



December 20, 2010

Office of Federal Procurement Policy
725 17th Street, NW, Room 9013
Washington, DC 20503
ATTN: Raymond J.M. Wong
By e-mail: casb2@omb.eop.gov

RE: (b)(14) Overseas Exemption NPR

Subject: Notice of Proposed Rule – Cost Accounting Standards: Elimination of the Exemption From Cost Accounting Standards for contracts Executed and Performed Entirely Outside the United States, Its Territories, and Possessions

Dear Mr. Wong:

The Aerospace Industries Association (AIA) is pleased to have the opportunity to respond to the subject Notice published October 20, 2010 in the Federal Register, and we offer the following comments and recommendations.

According to our most recently published Aerospace Facts & Figures 2010, aerospace exports in 2009 totaled \$81.2 billion and accounted for 7.7 percent of total U.S. merchandise exports. This vital U.S. industry employed 644,200 in 2009, representing 8.8 percent of durable goods manufacturing employment. The aerospace industry continues to enjoy a trade surplus. This surplus is from export sales enabled by imports of primarily aircraft parts made by foreign concern subcontractors not covered by CAS but many of whom would become covered should your proposed rule become a final rule without revision. Our issue with the proposed elimination of this CAS exemption is the impairment to the U.S. contractors' ability to compete for defense industry export sales. While we believe these to be unintended consequences, this harm to the U.S. contractors and the related broader harm to the U.S. economy is the focus of our response to your proposed rule.

In more than 100 industrialized countries around the globe, foreign companies bidding to sell defense industry products must satisfy industrial participation requirements, also known as offsets, for their bid to be accepted for consideration. The list of countries with these requirements includes Canada, United Kingdom, Turkey, South Korea, Saudi Arabia, India, Italy, Israel, Netherlands, and Taiwan. We note that President Obama personally visited India and Saudi Arabia recently to advance their consideration of purchasing U.S. defense industry products valued at \$12 billion and \$60 billion, respectively. The Foreign Military Sales (FMS) to India of 126 fighter aircraft worth \$12 billion is a competition which includes not only U.S. contractors but also other non-U.S. offers such as the SAAB GripenNG, Dassault Rafale, Eurofighter Typhoon, and Russian MIG-35. The Request for Proposal (RFP) issued by India for this competition requires offsets totaling 50 percent of the value of the proposal submitted,

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which could mean up to a \$6 billion value of USG subcontracts from U.S. contractors to Indian companies. For offset requirements with Saudi Arabia, the foreign government must approve all offset projects and one of the criteria for the evaluation is "Conform to Saudi Laws and regulations and recognized Saudi values and traditions". We question whether demanding Saudi Arabian companies to comply with CAS when performing offsets may be viewed as unacceptable based on this criterion and possibly even an affront to their sovereignty.

Offset agreements committed to by U.S. contractors are mandatory in almost all foreign markets for export sales. The U.S. Department of Commerce, Bureau of Industry and Security, collects data from U.S. contractors for all offset agreements exceeding \$5 million, and publicly reports that data in its annual "*Offsets in Defense Trade*". The most recent report dated December 2009 states, "During 1993-2008, U.S. defense firms reported 9,877 offset transactions with 47 countries with an actual value of \$48.96 billion and offset credit value of \$58.32 billion." The study reports that these offset transactions related to defense export sales totaling \$97.13 billion. The study notes that in 2008 alone, "U.S. firms reported 628 offset transactions with 30 countries with an actual value of \$3.23 billion, and an offset credit value of \$4.71 billion." Because establishing relationships with foreign subcontractors to develop potential offset placements is a critical part of positioning for new contract awards for export sales, often those relationships are developed by U.S. contractors through strategic placement of USG subcontracts in anticipation of new export sales opportunities and related offset obligations. However, such strategic subcontracting would not be reflected in the U.S. Department of Commerce reports since an offset requirement may not yet exist, so the number and value of foreign concern subcontracts potentially exposed to CAS applicability by the Board's proposed rule is significantly more than those provided here.

It has been a long standing belief that the export of defense industry products is beneficial to the U.S. Government, and U.S. laws and regulations have reflected this. In the National Defense Authorization Acts for FY 1988 (Pub. L. No. 100-202) and FY 1989 (Pub. L. No. 100-456), Congress passed provisions to make allowable costs incurred in promoting the export of all U.S. defense industry products, and those provisions were incorporated into the Federal Acquisition Regulations (FAR) in 1991. This belief has been underscored during 2010 by a number of events highlighting the importance of exports to the U.S. economy. On March 11, 2010, an Executive Order was released to establish the National Export Initiative. The Executive Order asserted that, "A critical component of stimulating economic growth in the United States is ensuring that ***U.S. businesses can actively participate in international markets by increasing their exports*** of goods, services, and agricultural products" [Emphasis added]. The Order goes on to establish the Administration's goal of doubling exports over the next 5 years. Given that aerospace is the single largest category of U.S. exports, we do not believe such a goal is obtainable without significant participation from our industry. Your rule, as proposed, would create competitive disadvantages for U.S. contractors in their attempts to win new contracts to export defense industry products.

We believe the need is compelling for an exemption from CAS for foreign concerns because of the benefit to U.S. exports, and we disagree that any other existing CAS exemption will satisfy this need effectively. Given the developments in the global economy since the initial writing of the existing exemption, rather than its removal, we recommend revising the language to clarify the purpose of the exemption. For example, we agree with the Board that the location of contract execution is irrelevant to the applicability of CAS, so that criteria should be

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eliminated from the exemption. We strongly encourage the CAS board to consider revising exemption #14 to read as follows.

Subcontracts awarded to a foreign concern with a U.S. prime contractor, where the subcontract will be substantially performed (e.g., product manufactured, services rendered) outside the United States, its territories, and possessions.

Please refer to the attachment to this letter for a more detailed analysis and supporting information and data related to our concerns.

If you have any questions on this letter or would like to meet with AIA representatives to discuss this subject, please contact Richard Sylvester at (703) 358-1045 or at richard.sylvester@aia-aerospace.org.

Sincerely,



Richard K. Sylvester
Vice President, Acquisition Policy

Attachment

ATTACHMENT

1. Practical considerations of foreign concern subcontracts for offsets

When a contractor submits a proposal for a sales contract award to a foreign country government, there is often a stated offset requirement (percentage or amount) in the RFP. There may be an offset requirement whether the RFP is competitive or sole-source. Before a proposal can be submitted, the contractor must establish a plan for meeting the offset requirements which will then be submitted with the proposal.

In order to develop a plan to satisfy an offset requirement to submit a proposal or in anticipation of the RFP for the export sale, a contractor will seek out foreign concerns in the country to assess its options. Considerations include technical capability, production capacity, access to raw materials, and shipping requirements. A contractor will then determine what aerospace components may be able to be subcontracted to a foreign concern in the country. Often, due to limitations in the industrial base, the subcontracts cannot be effectively competed. One major contractor estimated that less than 20 percent of foreign concern subcontracts in India could be competed because of industrial base limitations. Broader global competition would defeat the purpose of the in country subcontract award to enable the export, so such competitions would be pointless. The lack of competition, however, creates an exposure for CAS applicability should the existing exemption for foreign concerns be eliminated.

The foreign concern subcontracts awarded must be significant enough to satisfy offset requirements and justify the shipping costs of the components to the U.S. where final assembly of the products by the prime contractor occurs. The foreign concern subcontract is often not simply a subcontract to the export sales contract; it is part of the normal supply chain for the product. Thus, when the components are shipped to the U.S. location, they are generally used for final assembly in the production line without regard to end customer—U.S. government or foreign government.

Performance on the offset obligations may begin with the RFP issuance and either run concurrently with performance of the export sales contract or have a separate contractually agreed to period of performance. The foreign country government audits to validate the offset progress through reporting on contract performance, milestone achievements, and program completion. Penalties are applied to the U.S. contractor for failure to meet offset requirements.

2. Competition for limited foreign concerns to satisfy offsets

Satisfying offset requirements is particularly challenging in countries whose industrial base has limited capability for performing aerospace work. This lack of capability is one of the reasons the foreign government requires the industrial participation programs (offsets) to develop the country's industrial base.

India is an example of the challenging environment of exports and offsets for U.S. contractors. According to Aviation Week (November 15, 2010), India's purchase of 6

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Lockheed Martin C-130Js to begin delivery in December 2010 are the first U.S. built aircraft acquired by India in 40 years. Based on the AIA publication Aerospace Facts & Figures 2009, the U.S. had no imports of aerospace products from India during 2004-2008. These facts indicate that U.S. contractors are unlikely to have extensive relationships with foreign concern aerospace subcontractors in India who are capable and willing to accept offset work. The \$12 billion 2010 competition for the 126 fighter jet aircraft includes a 50 percent offset requirement (\$6 billion). A study by defense contractors of the aerospace capabilities in India yields about 18 companies as potential subcontractors (see Appendix I). Those same 18 Indian companies will likely be pursued by all of the 6 prime contractors competing for the contract award. Given the limited capability, limited production capacity, and the amount of work necessary to satisfy a \$6 billion offset requirement, the competition among prime contractors for Indian subcontractors would likely be fierce. It seems unlikely that the Indian companies would be willing to compete against each other for the subcontracts since award is nearly inevitable by some prime contractor. In addition, it seems highly unlikely that the Indian companies would be willing to accept subcontracts from U.S. contractors requiring them to comply with CAS—even if compliance is limited to CAS 401, 402, disclosure statement submittals and filing cost accounting practice changes—rather than accept subcontracts from the non-U.S. competitors. Thus, U.S. contractors would be at a serious competitive disadvantage in their ability to satisfy the Indian offset requirements vital to winning the jet fighter competition.

This competitive disadvantage is worse in Saudi Arabia, Turkey, and South Korea where the industrial base has fewer capable aerospace companies (refer to Appendix I). Yet these are the countries anticipated to be in the market for acquiring defense products with associated offset requirements.

3. Materiality of foreign concern subcontractors

According to the U.S. Department of commerce, Bureau of Industry and Security, "*Offsets in Defense Trade*" December 2009 report, during the 15 years from 1993 to 2008 U.S. defense firms reported 9,877 offset transactions in excess of \$5 million. This is an average of over 650 transactions annually. The 9,877 transactions are spread across 47 countries, yielding an average of about 210 transactions per country. Our own survey of AIA defense industry members indicates that when foreign concern subcontracts less than \$5 million in value are considered, the population of transactions is thousands more than the 650 annual average.

Given the industrial base limitations in a number of these countries, it is likely that some foreign concerns have multiple subcontracts placed by U.S. companies to satisfy offset requirements—almost certainly some of these foreign concerns have subcontracts in excess of the \$50 million trigger for submittal of a disclosure statement and the related notification of changes in accounting practices. Our survey of AIA defense industry members indicates that several large U.S. contractors have already placed a number of subcontracts with foreign concerns in excess of \$50 million. .

The same limited number of foreign concerns are accepting subcontracts to satisfy offset requirements not just from U.S. contractors but non-U.S. contractors too, such as in the fighter aircraft competition in India. In these circumstances, the competition by prime

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contractors to secure in country subcontracts with the few capable foreign concerns available effectively eliminates the ability to compete the subcontracts. Clearly the foreign concern subcontractors have the advantage since the prime contractors are required by industrial participation to use them. Our survey of AIA defense industry members indicates that of foreign concern subcontracts in excess of \$650 thousand less than 20 percent of them are competed.

The Government report indicated that from 1993 to 2008, 48 companies reported foreign concern subcontracts in excess of \$5 million to satisfy offset requirements to enable exports. Our member companies surveyed regard using foreign concern subcontractors a business reality continuing to grow for those who export.

We believe this data illustrates why a CAS exemption for foreign concern subcontracts is a significant concern for U.S. contractors and is not limited to only a small number of contractors and subcontractors.

4. No other exemption to CAS applies

There is a misperception that some other exemption to CAS could effectively be relied upon in circumstances where the current exemption #14 is used. This is not correct. This is illustrated below by examining the criteria for each CAS exemption in 9903.201-1(b) and its applicability to actual facts and circumstances.

- (1) **Sealed bid contracts** – The criteria for using sealed bid contracts are found in FAR Subpart 6.4 and FAR Part 14. The criteria include that time permits for the solicitation and evaluation of bids, the award will be made on the basis of price and other price-related factors, no discussions with the responding offerors about the bids will be necessary, and there is a reasonable expectation of receiving more than one bid. Sealed bidding would not be effective for contracting with foreign concerns to secure subcontracts for offsets. Discussions with the offerors will always be necessary. It is highly unlikely to expect to receive multiple bids, if any, since not only is the number of capable companies limited but other non-U.S. contractors are likely offering subcontract opportunities to the same foreign concerns to meet offset requirements. Technical capability must be considered in addition to price.
- (2) **Negotiated contracts and subcontracts not in excess of \$650,000** – Based on the study reported by the U.S. Department of Commerce report there are over 650 transactions annually in excess of \$5 million. A study by several major contractors indicates foreign concern subcontracts with nearly 2,000 suppliers worldwide with an average subcontract value of over \$700,000.
- (3) **Contracts and subcontracts with small businesses** – This applies only to U.S. businesses, so this exemption would not be relevant to foreign concerns.
- (4) **Contract and subcontracts with foreign governments or their agents or instrumentalities or, insofar as the requirements of CAS other than 9904.401 and 9904.402 are concerned, any contract or subcontract awarded to a foreign concern** – We understand this exemption relieves foreign concerns of

most CAS standards. However, we believe the applicability of CAS 401 and 402 would be a deterrent to foreign concerns in accepting subcontracts to satisfy U.S. contractor offset requirements when the same foreign concerns can obtain subcontracts from non-U.S. prime contractors without any CAS requirements. This deterrent effect would be exacerbated when U.S. contractors are competing against foreign competitors in countries with a limited industrial base. A greater deterrent to foreign concerns—especially those with multiple subcontract awards who will reach the \$50 million threshold—are the requirements to submit a disclosure statement and notification of changes in accounting practice with cost impact analyses. The AIA survey of defense industry members indicates that several large U.S. contractors have already placed subcontracts with foreign concerns in excess of \$50 million. For the Indian RFP for fighter jet aircraft with the related \$6 billion offset requirement, it is likely that Indian concerns will reach the disclosure statement threshold. This exemption would be insufficient to protect the interests of the U.S. government related to exports. Even partial CAS coverage will weaken the competitive position of U.S. contractors by weakening their ability to meet offset requirements.

- (5) **Contracts and subcontracts in which the price is set by law or regulation** – This exemption is irrelevant to foreign concern subcontracts for aerospace products.

- (6) **Firm fixed-priced, fixed-priced with economic price adjustment (provided that price adjustment is not based on actual costs incurred), time-and-materials, and labor-hour contracts and subcontracts for the acquisition of commercial items** – While a limited number of foreign concern subcontracts may qualify for this exemption, a significant number will not. For example, the major subcontracts actually being performed by foreign concerns for F-35 Joint Strike Fighter or the F/A-18 Super Hornet components would not be considered commercial items. The AIA survey of defense industry members indicates that of foreign concern subcontracts in excess of \$650 thousand in value only about 10 percent of them are for commercial items.

- (7) **Contracts or subcontracts of less than \$7.5 million, provided that, at the time of the award, the business unit of the contractor or subcontractor is not currently performing any CAS-covered contracts or subcontracts valued at \$7.5 million or greater** -- Based on the U.S. Department of Commerce report, there are over 650 transactions annually in excess of \$5 million. The AIA survey of defense industry members indicates that of foreign concern subcontracts in excess of \$650 thousand, about 15 percent are for \$7.5 million or more. For the impending Indian fighter jet \$6 billion offset requirement and the limited number of technically capable companies to receive the subcontract awards, Indian companies are likely to receive contracts in excess of the \$7.5 million threshold. The \$50 million threshold requiring the submission of a disclosure statement, notice of cost accounting practice changes, and calculation of cost impacts will be reached as well. It is likely that the most technically capable foreign concerns with adequate production capacity are most likely to be at risk for CAS coverage through award of offset subcontracts in excess of \$7.5 million. This exemption

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would be insufficient to protect the interests of the U.S. government related to exports.

- (8) **Subcontractors under the NATO PHM Ship program to be performed outside the United States by a foreign concern** – We understand this exemption to have been specific to the refurbishment of certain ships performed by other countries. This exemption is not relevant to foreign concern aerospace subcontracts.
- (9) **Firm-fixed-price contracts or subcontracts awarded on the basis of adequate price competition without the submission of cost or pricing data** –The limited technical capabilities of the industrial bases of many countries in which U.S. contractors are seeking foreign concern subcontractors to satisfy offset requirements makes competition not tenable. Appendix I lists the various foreign concern subcontractors and their relative capability assessment. This exemption will have some applicability for subcontracts awarded for offsets to foreign concerns in countries with an established aerospace industrial base. However, in the most competitive emerging markets, such as India, South Korea, Saudi Arabia, and Turkey, competition for subcontracts will be severely limited by the industrial base, so this exemption is likely to have little applicability. We believe this exemption would be insufficient to protect the interests of the U.S. government related to exports.

5. CAS waiver sponsored by USG executive agency unsuitable solution

CAS 9903.201-5 does provide for waivers of CAS applicability in full or in part. However, the waiver must be requested by the head of an executive agency not by a contractor. The waiver requires consideration of the needs of the agency and must contain justification for the request from the perspective of the agency.

The waiver process would not be effective for contractors placing subcontracts directly with foreign concerns for offset obligations or for strategic positioning to meet anticipated offset obligations. The existing waiver process is structured for situations where no other source is available to satisfy the agency's needs on a timely basis (9903.201-5(e)(5)). It is unlikely an executive agency would be willing to request a waiver from the CAS Board on behalf of a contractor seeking to award a subcontract to a foreign concern to meet an offset requirement. Consider that the justification requirements include such criteria as no other source available and a statement of the steps being taken to establish other sources for future contracts to avoid another waiver. These justifications would not be true for an offset contract, where the subcontract must be placed with the foreign concern to enable the FMS export even though there are other existing sources, and steps to establish another source to avoid a waiver are irrelevant because the primary need is an in country award for the offset.

We believe the existing CAS waiver process is not suitable for U.S. contractors in need of subcontracting with foreign concerns to enable exports.

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Appendix I: Aerospace capability of select countries

(Note: Companies with capabilities across categories appear multiple times)

Color codings indicate aggregate capabilities within the country. Capabilities vary between companies.

	Advanced Capabilities
	Moderate Capabilities
	Limited Capabilities

Primary Capability	Secondary Capability	India	South Korea	Turkey	Saudi Arabia
Avionics		HINDUSTAN AERONAUTICS LTD BHARAT ELECTRONICS AVANTEL SOFTECH ECIL SAMTEL DISPLAYS	LIG NEX1 CO LTD HUNEEED TECHNOLOGIES SAMSUNG THALES CORP	SELEX KOMUNIKASYON ASELSAN INC.	
Electra/Hydro/ Mechanical		HINDUSTAN AERONAUTICS LTD	HANHWA CORP. HUNEEED TECHNOLOGIES		AEC AACC
Major Structures		HINDUSTAN AERONAUTICS LTD DYNAMATIC TECHNOLOGIES TATA TECHNOLOGIES	KOREA AEROSPACE INDUSTRIES WORLD INDUSTRIES ACE KOREAN AIR AEROSPACE DIVISION	TURKISH AERO IND ALP AVIATION	Alsalam
	Machined Parts	LARSEN AND TOUBRO HINDUSTAN AERONAUTICS LTD DYNAMATIC TECHNOLOGIES	KOREA AEROSPACE INDUSTRIES KOREAN AIR AEROSPACE DIVISION WORLD INDUSTRIES ACE		
Purchased Outside Production	Composites	TATA ADV. MATLS LARSEN AND TOUBRO HINDUSTAN AERONAUTICS LTD		TURKISH AERO IND ALP AVIATION	
	Processors	DYNAMATIC TECHNOLOGIES HINDUSTAN AERONAUTICS LTD MAHINDRA			
	Sheet Metal	MAHINDRA HINDUSTAN AERONAUTICS LTD	KOREA AEROSPACE INDUSTRIES KOREAN AIR AEROSPACE DIVISION		
Propulsion		HINDUSTAN AERONAUTICS LTD	SAMSUNG TECHWIN		
Common Aerospace Commodities	Electrical	BHARAT ELECTRONICS HINDUSTAN AERONAUTICS LTD TCS MAHINDRA	LIG NEX1 CO LTD SAMSUNG THALES CORP.		
	Mechanical Fasteners				
	Wire Bundles	BHARAT ELECTRONICS LARSEN AND TOUBRO	HANHWA CORP. HUNEEED TECHNOLOGIES	TURKISH AERO IND	AEC
	Aluminum	HINDALCO - ALMEX HINDALCO INDUSTRIES			
	Composites	HINDUSTAN AERONAUTICS LTD			

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Appendix I: Aerospace capability of select countries Continued

(Note: Companies with capabilities across categories appear multiple times)

Color codings indicate aggregate capabilities within the country. Capabilities vary between companies.

	Advanced Capabilities
	Moderate Capabilities
	Limited Capabilities

Primary Capability	Secondary Capability	India	South Korea	Turkey	Saudi Arabia
Common Aerospace Commodities Cont'd	Forgings	BHARAT FORGE HINDUSTAN AERONAUTICS LTD SRI ASHA FORGINGS HINDUSTAN AERONAUTICS LTD	HANHWA CORP. WORLD INDUSTRIES ACE		
	Castings	HINDUSTAN AERONAUTICS LTD DYNAMATIC TECHNOLOGIES	CHUNJI CORPORATION KOREA LOST WAX		
Aerospace Support	Engineering Services	CADES DIGITECH PVT LTD SAMTEL DISPLAYS MAHINDRA WIPRO LTD. HCL TECHNOLOGIES	KOREAN AIR AEROSPACE DIVISION KOREA AEROSPACE INDUSTRIES		
	Aerospace Support	HINDUSTAN AERONAUTICS LTD MAHINDRA	KOREAN AIR AEROSPACE DIVISION		
	Logistical Services		KOREAN AIR AEROSPACE DIVISION	TURKISH AERO IND	
	Maintenance / Modification		KOREA AEROSPACE INDUSTRIES KOREAN AIR AEROSPACE DIVISION		Aisalam
	Repair/Overhaul	HINDUSTAN AERONAUTICS LTD	KOREA AEROSPACE INDUSTRIES KOREAN AIR AEROSPACE DIVISION		
	Spares		KOREAN AIR AEROSPACE DIVISION		
	Training Systems	MAHINDRA	DODAM SYSTEMS LTD SAMSUNG THALES CORP. KOREAN AIRLINES	HAVELSAN	
Non Production	Business Solutions	GEOMETRIC SOFTWARE SOLUTIONS MAHINDRA WIPRO LTD.	HUNEED TECHNOLOGIES		
	Ops Equipment, Tooling	TATA TECHNOLOGIES			
	Info Tech Services	HCL TECHNOLOGIES CADES DIGITECH PVT LTD TATA TECHNOLOGIES WIPRO LTD. INFOSYS TECHNOLOGIES LTD			
	Tooling	DYNAMATIC TECHNOLOGIES TATA TECHNOLOGIES			
Technology			KOREA ADVANCED INST SCI AND TECH AGENCY FOR DEFENSE DEVELOPMENT		