft copies of the report and their responses were also generally supportive. Comments from these sources were considered in preparing the final draft of this report.

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

OFFICE OF
ASSISTANT SECRETARY
FOR INTERNATIONAL AFFAIRS

NOV 6 1978

Dear Mr. Voss:

Thank you for your August 31 letter to Secretary Blumenthal, by which you give Treasury an opportunity to review and comment on the draft GAO report "A New Approach for the Establishment of Coproduction Programs Between the United States and American Allies."

We too, are concerned about the impact of coproduction projects, although in a more specific way than contained in the draft report. We are particularly interested in the program called "rationalization - standardization - industrialization" (RSI), which the Department of Defense is pursuing so vigorously with our NATO allies, because of its potential for significant impact on the U.S. economy. It also should be of interest to your office because RSI should account for the majority of future coproduction projects (in addition to its economic impact).

Treasury has reviewed the draft report and suggests that further work is required. There are factual areas to be corrected, e.g., there were NATO coproduction projects before the F-16 program; at present private U.S. contractors, to the maximum extent, do enter into direct coproduction contracts with foreign countries. Additional thought needs to be given to some of the proposals, for example:

-- Would it be sound management to divide responsibility for a coproduction program among and in proportion to the respective interests of the countries participating?

-- Should a future Congressional directive be restricted to NATO, Australia, New Zealand and Japan or should other countries having coproduction programs be included (e.g. South Korea, Taiwan, Spain and Israel)?

-- Should OMB act as an administrative agent for industrial participation programs?

You have mentioned the need for waiving certain laws or procurement regulations in order to reduce friction caused by the U.S.G. requirements which are designed to protect domestic commercial interests, establish auditing and accounting procedures, and further social objectives. We have no objection to the waiver of the Buy American Act; however, other waivers should be considered carefully, from both legal and policy viewpoints. Some may touch on Congressional interests and attempts to waive them could encounter difficulties. From another standpoint, there can be criticism if regulations were to be more lenient for foreign producers (even though part of a coproduction project) than for domestic producers of U.S. defense material.

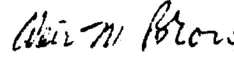
From experience with some past coproduction projects, we strongly recommend that no consideration be given to any waiver of regulations or policies which would change present Federal cash management practices. The continued improvement of such practices is an explicit and ongoing Presidential concern. We have noted attempts to obtain early U.S. payment in order that projects could increase their funding by earning interest on deposits of funds until they were needed. It is U.S.G. policy to pay bills when due, rather than in advance as is sometimes the practice of European countries.

With respect to auditing and accounting control procedures, Treasury desires to become involved in the negotiation of any cooperative production arrangement. If the U.S.G. will be surrendering control of the financial management to the management organization established for that specific project, it will be losing many of its controls and checks on cash flows. Assuming that the Congress will continue to expect Executive Brance assurance that coproduction projects are properly managed, each involved Department will have to participate in the development of memoranda of understanding on coproduction projects. This will be particularly true for the management of cash flows. We presume that was considered part of the centralized management organization proposed on pages 22-23 of the draft report.

These comments provide some examples of the need for further review of the draft report, and outline our interest in the impact of coproduction projects on government operations and the U.S. economy. We understand that State and Defense, which are the Departments principally concerned with the draft report, will comment in much more detail. Treasury will be happy to assist in the future as you require.

Please feel free to have your office contact the Office of Trade Finance within Treasury (Tel. 566-5757) as needed.

Sincerely,



Weir M. Brown
Inspector General for
International Finance

Mr. A.R. Voss
Director,
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UNITED STATES DEPARTMENT OF COMMERCE
The Assistant Secretary for Policy
Washington, D.C. 20230

October 31, 1978

Mr. Eschwege
Director, U.S. General
Accounting Office
Washington, D.C. 20548

Dear Mr. Eschwege,

I appreciate the opportunity to comment on behalf of the Department of Commerce on the draft GAO report, "A New Approach for the Establishment of Coproduction Programs Between the United States and American Allies." The study identifies some potentially significant problems in the manner in which the United States Government initiates and administers coproduction agreements. It is not clear, however, that the recommended changes would improve the operation of these programs.

The GAO report starts from the presumption that coproduction agreements are in the U.S. interest. Problems arise from the application of Foreign Military Sales (FMS) procedures to coproduction programs. First, FMS treatment "complicates, delays, and substantially increases the costs" of doing business on a coproduction basis. Second, the use of Memorandums of Understanding (MOUs) to negotiate coproduction agreements frustrates Congressional participation and oversight.

In discussing the first issue, the report highlights a fundamental difference between FMS and coproduction arrangements: the joint venture relationship inherent in the latter diminishes the ability of the United States Government to guarantee performance of the contract. In addition, the report notes that coproduction programs are more likely to surface conflicts in the regulatory practices of participating governments. GAO recommends the adoption of a direct sales approach, supported by regulatory review and an interagency committee to furnish policy and management guidance.

The discussion of administrative problems, however, is too superficial to promote confidence in this approach. The problems of the existing system are merely asserted, while those of the proposed procedures are overlooked. For example, in what ways do the present administrative arrangements delay the

progress of coproduction agreements? How do they increase the costs to the U.S. contractor? To foreign governments? To the U.S. Government? How would the negotiating position of U.S. companies vis-a-vis foreign governments or government-owned companies change under a direct sales approach? The GAO report would have been strengthened in this regard by examining coproduction arrangements other than the F-16 (e.g., the Canadian new fighter aircraft purchase presently under consideration). It may be that contractual obligations can be reallocated without changing the underlying government-to-government nature of the agreements.

The lack of timely Congressional review is a more fundamental problem. The report cites the many economic and political constraints already in place by the time a Letter of Agreement (LOA) is submitted for Congressional review. The GAO recommends that the LOAs be eliminated and that Congress approve the MOUs before they are signed. The MOUs would be submitted as soon as the United States <u>decides to enter</u> a joint program, and would be updated for Congressional comments as the program details are fleshed out.

This proposal puts the Congress right in the middle of the Executive Branch international negotiating process. It is likely to be time-consuming; opens each agreement to special interest considerations; and raises the issue of foreign parliamentary participation and review.

The more important questions are whether Congress accepts the desirability of coproduction for military systems, on what general terms, and for what weapon systems. Thus, Congress may wish to promulgate general guidelines against which each MOU will be judged, e.g., requiring that the coproduction shares going to Europe be based on mature and commercially available technology. It may also be desirable to present MOUs for preliminary Congressional approval after they are signed to ensure that these guidelines are reflected in the final LOA. But it should remain the responsibility of the Executive Branch to negotiate coproduction agreements consistent with national policy objectives.

I hope these comments will be helpful in preparing your final report, and would be pleased to discuss them further with you at your convenience.

With best wishes, I remain,

Sincerely,

Frederick T. Knickerbocker

Frederick T. Knickerbocker
Deputy Assistant Secretary
for International Policy
Coordination

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