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MONTEREY, CALIFORNIA

THESIS

**COMPARATIVE ANALYSIS OF THE USE OF FOREIGN
MILITARY SALES (FMS) AND DIRECT COMMERCIAL
SALES (DCS) IN THE PROCUREMENT OF US DEFENSE
ARTICLES BY THE PHILIPPINE GOVERNMENT FOR
THE USE OF THE ARMED FORCES OF THE
PHILIPPINES**

by

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June 2004

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USE OF THE ARMED FORCES OF THE PHILIPPINES**

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ABSTRACT

The Philippine government may use two methods to procure defense articles from the United States, either Foreign Military Sales (FMS) or Direct Commercial Sales (DCS). This thesis examined the differences between FMS and DCS as methods of procurement used by the Philippine government in the acquisition of U.S. defense articles. The study identified the processes involved in using each of the two methods as well as the advantages and disadvantages of each when used within the socioeconomic and political environment of the Philippines. Issues and considerations that influence selection decision are also discussed. DCS may offer the lowest fixed price, timely/earlier delivery, easier countertrade arrangements, and penalty for non-compliance to the provisions of the contract. FMS is preferable because it is a government-to-government sale, provides opportunities for Philippine military training in the United States and enhances interoperability among coalition forces. In addition, FMS allows for financing of defense articles from the U.S. using Foreign Military Financing, thus conserving Philippine government funds.

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I. INTRODUCTION

A. PROBLEM

The Philippine's defense industrial base alone cannot support the defense needs of its Armed Forces to enable it to perform fully its constitutional mandate of upholding the sovereignty and preserving the patrimony of the Republic. Production of these defense goods and services within the country would be very costly if not nearly impossible. As a result, acquisition of its needed defense articles must be sourced from foreign countries, especially from the United States. Historically, the U.S. has been the major source of arms and equipment for the Armed Forces of the Philippines (AFP), mostly through Foreign Military Sales (FMS). Beginning in 1996, a modest capital outlay has been programmed for AFP modernization, signaling the start of a substantial level of acquisition of the priority defense articles identified by the AFP leadership. The Philippine government intends to get the best value from the funds allocated for this purpose.

There are two methods by which the Philippine government can acquire defense articles from the United States: Foreign Military Sales (FMS) or Direct Commercial Sales (DCS). The decision whether to choose either FMS or DCS will remain a predicament for the Philippine government. It may be influenced by existing laws, policies and regulations, as well as the socio-economic and political environment prevailing in the country.

B. BACKGROUND

The Armed Forces of the Philippines Modernization Program has its legal basis in Republic Act No. 7898, otherwise known as the AFP Modernization Law, approved by the President of the Philippines on February 23, 1995. The law declares it a policy of the state to modernize the AFP to a level where it can perform its constitutional mandate of upholding the sovereignty and preserving the patrimony of the Republic fully and effectively (AFP Modernization Program Primer, 1998).

The development of AFP defense capability had been considerably impaired by the lack of necessary funds to procure arms and equipment. This was further aggravated when U.S. security assistance to the Philippines, which supplements the AFP's defense budget, was discontinued as a result of the termination of the Military Bases Agreement in 1991.

Strong bilateral relations were restored in 1999, and in 2003 the Philippines was designated by President Bush as a major non-NATO ally. That designation resulted in U.S. pledges of funding for a broad range of requirements intended to bolster the AFP's defense capability to address its internal and external threats. The United States also promised a "comprehensive security review" to assess how best the United States can "support Philippine military modernization and reform" ("AFP Procurement Detail," 2003, p. 1).

The AFP Modernization Law provided for a program capital outlay of 331.6 billion pesos, broken down into two sub-programs. Sub-program 1, the priority program, with a budget of 164 billion pesos, will be funded from appropriations to include projects essential in developing the AFP's core capability requirements. Sub-program 2, amounting to 167 billion pesos, will be funded from sources other than appropriations identified in Section 11 of Republic Act No. 7898 or from additional funds generated as a result of an increase in the gross domestic product (GDP) in the future.

Acquisition of defense articles and weapons systems is a very crucial part of the AFP Modernization Program, for it comprises the bulk of the budgetary requirement of the program. The total capital outlay will have a significant impact on the national budget as well as on the country's trade balance. It is, therefore, essential that an intensive review, analysis and evaluation of administrative, technical, financial and counter trade considerations be undertaken before acquisition of particular equipment is approved at the Department of National Defense level.

C. OBJECTIVES

The thesis aims to provide guidance to AFP and Philippine leadership as they implement the AFP Modernization Program. It begins by defining Foreign Military Sales and Direct Commercial Sales. It then identifies the policies, processes and procedures

that govern these two methods of procurement. Finally, it provides an analysis and assessment of the advantages and disadvantages for the Philippine government of each method for acquiring U.S. defense items. The analysis will assist AFP officers involved in acquisition and contracting in their decision whether to use either FMS or DCS.

D. SCOPE AND LIMITATIONS

The scope of this thesis will include the processes and procedures involved in Foreign Military Sales and Direct Commercial Sales, including their advantages and disadvantages when used to procure U.S. defense articles within the Philippine socioeconomic and political environment. This thesis will also discuss relevant procurement laws, rules and regulations, as well as the AFP equipment acquisition processes and procedures and analyze their effects on the selection of the best method of procurement to be used in the procurement of U.S. defense articles. It will also include an analysis of the effects, if any, of using either FMS or DCS on the operational effectiveness and efficiency of the Armed Forces of the Philippines.

E. RESEARCH QUESTIONS

1. Primary Question

What is the most advantageous method of procurement to be used by the Philippine government in the acquisition of defense articles from the United States to be used by the Armed Forces of the Philippines?

2. Subsidiary Questions

- What is Foreign Military Sales and how does it operate as a model of procurement by the Philippine government?
- What is Direct Commercial Sales and how does it operate as a model of procurement by the Philippine government?
- What are the pertinent laws, rules and regulations, and policies that govern Foreign Military Sales and Direct Commercial Sales when used by the Philippine government in its procurement activities?
- How do defense articles procured through FMS or DCS affect the operational effectiveness and efficiency of the Armed Forces of the Philippines?

F. ORGANIZATION OF STUDY

Chapter I presents the problem and the background of the thesis.

Chapter II provides the historical precedents of Security Assistance provided by the United States to foreign countries from the early 1900 to the year 2004.

Chapter III discusses the security assistance provided to the Philippines and how this security assistance affects the security relationships of the Philippines and the United States.

Chapter IV discusses the definitions of FMS and DCS, the policies and procedures that govern both methods of procurement in the acquisition of U.S. defense articles. Offsets and funding of security assistance are also discussed in this chapter.

Chapter V identifies and examines the major factors that influence decision makers in the Philippines in the selection of the method of procurement of U.S. defense articles.

Chapter VI is a comparative analysis between Foreign Military Sales and Direct Commercial Sales.

Chapter VII presents the conclusions and recommendations and suggestions for further research on this topic.

G. METHODOLOGY

The methodology to be used in this thesis will consist of the following:

- Conduct literature review of books, journal articles, web sites and other library information resources.
- Conduct interviews with Philippines government officials as well as procurement/acquisition and contracting officials of the Armed Forces of Philippines through telephone calls and e-mail.
- Conduct visit to Washington, D.C to interview defense officials at the office of the Philippines' Embassy.
- Conduct interview of U.S. government official involved in acquisition and contracting through telephone calls and e-mail.
- Analyze interview results as they relate to the procurement of US defense articles for the RP using FMS or DCS.
- Analyze the existing literature in conjunction with current Philippine procurement practices using FMS and DCS.

H. SUMMARY

The Philippines approved the AFP Modernization program February 23, 1995, giving impetus to the acquisition of appropriate weapons system and materiel to improve the defense capabilities of the AFP. This program is critical to the execution of its mandate of protecting the Filipino people and upholding the sovereignty of the State.

The AFP will use Foreign Military Sales (FMS), Direct Commercial Sales (DCS) or both in the acquisition of U.S. defense articles. Each of these two methods of procurement has its own advantages and disadvantages when used by the AFP within the socio-economic and political environment of the Philippines. This thesis aims to provide an objective comparison between FMS and DCS that will assist decision-makers in the Philippines in choosing the appropriate method of procurement.

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II. BACKGROUND TO SECURITY ASSISTANCE

A. U.S. ARMS TRANSFER POLICIES

The transfer of arms and defense articles plays an important role in the foreign and national security policies of many nations. History reveals that arms transfers occur as a result of the instinct of nations for survival and the promotion of their national interest. The transfer method of these arms and defense articles varies depending on the prevailing political and economic environment of the countries involved.

During World War I, the United States was a leading participant in the international munitions trade, notwithstanding its initial declaration of neutrality. Despite great controversy and public debate arising from U.S. involvement in the international arms trade, President Wilson characterized the U.S. and its output of munitions as an “arsenal of freedom” (DISAM, 1994).

The involvement of the United States in international arms trade continued during World War II, as the U.S. Congress permitted the sale of arms to the British on a cash-and-carry basis. U.S. arms transfer policies were broadened to include arms support for allied nations. In September 1940, President Roosevelt entered into a destroyers-for-bases agreement with the British, in which 50 old destroyers were exchanged for 99-year leases of several British bases, as these bases might become critical to American defense (DISAM, 1994).

Likewise, in an effort to provide aid to Britain, Russia and China as they became engaged in the war, the U.S. Congress passed the Lend-Lease Act in March 1941. Under this act, the United States loaned approximately 50 billion dollars in food, arms, and other aid to allies with the premise that they would repay when able to do so or through the “reverse lend-lease” arrangement, whereby payment to the United States would be in terms of certain materials and services (DISAM, 1994).

The post-World War II scene was a competition between the United States and the USSR, two superpowers having diametrically opposed ideologies, capitalism and communism, respectively. In an effort to prevent Soviet-inspired communist insurgencies

in Greece and Turkey, President Truman asked Congress in March 1947 for \$400 million in aid for these two countries. The Truman doctrine justified and accompanied the request.

For three years, Greece and Turkey were continuously provided, free of charge, with over \$600 million in economic and military aid, administered by the Joint United States Military Assistance Group (JUSMAG), to contain Russian expansion. U.S. military assistance after the war consisted mostly of surplus war materiel given to allies as “grant aid,” later known as the Military Assistance Program (MAP) (DISAM, 1994).

President Eisenhower continued the containment policy of President Truman. Military assistance became the building block of this containment policy, which was expanded to include not only “arms to allies” but also “arms to friends,” referring to friendly non-aligned nations in Northeast and Southeast Asia. The Eisenhower doctrine was borne out of the need to contain Soviet influence in the Middle East, particularly in Syria and Egypt. The doctrine declared that the United States would employ force, if necessary, to assist a nation or group of nations in the Middle East requesting assistance in the event of an external, communist armed aggression (DISAM, 1994).

President Kennedy inherited the doctrine of “massive retaliation,” developed during the Eisenhower administration, which called for the employment of U.S. conventional force capabilities against adversaries. As communist insurgencies began to threaten Asian regions, the Military Assistance Program was expanded and became the primary element used by the Kennedy-Johnson administration to maintain regional stability. Increasing arms sales under the Foreign Military Sales (FMS) program precipitated the gradual reduction of MAP grant aid given to allies (DISAM, 1994).

In an effort to reduce the number of U.S. troops deployed in Asia to contain communist expansion, and driven by the American disappointment over the war in Vietnam, President Nixon made an important change in U.S. foreign policy guidelines in his speech during a visit to Guam in 1969. He stated that the United States would keep its treaty commitments, provide a shield if a nuclear power threatened the freedom of an allied nation, and furnish military and economic assistance when requested and as appropriate. This foreign policy, later known as the “Nixon Doctrine,” would assist

countries in building and strengthening their own self-defense through U.S. economic and military assistance. The Nixon doctrine emphasized that allies would assume the primary responsibility for their own defense even if the United States continued to participate in their security development program (DISAM, 1994).

During the Ford administration, Congress acted to check the increasing involvement of the United States in arms sales abroad. With “détente” as a major foreign policy goal, President Ford’s request for security assistance could no longer be justified by the containment of communism, especially if it involved military grant aid. While there was a growing demand for security assistance by allies, the President could not just grant such a request when Congress continued to block certain types of sales. The International Security Assistance and Arms Export Control Act (AECA) of 1976 was passed to reduce arms sales during Ford’s presidency (DISAM, 1994).

The Ford policy on arms control was further reinforced when, in 1977, President Carter stated that the United States would henceforth view arms transfers as an “exceptional foreign policy implement,” and that in the future, the burden of persuasion for sales would fall on those who favored a particular arms sale, rather than on those who opposed it. Human rights issues also became an important consideration in Carter’s security assistance program (DISAM, 1994).

President Reagan’s arms transfer policy viewed arms transfers as an essential element of U.S. global defense and an indispensable component of U.S. foreign policy. According to the Reagan policy, the United States would only transfer arms to:

- reinforce military capabilities to assist in the deterrence of aggression, especially from the USSR and its surrogates, and reduce the requirement for direct U.S. involvement in regional conflict;
- reinforce the perception of friends and allies that the United States, as a partner, is also a reliable supplier with a measurable and enduring stake in the security of the recipient country;
- point out to potential enemies that the United States will not abandon its allies or friends or allow them to be militarily disadvantaged;

- improve the American economy by assuring a more stable defense production base, and by enhancing the balance of payments. However, this objective should not be construed to mean that the approval of the transfer of arms will be based solely, or even primarily, on economic considerations and gain;
- enhance the effectiveness of the U.S. military through improved possibilities of access to regional bases, ports, or facilities needed for the support of deployed forces during contingencies. Further, security assistance should be such to improve the ability of the host nations to complement U.S. forces during deployments; and
- strengthen the stability of a region and the internal security of the countries therein by fostering a sense of a recipient nation's security and thereby its willingness to settle disputes amicably. Through this objective, it is held that a government which feels secure is more likely to cope with such challenges in a more progressive and enlightened manner (DISAM, 1994, pp. 23-24).

The pivotal point of Reagan policy was that the U.S. could not alone defend the free world's interest, but must be ready to strengthen the military capabilities of friends and allies by the transfer of arms and other forms of security assistance (Pierre, 1982). The U.S. would evaluate the transfer of arms in relation to the net contribution such transfers would make to U.S. global or regional security interests (DISAM, 1994).

President Bush continued the arms transfer and security assistance policies formulated during the Reagan presidency. Significant events worldwide, such as the political collapse of the Iron Curtain countries in 1989, the Iraqi invasion of Kuwait in 1990, the Middle East peace talks, the economic and political dismemberment of the USSR, and the global economic recession of 1991 and 1992, influenced U.S. foreign and security assistance policies under President Bush. These developments prompted the flow of U.S. foreign assistance in FY 1991, not only to NATO countries and allies but also to former Warsaw Pact nations. However, due to continuing domestic economic problems in the last year of Bush's presidency, a decreasing level of security assistance became apparent as his administration addressed these problems (DISAM, 1994).

President Clinton's administration indicated little change from the foreign policy and national security interests and goals of previous administrations. Its policy maintained the concept that the transfer of conventional arms is a "legitimate instrument of U.S. foreign policy" deserving of U.S. government support (Gultekin, 1998).

However, in order to sustain these foreign policy goals, President Clinton had to improve the economic situation of the United States. This included encouraging embassies abroad to assist U.S. marketing efforts, interpreted to encompass arms sales through Foreign Military Sales and Direct Commercial Sales. Foreign Military Sales in 1993 alone rose to \$33 billion dollars, contributing to the strength of the U.S. defense industry (DISAM, 1994).

After the 9/11 incident in the United States, President George W. Bush, Jr. began building an international coalition that included NATO. The day after the attack, NATO affirmed that the attack against the United States was also an attack on the alliance. Considering the importance of arms transfers to building and maintaining the coalition over the long-term, U.S. arms export licensing and Foreign Military Sales were accelerated. Easier access to U.S. arms was used as an incentive to attract allies to the U.S. cause (“DSCA forms War Room,” 2004).

The following table summarizes U.S. arms transfer policy from 1913 to 2004.

Table 1. U.S. Arms Transfer Policy, From Woodrow Wilson to George Bush, Jr. (From: (Gultekin, 1998) and (“DSCA forms War Room,” 2004).

The Woodrow Wilson Administration (1913-1921)	American output of munitions as “arsenal of freedom”
The Roosevelt Administration (1933-1945)	- The “destroyers-for-bases” arms trade during WW II. - The United States supplied about 50 billion dollars in food, arms and other aid to allies through the “lend-lease program. - Use of the “Reverse-Lend-Lease” as a means of payment by allies.
The Truman Administration (1945-1953)	- To support free people with economic and financial aid. - The policy of aid became a precedent for “collective security”.
The Eisenhower Administration (1953-1961)	Military assistance became the building block of U.S. containment policy

The Kennedy and Johnson Administrations (1961-1969)	• Military assistance was primarily used to maintain regional stability in the Middle East.
The Nixon Administration (1969-1973)	• The Nixon Doctrine • The emphasis on arms sales as a major policy instrument • Sending arms instead of U.S. troops
The Ford Administration (1973-1977)	• The continuation of the Nixon Doctrine • The growing anxiety of Congress over U.S. arms transfers • Arms Export Control Act (AECA) of 1976
The Carter Administration (1977-1981)	• The Carter Doctrine • Arms transfers viewed as an “exceptional foreign policy instrument”. • Attempts to reduce U.S. arms sales.
The Reagan Administration (1981-1989)	• Arms sales were an essential and indispensable component of U.S. foreign policy. • Arms sales were integral to countering the growing Soviet influence abroad
The Bush Sr. Administration (1989-1993)	• No deviation from the Reagan administration.
The Clinton Administration (1993-2001)	• Transfer of conventional arms as a “legitimate instrument of U.S. foreign policy” • Restraint of arms transfers that may be destabilizing or dangerous to international peace.
The Bush Jr. Administration (2001-2004)	• Arms transfer is important to building and maintaining the international coalition.

B. SUMMARY

This chapter presented the evolution of U.S. arms transfer policies from the time of President Wilson in the early 1900 to the administration of President Bush, Jr. in 2004. It also reveals how security assistance shaped the life of certain nations, both providers

and receivers of said security assistance. A case in point is the security assistance provided by the U.S. to Greece, Turkey and other American allies threatened by Soviet communist expansion. These allies remained democratic countries, thanks in part to the security assistance provided as part of the containment policy of the United States.

The economic difficulties in the 1990s affected the U.S. security assistance programs to allies. To sustain foreign policy goals, the U.S. increased its marketing efforts abroad for cash sales of defense articles to improve the U.S. economy.

Security assistance for the 21st century focused on supporting the U.S. global war against terrorism. Security assistance to allies and friendly countries supporting the foreign policy of the United States on counterterrorism was increased and facilitated.

The next chapter traces the history of security assistance provided to the Philippines, and the manner in which this security assistance influenced the political and security relationships of the United States and the Philippines.

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III. HISTORY OF U.S. SECURITY ASSISTANCE TO THE PHILIPPINES

A. PRE-WORLD WAR II SECURITY ASSISTANCE

The transfer of U.S. defense articles to the Philippines began shortly before the outbreak of World War II. The U.S. Congress authorized the Secretary of the Navy to sell naval equipment, non-transferable to third parties, to the Philippines at prices not less than cost (Meyer, 1965).

Even before World War II broke out, the Philippines was already promised its independence by the United States. World War II intervened and it was only on July 4, 1946 that it had gained its independence. Having been physically, economically and militarily devastated during World War II, the Philippines had no other alternative but to accept an offer from the United States to retain its bases in the Philippines. The retention of the Philippine bases by the Americans has its basis in U.S. Senate Resolution 93 on 3 November 1943. This document in part, authorized the President of the United States, with the President of the Commonwealth or Republic, “to withhold and acquire and to retain such bases, and the right incident thereto as he may deemed necessary for the mutual protection of the Philippine Islands and the United States” (Gregor and Aganon, 1987, p. 6).

B. POST-WORLD WAR II SECURITY ASSISTANCE

The mutual protection clause in the resolution obligated the United States to extend economic and military assistance to the Philippines. In June 1946, President Truman approved the Philippine Military Assistance Act which authorized the United States to conduct training and provide equipment to the Philippine military. Soon after its approval, the U.S. government earmarked \$100 million for arms and equipment to the Philippine Army. These materials consisted of surplus goods and installations, excluding aircraft, but including most types of maritime equipment and non-demilitarized material (Meyer, 1965).

The Philippines was formally granted its independence on July 4, 1946. After gaining independence, the Philippines entered into several treaties with the United States. The Military Bases Agreement (MBA), signed on March 1947 by President Roxas and

U.S. Ambassador Paul McNutt, allowed the United States rent-free use of 23 military base sites in the Philippines for 99 years. The agreement also outlined criminal jurisdiction authority for offenses committed by American servicemen in the Philippines (Meyer, 1965).

Following the signing of the MBA, the Military Assistance Agreement was signed on March 21, 1947, which mandated the United States to furnish military assistance to the Philippines. The Philippines received 83 ships for offshore patrols but America retained title to the equipment. The agreement also mandated the creation of the Joint United States Military Advisory Group (JUSMAG) to provide military advice and training to the Philippine armed forces (MAA, 1947). This training included jet pilots at Clark Field, the delivery of training jets, minesweepers and ammunition, the improvement of airfields, and the construction of warehouses and divisional training sites (Taylor, 1963).

Due to the weak defense capabilities of the Philippines immediately after World War II, and doubting the sincerity of the Americans to help the Philippines in case of an external attack on the Philippines as a reflection of their experience during the Japanese occupation, President Quirino sought military arrangements that would ensure security protection from the United States. This led to the signing of the Mutual Defense Treaty by the United States and the Philippines in Washington, D.C. on August 30, 1951. The treaty generally states that “an armed attack in the Pacific Area on either of the parties in the Pacific would be dangerous to its own peace and safety and declares that it would act to meet the common dangers in accordance with its constitutional process”(MDT, 1951).

Despite the growing threat of communism in Southeast Asia and the indigenous communist movement in the Philippines, military assistance was limited and slow in coming in the Philippines. Despite continuing criticism, the United States repeatedly assured the Philippines of immediate and automatic response, in case of an outside aggression, further assuring Filipinos there was no immediate external threat against the country (Almqvist and Wiksell, 1971).

It was only during an actual communist armed aggression against South Korea in 1950 that President Truman directed the acceleration of the delivery of military assistance

to the Philippines. These military assistance funds were used to strengthen the Philippines' military capability to deter communist aggression which was then gaining influence in Southeast Asia. Defense articles transferred to the Philippines at that time consisted of counterinsurgency equipment such as patrol and landing craft, T-28 and T-33 trainer aircraft, and helicopters (Almqvist and Wiksell, 1971).

Meanwhile, the local armed communist group, known as Hukbong Bayan Laban sa Hapon (HUKBALAHAP), continued to be a security problem since after World War II until the early 1950's. Secretary of National Defense Ramon Magsaysay was credited with breaking the backbone of the local communist group, not only because of his leadership but also due to the increased U.S. security assistance during that time (Taylor, 1963).

On May 15, 1958, the United States and the Philippine government established a Mutual Defense Board to look into and supervise the implementation of three bilateral military treaties-namely the Mutual Defense Treaty of 1951, the Military Assistance Agreement and the Military Bases Agreement (Cabal, 1960).

In an effort to provide military capabilities against outside aggression, the U.S.-R.P. Mutual Defense Board considered the establishment of missile bases in the Philippines. Despite strong opposition from Filipino nationalists, the Philippines received 18 F-86D and 40 F-86F Sabres armed with Sidewinder anti-aircraft missiles in 1957-58, while in 1965-67, 19 F-5A and three F-5B Freedom Fighters were received under the U.S. military aid program (Almqvist and Wiksell, 1971). For the period 1955-60, the United States has transferred in excess of \$219,000,000 in military assistance to the Philippine government, an amount continuously denied by Philippines defense officials claiming that only 70% of this amount was received by the country (Daniel, 1960).

The administration of President Marcos was very supportive of the foreign policy initiatives of President Johnson. President Marcos manifested his full support for the U.S. effort in Vietnam by sending a 2000-man contingent and extolled the United States to maintain its role to deter communism in Asia. President Johnson called Mr. Marcos his "strong right arm in Asia" (Berry, 1989).

President Johnson provided full U.S. support to the Philippine efforts to obtain loans from international lending institutions such as the World Bank. He also provided the necessary equipment for five engineer construction battalions designed to conduct civic action functions in the Philippines. This military aid was to be delivered during FY 1967, with the equipment for the five additional battalions to be made available in FY 1968. The U.S. government also extended \$38,809,661 in financial support to the Philippine troops in Vietnam. (Berry, 1989)

Meanwhile, military base renegotiation continued between the United States and the Philippines during the Ford presidency to iron out criminal and sovereignty issues as well as compensation or rent for the bases. Unfortunately, the negotiations were stalled in 1975 due to disagreements on the amount of compensation and sovereignty issues. The United States reduced its military assistance to the Philippines despite the growing communist threat and the emergence of the Muslim armed secessionist movement in the Philippines at that time. The Philippines received only \$8 million in security assistance in the few years preceding 1979 (Taccad, 1978). This amount contrasted noticeably with the aid received by those countries hosting military bases, such as Spain, Turkey, and Greece. These governments concluded a \$1.2 billion 5-year agreement, a \$1.0 billion 4-year agreement and \$700 million 4-year agreement, respectively (Gregor and Aganon, 1987).

When President Carter won the Presidency, most of those opposed to President Marcos had high hopes that U.S. military assistance to the Philippines would finally end due to the poor human rights record of the Marcos administration. However, it was during Carter's presidency that the U.S. became interested in renegotiating the terms for the bases, including rent or compensation. An amendment to the Military Bases Agreement was signed in 1979. In addition to significant provisions contained in the amendment, President Carter promised Mr. Marcos, his 'best effort' to provide 500 million dollars in U.S. military and economic aid, representing an increase of 163 percent for FY 1980 as compared to FY 1979 (Berry, 1989).

Substantial military assistance continued to pour in during the time of President Ronald Reagan, who called Mr. Marcos a “personal friend”. In 1983, President Reagan sent a letter to President Marcos pledging his “best effort” to obtain security assistance for the Philippines in the following categories and amounts over the next five years;

- Military assistance-----\$125 million
- Foreign military sales credit (FMS)----\$300 million
- Economic support fund assistance-----\$475 million

Reagan also sought a 10-year grace period for the FMS credits granted the Philippines, thus spreading repayment over a period of 20 years (Berry, 1989).

During Aquino’s presidency, 1986 to 1992, the Philippine government tried to negotiate a higher compensation for the use of its bases. By 1989, compensation would have reached a billion dollars per year, while aid payments to the Philippines for 1982-1987 averaged \$180 million (Webb, 1993). In 1988, President Aquino finally agreed to \$481 million compensation per year for FY 1990 and FY 1991 but emphasized that the future negotiations would require substantial changes (“Philippines: Foreign Military Relations,” 2004). The base renegotiations in 1991 failed, which led to the complete pull-out of U.S. forces from the Philippines in 1992.

As the RP-U.S. Military Bases Agreement had been terminated, RP-U.S. military exercises on Philippine territory were suspended. President Ramos’ extension of a pre-existing Status of Forces Agreement (SOFA), which would establish the legal status of U.S. forces stationed in the Philippines, was also rejected by the Philippine Supreme Court (Hubbard, 2001). Nonetheless, between 1992 and 1998, the Philippines received, free of charge, Excess Defense Articles, as follows: 3,638 M-14 rifles; 16,488 M-1911 pistols; 10 M-240 machineguns; 22,500 Colt M16A1 automatic rifles and two refurbished Lockheed Martin C-130B transport planes. These giveaways have paid off with the purchased, through Direct Commercial Sales, from the U.S. of 12 Commando V-300 armored personnel carriers, 12 V-300 infantry fighting vehicles, 5 McDonnell Douglas 530-MG Defender helicopters and 5 second hand Cessna-172/T-41 aircraft by the Philippine government. (“Arming an Old Enemy,” 2004).

When President Estrada was elected in 1998, he advocated strong U.S.-Philippine ties. He actively supported approval of the 1999 U.S.-Philippines Visiting Forces Agreement which would allow RP-U.S. joint military training exercises and U.S. troops access to Philippine ports (VFA, 1999). The Philippines was also provided a FMF program fund of \$2 million for CY 2001. The Estrada administration also volunteered to send 750 troops to join the International Forces in East Timor (INTERFET) and in exchange, the Philippines received U.S. aid in the form of trucks to help it accomplish its mission in East Timor (Hubbard, 2001).

C. SECURITY ASSISTANCE FOR COUNTERTERRORISM

President Gloria Macapagal-Arroyo took over the presidency from President Estrada in January 2001. After the attacks by Muslim terrorists on the World Trade Center in New York and the Pentagon building in Washington, D.C. on September 11, 2001, President Gloria Macapagal-Arroyo immediately expressed her support for President Bush's call for a global coalition against terrorism (Hubbard, 2001).

She also sent a small military contingent for humanitarian and civic actions to join the coalition forces in Iraq. In return for this manifestation of support, President Bush, in a joint statement issued in Washington during President Macapagal-Arroyo's state visit, designated the Philippines as a major non-NATO ally, thus giving the Philippines greater access to supplies and materials from the United States. In 2001, the Philippines was due to receive one C-130B Hercules transport aircraft and five UH-1H helicopters, drawn cost-free from Excess Defense Articles (EDA) stocks. In 2002, the U.S. State Department also proposed that the Philippines receive \$19 million FMF credit (Karniol, 2001).

President Bush also pledged the following assistance for FY 2003:

- \$30 million in new grant aid for equipment and training of the Armed Forces of the Philippines.
- \$30 million in new bilateral development assistance for Mindanao and support for the peace process with the Moro Islamic Liberation Front.
- \$25 million in new grant assistance to train and equip a combat engineering unit and provide military needs in the war on terror ("RP-US Relations," 2003, p. 1).

The U.S. government has also promised delivery of 20 UH-1H helicopters to the Philippine Air Force, together with funding for their refurbishment, and to supply the

AFP with approximately 50,000 new rifles by 2003. However, it was able to deliver only 8 UH-1H and 15,000 M-16 rifles by the end of CY 2003 (“Defense Equipment Requirements,” 2004). Total U.S. military aid for CY 2003 amounted to US\$114.46 million (“U.S. Military Aid to the Philippines,” 2003).

Finally, the Bush administration has also asked Congress for \$164 million military and economic assistance for the Philippines in FY 2005 (Katigbak, 2004).

D. SUMMARY

This chapter outlined U.S. security assistance to the Philippines from the period prior to World War II through the 21st century war against terrorism. Little U.S. security assistance was provided to the Philippines shortly before World War II. After World War II, the Philippines depended significantly on the United States for security assistance to develop its armed forces. To address its security concerns, the Philippines allowed the use of its bases by the U.S. and also entered into several security treaties with the United States. The amount of security assistance to the Philippines appeared to have been tied to the support by Philippine political leaders for the foreign policy and security interests of the United States.

The U.S. bases in the Philippines later became a major source of irritation between the Philippines and the U.S. due to sovereignty and compensation issues. RP-US bases negotiators failed to agree on some issues, leading to the termination of the MBA in 1991 and the eventual withdrawal of U.S. forces from the Philippines. From 1994 to 1998, Foreign Military Financing (FMF) funding used to finance FMS for the Philippines was halted.

FMF funding in support of FMS purchase of U.S. defense articles was renewed in 1999 after the signing of the Visiting Forces Agreement allowing U.S. access to port and training facilities in the Philippines. It started to increase in 2001 as the Philippines actively supported the United States global war against terrorism.

The next chapter will discuss two components of security assistance by which U.S. defense articles are transferred to the Philippines. These are Foreign Military Sales and Direct Commercial Sales.

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IV. REVIEW OF THE LITERATURE ON FMS AND DCS

A. FOREIGN MILITARY SALES

1. Definition

Foreign Military Sales (FMS) is a component of the United States Security Assistance Program authorized by the Arms Export Control Act (AECA). It provides for the transfer of defense articles and/or defense services, including training, to eligible foreign purchasers. It is a government-to-government sale of U.S. defense articles and services, usually from Department of Defense (DoD) stocks or through new procurement under DoD-managed contracts (DoD 5105.38-M, 2003).

2. Basic Policies

a. Eligibility

Defense articles and/or services may be sold or leased to a country or international organization only if the President of the United States, in accordance with AECA, determines that the prospective purchaser is eligible based on the following criteria:

- The President finds that the furnishing thereof will strengthen U.S. security policy and promote world peace.
- The country or international organization has agreed not to transfer title to, or possession of, any defense article or related training or other defense service so furnished to it, or permit the use of such an article or related training or other defense service for purposes other than those for which furnished unless the consent of the President has first been obtained.
- The country or international organization shall have agreed to provide substantially the same degree of security protection afforded to such article by the United States.
- The country or international organization is otherwise eligible to purchase or lease defense articles or defense services (DISAM Online Green Book, 2003, Chapter III).

This eligibility is confirmed by a “Presidential Determination” written and signed by the President in the form of “Memorandum for the Secretary of State” authorizing the sale of U.S. defense articles and services (DISAM Online Green Book, 2003).

b. FMS Authorization Acts

The transfer of defense articles from the United States to a potential purchaser country is governed by two basic congressional acts, as follows:

- The Foreign Assistance Acts (FAA) of 1961, originally enacted on September 4, 1961, is the authorizing legislation for Economic Support Fund (ESF), International Military Education and Training (IMET), Transfer of Excess Defense Articles (EDA), Peacekeeping Operations (PKO), and other foreign non-military related assistance programs. FAA was also the basic authority for FMS prior to 1968. (DISAM Online Green Book, 2003).
- The (AECA) was formerly the Foreign Military Assistance Act of 1968 (FMSA). It was amended and changed to its current name in 1976. The AECA provides the policies that govern the licensing and sale of U.S. defense articles through Direct Commercial Sales and Foreign Military Sales (DISAM Online Green Book, 2003). Figure 1 shows evolution of significant Security Assistance Authorization Acts.

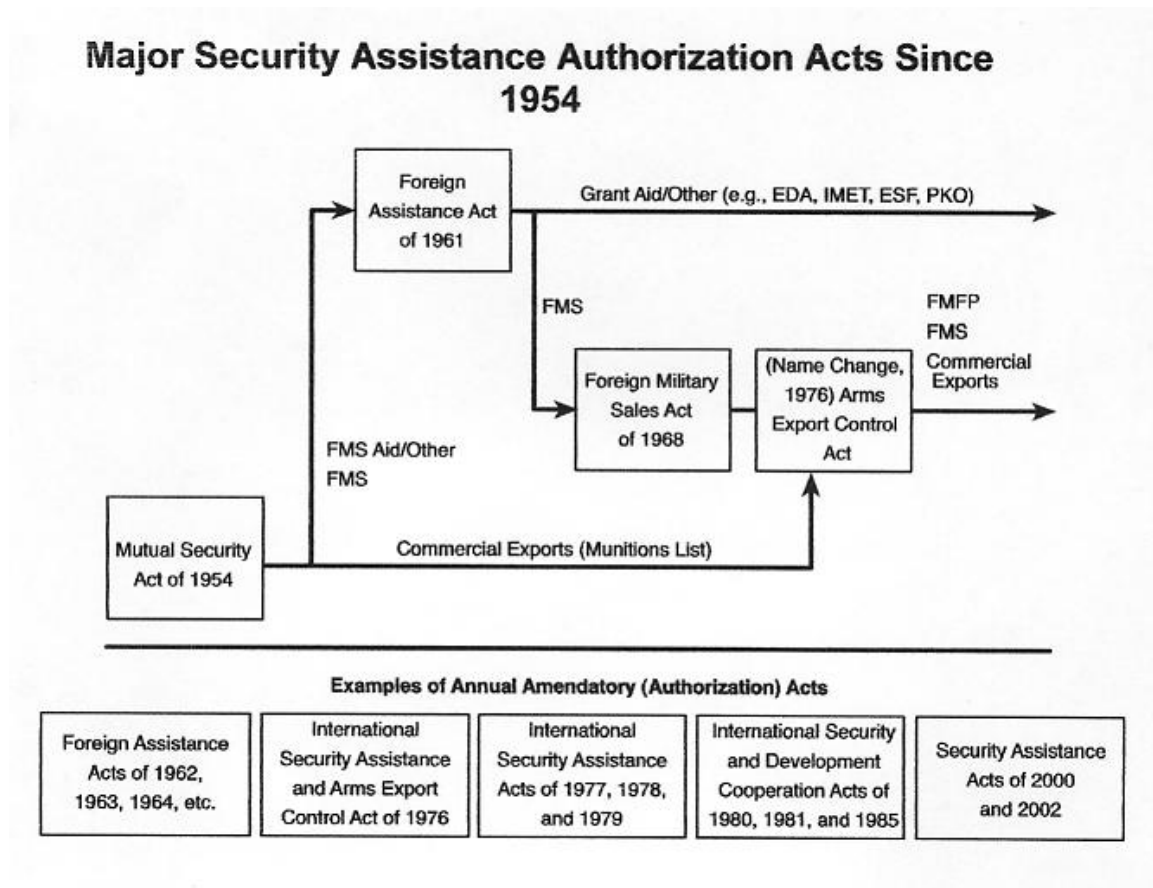


Figure 1. Major Security Assistance Authorization Acts since 1954. (From: DISAM Online Green Book, 2003)

c. Appropriations Acts

An appropriation act is the authority for funding the security assistance programs. Appropriations for Security Assistance are included in the annual “Foreign Operations, Export Financing, and Related Programs Appropriations Act” for each year (DISAM Online Green Book, 2003).

B. FOREIGN MILITARY SALES PROCESS AND PROCEDURES

1. Definition of Requirements/Initiation

A country’s requirements for defense articles arise because of needs, to include:

- to establish a new operational capability
- to improve an existing capability
- to exploit an opportunity to reduce cost or enhance performance, and
- to preserve a current capability through maintaining or replenishing inventory (Engelbeck, 2002, p. 88).

Once a purchaser country has determined the defense articles for procurement and has decided to procure the articles from the United States, it will still have to choose whether to buy the item through FMS or DCS.

A purchaser country intending to use FMS in its procurement of U.S. defense articles begins planning on how it can get the best value for every dollar spent on procurement. During the planning process, purchaser country representatives discuss their defense requirements and special needs with U.S. Security Assistance Organization (SAO) personnel stationed in the country. This discussion includes technical and financial requirements, systems information, conformance with U.S. security assistance plans and other security related issues (DISAM Online Green Book, 2003). Figure 2 shows the basic process being followed by the Armed Forces of the Philippines prior to preparing the Letter of Request (LOR).

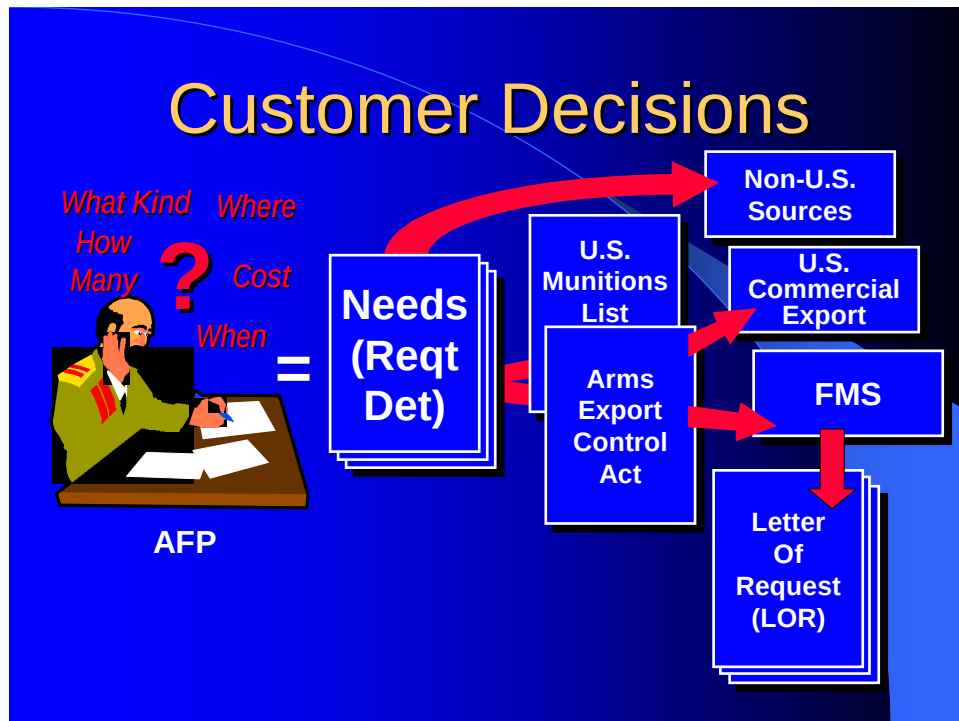


Figure 2. Basic Process Followed by the Armed Forces of the Philippines Prior to Preparation of Letter of Request (LOR). (From: Briefing Presentation of MGen. Castellano, Deputy Chief of Staff for Logistics, AFP at the Naval Postgraduate School, Monterey, California, December 2003)

2. Letter of Request (LOR) – Channels of Submission

The Foreign Military Sales (FMS) process begins when a purchasing eligible foreign country sends a request for information, referred to as Letter of Request (LOR) for defense articles or services considered for purchase (DoD 5105.38-M, 2003).

The purchaser country determines the channels of submission for the Letter of Request (LOR) based upon whether the request is for “Significant Military Equipment (SME)” or for all other FMS (non-SME) requirements. SME are items in the U.S. munitions list designated in the International Traffic in Arms Regulation (ITAR) that warrant special export controls because of their capacity for substantial military utility. Requests for Major Defense Equipment are treated as request for SME (DISAM Online Green Book, 2003). Major defense equipment includes items having nonrecurring research and development cost of more than \$50 million or a total production cost of more than \$200 million (DoD 5105.38-M, 2003).

Requests for SME must be forwarded by the purchaser country to the U.S Embassy which transmits the same LOR to the DoD Component or Implementing Agency (IA) with an attached justification, commonly referred to as “country team assessment” for the request. A Country Team Assessment includes the reason(s) why the country needs the SME/MDE from the U.S., evidence of ability to operate, finance, maintain and support it, as well as the reaction of neighboring countries to said sale. Information copies are furnished to Defense Security Cooperation Agency (DSCA), Department of State, Politico-Military Affairs (DoS/PM), and the appropriate Combatant Command by the IA. The DoS and DSCA initiate the necessary coordination to determine if there will be any objection to the proposed sale, while the Implementing Agency validates said LOR as to the eligibility of the potential purchaser country for FMS, that the request was transmitted through proper channels, and that the items sought may be sold. The Military Articles and Services List (MASL) maintained by DSCA provides a generic listing of military articles and services available for sale under FMS (DISAM Online Green Book, 2003). The basic channels of requests for FMS are illustrated in Figure 3.

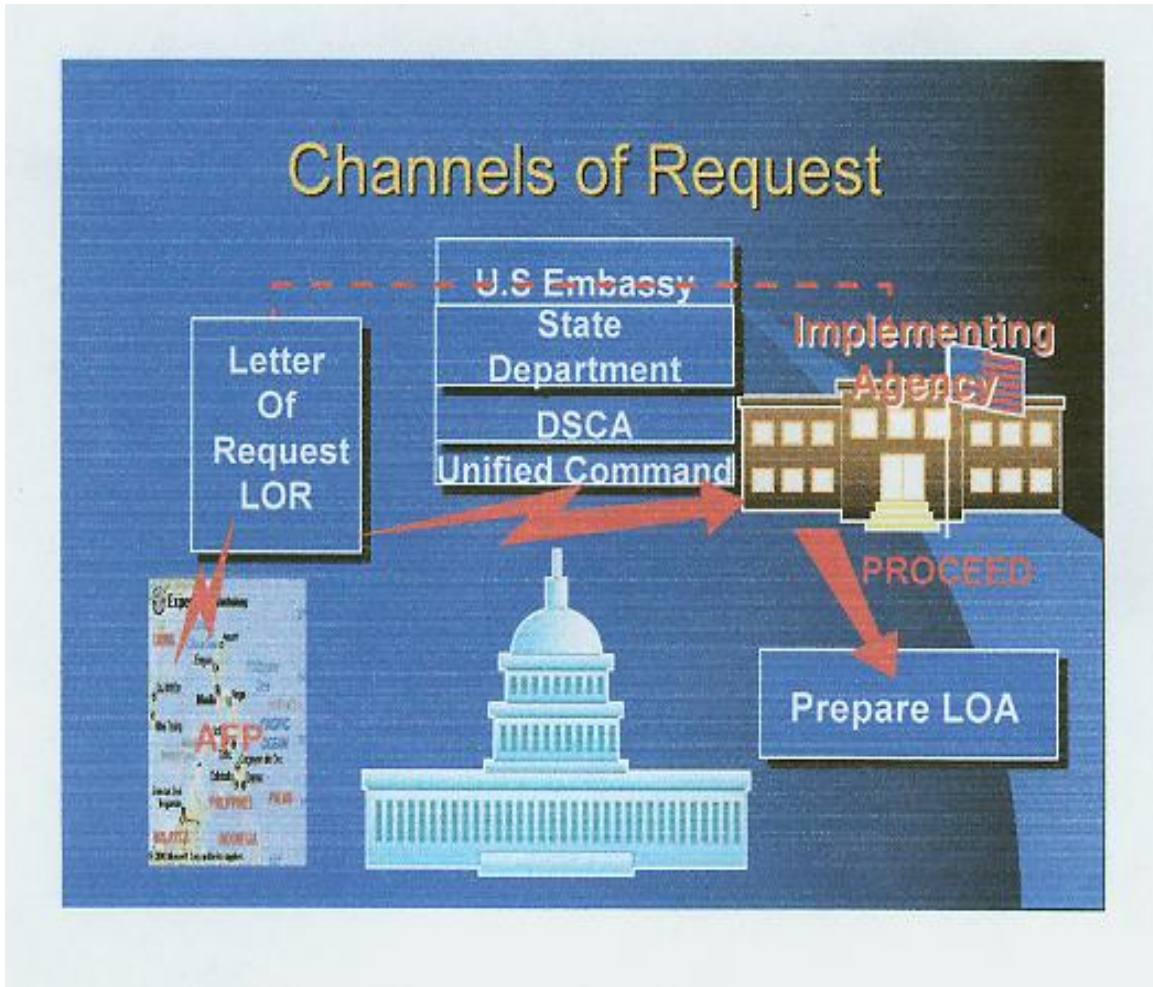


Figure 3. Channels of Request for FMS. (From: DISAM Online Green Book, 2003)

For non-SME, LORs are transmitted either by the purchaser's authorized representative or by the U.S. country team directly to the appropriate DoD Implementing Agency with information copies to the DoS/PM, appropriate Combatant Command and DSCA. LORs may be submitted directly to DoS(PM) and DSCA if the U.S. Embassy or the purchaser country believes that the request is sensitive and requires a higher level policy determination or if the submission channel is unclear (DISAM Online Green Book, 2003).

3. Price and Availability (P&A) Data

The LOR from a purchaser country should indicate whether the request is for Price and Availability (P&A) data or a request for Letter of Offer and Acceptance (LOA). P&A data are rough estimates of cost and the projected availability of the U.S. defense

articles or services. The P&A data estimate is normally provided to the prospective purchaser by the IA within 45 days after receipt of the LOR. P&A data is not valid for use in the preparation of a LOA or for use in budgeting but is for planning purposes only by the purchasing country (DoD 5105.38-M, 2003).

4. The Letter of Offer and Acceptance (LOA)

The LOA is the authorized document used by the USG as an offer to sell defense articles and defense services to a purchaser country. Once the Implementing Agency receives the LOR and after checking its validity and completeness, the IA will prepare the LOA, ensuring that it is in accordance with the FMS Total Package Approach (TPA). TPA provides for the necessary support items and services which include training, technical assistance, initial support and follow-on support. The LOA is forwarded to the purchaser country and becomes a contract when accepted and signed by the purchasing country or international organization. A signed LOA now referred to as a Foreign Military Sales “case”, is assigned a unique case identifier to differentiate it from other cases (DISAM Online Green Book, 2003).

Before issuing the letter of offer to sell defense articles or services worth \$50 million or more, or any design and construction services worth \$200 million or more, or major defense equipment for \$14 million or more, the President is required to submit justification to Congress with respect to such offer (DISAM Online Green Book, 2003).

FMS “cases” are categorized into Defined Order cases, Blanket Order cases, and Cooperative Logistics Supply Support Arrangement (CLSSA). The definitions of these cases are as follows:

a. Defined Order Case

A defined order case is the type of FMS case used when the articles or services provided are specifically identified by the purchaser in the Letter of Request (LOR). The following defense articles are normally processed as defined order cases:

- Major items and weapons systems
- Munitions, ammunitions and other explosives
- Transportation services
- Aircraft ferry

- Cartridge Actuated Devices/Propellant Actuated Devices
- Technical data packages (SAMM, 2003).

b. Blanket Order Case

A blanket order case is when no definitive listing of items or quantities is set but the LOA specifies a dollar ceiling against which orders may be placed. Customers may requisition against a blanket order case as long as funds are available. The types of defense articles normally considered under this category include:

- spare and repair parts
- publications
- support equipment
- minor modifications/alterations performed at United States military installations
- technical assistance services
- training and training aid devices
- reparable (SAMM, 2003).

c. Cooperative Logistics Supply Support Arrangement

A Cooperative Logistics Supply Support Arrangement is an FMS case wherein a military logistics support arrangement is designed to provide follow-on logistic support for U.S. defense articles acquired by purchaser countries. The arrangements provide for the execution of two Foreign Military Sales Orders (FMSOs) covering stockage, consumption, and storage requirements.

- FMSO case I covers the estimated dollar value of the total initial list of items and quantities to be stocked and maintained on order from sources for the support of the purchaser's U.S.-furnished equipment.
- FMSO case II covers the estimated annual withdrawals from the U.S. supply system by the purchasing country.

The scope of CLSSA sales is limited by the LOA description of end items to be supported and dollar values of the FMSO I and II cases, based on the cost of forecasted requirements for the anticipated period of support (SAMM, 2003).

5. Compilation of LOA Data

The actual LOA data estimates are provided by applicable service program/system/item manager and are based on either the U.S. contractor's cost, or on the current cost of the desired items in DoD inventory. The identification of each of the

required items and services for major system cases is the primary responsibility of the Army Major Subordinate Command, Navy Systems Command, or the Air Force Material Command (DISAM Green Book, 2003).

FMS case managers within these agencies obtain and review the necessary data on costs, schedules, configuration, and other factors to prepare an FMS proposal. The FMS proposal is also coordinated with other concerned USG agencies.

The following figures show the U.S. Navy, Army and Air Force organizational structure and processing flow for the compilation of data for a major weapons systems sale (DISAM Online Green Book, 2003).

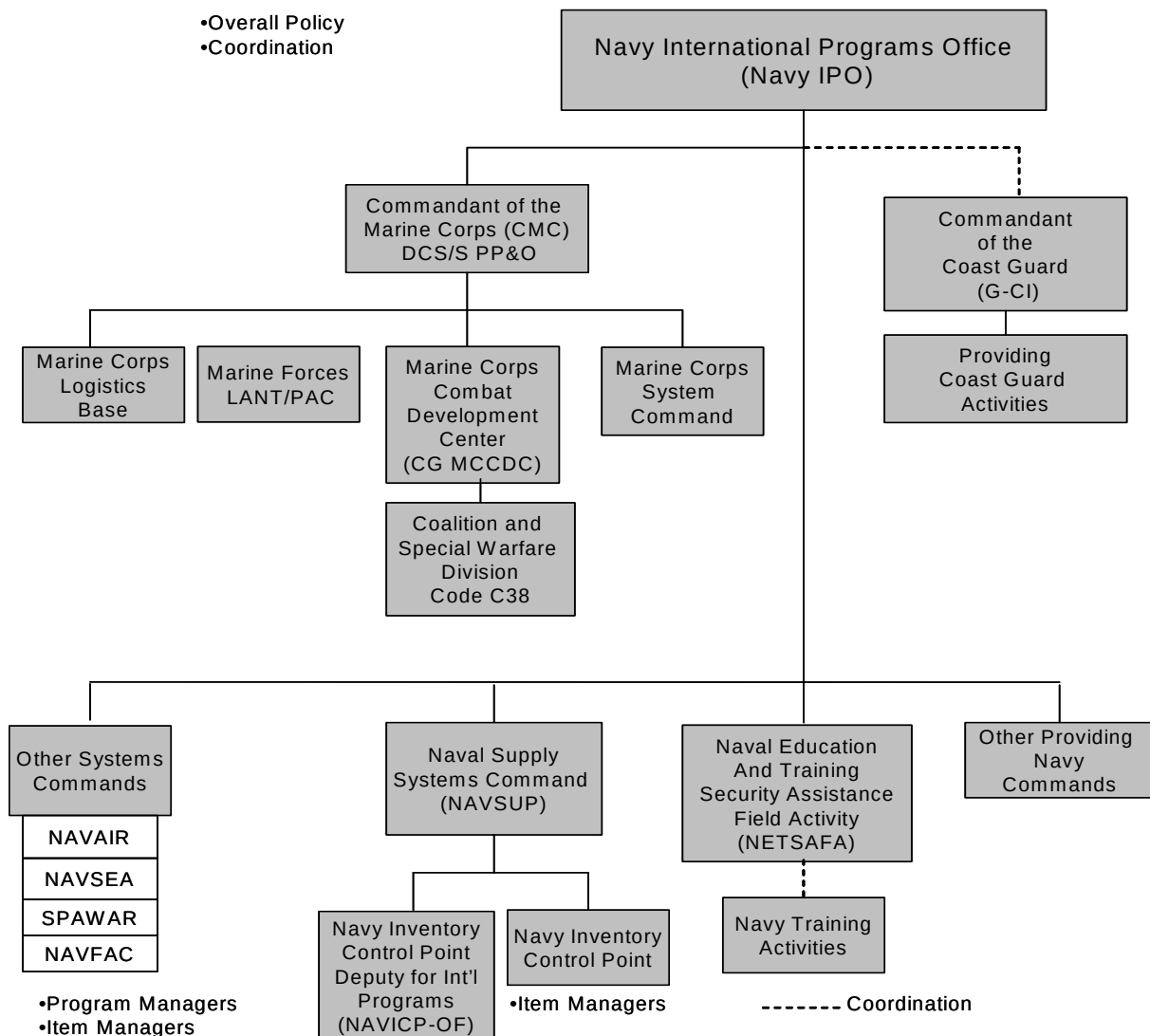


Figure 4. Department of the Navy Functional Organization for Security Assistance.
(From: DISAM Online Green Book, 2003)

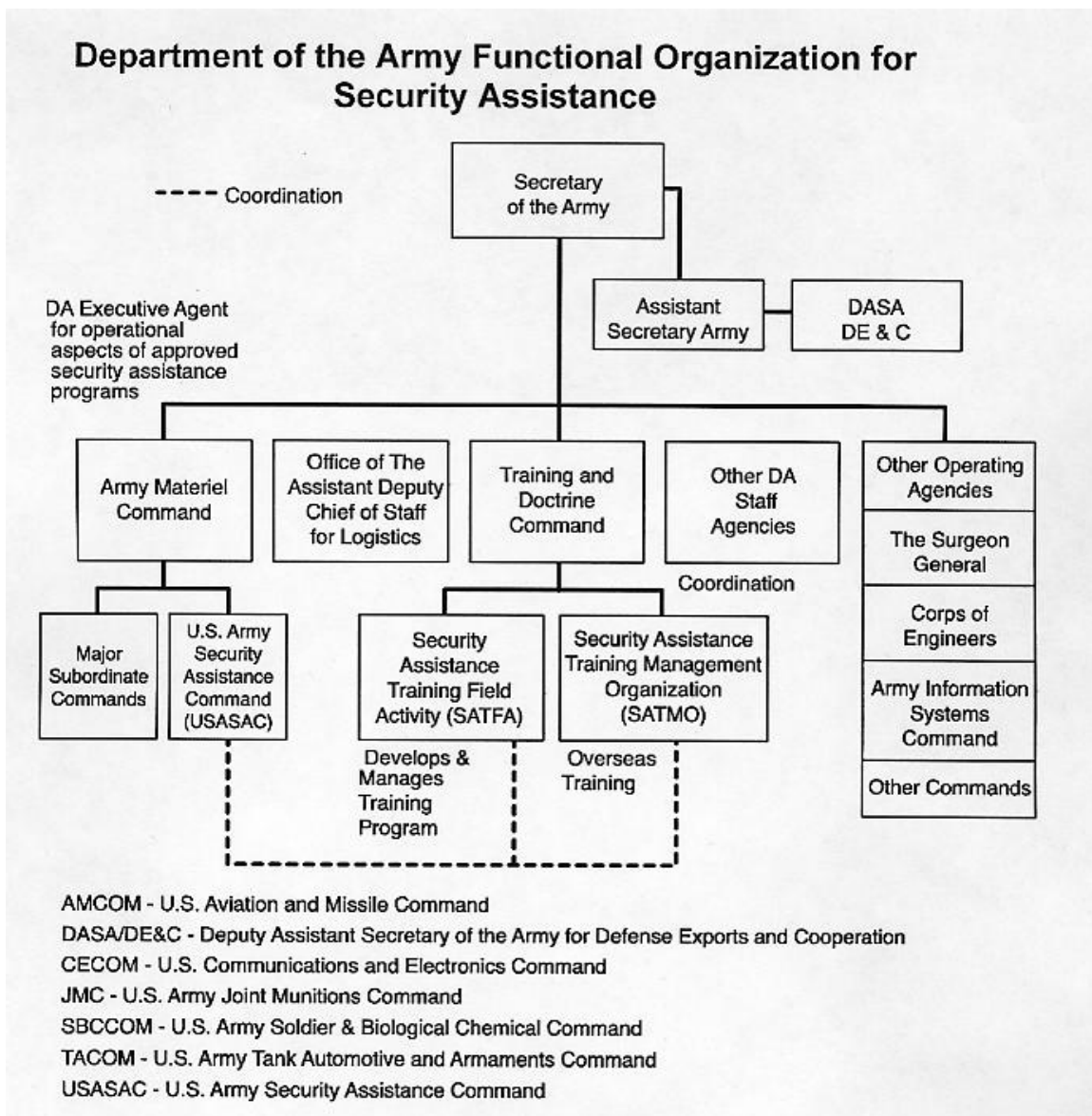


Figure 5. Department of the Army Functional Organization for Security Assistance.
 (From: DISAM Online Green Book, 2003)

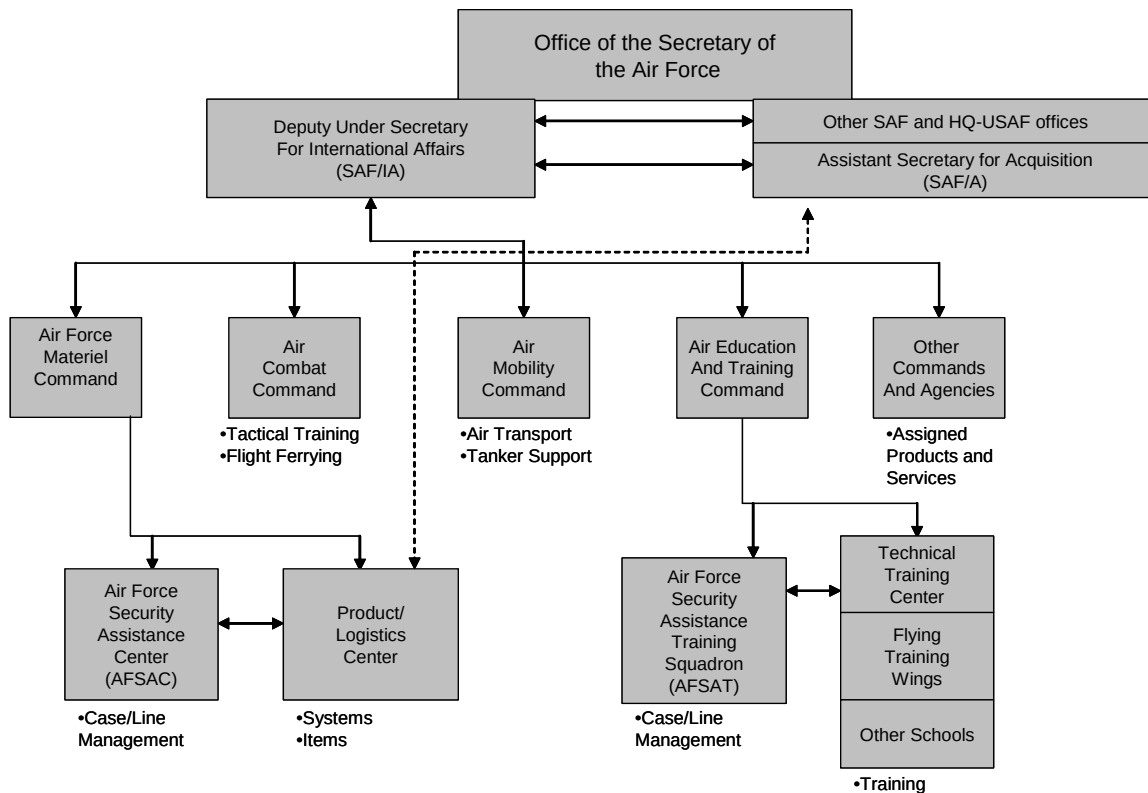


Figure 6. U.S. Air Force Functional Organization for Security Assistance. (From: DISAM Online Green Book, 2003)

6. Preparation of the Final LOA

After checking for the completeness and validity of the LOR, the Implementing Agency writes the LOA. The U.S. Army Security Assistance Command (USASAC), Virginia, for the U.S. Army, the International Programs Office (Navy IPO) for the Navy, and the Secretary of the Air Force for International Affairs (SAF/IA) for the Air Force write the major system LOAs. Follow-on support and spare parts LOAs are written and managed by the USASAC, New Cumberland for the Army, Air Force Security Assistance Center (AFSAC) for the U.S. Air Force, and the Navy Inventory Control Point for FMS (NAVICP-OF) for the U.S. Navy (DISAM Online Green Book, 2003).

7. Final Review of LOA

a. DSCA Countersignature

The IA forwards the LOA to the DSCA Comptroller for countersignature prior to release to the purchaser. DSCA comptroller reviews the LOA with regard to policy compliance, payment schedule and pricing, and records data from the LOA into

the Defense Security Assistance Management System (DSAMS) data system. DSCA also reviews those cases which must be presented to Congress for their review (DISAM Online Green Book, 2003).

b. Other DSCA Coordination Actions

DSCA completes policy and technical review of the LOA, makes any other necessary coordination and then submits the LOA for review by the State Department. If the State Department approves the LOA, and if Congress does not object to the proposed sale within 30 calendar days, the DSCA Comptroller “countersigns” the LOA and forwards it to the IA for submission to the requesting government. At the same time, a copy is sent to the Defense Finance and Accounting Service-Denver Center, Directorate for Security Assistance (DFAS-DE) for their information (DISAM Green Book, 2003).

8. Acceptance of Offer by Purchaser

Upon receipt of the LOA, the purchaser country is given 60 days to decide whether to accept or reject the LOA. An accepted and signed LOA is forwarded to the Implementing Agency and to DFAS-DE with the required initial payment on or before the Offer Expiration Date (OED) as indicated on the LOA. Payment must be in U.S. dollars and may be transmitted by check or wire transfer to the Department of the Treasury. Within five days of acceptance, the SAO should advise DSCA, DFAS-DE, and the IA of the acceptance of the LOA by the purchaser country (DISAM Online Green Book, 2003).

9. FMS Pricing

The methodology employed in developing an FMS price depends upon whether that price is to be placed on an LOA as a cost estimate or whether it is the price which is later reported in the billing system after delivery of an article or service. The prices entered on an LOA are projected cost estimates of the articles and services to be delivered in the future. Prices put into the billing system represent the actual costs of articles and services delivered to FMS purchasers. However, the exact cost of major procurements may not be determined until the total contracts for all systems obtained under such procurements are complete (DISAM Online Green Book, 2003).

FMS prices are calculated using two price elements, the base price and the authorized charges. The base price calculation differs if the item is sold from the DoD stock or from new procurement. If the item is to be sold from DoD stock, the cost of the item is the inventory value. The base price for new procurement is the purchase price of the item or the full amount of the contract. “Authorized charges” are added to both the DoD’s stock and new procurement’s cost, consisting of the investment costs and operating costs (DISAM Online Green Book, 2003).

Investment costs are the Non-recurring Costs (NC) incurred in Research, Development, Test and Evaluation (RDT&E) funded through appropriation. NC charges are applicable only in FMS sales of SME/MDE having a NC RDT&E of \$50 million or a production cost of \$200 million. Contract administration services (CAS) charges are the costs incurred by contract administration offices as listed in the Federal Acquisition Regulation (FAR), and include reviewing contractors’ compensation structure, consent to the placement of subcontracts, pre-award surveys, quality assurance and inspection, making payments on assigned contract, contract audit, and other related charges. CAS charges may range from 0.2 to 1.7 percent of the item’s purchased cost. Administrative charges, which may range from 2.5 to 5 percent of the purchased price of the item(s), are expenses incurred by DoD contracting personnel in sales negotiations, case implementation, program control, computer programming, accounting and budgeting, and general administrative support of the FMS program. Accessorial costs are expenses incident to issues, sales, and transfer of materiel that are not included in the price of the materiel. Examples of these charges are the Packing, Crating and Handling (PCH) cost, which is pegged at 3.5 percent of the purchased price of the item(s), and transportation costs which may range from 3.75 to 16.25 percent of the purchased price. The Logistics Support Charge (LSC), pegged at 3.1 percent of the purchased price, is a cost that may be added to FMS sales of spare parts, supplies and maintenance of customer-owned equipment to recoup an appropriate share of the cost incurred in logistics support (DISAM Online Green Book, 2003). Figure 6 shows the basic formula for computing FMS prices.

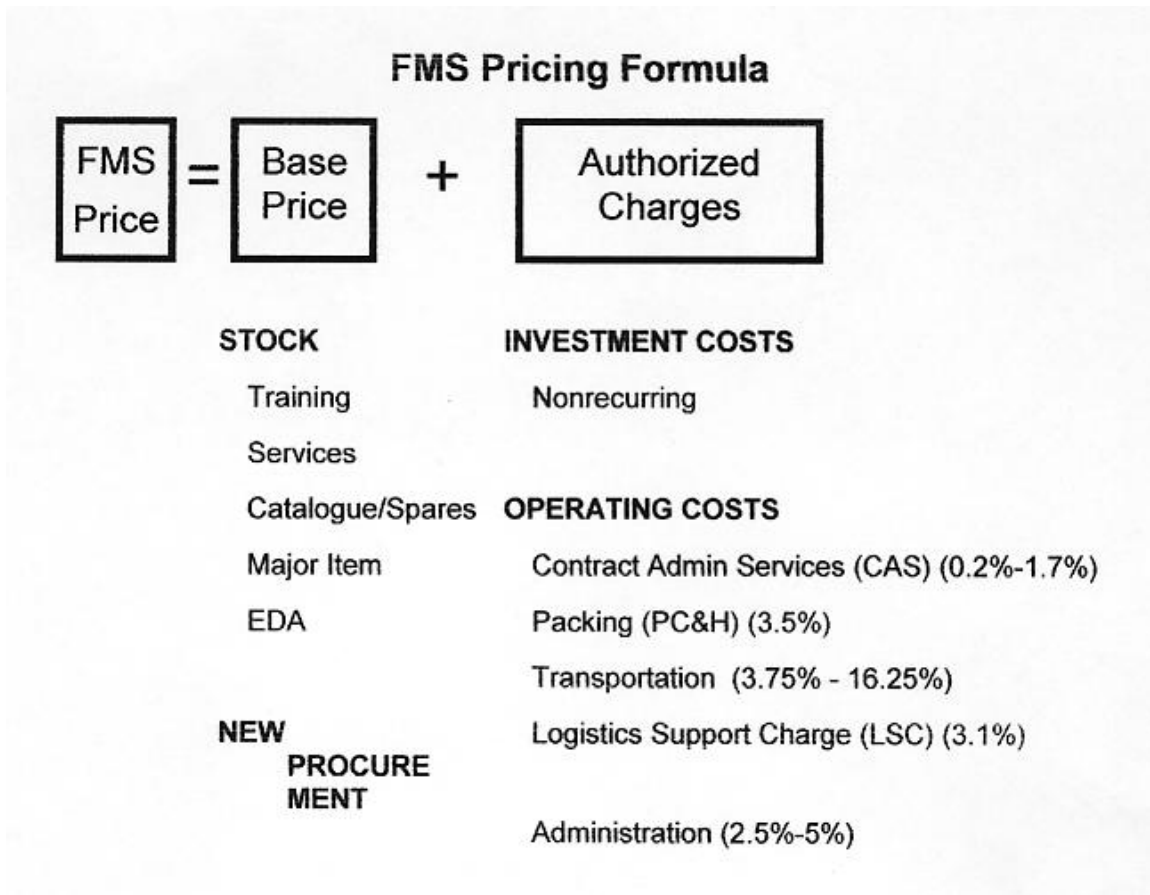


Figure 7. FMS Pricing Formula. (From: DISAM Green Book, 2003)

The U.S. government is mandated to recover all costs associated with FMS cases except when waived or reduced by the proper authority. The Standard Terms and Conditions of the LOA will indicate whether or not the U.S. government will procure and provide the U.S. defense articles required by the FMS eligible purchaser on a “nonprofit-no loss” basis (DISAM Online Green Book, 2003).

10. Implementation of the Case

After receiving the required initial payment, DFAS-DE releases the Obligational Authority (O/A) to the Implementing Agency (IA). The USG fulfills the FMS requirements by procuring new items or providing them from DoD stocks. FMS requirements may be consolidated with DoD requirements or implemented separately, whichever is more expedient and cost effective. The Implementing Agency may create an office or position within their organization to manage the FMS program and serve as an interface with other organizations involved in managing the program. Although the LOA

C. DIRECT COMMERCIAL SALES LICENSED UNDER THE AECA

1. Definition

A Direct Commercial Sale (DCS) is a sale made by a U.S. defense contractor directly to a foreign buyer without U.S. government intervention except for the licensing of the export sale in accordance with the AECA (DISAM Online Green Book, 2003).

2. Basic Policies and Procedures

The law that gives authority for the transfer of U.S. defense articles through a Direct Commercial Sales is the AECA of 1976, specifically Section 38 (**Arms Export Control Act P.L 90-629**). Direct Commercial Sales are not administered by DoD. The purchaser country will select the source and manage the awarded contract directly with the U.S. contractor. If the purchaser decides to buy its defense needs directly from a U.S. defense contractor, it is still subject to the review and approval of the DSCA as well as DoS. A U.S. company that wishes to sell defense articles directly to foreign purchaser must first request DSCA to enter into such a sales arrangement, and if approved, is given the “DCS Preference” authority valid for one year.

However, this approval does not in itself constitute an approval to transfer the defense articles. Exports of defense articles are authorized only after a munitions export license is obtained from the Directorate of Defense Trade Controls (DDTC) within DoS. Furthermore, if the proposed sale is an MDE worth in excess of \$14 million or other defense articles/services worth in excess of \$50 million, the President must submit a numbered certification to the Congress. An export license may not be issued within the 30-calendar day Congressional review period unless the President states in his certification that an emergency exists. Likewise, no export license shall be issued if Congress adopts a joint resolution objecting to the proposed sale. Applicable rules and procedures for Direct Commercial Sales are contained in the International Traffic in Arms Regulations (DISAM Online Green Book, 2003).

D. OFFSETS IN FMS AND DCS

Countertrade, as defined in the “Handbook on the Countertrade Program of the Philippines,” is a general term for an international transaction premised on some form of reciprocity. Various forms of countertrade used in the Philippines include counterpurchase, offsets, product buy back, debt-for-goods, build-operate-transfer, and

any combination of the above (Handbook on the Countertrade Program of the Philippines, 2002, pp. 1-4). A sample text of an undertaking to pursue countertrade relative to the supply of an item/defense article as used in the Philippines is as shown below. (Venturanza, Personal Communication, May 5, 2004)

**UNDERTAKING TO PURSUE COUNTERTRADE RELATIVE TO THE
SUPPLY OF**

Cite type of Importation

Pursuant to E.O. 120 s. 1993 relative to the adoption of COUNTERTRADE in government procurement, and in order to assist in the economic progress of the Philippines, the undersigned bidder hereby commits that should it be awarded the supply contract for the above-cited project by (Name of Importing Government Office) it shall, directly or through a nominated third party, undertake countertrade arrangements equivalent to ____% (not less than fifty percent (50%)) of the value of the total Contract Price of the Supply Contract, said countertrade arrangements to be concluded in writing between the undersigned bidder and Philippine International Trading Corporation (PITC) – the herein countertrade nominee of the Philippine Government – within (90) days from the signing of the said Supply Contract.

Failure on the part of the undersigned bidder to comply with this Undertaking shall entitle (Name of Importing Government Office) to rescind/cancel the Supply Contract and award the same to another party and/or disqualify the undersigned from participating in future supply contracts with the said government office without liability on the part of the latter.

This Undertaking shall form part of the undersigned's bid tender for the above project.

Issued this _____ day of _____ in _____, Philippines.

Name of Company
(Supplier/Bidder)

Name of Representative

Signature

Counterpurchase occurs when the seller of defense articles agrees to buy or to find a buyer for a specific value of goods, often stated as a percentage of the value of the exported item, from the buyer's country. This form of countertrade is sometimes called counter export (Handbook on Countertrade, 2002). Most of the countertrade performed in the Philippines is in the form of counterpurchase. The most significant example was the 1992 purchase of 150 Armored Personnel Carriers from the United Kingdom, costing US\$62 million, which resulted in a 100 percent counterpurchase. Products bought by the seller of this defense equipment were agricultural products from the Philippines (Handbook on the Countertrade Program of the Philippines, 2002).

Product Buy Back occurs when the seller of defense articles agrees to accept as full or partial payment products derived from the exported defense articles. For example, the seller of a Tomato Processing Machine agrees to be paid partially through the export of canned tomato paste processed from the machine.

Debt-for-Goods is a transaction whereby a debtor country offers its goods or services for export to cover full or partial payment of an outstanding debt (Handbook on the Countertrade Program of the Philippines, 2002). An example of a debt-for-goods countertrade occurred in 1998 when the National Electrification Administration of the Philippines incurred debt from China for the purchase of mini-hydro equipment. The Philippines paid its debt by exporting copper cathodes (Handbook on the Countertrade Program of the Philippines, 2002).

Offset is another form of countertrade in the Philippines. It is defined as an agreement whereby the seller undertakes or introduces a wide range of industrial and commercial activities for the benefits of the buyer (Handbook on the Countertrade Program of the Philippines, 2002).

The two main categories of offsets are direct and indirect. Direct offsets occur when the offset arrangements required by the purchaser country are directly related to the product being purchased. For example, as a condition for the purchase of \$1.75 million in communication equipment from Motorola of U.S.A. in 1999 by the Philippines, Motorola agreed to buy Integrated Circuits (IC) from the Philippines at no additional cost to the latter (Handbook on Countertrade Program of the Philippines, 2002).

Indirect Offsets occur when the offset arrangement required by the purchaser is not related to the product being purchased. For example, as a condition for the purchase of the Agusta II S-211 trainer jets program, the seller invested US\$16 million in New Leyte edible oil and US\$8.4 million establishment of Kinshi Philippines at no additional cost to the Philippines (Handbook on the Countertrade Program of the Philippines, 2002).

A type of offset arrangement that requires the seller or producer to manufacture its product or part of its product in the purchaser country is coproduction. It normally involves a government-to-government licensed production. Licensed production occurs when the offset agreement requires that the seller manufacture the defense articles in the buyer's country based on the technical information provided to a producer in the buying country.

Another type of offset arrangement that a buyer country may require from the seller is subcontractor production. It is the production of a part or component of defense articles being sold by the seller/producer in the buyer's country. The subcontract does not involve the license of technical information and is usually a commercial arrangement between the seller and a foreign producer.

As defined by the Investment Code of the Philippines, investment as an offset refers to equity investments made by a non-Philippine national in a Philippine enterprise, either in the form of foreign currency or in other assets actually transferred to the Philippines through joint venture (Handbook on the Countertrade Program of the Philippines, 2002). An example of investment as an offset is when the Philippines procured motorcycles from Kawasaki Corporation of Japan in 1997 and Japan agreed to invest in the expansion and modernization of its existing plant by constructing additional assembly lines and a new painting shop in the Philippines.

Technology transfer is another offset arrangement that the seller and buyer may enter into as a condition of sale. It is the transfer of specialized knowledge related to the defense products purchased which are not available in the buyer's country (Handbook on the Countertrade Program of the Philippines, 2002).

Purchasing governments frequently perceive that offsets provide them certain benefits, e.g., preserving foreign exchange, creation of employment, revenue generation

and technology transfers, not to mention the political gain that may be attached to the offset activity by the buying government. It is possible to achieve these economic benefits through various types of offsets as may be agreed upon by the buyer and the seller.

Many economists, on the other hand, view offsets as economically inefficient and market distorting. Aware of the adverse effects of offsets in the export of these defense articles, the U.S. government established a policy in 1990 that states:

- No agency of the U.S. Government shall encourage, enter directly into, or commit U.S. firms to any offset arrangement in connection with the sale of defense goods or services to foreign governments.
- U.S. Government funds shall not be used to finance offsets in security assistance transactions except in accordance with currently established policies and procedures.
- The decision whether to engage in offsets, and the responsibility for negotiating and implementing offset arrangements, resides with the companies involved.
- Any exceptions to this policy must be approved by the President through the National Security Council (Milligan, 2003).

For the past several years, some countries have benefited from various offsets connected with Foreign Military Sales. Some recipient countries of Foreign Military Financing (FMF) funds, including Israel, Egypt, Turkey and Greece, used these funds in developing their industrial bases and other aspects of their economies through offset requirements from U.S. contractors (GAO/NSIAD-94-127, 1994).

E. FUNDING FOR FMS AND DCS

Funding for FMS or DCS can either be in the form of cash from the purchaser country or in the form of credit/loans received by the purchasing country from the United States through its Foreign Military Financing Program (FMFP). If the purchasing country is funding its FMS procurement from its own national budget, then it is called FMS cash. FMS and DCS transactions may also be funded with a FMFP fund when a buyer country is eligible to receive such funds and the funds will be used to buy U.S. defense articles. The U.S. Congress appropriates the budget for FMFP, which is then managed by the DSCA (Foreign Military Financing, 2004).

F. SUMMARY

This chapter discussed the two components of security assistance which involve the transfer of U.S. defense articles to a foreign country: Foreign Military Sales and Direct Commercial Sales. Foreign Military Sales is a government-to-government transaction for the sale or transfer of defense articles. The sale or transfer is administered by DoD and the items for sale or transfer may come from DoD stocks or from new procurement. FMS processes and procedures are tedious and characterized by bureaucratic red tape as there are many government agencies involved in the transactions. The FMS process basically consists of seven phases, namely the Project definition phase, the Request phase, the Offer phase, the Acceptance phase, the Implementation phase, the Execution phase and case closure. FMS operates on a no profit-no loss basis and as a result, charges are added to the FMS price to recover costs to the U.S. government associated with the management and implementation of FMS sales.

Direct Commercial Sales as authorized by the AECA is a sale or transfer of defense articles directly to a purchaser country by the U.S. contractor. The government does not participate in the sale transactions except for the licensing of the export sale performed by the Office of Defense Trade Control under the DoS. However, if the purchasing country uses FMF funds to finance procurement of U.S. defense articles using DCS, it needs the approval of the U.S. government through DSCA (DoD 5105.38-M, 2003).

Before the sale of a defense article to a foreign country, whether through FMS or DCS, the country must be eligible to purchase U.S. defense articles. A Presidential Determination documented by the President's written memorandum to the Secretary of State affirms eligibility. Funding for both FMS and DCS may be in cash coming from the purchasing country's national fund or grants/credits provided to an eligible country by the U.S. government through its FMFP fund.

As a national trade policy on foreign procurement, the Philippines demands various forms of countertrade for procurement above \$1 million from the supplier or seller as compensation for the purchase of such defense articles by the Philippine government.

The next chapter will discuss the advantages and disadvantages of these two components of security assistance when used within the context of the economic and political situation of the Philippines, while at the same time considering relevant existing Philippine laws, policies, rules and regulations.

V. SIGNIFICANT FACTORS AFFECTING RP IN SELECTING METHOD OF PROCUREMENT

A. INTRODUCTION

All foreign procurements for the AFP are centrally managed at General Headquarters, Armed Forces of the Philippines (GHQ, AFP), although the implementation and contract management will be decentralized to the major service commands. The acquisition of defense articles and services by the Armed Forces of the Philippines from the United States is executed using two methods of procurement-- Foreign Military Sales and Direct Commercial Sales. FMS and DCS vary in the way they are processed but both are governed by existing procurement laws, rules and regulations in the Philippines. The relevant laws, rules and regulations influencing equipment acquisition in the AFP are discussed below, as well as economic and political factors.

B. MAJOR FACTORS CONSIDERED IN SELECTING METHOD OF PROCUREMENT

1. The Armed Forces of the Philippines (AFP) Equipment Acquisition Process

The Implementing Guidelines, Rules and Regulations (IGRR) of the AFP Modernization program prescribes two distinct but sequential stages for procurement, namely, the equipment acquisition stage and the contract negotiation stage. Each stage requires separate approval by the Secretary of National Defense (DND DC 01, 2000).

The first stage starts with a requirements generation, sometimes called project definition, by the major service command through Project Management Teams (PMTs). PMTs are normally composed of at least three military officers headed by a Project Manager. A PMT identifies, defines and prepares the Circulars of Requirements (COR) and the Bid Evaluation Plan (BEP). The Major Service modernization board will review and validate the CORs and forward it to the major service commander for his approval. It then submits these requirements to AFP, GHQ through the AFP Modernization Board. The AFP Modernization Board at GHQ, together with the AFP-Department of National Defense (DND) Technical Working Group, reviews and validates the CORs before

submission to the Chief of Staff (CS), AFP for approval. Once approved, the CORs and the BEP will be submitted to the DND Review Board. After review and validation, the board submits it to the Secretary of National Defense for final approval.

The second stage follows after the Secretary of National Defense approves the CORs and Bid Evaluation Plan submitted by the CSAFP. The SND issues the procurement directive, signaling the entry of the Bids and Awards Committee (BAC) into the procurement process. BAC conducts the pre-qualification and eligibility of bidders, bidding and post-qualification of Most Advantageous Bid (MAB) in coordination with the AFP- Philippine International Trading Corporation (PITC) Technical Working Group (TWG). The AFP-PITC TWG is responsible for the implementation of the counter trade policy on foreign procurement. After BAC finally selects the MAB, it then submits the same to the CSAFP for his approval and endorsement to the Secretary of National Defense. The SND approves the MAB and issues the Notice of Award. BAC prepares and finalizes the contract to be reviewed by the CSAFP for subsequent endorsement to SND. SND signs the contract and issues a Notice to Proceed (NTP). The implementation of the project(s) then takes place. In case of a multi-year contract, copies will be forwarded to Congress for the appropriation of funds. If the amount of the contract exceeds 300 million pesos, copies will be forwarded to National Economic and Development Authority (NEDA) for review and approval prior to implementation (Habulan, 2002).

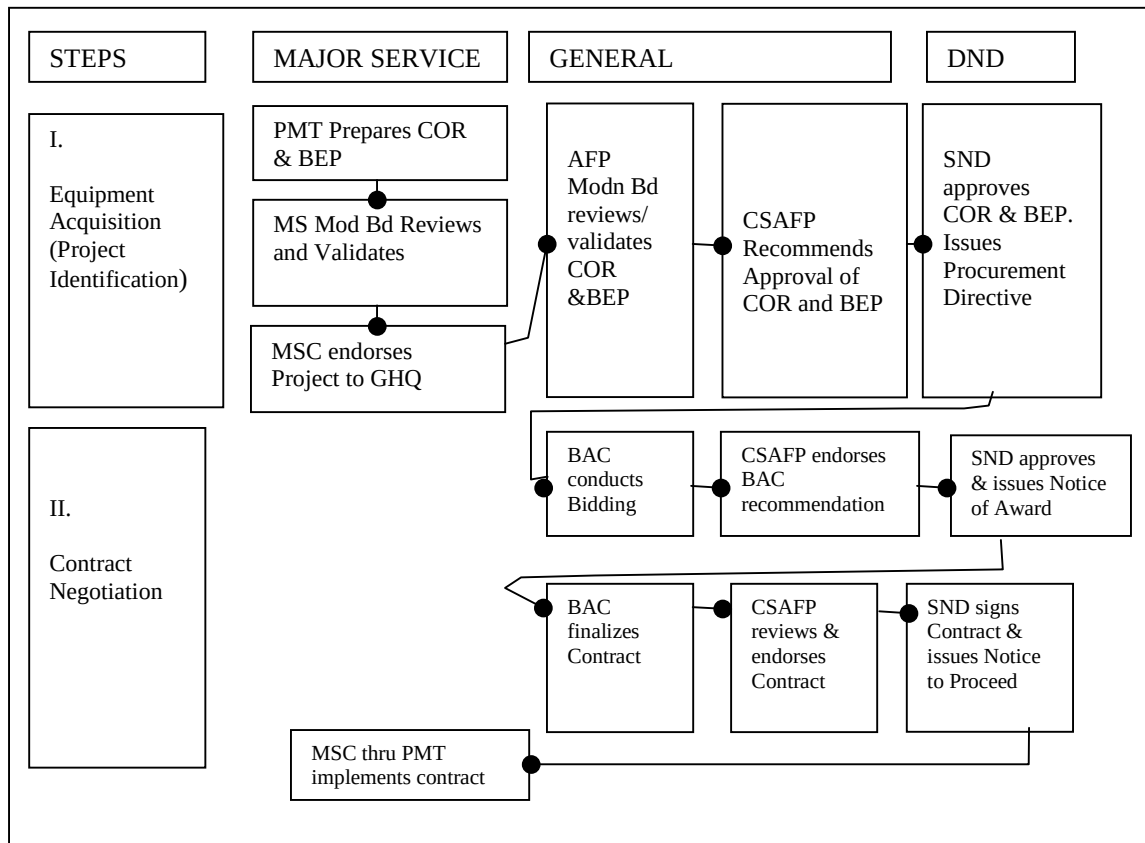


Figure 9. The AFP Equipment Acquisition Process. (From: Habulan, 2002)

2. Request for Foreign Military Sales

A request for procurement through the Foreign Military Sales method is a simple process. It starts with the definition of requirements by the major service command through its modernization or weapons board. The definition of requirements is preceded by a discussion or coordination with the Joint United States Military Advisory Group (JUSMAG) by the major service commands to determine if the items are available in U.S. DoD stocks. A Letter of Request (LOR) for procurement of the U.S. defense articles is then prepared and submitted by the major service command to GHQ, AFP. The request is then reviewed by the AFP Modernization Board and submitted to the CS, AFP for his approval. The approved requirement is then forwarded to the SND for his approval. The approved letter request goes back to GHQ, AFP which then prepares an LOR to be submitted to JUSMAG or to the Implementing Agency, depending upon whether the request is for Significant Military Equipment (SME) or non-SME (Calon, 2004). The FMS process as discussed in Chapter II will then apply.

3. Existing Philippine Laws Governing Procurement of Defense Articles from Foreign Countries

A series of laws, rules, policies and regulations has been enacted to govern the procurement of defense articles from foreign countries. The most important of these are identified below.

Republic Act 7898 is an act providing for the modernization of the Armed Forces of the Philippines. One of its provisions is a requirement to incorporate special foreign exchange reduction schemes in the procurement contract or agreement, including countertrade, in-country manufacture, co-production, offsets or other innovative arrangements.

Republic Act 6713 establishes a code of conduct and ethical standards for public officials and employees. It is intended to uphold the time honored principle of public office being a public trust. It also enumerates prohibited acts and transactions and provides penalties for their violation. These standards apply in the acquisition of equipment and in dealing with contractors, suppliers, proponents and others.

Republic Act 9184, enacted in CY 2002 and known as the Government Procurement Reform Act, contains the general guidelines on how to conduct competitive bidding and the alternative modes of procurement, including direct and negotiated procurements. It states that all procurement for the national government, its departments, bureaus, agencies and offices, including government-owned and controlled corporations, shall be governed by principles of transparency, competitiveness, a streamlined procurement process and a system of accountability.

E.O 120 is an executive order issued on August 19, 1993 which directs the national government, its departments, bureaus, agencies and offices, including government-owned and controlled corporations, to adopt countertrade as a supplemental trade tool with respect to the importation or procurement of foreign capital equipment, machinery, products, goods and services. The AFP and the PITC signed a memo of agreement in May 1996 creating the joint AFP-PITC countertrade working group (JCWG). That countertrade is a requirement in defense procurement programs.

DND Department Circular 01, dated 6 March 2000 is the Implementing Guidelines, Rules, and Regulations (IGRR) of the AFP Modernization Program. One of the guidelines (3.2.11) says that in contracts worth US\$1 million or more involving the acquisition or upgrade of equipment or weapons systems from foreign suppliers, Executive Order 120 and its Implementing Rules and Regulations (IRR) on Countertrade shall apply.

DND Department Circular 04 prescribes guidelines for the implementation of countertrade for procurement contracts under the AFP Modernization program. This circular covers foreign procurements, including acquisition and upgrades, of equipment and weapons systems by the AFP and DND valued at US\$1.0 million and above or its equivalent in other foreign currency. Table 1 shows the minimum countertrade level of commitment required of contractors/suppliers to be eligible as bidders.

Table 2. Countertrade Level of Commitment Required from the Supplier for the Purchase of Defense Equipment. (From: Venturanza, Briefing Slides, 2004)

MINIMUM COUNTERTRADE LEVEL OF COMMITMENT	
Value of Supply Contract (in US\$)	Countertrade Commitment/Obligations (Minimum)
\$ 1 M- \$20 M	100% of the value of the Supply Contract (SC)
Between \$20 M and \$40 M	90% of the value of the SC
- \$40 M and \$60 M	80% of the value of the SC
- \$60 M and \$80 M	70% of the value of the SC
- \$80 M and \$100M	60% of the value of the SC
over \$100 M	80% of the value of the SC

The circular further states that the Secretary of National Defense may revise or modify the minimum countertrade obligation on a case-by-case basis if it is in the best interest of the government for him to do so.

Memorandum Circular No. CT-95.1/01 establishes the guidelines for the evaluation and approval of offset arrangements to be undertaken pursuant to E.O 120 and its Implementing Rules and Regulations (IRR).

AFP Manual 4-6 is also known as the AFP Major Capital Equipment Acquisition Manual. It prescribes the capital equipment acquisition process to be followed, defines the acquisition organization structures such as committees, working groups and management teams to be adopted, describes the AFP Defense Acquisition Code of Ethics and Conduct, risk management in the AFP, and discusses the AFP's self-reliant defense program (SRDP).

The AFP Defense Acquisition Code of Ethics sets forth the general standard to be followed by personnel of the AFP in dealing with procurements.

Finally, DOF/DBM/COA Joint Circular No.4-98 prescribes the rules and regulations on the proper handling and administration of the AFP Modernization Act Trust Fund (AFPMATF).

The Philippines will procure its defense articles in accordance with the above laws, policies and regulations. The laws, however, are numerous, fragmented and sometimes not in agreement, which makes implementation very challenging. The provision of countertrade required from contractors as a condition of sale is a common thread among these laws, policies rules and regulations on foreign procurement.

4. Economic Factors

The Philippine economy remains the major stumbling block in the modernization program of the Armed Forces of the Philippines. One indicator of economic status of a country is its Gross Domestic Product (GDP), the total value of all goods and services produced within a country during a given year. It is also a measure of the income generated by production within a country ("Philippines: Facts at a Glance", 2004). The following chart shows the economic performance of the Philippines in terms of GDP from 1997 to 2001, which indicates a generally downward trend.

	1997	1998	1999	2000	2001
GDP (current US\$ billions)	82.3	65.2	76.2	74.7	71.4
GDP per Capita (US\$)	1,160.0	1,130.0	1,140.0	1,170.0	1,180.0

Table 3. Economic Performance of the Philippines in Terms of GDP from 1997 to 2001 (From: World Development Indicators, World Bank. www.janes.com. Accessed May 20, 2004)

Budget allocation for defense in CY 2002 was approximately US\$600 million, US\$500 million in CY 2003, and US\$800 million in CY 2004, with an estimated 80 percent of defense spending allocated to personnel costs (Country Briefing: the Philippines- Battling the Home Front, Jane's Defense Weekly, 2003). Over and above the defense budget is the budget for modernization. Funds for the AFP modernization program are to come from the P331.6 billion budget allocated and approved by both Houses of Congress through Joint Resolution Nr 28 in 1996 (Joint Resolution Nr 28, 1996). This amount was not completely provided. In CY 2000, the Estrada administration only allocated 5.0 billion pesos while the Arroyo administration allocated another 5.4 billion pesos for CY 2002 to support the modernization program projects of the AFP.

To jumpstart the modernization program, the AFP in 1996 formulated a five year rolling plan based on a budget ceiling of a total of P50 billion for the first five years as prescribed under Joint Resolution Nr 28 to support its priority program. The five-year rolling plan serves as the basis for the yearly appropriations and as a guide for the DND-AFP in the implementation of the first five years of the modernization program.

However, as of April 2004, eight years after approval of JR Nr 28, the total amount obligated for the modernization program stands at P6.561 billion but the total amount corresponding to the "Notice of Cash Allocation" is only P2.635 billion, approximately US\$48 million (Trinidad, Personal Communication, May 11, 2004). This is only 5.2 percent of the total funds programmed for the five year rolling plan. The term obligated means the amount was already programmed to finance the contracts, or vouchers are already existent with corresponding funding. It does not, however, necessarily mean that cash is actually available to pay the contract(s)/voucher(s). When the contract(s)/voucher(s) reach the Department of Budget and Management (DBM), DBM will issue a Notice of Cash Allocation (NCA) for the voucher to signify that cash is available and allocated to the contract/voucher. Therefore, even if approved contracts/vouchers are in the pipeline, it may not be possible to implement them if cash is not available for payment (Trinidad, Personal Communication, May 2004).

Since the approval of the AFP Modernization program, the AFP had only implemented three out of the 45 projects programmed under subprogram I (Trinidad, personal communication, 2004).

Funding problems continue to haunt the implementation of the AFP Modernization program. During a March 2004 interview, Senator Rodolfo Biazon said that the implementation of the AFP modernization program may not take place this year (2004) due to a lack of funds (“Modernization Funds Stalled,” 2004). An interview with Commander Montanez of the AFP Modernization Program Management Office disclosed that the real problem causing the slow implementation of the modernization program of the AFP is the lack of funds to procure the needed equipment.

It is significant to note that from 1989 to 2004, the Philippines had procured defense articles for the AFP from abroad through Direct Commercial Sales and that most of the contracts contain countertrade arrangements. The Philippines used DCS to procure materials from suppliers who promised the most benefits in terms of fulfillment of defense requirements and economic development. This is in compliance with procurement laws, policies and regulations, especially E.O.120 on adopting countertrade in the procurement of foreign capital equipment. Countertrade projects for AFP modernization are considered and evaluated by the AFP-PITC Technical Working Group for their impact on the Philippine economy, long range national economic objectives, contribution to export and job generation environmental remediation (Marvel, 2001). The Philippines is still considered a developing country and it has set a very high priority for its economic development. This is the main reason why in all its importation of defense articles, which are considered big ticket items, it attempts to take advantage of the opportunity to use countertrade.

In almost all of its procurement in 2000 to 2004 for the AFP Modernization Program, countertrade is included in the contracts. In December 2003, the AFP procured manpack communication equipment from the U.S. Company Harris with an associated 80 percent offset and 20 percent counterpurchase. A pending contract with U.S. Cadillac Gage for the upgrading of the V-150 armored vehicle will also provide countertrade arrangements. Several procurement projects for defense articles for the AFP using DCS

are still pending, as the finalization of offset arrangements are still on-going (Venturanza, Personal Communication, May 3, 2004). The total value of countertrade projects from CY 1989 to CY 2000 derived from foreign procurement by various Philippine government agencies is US\$300 million. Starting in 1999, U.S. economic and security assistance to the Philippines substantially increased. Summarized below is the actual amount of FMS supported by FMF credit funds to the Philippines from 1991 to 2003.

FMS Supported by FMF credits

In Millions of \$

USER	1991	1992	1993	94-98	1999	2000	2001	2002	2003
PA	32.50	4.48					0.50	4.80	4.63
PAF	86.50	7.55					0.99	8.60	5.95
PN	51.50	4.00					0.50	3.60	5.89
PC	17.50								
GHQ	12.00	8.97	15.00		1.00	1.44			
TAFT								2.00	1.90
CT								25.00	1.50
TOTAL	200.00	25.00	15.00	0.00	1.00	1.44	1.99	44.00	19.87

PA - Philippine Army

PAF - Philippine Air Force

PN – Philippine Navy

PC – Philippine Constabulary

GHQ – General Headquarters

TAFT – Technical Assistance Field Team

CT – Counterterrorism

Table 4. Foreign Military Sales to the Philippines from 1991 to 2003. (From: “MGen Castellano’s Briefing Slides,” 2003)

As indicated above, the Philippines is a regular recipient of the Foreign Military Financing credit funds from the United States. These funds were used by the Philippine government to finance the procurement of U.S. defense articles through Foreign Military Sales. The procurement of U.S. defense articles using funds from the Philippines treasury was comparatively lower than the FMF fund credit used to finance FMS transactions due to the Philippines’ lack of appropriated funds intended for the procurement of defense articles. An interview with Major Caranto, the Chief of International Logistics Branch under the Office of Assistant Chief of Staff for Logistics, OG4, PA, indicated that without U.S. FMF grants and credit used to finance FMS, procurement of U.S. defense articles by the Philippines would be greatly reduced. This was corroborated by Ms

Nancy Mikles, the DSCA's FMS Program Director for the Philippines, who said that Philippine government funds have never been used for FMS cases except for the funds intended for the refurbishment of 10 UH-1H helicopters in 2003 given as U.S. Excess Defense Articles.

It can be observed that U.S. security assistance to the Philippines provided in the form of FMF credits and Economic Support Fund (ESF) is inducing the Philippine government to procure defense articles from the U.S. using government-to-government transactions or FMS. The FY 2005 budget request for security assistance to the Philippines, at \$164 million, will again increase the amount of FMS to the Philippines. Just as in the previous three years, procurement through FMS would again increase as the United States extended FMF credits to the Philippines.

5. Political Factors

Political factors also influence procurement decision makers as to what and where to procure as well as what method of procurement to be used. A case that illustrates the influence of politics in arms transfer was when Malaysia was about to purchase MIG-29 fighters from Russia. The Clinton administration intervened and convinced Malaysia to buy some F/A-18s from the United States as well. Likewise, when Greece was about to purchase electronic warfare equipment from Britain, the U.S. administration intervened to help secure a deal for Litton Industries instead (Haynes, 2001, p. 7).

The renewed bilateral security relationship between the United States and the Philippines began in 1999, when President Estrada indicated his full support and approval for the Visiting Forces Agreement (VFA). VFA gives U.S. forces access to ports and training facilities in the Philippines. The manifestation of support given by Philippine President Gloria Macapagal-Arroyo to President Bush's war on terror broadened and further improved this renewed RP—U.S. diplomatic and security relationship. The political relationship between the Philippines and the United States was further strengthened when President Bush designated the Philippines as a major non-NATO ally in 2003. By being a U.S Major Non-NATO Ally (MNNA), the Philippines would be

given greater access to American defense equipment and supplies (“Philippine American Ties”, 2004). The Philippines is benefiting from this strong political relationship.

During the opening ceremony of the joint RP-US military exercises in the Philippines in March 2004, two months before the presidential election, President Arroyo, in her speech, said:

I want to emphasize the blessings to our country of a strong relationship with the United States. This economic and security relationship with the United States that was forged during my administration is worth \$6 billion, including American investments. She further said These are the blessings of a good foreign policy made up of two friends who are tied up by mutual interest and not by a relationship of dependency. There is more to come because we have been declared by the US as a major non-NATO ally (Sy, 2004, p. 1).

The amount of U.S security assistance given to a foreign country is dependent upon the existing political alliance between said foreign country and the United States at a certain time. The manifestation of support by President Bush to the administration of President Arroyo by designating the Philippines a MNNA may encourage the PGMA administration to procure more defense articles from the United States. President Bush may also request that President Arroyo procure defense articles from the United States to strengthen and further enhance the security and political stability of the two countries.

This situation occurred during the administration of President Marcos from 1965-1986. When President Marcos openly expressed his support for and cooperation with United States foreign policy in Southeast Asia, he received in return substantial economic and security assistance for the Philippines. The security assistance to President Marcos was subsequently reduced due to allegations of corruption and human rights violations committed by the Armed Forces using U.S. provided military assistance.

The political advantage of using FMS is the fact that this is a government to government sale of arms. In the book “Arms Transfer and Dependence,” author Christian Catrina quoted former President of Tanzania as saying:

For the selling of arms is something which a country does only when it wants to support and strengthen the regime or the group to whom the sale is made. Whatever restrictions or limits are placed on that sale, the sale is

a declaration of support- an implied alliance of a kind. You do not sell arms without saying, in effect: ‘In the light of the receiving country’s known policies, friends, and enemies, we anticipate that, in the last resort, we will be on their side in the case of any conflict. (Originally in the Far Eastern Economic Review, January 1971; quoted in Landgren-Backstrom 1980: 231)

The expression of friendship and support by the United States to the administration of President Arroyo is an incentive for the AFP for sourcing U.S. defense articles through FMS. This will also reinforce existing RP-US bilateral security relations as documented by the Mutual Defense Treaty and Visiting Forces Agreement, substantiated by the series of RP-US joint training exercises in the Philippines. Indirectly, this will address the external security concerns of the Philippines, especially in the hotly contested sovereignty claims over the Spratly Islands, specifically the Mischief Reef.

The benefits derived by sourcing through a government-to-government or Foreign Military Sales cannot be achieved using Direct Commercial Sales even if the DCS is sourced from the United States. The political advantage of FMS cannot be equaled by DCS because FMS is backed by the U.S. government (“USA Rethinks Foreign Military Sales,” 14 October 1998, www.janes.com. Accessed March 15, 2004).

The perception of corruption is another political factor to consider in choosing the method of procurement to be used in the acquisition of U.S. defense articles. Corruption is now closely watched in the AFP after mutinous soldiers on July 2003 claimed that one of their reasons for staging a coup d’état is the rampant corruption in the procurement activities of the AFP. Although the government and the AFP already have laws, policies and regulations, including the code of ethics to be followed in procurement, many corruption cases still exist. The investigation ordered by President Arroyo, conducted by the Office of the Ombudsman in CY 2003 regarding the allegations of graft and corruption in the procurement activities of the AFP ended with the filing of 195 indictment cases due to noted irregularities in the procurement of goods and services for the Philippine Navy alone [Jane’s Defense Weekly, 2002]. The investigation conducted by the Feliciano Commission created by President Macapagal-Arroyo revealed that corruption indeed marred the modernization funds of the AFP (“Internal Affairs, Philippines,” 2004).

The procurement of defense articles using FMS will likely reduce corruption, or the perception of it, in the AFP, as procurement personnel are not involved in the acquisition process except in the generation of the requirements and preparation of LOR. As the U.S. DoD manages and administers FMS on a “no profit-no loss basis”, the suspicion of corruption in procurement might be eliminated. This rationale may induce the government to resort to FMS procurement to maintain the political stability of the current administration.

6. Contract Administration

Contracting activity in the AFP was not afforded that much importance when the United States still maintained its bases in the Philippines. Most of the AFP’s defense requirements were provided by the United States under the U.S. military assistance program. The AFP acquired its defense articles and services without undertaking acquisition and contracting activities associated with the purchase. U.S. defense articles provided through FMS limits the participation of the purchasing country to requirements generation and submission of the LOR.

It was only after the termination of the U.S. Military Bases Agreement in 1991 that the AFP started to professionalize its acquisition and contracting workforce.

In a Master’s thesis at the Naval Postgraduate School, Commander Montanez concluded that the present AFP capability in contract administration is still inadequate. The AFP’s policies, rules and regulations on procurement were fragmented and subject to various interpretations. He stated, for instance, that Department Circular 1, which is the Implementing Guidelines, Rules and Regulations for the AFP Modernization Program, provides details on how to formulate contracts but does not give guidance on how to administer the contracts except for the preparation of the Program Status Report (PSR). He further stated that most of the laws, policies and regulations were focused on contract formation and not on contract administration, citing as an example EO 120, which governs countertrade arrangements, but did not touch on contract administration.

The current procurement of defense articles for the AFP in line with its modernization program was further hindered by the issuance of Executive Orders 235

and 240. These two E.O.s are believed to have resulted from the response to the clamor created by mutinous soldiers for the present administration to address corruption in the procurement activities in the Department of National Defense. In compliance with E.O 240, DND issued D.O. Number 205 which established a single AFP-BAC to handle acquisition and contracting jobs for the entire AFP below a P50 million threshold. Contracts with more than P50 million threshold will have to be approved and signed by the Secretary of National Defense (Trinidad, Personal Communication, 2004).

Circumstances occurring in the present AFP Equipment Acquisition Process tend to indicate that problems remain that delay the process. For instance, the tendency of the BAC to grant requests to foreign bidders for an extension of the date for the submission of bids, citing the bidders' failure to authenticate their eligibility documents, is clear evidence of a communications failure during the Invitation to Bid or pre-bid conference phase. Although the new law RA 9184 provides for specific timelines for the submission of bids, it has not been fully implemented (Trinidad, Personal Communication, May 7, 2004).

Another reason for the delay in procurement is the irregular attendance both of members of the AFP-BAC and the DND-BAC during their scheduled meetings. BAC members are only performing secondary functions on the Committee and are pre-occupied with their main jobs most of the time.

7. Defense Factors

The Philippines is still facing internal and external security problems. The AFP is still preoccupied containing the security threats posed by the local communist insurgents as well as the Abu Sayyaf terrorist group allegedly linked with the international terrorist movement Jemayah Islamiya. Meanwhile, sovereignty claims over the Mischief Reef and Kalayaan Island Group (KIG) in the South China Sea remain an external security threat for the Philippines. China, which is one of the six countries claiming these islands, has been seen as being aggressive in establishing structures in Mischief Reef claimed by the Philippines. The Philippines tries to link its security interest with regional defense, assuming that the United States would defend the Philippines in case China attempted to impose its will over Mischief Reef, as this is covered under the provision of the Mutual Defense Treaty of 1951 (Narcise, 2002).

The Mutual Defense Treaty of 1951 is an agreement between the United States and the Philippines to strengthen their collective defenses against external armed attack. Article II of the treaty says that “in order more effectively to achieve the objective of this treaty, the parties separately and jointly by self-help and mutual aid will maintain and develop their individual and collective capacity to resist armed attack (“Mutual Defense Treaty,” 1951).

Collective capacity to resist armed attack will be effectively attained only when there is commonality and interoperability of system, forces and equipment. The U.S DoD is motivated to sell US weapons systems to allies through FMS and FMF because this will enhance commonality and interoperability which in the future will enhance coalition operations. (“The United States Strategy for the East Asia-Pacific Region 1998,” <http://www.defenselink.mil/pubs/easr98/easr98.pdf>. Accessed March 3, 2004).

The present defense capabilities of the Philippines can be attributed largely to the security assistance provided by the United States to the Philippines since its independence in 1946. According to MGen Cicero Castellano, the Deputy Chief of Staff for Logistics, Armed Forces of the Philippines, the majority of the AFP’s inventory of equipment and platforms was acquired from the United States. The U.S. also remains the traditional source of maintenance funds for this equipment sourced from the United States (Mgen Castellano, Personal Interview, December 9, 2003).

Although some AFP weapons systems or components may be sourced from the commercial marketplace using Direct Commercial Sales, there are items which may be available only using FMS. Certain defense articles, especially spare parts available for sale through FMS, are most suitable for certain existing weapons systems of the AFP. This facilitates commonality and interoperability of forces and weapons systems for effective coalition operations.

C. SUMMARY

The chapter discussed the acquisition process used in the Philippines, including the governing rules and laws. It also identified major factors that influenced or affected the selection of the method of procurement to be used by Philippine decision-makers in the procurement of defense articles from foreign countries. The AFP Equipment Acquisition Process, which may lead to the use of Direct Commercial Sales, and the FMS

acquisition process are the procedures used by the AFP to procure materials locally and abroad. Existing laws as well as the political and economic situation of the Philippines may further influence the decision to choose either one of these two procurement methods.

The next chapter will present the advantages and disadvantages of FMS and DCS considering Philippines laws on procurement, processes and procedures, and the economic and political environment.

VI. COMPARATIVE ANALYSIS BETWEEN FMS AND DCS

A. INTRODUCTION

The Philippines has two methods by which it can procure defense articles from the United States, namely, DCS or FMS. The transfer of defense articles using these two methods needs the approval of the U.S. government through AECA and other statutes. The U.S. government has no preference as to the purchasing country's preferred method of procurement (DISAM Online Green Book, 2003). The transfer of the defense articles for both methods has been designed to achieve the common result of fulfilling the security and political objectives of the Philippines and the United States. The two methods have specific features, and in the purchaser's viewpoint, have corresponding advantages and disadvantages.

The characteristics of the two systems that reflect their advantages and disadvantages are discussed here to assist Philippine decision makers in their selection of the best method to acquire U.S. defense articles. However, special circumstances prevailing in the Philippines influence the decision for selecting the best method for procuring the needed U.S. defense articles.

B. ISSUES AND CONSIDERATIONS

1. Financing

The government of the Philippines may use either of two methods to pay for defense articles procured from the United States, i.e., Philippine national funds or U.S. Foreign Military Financing (FMF) grants/credits fund. FMF grant/credit funds are appropriated to provide financial support to eligible allied countries desiring to buy U.S. defense articles who do not have the needed cash for immediate payment. The Philippines is eligible to use such funds. The FMF fund is primarily used to finance Foreign Military Sales. Direct Commercial Sales may be funded by the FMF credit fund as well, but only in very rare cases. According to the DSCA Country Program Director, the Philippines has never been allowed to use the FMF credit fund to finance DCS.

AFP Comptroller Letter 82-9, dated 6 December 1982, allows the payment of the required initial deposit for FMS with funds from the AFP appropriations. For FMS cases, payments are made before the delivery of the defense articles. A signed LOA is not considered to be a binding contract without the required initial deposit from the Philippines. This initial deposit will be sent via wire transfer and held in an FMS trust fund at DFAS/DE, managed by DSCA. A cross leveling agreement allows the funds deposited by the Philippines in the FMS trust fund to be moved to and from a special holding account, or moved between separate FMS cases, thereby maximizing the use of the country's funds (DISAM Online Green Book, 2003).

In a Direct Commercial contract, items are delivered to the Philippines prior to payment. Terms of payment may be either in full cash payment, partial payment or installments, depending on the negotiated agreement.

FMF grant/credit provides an incentive for the Philippines to procure through FMS. By using the U.S. provided FMF grant/credit fund, the Philippines can save its own cash for later use for higher priority needs and avoid the sudden economic impact of costly purchases of U.S. defense articles.

2. Pricing

Price comparison between FMS and DCS remains a controversial issue. The U.S. government, as well as U.S. contractors, discouraged buyers from comparing the prices for the two methods of procurement. However, for the purpose of this thesis, it is important to present both sides of this issue.

The price indicated in the LOA is the best estimate of the cost to be incurred in an FMS transaction. The final or actual price for the defense articles being procured may be higher or lower than the estimated price in the LOA. The buyer country will have to pay the actual price, that is, the base price plus the authorized surcharges, whether the actual price is higher or lower than the LOA price. The price for an FMS case may become higher by as much as 25 percent compared to Direct Commercial Sales because of the application of investment and operational costs to the base price of the item.

The U.S. DoD is authorized by AECA to recover all costs incurred in the implementation and execution of a FMS case, which is in line with the U.S. government policy of the “no loss-no profit” basis for administering FMS cases. The base price for FMS items decreases when the ordered item is combined with DoD’s own requirement. This reduction results from the increased quantity of the items ordered from the contractor(s), thus attaining economies of scale.

The FMS price may also be affected by inflation because of the longer processing time in a FMS case. This situation will create another problem for the AFP, which depends on an annual program budget fixed by Congress except when the funding is for a multi-year procurement project approved by Congress.

Prices for DCS are influenced by the interplay of market forces. Unless the item is manufactured by only one source, competition will drive the prices of items down. A Firm Fixed Price (FFP) contract is the typical contract used in Direct Commercial Sales. FFP is characterized by a negotiated fixed price, a negotiated delivery schedule, and usually include penalties for the contractor’s failure to comply with the terms of the contract. Although this type of contract is riskier for the contractor, it may offer the contractor greater profits.

U.S. companies claimed that DCS price is lower because there is no “authorized charges” as is present in FMS cases. U.S. government officials indicated that the price quoted by DCS is cheaper because it does not include follow-on support and training. Furthermore, DCS can make higher profits through the sale of defense articles while under a FMS purchase, U.S. law and regulations may fix the percentage profit.

Price is a major consideration in the acquisition of defense articles by the Philippine government, as can be gleaned from the emphasis on the use of competitive bidding in the procurement process of the Armed Forces of the Philippines.

3. Flexibility in Contracting and Offsets

As offsets are used by buyer countries to enhance their economic and political interest, the United States and other foreign suppliers will have to accept it as an element of international market competition. The Philippines, as a buyer of U.S. defense articles, is no exception, as its laws, policies and regulations mandate the application of offsets in

the foreign procurement of capital equipment, machineries and other supplies. U.S. contractors have to compete with other foreign suppliers trying to win contracts with the Philippine government. Although offsets are not completely prohibited in FMS cases, the United States maintains a hands-off policy with respect to offset arrangements by allowing the concerned U.S. contractor and the Philippines to make the offset deal separately from the FMS case. In effect, the Philippines will be dealing with two contracts when it wants to arrange an offset with the contractor involved in an FMS case, one for the LOA and another for the offset contract with the private contractor. This process takes time to negotiate and may result in disconnects between the FMS contract and the offset arrangement. An interview with Ms. Mickles of DSCA reveals that the Philippines has never used offsets in Foreign Military Sales.

An offset is a major consideration in the selection of the method of procurement in the Philippines. It forms part of the eligibility requirements of bidders. It is easier for the Philippines to negotiate an offset arrangement under a DCS contract because it can deal directly with the U.S. contractor.

Aside from an offset, DCS may provide greater flexibility in contracting such as obtaining special warranty and tailoring special equipment to the particular needs of the AFP.

4. Buyer's Capability to Negotiate a Direct Contract

The Armed Forces of the Philippines has been dependent on the United States for the development and upgrades of its defense capabilities by acquiring U.S. defense articles through FMS. This has meant that there was less involvement of AFP personnel in acquisition and contracting of U.S. defense articles for the AFP. As such, AFP contracting personnel still lack the needed skills and experience to handle Direct Commercial Sales contracts, especially when it involves a complex weapons system.

Under the FMS system, DoD will conduct the contract administration in lieu of the AFP and is responsible for choosing the most qualified source, obtaining the best quality and fair price, as well as the timely delivery of the items to be purchased. Often, FMS and DoD orders are consolidated to obtain economic order quantity, thereby decreasing the item's unit price.

5. Buyer's Desire for U.S. Military Personnel Involvement

The involvement of U.S. military personnel in the military affairs of the AFP has its legal basis in the agreements and treaties signed by the two countries since Philippine independence in 1946. The Military Assistance Agreement (MAA) of 1947 paved the way for the creation of the Joint United States Military Advisory Group (JUSMAG), a contingent of U.S. military advisers permanently deployed in the Philippines, whose work focuses on facilitating the logistical and training requirements of the Philippines Armed Forces. JUSMAG personnel are still employed by the Armed Forces of the Philippines in purchasing needed U.S. defense articles using FMS. For example, the RP-US Joint Defense Assessment (JDA) reviewed and endorsed a comprehensive security assessment to assist the government of the Philippines in developing a defense program that will improve the ability of the AFP to address its existing security threats (“Joint Statement Between the United States of America and the Republic of the Philippines,” 2003).

The Armed Forces of the Philippines has benefited from its close working relationship with JUSMAG personnel since the early days of independence to the present. For example, as cited by the Chief of the Interlog branch of the Philippine Air Force's Office of the Assistant Chief of Staff for logistics, A4, most of the major defense equipment recently acquired by the Philippines from the United States is Excess Defense Articles sold through FMS. The recent procurement by the Philippine Air Force of the eight UH-1H helicopters (FMS Case PI-B-IAG) were Excess Defense Articles sold through FMS by the USG. These items were sold on an “as is, where is” basis, with no guarantee of either initial or follow-on support. However, JUSMAG personnel are not recommending procurement by the AFP of defense articles which cannot be sustained for future operations (Musico, Personal Communication, May 22, 2004).

Outside the FMS process, where the AFP may pursue efforts at purchasing Major Defense Equipment (MDE) using DCS, JUSMAG-Philippines personnel may also appear by aiding both parties in securing the required third-party transfer approval from the U.S. State Department. Without approval from the U.S. State Department, no such transfer of any U.S. (MDE) can ever take place, even if the parties involved are both allied with the U.S. government (Musico, Personal Communication, May 24, 2004).

6. Logistics and Training

One of the most important factors considered by the AFP in the procurement of defense articles is the availability of initial and follow-on support for the articles procured. The Total Package Approach (TPA) associated with FMS will make this possible. In the case of 19 OV-10A aircraft procured by the Philippines in 1992 (FMS Case PI-D-SBD), the Philippine government was informed of the availability of the TPA for the weapon system. The Philippine government accepted the TPA because there was no existing infrastructure at that time to support the operation and maintenance for this new weapon system. Included in the system's acquisition are the following:

- Purchase of initial spares support for one year
- Acquisition of all other necessary accessories such as test equipment, special tools, technical manuals and aerospace ground equipment (AGE) that established the initial support infrastructure
- Purchase of air munitions such as rockets, launchers, guns, and bombs that provided the OV-10A weaponry to support air strike missions
- Follow-on purchase of concurrent spare parts that provided the basic in-country supply system
- Transition training of pilots in the operation of the OV-10A
- Development of a maintenance capability by way of providing training and technical support equipment to PAF maintenance technicians at the organizational and intermediate levels (Musico, Personal Communication, May 5, 2004)

All provisions (spares, manuals, support equipment, training, technical reps, etc.,) necessary to allow the immediate deployment of the OV-10A aircraft to perform combat missions in the field as soon as they are delivered are included in the weapon system buy-out and indicated line by line in the LOA. Flight training of four Philippine Air Force pilots in the OV-10A was conducted in CONUS, while training for the PAF maintenance personnel for the aircraft was done in the Philippines by U.S. OV-10A technicians (Musico, Personal Communication, May 5, 2004).

FMS may be the best method of procurement by the Philippines for the OV-10A, since the U.S. Armed Forces uses this weapon system. The Philippines may be able to capitalize on U.S. experience and existing U.S. government logistics inventories. Under a Cooperative Logistic Supply Support Arrangement (CLSSA), most of the DoD inventory

and contracting system can be drawn upon to support the requirements for the spare parts of the OV-10A by the Philippine government. The DoD logistics system, in effect, serves as a procurement staff for the Philippines by procuring its required individual items from the current U.S. sources.

There are also some U.S. contractors who could provide full logistics support for the defense articles which they sell. If they are capable of furnishing the full logistics support, the results can be expected to be as stated in their contracts.

7. Procurement Lead Time/Delivery Schedule

In the Master's thesis of Steven J. Colcombe, he quoted CDR Michael R. Pease, USN Office of Defense Cooperation, United States Embassy Rome as saying:

DCS is much more responsive than FMS, and incentives are much better aligned to support the end user. It is not the 2.5% FMS admin fee that countries object to, it is that dealing with FMS adds a huge layer of red tape, delays and risks.

The same situation is happening in the Philippines in the case of the procurement of eight UH-1H helicopters from the United States through Excess Defense Articles. The contract was signed in 2002, but the helicopters were received in 2004.

The marked advantage of DCS over FMS is the delivery schedule. For defense articles already in production, delivery is faster through DCS than through FMS. Contractors under DCS are bound to follow the negotiated fixed delivery schedule stipulated in the contract or face a penalty for failure to do so. On the other hand, once the delivery schedule has been fixed under DCS, and an emergency situation arises, the Philippine government cannot simply change the negotiated fixed delivery schedule to meet its needs. Under FMS, DoD can remedy the situation if the items needed by the Philippines are available in the DoD stock or under current production for DoD procurements. DoD may divert these items under production to the Philippines or ship the items available in the DoD inventory to meet the emergency needs of the Philippines.

Causes for delays in FMS include the time for the development, review and acceptance of the LOA, and then consolidating these requirements for the next purchasing cycle, followed by the contract negotiation by DoD contracting personnel and U.S. contractor(s).

C. SUMMARY

FMS and DCS differ in style and substance, but also have some similarities. Sales or the transfer of defense articles using these two methods of procurement need the approval of the U.S. government and are governed by the AECA. Both are also designed to achieve the common result of an arms transfer that will enhance the security and political objectives of the Philippines and the United States.

Issues have been analyzed and differences between the two approaches have been identified. The Philippines places great weight on price, delivery schedule, offsets and logistics and training. DCS appeared to be more responsive for the first three considerations, while FMS promises the better choice when buying a complex weapon system used by the U.S. military. Procurement through FMS also enhances standardization and interoperability of the AFP and the US armed forces.

When the Philippines contemplates buying a complex weapons systems via a Total Package Approach, it is wise to buy using FMS, as it offers complete infrastructure and logistics support for the item(s). However, at the present time most of Philippine procurement only involves spare parts and other support system already in use in the Philippines, TPA is not used frequently.

Procurement method advantages and disadvantages may be difficult to assess, especially when there is a lack of knowledge and biased evaluations of the relative merits of each system. The potential advantages for each of the two procurement systems, as well as the common misperception of FMS and DCS are summarized in Appendix A.

However, the decision for selecting the best method to use in procuring the needed U.S. defense articles will be influenced by the economic and political circumstances prevailing in the Philippines at that particular time.

The next chapter will present the Researcher's conclusions, recommendations, and answers to the research questions.

VII. CONCLUSIONS AND RECOMMENDATIONS

A. INTRODUCTION

The goal of this thesis was to analyze the advantages and disadvantages of FMS and DCS and determine the most advantageous method of procurement to use in the procurement of U.S. defense articles needed for the modernization of the Armed Forces of the Philippines. The thesis traced the evolution of U.S. security assistance policies as well as the history of U.S. security assistance to the Philippines. The research conducted for this thesis indicates that there are many factors decision-makers in the Philippines and other concerned government agencies to consider in choosing the method of procurement to be used in the acquisition of U.S. defense articles. These factors were analyzed in conjunction with current U.S. laws, policies, and methodologies governing FMS and DCS. Based on the analysis and interpretation of the data gathered as well as the author's personal observations, conclusions and recommendations are provided.

B. CONCLUSIONS

Foreign Military Sales is characterized by bureaucratic red tape, making the processes and procedures lengthy, resulting in delayed delivery of the items bought and possible price changes due to inflation. Thus, foreign buyers have shifted to DCS, as it provides faster delivery, fixed prices and warranties, easier arrangements for offsets, and greater flexibility to tailor requirements to the customer's needs.

FMS procurement of items used by the U.S. Armed Forces enables the purchasing country to benefit from quality follow-on logistics support and training. Buying through FMS also promotes standardization and enhances interoperability for mutual defense and coalition operations. The apparent lack of skills and experience by acquisition and contracting personnel in the Philippines warrants the current use of FMS to obtain the best value defense articles from the United States.

The Philippine government gives high priority to an item's price, delivery schedule and the application of offsets in the contract. On those points, DCS has proven to be more responsive than FMS.

The selection of the method of procurement will be influenced by the economic and political situation prevailing in the Philippines at a particular time. As a developing country, the Philippines still needs security assistance from the United States to be able to effectively address its current internal and external threats. Eligibility for Excess Defense Articles, Military Education and Training, and Foreign Military Financing fund are incentives for the Philippine government to procure items through FMS. Procurement through FMS will enhance interoperability and promote the existing defense and security relationship between the Philippines and the United States.

C. RECOMMENDATIONS

The U.S. government should improve the FMS system so that it is more businesslike, including the application of countertrade. It is necessary to institute reforms to streamline the FMS process to elicit better responses to the needs of the customers, i.e., obtaining the items at the right price, at the right time and can best address the purchasing country's defense requirements.

The Philippines should use FMS in procuring items in use by the U.S. Armed Forces, as it promises better follow-on logistics support and offers opportunities for training. It will also improve interoperability and enhance the security agreements between the Philippines and the United States.

On the other hand, DCS promises better price, timely/early delivery and the potential for offsets, which are the main issues of the Philippines in its procurement policy. The Philippines should not only consider the economic side of the procurement but also consider the political and security implications of the purchase. The purchase of U.S. defense articles should strike a balance between economic and security/defense considerations.

D. SUMMARY AND REVIEW OF RESEARCH QUESTIONS

1. Primary Research Question

What is the most advantageous method of procurement to be used by the Philippine government in the acquisition of defense articles from the United States for use by the Armed Forces of the Philippines?

Generally, it may not be possible to do a direct comparison between FMS and DCS. There are important differences affecting prices, quality, schedule, direct buyer involvement, training and follow-on logistical support, application of offsets, and other factors when using FMS and DCS.

The strongest argument in favor of DCS will come from the existing Philippine laws on procurement which requires the use of competitive public bidding with the goal of obtaining the lowest price possible, a streamlined procurement process to achieve an earlier delivery schedule, and accompanying countertrade in all contracts for foreign procurements. A DCS contract is more responsive to all of these issues.

On the other hand, the Philippines still lacks the financial capability to support its defense modernization program needs fully. Security assistance from the United States which may be made available through FMS induced the Philippine government to procure through FMS, although sometimes at a higher cost and delayed delivery. An application for countertrade under FMS contracts is also more difficult to obtain than in DCS, resulting in an immense disincentive to the Philippine decision-makers to opt for FMS.

It must be recognized by Philippine decision-makers that it is not only the economy of the country at stake in the procurement of defense articles. Consideration for the politico-military situation of the country vis-à-vis the United States should be taken into account when buying U.S. defense articles. As previously discussed, buying through FMS has political advantages over DCS.

It is, therefore, up to the Philippine decision-makers to determine the relative weights of these factors considering the prevailing economic, political and security situation of the Philippines at a particular time.

2. First Subsidiary Question

- What is Foreign Military Sales and how does it operate as model of procurement by the Philippine government?

Foreign Military Sales (FMS) is a component of the United States Security Assistance Program authorized by the Arms Export Control Act (AECA). It provides for the transfer of defense articles and/or defense services, including training, to eligible

foreign purchasers. It is a government-to-government sale of U.S. defense articles and services, usually from Department of Defense (DoD) stocks or through new procurement under DoD-managed contracts (DoD 5105.38-M, 2003).

FMS is operated and managed by DoD through DSCA on a “no profit-no loss” basis, thus the purchasing country will have to pay for costs incurred by DoD in completing the sale transactions. The FMS process basically consists of seven phases. These are the project definition phase, wherein the requirements and specific needs of the purchaser are determined; the request phase, wherein the Letter of Request (LOR) is prepared by the purchaser country, sent to the United States, reviewed by the State Department and validated by MILDEP; the offer phase, wherein the LOA is prepared, reviewed and forwarded to the purchaser country; the acceptance phase, wherein the purchaser country reviews the LOA, signs it and sends it back to the Implementing Agency (IA) in the United States; the implementation phase, wherein deposits are received by the DFAS and FMS directives are issued; the execution phase, during which the item is delivered to the customer; and finally, case closure when DFAS bills the customer, reconciles the records, and the MILDEP closes the case. Payment for FMS may come from Philippine national funds and/or from U. S. provided Foreign Military Financing.

3. Second Subsidiary Question

- What is Direct Commercial Sales and how does it operate as a model of procurement by the Philippine government?

A Direct Commercial Sale (DCS) is a sale made by a U.S. defense contractor directly to a foreign buyer without U.S. government intervention except for the licensing of the export sale in accordance with the AECA. Under DCS, the purchaser country has more direct involvement during contract negotiation, allows firm fixed pricing, fixed delivery, warranty and penalty for violation(s) of provisions of the contract. (DISAM Online Green Book, 2003).

4. Third Subsidiary Question

- What are the pertinent laws, rules and regulations, and policies that govern Foreign Military Sales and Direct Commercial Sales when used by the Philippine government in its procurement activities?

Before a sale of U.S. defense articles to a foreign country, whether through FMS or DCS, the country must be considered eligible to purchase U.S. defense articles. Eligibility is affirmed by a Presidential Determination documented by the President's written memorandum to the Secretary of State. AECA governs the purchase of U.S. defense articles through either FMS or DCS.

The Philippine government, on the other hand, has existing laws that govern both FMS and DCS as discussed in Chapter IV. The most significant and most common provision in these laws, policies and regulations governing foreign procurement is the requirement for countertrade. For instance, E.O 120 issued on August 19, 1993, directs the national government, its departments, bureaus, agencies and offices, including government-owned and controlled corporations, to adopt countertrade as a supplemental trade tool with respect to the importation or procurement of foreign capital equipment, machinery, products, goods and services.

5. Fourth Subsidiary Question

- How do defense articles procured through FMS or DCS affect the operational effectiveness and efficiency of the Armed Forces of the Philippines?

The majority of the Philippine defense equipment, including logistical support, was sourced from the United States through FMS and DCS, but mostly with FMS. Some items are only authorized to be sold through FMS due to security considerations. Procurement through FMS promotes commonality, standardization and interoperability with the U.S. forces, as well as enhancing a closer security relationship between the Philippines and the United States.

The benefits derived by sourcing through a government-to-government or Foreign Military Sales cannot be achieved using Direct Commercial Sales even if DCS is sourced from the United States. The political advantage of FMS cannot be equaled by that of DCS because the U.S. government backs FMS.

E. AREAS FOR FURTHER RESEARCH

The following are some suggested areas for further research related to the thesis:

- To study the possibility of privatizing the administration and management of FMS.

- To study the effect of countertrade on FMS to both the buyer and the seller.
- To study the appropriate amount of surcharges for FMS.

APPENDIX. POTENTIAL ADVANTAGES OF FMS AND DCS

A. FOREIGN MILITARY SALES

Potential Advantages		Considerations	
1.	Total package approach based on U.S. military experience.	1.	Purchaser must decide whether the total package may exceed his needs or financial capabilities.
2.	U.S. government uses its own procurement procedures and acts as procurement agent for foreign countries.	2.	Sophisticated foreign purchasing staff may (or may not) be able to achieve better overall deal by negotiating directly with contractor.
3.	Proven and established logistics support for items common to DoD.	3.	It occasionally is possible to achieve a full range of contractor logistics support.
4.	Federal Acquisition Regulations (FAR), economic order quantity buys, use of Government Furnished Equipment (GFE) or Government Furnished Materials (GFM), and competitive procurements tend to reduce price.	4.	Compliance with DoD procedures also tends to increase lead times, thus emphasizing need for country planning to start procurement process earlier.
5.	Facilitates establishment of design configuration and enhances potential for standardization.	5.	Purchaser must decide on the degree of standardization required for a particular purchase.
6.	Purchaser pays only the actual cost to DoD (including management expenses), with profits controlled by FAR.	6.	While initial LOA estimates tend, in the aggregate, to be considerably higher than final LOA costs, final costs fluctuate (both up and down), making purchaser funds management more difficult.

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| <p>7. Cross-leveling in the FMS Trust Fund can maximize use of country funds.</p> | <p>7. Firm fixed priced contracts and fixed payment schedules can be obtained under direct commercial contracts.</p> |
| <p>8. Quality control to assure item meets MILSPECs is done by U.S. government personnel.</p> | <p>8. This service can be purchased under FMS for certain commercial contracts</p> |
| <p>9. Items may be available from DoD stocks in times of emergency.</p> | <p>9. Availability is significantly dependent on DoD's own priorities and inventory positions.</p> |
| <p>10. Government-to-government obligation, assuring involvement of DoD personnel in military planning, deployment concepts, operational planning, etc.</p> | <p>10. If closer military-to-military relationships are a purchaser objective, FMS provides one avenue toward achieving them.</p> |
| <p>11. Better access to training at U.S. military schools.</p> | <p>11. Purchaser can procure hardware under commercial contract, and generally obtain associated training at U.S. military schools via FMS.</p> |
| <p>12. Purchase of end item facilities maintenance of design configuration, provision of technical data, modifications, and catalog information.</p> | <p>12. Arrangements for continual configuration commonality with DoD are an integral objective of the FMS system.</p> |
| <p>13. FMS customers can use ILCS system.</p> | <p>13. Commercial customers must rely on the commercial telecommunications system.</p> |

B. DIRECT COMMERCIAL SALES

- | Potential Advantages | Considerations |
|--|--|
| <p>1. Potential for fixed delivery or fixed price, with penalty if contractor fails.</p> | <p>1. Requires considerable experience and sophistication by country negotiators.</p> |
| <p>2. Business-to-business relationship allows country to negotiate cost and contract terms.</p> | <p>2. Closer military-to-military relationships are a purchaser's objective; FMS provides an avenue to achieve this objective.</p> |

Potential Advantages		Considerations	
3.	Direct negotiations with contractor can result in a quicker response.	3.	Requires considerable experience and sophistication by country negotiators.
4.	Sometimes the only source of logistics support for items not included in U.S. inventory.	4.	Purchaser must decide upon desired degree of standardization with U.S. forces.
5.	More capability to tailor package to unique country needs.	5.	Tailored” package may detract from standardization desires.
6.	Continuity of personal contacts with contractor technical personnel.	6.	Generally, also can be arranged via FMS.
7.	New equipment directly from production line.	7.	Generally, also can be arranged via FMS, although some spares may come from DoD inventories.
8.	Lower prices possible under certain circumstances.	8.	Significantly dependent on item or service involved and sophistication of country negotiators.
9.	Generally fixed payment schedule which eases budgeting problems.	9.	Preponderance of payment schedules is more “front-loaded” than under FMS.
10.	Purchaser can include offset provisions in one contract.	10.	Purchaser can negotiate offsets (directly with contractor) and still procure under FMS.
11.	FMS administrative surcharge and DoD management costs can be avoided.	11.	Purchaser must consider entire cost of transaction, including his contracting staff costs and possibly increased contractor administrative costs.
12.	Commercial purchase of some types of items could help to create and develop a procurement capability.	12.	Scarcity of resources and time may not allow for this type of on-job training for procurement staffs.

C. COMMON MISPERCEPTIONS OF FMS OR COMMERCIAL SALES

Misperceptions		Facts	
1.	FMS prices are cheaper.	1.	Depends on item being purchased,

Misperceptions	Facts
	negotiating skills, and many other variables.
2. Commercial prices are cheaper	2. Depends on item being purchased, negotiating skills, and may other variables.
3. FMS offers better assurance for approval of transfer of technology.	3. Technology release considerations are identical for FMS and commercial sales.
4. Commercial sales offer a better assurance for approval of transfer of technology.	4. Technology release considerations are identical for FMS and commercial sales.
5. FMS is unreliable during hostilities involving either the user or the U.S. government.	5. Foreign policy or DoD military priority decisions affect the flow of supplies to a country and can be expected to relate to the resource involved. FMS orders may still be filled depending on the nature of the hostilities.
6. Commercial sales are unreliable during hostilities involving either the user or the U.S. government.	6. Foreign policy or DoD military priority decisions affect the flow of supplies to a country and can be expected to relate to the resource involved. There may be a tendency to fill FMS orders first, depending on the nature of the hostilities.
7. FMS provides slow or slack delivery schedule, with frequent slippages.	7. The numerous built-in FMS system safeguards do slow the procurement process sometimes, although there seldom are slippages once delivery schedules are established. However, in a contingency situation where a USG decision is made to divert items from service stocks and expedite delivery, service is exemplary.
8. Nonrecurring cost (NRC) recoupment charges for Major Defense Equipment is always accessed on FMS sales.	8. Nonrecurring cost (NRC) recoupment waivers may be authorized for FMS on a case-by-case basis. Recent history indicates a high probability of waiver approval.
9. A country cannot have an offset arrangement when they have an FMS case.	9. A country may leave an offset arrangement in an FMS agreement, but the U.S. government will not be the enforcer of offset arrangements between the country and the

Misperceptions	Facts
	commercial contractor.
11. FMS system is characterized by a lack of continuity of personnel contact due to military personnel rotations.	11. While this may be true for some cases, there are many DoD civilians who do not rotate. Also, military tour is normally three to four years about equal to commercial executive transfer patterns.
12. No offset arrangements or coproduction programs are possible under FMS.	12. Not true. These are common to many FMS LOAs. However, offsets must be negotiated separately by the purchaser with the contractor.
13. Only FMS required U.S. government approval and congressional notification (AECA, Section 36(b), if necessary.	13. All items meeting AECA notification thresholds require notification under both sales systems. AECA, Section 36(c) applies to commercial sale notifications to Congress.
14. U.S. government reserves the right to terminate an FMS sale in the U.S. national interest.	14. Applies equally to both FMS and commercial sales systems.
15. Quality control is not assured for items bought commercially.	15. Contractor sales depend on product reputation. Also, USG quality control procedures may be purchased for standard items.
16. Contractor involvement stops once an end item is sold.	16. Contractor participation in follow-on support and maintenance programs is common under either commercial or FMS.
17. U.S. government controls third country sales only for items sold under FMS.	17. Criteria and policy are the same for items purchased through either commercial or FMS.

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