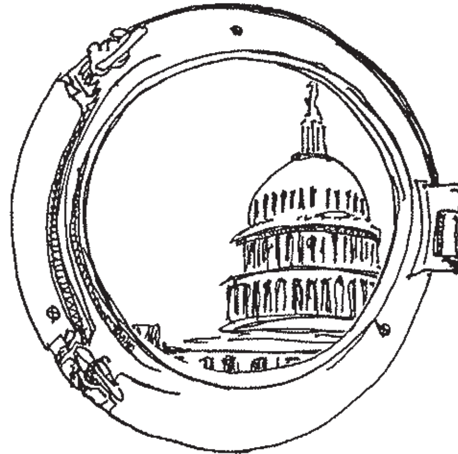
WINDOW ON WASHINGTON



In Pursuit of a National Maritime Strategy

By Bryant E. Gardner

The U.S. Merchant Marine forms the backbone of our national defense sealift capability, and is the foundation of our nation's ability to project power and sustain essential trade across the oceans. This proud corps of mariners has served in a public-private partnership with the Federal government since the birth of the Republic, but there is widespread agreement that it is at greater risk today than at any time in the last century. The domestic Jones Act fleet, sheltered within the brown waters of cabotage, remains stable and in some sectors thriving.[1] In contrast, the deep water, internationally trading fleet stands at the precipice, having reached a critical point following a long, slow period of decline in face of unequal and unfair competition with open registries.

For years, maybe decades, Washington maritime industry insiders have watched our international fleet atrophy with varying degrees of alarm, shaking their heads and blaming the U.S. Maritime Administration ("MARAD"), the Office of Management and Budget ("OMB"), the loss of the House Merchant Marine Committee, the passing of great maritime champions in Congress such as the late Senator Daniel Inouye (D-HI), foreign flag subsidies, or even sometimes themselves. But, for the most part, little has changed following the last Alamo establishment of the Maritime Security Program of 1996, as amended in 2003, to include 60 core military sealift vessels under the U.S. flag.

New leadership at MARAD, Acting U.S. Maritime Administrator Paul N. "Chip" Jaenichen has announced his intention to reverse this decline. During Senate confirmation hearings in November 2013, Jaenichen stated:

> *First*, I plan to continue to work with industry stakeholders and Congress to identify ways to revitalize the U.S. Merchant Marine. The U.S.-flag fleet not only provides safe, reliable and environmentally responsible transport of cargo to support economic activity, both domestically and internationally, but also supports Department of Defense (DOD) sustainment sealift capacity requirements in

[1] The Jones Act and complementary cabotage laws are codified at 46 USC Ch. 551. For discussion regarding recent controversies surrounding the Jones Act, *see* Bryant E. Gardner, *Waiving the Flag*, Window on Washington, 10 Benedict's Mar. Bull. 98 (Second/Third Quarter 2012); C. Kilgannon and M. Santora, *40,000 Tons of New Jersey Salt, Stuck in Maine*, N.Y. Times, Feb. 18, 2014, available at http://www.nytimes.com/2014/02/19/nyregion/rock-salt-bound-for-new-jersey-is-held-up-by-decades-old-maritime-law.html (last visited April 22, 2014).

> times of armed conflict or national emergencies. The U.S. Merchant Marine engaged in international trade has steadily declined since World War II and currently carries less than 2 percent of our Nation's overseas trade. *We need a strategy that will result in a significantly higher portion of U.S. overseas trade being carried on U.S. flag vessels*.[2]

Subsequently, MARAD issued a Federal Register notice announcing a "National Maritime Strategy Symposium" to be held January 14-16, 2014.[3] The notice stated "The purpose of this initial public meeting is to generate ideas that will improve, strengthen, and sustain the cargo opportunities and sealift capacity of the U.S.-flagged fleet engaged in international commercial trade."[4] MARAD also opened a docket, No. MARAD-2013-0101,[5] and solicited comments from concerned stakeholders, to precede further stakeholder input at the symposium itself.

Appropriately, Acting Administrator Jaenichen kicked-off the Symposium by refocusing the discussion on existing statutory maritime policy as set forth in the Merchant Marine Act:

> It is necessary for the national defense and development of its foreign and domestic commerce that the United States shall have a Merchant Marine
>
> (a) Sufficient to carry its domestic water-borne commerce and a substantial portion of the water-borne export and import foreign commerce of the United States and to provide shipping service essential for maintaining the flow of such domestic and foreign waterborne commerce at all times,
>
> (b) Capable of serving as a naval and military auxiliary in time of war or national emergency,
>
> (c) Owned and operated under the United States flag by citizens of the United States, insofar as may be practicable,
>
> (d) Composed of the best-equipped, safest, and most suitable types of vessels, constructed in the United States, and manned with a trained and efficient citizen personnel, and
>
> (e) Supplemented by efficient facilities for shipbuilding and ship repair. It is declared to be the policy of the United States to foster the development and encourage the maintenance of such a merchant marine.[6]

Thus, U.S. maritime policy requires the development and promotion of an internationally trading U.S. Merchant Marine for national security firstly by supporting U.S. commerce, and secondly by providing sealift capacity for use in war and in civil emergencies such as Hurricane Katrina or the Haiti earthquake.[7] As observed by the Senate Commerce Committee during its 1970 consideration of amendments to the Merchant Marine Act:

> The Merchant Marine has been appropriately termed our fourth arm of national defense. To permit our security and economy to become totally dependent upon foreign vessels, operated by foreign crews, subject to the wishes of foreign governments would be to run an unacceptable risk. The presence of a viable U.S. merchant fleet is necessary to provide some assurance that this nation's security and foreign policy objectives will not be subject to the dictates of other nations, and that the ability of our export shippers to compete in world markets and the delivered price of our import commodities will not be unilaterally determined by foreign competitors.[8]

However, as highlighted by Administrator Jaenichen at the opening of the Symposium, today the U.S. Merchant Marine carries only a very small percentage

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[2] Testimony of Paul N. Jaenichen before the Senate Commerce, Science, and Transportation Committee (Nov. 21, 2013) (emphasis added).

[3] 78 Fed. Reg. 79,071 (Dec. 27, 2013).

[4] *Id.*

[5] The docket is accessible at http://www.regulations.gov/#!documentDetail;D=MARAD-2013-101-0064 (last visited April 22, 2014).

[6] Opening Remarks of Acting Administrator Jaenichen (Jan. 14, 2014) (quoting § 101 of the Merchant Marine Act of 1936).

[7] *See also* National Security Directive 28 (Oct. 5, 1989) ("Sealift is essential to executing this country's forward defense strategy *and to maintaining a wartime economy*.") (emphasis added).

[8] S. Rep. No. 91-1080, 1970 USCC.A.N. 4188, 4190.

of the U.S.-foreign trade, having fallen from its peak number of vessels in 1951 to less than 200 today, or from its peak of 13.6 million gross tons in 1988 to 6.9 million tons at the end of 2013.[9] Put another way, the percentage of U.S. waterborne foreign trade carried in U.S. bottoms dropped from approximately 10% in the 1960s, then to 4% in the 1990s, and stood at 3% in 2003, the last year for which MARAD has data.[10] Many in Congress and the Administration have openly challenged whether these numbers constitute "a substantial portion of the water-borne export and import foreign commerce," as required by statute.

The January Symposium was, for the most part, a listening session for MARAD. Industry participants provided various ideas for revitalization of the U.S. Merchant Marine, both through written docket submissions and in person during the various break-out and plenary sessions in mid-January. Participants included ship owners and operators, maritime unions, shipper interests such as large manufacturers, shipbuilders, and Government facilitators collecting ideas. The ideas put forward fall into roughly four groups: (1) protect existing programs; (2) expand cargo reservation programs; (3) level the playing field between U.S. and foreign registries with respect to costs and regulatory burdens; and (4) obtain new cargoes through shipper incentive programs.

Protect Existing Programs

Stakeholders were in near universal agreement that they need to protect the programs that currently sustain what remains of the Merchant Marine, i.e., the Maritime Security Program ("MSP"), which provides reservation payments to 60 militarily useful vessels as determined by MARAD and the U.S. Transportation Command, and cargo preference which requires the shipment of some Federal government impelled cargoes in U.S. bottoms. Although the complementary operation of these two programs is indisputably key to maintaining the existing blue water fleet, they have not been enough to stem the decline of the fleet. The objective of the Symposium, and the MARAD effort in general, is to grow and restore the Merchant Marine, and it is hard to see how doing more of the same will reverse the decline. This is particularly the case since preference cargo volumes are in jeopardy given the draw-downs in Iraq and Afghanistan for military cargo, and the Obama administration's persistent attempts to eliminate our nation's flagship food aid programs, such as Food for Peace, which have historically provided the bulk of peacetime cargoes to the fleet.

Some comments submitted to the MARAD docket, however, focused upon a nagging concern: MARAD's perceived failure to adequately enforce the cargo preference laws as they stand. Anecdotes continually circulate through the U.S.-flag community regarding shipper agencies circumventing or ignoring cargo preference requirements. And although these concerns led to the establishment of new enforcement powers for MARAD in 2008, the agency has taken the position that it cannot exercise these powers until it promulgates implementing rules, yet for six years has failed to do so. In a February 12, 2014, interview with Maritime TV, Acting Administrator Jaenichen reported that the agency decided to go back to the drawing board with its regulation after running into "red lines" with other agencies during the interagency process, and to come back with a regulation that avoids those tripwires in order to put "real teeth" into the enforcement regulation and increase cargo opportunities for the U.S. flag.[11]

MSP, too, has faced challenges in recent years, with sequestration dangers posing a threat to funding for the existing 60 slots, and fears that the Department of Defense may no longer require the full number of slots following Secretary Gates's downsizing of the Department and reorientation toward nimbler, lighter forces. MSP also suffers under several programmatic flaws, most particularly its permanent grandfathering of slots to the successors of the U.S.-flag liner companies which were acquired by foreign interests in the 1990s and remain so today to the exclusion of U.S.-owned "Section 2" citizen operators with newer, more militarily useful vessels than many enjoying grandfathered status.

Turning around the fate of the U.S.-flag is going to take something more than just doing more of the same. It is going to take new ideas and bold leadership to get the cargo needed to sustain the fleet.

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[9] Opening Remarks of Acting Administrator Jaenichen (Jan. 14, 2014).

[10] *Id.*

[11] Maritime TV, Interview with Acting Maritime Administrator C. Jaenichen, Feb. 12, 2014, *available at* http://www.maritimetv.com/Events/jaenicheninterviews/TabId/1025/VideoId/601/Maritime-TV-InDepth-Interview-With-Acting-Maritime-Administrator-Paul-Chip-Jaenichen.aspx (last visited April 22, 2014).

Expand Cargo Reservation Programs

Many commenters also expressed support for an expansion of cargo preference, or cargo reservation opportunities, and Acting Administrator Jaenichen has subsequently indicated his conclusion that revitalization of the fleet requires new cargoes, not just enforcement of existing cargo preference laws.[12] With respect to cargo preference, i.e., government-impelled cargo, there seems little room for expansion to new cargoes. Military[13] and Export-Import Bank[14] cargoes are already reserved to 100% U.S.-flag, and only food aid remains for expansion of government impelled cargoes to U.S.-flag, since it is currently exempted to only 50% cargo preference.[15] However, hydrocarbon-based energy exports, arising primarily because of new onshore drilling capabilities in the Bakken formation and elsewhere, have been discussed as a potential source of cargoes which may be reserved to U.S.-flag carriers in at least a small part.[16]

Bootstrapping U.S.-flag requirements onto oil and gas exports is not without its challenges. First, the existing legal prohibitions upon LNG export are scant, despite the oversized attention they have attracted. Therefore hitching a U.S.-flag requirement to them will require the development of new legislation which may encounter significant resistance from potential exporters, although potentially allies consist of U.S.-based manufacturers and others looking to capture these new energy sources for domestic enterprises. Moreover, in February 2014, John Garamendi (D-CA), ranking member of the Coast Guard and Maritime Transportation Subcommittee and one of the U.S. flag's great supporters, offered an amendment to the 2014 Coast Guard Authorization Bill, H.R. 4005, which would have tied LNG exports to U.S.-flag carriers, but he subsequently withdrew the amendment. In its place, the manager's amendment included a reporting provision requiring exploration of U.S. flag opportunities in LNG export, and that provision remains in the version of the bill passed by the House on April 1. In contrast, crude oil exports are currently hindered by a wide array of energy crisis era prohibitions, and therefore U.S. flag interests might be able to hitch onto legislation introduced to loosen these restrictions as part of any final grand bargain.

Some U.S.-flag operators advocated during the symposium for U.S.-flag requirements applicable at least partially to crude exports, but knock-on support from the unions and associations was silent, and even the MARAD presentation focused upon the possibility of LNG cargo reservation to the exclusion of crude exports. Why is that? G. Allen Brooks suggests in the recent January/February 2014 *Maritime Executive* that Jones Act carriers operating in the domestic trades are currently benefitting enormously from the imbalance between available crude in one part of the country and available refining capacity in another part of the country.[17] Since refined products are largely free of export restrictions, unlike crude, and existing pipeline capacity does not match these new requirements for hydrocarbon flows, energy interests have little choice but to employ Jones Act carriers and get their products to market in the U.S. or abroad. Upsetting this applecart, and overcoming U.S. refiners who want to keep U.S. crude captive in the U.S. will be a tall order, and one that is going to be filled by energy producers if it is going to happen.

Leveling the Playing Field With Foreign Flag Operators

U.S. flag operators cannot price competitively with foreign carriers in most trades because the cost structure for U.S. operators is substantially higher. The call to eliminate cost disparities between U.S. and foreign flag operators has been frequent and popular.[18] Many such changes are politically easy insofar as the blame falls upon cut-rate foreign registries, foreign subsidies, or bureaucratic red tape here at home, and many of the changes are relatively costless from an appropriations and budgeting standpoint. Among the changes proposed

[12] *Id.*

[13] Military Cargo Preference Act of 1904, 10 USC § 2631.

[14] Public Resolution 17, 73rd Congress, 46 USC § 55304.

[15] 46 USC § 55305.

[16] For further discussion regarding crude oil and LNG possibilities, *see* Bryant E. Gardner, Window on Washington, 11 Benedict's Mar. Bull. 141 (Third/Fourth Quarter 2013).

[17] G. Allen Brooks, Should the U.S. Allow Oil Exports? 20, Maritime Executive (January/February 2014). *See also*, Comments of Crowley Maritime Corp. at 2 (Docket No. MARAD-2013-0101) ("Dramatic growth and change in the American energy business has led to corresponding growth and change in the domestic maritime industry.").

[18] *See generally*, U.S. Maritime Administration, Comparison of U.S. and Foreign-Flag Operating Costs (September 2011).

under this heading are the elimination or reduction of operator or U.S. mariner income taxes, expansion of the U.S. tonnage tax to include ancillary or related inland services, reforming seamen's protection laws to conform with international standards or with on-shore U.S. workers' compensation schemes, eliminating U.S. Coast Guard and other inspections in lieu of classification society requirements, establishment of a bareboat charter registry under the U.S. flag, and eliminating the 50% *ad valorem* duty on repairs to U.S. flag vessels performed outside of the United States.

However, these cost equality proposals are not without their challenges. The largest of the equalization measures, income tax relief, will require a "pay-for" or budget off-set, and therefore will have to clear a significant hurdle, the size of which will depend upon how it is ultimately scored by the Congressional Budget Office. The reform of seamen's protection laws, including the Jones Act personal injury law (as distinguished from the Jones Act cabotage law), engendered quick opposition from maritime labor during symposium break-out groups, and therefore is sure to encounter headwinds moving forward. One commenter advocated the establishment of a bareboat charter registry, permitting ships to enter and leave the U.S. flag at will. This proposal will likely meet stiff opposition from owners who invested in much more costly tonnage under the existing U.S.-build regime applicable to the cabotage and civilian cargo preference trades. However, MARAD's reflag permission process could surely benefit from some streamlining.[19] The elimination of the 50% *ad valorem* duty seems sensible, but in the first instance it will likely trigger resistance from the U.S. shipbuilding industry it was designed to protect, and U.S. carriers now benefit from so many free trade agreement exceptions to the tax for repairs in Singapore, Korea, and elsewhere, that they are unlikely to push heavily for its repeal nor is it likely to have a substantial impact on cost equalization.

Cost equalization measures are politically and technically available, and they ought to be pursued as part of any strategy to revitalize the Merchant Marine. However, it is unlikely that any of the measures on the table can bring U.S.-flag costs in line with open registry cost profiles. This is because the political backbone of the U.S. Merchant Marine is in the mariners themselves and in the maritime unions representing them, and the greatest single cost disparity between U.S. and foreign flag carriers lies in the crewing costs. According to a 2011 MARAD report, average daily operating costs are $7,454 for foreign-flag operators, but $20,053 for U.S. flag operators, or a difference of $12,599 per day.[20] The vast majority of this cost differential arises out of crew costs, which MARAD reported as $2,590 per day for foreign flag operators, but $13,665 per day for U.S.-flag operators, or a difference of $11,075 per day. If crew costs were equalized, the difference falls to only $1,524 per day, about half of which is due to higher maintenance and repair costs (likely related to the *ad valorem* tax and requirement to use more expensive U.S. yards), and $365 of the remainder due to higher insurance costs, primarily P&I costs attributed to U.S. personal injury laws.[21] Since the U.S. mariner is the heart and soul of the U.S.-flag and the foundation of its political support, it is difficult to see how the various cost equality proposals can do more than eat around the edges of the disparity.

Shipper Incentives

Symposium attendees appeared to agree that shipper incentives hold out promise for increased cargoes to sustain the U.S. flag international fleet. Such incentives could work to supplement cargoes obtained through cargo preference or reservation schemes, by providing tax credits or deductions, or reduced export or import fees for the use of U.S. flag vessels. As with the income tax equalization proposal discussed above, such incentives immediately run into PAYGO problems under budget law, and therefore require the targeting of another program which is sure to have its own entrenched constituency. One solution may be to develop incentives which do not require PAYGO, such as providing priority loading and discharging for U.S.-flag vessels. To the extent that such preferential treatment triggers fair trade complaints, justifications based upon pre-screening or other rational bases would need to be put forth.

[19] *See, e.g.*, Bryant E. Gardner, *MARAD Announces Guidance on Vessel Reflaggings*, Maritime FedWatch, June 28, 2011, http://www.winston.com/en/maritime-fedwatch/marad-announces-guidance-on-vessel-reflaggings.html (last visited April 22, 2014).

[20] *Id.*

[21] *Id.* Exempting mariner incomes from income taxes would go part of the way towards eliminating the crew cost disparity.

Next Steps

At the conclusion of the Symposium, Acting Maritime Administrator Jaenichen indicated that the Symposium was a success insofar as it gathered ideas and stakeholders together to get MARAD the input it needs to go forward with the development of a National Maritime Strategy for the blue water U.S. Merchant Marine.[22] And in consonance with his constituents at the Symposium, he appears to have come away from the exercise with the conclusion that the key driving force is cargo: Fill the ships, and the Merchant Marine will thrive.[23] Looking at current alternatives, the best chances for this appear to be the expansion of cargo preference to cover all civilian cargoes, the establishment of some kind of U.S. flag requirement on LNG, LPG, or crude oil exports, and the development of shipper incentives. Although the maritime industry is looking to Jaenichen to see what their agency's dynamic new leader will do next, ultimately each of these changes is going to require some political sacrifice, and some political muscle that must come from industry, its congressional champions, and from the highest levels of the Administration. If the U.S. flag can activate its champions, cultivate a few new ones, and help MARAD break out of the neglect and indifference shown by the Obama Administration until recently, there just might be a chance to restore the national treasure that is the blue water U.S. Merchant Marine.

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[22] Maritime TV, Interview with Acting Maritime Administrator C. Jaenichen, Feb. 12, 2014, *available at* http://www.maritimetv.com/Events/jaenicheninterviews/TabId/1025/VideoId/601/Maritime-TV-InDepth-Interview-With-Acting-Maritime-Administrator-Paul-Chip-Jaenichen.aspx (last visited April 22, 2014).

[23] *Id.*