

**INCREASING THE SIZE OF THE EFFECTIVE UNITED
STATES CONTROL FLEET**

FINAL REPORT

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EXECUTIVE SUMMARY

The Effective United States Control (EUSC) Fleet is comprised of merchant vessels, registered in Liberia, Panama, Honduras, the Bahamas, and the Marshall Islands, that are owned and operated (often through foreign subsidiaries) by American companies in international shipping, and which are available for requisition, use, or charter by the U.S. in the event of war or national emergency. Tankers represent the predominant type of vessel in the EUSC fleet.

A purpose of this research was to evaluate the status of the EUSC fleet, its relevance to U.S. military requirements, and the economic realities of maintaining or increasing the size of the fleet. The first part of this report brings together the publicly available information concerning the size and composition of the EUSC fleet, the related trends, the legislative background, the military aspects of having such a fleet, and the conclusions of previous studies pertaining to the EUSC fleet.

The second part of this document reports on the additional data that we have been able to obtain and analyze. Unclassified portions of a recent military analysis show the extent to which the Department of Defense (DoD) is counting on the EUSC fleet to meet its requirements in certain scenarios. Our analysis of the ships in the EUSC fleet uncovered the inaccuracies in the existing EUSC database used by the government in its analysis. We have also considered means to maintain the size of the existing fleet and possibly increase it.

**FOR MANY DECADES U.S. POLICY HAS CONSISTENTLY SUPPORTED THE
POTENTIAL VALUE OF THE EFFECTIVE UNITED STATES CONTROL
FLEET.**

Effective U.S. Control is a long standing policy formulated by the Joint Chiefs of Staff that has its roots leading up to and during World War II. More recently, President Bush signed the “National Security Sealift Policy” (National Security Directive #28) reiterating support for the EUSC fleet in 1989.

**THE EUSC FLEET HAS BEEN DECLINING OVER THE PAST QUARTER
CENTURY AS U.S. CONTROLLED SHIPOWNING COMPANIES GRADUALLY
HAVE DIVESTED EQUITY CONTROL OVER OPEN REGISTRY VESSELS.**

Faced with the prospect of paying income tax while their competitors typically did not, EUSC shipowners generally stopped investing in their EUSC fleets. Consequently, the total EUSC dropped 38% in terms of number of ships and nearly 55% in terms of deadweight tonnage between 1986 and 2000.

The key exception in terms of shipowners was the companies with large amounts of deferred U.S. income tax. Unless they continue to make new investments in ships, they would have no longer been able to defer these payments. Overall, the trend was to greatly reduce new investments in the EUSC fleet.

**THE PRIMARY CAUSE OF THE DECLINE IN THE SIZE OF THE EUSC
FLEET HAS BEEN U.S. LEGISLATION THAT HAS CHANGED THE
FUNDAMENTAL ECONOMICS OF AMERICAN BENEFICIAL OWNERSHIP
OF OPEN REGISTRY VESSELS**

The combination of U.S. tax laws passed in 1975 and 1986 resulted in a business environment where EUSC shipowners could no longer avoid paying tax on current income. This change put them at a major disadvantage to their foreign competitors who often paid little or no income tax.

The literature confirms the conventional wisdom that shipowners prefer to operate in an environment where they do not have to pay income tax. Consequently, EUSC shipowners have greatly reduced their investment in EUSC ships since the Tax Reform Act of 1986.

**THE DECLINE WILL CONTINUE IN THE FUTURE, AND EVEN
ACCELERATE IN THE FUTURE, UNLESS THERE ARE CHANGES IN
LEGISLATION**

There is no reason to believe that the existing trend in the size of the EUSC fleet will stop. New legislation, which allows EUSC shipowners to be competitive in the global marketplace, has the potential for stopping, and possibly reversing, this trend. However, there is no guarantee.

**MANY ATTEMPTS HAVE BEEN MADE TO CHANGE THE LEGISLATION
SINCE 1986, BUT ALL HAVE FAILED**

On several occasions since 1986, bills have been introduced in Congress that would have allowed EUSC shipowners to avoid paying tax on current income, thereby making them more competitive in the global marketplace. Recently, a bill has been introduced that would greatly reduce the amount of income tax paid by U.S. flag shipowners in international trade. To date, none of these attempts has been successful.

**MOST SHIPOWNING COMPANIES CONTROLLING EUSC VESSELS ALSO
OWN OR OPERATE U.S. FLAG SHIPS OR ARE OTHERWISE AFFILIATED
WITH U.S. FLAG OPERATIONS.**

Since EUSC shipowners are U.S. citizens, it is not surprising that many of them own U.S. flag vessels or are affiliated with U.S. flag companies. Since the tax environment for EUSC weakens their ability to compete, the overall effect is to reduce the viability of the overall organization, including the U.S. flag affiliation.

U.S. flag tankers are generally built in the U.S. and manned with U.S. seafarers.

Because of the higher costs of construction and operation, these vessels are not competitive in the world marketplace (and typically focus on the Jones Act trades). Consequently, aiding the competitiveness of EUSC tankers will not hurt U.S. flag

tankers. On the contrary, where the EUSC shipowners are also affiliated with U.S. flag operations, there will be an overall benefit to all involved.

ENABLING FUTURE INVESTMENTS BY U.S. CONTROLLED SHIPOWNING COMPANIES IN EUSC VESSELS WOULD CONCOMITANTLY ENHANCE THOSE COMPANIES' U.S. FLAG OPERATIONS AT A TIME WHEN BOTH FOREIGN AND DOMESTIC FLAG FLEETS ARE EXPECTED TO DECLINE EVEN FURTHER BECAUSE OF THE FORTHCOMING DOUBLE HULL REQUIREMENTS.

National legislation and international agreements will result in the replacement of single hull tankers with double hull tankers no later than 2015. Since owners of current EUSC single hull tankers will generally not be replacing them with double hull vessels, the impact of this double hull requirement will further reduce the size of the EUSC fleet. (While we are focusing on the EUSC fleet, we note that the U.S. flag tanker fleet will also be reduced by this double hull requirement.)

CERTAIN MILITARY SCENARIOS SHOW A REQUIREMENT FOR THE ENTIRE EUSC FLEET

A recent DoD analysis shows that all militarily useful U.S. flag and EUSC tankers would be needed in certain scenarios. This result of this analysis is that there is now a critical importance in maintaining an EUSC fleet equal to the size of that in the database used by

the government. Since the EUSC database used in this analysis grossly overestimated the size of the EUSC fleet, it is clear that the scenario described in this analysis cannot be implemented with the existing EUSC fleet.

THE ACTUAL MILITARILY USEFUL, EUSC FLEET IS MUCH SMALLER THAN THAT USED IN THE MRS-05 SEALIFT TANKER ANALYSIS

The actual EUSC fleet is much smaller than that represented by the government database used in recent MRS-05 Sealift Tanker Analysis. Consequently, it is clear that the DoD will not be able to get access to the 57 militarily useful EUSC tankers that it includes in its analyses. Instead, we estimate that only 25 will be available in 2005.

THE ONLY WAY TO INCREASE THE NUMBER OF MILITARILY USEFUL EUSC TANKERS IN THE NEAR TERM IS TO CHANGE THE DEFINITION OF “MILITARILY USEFUL” IN THE MRS-05 SEALIFT TANKER ANALYSIS

The Chairman of the Joint Chiefs of Staff Instruction (CJCSI 3110.11B, January 30, 1996) defines militarily useful tankers as being: under 100,000 deadweight tons, and capable of a speed over 12 knots. However, accepting EUSC tankers of all sizes will increase the militarily useful fleet from 25 to 62 ships in 2006. While many of these ships will not be of the ideal size or have the ideal tank coatings, these tankers will give the DoD an option other than acquiring the use of foreign owned vessels on the world charter market. With prior arrangements it will be possible for the U.S. government to

pre-screen or vet the crews on EUSC tankers. EUSC tankers over 100,000 deadweight tons could be used: for direct movements (although some would be of inefficient size); for linehaul movements as “mother ships” to be lightered; as replacements for U.S. flag tankers removed from the Jones Act trade by DoD; and to move crude oil from foreign countries to the U.S. in time of an emergency.

**IT IS ESSENTIAL THAT DOD ESTABLISH AN ON-GOING COOPERATIVE
ARRANGEMENT WITH SHIPOWNERS OF THE EUSC TANKER FLEET**

There is not an on-going, current relationship between the U.S. government and the EUSC shipowners. In order to obtain the military benefits desired, it is necessary to develop such a cooperative arrangement. The Voluntary Tanker Agreement which was initiated many years ago may be the appropriate starting place, but the related Tanker Requirements Committee has not met in 6 years. One might argue that aspects of the existing VISA programs should be considered.

It would be useful for the DoD to have procedures to pre-screen the crews on EUSC tankers and obtain access to the EUSC tankers as needed. In some instances the DoD may wish to place U.S. seafarers on EUSC tankers. (Such procedures could be tied to new legislation or be negotiated through the existing Voluntary Tanker Agreement.)

**THERE ARE VARIOUS ALTERNATIVE APPROACHES FOR NEW U.S.
LEGISLATION THAT LIKELY WOULD RESULT IN MAINTAINING OR
INCREASING THE SIZE OF THE EUSC FLEET.**

Key criteria for new legislation are: it should encourage EUSC tanker owners to maintain or increase the size of the EUSC tanker fleet; it should support DoD objectives; it should be able to gain the support of the executive and legislative branches of the U.S. government. The larger the number of useable tankers available, the more potential benefits for the DoD.

The major aspect of new legislation to help EUSC shipowners is to allow them to defer or avoid payment of U.S. tax on current income. One approach (which has been adopted by some European nations) could be a “flat tax” in the form of a tonnage tax that would minimize income tax payments by EUSC owners. However, the authors believe that it would be more practical and realistic in the near term to focus on tax deferment rather than tax exemption for EUSC tanker owners. Another encouragement to EUSC shipowners would be to give cargo preference on U.S. government cargo to some or all types of EUSC ships over other foreign flag vessels.

The scoring of the proposed legislation will estimate the amount of lost revenue to the federal government as a result of the new law. By expanding the proposed legislation to include other types of ships in addition to tankers, more self-interest groups may be included as supporters of the bill. At the same time, including more ships in the bill will also increase the scoring.

THE AUTHORS RECOMMEND LEGISLATION THAT FOCUSES ON
TANKERS

By focusing on tankers any proposed legislation will have direct potential national security benefits. Including tankers of all sizes will maximize the amount of potential benefits to DoD. The authors have performed a rough estimate of the scoring that would accompany such a bill. It appears that given the small –and decreasing – number of EUSC tankers (as well as U.S. flag tankers), the potential benefits of maintaining or increasing the EUSC tanker fleet outweigh the declining revenue stream to the Federal Government as the EUSC fleet further decreases over time. While including other types of ships in the proposed legislation may increase the support for new legislation from the various self-interest groups that would be involved, the authors prefer to focus on the national security benefits and the lower scoring that would result from including only tankers. In addition, the authors would favor cargo preference for EUSC tankers over other foreign flag tankers for U.S. government cargo (although only a limited amount of cargo exists).

One might argue that proposed legislation should focus on only smaller sizes of tankers which are more militarily useful. However, if the long term objective is to build up the EUSC tanker fleet, the authors feel that a major push for EUSC tanker owners in terms of giving tax benefits to all of their EUSC tankers will be a start in the right direction. We think that even if this proposed legislation is passed, it would be overly optimistic to predict that there will be a substantial increase in the EUSC fleet overnight. Nevertheless, by “leveling the playing field” in the area of income taxes with their competitors, the EUSC tanker owners will finally have some reason to grow their fleets.

CHAPTER 1

INTRODUCTION

The Effective United States Control (EUSC) Fleet is comprised of merchant vessels, registered in Liberia, Panama, Honduras, the Bahamas, and the Marshall Islands, that are owned and operated (often through foreign subsidiaries) by American companies in international shipping, and which are available for requisition, use, or charter by the U.S. in the event of war or national emergency. Tankers represent the predominant type of vessel in the EUSC fleet.

The purpose of this research is to evaluate the status of the EUSC fleet, its relevance to U.S. military requirements, and the economic realities of maintaining or increasing the size of the fleet. The first choice of the DoD is to use U.S. flag ships. Once these vessels are utilized, DoD policy is to next focus on EUSC ships. The first part of this report brings together the publicly available information concerning the size and composition of the EUSC fleet, the related trends, the legislative background, the military aspects of having such a fleet, and the conclusions of previous studies pertaining to the EUSC fleet.

The second part of this document reports on the additional data that we have been able to obtain and analyze. Unclassified portions of a recent military analysis show the extent to which the Department of Defense (DoD) is counting on the EUSC fleet to meet its

requirements in certain scenarios. Our analysis of the ships in the EUSC uncovered the inaccuracies in the existing EUSC database used by the government in its analysis. Options available to the DoD once all the available U.S. flag and EUSC tankers have been utilized have been analyzed. We have also considered means to maintain the size of the existing fleet and possibly increase it.

ORGANIZATION BY CHAPTER

Chapter 2 presents data that is publicly available through U.S. government databases. We look at all vessels owned by U.S. citizens or corporations. We start with all foreign flag ships owned by U.S. citizens/corporations. The EUSC is a subset of that fleet and militarily useful tankers represent a further subset. While the U.S. flag fleet is not the focus of our research we present it for completeness in showing the assets readily available to the DoD in time of need. Historical data is presented on each fleet category and they all show a pattern of decline.

The across the board decreases in fleet size for foreign flag ships owned by U.S. citizens/corporations raises the question as to the cause. Chapter 3 describes the legal history pertaining to this U.S. owned foreign flag fleet (including the EUSC ships), since this legislation could be a major cause of the decline.

Chapter 4 presents a literature review covering the major topics of concern to us: the military justification for the EUSC fleet, the mixed opinions that went along with the passage of the Tax Reform Act of 1986, current opinions related to the EUSC fleet, and attempts at related legislation since 1986.

Chapter 5 studies the extent to which the EUSC is militarily important. Unclassified portions of a Joint Staff/OSD study provide insight into this issue. We also take a closer look at the government database for militarily useful EUSC tankers and discover that this database is in need of updating. We start this process and get far enough to realize that the military really does not readily have access to nearly the number of EUSC ships it assumes in its analyses. By forecasting the future of the EUSC fleet we show that the existing fleet will be further reduced by the end of 2015 by the implementation of the double hull requirement on tankers.

Chapter 6 considers options available to the DoD once all the militarily useful U.S. flag and EUSC tankers have been utilized. Key alternatives include expanding the current definition of “militarily useful” and going to the worldwide charter market for vessels.

Regardless of what approach the DoD decides to use, there is a need to have an agreement on the procedures to be used when the DoD desires some of the capacity of the EUSC fleet. Although a Voluntary Tanker Agreement (VTA) and a Tanker Requirements Committee (TRC) were developed many years ago, it has been at least six years since much attention has been directed at these issues. Chapter 7 briefly reviews the VTA and the TRC. Then it describes the Voluntary Intermodal Sealift Agreement (VISA), a partnership between the U.S. government and transportation carriers that is currently receiving a lot of attention.

In Chapter 8 we identify alternative approaches to maintaining or increasing the size of the EUSC fleet. The key factor is to change the legislation faced by EUSC shipowners so that they can better compete in the world marketplace. However, there is a wide range of issues to be dealt with in such a process. Another important aspect is the “scoring” of proposed legislation. With this process the government estimates how much money will be lost to the federal government by giving benefits to various U.S. citizens/corporations.

Chapter 9 presents our conclusions and recommendations.

CHAPTER 2

PUBLICLY AVAILABLE INFORMATION ON THE EUSC FLEET AND RELATED SEALIFT RESOURCES

The strategic sealift plans of the United States military rely on a variety of sources to meet the predicted requirements for marine vessels during military emergencies. The U.S. military's initial source of strategic sealift vessels comes from vessels owned or on long-term charter by the Military Sealift Command. These vessels are maintained in a constant state of readiness and serve actively in support of the U.S. military. As additional vessels are required to meet military sealift needs, the Ready Reserve Force (RRF), which is maintained by MARAD, would be activated if U.S. flag or foreign flag ships were not available for charter. Following the commitment of both the MSC vessels and the RRF, the U.S. government could declare a national military emergency and either begin the reactivation of the National Defense Reserve Fleet (NDRF) or authorize the acquisition of U.S. flag merchant ships and/or certain foreign flag vessels that are majority owned by U.S. citizens. The latter category of ships is referred to as the Effective U.S. Control fleet or the EUSC fleet.

As the MRS-05 Sealift Tanker Analysis confirms, the adequate transport of petroleum, oil, and lubricants (POLs) to a military theater is critical to the highly fuel dependent operational requirements of the Department of Defense (DoD). Therefore, one of the most important categories of military sealift vessels is tankers, a category in which the

EUSC fleet traditionally has been strong. In this chapter, historical and current information on the EUSC fleet as a source of military sealift tankers will be summarized. In addition, a comparison of the total strategic sealift resources available to U.S. military planners will be presented. U.S. flag ships always take precedence over EUSC vessels as long as the U.S. flag ships are available.

U.S. OWNED, FOREIGN FLAG FLEET

It is important to differentiate between U.S. owned vessels registered in foreign countries generally and those U.S. owned, foreign flag vessels in the EUSC fleet. The latter is a subset of the former, and in terms of military sealift planning has, as will be explained herein, much greater significance.

It has been a common practice, dating back to the Nineteenth Century, for American shipowning companies to own and operate vessels under various registries for a variety of reasons: lower construction and operating costs, lower tax (certainly so in earlier years), very attractive subsidies, marketing or natural resource extraction opportunities, national flag requirements, neutrality in time of war, etc. Particularly in earlier years, the size of the overall U. S. owned, foreign flag fleet was indeed substantial. For instance, if the U.S. owned segment of foreign flag tonnage in 1900 was deemed to be a fleet all by itself, compared to other national flag fleets it would have ranked as the fourth largest fleet in the world.

In the early years of the Twentieth Century, the European registries accounted for most of the American owned tonnage registered abroad. However, in the 1920s and increasingly

so in the 1930s American shipowners registered vessels in Panama and, to a much lesser extent, Honduras. These registries, along with more recent additions, are sometimes referred to pejoratively as “flags of convenience,” although the phrase “open registries” (a United Nations creation) is more commonly accepted today. As distinguished from the so-called “traditional registries” of the United States, Europe, Japan, etc., the open registries offer shipowners of other nations no restrictive shipowning nationality requirements, no national restrictions on shipbuilding or repair, no limitations on crew nationalities, less restrictive manning requirements, and more favorable tax structures. Today, open registries still account for a significant percentage of the world’s merchant tonnage. U.S. shipowning companies were once the predominant nationality among owners of open registry tonnage but their share has declined sharply in more recent years. On the other hand, American shipowners, ever since the onset of World War II, have continued to favor open registries over other traditional foreign registries as well as the “second registries” some European nations have adopted to be more competitive with open registries.

Nevertheless, there are currently a small number of vessels owned by U.S. shipowning companies and registered in several foreign nations other than Liberia, Panama, Honduras, the Bahamas and the Marshall Islands. Notably, under U.S. law (Section 902 of the Merchant Marine Act of 1936, as amended in 1939) these vessels would be subject to requisition, use or charter by the United States in the event of a national emergency. However, they cannot be deemed to be under Effective U.S. Control because they do not meet the considerations established by the Joint Chiefs of Staff following World War II,

one of which is that the nation of registry must be “...willing and able to bring the vessel under control of the United States in an emergency for such use as the United States may wish to make of the vessel...” (J.L.S. 1454/11). From the standpoint of military sealift planning, the problem is that the non-EUSC flag states have not tacitly or explicitly consented in advance to making the U.S. owned ships flying their flags available in such manner because they may want the vessels to meet their own sealift needs, or because of political, sovereignty or neutrality considerations, etc. Thus, reliance on non-EUSC vessels to meet U.S. emergency sealift needs would be, at best, problematic. The problem is compounded by the rule of international law that clearly recognizes the paramount rights of the flag states to exercise control over vessels flying their flags.

On the other hand, there is some value in tracing the growth and decline of the overall U.S. owned, foreign flag fleet because there are some clearly discernible parallels with the growth and decline of its subset, the EUSC fleet. In considering these parallels it should be kept in mind that the overall U.S. owned, foreign flag fleet has been generally impacted by the 1975 and 1986 changes in U.S. tax laws to the same extent as the EUSC fleet.

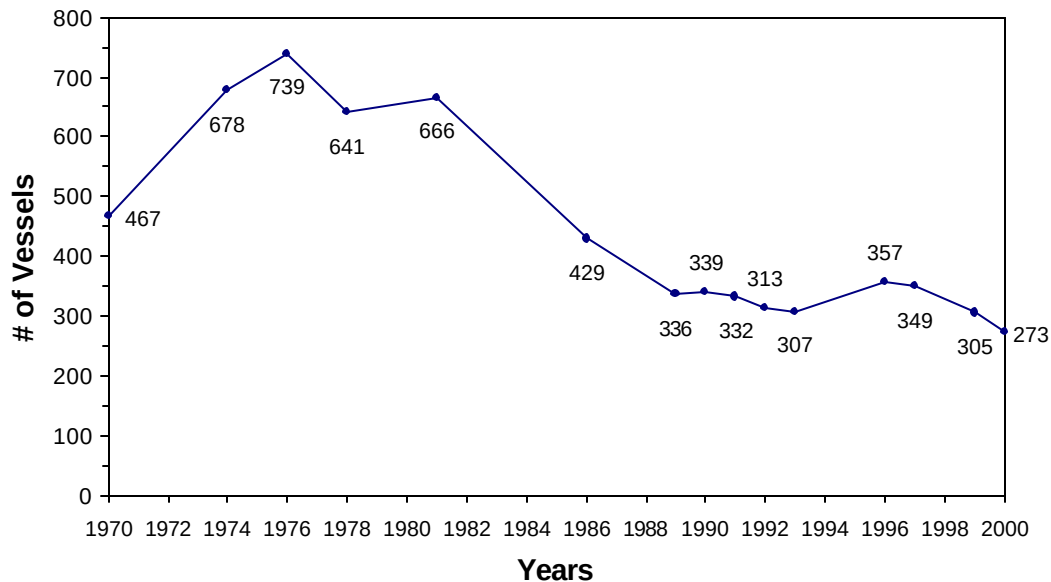
The historic trends of both the U.S. owned, foreign flag and the EUSC fleets will be traced from 1970 to 2000. This period covers the growth of these fleets to their historic peaks and their subsequent decline through the year 2000 in terms of deadweight tonnage (dwt). Data for earlier years was intermittent and deemed less important with regard to the impact of the changes in U.S. tax laws in 1975 and 1986. However, it is useful to

first consider the importance placed upon obtaining access to sealift vessels by military planners in the wake of World War II. The Merchant Vessel Register was a quarterly report compiled by the Merchant Vessel Section of Naval Transportation Service in the Office of the Chief of Naval Operations that tracked the inventory of U.S. controlled merchant vessels. This publication monitored government owned and privately owned vessels, including both the U.S. flag and the effectively controlled foreign flag fleets. The June 30, 1949, Register reports that the modern EUSC fleet contained 202 vessels with a combined dwt of 2,476,500, which included 140 tankers consisting of 2,063,900 dwt. Even in an era where the U.S. flag fleet of 1202 vessels dwarfed the EUSC fleet, the EUSC tankers still accounted for 22 percent of America's tanker sealift planning by dwt. In the years after 1949, the size of the U.S. owned, foreign flag fleet grew rapidly until the mid-1970's. Since its peak, this fleet has experienced a substantial decline while the total world fleet has continued to grow. It will be demonstrated in the remainder of this chapter that the current significance of the contribution of the EUSC tanker fleet to America's sealift planning has increased despite its present state of decline.

The historic trends of the U.S. owned, foreign flag fleet in terms of number of vessels and of dwt since 1970 are contained in Figure 2.1 and Figure 2.2 respectively. From these graphs, it is apparent that the total number of vessels in the overall U.S. owned, foreign flag fleet peaked in approximately 1976 and has been in decline since that year. The sharpest period of decline in terms of total numbers occurred between 1981 and 1989. In terms of dwt, the total fleet size declined by 72 percent between 1981 and 2000. Between 1986 and 2000, the total dwt declined by 53 percent. The MARAD database of the U.S.

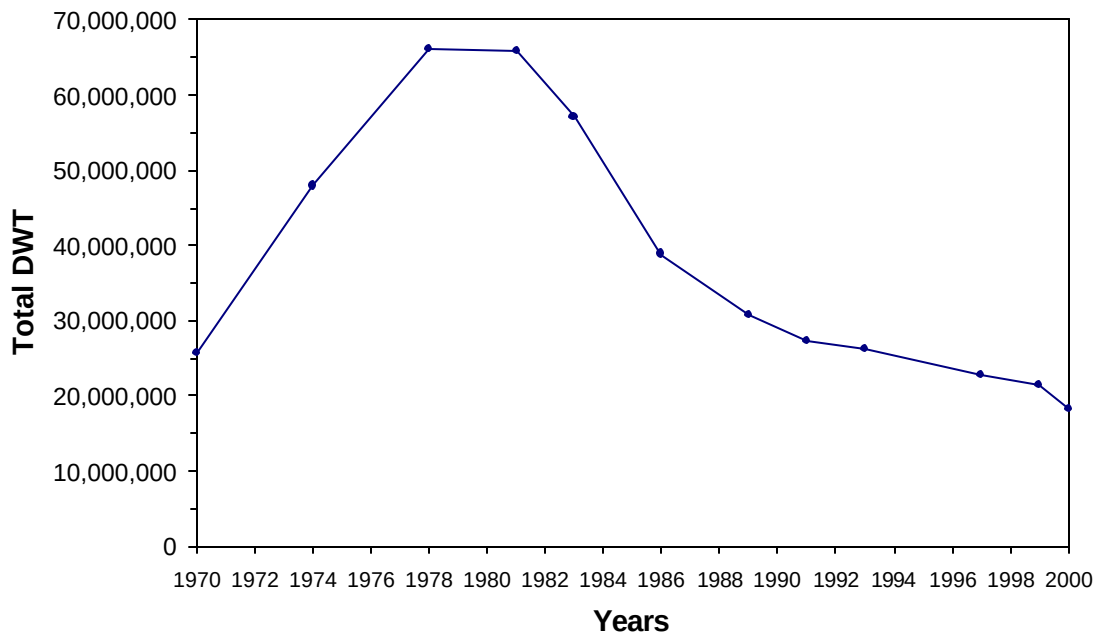
owned, foreign flag fleet for April 2000, the last year for which a complete MARAD database of the U.S. owned, foreign flag fleet is available, is contained in Appendix A.

The composition of the U.S. owned, foreign flag fleet includes container vessels, breakbulk vessels, passenger vessels, bulk carriers, and tankers. The largest segment of this fleet is the tanker portion, which accounted for 82 percent of the total dwt of the fleet in 2000. The trend in tanker ownership by U.S. companies has followed the historic pattern of the combined U.S. owned, foreign flag fleet. Figure 2.3 displays the total



- Source: 1) Marcus, Henry et. al., "U.S. Owned Merchant Fleet: The Last Wake-Up Call?", M.I.T., 1991.
2) Dean, Warren L. and Michael G. Roberts, "Shipping Income Reform Act of 1999: Background Materials Regarding Proposal to Revitalize the U.S. Controlled Fleet Through Increased Investment in International Shipping." Thomas Coburn LLP, 1999.
3) U.S. Owned, Foreign Flag Fleet Database, MARAD, January 1997.
4) U.S. Owned, Foreign Flag Fleet Database, MARAD, July 1999.
5) U.S. Owned, Foreign Flag Fleet Database, MARAD, April 2000.

Figure 2.1, Historical U.S. Owned, Foreign Flag Fleet - # of Vessels



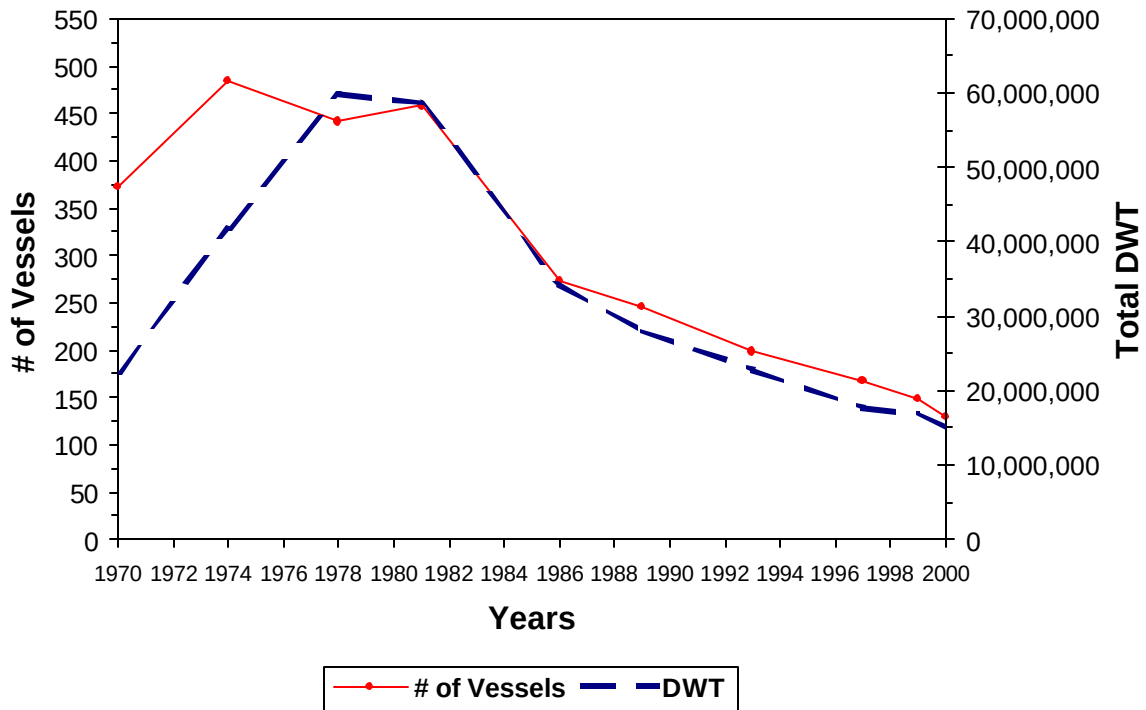
Source: 1) Marcus, Henry et. al., "U.S. Owned Merchant Fleet: The Last Wake-Up Call?", M.I.T., 1991.
 2) Waters, Robert C. and Philip C. Koenig, "Decline of the U.S. Owned, Foreign Flag Merchant Fleet." 36th Annual Forum, Transportation Research Forum, 1994.
 3) U.S. Owned, Foreign Flag Fleet Database, MARAD, January 1997.
 4) U.S. Owned, Foreign Flag Fleet Database, MARAD, July 1999.
 5) U.S. Owned, Foreign Flag Fleet Database, MARAD, April 2000.

Figure 2.2, Historical U.S. Owned, Foreign Flag Fleet – Total DWT of Fleet

number and total dwt of tankers within this fleet from 1970 to 2000. In 2000, there were a total of 130 tankers. The dwt of this subset of the U.S. owned, foreign flag fleet dropped by 56 percent between 1986 and 2000.

The long term decline of the U.S. owned, foreign flag fleet reflects the selling or scrapping of vessels by their owners. It is apparent that vessels were removed from this fleet at a faster pace than owners sought to replace those ships. Figure 2.4 presents the average age of the vessels comprising the U.S. owned foreign flag fleet from 1978 to 2000. The graph reveals a steady increase in the average age of the fleet between 1978

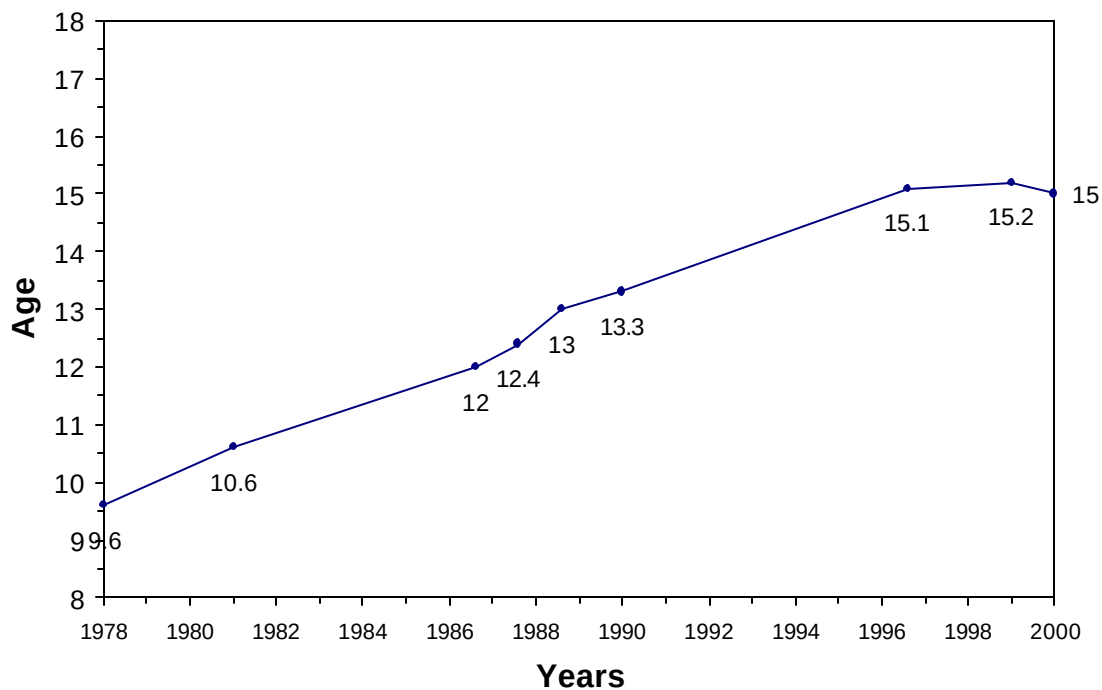
and mid-1996, which reflects the tendency of U.S. owners to avoid replacing ageing vessels after 1978. Since 1996, the average age has stabilized at about 15 years.



Source: 1) Marcus, Henry et. al., "U.S. Owned Merchant Fleet: The Last Wake-Up Call?", M.I.T., 1991.
 2) Waters, Robert C. and Philip C. Koenig, "Decline of the U.S. Owned, Foreign Flag Merchant Fleet." 36th Annual Forum, Transportation Research Forum, 1994.
 3) U.S. Owned, Foreign Flag Fleet Database, MARAD, January 1997.
 4) U.S. Owned, Foreign Flag Fleet Database, MARAD, July 1999.
 5) U.S. Owned, Foreign Flag Fleet Database, MARAD, April 2000.

Figure 2.3, Historical U.S. Owned, Foreign Flag Tankers – # of Vessels & Total DWT

An additional measure of the decline of the U.S. owned, foreign flag fleet is the decrease in the number of U.S. companies participating in this industry. The total number of U.S. companies that owned foreign flag vessels in 1987, 1990, 1993, 1997, 1999, and 2000 is presented in Table 2.1. In 2000, seventeen American parent companies owned foreign flag tankers.



Source: 1) Dean, Warren L. and Michael G. Roberts, “Shipping Income Reform Act of 1999: Background Materials Regarding Proposal to Revitalize the U.S. Controlled Fleet Through Increased Investment in International Shipping.” Thomas Coburn LLP, 1999.
 2) U.S. Owned, Foreign Flag Fleet Database, MARAD, July 1999.
 3) U.S. Owned, Foreign Flag Fleet Database, MARAD, April 2000.

Figure 2.4, Historical U.S. Owned, Foreign Flag Fleet – Average Age

# of U.S. Companies w/ Foreign Flag Vessels	Years					
	<u>1987</u>	<u>1990</u>	<u>1993</u>	<u>1997</u>	<u>1999</u>	<u>2000</u>
	52	43	38	48	39	35

Source: 1) Waters, Robert C. and Philip C. Koenig, “Decline of the U.S. Owned, Foreign Flag Merchant Fleet.” 36th Annual Forum, Transportation Research Forum, 1994.
 2) U.S. General Accounting Office, Tax Policy: “Uncertain Impact of Repealing the Deferral for Reinvested Shipping Income”, (GAO/GGD-90-35), Washington, D.C., 1990.
 3) U.S. Owned, Foreign Flag Fleet Database, MARAD, January 1997.
 4) U.S. Owned, Foreign Flag Fleet Database, MARAD, July 1999.
 5) U.S. Owned, Foreign Flag Fleet Database, MARAD, April 2000.

Table 2.1, Number of U.S. Owners of Foreign Flag Vessels

EFFECTIVE U.S. CONTROL FLEET

A. Historical Perspective

Effective U.S. Control is a long standing policy formulated by the Joint Chiefs of Staff that has its roots in the years leading up to and during the World War II. In essence, it provides that U.S. owned vessels registered under the laws of certain open registries can be deemed to be under the effective control of the United States for use in time of national emergency. It is noteworthy that not all open registries (e.g., Cyprus, Malta, Vanuatu, St. Vincent, etc.) have been deemed to be eligible EUSC registries, but that the five eligible open registries have all come into being with the strong support of American shipowning interests and, in most cases, the indirect support of the U.S. government.

The formulation of EUSC policy and the growth of open registries have run on parallel courses. Panama created the first open registry in the early years of the 1920s when two former German flag passenger vessels, having been transferred to the U.S. flag as war reparations, were transferred by Harriman Lines to the Panamanian registry in order to avoid the prohibition against sale of alcohol on U.S. flag vessels under the Volstead Act. In the years that followed another open registry came into being when the United Fruit Company began to register its ships in Honduras. The Panamanian fleet experienced a growth spurt during the mid-1930s when the Standard Oil Company of N.J. transferred its fleet of 25 tankers flying the flag of the Free City of Danzig to Panama in order to assure that the ships did not fall under Nazi control.

As originally enacted, the emergency requisitioning and use authority under Section 902 of the Merchant Marine Act of 1936 applied only to U.S. flag vessels. In the spring of 1939, however, as the likelihood of war in Europe and the Far East became increasingly apparent, Rear Admiral Emory S. Land, Chairman of the United States Maritime Commission and the official responsible for marshalling the nation's sealift assets during World II, appeared before Congress to urge enactment of certain amendments to Section 902 that the Navy and the Maritime Commission believed were "desirable, in the interest of our national defense." He told Congress that "...The power to requisition or purchase should not be confined to vessels 'documented under the laws of the United States,' because many vessels owned by our citizens are now under foreign registry.

Accordingly, the authority to requisition or purchase should extend to all vessels or watercraft owned by citizens of the United States." (Hearings on H.R. 4983 Before the House Committee on Merchant Marine and Fisheries, 76th Cong., 1st Sess. (1939), p. 9) (Emphasis added.) The House Report on Section 902 repeated verbatim this portion of his testimony. The amended Section 902 was enacted into law three weeks prior to the Nazi invasion of Poland.

When the war began, the Neutrality Act of 1939 prohibited U.S. flag vessels from trading with belligerents. This caused the Roosevelt Administration, seeking to ship oil and other essential supplies to Great Britain and France, to encourage the transfers of 70 U.S. flag ships to Panama and Honduras. In 1941, before the United States entered the war, the Maritime Commission requisitioned (under a statute passed earlier that year) 40 Danish flag vessels in U.S. ports and then arranged for the transfer to Panama of 30 of the

vessels, which were then operated by U.S. shipping companies. During 1941 and 1942 the Maritime Commission also arranged for the transfer of 47 other European owned vessels (primarily Italian and Finnish) it had seized in U.S. waters. Various other European flag vessels, including Norwegian and Greek ships, were transferred to Panama by their owners in order to assure that authorities controlled by the Germans would have no legal claim over them. Throughout the war the Panamanian and Honduran flag ships sailed alongside U.S. flag ships and other allied vessels, suffering many losses in the process. For instance, the ESSO tanker fleet flying the Panamanian flag lost 20 ships to enemy action, while the United Fruit Company fleet lost 17 ships. By May of 1944 the War Shipping Administration controlled a total of 127 Panamanian flag ships, including 61 owned and under charter from American companies and 66 either confiscated or requisitioned by the United States and operated for the most part by American companies.

It was during the war that the term “effective control” was adopted by the War Shipping Administration to differentiate between U.S. flag ships and those under foreign flags, principally Panamanian. In 1945 the Joint Chiefs of Staff considered the role of merchant shipping from the standpoint of national defense and concluded that “to be effective as an instrument of national defense U.S. merchant shipping should be under U.S. flag or effective U.S. control....” It further stated that “the term ‘effective United States control’ as applied to shipping is considered to include all shipping which can be expected to be available for requisition by the United States Government in time of

national emergency even though such shipping may not be under the United States flag...” (J.C.S. 1454/1).

In 1947 the Joint Chiefs of Staff clarified its earlier definition, apparently seeking to resolve the problem of those flag states that would not consent to the use of the vessels in their registries by the United States, as follows:

“The term ‘effective United States control’ as used [in J.C.S. 1454/1] appears to be inadequately defined. On a number of occasions doubt as to the meaning of the term has arisen. Except through agreement there are no legal means by which the United States can regain control of a United States merchant vessel the registry of which has been transferred to another country. From a legal standpoint therefore it can be considered that the only time a vessel is under absolute ‘effective United States control’ is when it flies the United States flag.

Actually, however, there are certain countries in this hemisphere which through diplomatic or other arrangements will permit the transfer to their registry of United States ships owned by United States citizens or United States corporations and allow these citizens or corporations to retain control of these vessels. Prior to entry of the United States into World War II, United States vessels were transferred to Panamanian registry for the purpose of rendering aid to the allies. Such a case as the above can be considered to be within the meaning of the term ‘effective United States control.’

When the foreign authorities who are in a position to dictate to the owner, master, crew, charterer or other individual or agency having physical control of the vessel are willing and able to bring the vessel under control of the United States in an emergency for such use as the United States may wish to make of the vessel, such vessel may also be considered to be under ‘effective United States control.’ It can be concluded, therefore, that the

primary considerations in determining whether or not a United States merchant ship would still be under ‘effective United States control’ are:

- a. The practice followed in the past in regard to transfer of United States merchant vessels to foreign registry.
- b. The status of diplomatic relations between the United States and the foreign country concerned.
- c. Its relations with countries opposed to our system of government or foreign policy.
- d. Proximity of the foreign country to the United States.
- e. The stability of its government.” (J.C.S. 1454/11)

World War II had introduced many U.S. shipping companies to open registries.

Following the war the Merchant Ship Sales Act of 1946 enabled the companies to acquire tankers and dry cargo vessels built during the war and transfer them to foreign registry.

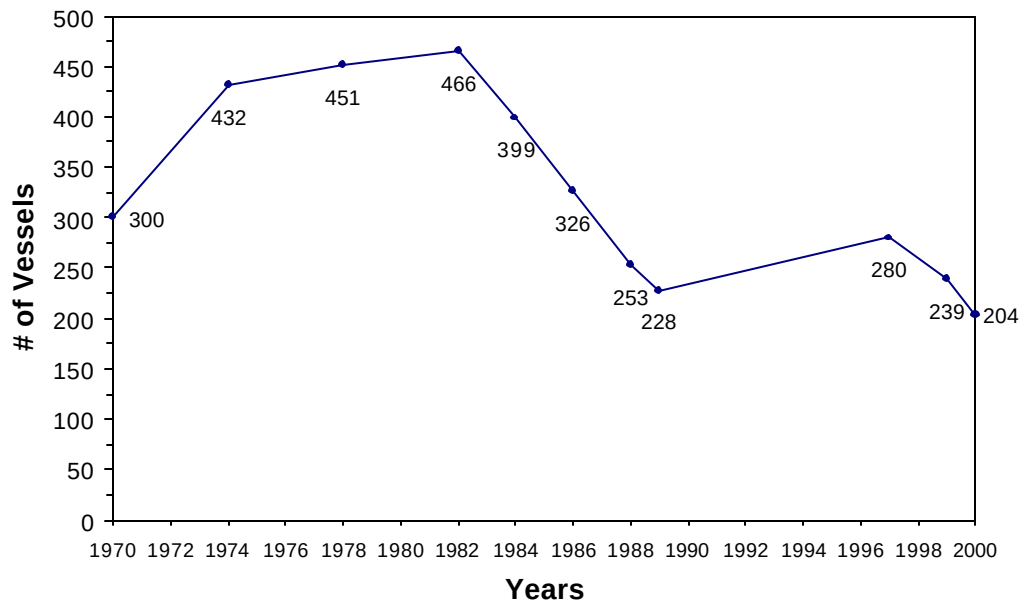
This growth spurt caused American shipowners to seek out another open registry more to their liking. In 1948, while preparations for a new Liberian registry were underway, the Joint Chiefs of Staff approved the status of Liberia as an EUSC registry, conditioned on the agreement by the Liberian government and shipowners that vessels would be returned to the United States in time of emergency.

For more than three decades the so-called PANLIBHON registries constituted the three eligible EUSC registries. However, in the early 1980s in the wake of political turmoil in Liberia, American shipowners undertook the search for another desirable open registry, an effort that resulted in the modernization of the almost moribund Bahamian registry, which was recognized as an eligible EUSC registry in 1983. In 1990, again with the

support of American shipping companies, the Marshall Islands also was recognized as an eligible registry.

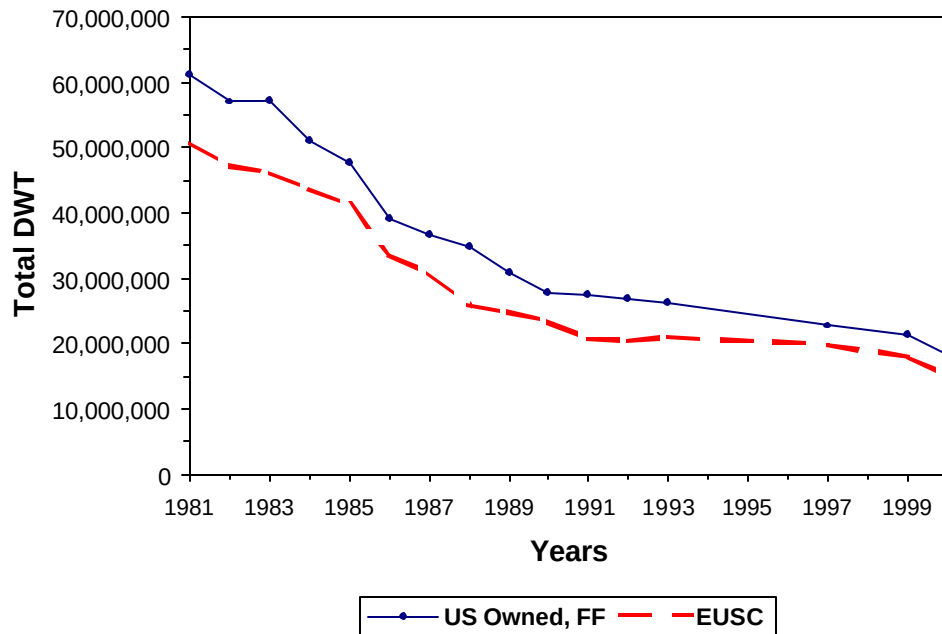
B. Growth and Decline

Not surprisingly, the growth and decline of the EUSC fleet over the past three decades is similar to the historical pattern of the overall U.S. owned, foreign flag fleet. In addition, the patterns of an increase in average age and of a decrease in the numbers of participating U.S. companies for the U.S. owned foreign flag fleet also apply to the EUSC fleet. Figure 2.5 and Figure 2.6 provide the trends for this fleet's size for the period 1970 to 2000 and 1981 to 2000, respectively. From Figure 2.5, a reversal of the decline in the number of EUSC vessels is apparent between 1989 and 1997. This upswing corresponds to a similar trend for this period for the U.S. owned, foreign flag fleet. It is possible that the addition of the Marshall Islands to the list of eligible flag states in 1990 was a cause for this upturn as both U.S. owners using ineligible foreign flags and several U.S. flag owners switched to the Marshall Islands registry. The historical pattern for dwt in the U.S. owned, foreign flag fleet is also included in Figure 2.6. A comparison of the sizes of the EUSC and total U.S. owned, foreign flag fleets reveals that the EUSC fleet encompasses the vast majority of the total fleet, which suggests that references to these fleets have increasingly become synonymous. While the number of EUSC and U.S. owned, foreign flag vessels realized an increase between 1989 and 1997, the total dwt of both fleets has maintained its decline. The number of tankers and total dwt of this portion of the historical EUSC fleets are presented in Figure 2.7. In 2000, the tanker subset comprised 84 percent of the total dwt of the EUSC fleet.



Sources: 1) Marcus, Henry et. al., "U.S. Owned Merchant Fleet: The Last Wake-Up Call?", M.I.T., 1991.
 2) U.S. Owned, Foreign Flag Fleet Database, MARAD, January 1997.
 3) U.S. Owned, Foreign Flag Fleet Database, MARAD, July 1999.
 4) U.S. Owned, Foreign Flag Fleet Database, MARAD, April 2000.

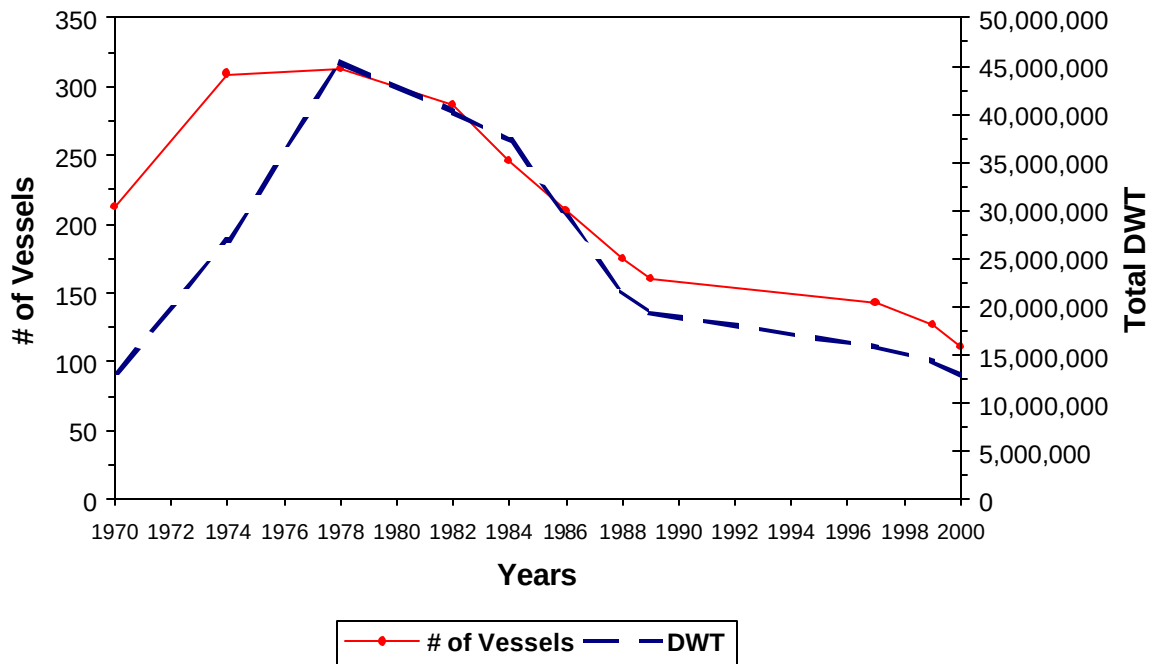
Figure 2.5, Historical EUSC Fleet - # of Vessels



Sources: 1) Waters, Robert C. and Philip C. Koenig, "Decline of the U.S. Owned, Foreign Flag Merchant Fleet." 36th Annual Forum, Transportation Research Forum, 1994.
 2) U.S. Owned, Foreign Flag Fleet Database, MARAD, January 1997, July 1999, April 2000.

Figure 2.6, Total DWT of Historical Fleets: U.S. owned, foreign flag and EUSC

On a dwt or carrying capacity basis, the EUSC tanker fleet has experienced a 72 percent decline between 1978 and 2000. For the period 1986 to 2000, the dwt of the tanker portion of the EUSC fleet dropped by 57 percent.



Source: 1) Marcus, Henry et. al., "U.S. Owned Merchant Fleet: The Last Wake-Up Call?", M.I.T., 1991.
 2) U.S. Owned, Foreign Flag Fleet Database, MARAD, January 1997.
 3) U.S. Owned, Foreign Flag Fleet Database, MARAD, July 1999.
 4) U.S. Owned, Foreign Flag Fleet Database, MARAD, April 2000.

Figure 2.7, Historical EUSC Tanker Fleet – # of Vessels & Total DWT

MILITARILY USEFUL EUSC TANKER FLEET

The numbers presented in Figure 2.7 represent the totals for all tanker vessels in the EUSC fleet. In terms of military sealift capabilities, not all of these vessels can be defined as *militarily useful*. The term *militarily useful* has different relevance in regard to dry cargo vessels and bulk liquid carriers. In addition, the Joint Chiefs of Staff has

altered the bulk liquid carrier standard over time. For example, the 1990 tanker standard was identified as:

- ✓ Sized between 6,000 and 100,000 dwt
- ✓ Possessing a beam less than 106-feet
- ✓ Capable of handling petroleum product cargos.¹

This standard permitted the use of chemical carriers but excluded specialty tankers, such as liquefied natural gas (LNG) carriers.

For the tank vessels of concern in this study, the term refers to bulk liquid carriers, including most types of tankers and integrated tug-barges, that meet the following criteria as defined by the Joint Chiefs of Staff under CJCSI 3110.11B of January 30, 1996:

- ✓ Sized between 2,000 and 100,000 dwt
- ✓ Possess a speed greater than 12 knots.

While chemical carriers are deemed militarily useful, specialized tankers such as liquefied natural gas (LNG) and liquefied petroleum gas (LPG) are still excluded.

Most literature on the subject of the EUSC fleet does not provide information on the historical size for the militarily useful portion of this fleet. As a result of the decline in the total size of the EUSC fleet over recent decades, the remaining militarily useful portion has become an increasing concern for military sealift planners. Two sources provide a limited historical view of the militarily useful tankers within the EUSC fleet. A 1990 Government Accounting Office (GAO) report cited the U.S. Navy as identifying 92

¹ U.S. General Accounting Office, Tax Policy: “Uncertain Impact of Repealing the Deferral for Reinvested Shipping Income”, (GAO/GGD-90-35), Washington, D.C., 1990.

militarily useful tankers to be drawn from the EUSC fleet. As of January 2001, the Maritime Administration's (MARAD's) database of militarily useful tankers within the total EUSC fleet identified 63 vessels. The information from these sources indicates a decline of approximately 32 percent in the number of militarily useful tankers in just over a decade. Table 2.2 provides the size and composition of the militarily useful portion of the EUSC tanker fleet as contained in the MARAD database for January 1, 2001. The 2001 MARAD database for the militarily useful EUSC fleet is contained in Appendix B. The average age of this portion of the EUSC fleet was 13.4 years in 2001.

<u>Type</u>	<u>#</u>	<u>Characteristics</u>	
		<u>DWT</u>	<u>Barrels</u>
Product Tanker < 80,000 DWT	28	1,281,928	9,595,005
Product Tanker > 80,000 DWT	7	609,250	4,369,410
Crude Carriers	18	1,642,623	11,702,755
Chemical Tankers	10	210,077	2,875,286
Total	63	3,743,878	18,947,451

Source: Maritime Administration, U.S. Department of Transportation, Militarily Useful, EUSC Tanker Fleet Database, January 2001.

Table 2.2, Size and Composition of the Militarily Useful, EUSC Tanker Fleet (2001)

The militarily useful standard for 1996 will be the baseline applied to all EUSC and U.S. flag tankers throughout this study. There are additional standards that can be applied to the tanker fleets. One additional requirement for modern tankers calls for the vessel to be 25 years or less in age. This condition is appropriate as many refineries and prominent oil companies are refusing to deal with tankers over this age. This standard was included by the military planners in the MRS-05 Sealift Tanker Analysis report. Another requirement, that is appropriate in light of the Oil Pollution Act of 1990 and MARPOL's Resolution 13/G, involves the phasing out of non-double hull tankers. These regulations will be discussed further in Chapter 5. As these regulations take effect, there will be few remaining trade routes where non-double hulled tankers will be permitted to trade.

Therefore, it seems reasonable to expect that these vessels will be scrapped upon reaching their respective phase out dates. Where these requirements are applied in addition to the JSC militarily useful standard, it will be noted.

OTHER SOURCES OF MILITARY SEALIFT TANKERS

There are three other primary sources of strategic sealift vessels available to U.S. military planners in addition to EUSC vessels. These sources include the Military Sealift Command, the National Defense Reserve Fleet, and the privately owned, U.S. flag merchant fleet. In addition, the MSC can charter foreign owned tankers, but these ships are not considered for planning purposes. The past and present sizes of these fleets are summarized in the following sections.

Military Sealift Command

The Military Sealift Command (MSC) operates a fleet of dry cargo ships and tankers in support of U.S. military forces. As a part of the U.S. Navy, this fleet is active in both peacetime and during military crises. These vessels are directly owned by the U.S. government, borrowed from the Ready Reserve Force (RRF) maintained by MARAD, or obtained through long-term charters of U.S. flag vessels owned by U.S. companies or citizens. According to its official website, MSC currently operates 122 active, non-combatant vessels in sealift, prepositioning, special mission, and naval fleet auxiliary force roles. MSC's operating plans call for a pool of fifteen Common User Tankers comprised of nine RRF and six long term chartered vessels. The six chartered vessels are privately owned, U.S. flag product tankers. For the purposes of this report, the chartered

vessels are considered the only MSC vessels that could be committed to supporting the transport of POLs during military emergencies. The RRF tankers are included with the National Defense Reserve Fleet discussed in the next section. It should be noted that these vessels are usually committed to on-going MSC duties, and they may not be available for sealift purposes. Table 2.3 contains the number, deadweight, and average age of the tanker sealift portion of the MSC fleet.

	#	Characteristics	
		<u>DWT</u>	<u>Average Age</u>
MSC Tanker Sealift Fleet	6	156,315	14.3

Source: 1) Military Sealift Command Website, www.msc.navy.mil, 2001.

2) Clarkson Research Studies, "Clarkson Register CD – 2001 Edition", London, January 2001.

Table 2.3, MSC Tanker Sealift Fleet Characteristics

National Defense Reserve Fleet & Ready Reserve Fleet

During World War II, a vast number of merchant vessels were constructed by the U.S. government to support the movement of supplies, military hardware, and troops from the United States to various locations around the world. Following the conclusion of World War II, the U.S. government possessed an excessive amount of tonnage for its sealift needs. To deal with the issue of these excess vessels, the NDRF was formed under the Merchant Ship Sales Act of 1946. Under this act, a portion of the excess tonnage was to be kept as an inactive fleet maintained by MARAD for use during national emergencies. During the decades following its inception, many vessels within the fleet were sold or scrapped, while naval auxiliaries and other government vessels retired from active service have been added to its total. The total number of vessels within the NDRF between 1946 and 2000 is graphed in Figure 2.8. The fleet currently encompasses 325 vessels of various types according to MARAD's Annual Report for 2000.

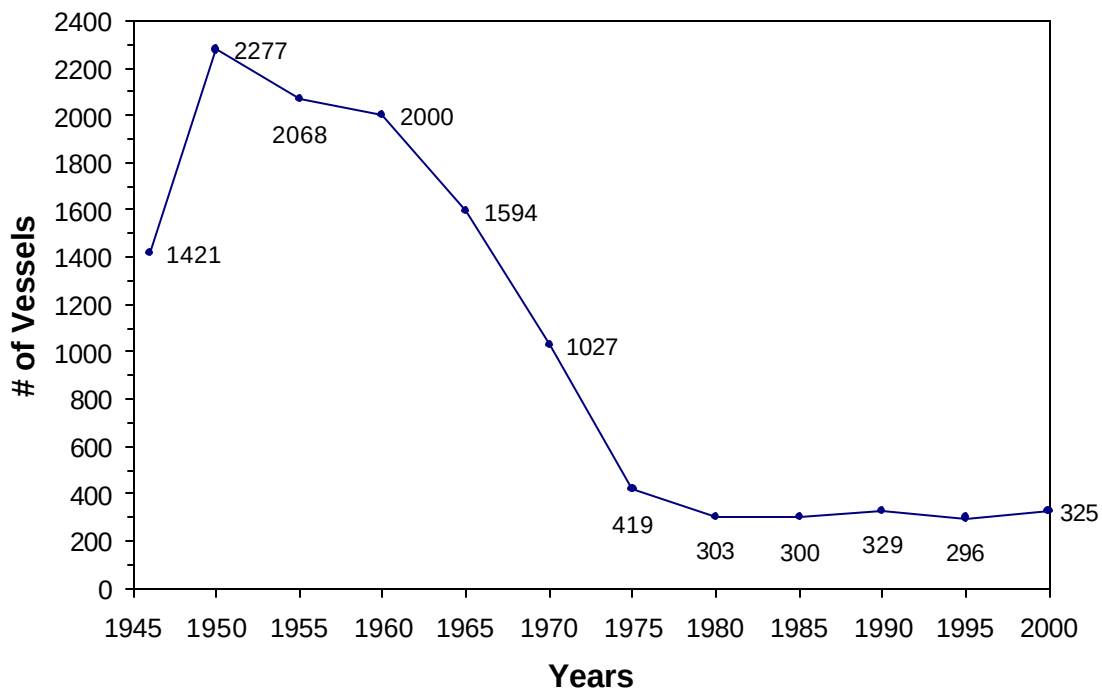
In terms of military sealift, the vessel totals for the NDRF are misleading. The vessels of the NDRF are maintained at a time-to-readiness of 60 days.² Further, as of September 2000, only 143 of these vessels were “being kept for the purposes of emergency activations, future historic display, spare parts, or congressionally legislated sale” according to the MARAD annual report for 2000. The remaining vessels are scheduled for scrapping or are being maintained by MARAD on behalf of other government agencies. For these reasons, the DoD only considers the use of a portion of this fleet in its current military sealift analyses. Within the pool of 143 “retention status” vessels is a subset of the NDRF referred to as the Ready Reserve Force (RRF), which is maintained at between 4 and 20 days of readiness.³

The tankers of the RRF serve as a source of additional tonnage for the DoD following the full mobilization of the MSC tanker fleet. In 1990, the RRF included 11 product tankers. The current total size and tonnage of the tanker portion of the RRF is presented in Table 2.4. All vessels within this fleet are product tankers of less than 80,000 dwt. The average age of the tanker portion of the RRF was 41 years in 2002, and the youngest vessel in this fleet was 32 years old. It should be noted that some of these vessels have limited usefulness in terms of interregional military sealift because of their small size and low speed. In addition, MSC occasionally uses RRF vessels for long term duties other than sealift, such as the current use of the Chesapeake and Petersburg in MSC’s Prepositioning Program.⁴

² Ibid.

³ Maritime Administration, U.S. Department of Transportation, The Annual Report of the Maritime Administration for Fiscal Year 2000, July 2001.

⁴ Military Sealift Command Website, www.msc.navy.mil, 2001.



Source: 1) Maritime Administration, U.S. Department of Transportation, The Annual Report of the Maritime Administration for Fiscal Year 1999, May 2000.
 2) Maritime Administration, U.S. Department of Transportation, The Annual Report of the Maritime Administration for Fiscal Year 2000, July 2001.

Figure 2.8, Historical NDRF - # of Vessels

<u>Vessel Name</u>	<u>DWT</u>	<u>Characteristics</u> <u>Speed (knots)</u>	<u>Age</u>
Alatna	7,300	10.4	46
Chattahoochee	7,300	10.4	46
Chesapeake	14,977	14.0	38
Mission Buenaventura	45,243	14.0	34
Mission Capistrano	45,877	14.0	32
Mount Washington	65,800	15.3	40
Nodaway	5,984	8.5	57
Petersburg	48,993	14.5	39
Potomac	35,330	15.7	38
Total Product Tankers	276,804		Avg. Age = 41

Source: 1) Military Sealift Command Website, www.msc.navy.mil, 2001.
 2) American Bureau of Shipping, "ABS Record 2002", 134th Edition, Port City Press, Baltimore, 2002.

Table 2.4, RRF Sealift Tanker Characteristics

U.S. Flag Merchant Fleet

Private companies and citizens own the majority of the U.S. flag fleet. The U.S. flag fleet can be divided based upon the trading regions served by the vessels. The foreign trade share of the fleet sails between American ports and foreign ports or between foreign ports. The domestic portion of the privately owned, U.S. flag fleet sails between American ports. These trade routes are restricted to certain vessels under the U.S. flag through cabotage laws. These cabotage laws, in conjunction with the Merchant Marine Act of 1920, known as the Jones Act, require that vessels trading between U.S. ports meet the following requirements:

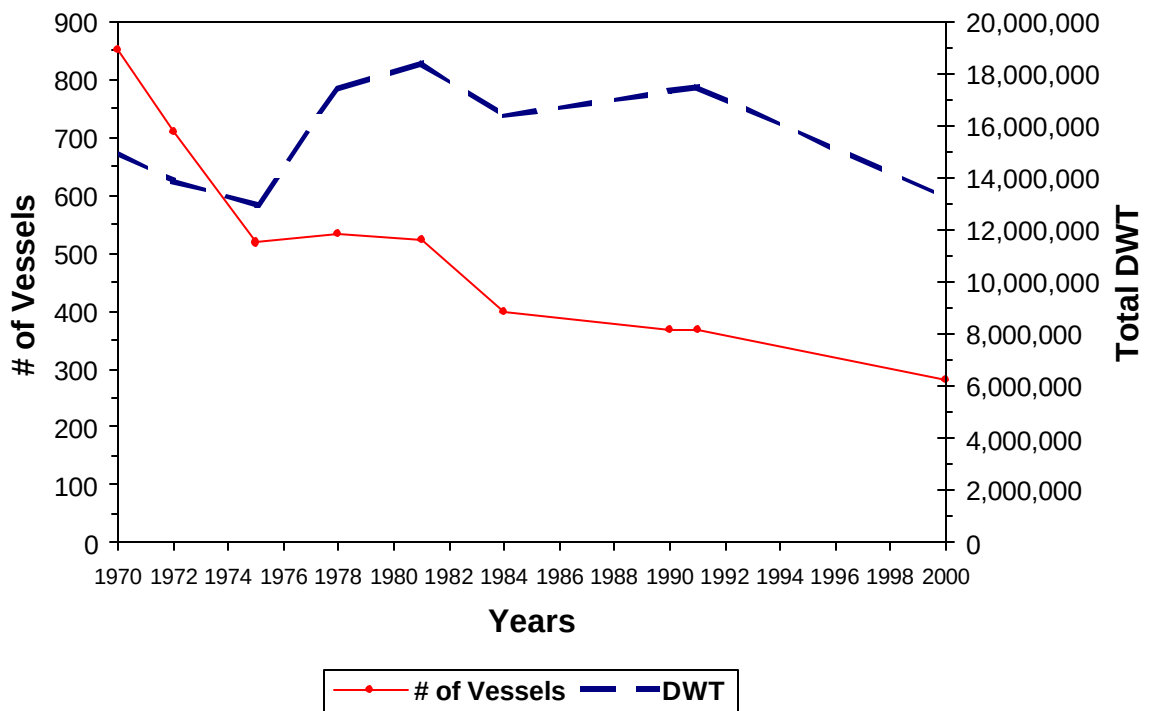
- 1) Vessels must be U.S. flag
- 2) Vessels must be owned by U.S. citizens
- 3) Vessels must be built and repaired in U.S. shipyards
- 4) Vessels must be crewed by U.S. citizens.

For privately owned, U.S. flag vessels operating on foreign trade routes, the competitiveness of the marketplace has resulted in a steady decline of this portion of the fleet over the past three decades. The higher crewing costs, higher insurance rates, more demanding regulations, and higher tax burden of vessels employing U.S. citizens and operating under the U.S. flag, as compared to most foreign flag vessels, has greatly reduced this segment. Many of the companies who owned these vessels have been forced to re-flag or sell their ships as they became uncompetitive in international trade.

A few older, U.S. flag tankers have been retained for the government-sponsored PL480 grain program. These privately owned tankers survive because U.S. flag carriers are guaranteed a portion of this trade. In 2001, there were approximately twelve U.S. flag

ex-tankers operating in this trade. A few of these tankers have not yet reached their non-double hull phase out dates under the requirements of the Oil Pollution Act of 1990 (discussed in Chapter 5), and these are included in the current figures in this report. The remaining PL480 vessels, now only capable of carrying dry bulk cargos, do not appear as tankers in any of the current figures in this document as they can no longer carry oil in U.S. waters.

With the domestic market protected from foreign competition, the cabotage fleet must compete only with land-based alternatives. This fleet has also benefited from the opening of the Alaska North Slope to oil production in the mid 1970's, which resulted in



Note: Totals for 2000 include all self-propelled vessels over 1000 GRT including ITBs and ATBs.

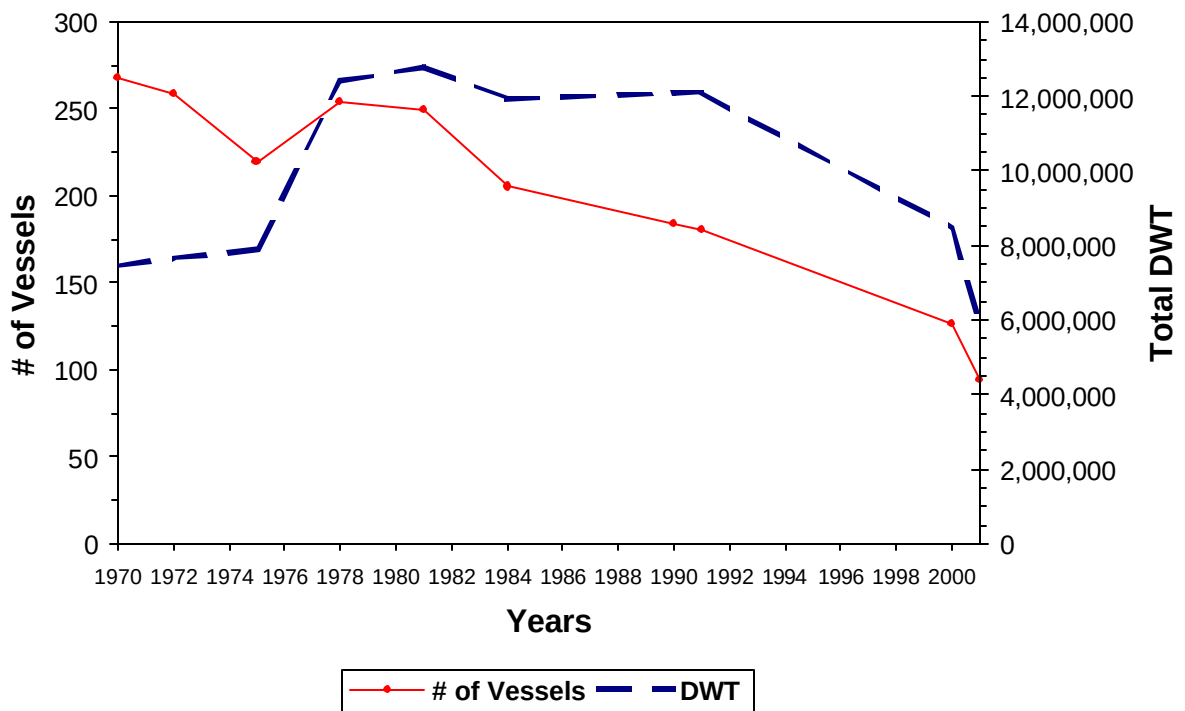
Source: 1) MARAD Annual Reports for 1970, 1972, 1975, 1978, 1981, 1984, 1990, 1991

2) Maritime Administration, "Cargo-Carrying Capacity of U.S. Flag Fleet by Area of Operation for January-June 2000", www.marad.dot.gov, 2001.

Figure 2.9, Historical Privately Owned, U.S. Flag Fleet – # of Vessels & DWT

substantial growth in the domestic crude oil trade. While the total domestic seaborne trade has grown substantially over the past thirty years, the average size and deadweight of vessels in this trade also grew. As a result, the domestic fleet has maintained a relatively stable size in terms of dwt while the number of vessels has declined steadily since 1970. The total number of ships and the deadweight tonnage of the combined domestic and foreign trades since 1970 are shown in Figure 2.9.

The U.S. flag fleet contains a significant number of tankers. The historical size, in terms of number of vessels and of capacity in barrels, of the privately owned, U.S. flag tanker



Note: DWT of tanker fleet for 2001 is estimated by dividing fleet capacity in barrels by 7.1 barrels/DWT.

Source: 1) MARAD Annual Reports for 1970, 1972, 1975, 1978, 1981, 1984, 1990, 1991

2) Maritime Administration, "Cargo-Carrying Capacity of U.S. Flag Fleet by Area of Operation for January-June 2000", www.marad.dot.gov, 2001.

3) U.S. Coast Guard, U.S. Department of Transportation, "Status of the Replacement of U.S. Single Hull Tank Vessels with Double Hull Tank Vessels under OPA 90." 2001.

Figure 2.10, Historical Privately Owned, U.S. Flag Tankers – # of Vessels & DWT

fleet is shown in Figure 2.10. The U.S. flag tanker fleet, including integrated tug barges and articulating tug barges, contained a total of 94 tankers in 2001, according to a United States Coast Guard (USCG) report to Congress concerning the U.S. flag tanker fleet. The modern tanker fleet can be further separated into crude oil tankers, product carriers, chemical carriers, LNG and LPG tankers, and specialty tankers. Specialty tankers include asphalt, bitumen, and molten sulphur carriers. There are currently no LNG tankers or LPG tankers in the U.S. flag fleet. The most recent breakdown of the U.S. flag tanker fleet is presented in Table 2.5.

<u>Type</u>	<u># of Vessels</u>	<u># of Double Hulls</u>
Crude Carriers	28	4
Product Tankers	55	20
Chemical Tankers	15	3
Specialty Tankers	1	0
LNG & LPG Tankers	0	0
Fleet Total	94	27

Source: 1) U.S. Coast Guard, U.S. Department of Transportation, "Status of the Replacement of U.S. Single Hull Tank Vessels with Double Hull Tank Vessels under OPA 90," 2001.
2) Clarkson Research Studies, "Clarkson Register CD – 2001 Edition", London, January 2001.

Table 2.5, Composition of Privately Owned, U.S. Flag Tanker Fleet in 2001

As with the EUSC fleet, not all of these tank vessels are considered militarily useful by the DoD. If the same Joint Chiefs of Staff standard applied to the EUSC tanker fleet is applied to the U.S. flag tanker fleet, there is a substantial reduction in the size of this fleet. In addition, the OPA-90 phase out dates for non-double hulled tankers cited by the report are used to remove individual vessels that can no longer trade in U.S. waters after June 2001. While these retired tankers could presumably still trade in other areas of the world, the combination of similar MARPOL regulations for other trade routes and of the present inability of U.S. flag tankers to compete in the remaining markets, except in

special circumstances, justifies their elimination. After all vessels have been screened for capacity, speed, and phase out requirements, the fleet is reduced from 94 to 62 vessels as of July 1, 2001. Of these militarily useful tank vessels, only 19 are double-hulled. It should be noted that U.S. flag vessels on long term charter to MSC were removed to avoid double counting and that specialty tankers, such as asphalt carriers, have been removed. In addition, integrated and articulating tug-barges were removed because these tank vessels were excluded by the Joint Staff/OSD study approved by the Director of the Joint Staff on January 27, 2001. These tug-barge combinations may have been excluded because either their operating speeds were below 12 knots or they were deemed unsuitable for sustained transoceanic voyages. Although some of the newer tug-barge combinations may be able to travel at 12 knots, it apparently would be unsafe for the tug and barge to disconnect if the weather got too rough on a transoceanic voyage.

The total U.S. flag tanker fleet database for 2001 and the militarily useful, U.S. flag tanker fleet database for July 1, 2001, are included as Appendix C. Both databases utilize the U.S. Coast Guard database of all U.S. flag tank vessels as of February 2001 as a

<u>Type</u>	<u># of Vessels</u>	<u># of Double Hulls</u>
Crude Carriers	16	1
Product Tankers	37	15
Chemical Tankers	9	3
Fleet Total	62	19

Note: Vessels on MSC Charter, asphalt carriers, ITBs, and ATBs excluded.

The JSC 1996 militarily useful standard plus OPA-90 phase out requirements by the end of June, 2001, were applied to the remaining tankers.

Source: 1) U.S. Coast Guard, U.S. Department of Transportation, "Status of the Replacement of U.S. Single Hull Tank Vessels with Double Hull Tank Vessels under OPA 90." 2001.

2) Clarkson Research Studies, "Clarkson Register CD – 2001 Edition", London, January 2001.

Table 2.6, Militarily Useful Privately Owned, U.S. Flag Tanker Fleet in July 2001

baseline source. Table 2.6 summarizes the composition and characteristics of the militarily useful portion of the privately owned, U.S. flag tanker fleet in July 2001.

STRATEGIC SEALIFT SOURCES

The MRS-05 Sealift Tanker Analysis is the most recent tanker sealift study by the Department of Defense (DoD). According to the unclassified portion of the MRS-05 report, the Military Sealift Command's fleet, the Ready Reserve Force, the privately owned U.S. flag fleet, and the EUSC fleet comprise the primary sources of strategic sealift for U.S. military planners. In the event of a protracted conflict, the DoD would presumably call upon these sources of tankers in the following order:

1. Vessels owned or chartered by the Military Sealift Command
2. Vessels chartered from the U.S. market on a voluntary basis (required by law before other government vessels may be activated)⁵
3. Ready Reserve Force vessels from the NDRF
4. Requisitioned U.S. Flag vessels (requisitioning enabled after Presidential declaration of a national emergency)
5. Requisitioned EUSC vessels (requisitioning enabled after Presidential declaration of a national emergency)

While there are a few tankers within the NDRF not used by the RRF, the remaining tankers of the NDRF are presumably excluded as a result of the age of these vessels and the extended period of time required to reactivate these vessels.

In certain wartime scenarios, the U.S. military could gain access to tankers promised by NATO and/or South Korea.⁶ However, as will be discussed in the later chapters, the

⁵ Military Sealift Command Website, www.msc.navy.mil, 2001.

most pressing war scenarios in terms of POL sealift are expected to involve regions that do not require participation by our NATO or South Korean allies. In addition, the South Korean's had pledged no tankers as part of their sealift contribution according to the GAO report of 1990. The MSC is also able to charter vessels on the world markets to meet sealift requirements. This method was utilized during the Gulf War after MSC and RRF sources were exhausted. This conflict was of short duration and did not involve an opponent capable of attacking this chartered shipping. This approach may not be feasible in all scenarios, and it is outlined as a last resort by military planners in the unclassified version of the MRS-05 study.

Table 2.7 summarizes the total strategic tanker sealift sources available to U.S. military planners in 1990 and in July 2001. As previously mentioned, the EUSC fleet provided 22 percent of America's controlled tanker sealift capacity in June 1949. The EUSC fleet

	Militarily Useful Tankers		<u>Change</u>
	<u>1990</u>	<u>2001</u>	
Military Sealift Command ^{1,2}	24	6	- 75%
Ready Reserve Fleet ^{1,2}	11	9	- 18%
U.S. Flag Merchant Vessels ^{1,4}	134	62	- 54%
Effective U.S. Control Fleet ^{1,3}	92	63	- 32%
Total	261	140	- 46%

Note: The most recent JCS standard for militarily useful tankers was applied to vessels of the EUSC and U.S. flag fleets for 2001. An earlier standard was applied to these fleets in the 1990 GAO report.

Source: 1) U.S. General Accounting Office, Tax Policy: "Uncertain Impact of Repealing the Deferral for Reinvested Shipping Income", (GAO/GGD-90-35), Washington, D.C., 1990.

2) Military Sealift Command Website, www.msc.navy.mil, 2001.

3) Appendix B for Militarily Useful, EUSC Tanker Fleet

4) Appendix C for Militarily Useful, U.S. Flag Tanker Fleet

Table 2.7, U.S. Strategic Tanker Sealift Sources for 1990 and 2001

⁶ U.S. General Accounting Office, Tax Policy: "Uncertain Impact of Repealing the Deferral for Reinvested Shipping Income", (GAO/GGD-90-35), Washington, D.C., 1990.

provided 35 percent of the DoD's primary tanker sealift vessels in 1990. As of 2001, the EUSC fleet's contribution had reached 45 percent of the total vessels in the primary strategic sealift pool. The total estimated dwt of the primary fleet of militarily useful tankers was 7,261,252 in 2001. See Appendix B, Appendix C, Table 2.3, and Table 2.4. Of this total dwt, the EUSC tanker fleet contribution was 52 percent.

CONCLUSIONS

Several conclusions can be drawn about the primary sources of strategic sealift vessels available to U.S. military planners from the information presented in the previous sections. These conclusions can be summarized as follows:

- 1) The U.S. owned, foreign flag fleet has been declining in terms of total vessels and total dwt since 1976 and 1978, respectively. Between 1986 and 2000, the total carrying capacity of the fleet fell by 53 percent. The increase in the average age of this fleet after 1978 and the decrease in the number of U.S. companies participating in this industry after 1987 are also indicators of a decline within this fleet.
- 2) The size of the EUSC fleet is nearly synonymous with the size of the U.S. owned, foreign flag fleet, and it has followed the latter fleet's historical decline. Tankers comprised 84 percent of the total deadweight of the EUSC fleet in 2000. The EUSC tanker fleet experienced a 57 percent decline in DWT between 1986 and 2000. The number of militarily useful tankers within the EUSC fleet has fallen nearly 32 percent in the past 11 years.

- 3) The Military Sealift Command has exclusive access to just 6 tank vessels to commit to strategic sealift efforts as of 2001. These tankers are key contributors to daily MSC duties and may not be available for tanker sealift needs because of other commitments.
- 4) Many of the vessels of the NDRF are no longer included as strategic sealift assets by the Department of Defense. The tankers in the Ready Reserve Force portion of this fleet, which is still included in U.S. strategic sealift planning, has shrunk 18 percent, to 9 vessels, since 1990, and it has an average age of 40.1 years. Several vessels lack the speed and capacity to serve in a significant interregional sealift role. These vessels may be unavailable at times as they can also be called upon by MSC for extended support roles, such as the Prepositioning Program.
- 5) The privately owned, U.S. flag fleet has witnessed a steady decline in terms of total fleet size and of total tankers over the past 30 years. The militarily useful portion of the U.S. flag tanker fleet has fallen by 54 percent since 1990. This sharp decline is the result of the application of more recent Joint Chief of Staff bulk liquid carrier standards, reflagging, non-double hulled tanker phase out requirements, the scrapping of vessels, and the replacement of product tankers with combination tug-barges.
- 6) Between 1990 and 2001, the total pool of strategic sealift vessels available to the Department of Defense fell from 261 to 140 vessels, or 46 percent. The EUSC fleet's contribution, in terms of number of militarily useful tankers, to this pool has risen from 35 to 45 percent despite its own decline during this

period. In June of 1949, the EUSC militarily useful tankers made up 22 percent of the military's combined tanker sealift resources by dwt. The EUSC militarily useful tankers comprised 52 percent of the total primary tanker sealift resources in terms of dwt for 2001. As such, the remaining EUSC militarily useful tanker fleet provides a larger portion of the dwt to America's strategic tanker sealift resources than it did in June of 1949, which was only a few years after the inception of the U.S. effective controlled concept created during World War II.

- 7) This chapter has relied on MARAD databases and on other sources referencing MARAD databases to establish the historical EUSC fleet. In Chapter 5, we will analyze the accuracy of the most recent databases in more depth when describing the current EUSC militarily useful tanker fleet.

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CHAPTER 3

LEGAL HISTORY

INTRODUCTION

In Chapter 2, the decline in the EUSC fleet was shown over the past quarter century. In this chapter we identify how tax laws have changed during this time period. In Chapter 4, we will consider the impact of this legislation on the size of the EUSC fleet.

REVENUE ACT OF 1962

At the time that the Revenue Act of 1962 was under consideration by Congress, U.S. shipowners of foreign flag vessels operated under the general rule that U.S. taxpayers operating abroad are not subject to U.S. taxation on the income of their foreign subsidiaries so long as the foreign earnings were not paid upstream and the foreign subsidiaries were not operating in U.S. business. This rule, which still applies today to most U.S. companies operating abroad, allowed for the deferment of U.S. tax on foreign shipping income pending its payment or “repatriation,” usually in the form of dividends, to U.S. taxpayers. In effect, tax deferral provided U.S. shipowners with options for reinvestment and capitalization.

The 1962 tax bill was aimed at certain types of income (e.g., “tax haven” income) earned by a “controlled foreign corporation” or “CFC” by subjecting those types of income to U.S. taxation irrespective of repatriation to U.S. taxpayers. Of most importance in the

income classes established by the 1962 Act is “Subpart F” income which can occur in the case of a CFC in which the value or voting power is more than 50% controlled (directly, indirectly or constructively) by U.S. taxpayers, accounting for only those with stakes exceeding 10% of the vote. The 1962 Act imposed U.S. tax on the shareholders of the CFC – not on the foreign entity itself – based on the shareholders’ appropriable portions of the Subpart F income. All income that falls under this category is treated as a paid dividend, whether a dividend is paid or not.

During the congressional deliberations on the 1962 Act the Senate Finance Committee gave specific attention to shipping income earned by foreign subsidiaries of U.S. shipowning companies. The result was the Finance Committee voted to exclude such shipping income from the reach of Subpart F and in its Report explained that “this exception was provided by your committee primarily in the interests of national defense.” The 1962 Act that was ultimately passed by Congress contained this specific exclusion.

Consequently, the Revenue Act of 1962 continued tax deferral for shipping income of U.S. owned foreign shipping companies, but it laid the foundation for CFC taxation to come.

TAX REDUCTION ACT OF 1975

Prior to 1976, a blanket exemption existed for companies engaged in international shipping, absolving their profits from CFC tax obligations. The Tax Reduction Act of 1975, effective in 1976, eliminated the previous exemption for the shipping industry. As

a result, all income from international shipping became taxable; full-scale shipping operations, bareboat chartering, ship sales, and unrelated party income were all included in taxable income. Regardless, Congress was aware of the potential impacts such taxation had on an American-controlled merchant fleet in times of war or national emergency. As such, in H. Rep't No. 93-1502, 93d Cong., 2d Sess. (1974) accompanying H.R. 17488, at p. 106 (H.R. Committee Report accompanying a bill to repeal the shipping exemption of subpart F) it was noted:

"...the interests of the United States are best served if we have a significant U.S. owned maritime fleet. To assume and maintain this status, large amounts of capital are necessary. Further, many U.S. investors in foreign shipping corporations find their investments in such corporations "locked in" by the corporations' financing arrangements and its [sic] need to retain amounts for repairs and maintenance. If the present exclusions for shipping income were simply terminated and such income treated as constructively distributed to U.S. Shareholders, the foreign corporation's ability to meet these obligations would be jeopardized."

In response, Congress excluded from subpart F any international shipping income that was timely reinvested in specified foreign shipping investments. Included in "shipping income" were such items as dividends and interest from other related foreign corporations, gains from the sale of stock in such entities, the corporation's distributive share of a partnership's foreign shipping income, and of course income generated by a corporation's own international shipping activities. A provision of these rules permitted CFCs to combine foreign shipping incomes and qualified investments to determine to what extent subpart F income would be offset. Though reinvestment was an option, it often proved to be of little value. Restrictions of the deferral required that reinvestment

totals not be exceeded by depreciation or sold assets in any given year; any reinvestment made under those circumstances would result in the taxation of the corresponding income. Similarly, income retained for future long-term investment was not protected. Thus, any excessive qualified investment in a given year could not be exempted in future years.

TAX REFORM ACT OF 1986

The Tax Reform Act of 1986 further influenced the shipping industry by eliminating the last vestiges of tax deferral available to U.S. controlled foreign shipping companies, while leaving existing tax burdens. First, the reinvestment exemption was repealed, meaning that capital must be obtained from earnings after tax. Secondly, the ability to carry-over E&P (earnings and profits) deficits from pre-1987 years was eliminated, and subsequently such deficits could not be used to discount subpart F income. Lastly, the recapture provision which applied to prior year deferrals and reinvestment in international shipping businesses was continued, limiting companies' ability to make investments when needed.

Additional changes were made regarding a CFC's ability to offset E&P deficits of a related CFC's subpart F income. As required, only CFCs in the same chain of ownership, which are 100% owned by other members of the chain, and are formed in the same jurisdiction, may offset each other's subpart F income. This stipulation holds many impracticalities, in that the complexity of foreign registries alone does not lend itself to alignment under a single jurisdiction. The result is a disallowance of risk distribution both in jurisdiction and ownership - as joint ventures and financing options are eliminated

through the 100% ownership requirement.

The U.S. controlled foreign fleet is now responsible for taxes on its offshore earnings without any avenue for exemption by reinvestment. Similarly, U.S. shipowners are subject to taxation without the option of offsetting for economic operating losses generated in years before 1987.

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CHAPTER 4

LITERATURE REVIEW

INTRODUCTION

The discussion surrounding the size of the Effective United States Controlled fleet is one that has been ongoing for many decades, particularly since the revocation of the income deferral clause by the Tax Reform Act of 1986. As such, literature is available on this very subject, and much can be learned through a review of this literature. This section of the report summarizes and discusses key points presented in representative pieces of literature. We wish to learn to what extent this literature can explain the decline in the size of the EUSC fleet. We have separated the documents into the following categories: Justification for the EUSC Fleet, Questioning the Impact of the Tax Reform Act of 1986, Current Issues, and Attempts at Improving the Competitiveness of U.S. Shipowners.

JUSTIFICATION FOR THE EUSC FLEET

Introduction

This research is based on the premise that the EUSC fleet can be of military value in time of need. We start the literature review with two documents that explain the justification for the EUSC fleet.

Boleslaw Adam Boczek - Flags of Convenience - An International Legal Study

Mr. Boczek's book, published in 1962, presents a very detailed analysis of the definition and justifications for using flags of convenience in international shipping. Offered in the book is an excellent presentation on the history and predicted future of the Effective U.S. Controlled fleet.

Of most importance in this book is the discussion of the military usefulness of American-owned, foreign flag ships. Despite being written in 1962, the discussion clearly shows America's dependence on foreign flag ships during times of emergency. Having access to these ships is an advantage that is clear enough to see. Yet, the primary importance of these ships, according to Mr. Boczek, is that the U.S. military includes these vessels in its count of ships available for transporting military cargo. Were these ships removed from the count, or were the EUSC to dwindle from existence entirely, would the U.S. retain the ability to successfully execute a multiple theater war? The answer, according to Boczek (and the Navy spokesmen cited in the book), is no.

Federation of American Controlled Shipping – “The EUSC Fleet – Trends Relating to Present and Future Availability”

On January 13, 1986, The Federation of American Controlled Shipping (FACS) published an organized discussion of Effective U.S. Controlled shipping issues. A very thorough review of the definition of EUSC vessels is included, and is accompanied by statistical analysis of the fleet's decline. However, of particular import to our discussion

is the collection of quotes regarding EUSC. These statements show the supporting opinions of assorted officials throughout the 20th century.

The Joint Chiefs of Staff, in 1945, included EUSC ships in its strategic outline:

“To be effective as an instrument of national defense U.S. merchant shipping should be under U.S. flag or effective U.S. control and should be of such capacity that it is able to absorb substantial initial losses which may be occasioned by either a surprise attack or an efficient submarine and air interdiction of sea lanes, or both, and still perform the following services. . .”

The National Academy of Sciences-National Research Council completed a study in 1959 entitled “The Role of the U.S. Merchant Marine in National Security.” The report included the following comments on EUSC:

“For purposes of indisputable control, it would be preferable that all U.S. owned merchant shipping be documented under U.S. flag. Such an ideal situation does not exist. At the same time, U.S. flag merchant tonnage is not adequate to meet our total wartime needs. This is particularly true with tankers . . . In the event of war it will be necessary to augment U.S. flag shipping. The Maritime Administration and the Navy Department have determined jointly that it will be practicable to bring a portion of the U.S. owned foreign flag shipping under direct U.S. control in the event of a national emergency. This effective U.S. control concept is a matter of expediency, rather than choice, and applies essentially to designated shipping under the ‘flags of convenience.’”

Then Under Secretary of State C. Douglas Dillon also stated, in 1959, his support for the EUSC:

“My final thought on this subject is that, until such time as it may be feasible for these American shipowners to operate competitively under the United States flag, my Government retains its interest in the continued operation of ships under foreign flags, including the PANLIBHON (Panama, Liberia and Honduras) registries. From our viewpoint there are important and valid defense requirements which support this position.”

Attesting to the historical success of EUSC inclusion, the Office of Civil and Defense Mobilization reported in 1960:

“...in practice during World War II and Korea, when the United States called on privately-owned tonnage to meet defense needs, PANLIBHON vessels subject to emergency utilization by the United States were immediately made available. In neither case did serious problems develop because of the foreign nationality of the crews.”

In 1966, Maritime Administrator Nicholas Johnson confirmed the reliability of EUSC ships:

“Certainly if the history of Second World War and Korea is valid for purposes of future planning, history is on the side of this judgment. As a practical matter these ships have been available to the United States when needed. . .We are not now talking about ships owned by foreign citizens and

registered in foreign countries – which have in a small number of cases refused to carry our defense cargoes – but ships owned by American citizens. We are talking of plans that, by and large, those ships will continue to serve the raw materials import trades that they now serve – although some of them would be directly involved in the defense effort (and are today).”

Secretary of Defense, Robert S. McNamara, said in 1967:

“In a full scale national emergency, we believe ‘effective U.S. controlled ships’ will be as available to DoD as U.S. flag ships.”

Admiral James L. Holloway III, Chief of Naval Operations, said in his policy statement on March 1, 1978, the following things about EUSC:

“The United States has plans for the utilization of foreign flag ships of the Effective U.S. Control Fleet. These are U.S. owned or U.S. controlled ships of foreign registry of 1,000 gross tons or more, which are under contract to the Maritime Administration. These can be reasonably expected to be made available for U.S. use in time of emergency.”

On June 8, 1981, Secretary of Defense Caspar W. Weinberger told the National Maritime Council the following things regarding EUSC ships:

“The EUSC fleet is composed of some 465 ships primarily under Liberian registry with a few under Panamanian and Honduran flags. These ships, owned or controlled by U.S.

citizens, are considered in contingency plans for sealift requirements primarily as a source of ships to move essential oil and bulk cargoes in support of the national economy. The majority of those vessels are not considered militarily useful...

The EUSC countries of registry have stated that they will assert no control over the employment of ships on their registries, and that they will not interfere with the exercise of emergency authority by the governments of shipowners. They have indicated, with varying degrees of formality, that they would not interpose any objections to the exercise of U.S. requisitioning authority over U.S. owned ships ...the real basis for the effective U.S. control concept is the authority provided by Section 902(a) of the Merchant Marine Act of 1936 which authorizes the Secretary of Commerce to requisition ships in time of war or national emergency regardless of registry. . . Although we do not consider [foreign] crews as reliable as U.S. crews, we have no basis to believe that most of the ships in question would not be made available when needed.”

“National Security Sealift Policy”, National Security Directive #28, October 5, 1989

President George Bush signed this national security sealift policy directive on October 5, 1989. Key portions of the document of interest to us are:

“...in addition to the U.S. flag fleet we will continue to rely on the U.S. owned and allied shipping resources to meet strategic commitments to our established alliances. The Department of Transportation is responsible for ensuring that the appropriate legal and procedural mechanisms for exerting effective control over “effective U.S. control” ships are in place.

...development and implementation of specific sealift and supporting programs will be made with full consideration of the costs and benefits involved. New programs to enhance our ability to meet national security sealift requirements shall compete for resources with other national security programs.”

Authors’ Comments

What we hoped to demonstrate by including this first portion of Chapter 4 was the acknowledged importance of the EUSC fleet. Mr. Boczek’s observations, coupled with the numerous government quotes that follow, show that the greatest value in maintaining an EUSC fleet is not commercial, but military in nature. The practice of using U.S. owned, foreign flag ships for the transport of commercial American cargo (and military cargo, in few instances) during times of national emergency is “tried and true,” and presents a viable means of closing the capacity gap created by the decrease in U.S. flag ships.

QUESTIONING THE IMPACT OF THE TAX REFORM ACT OF 1986

Introduction

When the Tax Reform Act of 1986 was passed there was a difference of opinion as to its future impact. Phil Loree, who was then the Chairman of the Federation of American Controlled Shipping wrote in an op-ed piece in the Journal of Commerce:

“The losers are easy to identify. Heading the list are the U.S. shipowning companies (and their U.S. based employees) which have basically three choices open to them in the future:

First, they can continue their shipowning operations as before, and attempt to compete in a high risk, capital intensive business with after-tax dollars worth 66 cents while their foreign counterparts continue to amortize, upgrade and expand their fleets with full value dollars. Under this scenario the prospects of a lower return on investment by U.S. companies and the obvious tax advantage enjoyed by foreign owners will surely discourage future investments by the former. If they cannot renew and modernize their fleets on the same terms as their competitors, they will eventually lose their market position and many will be forced out of business.

A second choice is to transfer majority interest in the shipowning company to foreign interests. This would handle the tax problem. But it would be at the expense of control by Americans. For some this would be a distasteful but necessary option.

Obviously the third choice is simply to liquidate the fleets, and, if necessary to meet their own shipping requirements, to rely on tonnage chartered from foreign owners.

There are numerous variations on these approaches, and some companies may have other options open to them. But the bottom line is that repeal of the ability of U.S. companies to meet foreign competition on an even playing field will, under the inexorable laws of the market place, cause many U.S. shipping companies to be squeezed out of international shipping, particularly in the bulk and cruise trades. That process will predictably spill over and dampen future prospects for U.S. flag vessels, simply because many of the companies detrimentally affected by repeal of subpart F [tax deferral] also operate U.S. flag vessels, and in many cases the economic viability of each fleet is inextricably linked to the other.”

We can compare this prediction to the conclusions of four studies completed in the five years following the new Act.

General Accounting Office - Study of Effects of Repealing Tax Deferral

One of the most comprehensive reviews of the EUSC was prepared by the General Accounting Office as per the request of Charles E. Bennett, then Chairman of the Subcommittee on Seapower. Specifically, the GAO was asked to study the "effects of repealing the tax deferral for foreign earned shipping income," and to present figures for revenue generated by this repeal.

The GAO report begins with an intuitive explanation of the general circumstances surrounding the foreign earned shipping segment of American shipping. GAO indicates that the repeal of the tax deferral was effected because Congress "did not consider promoting U.S. investment in foreign flag shipping to be in the United States' interest . . ." Estimated revenue yields from the repeal were between \$160 million and \$240 million over a period of 5 years, as provided by the Department of the Treasury's Office of Tax Analysis. GAO was unable to determine the actual amount of tax revenue generated by foreign earned shipping income, but it is indicated that the amount of taxable foreign earned shipping income has risen substantially since the passage of the Tax Reform Act; this rise is attributed largely to the repeal of the tax deferral. In 1984, before the Tax Reform Act of 1986, approximately 21 percent of foreign earned shipping profit was taxable, while 70 percent of the same profit was taxed after the Tax Reform Act, in 1987.

Though GAO acknowledges a general increase in the proportional taxation of foreign earned shipping income, it does not believe that such taxation is a cause for the reduction in EUSC ships. The report indicates that the 1986 Tax Reform Act included a general tax reduction for all corporations that helped offset the increase realized by repealing the deferral. Similarly, the amount of income reported for taxation purposes declined after the Tax Reform Act, resulting in less tax revenue. Most interestingly, it is noted that the total tax revenue generated from foreign earned shipping income may have actually decreased following the Tax Reform Act: ". . . resulted in a small decline in tax revenue generated from foreign earned shipping income in 1987 compared with 1984. Had the deferral not been repealed, 1987 tax revenues would have been even less."

As mentioned before, GAO did not find any correlation between the reduction in EUSC ships and the repeal of the tax deferral. As cited in the report, the rate of decline of EUSC ships before 1986 is approximately equal to that of years after the Tax Reform Act.

Professor Henry Marcus - "U.S. Owned Merchant Fleet: The Last Wake-Up Call?"

In July of 1991, Professor Henry Marcus led a study on the future of the U.S. merchant marine, entitled "U.S. Owned Merchant Fleet: The Last Wake-Up Call?" Sponsored by Skaarup Shipping Corporation, this study analyzes the then recent decline of the fleet of American-owned ships, and offers explanations for the decrease.

One of the issues identified by the study is the relationships between American marine corporations and the United States government. Because the interests of the maritime

industry leaders are diverse (depending on the market served), lobbying is never consolidated. The result is a garbled expression of needs to the government, and no clear answer from the government. Instead of identifying the problems with proposed legislation in a single voice, the maritime industry retreats into several interest-specific camps and its needs remain unanswered by the government.

Though the higher cost of manning is a disadvantage to American shipowners, the real disadvantage is cited as being duties and taxation, particularly as it affects U.S. owned foreign flag ships. As before, the Tax Reform Act of 1986, and the repeal of the tax deferral are included as major setbacks for the industry. In addition, while many foreign countries do not require their seafarers to pay national income tax, American seamen have no such benefit.

In conclusion, Professor Marcus suggests that it is the responsibility of the U.S. government to act quickly, if it wishes to save the merchant marine. Only pro-maritime legislation and investment can keep the American-owned shipping fleet -- both U.S. flag and foreign flag -- from declining dramatically.

"Survey of American Controlled Shipping – Price-Waterhouse"

Another study entitled "Survey of American Controlled Shipping" was published in early 1990. The study, sponsored by the Federation of American Controlled Shipping, presents a complete analytic summary of all ships controlled by Americans.

An official definition of the EUSC is provided, and says that included are any "vessels owned by U.S. citizens or corporations and registered in certain foreign countries which will permit the United States to exercise control over such ships in an emergency." At the time of the study, Liberia, Panama, The Bahamas and Honduras were deemed to permit the requisitioning of U.S. ships, and thus comprise the EUSC countries. Extensive attention is given to the Tax Reform Act of 1986 in this report as well, and is cited as a primary cause for the decrease. A percentage change of -8.6 percent is shown in the number of ships between 1986 and 1988, which equates to a -13.7 percent change in deadweight carrying capacity. An average remaining useful life of 1.9 years was calculated for U.S. owned ships disposed of in 1989, suggesting that ships were being scrapped before necessary. Along that line, the average age of a U.S. owned ship was 12.6 years in 1989, a 10.8% increase from 1986, suggesting that reinvestment in new ships declined in that period.

Perhaps of greatest interest to the EUSC discussion are the results of the survey provided by assorted U.S. companies. Price Waterhouse conducted a telephone survey of those responding to the initial survey, asking whether or not a reinstatement of the tax deferral would be incentive for re-flagging ships to EUSC. The results of this survey show that "29 percent of nonEUSC ships would be reflagged (to EUSC nations) if deferral of tax on income from EUSC ships were restored. Thus, a restoration of deferral would translate into 1.55 million tons of additional EUSC flag ships." Survey respondents also estimated that the number of dispositions annually would decrease from 452,000 tons/year without the deferral to 363,000 gross tons/year if the deferral were restored.

"Taxation of the International Maritime Industry: A Comparative Study – Price-Waterhouse"

In 1990, a report entitled "Taxation of the International Maritime Industry: A Comparative Study" was prepared as per the request of the Federation of American Controlled Shipping. This study compared the taxation practices of the United States, Norway, Germany, United Kingdom, Japan and Greece; specific attention was given to policy with regard to foreign flag shipping operations.

The first portion of the Price Waterhouse study discusses the history of taxation on foreign controlled shipping corporations. Such history will not be re-discussed here, as chapter 2 of our report details just that; regardless, much of the material included in chapter 2 was obtained from the corresponding section of "Taxation of the International Maritime Industry: A Comparative Study."

Within the comparisons between countries, some very distinct differences are illustrated. Pooling systems exist in countries such as Norway and United Kingdom that allow for the manipulation of depreciable and taxable assets. These pools may allow the dispersal of gains to unrelated portions of the business (i.e. gains charged against machinery and equipment) in order to facilitate a deferral. Norway allows shipping losses incurred by an individual to be used to offset income from other unrelated sources, e.g. salaries and other business income. Other benefits are seen in Germany, Norway and Japan wherein simply having most of the company operate outside of the country in question is enough

to exempt it from CFC status, and absolve it from tax obligations. Greece is in a category of its own, as complete tax exemption is obtained almost without effort.

A complete review of the specific advantages and disadvantages experienced by shipowners of the various major maritime industries (as outlined by “the Price-Waterhouse study”) shows that American owned, foreign controlled shipping companies have far fewer tax advantages than do their contemporaries; furthermore, the same corporations have far more tax disadvantages/burdens than do their competition.

Authors’ Comments

The above analyses present many different issues to consider in reviewing the Tax Reform Act of 1986. However, all of the literature point in the direction of two primary trends:

- 1.) Shipowners, facing higher taxes and lower profits, opt to leave their current business. Typically, this can be realized by leaving the industry entirely (i.e. liquidation of all assets), or by transferring control/ownership of the corporation to foreign citizens. In many instances 51 percent of a corporation’s shares are controlled by a foreign entity, thus alleviating U.S. tax obligations.
- 2.) Shipowners stay in the market, and simply pay the higher taxes. Of course, this option is preferred by the U.S. government, but it also forces the company in question to operate at a guaranteed lower profit margin than its foreign competitors; the result is a decreased ability to compete, and may ultimately lead back to option 1 (leaving the U.S.).

Whether the Tax Reform Act of 1986 facilitated the decline of the EUSC was greatly disputed in the late 1980's and early 1990's, as shown in the conflicting opinions presented above. Regardless, the next section presents current opinions on the impact of the Tax Reform Act of 1986, over a decade after its implementation.

CURRENT OPINIONS

Chris Dupin - "Sailing Away," Journal of Commerce, January 2001

In the January 15-21, 2001 issue of Journal of Commerce Week, Chris Dupin published an article discussing the taxation of U.S. based shipping companies, and the impact such taxation has had on the industry. As with the other articles reviewed, Dupin cites the Tax Reform Act of 1986 as a primary source of the decline in U.S. owned foreign flag ships. A later Price-Waterhouse study is referenced in the article, and it suggests that U.S. owned tonnage in "open registries" dropped from 21.8 million gross tons (25.8 percent of the world's ships flying flags of convenience) in 1975 to 11.8 million tons (only 4.9 percent of the world's flag-of-convenience fleet) in 1996. It is observed in the article that U.S. maritime unions have opposed all attempts to undo the 1986 effects on foreign flag shipping, but have done so for no apparent purpose. The thought that eliminating U.S. owned, foreign flag ships would increase the amount of U.S. flag tonnage has been disproved, and is apparent in the industry's current reliance on subsidies.

Another valid point is made in regard to the overall tax revenue generated by U.S. based foreign flag shipping corporations. Whereas before 1975, tax revenues were as high as \$90 million, 1999 tax revenues were but \$50 million. Thus, while the individual

percentage of taxable income has risen, the number of participants in the industry has dropped sufficiently to offset any increased revenue. The article suggests that shipping companies sold their fleets, moved their companies overseas, began joint ventures, or were bought by foreign corporations as a result of an inability to compete.

The article offers several key perspectives on the causes and effects of decline of the American-owned merchant fleet. The most commonly cited cause for the deterioration of the EUSC fleet is clearly the repeal of the tax deferral option in the Tax Reform Act of 1986, which eliminated the option for CFC's to defer taxable income by reinvesting in shipping. This disadvantage is one with which foreign owned shipping competitors are not faced. Similarly, the information would suggest that the United States has taken a passive approach to the shipping issue. Numerically, the physical decline in the number of EUSC ships is shown, as is an increase in the average age of ships in the EUSC. Comparisons are made between American maritime policy and that of competitive nations, and the results show that American-owned foreign flag shipowners are given far more stringent tax treatment than are similar owners in countries such as United Kingdom, Greece and Norway.

“Analysis of Selected Maritime Support Measures” - Maritime Transport Committee of The Organization for Economic Cooperation and Development

In December of 2000, a report was prepared by a consultant, on behalf of the Maritime Transport Committee, addressing fundamental issues surrounding international shipping expenditures. The report addresses some of the key financial/fiscal issues facing various

OECD (Organization for Economic Cooperation and Development) and non-OECD governments, with regard to shipping.

One of the first conclusions found in this study is that shipping is a very capital intensive industry, and is therefore particularly sensitive to differences in returns on capital.

Because of this, many governments will make particular efforts to ensure that shipping companies retain the option of being competitive.

The effective tax rate of a country with regard to shipping is cited as being one of the most important influences on its success. With consolidation, effective tax rates in the world were found to be between –27 percent (i.e. tax credit) and 15 percent under "lean" freight rates. "High" freight rate levels showed an effective tax level between –13 percent and 18 percent. The report summarizes, "With consolidation, all countries except the United States came out with extremely low, and often negative, effective rates."

The report is very intuitive, and covers many assorted specifics regarding the international shipping industry. But most worthy is the conclusion that tax policy is fundamentally deterministic of a country's ability to support a profitable, commercial merchant marine; according to this report, the United States does not have a tax policy that accomplishes this.

“The NFTC Foreign Income Project: International Tax Policy For The 21st Century” – National Foreign Trade Council, Inc., March 25, 1999

In 1999, the National Foreign Trade Council published a study of tax policies and their relationship with foreign income. The analysis of the 1986 Act included in this report is particularly interesting. A very intuitive example, demonstrating the financial disadvantage experienced by U.S. shipowners, is in the report:

“The effect of the 1986 Act can be illustrated by the following simple example. A U.S. Company and a Japanese company both own and operate a shipping fleet through a Panamanian corporation, which is a common flag of convenience. . .Both companies have similar costs. . .and, for the sake of example, both companies earn \$1,000 from international shipping operations. This income is assumed not to be taxable under Panama’s income tax system.

“Under these facts, the Japanese-owned company can reinvest its \$1,000 of profits in new shipping assets, and is not liable for tax in Japan until its shipping profits are repatriated. By contrast, the U.S. owned shipping company is subject to \$350 of U.S. income tax because the \$1000 of shipping income earned by its Panamanian subsidiary is deemed to distributed to the U.S. parent under subpart F. As a result, the U.S. company has only \$650, after tax, to invest in new shipping assets. . .the cost of capital for the U.S. shipping company is over 50 percent higher than for its Japanese competitor.”

The report also concludes that the “extension of subpart F to shipping income” is largely responsible for U.S. owned shipping companies’ inability to compete internationally. The U.S. owned share of world open-registry ships has dropped from 26 percent in 1975 to just 5 percent in 1996. Lastly, the report makes a keen observation regarding tax income: “It is difficult to see how the U.S. economy or U.S. Treasury has benefited from the decline in the U.S. controlled foreign flag fleet. . .data indicate that the Treasury actually collects less tax on foreign shipping income. . .than under the pre-1975 law with full deferral.”

“U.S International Tax Policy Outdated” – National Foreign Trade Council, Inc.

On December 19, 2001, the NTFC released a report regarding the conclusion of the NFTC Foreign Income Project. In this report, the ultimate views of the report are summarized.

“We are dealing with 40-year-old tax laws that were written at a time when the global economy was a substantially different beast. . . Current law was established to discourage U.S. companies from entering into foreign operations. Today’s global economy, however, virtually requires major corporations to establish foreign operations just to remain competitive. In our view . . . the world’s economy has changed drastically, and it is high time to re-evaluate our international tax policies.”

It is further noted in the report that “among the United States’ major world trading partners, no other country taxes the foreign income of its companies as aggressively as the United States.”

Warren L. Dean, Jr. – Testimony Before House Committee on Ways and Means

On June 30, 1999, Warren L. Dean, Jr., Chair of the Subpart F Shipping Coalition, testified before the House Committee on Ways and Means regarding the deferral of foreign based shipping income. His presentation compares the legislative actions of the United States with those of competing maritime nations; he describes a general increase in taxation on American ship-owners operating under flags of convenience, countered by a substantial decrease in taxation on foreign flag shipping of other countries. Mr. Dean also cites a study by the National Foreign Trade Council ("The NFTC Foreign Income Project: International Tax Policy for the 21st Century") that showed "that the U.S. controlled foreign fleet cannot afford to compete effectively in the international market against trading partners that have adopted tax policies and incentives to support their international shipping industries." Mr. Dean's presentation urged the reinstatement of the taxable income deferral, and included a variety of examples and figures to support the request.

One example is as follows:

Assume an American-controlled shipping company needs, for competitive purposes, to offer service between Indonesia and Japan. U.S. flag services by a U.S. corporation is not an option. The expense of flying crews back and forth alone would be prohibitive. Subpart F, the purpose

of which is to prevent tax-motivated earnings through foreign corporations, reaches this transportation service and taxes it more onerously than it would tax U.S. flag service – even though this transportation is not within any rational definition of U.S. commerce. There is no legitimate tax policy for this absurd result.

Accompanying Mr. Dean’s testimony was the Shipping Income Reform Act of 1999, introduced to the 106th Congress by Representative E. Clay Shaw, Jr. This proposed bill outlines the current operating disadvantage of American-owned foreign flag ships caused by tax policy, and proposes that the subpart F exclusion be restored for U.S. owned ships.

U.S. Treasury Department: May 2002 Report

In May 2002 the Treasury Department issued a report entitled “Corporate Inversion Transactions: Tax Policy Implications” in which it reviewed the manner in which U.S. law currently treats the taxation of income earned outside the United States. In the course of its review the Treasury Department considered the impact of Subpart F and specifically cited shipping as a problem area:

“Income earned through a foreign subsidiary is subject to U.S. tax at the U.S. parent corporation level generally when it is distributed by the foreign subsidiary to the U.S. parent. However, under the rules of subpart F, the U.S. parent is subject to current U.S. tax on certain income of its foreign subsidiaries, without regard to whether the income is actually distributed to the U.S. parent. While the focus of the Subpart F rules is on passive, investment-type income earned abroad, the income subject to this current taxation can include income from active foreign business operations.

In contrast, many of our trading partners operate tax systems under which active

income earned by foreign subsidiaries and profits earned by foreign branches are exempt from domestic taxation...Other countries among our key trading partners have tax systems that are more similar to the U.S....However, no country has rules for the immediate taxation of foreign source income that are comparable to the U.S. rules in terms of breadth and complexity.

For example, the U.S. tax system imposes current tax on the income earned by a U.S. owned foreign subsidiary from its shipping operations, while that company's foreign owned competitors are not subject to tax on their shipping income. Consequently, the U.S. based company's margin on such operations is reduced by the amount of the tax, putting it at a disadvantage relative to the foreign competitor that does not bear such a tax. The U.S. based company has less income to reinvest in its business, which can mean less growth and reduced future opportunities for that company."

The Treasury Department Report concluded that "a comprehensive reexamination of the U.S. international tax rules is needed," and with respect to Subpart F stated that "the reach of the various anti-deferral regimes, which can operate to impose current U.S. tax on active business income earned abroad, should be reevaluated."

Authors' Comments

The above pieces of literature are representative of modern opinion regarding the 1986 Act and the EUSC. As shown before, opinions immediately following the passage of the 1986 Act were speculative and conflicting. But years after the legislation's implementation, a general agreement becomes clear: the EUSC fleet has declined tremendously, and the Tax Reform Act of 1986 is largely responsible for the condition.

While some EUSC shipowners were “trapped” into investing in new ships in order to keep from paying taxes on large amounts of “deferred taxes” that they had accumulated before the Tax Reform Act of 1986, the majority of EUSC shipowners moved in the direction of liquidating their EUSC ships while minimizing new investments.

Next, we will review legislative attempts to alter the 1986 tax code in an effort to revitalize the EUSC fleet.

ATTEMPTS AT CHANGING THE COMPETITIVENESS OF U.S. SHIPOWNERS

Introduction

Since 1986 attempts have been made at legislation that would increase the competitiveness of U.S. shipowners. Not all these proposed pieces of legislation would help EUSC tanker owners, but some identified below give a flavor of what some members of congress are thinking.

H.R. 3312 “Restore Access To Foreign Trade Act” – Rep. Weller of Illinois, November 16, 2001

This bill, as introduced, would “amend the Internal Revenue Code of 1986 to eliminate foreign base company shipping income from foreign base company income.” Effectively, the earnings of U.S. owned foreign flag shipping companies would be tax deferred as they were under the Revenue Act of 1962. This bill was cosponsored by Representatives

Judy Biggert, Mark Foley, John Shimkus, Philip M. Crane, and Charles B. Rangel. The last action, on date of introduction (11/16/2001) was referral to House committee.

H.R. 3262 - “Merchant Marine Cost Parity Act” – Rep. Oberstar of Minnesota, November 2001

This piece of legislation proposes to help the American merchant marine by reducing taxation on U.S. flag ships, and on American sailors. Additionally, for ships that have re-flagged to U.S. registry, the bill seeks to absolve ships from complying with U.S. Coast Guard standards, so long as they are in compliance with IMO regulations. These actions have the potential to decrease the cost of building, owning and operating a ship in the United States. Similar modifications in the insurance law governing vessel insurance would help to reduce total costs for American companies. This bill was cosponsored by Representative Don Young. The last action, on date of introduction (11/8/2001), was referral to House committee.

H.R. 3102 – Rep. Weller of Illinois, October 19, 1999

The bill proposed to amend the Internal Revenue Code so as to eliminate foreign base company shipping income from foreign base company income. This bill was cosponsored by Representatives Judy Biggert, Thomas W. Ewing, Henry J. Hyde, Donald A. Manzullo, Robby L. Rush, Philip M. Crane, Mark Foley, William O. Lipinski, David D. Phelps, and John Shmikus. The last action, on date of introduction (10/19/1999), was referral to House committee.

H.R. 265 – Rep. Shaw of Florida, January 6, 1999

This bill, known as the Shipping Income Reform Act of 1999, proposed the exclusion of certain shipping income from subpart F. Excluded from the bill were oil companies (though not oil carriers). Though this bill did not leave committee (last referred to House Committee on Ways and Means on 1/6/99), a scoring was completed on October 10, 2000. The scoring showed two things: first, an estimated \$264 million would be lost over a ten year period (2000-2010); second, some congressional staffers believe that the number of tax-paying EUSC shipowners will increase over the next 10 years, if no action is taken. Such an increase in EUSC investment is unrealistic, given the data presented thus far in our study. In fact, all available information suggests that without a major incentive, EUSC owners will continue to leave the United States and result in fewer tax dollars paid to the government (not more, as the scoring would suggest).

After reviewing the bill, we estimate that the major exclusions from eligibility would be non-EUSC ships and tankers owned directly by oil companies. That said, as of April 2000, there were 273 foreign flag vessels owned by U.S. parent companies; of these, 102 appear to be unqualified for the plan. In other words, up to 171 vessels may have been used in the official scoring (though the details of the scoring are unavailable). That equates to very little income lost for the government – especially if viewed on a per ship basis.

H.R. 3730 - “Shipping Income Reform Act of 1997” – Rep. Shaw of Florida, April 23, 1998

The Shipping Income Reform Act proposed to exclude certain shipping income from Subpart F. Specifically, any non-oil carrying ship, owned by U.S. citizen(s), operating in foreign to-foreign trades or in the Caribbean trades, or that belongs to a mixed fleet of U.S. and foreign flag ships, would not be considered a source of Subpart F income for taxation purposes. This bill was cosponsored by Representative William J. Jefferson. The last action, on date of introduction (4/26/1998) was referral to House committee.

H.R. 2684 – Rep. Shaw of Florida, October 21, 1997

Proposed legislation to amend the Internal Revenue Code of 1986 and provide for elimination of certain foreign base company shipping income from foreign base company income. This bill had no cosponsors. The last action, on date of introduction (10/21/1997), was referral to House committee.

CFC Amendment Draft – Rep. Jefferson of Louisiana, 1993

Representative Jefferson drafted an amendment to restore deferral of income for overseas shipping operations by a CFC, provided that the CFC’s controlled group maintained a U.S. flag fleet and the CFC does not carry proprietary cargo.

Proposal Scoring – Joint Tax Committee, October 5, 1993

The Joint Tax Committee advised Representative Jefferson that his proposed amendment had been “scored” at a cost of \$535 million over the period of 1994-1998 (effectively killing the proposal because of its perceived high cost).

Proposed Amendment, Jefferson Bill, September 29, 1993

Rep. Sam Gibbons, then Chairman of the House Ways and Means Trade Subcommittee, proposed amending the Jefferson provision to include relief for shipowners involved primarily in the Caribbean region.

National Sealift Strategy Task Force Report, 1990

Compiled by the Office of the Assistant Secretary of Defense (Production and Logistics), the report urged Congress to “restore the subpart F deferral for income from foreign shipping subsidiaries of U.S. companies that is reinvested in shipping operations.”

Testimony to Congress, MEBA, February 21, and March 1-2, 1990

During review of the fairness of the Tax Reform Act of 1986, industry and labor submitted testimony to the House Committee on Ways and Means. MEBA testified that “MEBA believes that the repeal of the shipping reinvestment rule . . . departs substantially from the overriding goals of the 1986 Act,” and requested “a limited restoration of the shipping income reinvestment rule, such as that proposed by Overseas Shipholding Group, Inc., which again would permit deferral of current tax on income from shipping

cargo on vessels pledged to aid the United States Government [in times of emergency] if such income is reinvested in those shipping operations.”

Authors’ Comments

The above list shows clearly that foreign earned shipping income is not out of the minds of all lawmakers. Rather, several official attempts have been made at allowing U.S. shipowners the opportunity to be more competitive. However, it should be noted that with each of the pieces of proposed legislation, a vote never took place. In other words, Congress hasn’t been given the opportunity to approve any of these bills – because they never leave committee. What results is a necessary re-submittal of each bill that goes unaddressed, and explains the similarities between many of the bills (they were simply resubmitted with new reference numbers).

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CHAPTER 5

ANALYSIS OF THE EUSC FLEET: MILITARY RELEVANCE & FLEET PROJECTIONS

In Chapter 2 of this study, the role of the EUSC fleet in providing the U.S. military with a significant source of sealift vessels was discussed. In terms of the transport of POLs, the 2001 EUSC fleet was shown to offer 63 militarily useful tankers, or 45% of the total pool of available tankers for military sealift. In this chapter, the current EUSC fleet for 2002 will be examined by investigating the parent companies found in MARAD's databases. The militarily useful tankers of the EUSC fleet will be discussed in the context of current and future military sealift analyses. These projections will take into account the effects of the Oil Pollution Act of 1990 and of the MARPOL 13/G regulations on the size of the EUSC fleet through 2015. In addition, a limited forecast of the militarily useful, U.S. flag tanker fleet will included. Finally, the effects of uncertainty concerning the replacement of scrapped non-double hull tonnage by current U.S. foreign flag vessel owners will be presented.

MRS-05: UNCLASSIFIED PORTIONS OF A MILITARY ANALYSIS

In 2001, we received an unclassified version of the U.S. military's latest sealift tanker analysis. This Joint Staff/OSD study centers around the transport of the primary fuel products used by the military to specific theaters of operation. The sealift analysis is defined by the following major assumptions:

- ✓ Sufficient tanker sealift resources must be available to U.S. military planners to support dual, simultaneous theater wars or conflicts as defined by the National Military Strategy.
- ✓ Tanker requirements are based upon meeting the shortfalls in military fuel product needs after sources within the theater are depleted.
- ✓ Only tankers meeting the Joint Chiefs of Staff standard for militarily useful tankers were utilized. Qualifying vessels that possess coated cargo tanks are the most desirable vessels.
- ✓ The tanker fleet used in this study is based upon a forecast for the year 2005 of available vessels from the MSC, the RRF, U.S. flag merchant fleet, and the EUSC.
- ✓ No vessels were set aside to support the economy of the United States.

Although many of the details were removed in the unclassified version of the analysis, the report does provide useful information about the needs of U.S. military planners. The scenarios involving U.S. military operations in Southwest Asia and the Far East, especially Korea, required the largest amount of tanker sealift support. The fuel products, which include JP-8, JP-5, and F-76, requiring transport would be sourced under all scenarios primarily from the United States, Europe, or Singapore.

This POL sealift would be shipped using a forecasted pool of strategic sealift sources as determined by MARAD and MSC for the year 2005. Their forecasts estimated a pool of 127 militarily useful, bulk liquid carriers available to the Department of Defense in 2005. These forecasts took into consideration the decline in the production of the Alaskan North Slope oil fields and the current rate of decline in the coastwise petroleum product trades of the U.S. In addition, their forecasts accounted for the phaseout of single hull, commercial tankers in the U.S. flag and EUSC fleets under OPA 90 and MARPOL 13/G regulations. The breakdown of this fleet by source is contained in Table 5.1. The planners creating this study separated seventeen shallow draft vessels from the original

pool of 127 vessels for use as intra-regional supply vessels. In this study, shallow draft RRF, Offshore Petroleum Discharge System (OPDS) tankers, and other commercial vessels of less than 20,000 dwt and 150,000 barrel capacity comprised the intra-theater fleet. The OPDS tankers are all drawn from the RRF, and the fleet included the SS Potomac, SS Petersburg, SS Mount Washington, and SS Chesapeake in 2000.⁷

The remaining 110 vessels are employed as inter-regional sealift tankers. As previously mentioned, the planners preferred vessels with coated tanks for this inter-regional sealift. The use of coated tanks is preferred because it improves the flexibility of the vessel by allowing it to carry all of the primary fuel products. Vessels with uncoated tanks are generally permitted to carry only one type of fuel product, F-76, following extensive cleaning of the cargo tanks. The 87 inter-regional sealift tankers with coated tanks form the fleet used in the analysis of possible military sealift scenarios. Within this fleet, 37 of the tankers would come from the EUSC fleet.

<u>Tanker Fleets</u>	# of Vessels	<u>Inter-regional Sealift Tankers</u>	
		All vessels	Vessels w/ Coated Tanks
Military Sealift Command	5	5	5
Ready Reserve Fleet	10	3	3
U.S. Flag Merchant Fleet	55	51	42
EUSC Fleet	57	51	37
Totals	127	110	87

Source: Joint Staff/OSD, Department of Defense, "MRS-05 Tanker Sealift Analysis" (Unclassified Version), U.S. Department of Defense, 2001.

Table 5.1, DoD Forecast of Sealift Tanker Fleet in 2005

⁷ Maritime Administration, U.S. Department of Transportation, The Annual Report of the Maritime Administration for Fiscal Year 2000, July 2001.

The analyses of the various scenarios covered by the MRS-05 study were performed using the Model for Inter-Theater Deployment by the Air and Sea, or MIDAS. The ability of available U.S. strategic sealift tanker sources to meet the sealift requirements of each scenario was evaluated based upon three Measures of Effectiveness (MOE). Only the description of MOE-1, which refers to the ability of the sealift fleet to avoid military fuel shortfalls during the early stages of a conflict, is pertinent to the current discussion. However, the results of the study indicate that the MRS-05 fleet of 87 tankers with coated tanks is insufficient to meet the standards of these MOEs in all scenarios. One solution, which is referred to as the Added Ship case, calls for the use of 20 of the 23 available uncoated tankers. When the additional tankers are employed, all evaluated scenarios achieve acceptable MOEs for 2005 except for MOE-1 in the Southwest Asia eastern region scenario. An alternative to adding uncoated tankers is also cited. Defense Energy Support Center (DESC) requirements and projections call for the assumption of minimal Host Nation Support (HNS) in performing these tanker sealift analyses. If additional in-theater sources of fuel products are assumed, which is referred to as the Added HNS case, then 78 tankers from the baseline MRS-05 fleet of 87 tankers are sufficient to achieve all applicable MOEs in all scenarios.

CAPACITY ANALYSIS OF THE EUSC TANKER FLEET

The MRS-05 study does not provide fleet projections after 2005 when the OPA 90 and MARPOL 13/G regulations will begin to have a more pronounced effect. Our research develops projections of the capacity of the militarily useful, EUSC tanker fleet through 2015. The decline of the EUSC fleet over the past three decades and the looming

enforcement of OPA 90 and MARPOL 13/G regulations make projections beyond 2005 an important subject. The first step in forecasting the future of this fleet is the construction of a capacity analysis for the fleet in 2002. The recreation of the MRS-05 analysis was considered as a possible way to evaluate the EUSC fleet through 2015. However, the amount of classified information required to achieve the level of detail involved in the MRS-05 study proved prohibitive. Instead, an analysis was generated that would provide the capacity of the militarily useful, EUSC tanker fleet in a given year based upon voyages to an unspecified destination 3,000 nautical miles from an unnamed loading port. The value of 3,000 nautical miles was determined by reviewing the unclassified portions of the MRS-05 study. In this report, it appeared that the most pressing scenarios, in terms of fuel deliveries, involved conflicts in Southwest Asia, on the Korean Peninsula, and in mainland Japan. We concluded that Singapore and Europe would be the closest reliable supplier regions for most scenarios under consideration in MRS-05. The approximate distances from Singapore to South Korea, Singapore to Southwest Asia, and Europe's Mediterranean coast to Southwest Asia (via the Suez Canal) averaged on the order of 3,000 nautical miles.

For this analysis, the term *capacity* refers to the barrels delivered per month and to the ton-miles attained per month. While this steady state analysis is more limited than the MRS-05 study, the projections generated are sufficient to demonstrate the estimated rate of decline in the capabilities of the pertinent EUSC tanker fleet.

EUSC, Militarily Useful Fleet as of June 2002

In Chapter 2, the latest strategic sealift capacity available to U.S. military planners as of 2001 is presented. The EUSC contribution is provided based upon a MARAD database of EUSC militarily useful tankers for January 2001 with 63 vessels and a total dwt of 3,743,878. We also obtained a MARAD database for militarily useful tankers for January 2002, which contained 63 vessels with a combined dwt of 2,996,856. Before determining the capabilities of the current EUSC, militarily useful fleet, the size and composition of the EUSC fleet as of June 2002 would need to be determined. Creating an independent, current database was undertaken in order to confirm MARAD's information. We felt this investigation was important given the increasingly global shareholder base of publicly traded shipping companies, the rise in joint ventures, and the restructuring of the world's fleet as a result of double hull tanker legislation and mergers.

The determination of a vessel's qualifications as an EUSC candidate can be complicated. The greatest concern is the issue of the nationality of the majority ownership of the vessel. For a vessel to qualify for the EUSC fleet, it must be more than 50 percent owned by a U.S. citizen or corporation (that could be the parent of a foreign subsidiary), and it must meet the requirements that force the owners to pay U.S. taxes on the income from these ships. An additional complicating factor that we took into account is that ships on capital leases are treated as wholly owned vessels of the leasee for tax purposes by the U.S.

There is historical precedence for joint ventures with foreign firms by U.S. based shipping companies. Following the passage of the Tax Reform Act of 1986, the percentage of foreign ownership in the U.S. controlled fleet began to increase. A 1990 study found that this percentage had become particularly high among newer vessels.⁸ By 1989, while older vessels in the U.S. owned, foreign flag fleet involved nearly no foreign investment, the pool of vessels built in the previous five years were 33.6 percent foreign owned. This survey also found that 31 of the 374 vessels assumed to be a part of the U.S. owned, foreign flag fleet, according to the 1988 MARAD database, were actually majority owned by foreign interests. Thus, these vessels would qualify neither as U.S. owned, foreign flag vessels nor as EUSC ships.

The January 2001 and January 2002 MARAD databases are the starting point for constructing a M.I.T. database of militarily useful, EUSC tankers for June 2002. We first reviewed the database for January 2001 for comparison to 2002. The operating companies in the 2001 MARAD database were:

- ✓ OMI Marine Services LLC
- ✓ OMI Bulk Management Co.
- ✓ Exxon Corporation
- ✓ OSG Corporation
- ✓ Mobil Shipping Co. Ltd.
- ✓ Fairfield-Maxwell Ltd.
- ✓ Fairfield-Maxwell Services
- ✓ General Maritime
- ✓ Conoco, Inc. (TX)
- ✓ Conoco Shipping

⁸ Price Waterhouse, Survey of American Controlled Shipping, Prepared for Federation of American Controlled Shipping, January 25, 1990.

- ✓ Chevron
- ✓ Dorval Kaiun
- ✓ Hiltveit Associates.

Next, we investigated the operating companies and associated parent companies in the January 2002 database to confirm the EUSC status of each vessel. The list of operating companies found in the MARAD database for January 2002 is:

- ✓ Alcoa Steamship Co., Inc.
- ✓ ChevronTexaco Shipping Co.
- ✓ Conoco Shipping Co.
- ✓ El Paso Marine Co.
- ✓ ESSO SAPA
- ✓ International Marine Transportation
- ✓ OMI Corporation
- ✓ OMI Marine Services LLC
- ✓ OSG Ship Management, Inc.
- ✓ PCS Phosphate
- ✓ Pertamina
- ✓ Ravenscroft Shipping Inc.
- ✓ Seaarland Shipping Management
- ✓ Y Ships USA, Inc. (Florida).

For each of these 2002 companies, a current or former employee was contacted to discuss the company, its current fleet, the types of vessel leases involved, and the nationality of the majority ownership of each vessel. In addition, each vessel's hull type and cargo tank coating information were collected. The results of this research have been compiled into the M.I.T. database of militarily useful, EUSC tankers for June 2002 as shown in Table 5.2. Appendix D contains the January 2002 MARAD database for EUSC, militarily useful tankers and the explanation of how the current database was derived from the

M.I.T. EUSC, Militarily Useful Tankers – Listing by Operator					
<u>Ship Name</u>	<u>Vessel Owner/Operator</u>	<u>Built</u>	<u>DWT</u> <u>(LT)</u>	<u>Speed</u> <u>(knots)</u>	<u>Hull</u>
Alcoa Steamship Co. Inc.					
MARLIN	Alcoa Steamship Co. Inc.	1977	15,000	13	DB
TARPON	Alcoa Steamship Co. Inc.	1977	15,000	13.5	DB
ChevronTexaco Shipping Co.					
CHARLES B. RENFREW	Chevron Transportation Corp.	1988	78,656	14	SH
R. HAL DEAN	Chevron Transportation Corp.	1988	78,656	14.8	SH
KENNETH E. HILL	Chevron Corp.	1979	81,273	15.1	SH
CHEVRON ZENITH	Chevron International Ltd.	1972	96,716	15.5	SH
Conoco Shipping Co.					
CONTINENTAL	Conoco Shipping Co.	1993	98,231	14.9	DH
GUARDIAN	Conoco Shipping Co.	1992	96,920	14.8	DH
PATRIOT	Conoco Shipping Co.	1992	96,920	14.9	DH
PIONEER	Conoco Shipping Co.	1993	96,724	14.9	DH
ExxonMobil Corporation					
PALM BEACH	Esso Petrolera Argentina SRL	1978	50,801	16.3	SH
RIO GRANDE	Esso Petrolera Argentina SRL	1982	15,450	12.5	SH
BAYWAY	Esso Petrolera Argentina SRL	1978	50,915	16.2	SH
El Paso Marine Co.					
ARUBA	El Paso Corporation	1980	69,118	15	DS
OSG Ship Management, Inc.					
DELPHINA	Overseas Shipholding Group	1989	39,674	14	DS
DIANE	Overseas Shipholding Group	1987	64,140	14	DS
LUCY	Overseas Shipholding Group	1986	64,000	14	DS
MARY ANN	Overseas Shipholding Group	1986	64,239	14	DS
NEPTUNE	Overseas Shipholding Group	1989	39,800	14	DS
SUZANNE	Overseas Shipholding Group	1986	64,000	14	DS
URANUS	Overseas Shipholding Group	1988	39,171	14	DS
VEGA	Overseas Shipholding Group	1989	39,674	14	DS
ANIA	Overseas Shipholding Group	1994	94,847	14.5	DH
BERYL	Overseas Shipholding Group	1994	94,799	14	DH
ELIANE	Overseas Shipholding Group	1994	94,813	14.5	DH
PACIFIC RUBY	Overseas Shipholding Group	1994	84,999	15.5	DH
PACIFIC SAPPHIRE	Overseas Shipholding Group	1994	96,173	15.5	DH
REBECCA	Overseas Shipholding Group	1994	94,872	14.5	DH
VENUS V	Overseas Shipholding Group	1981	79,999	14.7	SH/SBT
VESTA	Overseas Shipholding Group	1980	81,278	14.7	SH/SBT
COMPASS 1	Overseas Shipholding Group	1992	95,544	14	DS
V Ships USA, Inc. (Florida)					
CLEMENT	PLM International	1976	59,650	16	SH

Note: 1. DS – Double Sided; DB – Double Bottomed; DH – Double Hulled; SH – Single Hulled; SBT – Segregated Ballast Tanks

2. Esso Petrolera Argentina SRL (Sociedad de Responsabilidad Limitada) new name for Esso SAPA (Sociedad Anonima Petrolera Argentina)

Source: Appendix E

Table 5.2, M.I.T. EUSC, Militarily Useful Tanker Fleet for June 2002

MARAD Database. Appendix E contains a more detailed version of the M.I.T. database summarized in Table 5.2. The breakdown by vessel type for the June 2002, EUSC fleet is presented in Table 5.3.

			<u>Vessel Type</u>		OBOs	Total Fleet
	CPP < 80,000 dwt	CPP > 80,000 dwt	Crude Carriers	Chemical Carriers		
Number	15	4	11	0	2	32
Coated Tanks	9	1	5	0	0	15
Double Hull	0	4	6	0	0	10

Note: CPP = Clean Petroleum Product Carriers; OBO = Oil/Bulk/Ore Carriers

Source: Appendix E

Table 5.3, Breakdown of the M.I.T. EUSC, MU Tanker Fleet for June 2002

The M.I.T. database of June 2002 contains a total of 32 vessels with a combined dwt of 2,264,078 as described in Appendix E. MARAD is in agreement with this M.I.T. database. Of the vessels in the M.I.T. database, fifteen had fully coated tanks and ten had double hulls. The most valuable vessels according to the MRS-05 study are smaller product tankers with fully coated cargo tanks because of their greater operational flexibility and their ability to carry all fuel products. In the current fleet, the category for clean petroleum product carriers under 80,000 dwt included only fifteen vessels of which nine had fully coated tanks. None of the vessels in this category had double hulls.

The effort to compile this database has resulted in some other important characteristics regarding the EUSC, militarily useful tanker fleet. The MARAD databases for 2001 and 2002 listed thirteen and fourteen operating companies, respectively. The M.I.T. database for June 2002 contains only seven operating companies. Within this militarily useful database, one owner/operator, Overseas Shipholding Group, provides 56% of the fleet by

dwt. The three largest owner/operators in our database, OSG, ChevronTexaco, and Conoco, Inc., provide 88% of the EUSC, militarily useful tanker fleet for 2002 by dwt.

The initial analysis is based upon the M.I.T. database of militarily useful, EUSC tankers for June 2002 presented in Table 5.2. This analysis was done to show the available capacity of this fleet for June 2002 under the most optimistic circumstances. In this phase, all vessels in the database were used regardless of the presence of coated or uncoated tanks. In addition, all vessels are employed in the inter-regional tanker sealift role. This decision was based upon the standards for intra-regional tankers found in the MRS-05 study. Three vessels, the Alcoa Steamship OBOs and the Esso Petrolera Argentina SRL product carrier, *Rio Grande*, in the database have a dwt less than 20,000. However, the Alcoa vessels are primarily ore carriers and all three vessels have ageing, uncoated cargo tanks. It is assumed that these vessels would not be selected for this role. The final simplification is the assumption that all tankers carry the same type of fuel. No distinction is made between vessels carrying JP-8, JP-5 or F-76.

In order to determine the capacity of the fleet on a monthly basis, the number of voyages per month completed by each vessel within the fleet had to be calculated using a spreadsheet model. Calculating the voyages per month required the speed, the loading rate, and pump out rate of each vessel. The loading and pump out rates for these vessels were obtained from the 2001 version of the Clarkson Registry. When these rates were unavailable for certain vessels, this information was estimated using the data for similarly sized vessels of the same type.

In practice, cleaning time may be required to prepare a ship for the carriage of military fuel products. This period can range from 0 to 18 days depending upon the type of cargo carried on the previous voyage according to the MRS-05 study. For the present analysis, initial delays were deemed extraneous, and all cleaning times were set to zero days.

These assumptions will result in underestimating the number of vessels needed. With the information cited above, the total time required per voyage and the voyages completed per month for each vessel could be calculated. Using the voyages per month and cargo capacity of each vessel, the total amount of fuel delivered by the fleet in a given month was determined. The capacity, for a distance to theater of 3,000 miles, of the militarily useful, EUSC tanker fleet on both a barrels delivered per month and a ton-miles achieved per month basis is presented in Table 5.4.

	# of Vessels	<u>Characteristics & Capacities</u>		
		Total DWT	Mbbbls/month	Ton-miles/month
Militarily Useful, EUSC Tanker Fleet	32	2,264,078	24,695	10,434,602

Source: Appendix F

Table 5.4, Size & Capacity of the M.I.T. Militarily Useful, EUSC Tanker Fleet for June 2002

The capacity analysis used for the applicable EUSC fleet in June 2002 forms the basic model for generating forecasts of this fleet for years beyond 2002. In the next phase of this analysis, some tankers within the EUSC fleet were removed from the database under both the OPA 90 and MARPOL 13/G standards for the phasing out of single-hull tankers. Where information is available, vessels on order by companies that currently possess vessels within the EUSC fleet were added to the database. Following the incorporation

of these additions and deductions into the database, the fleet's capacity was determined for January 1, 2006, January 1, 2011, and January 1, 2016. These dates correspond to important deadlines within the phase out regulations.

Double Hull Legislation

There are two forms of double hull tanker regulations that are beginning to affect the global tanker industry. These new regulations are the Oil Pollution Act of 1990 (OPA 90) enacted by the U.S. Congress and MARPOL Regulation 13/G (Revised) approved by the International Maritime Organization in April 2001. Both forms of the double hull legislation restrict all single hulled, double sided, and double bottom tankers from trading past certain deadlines. After these deadlines, only double-hulled tankers will be allowed to operate in the ports of nations that have adopted these regulations. Although similar in intent, the phase out schedules of non-double hulled vessels under these acts do differ.

Year of Double Hull Compliance	Size of Vessel					
	5,000 to 14,999 GT		15,000 to 29,999 GT		30,000 GT or more	
	Single Hull	DS or DB	Single Hull	DS or DB	Single Hull	DS or DB
2001	35	40	29	34	23	28
2002	35	40	28	33	23	28
2003	35	40	27	32	23	28
2004	35	40	26	31	23	28
2005	35	40	25	30	23	28
2006	25	30	25	30	23	28
2007	25	30	25	30	23	28
2008	25	30	25	30	23	28
2009	25	30	25	30	23	28
2010	25	30	25	30	23	28
2011		30		30		28
2012		30		30		28
2013		30		30		28
2014		30		30		28
2015		30		30		28

Note: Vessels of ages shown or older must be phased out.

Source: National Research Council, Double-Hull Tanker Legislation: An Assessment of the Oil Pollution Act of 1990, National Academy Press, Washington, D.C., 1998.

Table 5.5, OPA 90 Phase Out Schedule for 2001 through 2015

OPA 90 began to affect vessels trading in U.S. waters starting in 1995. Table 5.5 presents the phase out schedule for all vessels to be removed under OPA 90 for 2001 through 2015. After 2010, all single hulled vessels must be phased out regardless of vessel age. After 2015, all single hull, double sided, or double bottomed vessels are prohibited from the carriage of all petroleum products within U.S. waters regardless of vessel age.

The MARPOL 13/G (Revised) regulation does not begin to affect vessels operating outside of U.S. waters until 2003. The phase out schedule of this regulation is divided into three categories. These categories are further divided based upon the deadweight of the vessel and the type of petroleum product carried. Table 5.6 presents the phase out schedule under MARPOL 13/G (Revised). For Category 1 through 3, a vessel must be removed from service by the start of its 26th year of operation. All Category 2 and 3

Category	Type	DWT	Cargo	Phase Out
1	Pre PL/SBT Pre-1981	> 20k	Crude and Dirty Oil	2003 – 2007
		> 30k	Other than Crude/Dirty	
2	PL/SBT Pre-1996	> 20k	Crude and Dirty Oil	2003 – 2015
		> 30k	Other than Crude/Dirty	
3	Oil Tanker	5k < dwt < 20k	Crude and Dirty Oil	2003 - 2015
		5k < dwt < 30k	Other than Crude/Dirty	

Note: PL/SBT refers to Protectively Loaded Segregated Ballast Tank regulations.

Source: National Research Council, Double-Hull Tanker Legislation: An Assessment of the Oil Pollution Act of 1990, National Academy Press, Washington, D.C., 1998.

Table 5.6, MARPOL 13/G (Revised) Phase Out Schedule

vessels must be removed from service by 2015 regardless of vessel age. Unlike the OPA-90 legislation, the MARPOL 13/G (Revised) regulation does not affect any chemical carrier involved exclusively in the carriage of chemicals. It should be noted that none of the vessels in M.I.T.'s EUSC, militarily useful database for June 2002 operate exclusively as chemical carriers. Category 1 and 2 vessels are also subject to a Condition Assessment Scheme (CAS), which is performed in 2005 for Category 1 vessels and in 2010 for Category 2 vessels. The failure of a CAS results in the early retirement of a subject vessel. In the present analyses, all Category 1 and 2 vessels were assumed to pass the CAS.

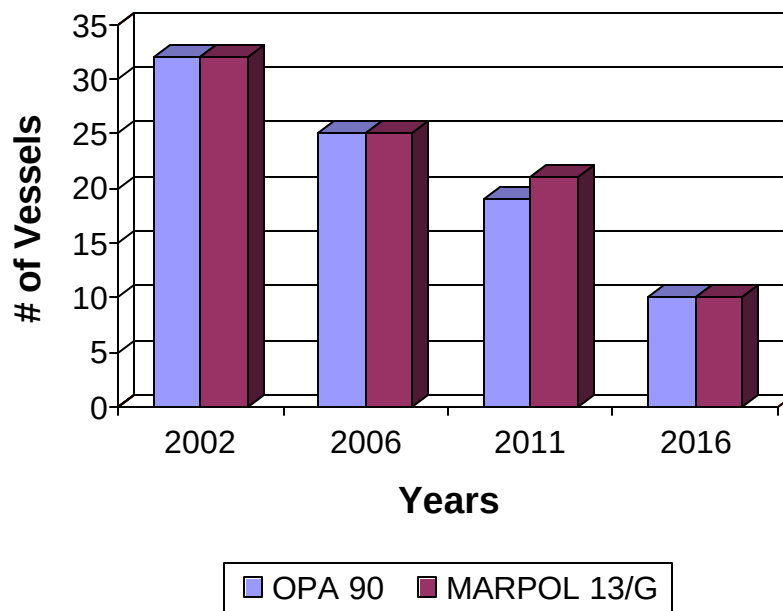
EUSC Fleet Projections

Based upon the phase out schedules described in the previous section, the M.I.T. database used in the analysis of the applicable EUSC fleet in 2002 was modified to indicate the availability of each vessel at the start of 2006, 2011, and 2016. The modified database was then duplicated for each single-hulled tanker phase out schedule and for each year under consideration to form a total of six separate databases (three for OPA 90 and three for MARPOL 13/G). Within each database, vessels that were unavailable for the year of the database using the applicable phase out schedule were removed.

New vessels under construction for companies currently operating vessels within the EUSC fleet were investigated using Fairplay Solutions for April 2002 and through discussions with current owners and operators within this fleet. Currently, none of these companies have militarily useful tankers on order. The uncertainty surrounding

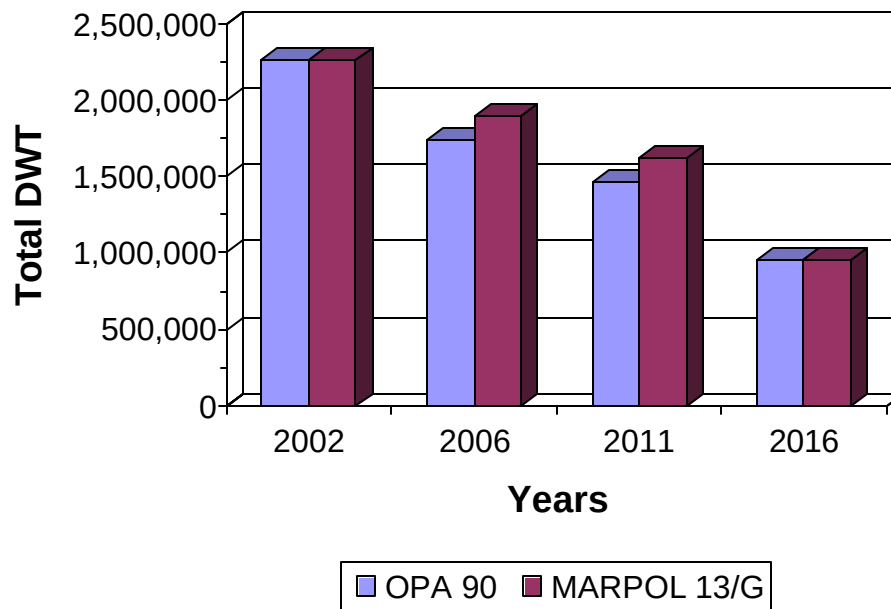
newbuildings over the next thirteen years will be dealt with in a later section. With each database corrected for pending additions and deletions, the projected fleet size and capacity could be determined for the start of 2006, 2011, and 2016 under both phase out schedules. The results are included as Appendix F. The projections for number of vessels, total deadweight of the fleet, barrels delivered per month delivered, and ton-miles achieved per month are displayed in Figure 5.1, Figure 5.2, Figure 5.3, and Figure 5.4, respectively, for 2002 through the end of 2015. It is important to note that only vessels affected by single-hulled tanker phase out schedules have been removed from the database. Projected sales or scrappings as a result of vessel age have not been included. The oldest double-hulled EUSC, militarily useful tanker in the database would be 19 years old in 2011 and 24 years of age in 2016.

The results presented in Figure 5.1 through 5.4 indicate that the OPA 90 regulations impose a more accelerated phase out schedule on the militarily useful, EUSC tanker fleet than the MARPOL 13/G schedule.⁹ By 2016, the fleet projections are identical. This result holds only for the vessel database under consideration because vessels exclusively utilized as chemical carriers do not require phase out under MARPOL 13/G. As the June 2002 database contains no pure chemical carriers, the results are identical for January 1, 2016. Both phase out methods result in a 69 percent reduction in the total number of tankers and a 56 percent drop in delivered capacity by the start of 2016. As the applications of the OPA-90 and MARPOL 13/G (Revised) regulations result in roughly the same rate of decline in the size of the EUSC, militarily useful tanker fleet, the OPA-



Source: Appendix F

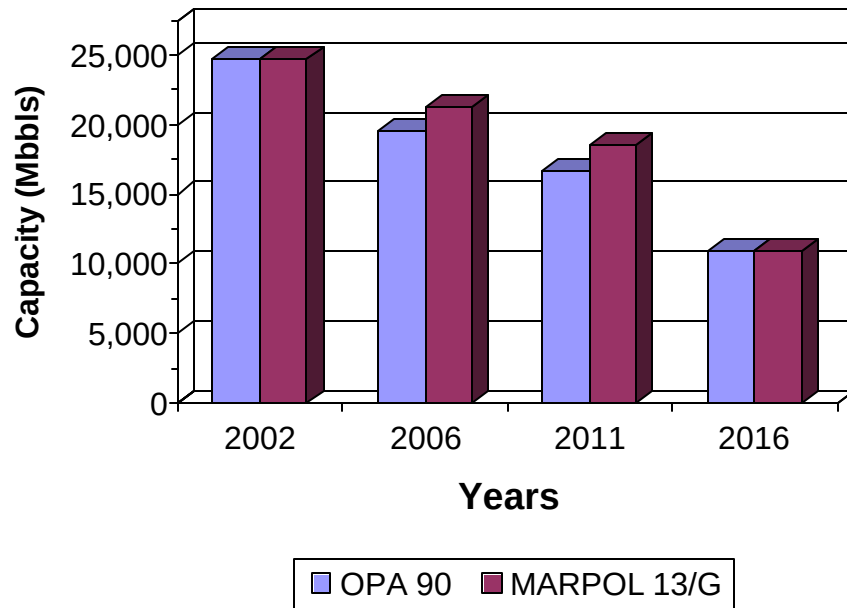
Figure 5.1, Forecast of # of Vessels in Militarily Useful, EUSC Tanker Fleet



Source: Appendix F

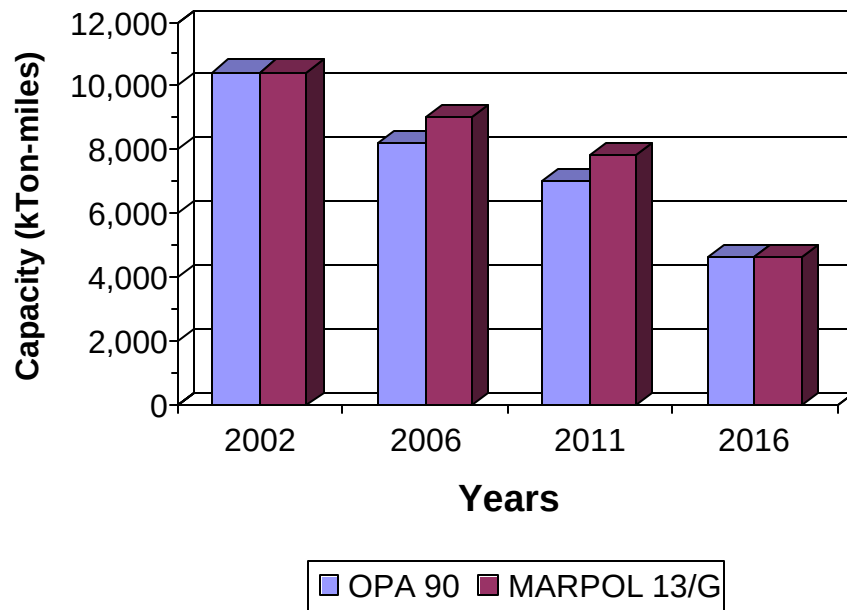
Figure 5.2, Forecast of Total DWT of Militarily Useful, EUSC Tanker Fleet

⁹ Note that identical fleet sizes in 2006 do not result in identical capacities for that year. While the fleet sizes match, the list of remaining vessels differ because of differences in the OPA-90 and MARPOL 13/G (Revised) regulations.



Source: Appendix F

Figure 5.3, Forecast of Barrels Delivered per Month by Militarily Useful, EUSC Tanker Fleet



Source: Appendix F

Figure 5.4, Forecast of Ton-miles Attained per Month

by Militarily Useful, EUSC Tanker Fleet

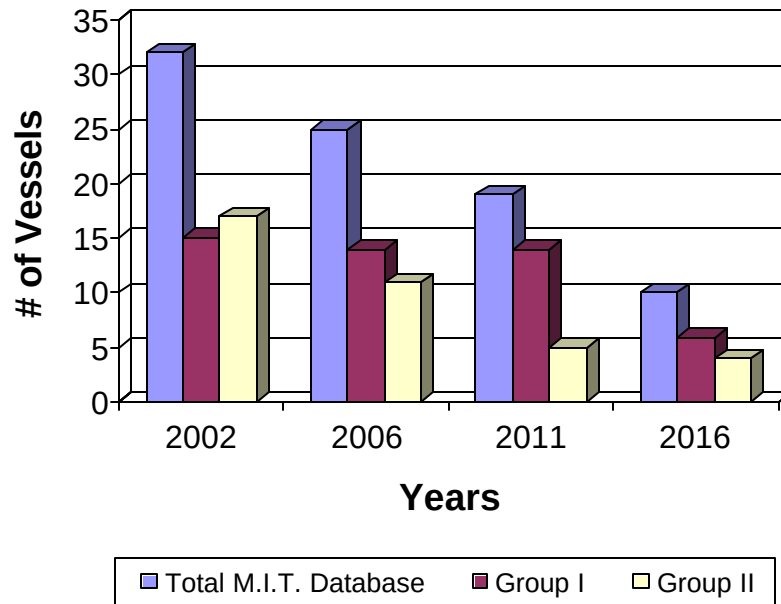
90 regulations will be used to establish the availability of tankers in future years for all remaining fleet size projections in this report.

EUSC Fleet Projections - Cargo Tank Coatings

The importance of tank coatings was established in the discussion of the MRS-05 report. Military planners prefer vessels with fully coated tanks because these vessels are able to carry all fuel products without the danger of contamination. The time required to clean coated cargo tanks when switching from crude oil to petroleum products is also reduced. The MRS-05 study considers uncoated tankers a backup source in the event that coated tankers are inadequate to meet sealift needs. The use of uncoated tankers and cleaning requirements are discussed more in Chapter 6.

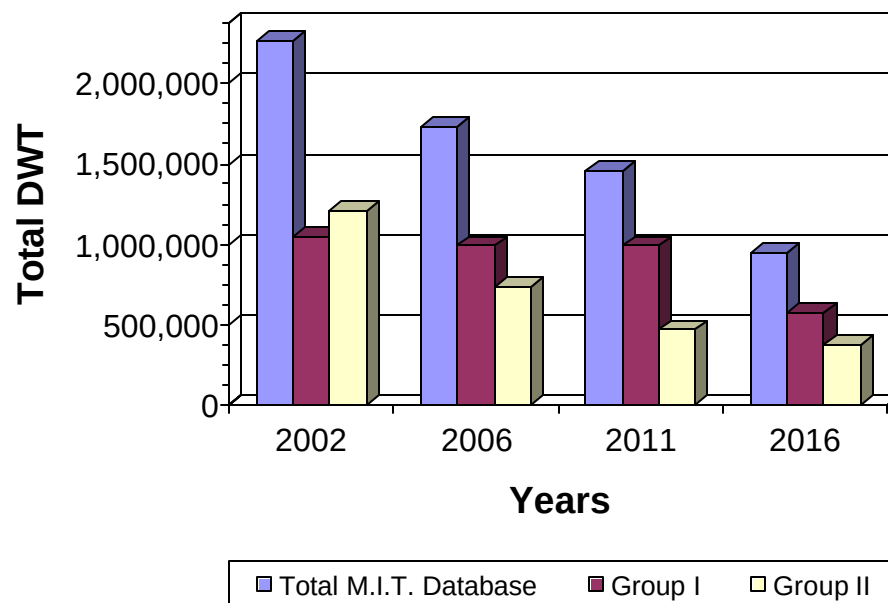
In this section, the fleet information obtained from the previous EUSC fleet projections will be broken down into groups based upon a vessel's cargo tank coatings. Group I will include only vessels with fully coated tanks. Group II will include vessels with partially coated or uncoated tanks. The breakdown of the projections for the EUSC, militarily useful fleet for 2002 through 2016 are presented in Figures 5.5, 5.6, 5.7, and 5.8. See Appendix F. It is quickly apparent that less than half of the available EUSC militarily useful tankers possess coated tanks. The figures also indicate that the Group I portion of the fleet will remain stable until after 2010. The large drop in Group I tankers between the end of 2010 and the end of 2015 is the result of the phase out of eight of OSG's

double-sided product tankers. The Group II fleet demonstrates steady decline over the next thirteen years. While the fleet will contain ten double hull tankers in 2016, only six



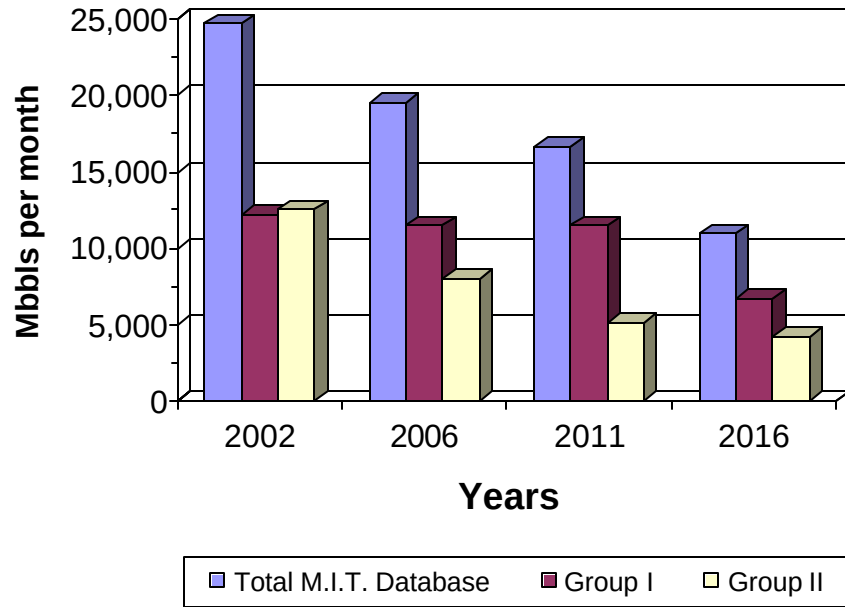
Source: Appendix F

Figure 5.5, Breakdown of Forecast of Militarily Useful, EUSC Tanker Fleet by Tank Coatings - # of Vessels



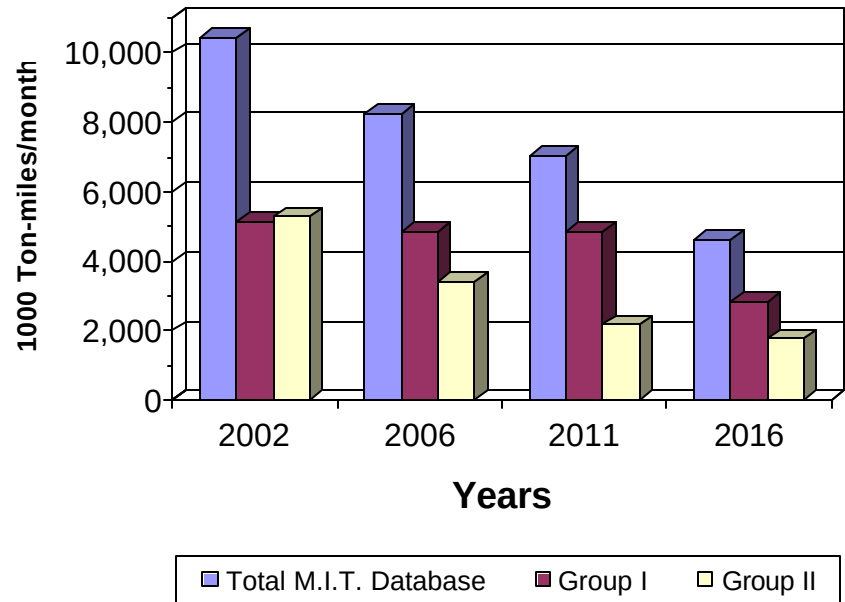
Source: Appendix F

Figure 5.6, Breakdown of Forecast of Militarily Useful, EUSC Tanker Fleet by Tank Coatings – Total DWT



Source: Appendix F

Figure 5.7, Breakdown of Forecast of Militarily Useful, EUSC Tanker Fleet by Tank Coatings – Barrels Delivered per Month



Source: Appendix F

**Figure 5.8, Breakdown of Forecast of Militarily Useful, EUSC Tanker Fleet
by Tank Coatings – Ton-miles Achieved per Month**

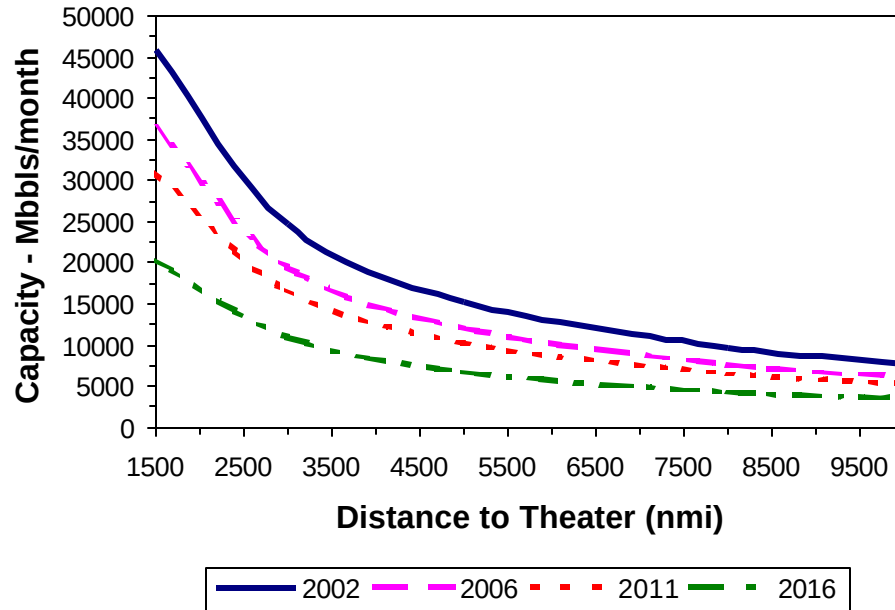
of these will have the coated cargo tanks most desired by military planners. In addition, these remaining tankers with coated cargo tanks will all possess a dwt between 85,000 and 98,200, which is approaching the upper limits of military usefulness.

EUSC Fleet Projections – Distance to Theater

In the previous analyses, the distance from the fuel supplier regions to the theater of war was assumed to be 3,000 miles, or a 6,000-mile roundtrip. The 3,000-mile assumption was an average value suitable when using supply regions outside the U.S. However, there may be war situations where the fuel products must be obtained from the mainland U.S. This consideration prompted the following investigation of the effect of varying the distance to theater on the capabilities of the EUSC, militarily useful tanker fleet. Varying the distance to theater will have no effect on the size of the EUSC fleet. However, it will affect the delivered capacity on both a barrels per month and ton-miles per month bases. This analysis will use the same database and methodology used in the previous cases. It should be noted that all EUSC, militarily useful tankers are used regardless of the presence of cargo tank coatings.

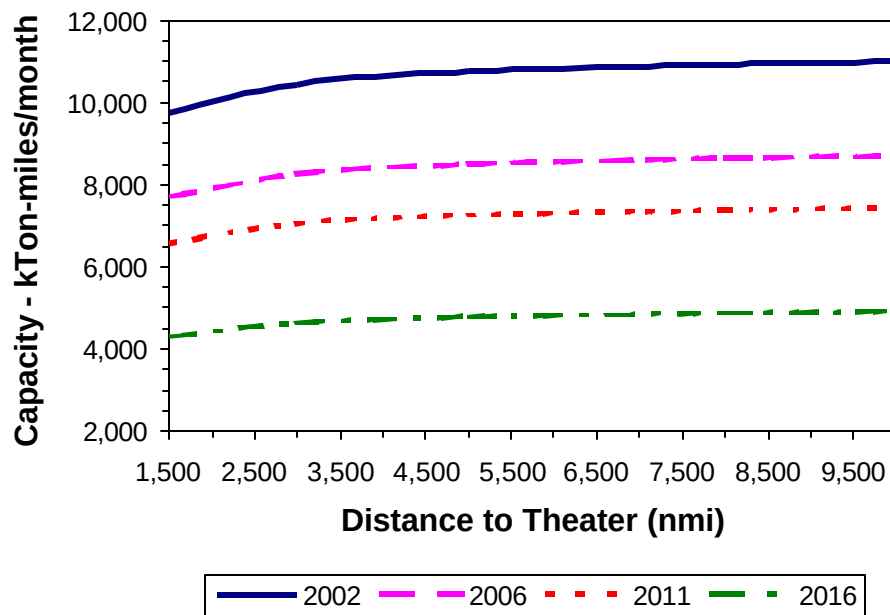
In this analysis, the distance to theater was varied between 1,500 miles and 10,000 miles. These extreme values are simply used as the upper and lower bounds of this analysis. All likely distances between military fuel supplier and consumer regions should fall between these bounds. In a scenario where the U.S. West Coast is used as a supplier region for a

conflict on the Korean Peninsula, the distance to theater is approximately 5,000 miles. In the case that the U.S. Gulf Coast supplies the fuel for a conflict in Southwest Asia, the



Source: Appendix G

Figure 5.9, Effect of Varying Distance to Theater on Capacity of Militarily Useful, EUSC Tanker Fleet – Barrels Delivered per Month



Source: Appendix G

Figure 5.10, Effect of Varying Distance to Theater on Capacity of Militarily Useful, EUSC Tanker Fleet – Ton-miles Achieved per Month

distance to theater is around 8,000 miles, assuming the Florida Straits and the Suez Canal are used. The results of this investigation are contained in Appendix G. Figures 5.9 and 5.10 display the effects of varying the distance to theater on the capacity of the EUSC, militarily useful fleet. Figure 5.9 can be used to find the fleet's delivered barrels per month for all forecast years at any distance to theater. Figure 5.10 provides the fleet's capacity on a ton-miles achieved per month basis for all forecast years and at any distance to theater.

Altering the distance to theater was found to have a significant, non-linear effect on the barrels of fuel delivered per month for all years. The effect of varying distance was most pronounced between 1,500 and 5,000 nautical miles. For the 2002 fleet, increasing the distance from 3,000 to 5,000 nautical miles reduced the delivered barrels per month by 38

percent. For this same year, increasing the distance from 3,000 to 8,000 miles results in a 61 percent reduction in delivered barrels per month. For all forecast years, an identical increase in the mileage resulted in the same percentage reduction in delivered capacity per month.

The results for ton-miles achieved per month also require some consideration. As the distance to theater increases, the ton-miles achieved also rises, especially between 1,500 miles and 3,500 nautical miles. This trend is the result of the vessels spending proportionally more time at sea and less time in port as the distance to theater rises. While the fleet's efficiency may rise as the distance is increased, the more significant result for military planners is the substantial decrease in the amount of fuel delivered per month as distance to theater increases.

CAPACITY OF THE PRIVATELY OWNED, U.S. FLAG TANKER FLEET

As the vast majority of U.S. flag tankers trade between American ports only or between foreign ports and the United States, only the OPA 90 regulations were used in projecting the militarily useful, U.S. flag tanker fleet after 2001. Projections of the future fleet size and capacity were made based upon the U.S. flag tanker fleet database for 2001 created from a U.S. Coast Guard database in Chapter 2. Unlike the EUSC projections, these forecasts do not provide a delivered capacity for a given distance to a theater of war.

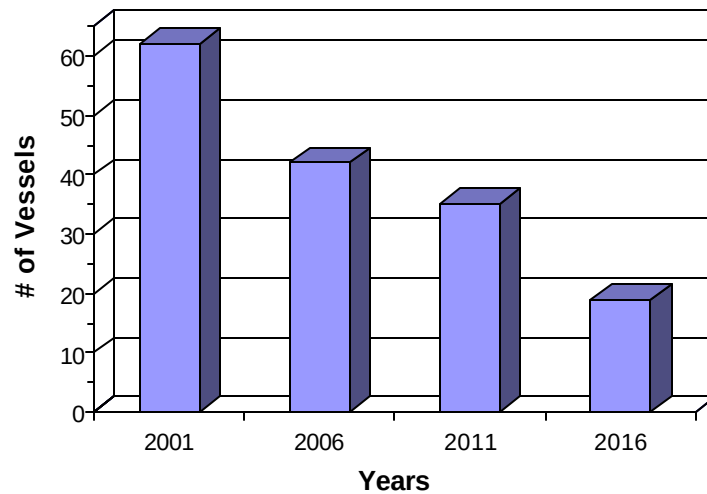
Projection databases were created for 1/2006, 1/2011, and 1/2016 using the phaseout date for each tank vessel provided by the U.S. Coast Guard.

Many current owners of single hulled tank vessels in the U.S. flag fleet have been slow to replace vessels scheduled for phasing out by OPA 90. Uncertainty about the volume of seaborne trade in the future domestic market, the high costs of building new vessels in U.S. shipyards, the strength of competitors, such as pipelines and direct foreign imports, and the future price levels of crude oil and petroleum products are the major concerns of domestic owners of tank vessels. Information on new, militarily useful tonnage to be built for the U.S. flag tanker fleet was obtained from Marine Log for November 2001, from Marine Log for April 2002, and from the OPA 90 listing by the USCG. As of April 2002, there were pending orders for ten 40,000 dwt product tankers and one chemical tanker in U.S. shipyards. However, all of these pending contracts were dependent on receiving Title XI loan guarantees from MARAD. The current Title XI funding levels have resulted in a significant waiting list of owners. In fact, the letter of intent for four of these product tankers has expired. While there are currently no confirmed orders for double hulled product tankers, several double hulled tank-barge combination vessels are on order. Other Jones Act operators are bringing their fleets into compliance by converting single hull barges into double hulled barges. If present newbuilding and conversion trends hold over the next few years, then product tankers scheduled for phase out will be replaced with double-hulled combination tug-barges. As discussed in Chapter 2, combination tug-barges are not considered militarily useful for

inter-regional sealift because of their slow speed and their reduced seakeeping ability.

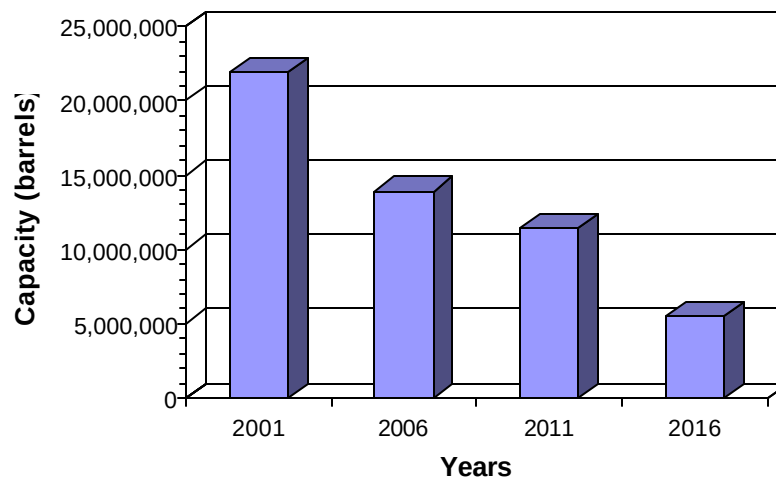
Therefore, no new vessels were added to the databases for 2006, 2011, and 2016.

With the projection databases updated for additions and deletions, the forecasts of the number of vessels and of the capacity of the military useful, U.S. flag tanker fleet could be generated. The results are included in Appendix H. These forecasts for 2001 through the end of 2015 are presented in Figure 5.11 and Figure 5.12. It should be noted that the



Source: Appendix H

Figure 5.11, Projected Militarily Useful, U.S. Flag Tank Vessel Fleet - # of Vessels



Source: Appendix H

Figure 5.12, Projected Militarily Useful U.S. Flag Tank Vessel Fleet– Total Capacity

decline shown in fleet capacity in Figures 5.11 and 5.12 over the next 13 years is a projection of the available militarily useful tankers based upon current trends. It is not a forecast of the decline of the U.S. flag tank vessel fleet as a whole.

These forecasts provide useful insight into the future makeup of the U.S. flag, militarily useful tanker fleet. A comparison of Figures 5.11 and 5.12 reveals that both the total number of vessels and the fleet's capacity are expected to decline in two stages. The periods of greatest decline should take place between 2001 and 2006 and between 2011 and 2016. It is possible that total fleet capacity will decline by as much as 36 percent by 2006. By the start of 2011, the fleet's capacity could drop by as much as 48 percent compared to 2001.

UNCERTAINTY IN THE FORECASTS OF THE EUSC FLEET

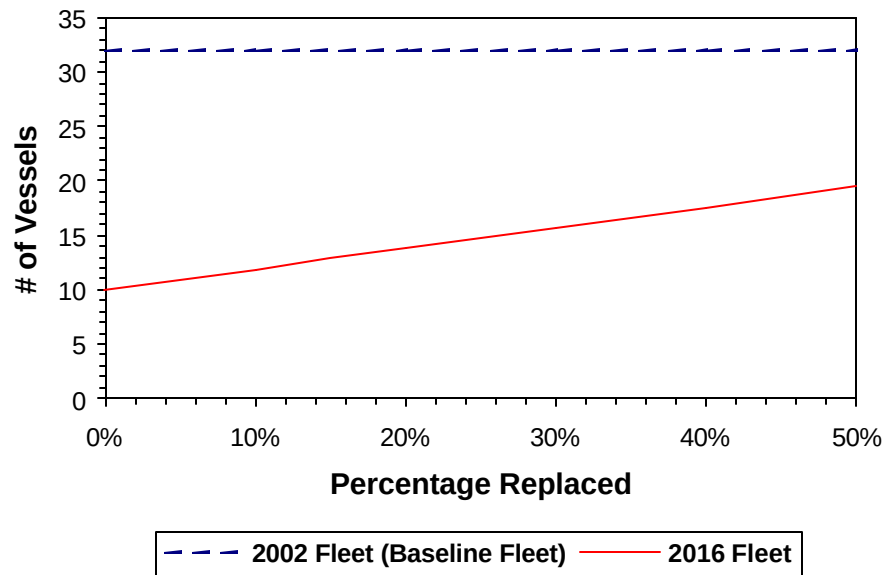
The previous sections provided projections for both the militarily useful, EUSC tanker fleet and the militarily useful, U.S. flag tanker fleet through the end of 2015. A degree of uncertainty surrounds both forecasts. It was previously mentioned that there were presently no militarily useful newbuildings planned by U.S. owners in the current EUSC tanker database. Therefore, no newbuildings were presumed to enter the fleet over the next thirteen years. Although the general prediction of a reduction in the size and capacity of both fleets is reinforced by a history of decline and by the current rates of

newbuildings, changes in government policies or in market conditions could greatly affect the status of these fleets in future years. Such changes are difficult to predict and would produce additional uncertainty in the present analyses. However, the effect of adding in new tonnage between 2002 and January 2016 can be examined.

If the OPA-90 and MARPOL 13/G regulations were not in place, some vessels in the EUSC military useful tanker fleet would still be scrapped or sold to other companies over the next thirteen years. It is unreasonable in the face of the steady decline of the U.S. owned, foreign flag fleet since the 1970's to expect that the remaining companies with EUSC tankers will add to their fleets beyond their 2002 total. It is reasonable to assume, however, that some phased out vessels will be replaced. In all of the previous analyses, no vessels were added over the next thirteen years because there are currently no EUSC, militarily useful tankers on order. So, the lower bound of this analysis is the assumption that no phased out tonnage may be replaced between 2002 and 2016. The upper bound on this analysis will be assumed to be 50% of phased out tankers and 50% of the retired tonnage. The actual value of tonnage and vessel replacement can reasonably be expected to lie between these limits.

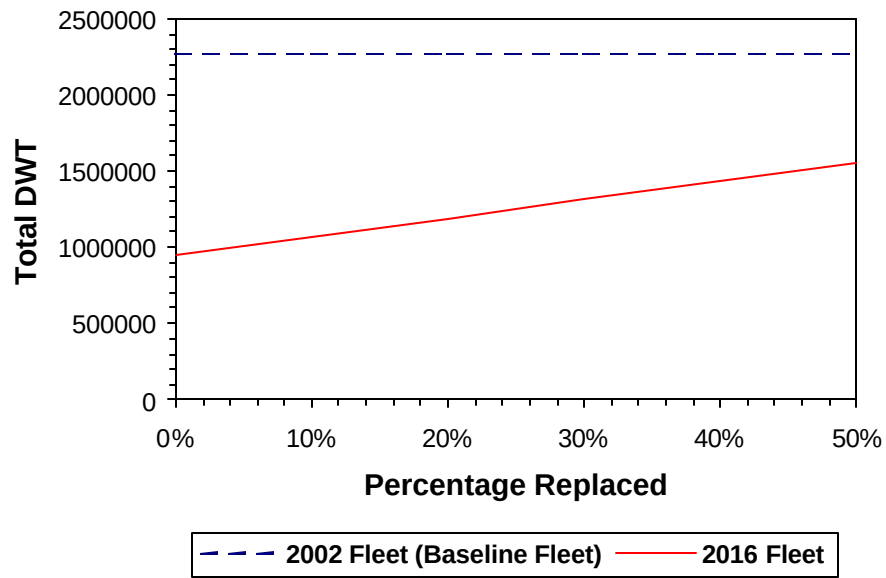
For this analysis, all tankers, regardless of tank coating type, were used. The distance to theater was assumed to be 3,000 miles. For the year 2016, the percentage of the total retired vessels over the past thirteen years that is added back in 2016 was varied from 0% to 50%. The average dwt of these new vessels is found by dividing the total retired dwt for 2002 to 2016 by the number of retired vessels. The pump out rate is assumed to be

6000-metric tons/hr, and the oil capacity is approximated as 7.1 barrels per LT of deadweight. The results are included in Appendix I. Figure 5.13 displays the effect of altering the percentage of replaced vessels on the number of vessels in the fleet. Figure 5.14 and 5.15 demonstrate the effect of varying the percentage of vessels replaced after



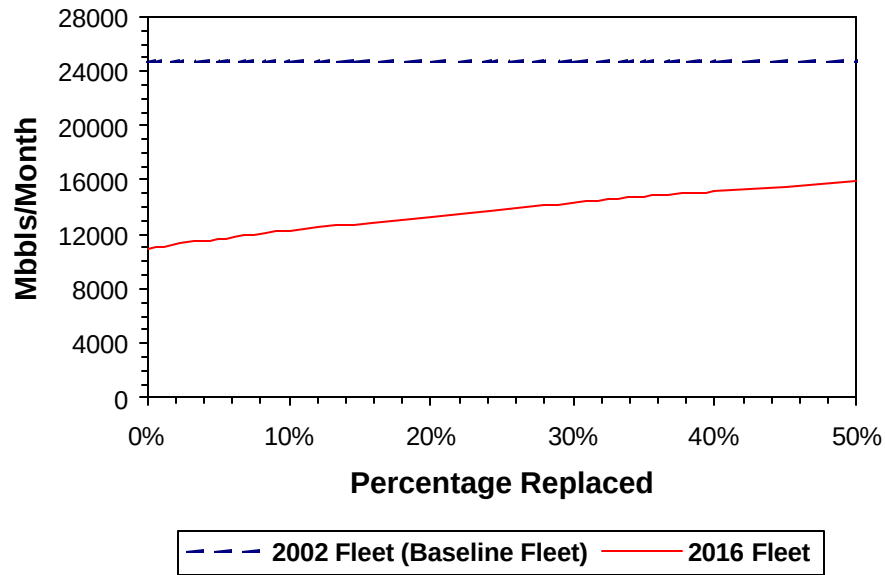
Source: Appendix I

**Figure 5.13, Effect of Replacing Phased Out Tankers
on the Militarily Useful, EUSC Tanker Fleet - # of Vessels**



Source: Appendix I

Figure 5.14, Effect of Replacing Phased Out Tankers on the Militarily Useful, EUSC Tanker Fleet – Total DWT of Fleet



Source: Appendix I

Figure 5.15, Effect of Replacing Phased Out Tankers on the Militarily Useful, EUSC Tanker Fleet – Barrels Delivered per Month

phase out on the total dwt of the fleet and on the delivered capacity in barrels per month, respectively. The horizontal line, labeled “2002 Fleet (Baseline Fleet)”, in these figures provides the value for the fleet in June 2002 for comparison purposes.

The linear effect of altering the percentage of retired vessels that are replaced is expected. These figures provide a way of approximately adjusting the forecasts provided in this report for any reasonable level of vessel replacement within the next thirteen years. The important insight gained from these figures is that, even under the most optimistic expectations of EUSC, militarily useful tanker replacement for 2002 to 2016, the number of vessels, the total dwt, and the deliverable capacity of the fleet will still fall by around 39%, 32%, and 36%, respectively.

A LINK BETWEEN THE EUSC & U.S. FLAG FLEETS

One additional point should be made regarding the companies that currently own EUSC, militarily useful tankers vessels in M.I.T.’s database for June 2002. A majority of these companies, including Overseas Shipholding Group, ChevronTexaco, ExxonMobil, and Conoco (pending a successful proposed merger of Conoco and Phillips), own vessels in both the EUSC fleet and the U.S. flag merchant fleet. This group of companies also represents some of the largest owners of vessels in both fleets. Therefore, the futures of the militarily useful portions of the EUSC tanker fleet and the U.S. flag merchant fleet are linked. As such, favorable alterations in U.S. tax policy regarding the income from foreign flag vessels received by U.S. owners would also benefit many of the companies that sustain the U.S. flag merchant fleet.

PROJECTED STRATEGIC SEALIFT SOURCES

In Chapter 2, Table 2.7, the total strategic sealift sources available to the Department of Defense in 1990 and 2001 were compared. Using a 2005 projection for the MSC fleet and RRF from the MRS-05 study and the forecasts for the EUSC and U.S. flag fleets generated in our report, the projected total strategic sealift sources of the DoD can be estimated through the end of 2015. The projections included for the EUSC fleet used the OPA 90 phase out schedule. Table 5.7 summarizes the pool of vessels by source for June 2002, 2006, 2011, and 2016.

The numbers behind these projections require some consideration. For instance, the MSC fleet and RRF are assumed to remain constant after 2006. The average age of the vessels in the RRF was 40.1 years in 2001. Many of these vessels could be scrapped

	<u>Militarily Useful Tankers</u>			
	<u>2002</u>	<u>1/2006</u>	<u>1/2011</u>	<u>1/2016</u>
Military Sealift Command ¹	6	5	5	5
Ready Reserve Force ¹	9	10	10	10
U.S. Flag Merchant Vessels ³	61	42	35	19
Effective U.S. Control Fleet ²	32	25	19	10
Total	108	82	69	44

Source: 1) Joint Staff/OSD, Department of Defense, "MRS-05 Tanker Sealift Analysis" (Unclassified Version), U.S. Department of Defense, 2001.

2) Appendix F

3) Appendix H

Table 5.7, Projections of U.S. Strategic Tanker Sealift Resources, 2001 - 2016

during the next 15 years. In addition, it should be noted that vessels on MSC charter may be committed to other daily duties that preclude them from participating in a continuous

tanker sealift role. For some RRF vessels, other commitments, such as to the OPDS fleet, may prevent them from working as inter-regional sealift vessels.

For 2005, the MRS-05 study identified 110 tankers with coated and uncoated tanks for inter-regional tanker sealift from a total pool of 127 tankers. The remaining 17 tankers were utilized for intra-regional sealift. From the pool of inter-regional tankers, the 87 tankers with coated cargo tanks were considered the baseline fleet for all scenarios using the limited HNS assumption discussed in an earlier section. This fleet was inadequate, in terms of MOEs, for a few high demand sealift scenarios. One option used to meet the terms of the MOEs was the Added Ship case where 107 tankers, including 20 tankers with uncoated tanks, were used. These 107 tankers were adequate for all scenarios except for the Southwest Asia eastern region scenario where the MOE for avoiding fuel shortfalls during the early stages in this scenario was not met. Another option, defined as Added HNS case, required heavier reliance on Host Nation Support for fuel needs. For this case, the MOEs for all scenarios were met with 78 tankers.

The January 1, 2006 projections in our study identified a total pool of 82 tankers available for all inter-regional and intra-regional needs. The MRS-05 study assumes the withdrawal of seven RRF tankers for use as intra-regional and OPDS tankers, which reduces the available inter-regional tankers to 75 vessels. The potential for a shortfall in available tankers is compounded when the issue of coated versus uncoated tanks is considered. As stated previously, military planners prefer vessels with coated cargo tanks. While the coating status for the vessels in the U.S. flag, RRF, and MSC fleets

were not investigated in this study, the coatings of all EUSC, military useful tankers have been investigated. Of the 25 EUSC tankers available in 2006, only fourteen have fully coated cargo tanks. Assuming that inter-regional tankers from all other sources have coated tanks, the coating requirements reduce the pool of the most desirable sealift tankers available to U.S. military planners from 75 to 64 vessels. The assumption that all other sealift tankers have coated tanks results in substantially overestimating the supply of sealift tankers with coated tanks. Table 5.8 compares the total tankers projected by this study to be available in January 2006 to the tanker requirements found by the MRS-05 study.

	M.I.T. Projections of Available Inter-regional Tankers in 1/2006	<u>MRS-05: Sealift Tanker Analysis</u>		
		Preferred Fleet w/ Coated Tanks in 2005	Requirements for Added Ship Case	Requirements for Added HNS Case
# of Militarily Useful Tankers	75 (64)	87	107	78

Note: Value in parentheses indicates the maximum possible number of tankers with coated cargo tanks.

Table 5.8, Comparison of M.I.T. Projections to MRS-05 Study

Even with access to all 75 tankers, U.S. military planners would not have enough vessels to meet the inter-regional tanker sealift requirements of the Added HNS case identified in the MRS-05 study. In addition to the shortfall in the inter-regional tanker sealift effort, using all of these tankers for inter-regional sealift leaves no extra vessels for intra-regional sealift. Therefore, it appears that a shortfall in tanker sealift capacity is likely by January 2006 under the requirements of the MRS-05 report. The shortfall situation is expected to grow even worse by 2011 and 2016.

A final consideration is that withdrawing all available U.S. flag and EUSC militarily useful tankers from commercial service would leave no U.S. controlled tankers under 100,000 dwt to serve the U.S. economy. While the shortfall in supply for the U.S. economy could theoretically be overcome through the chartering of foreign owned tonnage, this approach places U.S. security at greater risk. Therefore, it is a reasonable conclusion to suggest that the sealift and security requirements of the United States are best served by an available pool of U.S. flag and EUSC tankers under 100,000 dwt to serve both needs in time of war.

SUMMARY

- 1) The most recent study of the tanker sealift needs of U.S. military planners is found in the MRS-05 Sealift Tanker Analysis report. This study used a forecasted fleet of military useful tankers sourced from the Military Sealift Command, the Ready Reserve Fleet, the U.S. flag commercial tanker fleet, and the EUSC fleet to analyze a variety of sealift scenarios. Based on this fleet in 2005, the study concluded that the expected available resources (110 militarily useful tankers) for inter-regional tanker sealift would be adequate to meet a dual theater war situation for all scenarios assuming that tankers with coated and uncoated cargo tanks were utilized and that no vessels were withheld to support the U.S. economy. U.S. military logistics planners would prefer to avoid the use of the 23 tankers with uncoated tanks in all scenarios.
- 2) The MARAD database for the militarily useful, EUSC tanker fleet in January 2002 was used as the basis for constructing an M.I.T. database for June 2002. The vessels owned by the U.S. companies in this database were investigated in order to confirm their EUSC qualifications and availability as a part of this study. The M.I.T. database contains 32 tankers with a combined dwt of 2,264,078 as opposed to the 63 vessels and 2,996,856 total dwt found in the

MARAD database for January 2002. Within the M.I.T. database, Overseas Shipholding Group provides 56 percent of the fleet by dwt. The three largest owner/operators in the M.I.T. database, OSG, ChevronTexaco, and Conoco, Inc., provide 88 percent of the EUSC, militarily useful tanker fleet for 2002 by dwt.

- 3) The M.I.T. database was used in generating projections of the EUSC militarily useful tanker fleet through the start of 2016. These projections provide estimates of the number of vessels, total DWT, barrels of fuel products delivered per month to a military theater, and the ton-miles of fuel products transported per month of the fleet for 2006, 2011, and 2016. Vessels were removed from the fleet using either the OPA 90 or MARPOL 13/G phase out schedules for single hulled, double sided, and double bottomed vessels. No militarily useful newbuildings were on order by current owners of EUSC tankers in the M.I.T. database as of June 2002. The EUSC, militarily useful tanker fleet is forecasted to decline by 69 percent, in terms of number of vessels, and by 56 percent, in terms of delivered capacity, between June 2002 and January 2016.
- 4) The OPA 90 phase out schedule produced a more accelerated decline in the capabilities of the militarily useful, EUSC tanker fleet than the MARPOL 13/G regulations. Figures 5.1 through 5.4 presented the forecasts for the applicable EUSC fleet for 2001 through 2016. Because there are no chemical carriers in the M.I.T. database, the OPA 90 and MARPOL 13/G (revised) regulations result in the same remaining fleet for 2016. Based on this observation, the OPA 90 phase out approach was used throughout the remainder of the chapter.
- 5) Military planners prefer tankers with coated cargo tanks. A breakdown of the EUSC, militarily useful tanker fleet for 2002 through 2016 is found in Figures 5.5, 5.6, 5.7, and 5.8. Group I tankers have coated cargo tanks while Group II tankers have partially coated or uncoated tanks. In 2006, only fourteen of the 25 remaining tankers have coated tanks. By 2016, only six Group I tankers remain.

- 6) The distance to theater was estimated to average around 3,000 nautical miles based upon expected supply regions and the most demanding war scenarios. The effect of varying the distance to theater was investigated for a range of 1,500 to 10,000 nautical miles. All possible sealift scenarios should fall within this range. Increasing the distance from 3,000 to 5,000 nautical miles resulted in a reduction in the EUSC fleet's delivered capacity of 38 percent. The delivered capacity was reduced by 61 percent when the distance is increased from 3,000 to 8,000 nautical miles.
- 7) A limited analysis of the future capacity of the militarily useful, U.S. flag tanker fleet was performed. Based upon the OPA 90 phase out schedule and the current orders of new tank vessels, the capacity of the fleet is expected to decline by 36 percent through 2006 and by 48 percent through 2011. A trend of replacing phased out product tankers with smaller combination tug-barges for coastwise trading has been observed. Tug-barge combinations have not been considered militarily useful in this study. The same assumption was used in the MRS-05 study.
- 8) A source of uncertainty in the forecasts of the EUSC tanker fleet was the amount of phased out tonnage that would be replaced with EUSC eligible, militarily useful tonnage. Currently, no replacement or additional tonnage is on order. Based upon the historical decline of the total EUSC fleet, it was decided that the rate of replacement would lie between zero and 50 percent. The effect of changing the percentage of replacement is displayed in Figures 5.13, 5.14, and 5.15. Even if 50 percent of phased out tonnage is replaced, the number of vessels, the total dwt, and the deliverable capacity of the fleet will still fall by around 39 percent, 32 percent, and 36 percent, respectively.
- 9) The great majority of vessels in the M.I.T. database for June 2002 are owned by U.S. companies that also operate vessels in the U.S. flag merchant fleet. This situation indicates that the futures of both fleets are linked. Favorable alterations in current U.S. tax policy concerning income from U.S. owned, foreign flag vessels would benefit many of the companies that operate vessels under the U.S. flag.

10) The strategic tanker sealift sources available to U.S. military planners dropped from 140 tankers in 2001 to 108 ships for 2002 (largely due to changes in the database of militarily useful, EUSC tankers). The total pool of vessels drawn from all tanker sealift sources available to the DoD is projected to fall to 82 vessels by 2006 and to only 44 vessels by 2016. A pool of 78 or 107 tankers for inter-regional sealift was deemed sufficient for U.S. military needs in 2005 according to the MRS-05 study. The lower number corresponds to the use of additional Host Nation Support while the higher number assumes the use of 20 uncoated tankers under the limited HNS requirement of the Defense Energy Support Center (DESC). However, our study estimated a maximum of 75 suitable tankers to be available to U.S. military planners for inter-regional sealift at the start of 2006. Some of these 75 tankers may only be suited for intra-regional sealift service or may be committed to on-going MSC duties. Of these tankers, a maximum of 64 tankers have coated cargo tanks. We expect that this value significantly overestimates the available tankers with coated cargo tanks as only the coatings of EUSC tankers have been confirmed. Based on the MRS-05 study's conclusions, the projections generated by our study indicate that a shortfall in sealift tankers is expected to exist in 2006. This situation is forecasted to deteriorate further by 2011 and 2016.

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CHAPTER 6

ALTERNATIVE SOURCES OF SEALIFT TANKERS

In Chapter 5, a potential shortfall in the number of available tankers for military sealift needs was identified for the beginning of 2006. This chapter will explore several possible approaches to alleviating this looming shortfall. The options will be discussed in the context of alternative sources to be utilized once U.S. controlled sources of militarily useful tankers have been exhausted. Legislative alternatives to increase the size of the EUSC tanker fleet in the long term will be discussed in Chapter 8. The U.S. controlled sources include the Military Sealift Command, the Ready Reserve Force, the U.S. flag fleet, and the EUSC fleet. Major alternatives include the chartering of foreign owned tonnage and the use of U.S. owned tankers of a size greater than 100,000 dwt. Primarily, this chapter will focus on the potential for using EUSC tankers over 100,000 dwt.

FOREIGN OWNED TANKER CHARTERS

In the event that the available pool of U.S. controlled, militarily useful tankers is insufficient to meet the needs of the U.S. military, military planners could attempt to charter foreign owned tonnage on the world market or possibly from NATO member nations and other allies. The MSC utilizes the world market for moving military fuels to destinations around the world when suitable U.S. flag tankers are unavailable. MSC is required by U.S. law to exhaust U.S. flag sources before utilizing the open market. This approach is also considered in the MRS-05 study when all U.S. controlled tonnage, including tankers with coated and uncoated cargo tanks, has been employed. The MRS-

05 study identifies a Handysize, militarily useful tanker for chartering as needed to augment the available U.S. controlled fleet. These tankers, referred to as Handysized Tanker Equivalents (HSTEs), have a length overall (LOA) of 625 feet, a 235,000 barrel capacity, a maximum beam of 100-feet, and a loaded draft of 36 feet. In the MRS-05 study, no foreign owned HSTEs are required under any scenario considered.

In accordance with current U.S. military requirements, foreign owned HSTEs would only be called upon in the event that the use of all available U.S. controlled tankers does not meet emergency sealift needs. The reason that the U.S. military would call upon these vessels only as a last resort involves the issue of the reliability of foreign owned tonnage during a conflict. Current U.S. military planning requires the consideration of various dual Major Theater War scenarios. One of the main advantages of using U.S. flag and EUSC tonnage is the authority of the president to requisition these vessels during a national emergency. Foreign owners may be unwilling to undertake U.S. charters because of the scope and scale of these potential conflicts. It is also difficult to foresee which nations and owners would remain strictly neutral partners with the U.S. or serve as allies of the U.S. during these diverse scenarios. The reliability concerns during these large-scale conflicts make reliance on non-U.S. companies a last resort for planning purposes.

Another concern with foreign owned vessels is the issue of crew nationality. In a conflict involving the United States, nationals unquestionably would be considered to be the most reliable officers and crew members. The law requires U.S. flag vessels to be manned by

American citizens, so the nationality of the crew is not an issue with respect to those vessels. However, with both EUSC and foreign owned vessels, the DoD has made no arrangements to pre-screen their crews. As discussed in Chapter 7, cooperative agreements with the owners of EUSC vessels could lead to an opportunity for the DoD to vet potential sealift tankers and their crews before requisitioning or chartering these ships. For instance, the four companies that currently own EUSC tankers over 100,000 dwt have been contacted to discuss the nationality of their seafarers. The breakdown of their crews by nationality is as follows:

- ✓ ExxonMobil – Predominately citizens of the United Kingdom, India, and the Philippines, to a lesser degree citizens of Greece.
- ✓ ChevronTexaco – Predominately citizens of Northern European countries, Italy, India, and the Philippines.
- ✓ Overseas Shipholding Group – Predominately citizens of South Korea, the Philippines, and Croatia.
- ✓ Conoco – Predominately citizens of Honduras and Norway.

This information combined with a frequently updated database of available EUSC tankers would permit the MSC to make decisions about individual EUSC tankers. A similar vetting system would be impractical, if not impossible, to develop for foreign owned vessels in the worldwide charter market.

U.S. OWNED TONNAGE OVER 100,000 DWT

As discussed in Chapter 2, the current definition of *military useful* includes only tankers under 100,000 dwt. An expansion of this definition to include tankers over 100,000 dwt can be considered for both the EUSC and the U.S. flag tanker fleets. This section will

examine the benefits and obstacles to utilizing tankers over 100,000 dwt, including Aframax tankers, Suezmax tankers, and VLCCs.

Canal and Port Restrictions

The current exclusion of tankers over 100,000 dwt from military useful status involves concerns over the ability to make use of these tankers in the maximum number of scenarios. The major concerns are the length, beam, and draft restrictions of loading and discharge ports and of canals. For certain trade routes, canal restrictions define the major dimensions and the maximum capacity of the vessels. The pertinent canals for inter-regional tanker seafight include the Panama Canal and the Suez Canal.

The Panama Canal has length, beam, and draft restrictions for transiting vessels. While the length restriction of 965 feet and the beam restriction of 106-feet cannot be circumvented, the draft restriction of 39' 6" for Tropical Fresh Water can be accommodated through the light loading of the vessel.¹⁰ The maximum tanker size that can transit the Panama Canal is referred to as Panamax. Generally, the maximum size of Panamax tankers is 80,000 dwt. This upper limit on capacity explains division of product tankers into separate categories for ships over and under 80,000 dwt in the MARAD militarily useful databases. However, many tankers classified as Panamax because of their dwt are still unable to use the Panama Canal because of the beam restriction. In the MRS-05 study, only six of the 87 tankers in the baseline fleet can transit this canal without light loading while seven ships still cannot use the canal because of excessive beams. In the M.I.T. database of EUSC, militarily useful tankers for June 2002,

seventeen of the 29 tankers in the database cannot transit the Panama Canal because of the beam restriction. At least five of the twelve tankers that can transit the Panama Canal must employ light loading to avoid the draft restriction. Fortunately for military planners, the use of the Panama Canal appears to be avoidable for all scenarios considered by the MRS-05 study.

The Suez Canal has no length restriction. It does have a beam restriction of 245-feet and a maximum permissible loaded draft of 58'-0".¹¹ Tankers of the maximum size that can transit this canal are referred to as Suezmax. Suezmax vessels encompass the size range between 115,000 to 200,000 dwt. Because of their size, no Suezmax vessels are currently considered militarily useful. The ability to transit the Suez Canal is an important attribute of militarily useful tankers as it facilitates the transfer of military fuels between Europe or the U.S. and the regions where conflicts are expected to result in the highest fuel requirements.

While the ability to transit canals is a significant consideration for defining a militarily useful tanker, a more important requirement for these tankers is the ability to access the available regional berthing for loading and unloading their cargos. The regional POL berths used in the MIDAS modeling of the MRS-05 study entail length and draft restrictions. While several berths have deepwater available, it is important to consider that the berth on the other end of the supply chain may be the limiting factor. Given the draft restrictions outlined in the MRS-05 study, it appears that many of the EUSC,

¹⁰ Panama Canal Commission Website, www.orbi.net/pancanal/pcc.htm, June 2002.

¹¹ Leth Suez Transit Ltd AS Website, www.lethsuez.com/suezcana.htm, June 2002.

militarily useful tankers in the M.I.T. database for June 2002 will be forced to employ light loading in order to access these berths. Length restrictions will also be an issue for the berths modeled in the MRS-05 study because nearly all of these tankers have lengths in excess of 750-feet. The MRS-05 study acknowledges that many of the tankers considered cannot be used efficiently in all scenarios and that the use of larger militarily useful tankers, between roughly 60,000 and 100,000 dwt, requires the use of light loading and lightering techniques.

U.S. Flag Tankers over 100,000 dwt for June 2002

From the database of U.S. flag tankers contained in Appendix B, it was found that there were twelve tankers with over 100,000 dwt available from the U.S. flag tanker fleet as of February 2001. All of these tankers operate as crude oil carriers on the West Coast of the United States, especially between Alaska and the West Coast refineries. Their sizes range from Aframax to smaller VLCCs. The importance of these vessels to the functioning of U.S. economy, especially during national emergencies when foreign supplies may be disrupted, should be noted. The crude oil transported from Alaska's oil fields to the West Coast makes up a large percentage of the oil supply for the western states. If these tankers were removed from their current service for use in a military sealift role, they would have to be replaced, as there is no other method of moving crude oil from Alaska to the lower 48 states. If these vessels were to be called upon, the most viable source for replacement vessels, while maintaining the security of American ports, would be similar tankers from the EUSC fleet.

EUSC Fleet over 100,000 dwt for June 2002

In the course of compiling the M.I.T. database for militarily useful tankers, a separate database of EUSC tankers over 100,000 dwt was investigated. Through our investigation, several companies with EUSC tankers over 100,000 dwt were discovered. These companies were contacted regarding the current size, the planned newbuildings, the cargo tank coatings, and the nationality of the crews of their EUSC qualified tankers. The M.I.T. database of EUSC tankers over 100,000 dwt for June 2002 was constructed as shown in Table 6.1. See Appendix J for more complete information.

The EUSC tanker fleet over 100,000 dwt contains 36 tankers with a combined dwt of 7,860,870. In April 2000, according to the MARAD EUSC database, this fleet included 42 vessels with a total dwt of 8,945,810, which indicates a 12 percent decline. The currently existing fleet is relatively new with an average age of 4.6 years. With the exception of the two Conoco tankers of roughly 105,000 dwt, the rest of these tankers have uncoated or partially coated tanks (Group II). Only five of these vessels will be phased out by the end of 2015 as they are non-double hull tankers.

Total EUSC Fleet for June 2002

With a confirmed database for EUSC tankers over 100,000 dwt for 2002, the size of the entire EUSC tanker fleet for June 2002 can be constructed. In June 2002, this M.I.T.-developed fleet has 68 vessels and a combined dwt of 10,090,756. The complete EUSC tanker fleet is shown for the years 1986 through 2002 in Figure 6.1. The total fleet is

shown to have declined by 68 percent in terms of number of vessels and by 66 percent in terms of dwt between 1986 and 2002. Between just 2000 and 2002, the total fleet

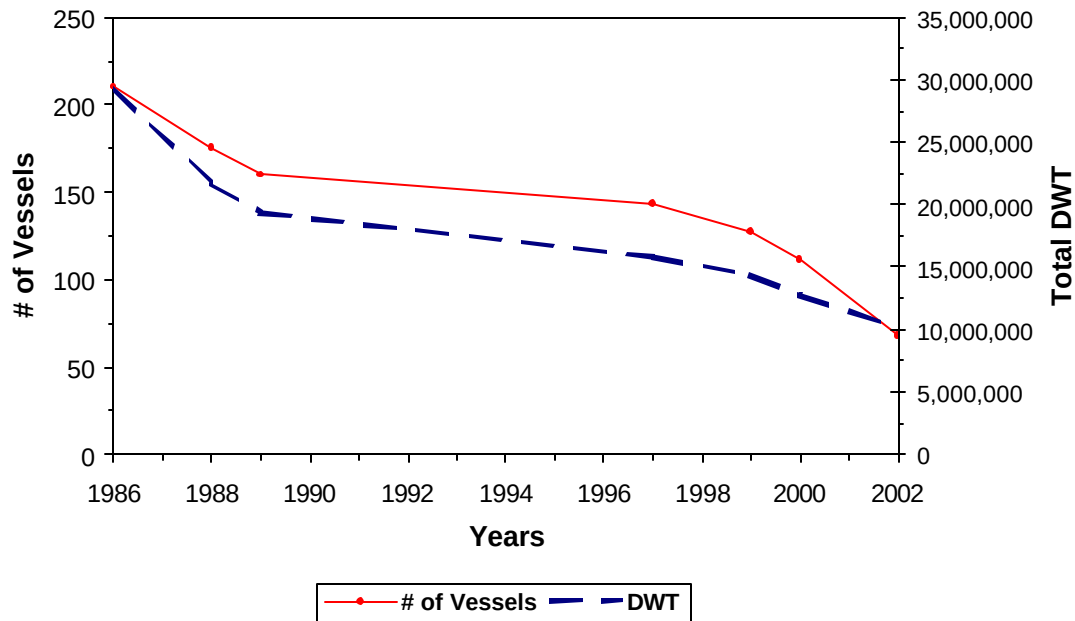
dropped by 39 percent and 21 percent in terms of number of vessels and dwt,

M.I.T. EUSC, Tankers over 100,000 DWT – Listing by Parent Company					
<u>Ship Name</u>	<u>Vessel Owner</u>	<u>Built</u>	<u>DWT (LT)</u>	<u>Hull</u>	<u>Group</u>
Chevron Texaco Shipping Co.					
CHEVRON EMPLOYEE	CM Pacific Maritime Corp.	1994	156,447	DH	II
PRIDE					
CHEVRON MARINER	Chevron Transportation Corp.	1994	156,382	DH	II
CONDOLEZZA RICE	Chevron Transportation Corp.	1993	135,829	DH	II
GEORGE SHULTZ	Chevron Transportation Corp.	1993	136,055	DH	II
CHEVRON PERTH	Chevron Transportation Corp.	1975	276,838	SH/NBT	II
JAMES N. SULLIVAN	Chevron Transportation Corp.	1992	135,915	DH	II
SAMUEL GINN	Chevron Transportation Corp.	1993	156,835	DH	II
WILLIAM E. CRAIN	Chevron Transportation Corp.	1992	155,127	SH/STB	II
Conoco Inc.					
SENTINEL	Conoco Shipping Co.	1999	104,700	DH	I
CONSTITUTION	Conoco Shipping Co.	1999	104,623	DH	I
ExxonMobil Corporation					
EAGLE	Mobil Shipping Co. Ltd.	1993	301,691	DH	II
RAVEN	Int'l Marine Transportation	1996	301,658	DH	II
ALREHAB	Int'l Marine Transportation	1999	301,620	DH	II
KESTREL	Int'l Marine Transportation	2000	307,000	DH	II
HAWK	Int'l Marine Transportation	2000	307,000	DH	II
FLINDERS	Mobil Shipping & Trans.	1982	149,000	SH/STB	II
ECLIPSE	Mobil Shipping & Trans.	1989	135,000	SH/STB	II
OSPREY	Int'l Marine Transportation	1999	301,000	DH	II
RAS LAFFAN	Int'l Marine Transportation	1999	105,424	DH	II
VALIANT	Int'l Marine Transportation	1999	105,476	DH	II
Overseas Shipholding Group					
EQUATORIAL LION	First Union Tanker Corp.	1997	273,539	DH	II
MERIDIAN LION	Second Union Tanker Corp.	1997	300,578	DH	II
REGAL UNITY	Regency Tankers Corp.	1997	309,966	DH	II
CROWN UNITY	Imperial Tankers Corp.	1996	300,482	DH	II
MAJESTIC UNITY	Royal Tankers Corp.	1996	300,549	DH	II
OLYMPIA	Olympia Tanker Corp.	1990	258,076	SH/STB	II
SOVEREIGN UNITY	Majestic Tankers Corp.	1996	309,892	DH	II
OVERSEAS CHRIS	OSG Affiliate/Subsidiary	2001	304,401	DH	II
OVERSEAS ANN	OSG Affiliate/Subsidiary	2001	304,494	DH	II
OVERSEAS DONNA	OSG Affiliate/Subsidiary	2000	304,608	DH	II
RAPHAEL	OSG Affiliate/Subsidiary	2000	304,722	DH	II
HULL 1372	OSG Affiliate/Subsidiary	2002	313,963	DH	II
OVERSEAS FRAN	OSG Affiliate/Subsidiary	2001	110,347	DH	II
OVERSEAS JOSEFA	OSG Affiliate/Subsidiary	2001	110,427	DH	II
OVERSEAS SHIRLEY	OSG Affiliate/Subsidiary	2001	110,286	DH	II
HULL 1286	OSG Affiliate/Subsidiary	2002	110,920	DH	II

Note: DH – Double Hulled; STB – Segregated Ballast Tanks; NBT – No Segregated Ballast Tanks

Source: Appendix J

Table 6.1, M.I.T. EUSC, Fleet of Tankers over 100,000 dwt for June 2002



Source: 1) Marcus, Henry et. al., “U.S. Owned Merchant Fleet: The Last Wake-Up Call?”, M.I.T., 1991.
 2) U.S. Owned, Foreign Flag Fleet Database, MARAD, January 1997.
 3) U.S. Owned, Foreign Flag Fleet Database, MARAD, July 1999.
 4) U.S. Owned, Foreign Flag Fleet Database, MARAD, April 2000.
 5) Appendix J

Figure 6.1, Total EUSC Tanker Fleet – # of Vessels & Total DWT

respectively. The average tanker size in the MARAD database for January 1997 was 110,506 dwt while the average tanker size in 2002 is 148,393 dwt.

A projection of the current EUSC tanker fleet over 100,000 dwt to the start of 2006 requires the removal of single hull tankers that will pass their phase out dates and the addition of newbuildings to the list. EUSC newbuilding information was acquired from the owners in the database for June 2002. For the start of 2006, the EUSC tanker fleet

over 100,000 dwt is expected to possess 37 vessels with a combined dwt of 7,970,835. See Appendix J. The projected totals for the entire EUSC tanker fleet for January 2006 are 62 vessels and 9,703,562 dwt. All replacement tonnage presently on order by companies with EUSC vessels possesses a dwt greater than 100,000 dwt.

Tanker Categories above 100,000 DWT

Most modern tankers can be categorized according to size as one of the five following types:

- ✓ Handysize/Handymax – 35,000 to 45,000 dwt
- ✓ Panamax – 45,000 to 80,000 dwt
- ✓ Aframax – 80,001 to 114,999 dwt
- ✓ Suezmax – 115,000 to 200,000 dwt
- ✓ VLCC/ULCC – over 200,000 dwt

Handysized tankers provide the most utility to military planners in terms of flexibility and access to ports and canals. These tankers and the Panamax vessels, which were described in an earlier section, meet the current dwt standards for militarily useful tankers. Aframax tankers encompass a dwt range that places some tankers within the militarily useful standard while others are disallowed. None of the Suezmax tankers, VLCCs, and ULCCs meet the current militarily useful standard. In this section, the general dimensions and potential applications of Aframax, Suezmax, and VLCCs in the tanker sealift service of the U.S. military will be discussed.

Aframax Tankers

There are fourteen Aframax size tankers in the June 2002 database for EUSC, militarily useful tankers. This group of tankers has the following approximate dimensions:

- ✓ Length Overall (LOA) of 805 feet
- ✓ Beam of 138 feet
- ✓ Draft of 44.5 feet.

Examining the June 2002 database for EUSC tankers over 100,000 dwt reveals a total of eight Aframax tankers in this fleet. The approximate dimensions of these vessels are as follows:¹²

- ✓ LOA of 800 feet
- ✓ Beam of 138 feet
- ✓ Draft of 49 feet

A comparison of the dimensions of militarily useful, Aframax tankers to non-useful Aframax tankers reveals that the only noteworthy difference is the larger draft of the latter group, which amounts to a difference of less than five feet.

Tankers exceeding Panamax size are approaching the limits of militarily usefulness because light loading is required to allow these vessels to enter the envisioned regional berths. In addition, some of these tankers are too long to use the proposed berths in the MRS-05 study. However, the limited differences between Aframax tankers below 100,000 dwt and those above 100,000 dwt makes the 100,000 dwt cutoff for military usefulness appear too low. It seems that all tankers up to about 115,000 dwt would be

useful in a tanker sealift effort. The light loading requirements make these vessels less efficient in this role; however, these vessels can still access most of the same ports as tankers between 80,000 and 100,000 dwt. Thus, they can provide an additional source of inter-regional sealift vessel. Considering the expected decline in EUSC, militarily useful tanker tonnage over the next thirteen years, an increase in the dwt cutoff to include these Aframax tankers would provide eight additional tankers in June 2002 and ten more tankers in 2006. The inclusion of all Aframax tankers is further justified when it is considered that by 2016 all remaining EUSC, militarily useful tankers will possess a size greater than 93,000 dwt.

Suezmax Tankers

The nine Suezmax tankers in M.I.T.'s 2002 database of EUSC, militarily useful tankers over 100,000 dwt range between 135,000 and 157,000 dwt. While the dimensions of Suezmax class tankers vary more than Aframax tankers, the average dimensions of this portion of the fleet are as follows:¹³

- ✓ LOA of 887 feet
- ✓ Beam of 159 feet
- ✓ Draft of 55 feet.

Even lightly loaded, Suezmax tankers are too large to use most of the berths proposed by military planners. Assuming that these tankers can operate in the same capacity as tankers under 115,000 dwt would result in overestimating the fleet's delivered capacity. However, these vessels could be used effectively as "motherships" in an inter-regional

¹² Clarkson Research Studies, "Clarkson Register CD – 2001 Edition", London, January 2001.

¹³ Ibid.

sealift role. The mothership would transfer its cargo to a fleet of smaller intra-regional tankers closer to the war zone. The major benefit of using a large tanker for the long-haul portion of the POL supply chain is that it can replace several smaller vessels. For example, a 140,000 dwt Suezmax tanker is roughly the equivalent of 3.5 handysized tankers of 40,000 dwt each. Such a strategy is especially useful when there is a shortage of available, militarily useful tonnage. Further, as shown in Figure 5.9 of Chapter 5, shorter routes for a fleet of militarily useful tankers result in a higher amount of delivered capacity per month. If large capacity tankers are used on the long haul routes, then the available shallow draft tankers working in a lightering/transfer role within the region will be capable of delivering more fuel per month. Employing Suezmax tankers in an inter-regional sealift role is also a viable option because these vessels can transit the Suez Canal.

VLCCs and ULCCs

The category for VLCCs and ULCCs encompasses all tankers above 200,000 dwt. These massive tankers have been built to sizes of more than 550,000 dwt. The dimensions of VLCCs and ULCCs vary widely with dwt. These vessels are incapable of transiting any canal and are substantially limited in the number of ports they can access, especially without lightering. A major drawback to using these tankers for military purposes is their extreme draft, which is upwards of 65 feet. However, these vessels could be employed in a mothership role similar to the Suezmax tankers.

Obstacles to Military Usefulness for Tankers over 100,000 dwt

The major problems with using Aframax and larger tankers for the carriage of fuel products are the lack of full coatings for the cargo tanks as most of these ships are employed as crude oil carriers. U.S. military planners prefer tankers with coated cargo tanks because the tanks are easier to clean and the risk of cross-contamination is reduced. They can be used to carry all military fuel products. However, there are procedures and standards for employing tankers with uncoated tanks during emergencies.

The military standards for tank cleaning procedures are outlined in the Defense Energy Support Center's MIL-STD-3004.¹⁴ In Chapter 5.11.4 of this document, reference is made to Table XXIV, where the minimum requirements for the preparation of tanker cargo tanks are presented. In this table, the process for switching a tanker with uncoated tanks from carrying crude oil to all military fuels can be found. It makes reference to the Naval Sea Systems Command's MIL-HDBK-291(SH)¹⁵, where the exact procedures for cleaning an uncoated cargo tank that previously carried crude oil are found. The first step in this process requires the mucking out the tanks, the cleaning the tanks with a hot water wash, the hand hosing of the tank bottom, and the flushing of cargo lines. After the first cleaning, a Quality Assurance Representative of the MSC inspects the vessel, and it is permitted to carry F-76 diesel fuel if it passes inspection. After successfully carrying the first load of F-76, the vessel's uncoated tanks can be switched to carrying the more sensitive jet fuels, JP-5 and JP-8, by another round of hot water machine-washing of the

¹⁴ Defense Energy Support Center, MIL-STD-3004, Department of Defense Standard Practice: Quality Surveillance for Fuels, Lubricants, and Related Products, Department of Defense, November 1, 1999.

¹⁵ Naval Sea Systems Command, MIL-HDBK-291(SH), Military Handbook: Cargo Tank Cleaning, Department of Defense, September 26, 1986.

tanks and cargo lines. Gaining MSC permission to carry the jet fuels necessitates another thorough inspection.

The switching of Suezmax tankers and VLCCs from crude oil to JP-8, the fuel generating the greatest sealift demand for the scenarios envisioned in the MRS-05 analysis, would require a great deal of cleaning and inspection time. However, these large crude carriers with uncoated tanks do have the potential to carry huge amounts of military fuels once the cleaning process is completed, especially during an emergency. Extensive reliance on these tankers in the early stages of a conflict, though, could lead to shortfalls because of the lengthy cleaning period.

It should also be considered that during a multiple war scenario, the value of U.S. controlled tonnage surpasses its potential for alleviating an undersupply of militarily useful tankers to meet the military's sealift needs. EUSC VLCCs and Suezmax tankers could also be called upon to supply the U.S. economy with crude oil from friendly foreign suppliers or to replace U.S. flag vessels in the domestic trade. In these ways, EUSC vessels are used to improve the security of the U.S. during war. Maintaining the EUSC fleet and reversing its decline would help protect more than just the military's supply of sealift vessels.

Substitution for Handysized Tanker Equivalents

The previous sections presented a conceptual approach to investigating the expansion of the DoD's interest in U.S. controlled tankers to include ships larger than 100,000 dwt. In

this section, the possibility of including a broader size range under the militarily useful concept will be further explored by calculating the number of smaller vessels that can be replaced through the use of larger EUSC tankers and the potential cost savings of this approach.

The EUSC tanker fleet of vessels over 100,000 dwt includes Aframax tankers, Suezmax tankers, and VLCCs. Using the general methodology and the spreadsheet model outlined in Chapter 5, the delivered capacity of these larger tankers was calculated for a distance to theater of 3000 nautical miles. Using this delivered capacity per ship, the number of Handysized Equivalent Tankers (HSTEs) that an average vessel from each size category in the current EUSC tanker fleet over 100,000 dwt for June 2002 could replace was determined. HSTEs are discussed in more detail in a previous section of this chapter. The vessel characteristics used for each category of large tanker are based upon the average vessel in that category in the current EUSC tanker fleet over 100,000 dwt. The characteristics are summarized in Table 6.2.

<u>Category</u>	<u>Vessel Characteristics</u>			
	DWT ^{1,2} (long tons)	Speed ³ (knots)	Capacity ^{1,2} (barrels)	Daily Cost at Sea ³ (dollars/day)
Aframax Tanker	107,775	15	765,205	26,680
Suezmax Tanker	147,513	15	1,072,889	31,142
VLCC	299,057	15	2,127,397	47,643
HSTE	40,000	14	235,000	18,645

Notes: Aframax Tanker includes only ships over 100,000 dwt

Source: 1) Appendix J

2) USTRANSCOM, Department of Defense, "MRS-05 Tanker Sealift Analysis" (Unclassified Version), U.S. Department of Defense, 2001.

3) Army Corp of Engineers, "Data for FY2000: Foreign Flag Tanker Costs: Double Hull (1999 Price Levels)", 2000.

Table 6.2, Vessel Characteristics of Average EUSC, Large Tankers and HSTEs

The daily cost information was obtained from the Army Corp of Engineers data for Fiscal Year 2000 Foreign Flag Tanker Costs¹⁶. The “Daily Total Cost at Sea” operating cost information is provided for 7-year old, double hull tankers for a size range from 20,000 dwt to 325,000 dwt. Where necessary, interpolation was used to obtain the cost information for the average tanker in each size category. This information is used to calculate the potential savings of using tankers over 100,000 dwt in the long-haul portion of the supply chain in lieu of the equivalent number of HSTEs. In an actual conflict, market conditions would set the charter rates of all vessels.

Information on the EUSC fleet of tankers greater than 100,000 dwt was taken from the M.I.T. database for this portion of the EUSC fleet for June 2002. A breakdown of the total fleet is presented in Table 6.3.

<u>Category</u>	<u>Vessel Characteristics</u>			
	DWT ¹	Avg. Speed ²	Capacity ¹ (barrels)	# of Avg. Sized Tankers ¹
Aframax Tankers	862,203	14.9	6,121,641	8
Suezmax Tankers	1,316,590	15.2	9,656,000	9
VLCCs	5,682,077	15.1	40,420,535	19
Total Fleet	7,860,870	15.1	56,198,176	36

Notes: Aframax Tanker includes only ships over 100,000 dwt

Source: 1) Appendix J

2) Clarkson Register

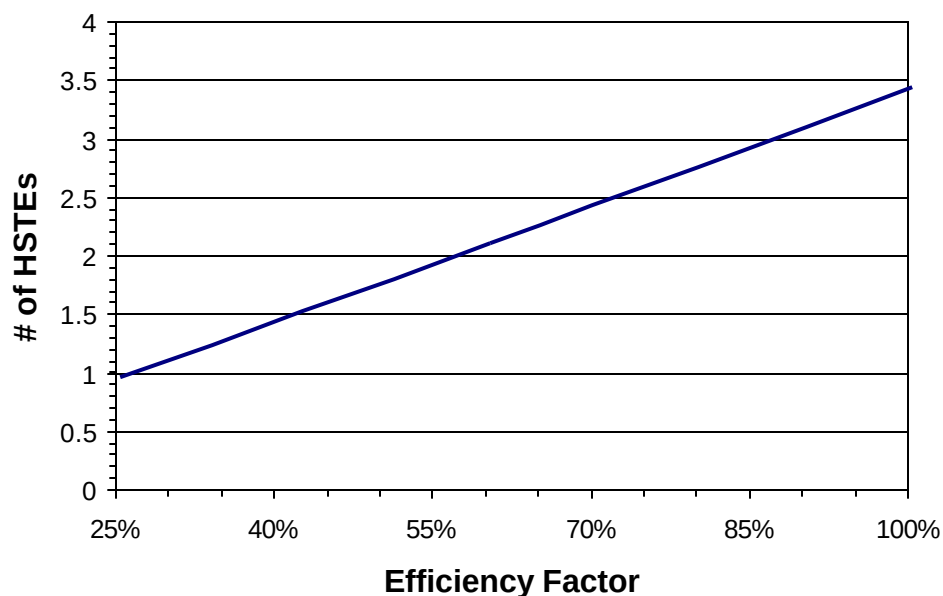
Table 6.3, Characteristics and Size of the EUSC Fleet of Tankers over 100,000 dwt

¹⁶ Army Corp of Engineers, “Data for FY2000: Foreign Flag Tanker Costs: Double Hull (1999 Price Levels)”, 2000.

In addition to a vessel's physical characteristics, there are efficiency constraints tied to the vessel's performance. Efficiency in this context is a measure of the achieved delivered capacity versus the maximum possible delivered capacity. The handysized vessels are assumed to achieve 100 percent efficiency in a tanker sealift role. For the larger tankers in this application, the need to light load, lighter, or transfer military fuels to and from these vessels is the primary factor that reduces the effectiveness of these vessels. Rough weather might delay lightering operations. In addition, there is the possibility that the Suezmax tankers and the VLCCs will have to remain in theater as floating storage vessels for a period of time until their entire cargo is required. For the VLCCs, certain routes may require additional trip time not included in the distance to theater value. All of these hindrances to top performance by larger EUSC tankers in the inter-regional sealift role can be compiled into one efficiency factor. The actual efficiency factor that occurs would depend on the specific situation involved. The efficiency was varied between 25 percent and 100 percent for each analysis to demonstrate the effect of this factor on performance.

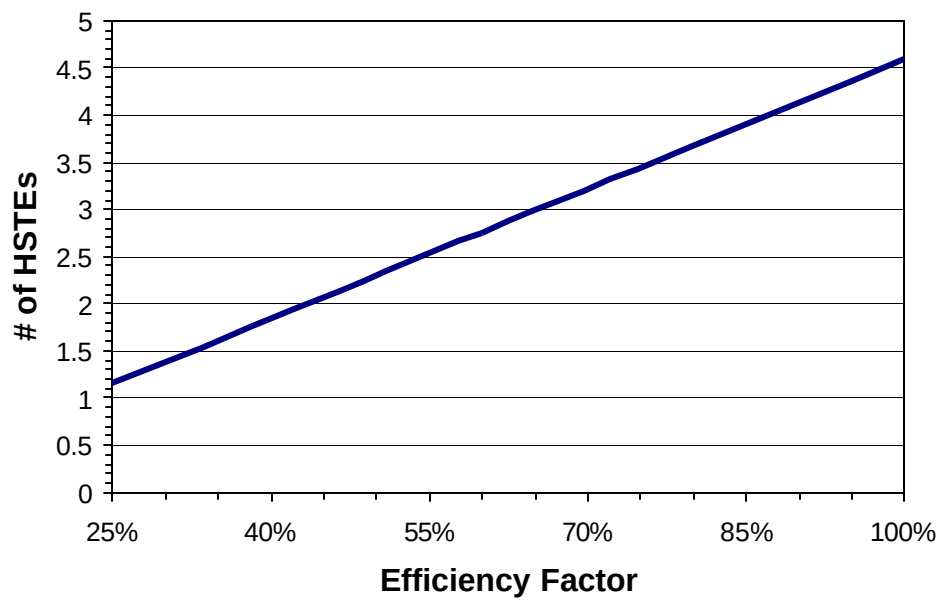
The results of this analysis have been collected into a series of figures. Figure 6.2, 6.3, and 6.4 display the number of HSTEs that can be replaced for each Aframax tanker, Suezmax tanker, and VLCC, respectively, while varying the efficiency factor. Figures 6.5, 6.6, and 6.7 provide the potential cost savings of using larger tankers versus HSTEs for each category of EUSC tanker over 100,000 dwt. See Appendix K.

As shown in these graphs, in an emergency where tankers under 100,000 dwt are in short supply, larger EUSC tankers can substitute for militarily useful tankers, as currently defined, even at efficiency factors as low as 25 percent. The number of replaced HSTEs for a selected efficiency factor can be scaled up to reflect all EUSC tankers of that size category by using the “# of Avg. Sized Tankers” for that category presented in Table 6.3. For instance, if the efficiency factor for Aframax tankers is assumed to be 80 percent, then the total number of HSTEs substituted by the Aframax portion of the EUSC fleet over 100,000 dwt is 21.3 ships. Similarly, for the same efficiency factor, the potential savings of using the Aframax portion of the EUSC fleet over 100,000 dwt are 5.5 million dollars per month.



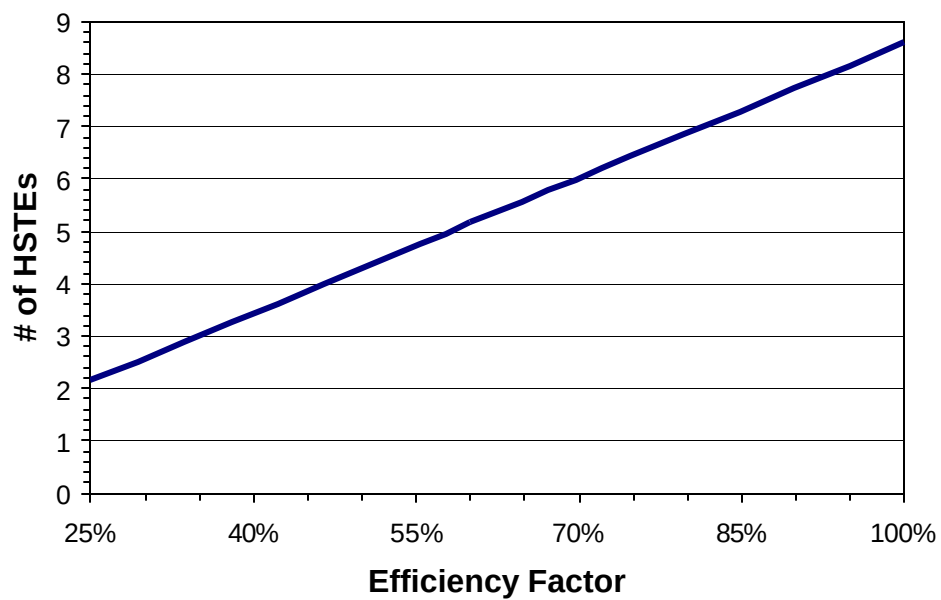
Source: Appendix K

Figure 6.2, # of HSTEs Replaced by an Average EUSC, Aframax Tanker



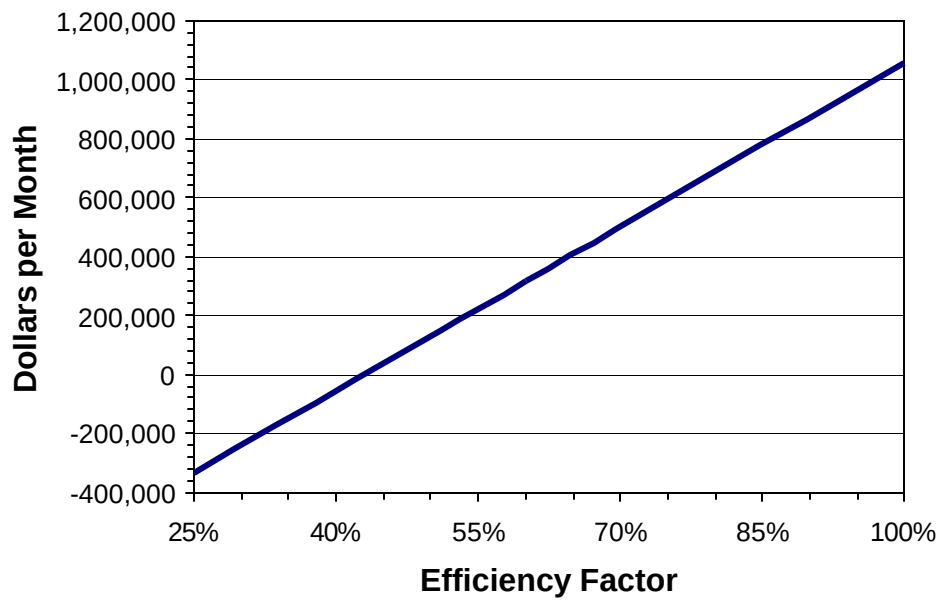
Source: Appendix K

Figure 6.3, # of HSTEs Replaced by an Average EUSC, Suezmax Tanker



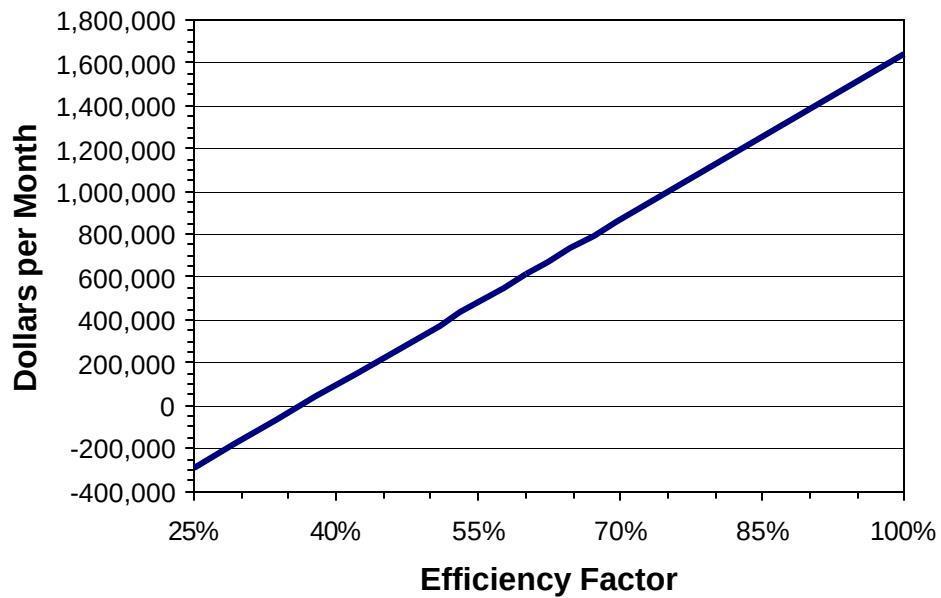
Source: Appendix K

Figure 6.4, # of HSTEs Replaced by an Average, EUSC VLCC



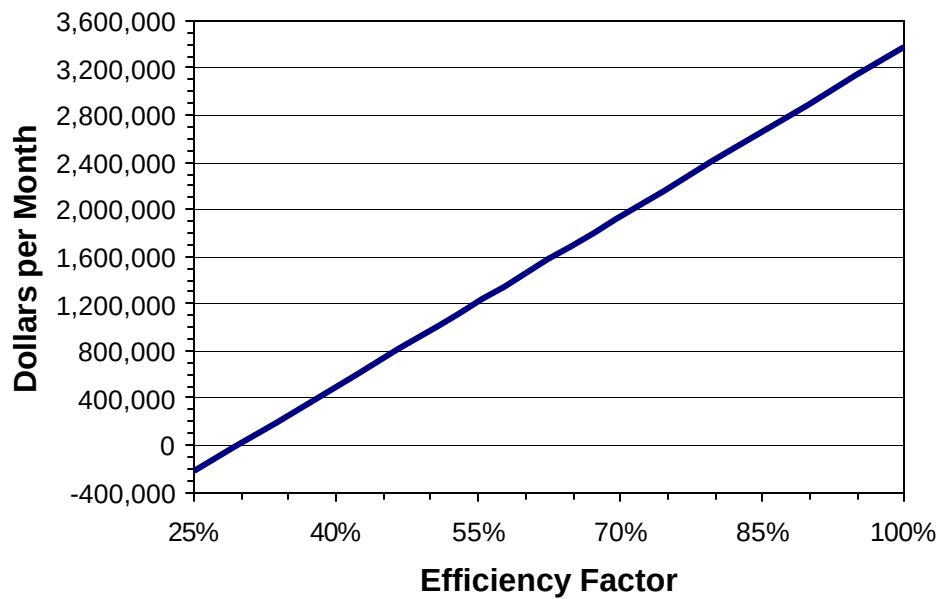
Source: Appendix K

Figure 6.5, Monthly Cost Savings of Replacing HSTEs with an Average, EUSC Aframax Tanker



Source: Appendix K

Figure 6.6, Monthly Cost Savings of Replacing HSTEs with an Average, EUSC Suezmax Tanker



Source: Appendix K

Figure 6.7, Monthly Cost Savings of Replacing HSTEs with an Average, EUSC VLCC

However, it is apparent that there is a sensible lower limit to the value in using EUSC tankers over 100,000 dwt as the efficiency factor assumed is decreased. The efficiency factor at which the operating cost of the larger tanker exceeds the operating costs of a chartered HSTE is one factor to consider. For Aframax tankers, Suezmax tankers, and VLCCs the efficiency factor for a breakeven cost is 43 percent, 36 percent, and 29 percent, respectively. It should be noted that actual charter rates during a conflict may be quite different than the cost factors used in this analysis.

It should be noted that the values cited apply only to a scenario using a distance to theater of 3,000 nautical miles. Increasing the distance to theater improves the effective substitution of EUSC tankers over 100,000 dwt for chartered HSTEs. As an example, an

average Aframax tanker, Suezmax tanker, and VLCC from the EUSC tanker fleet are substituted in scenarios where the distance to theater is changed to 1,500 and 5,000 nautical miles. The results are compared to the baseline case of 3,000 nautical miles in Table 6.4. The efficiency factor is assumed to be 50 percent for the calculations at both distances.

<u>Category</u>	<u>Replaced HSTEs</u>			<u>Potential Savings per Month</u>		
	1,500 nmi	3,000 nmi	5,000 nmi	1,500 nmi	3,000 nmi	5,000 nmi
Aframax Tanker	1.59	1.66	1.69	\$88,850	\$128,430	\$146,200
Suezmax Tanker	2.18	2.30	2.35	\$284,030	\$351,720	\$382,580
VLCCs	3.89	4.30	4.50	\$743,590	\$975,690	\$1,089,170

Note: The 3,000 nautical mile case is the baseline scenario.

Source: Appendix K

Table 6.4, Effect of Varying Distance to Theater on HSTE Substitution and Cost Savings per Month (Efficiency Factor = 50%)

From the results in Table 6.4, the larger tankers perform better as the distance to theater is increased from 3,000 to 5,000 nautical miles. These tankers are penalized as the distance is reduced from the baseline scenario distance. It is apparent that tankers over 100,000 dwt are more effective at substituting for an undersupply of militarily useful tankers in scenarios where the distance to theater is large.

SUMMARY

- 1) The U.S. military will call upon sources of tanker sealift in the following order: MSC controlled vessels, the Ready Reserve Force, U.S. flag fleet tankers, and EUSC tankers. After these U.S. controlled, military useful sources are exhausted, the military has two main options to obtain additional tonnage. The first of these options

is to charter foreign owned tonnage on the world market. Under this option, the military can obtain the exact type of tonnage it desires, in this case Handysized product tankers with fully coated cargo tanks. The dilemma associated with chartering foreign owned tonnage is the possibility that this source will be unavailable or unreliable during national emergencies. The other alternative is to utilize U.S. owned tonnage that does not meet the dwt requirements of the current military useful standard. These tankers can be sourced from the U.S. flag fleet or from the EUSC fleet. The obstacle to using these tankers is their large size, which limits the ports and canals accessible by these vessels, and their uncoated cargo tanks, which are less preferred by military sealift planners because of the additional cleaning time and the risk of contamination of military fuels. The decision to choose between chartering foreign owned, Handysized tankers and EUSC tankers over 100,000 dwt when the primary sources of sealift tankers have been exhausted will have to be made on a case by case basis.

- 2) There were only twelve U.S. flag tankers over 100,000 dwt available as of February 2001. These tankers, which serve in the domestic trades of the U.S., would have to be replaced with other tonnage in order to support the U.S. economy if they were requisitioned for sealift service. Substitute vessels could be obtained from the EUSC tanker fleet of vessels over 100,000 dwt.
- 3) The EUSC fleet of tankers of sizes greater than 100,000 dwt includes 36 ships with a combined dwt of 7,860,870. Nearly all of these tankers have uncoated cargo tanks. The total EUSC tanker fleet consisted of 68 vessels with a combined dwt of

10,090,756 as of June 2002. This fleet declined by 68 percent in terms of number of vessels and 66 percent in terms of dwt between 1986 and June 2002.

- 4) All Aframax tankers, which range in size between 80,000 and 115,000 dwt, have roughly the same dimensions. Larger dwt ships have a slightly deeper draft. Currently, only Aframax tankers up to 100,000 dwt qualify as militarily useful. All Aframax tankers could be effectively used with light loading or lightering techniques. Expanding the definition of military useful to encompass all Aframax tankers would provide an additional ten inter-regional sealift tankers in 2006, when a shortfall of militarily useful tankers is expected.
- 5) Both Suezmax tankers and VLCCs in the EUSC fleet could be used as motherships to support inter-regional sealift operations. In emergencies where smaller tankers are in short supply, these larger tankers could serve on the long-haul portion of the supply chain. This application would free the available small ships to work as intra-regional tankers, where they would operate more efficiently given the shorter route.
- 6) There are military standards and procedures for switching a tanker's cargo from crude oil, which most EUSC tankers over 100,000 dwt carry, to the sensitive diesel fuels and jet fuels of the military. These procedures can be applied to tankers with uncoated cargo tanks. Thus, during emergencies, the EUSC tankers over 100,000 dwt can be used to transport military fuels. However, the time needed for their cleaning and inspection presents a major difficulty in the event of a rapidly developing conflict of very short duration.
- 7) The utility of EUSC tankers over 100,000 dwt extends past their potential use in a sealift role. These tankers can be used to replace U.S. flag tankers withdrawn from

the U.S. Jones Act trades for sealift service or to provide crude oil from foreign sources for the U.S. economy. Unlike foreign owned tonnage, the continued presence of EUSC tankers helps to guarantee homeland security because these vessels can be requisitioned by presidential authority. In addition, these tankers and their crews could be vetted through cooperative agreements with EUSC tanker owners prior to their requisitioning. This topic is discussed in greater depth in Chapter 7.

- 8) EUSC tankers over 100,000 dwt can be substituted for several Handysized tankers if used in an inter-regional sealift role. The quantity of foreign owned, Handysized tankers that can be replaced by a single Aframax tanker, Suezmax tanker, or VLCC from the EUSC fleet will vary with the efficiency of the larger vessel. In this context, efficiency refers to the ratio of the achieved delivered capacity versus the theoretical maximum throughput of the tanker for a given distance to theater. While Handysized tankers are assumed to have an efficiency of 100 percent, a variety of factors related to the size of the vessel will reduce the efficiency factor for each category of larger EUSC tanker. Figures 6.2 through 6.4 provide information on the number of Handysize Tanker Equivalents (HSTEs) that can be replaced by each category of EUSC tanker over 100,000 dwt as this efficiency factor varies between 25 percent and 100 percent. Figures 6.5 through 6.7 show the potential cost savings associated with substituting a single large tanker for multiple HSTEs.
- 9) As the distance to theater increases, each EUSC tanker over 100,000 dwt is able to replace more HSTEs at any given efficiency factor. Tankers over 100,000 dwt appear to be most effective at substituting for HSTEs in scenarios where the distance to theater is 3,000 nautical miles or more.

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CHAPTER 7

COOPERATIVE PARTNERSHIPS BETWEEN THE U.S. GOVERNMENT AND CARRIERS

It is essential for the government to have some kind of cooperative agreement, with antitrust immunity, for dealing with transportation carriers. Two such agreements for shipowners already exist in the form of the Voluntary Tanker Agreement (VTA) and the Voluntary Intermodal Sealift Agreement (VISA). This section of the chapter will define and discuss these programs.

VOLUNTARY TANKER AGREEMENT (VTA)

The Voluntary Tanker Agreement was originally approved by the Acting Secretary of Commerce on January 23, 1951. The intent of VTA was to form an agreement between DOT and tanker owners to make tankers and tank space available when needed by DoD. VTA is formally defined as an agreement established by MARAD to provide for U.S. commercial tanker owners and operators to voluntarily make their vessels available to satisfy DoD needs. It is designed to meet contingency or war requirements for point-to-point petroleum, oil, and lubricants movements, and not to deal with capacity shortages in resupply operations.

VTa is designed to create close working relationships between the government (MARAD, DoD, DOT) and transportation carriers through which military needs and the needs of the civil economy can be met by cooperative action. It is intended that the VTA be activated prior to requisitioning ships under Section 902 of the Merchant Marine Act of 1936, whereby tanker owners would be given the opportunity to voluntarily contribute tanker capacity in an effort to proportionally distribute the burden.

MARAD has found that if conditions exist which pose a direct threat to the national defense or its preparedness programs, an agreement like VTA is necessary.

VTa provides transportation carriers antitrust protection through MARAD's Defense Protection Act. However, VTA has been paid little attention over the last six years. During this span, the related Tanker Requirements Committee has not met.

Consequently, it is not clear which industry individuals are still involved in the program and whether any set of procedures still exists since little or nothing has been done for several years. It may be useful to take some ideas from the VISA program, since this program has received much more attention from the government and industry.

VOLUNTARY INTERMODAL SEALIFT AGREEMENT (VISA)

The Voluntary Intermodal Sealift Agreement (VISA) program is intended to make commercial dry-cargo capacity (such as containers), and supporting global infrastructure available to meet contingency deployment requirements of the DoD. VISA essentially creates a partnership between the government and transportation carriers.

VISA is intended to provide a seamless transition from peacetime to wartime operations. The foundation of VISA is that it brings the transportation carriers into the DoD planning process. Furthermore, it is important to note that VISA carriers get preference to carry U.S. government cargo. This is a great incentive to participate in the VISA program.

According to MARAD, VISA's objectives are to:

- Assure DoD access to critical sealift capability for national security contingency requirements
- Contribute to a robust and healthy U.S. merchant marine
- Balance defense and economic elements of civilian transportation for national security

In order to receive financial support from the government, Maritime Security Program (MSP) participants are required to enroll 100 percent of their U.S. flag MSP vessel capacity, intermodal resources, and services in VISA.

VISA has three stages. Similarly, Stage I and II are for lesser crises, while Stage III is for national emergencies. A carrier desiring to participate in Stage III must commit no less than 50 percent of its total U.S. Flag capacity for non-MSP vessels.

Freight rate methodology has already been determined for vessels enrolled in VISA Stage III. There are two methodologies used. One of these methodologies is the revenue-based

method. In this method, there are two types of rates: unit and daily. The government will pay carriers a unit rate for each space unit activated (e.g., - MT's) and the vessel daily rate/perdiem rate for each day the vessel provides service. The vessel daily rate applies to liner service, while the per diem rate applies to tramp service. The second methodology is applicable only to shipping carriers offering rates for the MTMC VISA Contingency Contract (VCC), and the MSC Drytime Charter Contract (DCC). The vessel daily rates and per diem rates are derived from the rate and commodity information taken from the carrier's DoD peacetime contract, and from utilization and expense data taken from its most recent business year. There is an eight-step calculation used to determine the vessel daily rate/per diem rate in this methodology.

While VISA has yet to be fully tested in times of contingency, it is increasingly being recognized as a necessary, additional arm of national defense. James Bambrick, Farrell Lines executive vice president, said in an interview:

“VISA grew out of Desert Storm...The Gulf War really demonstrated that if you have to move thousands of tons of containers for hundreds of thousands of troops, you need a vehicle. VISA provides that.”

VISA also establishes antitrust immunity. In further detail, each carrier shall have available as a defense to any civil or criminal action brought under the antitrust laws with

respect to any action taken to develop or carry out this agreement. VISA illustrates another program that provides a legal format with antitrust immunity.

CONCLUSIONS

The U.S. government has already established the legal framework for dealing with EUSC tanker owners through VTA (and the related Tanker Requirements Committee). The VISA program has also provide procedures for the government to use in obtaining access to certain vessels owned by U.S. citizens.

Building on the background, the government has the ability to bring the EUSC tanker owners together to discuss procedures for pre-screening their crews and gaining access to their ships. The government could even consider circumstances where it would want to place U.S. seafarers aboard EUSC tankers. In addition, the government could take steps to learn to which trade routes the EUSC tankers were normally assigned and what plans the owners had for scrapping, selling, or buying EUSC tankers. These steps would improve the ability of the government to plan for the use of EUSC tankers.

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CHAPTER 8

LEGISLATIVE ALTERNATIVES

INTRODUCTION

This report has already outlined the current state of the Effective U.S. Controlled shipping fleet, and established its importance for the military security of the United States. Given this information, it becomes important to next ask: “What can be done to encourage investment in U.S. controlled shipping, and thus revitalize the EUSC?”

KEY CRITERIA

Key criteria for identifying and evaluating legislative alternatives are:

- It should encourage EUSC tanker owners to maintain or increase the size of the EUSC tanker fleet.
- It should support DoD objectives.
- It should be able to gain the support of the Executive Branch and the Congress.

TAX DEFERRAL

As outlined earlier in this report, tax law prior to 1975 provided a substantial concession with respect to shipping income earned by foreign subsidiaries of American companies. The most obvious approach to providing American shipowners with the incentive, once again, to invest in foreign flag ships is the restoration of tax deferral as it existed prior to

the 1975 legislation. Under such an approach, the earnings and profits of the foreign shipping subsidiaries would not be subject to U.S. income tax on a current basis but would be taxable when paid upstream to the American companies controlling the foreign shipping subsidiaries. Such an approach would greatly decrease the overall cost of EUSC shipping operations and help EUSC shipowners to compete in the international market. Though the immediate benefits to shipowners are easy to see, it is important to realize that such a strategic tax regime has the potential to help the U.S. in three ways:

1. Investment encouraged by tax deferral would contribute directly to the number of tankers available during times of emergency. The U.S. would have a greater number of merchant vessels at its disposal for military operational support.
2. As the number of American owners increases, as a result of the tax deferral incentive, collected income tax will eventually rise when shipping earnings and profits are repatriated. As was shown earlier in the report, the amount of income realized by the government as a result of EUSC income taxation has fallen dramatically since the Tax Reform Act of 1986; even though the percent of taxable income presumably would decrease for this particular group of corporations, if there is a rise in the number of corporations (or overall earnings and profits), an accompanying rise in total collected income tax from this market should eventually occur. In the absence of any new legislation, the size of the EUSC fleet, and accompanying U.S. income tax, would be expected to continue to decline.

3. It supports the U.S. maritime infrastructure including such occupations as ship managers, naval architects, marine engineers, surveyors, ship financiers, insurers, cargo brokers, accountants, admiralty lawyers, etc.

Some attempts have been made to reinstate tax deferral on shipping income, but they have been unsuccessful. Regardless, the United States has a pre-1975 model on which to work, should it choose to reinstate the deferral. Since the precedent has already been set, a tremendous amount of the difficulty associated with policy implementation can be discounted.

TAX EXCLUSIONS OR OTHER REVISIONS

A popular way of providing incentives to shipowners in many major maritime countries is to waive taxes or minimize them. Currently in effect in many major European countries is a tonnage tax. With this plan, shipowners are required to pay a flat tax based on the size of the vessels they operate – not on the amount of profit generated by those ships. Thus, in all situations where substantial revenue is realized, the percent of revenue dedicated to taxes is greatly decreased. Because the level of the tonnage tax can be manipulated, some discretion is afforded the government for variation in tax burdens, should the need for adjustment arise. A plan of this nature would also provide potential entrants with further opportunity to accurately predict their tax burden, and justify entrance.

Many countries have completely alleviated shipowners of all tax obligations; such an option would be an effective way of rejuvenating the EUSC. However, the flat/tonnage tax would help to provide the same end result, without as great a drop in total tax revenues.

The Oberstar Bill proposed a tonnage tax for the owners of U.S. flag ships in international trade. However, it seems unlikely that such legislation will pass in the near future. Consequently, it may be difficult to promote such an approach for EUSC shipowners at this time. However, over the longer term a flat or tonnage tax approach may have more merit.

CARGO PREFERENCE

At the present time U.S. flag shipowners receive a cargo preference benefit in that certain U.S. government cargos are reserved for U.S. flag vessels. It would be a benefit to EUSC shipowners if they could receive preference over other foreign flag vessels when the U.S. government was awarding contracts to move its cargo. Currently the amount of oil cargo moved by the U.S. government on foreign flag tankers is rather limited. According to the MSC website, over the time period from October 2001 through June 2002 only 58 lifts were awarded in the form of voyage or short term charters to foreign flag tankers¹⁷.

There were no long term charters awarded to foreign flag tankers during this period.

¹⁷ Military Sealift Command Website, "Cargo Preference Performance Data – Tankers for Oct. – June FY 02", Cargo Preference Performance Data, www.msc.navy.mil, 2002.

HOW NARROW, HOW BROAD?

Before any plan for revitalization of the EUSC can be approved and implemented, the scope of its application must be determined. Which ships would be eligible? Which owners would be eligible? What are the consequences, in terms of bill passage, in each situation?

Since the key criteria for evaluating legislative alternatives include increasing the size of the EUSC tanker fleet and supporting DoD objectives, it would seem reasonable to conclude that any legislation providing tax benefits should be limited to companies controlling EUSC tonnage. This would, in effect, provide an incentive to any American companies controlling tankers registered in non-EUSC registries abroad to reregister them in eligible EUSC registries and thus increase the size of the EUSC tanker fleet. Military Sealift Command expresses its greatest interest in militarily useful tankers under 100,000 DWT. These are the ships that can readily access their needed ports of call, and can adequately replenish a military operation. Thus, in the most narrow scope, any proposed plan could be limited to ships meeting this exact qualification. However, speculation exists as to the value of including tankers of greater than 100,000 DWT. While tankers of greater than 100,000 DWT may not be ideal in terms of size or cargo tank coatings, given the small number of EUSC tankers remaining, it may be useful to include tankers of all sizes.

Proposed legislation can be written to include or exclude certain self-interest groups. In this way the constituency supporting a bill can theoretically be increased. The types of factors that can be considered include: type of vessel (e.g. general cargo, cruiseship, tanker), type of owner (e.g. owner of mixed U.S. flag and EUSC flag fleet, oil company), or geographic trade region (e.g. Caribbean, foreign to –foreign trade). If judiciously done, selective inclusion/exclusion of parties might result in a larger constituency for proposed legislation. On the other hand, the larger the number of ships included in the legislation, the greater the “scoring” of the bill, which is described in the next section.

SCORING

A proper analysis of the amount of U.S. tax revenue that would be lost, if tax deferral was allowed, is very difficult for the following reasons:

- It would be necessary to predict how the international tanker market will react over the desired period, since tanker rates are tied to the industry supply-demand situation.
- It would require access to confidential information which companies do not make available to the public such as profits by EUSC ships within a company fleet and effective tax rates.
- It would be essential to describe the future plans of each EUSC tanker owner in terms of buying, selling, and scrapping in order to determine the size of the EUSC fleet.

Such an analysis is beyond the scope of this research. However, it would be useful to make even a rough estimate of the scoring involved with new legislation that would allow tax deferrals for the EUSC tanker fleet. In order to estimate the amount of tax dollars that would be sacrificed, we have focused our attention on the financial data for Overseas Shipholding Group, Inc. Available data covers the years from 1997-2001 with some level of detail (unlike available data on the other EUSC owners). U.S. flag ship profits are separated from foreign flag vessel profits. In addition, tanker size is differentiated in the data for the four most recent years. Since OSG is the largest EUSC tanker operator, the results from this analysis will be scaled up to estimate the lost U.S. tax revenues from the entire EUSC tanker fleet.

Nevertheless, many problems remain in performing a scoring analysis:

- Dry bulk vessels are not broken out in the profit figures.
- It is not obvious how we should handle the differences in the profits of the EUSC tankers versus the profits from the rest of the fleet (assuming they could be accurately broken out). However, EUSC tankers make up the great majority of the OSG foreign flag fleet during the time period considered.
- When you look at a particular time period (e.g. 1997-2001), the financial data may include the effects of events in earlier periods. In addition, events during the period under consideration may affect tax payments after this time period.
- An overall effective tax rate can be determined, but it is not clear to what extent it would apply to other EUSC tanker owners (or to OSG in future years).

We will briefly outline the procedures used, and the source of included numbers. Please reference the accompanying spreadsheets in Appendix L for numerical results.

It was decided to rely on publicly available profit and tax rate data. While the fleet of each EUSC tanker owner is unique, since OSG is the largest EUSC tanker owner it should be more representative of the overall fleet than any other single owner. While every year is unique in terms of market conditions, profits and tax deductions (including carry forward and carry back figures), by looking at five years of data we hope to cover a reasonable set of values. While the marginal U.S. federal income tax rate is 35%, the actual tax rate that an EUSC ship owner pays depends on the overall profit or loss from his entire fleet as well as tax deductions produced by his entire fleet (including both EUSC and non-EUSC vessels). Since most owners of EUSC tankers also own non-EUSC ships, we decided to use the actual tax rates by OSG on their overall fleet in our scoring analysis.

Fortunately, the OSG annual reports and 10-K documents for years 1999, 2000, and 2001 provide relatively thorough tax information for the five years in 1997-2001. The figure used for income before taxes (or taxable income) can be found in Note J – Taxes. Provided is “the components of income/(loss) before federal income taxes and extraordinary loss,” and each total is provided with distinction between U.S. and foreign earned income. It is important to note that years 1997 and 1998 both show substantial

losses on Domestic operations (\$19,147,000 and \$39,814,000 respectively). What results is a great reduction in total income before taxes, and a negative taxable income in 1998.

Outlined in Note J of these annual reports is a series of numbers for “actual income taxes paid,” and these numbers were cited for the amount of federal tax. The year, 1999, showed a tax credit of \$7.9 million, “all of which related to prior years.” In other words, it appears that the company received credit for substantial losses in the year(s) following the year of loss. This tax credit results in a negative tax expense for 1999, and thus a negative marginal tax rate. Similarly, 1998 has a negative tax rate on account of an operating loss, but positive tax expenditures.

Once the actual tax expenses were determined, we proceeded to ascertain what portion of that tax might be sacrificed if foreign earned income were not included for tax purposes. Our objective is to estimate the income and taxes of the EUSC tankers. Using the provided foreign earned income before taxes, we subtracted out all cruise earnings, as listed in the income statement, from years 1997 and 1998. Dividing the remainder of new “bulk foreign income” into the total taxable income provides us with an estimated percentage of total income derived from foreign bulk operations. Applying these respective percentages to the tax expenses gives us an idea of what percent of taxes were paid on behalf of foreign earned bulk shipping income, and yields the “Estimated Income Tax Paid on F.F. Income” column of the spreadsheet.

Because a portion of the foreign flag bulk fleet of OSG is comprised of ships which are either not EUSC, or not tankers (or both), it is necessary to further separate out EUSC income from foreign flag income. The ship listings for OSG are included, with organization information. Because the tax data estimated for OSG is to be extrapolated to the entire EUSC fleet (for scoring purposes), it is important to obtain an estimate of the tax dollars paid each year, per dwt. However, in order to effectively determine the tax dollars/dwt for any given year, you must know just how many dwt were operated in that year. Because ships are acquired/scrapped fairly often, a weighting system was used and applied to ship deadweights. The number of days a ship was owned in a given year was divided by 365 (days/year), and this factor multiplied by the actual dwt of the ship. These deadweight numbers are used for all calculation purposes in this study, and effectively adjust tonnages for time owned.

In order to look at taxation variations by ship size, we broke down tax expenditures by ship size as well. For years 1998-2001, OSG's annual reports provides specific "Percentage of Income from Vessel Operations" data (Part I, Operations) with differentiation by tanker size. These percentages were applied, in conjunction with tonnage calculations, to determine the amount of tax paid per dwt for VLCC's, Aframax and Product tankers.

Table 8.1 shows the results of the taxes/dwt calculation for the OSG EUSC tankers for the years 1997-2001. The average over this time period is \$1.26/dwt.

	Estimated Income Tax Paid on EUSC Income (\$ 000's)	Total EUSC Tanker DWT	\$ Income Tax / 1 DWT
1997	\$791	4,016,441	\$0.20
1998	\$15,133	4,087,053	\$3.70
1999	(\$3,341)	3,740,905	-\$0.89
2000	\$7,906	3,634,229	\$2.18
2001	\$4,534	4,065,842	\$1.12

Table 8.1 Estimated Amount of Income Tax Paid per Deadweight Ton on OSG EUSC Tankers

In order to extend the tax results to the rest of the EUSC tanker fleet, we applied the \$1.26/dwt average value to the total number of EUSC deadweight tons in 2002, as is shown below in Table 8.2. What results is a cost of approximately \$12.7 million to the U.S. government in one year, if all EUSC tankers were absolved of income tax obligations on foreign earned income.

TOTAL EST. COST OF DEFERRAL	1997-2001 Average \$ Tax / DWT	2002Total EUSC Tanker DWT	Est. Tax Revenue Lost Per Year
	\$1.26	10,090,756	\$12,714,353

Table 8.2 Anticipated Annual Cost to the Government of Eliminating EUSC Income From Subpart F

For a complete review of the procedures and numbers used in this scoring, please see Appendix L at the end of this report.

CONCLUSIONS

The most practical and realistic way to maintain and increase the size of the EUSC tanker fleet is to pass new legislation to allow EUSC tanker owners to defer U.S. income taxes

as was done before 1975. By focusing on tankers any proposed legislation will have direct potential national security benefits. Including tankers of all sizes will maximize the amount of potential benefits to DoD. The authors have performed a rough estimate of the scoring that would accompany such a bill. It appears that given the small –and decreasing – number of EUSC tankers (as well as U.S. flag tankers), the potential benefits of maintaining or increasing the EUSC tanker fleet outweigh the declining revenue stream to the federal government as the EUSC fleet further decreases over time. The authors also recommend that the U.S. government give cargo preference in the movement of its liquid bulk cargo to EUSC tanker owners over other foreign flag tankers (although only limited cargo volume exists). While including other types of ships in the proposed legislation may increase the support for new legislation from the various self-interest groups that would be involved, the authors prefer to focus on the national security benefits and the lower scoring that would result from including only tankers.

One might argue that proposed legislation should focus on only smaller sizes of tankers which are more militarily useful. However, if the long term objective is to build up the EUSC tanker fleet, the authors feel that a major push for EUSC tanker owners in terms of giving tax benefits to all of their EUSC tankers will be a start in the right direction. We think that even if this proposed legislation is passed, it would be overly optimistic to predict that there will be a substantial increase in the EUSC fleet overnight. Nevertheless, by “leveling the playing field” in the area of income taxes with their competitors, the EUSC tanker owners will finally have some reason to grow their fleets.

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CHAPTER 9

CONCLUSIONS AND RECOMMENDATIONS

A major conclusion of our work is that the EUSC requires the immediate attention of the U.S. government. The factors leading to this conclusion are as follows:

- Certain military scenarios utilized in the MRS-05 Sealift Tanker Analysis require all 57 militarily useful EUSC tankers forecasted to exist in 2005 in this DoD analysis. We estimate that only 25 of the required 57 ships will exist in 2005.
- The decline of the EUSC tanker fleet will continue in the future, and even accelerate in the future, unless there are changes in legislation.
- There is not an on-going current relationship between the U.S. government and the EUSC shipowners. In order to obtain the military benefits desired, it is necessary to develop such a cooperative arrangement. The Voluntary Tanker Agreement which was initiated many years ago may be the appropriate starting place, but the related Tanker Requirements Committee has not met in at least 6 years.
- The only way to greatly increase the number of U.S. owned tankers to be used by DoD in the near term is to redefine “militarily useful” to include ships over 100,000 dwt. While many of these ships will not be of the ideal size or have the ideal tank coatings, these tankers will give the DoD an option other than acquiring the use of foreign owned vessels on the world charter market. EUSC

tankers over 100,000 deadweight tons could be used: for direct movements (although some would be of inefficient size); for linehaul movements as “mother ships” to be lightered; as replacements for U.S. flag tankers removed from the Jones Act trade by DoD; and to move crude oil from foreign countries to the U.S. in time of an emergency.

While our focus is the EUSC fleet, it is clear that the U.S. flag tanker fleet will also be declining in the future, further jeopardizing DoD’s ability to obtain access to such vessels in time of need. Most of the EUSC shipowners also own or control U.S. flag vessels. Consequently, any assistance given to the EUSC shipowners will indirectly aid U.S. flag shipowners as well.

In order to maintain or increase the size of the EUSC fleet, it is necessary to pass new legislation that would allow EUSC shipowners to better compete in the world marketplace. The key aspect of new legislation to help EUSC shipowners is to allow them to avoid paying tax on current income.

Our key recommendations are:

- The U.S. government should pass new legislation that will focus on tankers, and only on tankers under Effective U.S. Control, thereby resulting in direct potential national security benefits. Including tankers of all sizes will maximize the amount of potential benefits to DoD. The authors have performed a rough estimate of the scoring that would accompany such a bill. It appears that given

the small –and decreasing – number of EUSC tankers (as well as U.S. flag tankers), the potential benefits of maintaining or increasing the EUSC tanker fleet outweigh the declining revenue stream to the federal government as the EUSC fleet further decreases over time. While including other types of ships in the proposed legislation may increase the support for new legislation from the various self-interest groups that would be involved, the authors prefer to focus on the national security benefits and the lower scoring that would result from including only EUSC tankers. One might argue that proposed legislation should focus on only smaller sizes of tankers which are more militarily useful. However, if the long term objective is to build up the EUSC tanker fleet, the authors feel that a major push for EUSC tanker owners in terms of giving tax benefits to all of their EUSC tankers will be a start in the right direction. We think that even if this proposed legislation is passed, it would be overly optimistic to predict that there will be a substantial increase in the EUSC fleet overnight. Nevertheless, by “leveling the playing field” in the area of income taxes with their competitors, the EUSC tanker owners will finally have some reason to grow their fleets.

- The U.S. government should develop an on-going relationship with the EUSC tanker owners. Building on the background of the VTA (and the related Tanker Requirements Committee) the government has the ability to bring the EUSC tanker owners together to discuss procedures for pre-screening their crews and gaining access to their ships. The government could even consider circumstances where it would want to place U.S. seafarers aboard EUSC tankers. In addition, the government could take steps to learn to which trade routes the EUSC tankers

are normally assigned and what plans the owners have for scrapping, selling, or buying EUSC tankers. These steps would improve the ability of the government to plan for the use of EUSC tankers.

- The U.S. government should give cargo preference in the movement of its bulk liquid cargos to EUSC tankers over other foreign flag tankers (although only limited cargo volume exists).