

September 1997

MARITIME SECURITY FLEET

Factors to Consider Before Deciding to Select Participants Competitively



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19971017 142

National Security and
International Affairs Division

B-277913

September 24, 1997

The Honorable Trent Lott
Majority Leader
United States Senate

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The Honorable John McCain
Chairman, Committee on Commerce,
Science, and Transportation
United States Senate

In accordance with the Maritime Security Act of 1996 (P.L. 104-239), the Department of Transportation's Maritime Administration (MARAD) recently entered into agreements with 10 shipping companies to participate in a program that would provide the Department of Defense (DOD) access to U.S.-registered commercial ships, their crews, and other related transportation assets in a time of national emergency. MARAD selected participants from applications submitted in response to its solicitation. As you requested, we evaluated whether program costs could be reduced by changing the selection process to permit owners to compete, rather than apply for, available slots. Specifically, we determined (1) the potential impact that a competitive selection process could have on the number of qualifying vessels, program costs, and existing agreements and (2) the views of Department of Transportation and DOD officials on making such a change to the selection process. On June 6, 1997, we briefed your staffs on the results of our work. This report summarizes and updates the information provided at that briefing.

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Background

The Maritime Security Act established the Maritime Security Fleet (MSF) program, authorizing MARAD to enter into agreements with maritime shipping companies to provide DOD access to commercial vessels operating under U.S.-flag registry and related assets, such as port facilities, containers, and rail systems in a time of national emergency.¹ In addition, the program was established to maintain U.S. presence in international commercial shipping by slowing the trend of U.S. ships seeking foreign registry, provide a readily available supply of U.S. mariners to crew government and commercial ships in a time of national emergency, and

¹Vessels operating under U.S.-flag registry, unlike those under foreign registry, must be owned by a U.S. citizen or an entity whose members are U.S. citizens and are capable of holding title under U.S. laws, crewed by trained U.S. merchant mariners, meet U.S. crewing and safety standards, and comply with U.S. tax laws.

encourage shipping companies to participate with DOD in contingency planning.

The MSF program replaces the Operating Differential Subsidy (ODS) program, which reimbursed American shipowners for cost differentials associated with operating under U.S. versus foreign registry, including higher crew, insurance, maintenance, and repair costs. The MSF program, in contrast, provides a reduced fixed rate to compensate U.S.-flag operators principally for the higher cost of employing U.S. citizens aboard U.S.-flag ships. MARAD estimates that ODS payments will average \$4 million per participating vessel in fiscal year 1997 compared with the authorized \$2.1 million per vessel under the MSF program.

Under the MSF program, participating companies will receive a yearly retainer for agreeing to maintain 47 selected ships under U.S. registry, crewing them with U.S. mariners, and making the ships available to DOD for sealift services in a time of national emergency. The act authorized the program to operate for 10 years—from fiscal year 1996 to 2005—and a total of \$1 billion, or \$100 million annually, to fund the program. It also authorized MARAD to enter into agreements to pay participating companies, subject to the availability of appropriations and other provisions of the act, \$2.3 million per vessel in fiscal year 1996 and \$2.1 million per vessel each year thereafter. Although the agreements are to be effective for 1 year, they are renewable, subject to the availability of appropriations, for each subsequent year of the program. The agreements are defined by the act as contractual obligations of the United States.

In October 1996, MARAD advertised in the Federal Register for MSF applicants; a total of 21 responded, offering 97 vessels. MARAD used specific eligibility and priority ranking criteria outlined in the act, to select applicants for available slots. To be eligible, a vessel had to be self-propelled, have a certain physical capacity, be less than a certain age, and be militarily useful and eligible for U.S.-flag registry.

In the selection process, MARAD followed criteria established in the act, giving first-priority consideration to vessels (1) owned and operated by citizens of the United States under section 2 of the Shipping Act of 1916 or (2) less than 10 years of age and owned and operated by a corporation that was either eligible for U.S. registry or currently operating, managing, or chartering vessels for the Secretary of Defense. The act limited the number of first-priority vessels per owner to the number that owner operated in U.S. foreign commerce as of May 17, 1995, plus the number that the owner

chartered to DOD as of that date. Also, if the number of vessels that qualified for first-priority ranking exceeded available funding, the act required that MARAD prorate the award of MSF slots among vessel owners based on the number of first-priority vessels each owned.

MARAD determined that 53 of the 97 vessels offered for the program met eligibility requirements for first-priority status. Because of their military usefulness, 6 additional vessels had the age requirement waived, bringing the total number of first-priority vessels to 59. The \$100 million in annual program funding was sufficient to fund 47 vessels, and by January 1997, MARAD had entered into agreements with the 10 owners of these vessels. However, not all of the 47 vessels will be immediately eligible for MSF payments. Some vessels will have to change from foreign to U.S. registry, and others will have to wait until their current participation in the ODS program expires or other government contractual obligations are completed—some possibly as late as November 2000. Because the act did not become law until fiscal year 1997 and not all vessels will be immediately eligible for payment, MARAD estimates the total program costs will be \$825.4 million, or about 17 percent less than the \$1 billion originally authorized in the act.²

Results in Brief

Three factors warrant consideration before determining whether to incorporate a competitive selection process into the Maritime Security Fleet program: the number of vessels that could qualify, the effect of such a process on program costs, and potential legal risks. First, opening up the selection process to competition would not increase the pool of qualified applicants or the number of eligible vessels without a change in the eligibility and selection criteria. Second, it is uncertain whether competitive selection would result in bids lower than the current \$2.1 million annual Maritime Security Fleet payment and thereby lower program costs because (1) annual crew costs alone for a commercial ship operating under U.S. registry exceed those for the foreign registry operation with the next highest crew cost by about \$2.4 million; (2) average annual payments under the expiring Operating Differential Subsidy program exceeded the \$2.1 million level in every year since 1982; and (3) bids under competitive selection may take inflation and operating cost increases into consideration, whereas the current program fixes the maximum annual per ship payment at \$2.1 million through fiscal year 2005. Finally, unilateral changes to the program could lead to legal challenges by

²Although the act authorized the government to enter into operating agreements beginning in fiscal year 1996, it did not become law until fiscal year 1997.

vessel owners with whom the government has contractual agreements. These challenges could result in substantial costs to the government and the transfer of vessels to foreign registry.

On the basis of their analysis of the number of fully qualified vessels eligible to participate in the program and the possibility that competitive selection would lower program costs, neither Transportation nor DOD favor changes to the current selection process. Officials of both agencies believe that a competitive selection process would not result in lower program costs and could actually result in vessel owners withdrawing from the program to operate their vessels under a less costly foreign registry. Such actions could result in a loss of assets needed in a time of national emergency.

Number of Qualified Vessels Would Not Increase

According to MARAD data, every commercial owner with vessels that were fully qualified under the existing MSF selection criteria, applied for and obtained at least one slot in the program. Therefore, the number of vessels that could be considered for the program under a competitive selection process would not increase unless the selection criteria were changed.

Of the 97 vessels offered for the program, 53 met all of the first-priority selection criteria. An additional six vessels, which DOD determined would be needed to meet contingency requirements to transport containerized ammunition from selected locations on the West Coast, were also granted age waivers to qualify as first-priority vessels. On the basis of a pro rata requirement set out in the act, each of the 10 owners of the 59 first-priority vessels was awarded at least 1 of the 47 slots in the program, leaving 12 first-priority vessels unselected. The number of awarded slots was based on the percentage of the 59 first-priority vessels each shipping company owned. Of the 47 vessels selected for the program, 24 were owned by 2 shipping companies.

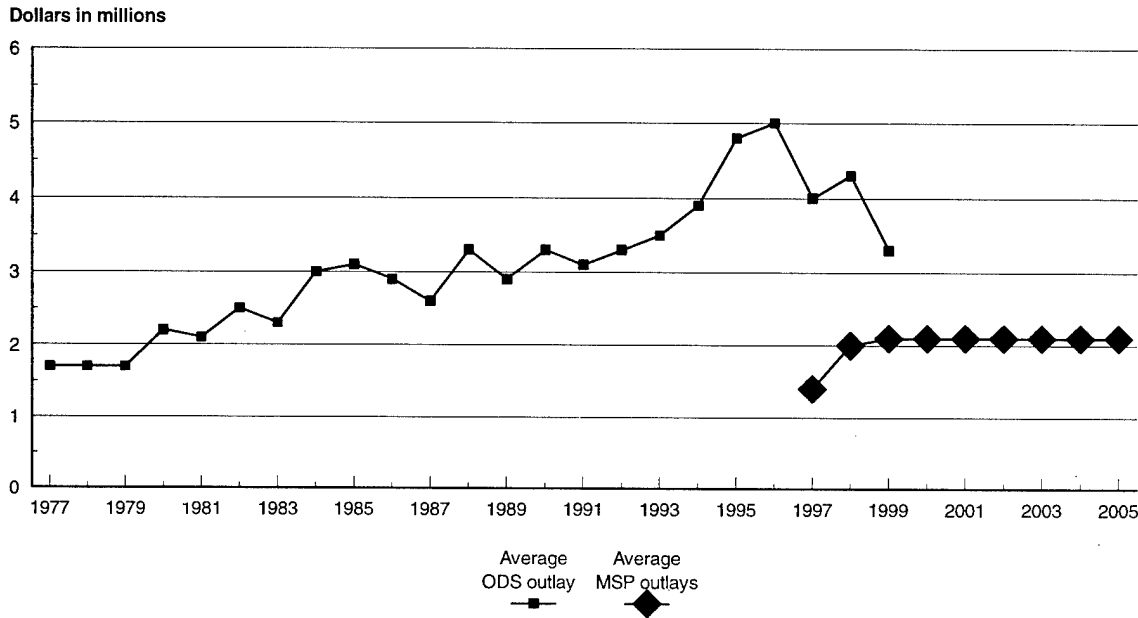
Some of the 97 vessels that were offered for the program were determined to be ineligible based on their age or their owner's citizenship. Other factors, including vessels not being militarily useful or not operating in a domestic-foreign trade route on May 17, 1995, excluded the remainder. Given the same qualifying and selection criteria, these vessels would still not qualify for the MSF program under a competitive bidding process.

Effect of a Bidding Process on Program Cost Is Uncertain

Although we cannot be certain of the effect that a bidding process would have on the total program cost, a number of factors suggest that owners may not bid lower than the current \$2.1 million per vessel authorization. MARAD data, for example, shows that annual crew costs alone for commercial ships operating under U.S. registry exceed those for the foreign registry operation with the next highest crew cost by about \$2.4 million. At the time of our review, shipping companies participating in the MSF program were having mixed results in their efforts to reduce operating costs by negotiating new labor contracts that would consider the reduced subsidy.

In addition, payments under the expiring ODS program have historically been higher than \$2.1 million. For example, since 1982 the average annual outlay per ship under the ODS program ranged from \$2.3 million in fiscal year 1983 to \$5 million in fiscal year 1996. In fiscal year 1997, the average annual subsidy per vessel under the ODS program is estimated at \$4 million compared with \$1.4 million under the MSF program (see fig. 1).

Figure 1: Expiring ODS and MSF Average Annual Payments

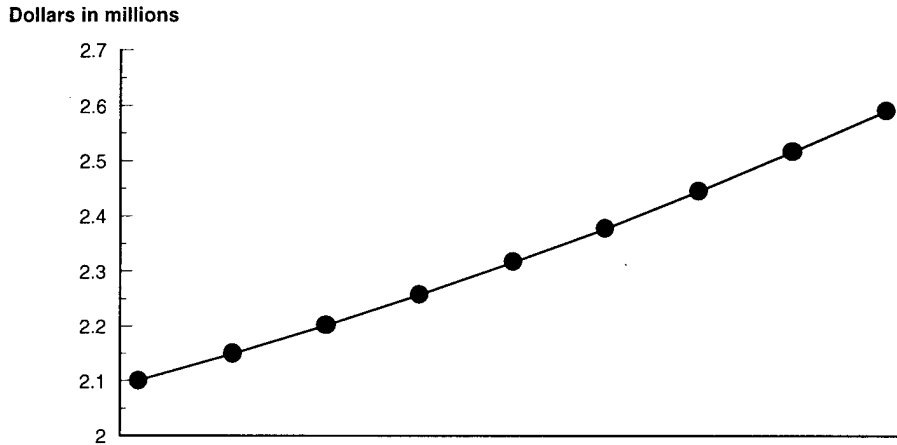


Source: MARAD.

Current legislation does not consider future inflation or increases in operating costs; therefore, the \$2.1-million cost per ship per year will remain constant through fiscal year 2005. Representatives of five shipping companies participating in the MSF program told us that if a competitive selection process were introduced, they would probably construct their bids to account for inflation. Our analysis indicates that bids would have to rise to about \$2.3 million in fiscal year 2000 and \$2.6 million in fiscal year 2005 to cover the current inflation projections (see fig. 2).³

³We averaged the annual inflation forecast of two major economic forecasting firms—WEFA and DRI/McGraw-Hill.

Figure 2: Impact of Inflation on the MSF Annual Subsidy of \$2.1 Million Per Vessel



Fiscal year	1997	1998	1999	2000	2001	2002	2003	2004	2005
Adjusted subsidy ●	2.100	2.149	2.201	2.257	2.316	2.377	2.444	2.515	2.590

The small number of vessel owners, all of whom are already participating in the MSF program, also limits the potential cost savings of competition, as does the fact that over one-half of the 59 first-priority vessels are owned by two companies. By owning a majority of the first-priority vessels, these two companies could possibly exert enough market power to affect both the amount of their bids and the number of ships they would make available. In addition, since DOD has requirements for specific vessel types and associated transportation systems, the competition may need to be categorized by vessel type, which would further reduce the number of potential bidders in each category. For example, medium-sized container ships, which were needed to meet DOD's unique containerized ammunition requirements on the West Coast, were operated by only one MSF program applicant.

Legal Risks Could Be Involved in Changing the Selection Process

Implementation of a competitive selection process into the MSF program presents certain legal risks to the government and could undermine the intent of the program. As noted by MARAD officials, current MSF participants may view implementation of a new selection process as a breach of the government's contractual obligations. Under the MSF program, the government entered into 47 operating agreements with vessel owners. These agreements, defined by the act as contractual obligations of the United States, obligate the government to pay the amount provided for in the agreement to the extent of actual appropriations. Provided there is sufficient funding, the government is obligated to pay \$2.1 million a year per ship to the vessel owners. The Supreme Court recently held that the government may be liable for damages if Congress enacts legislation that breaches an existing contract to which the government is a party.⁴

Changes to the selection process that do not interfere with existing agreements would minimize potential liability. According to the act, if funds are not appropriated, the current agreements would automatically terminate. Therefore, one option would be to allow current agreements to terminate and then enact new legislation to require competitive selection. However, vessel owners may have incurred expenses based on the assumption that the program would last through fiscal year 2005 and that the government would make a good faith effort to provide funds. This situation may provide some leverage for participating owners to pursue legal remedies. Also, if funds are not appropriated and the agreements automatically terminate, vessel owners could transfer participating vessels to foreign registry, undermining the intent of the MSF program. Another option for changing the selection procedure would be to retain current MSF agreements and amend the act to allow a bidding process for the selection of any additional or replacement vessels.⁵ Although this option presents the least risk to the government, current vessel owners could take the position that the language in the current agreements, specifying that contracts are renewable annually, would allow them to terminate their involvement in the program and bid again for their vacated slots at a rate higher than the current \$2.1 million.

⁴See *United States v. Winstar Corp.* 116 S. Ct. 2432 (1996).

⁵Vessels that originally qualify for the program may have to be replaced because of bankruptcy or changes in ownership from U.S. to foreign, for example.

Neither Transportation Nor DOD Support Changing the Selection Process

Transportation and DOD officials do not support a change in the MSF selection process to incorporate bidding. Transportation officials believe that the existing 47-vessel fleet is the best mix of ships and associated transportation systems at the best price possible. They also believe that the lower level of financial support provided by the MSF program, as opposed to the expiring ODS program, is challenging U.S. vessel owners to lower their costs. In addition, these officials note that the MSF program has broad consensus and support within government and industry. They believe that a change would offer little possibility of cost savings and introduce the risk of DOD not having access to the ships and associated transportation systems when needed. In particular, the officials are concerned that a bidding process could be more costly, result in the government being held liable for breach of contract, or result in the reflagging of vessels currently under U.S. registry. In June 1997, Transportation formally recommended that the current program not be reopened for competitive bidding.⁶

DOD officials believe that the current program provides the capability needed to ensure sealift support and access to critical transportation assets in a time of national emergency. They do not believe that significant cost savings can be achieved by introducing a competitive selection process. According to DOD, over 50 percent of the contingency sealift capacity needed in wartime would be provided by MSF recipients, and any disruption to the current program could affect DOD's ability to effectively plan for these contingencies. DOD officials noted that MSF agreements provide long-term stability for contingency planning and were concerned that changes could reduce participation by major U.S.-flag carriers, who provide the bulk of the transportation infrastructure, and leave only carriers with significantly reduced capabilities. In a July 1997 letter to the Chairman, Senate Committee on Commerce, Science, and Transportation, the Secretary of Defense recommended continuation of the current MSF selection process.

Agency Comments

The Department of Transportation and DOD reviewed a draft of this report and concurred with our findings. Transportation provided technical comments verbally, which we incorporated where appropriate. DOD advised us that it had no comments or suggested changes to the language of the report.

⁶Report to the Chairman, Senate Committee on Commerce, Science, and Transportation on the Issue of Introducing Competitive Bidding to the Maritime Security Program (P.L. 104-239), Department of Transportation, Maritime Administration, June 1, 1997.

Scope and Methodology

To address the potential impact of a bidding process on the number of vessels qualifying for the MSF program, we met with representatives from MARAD and the Transportation Command. We analyzed MARAD data regarding the pool of qualified bidders, the application process, and selection results. We also reviewed MARAD-generated data on the inventory of commercial ships to identify the universe of ships participating in foreign trade. We analyzed this inventory to determine whether ships that met the MSF selection criteria were not submitted for consideration.

To address the potential impact of a bidding process on MSF program costs, we interviewed officials from MARAD; representatives of five shipping companies that own 33 of the 47 MSF vessels; and the American Maritime Congress, which represents the interests of the U.S. shipping industry and lobbies on its behalf to impact proposed legislation and other purposes. We used MARAD cost data to compare the projected cost of the MSF program with the ODS program and noted the cost differences of operating U.S.- and foreign-registered vessels. We also computed the potential impact of expected inflation on the \$2.1-million MSF payments. We did not test the validity or reliability of MARAD cost data.

To address the legal issues related to introducing a competitive selection process into the MSF program, we reviewed the Maritime Security Act and relevant case law, and discussed possible legal implications with MARAD officials. We also discussed potential legal implications with representatives of shipping companies that have signed MSF agreements.

To determine Transportation's and DOD's views on the desirability of instituting a bidding process for MSF slots, we interviewed agency officials and reviewed related agency reports.

We conducted our review between April and September 1997 in accordance with generally accepted government auditing standards.

As requested, we plan no further distribution of this report until 15 days after its issue date. At that time, we will send copies to the Chairmen of the House and Senate Committees on Armed Services and the Senate Committee on Appropriations, the Director of the Office of Management and the Budget, and the Secretaries of Defense and Transportation. Copies will also be made available to other interested parties on request.

Please contact me at (202) 512-5140 if you or your staff have any questions concerning this report. Major contributors to this report are listed in appendix I.

A handwritten signature in black ink that reads "Mark E. Gebicke". The signature is written in a cursive style with a large, stylized initial "M".

Mark E. Gebicke
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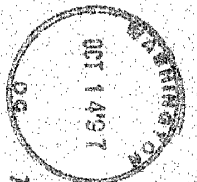
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