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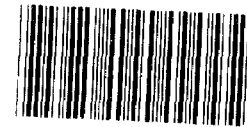
Testimony

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Industry Concerns Regarding the Policies and  
Procedures of the Military Sealift Command

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Before the  
Subcommittee on Merchant Marine  
Committee on Merchant Marine and Fisheries  
House of Representatives



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Mr. Chairman and Members of the Subcommittee:

We are pleased to be here today to discuss the results of our review of certain policies and procedures of the Military Sealift Command (MSC) and the concerns voiced by members of the U.S. Merchant Marine regarding their impact on the industry. Their concerns are in the areas of (1) the use of cost comparisons in determining who operates and maintains MSC ships, (2) the current system of setting cargo rates for MSC cargo, and (3) the use of Ready Reserve Force (RRF) ships. My statement summarizes our findings on these three areas. More details are provided in the appendixes.

Use of Cost Comparisons in  
Determining Who Operates and  
Maintains MSC Ships

In an attempt to operate its ships at the least cost to the government, MSC, since 1982, has completed five cost comparisons under the provisions of OMB Circular A-76 to determine if commercial firms or its own civil service mariners would provide the most economical operation and maintenance for a total of 27 MSC ships. Four of these comparisons favored MSC's operation of the ships and one favored the commercial firm.

The decision favoring the commercial firm showed a difference of about \$24.8 million between the low commercial offer and MSC's cost for the operation and maintenance of 12 oceanographic ships. On the other hand, the four decisions favoring MSC showed, in total, a

difference of about \$65.2 million between MSC costs and the low commercial offerors' costs for operating and maintaining tankers, hospital, cable, and range instrumentation ships -- a total of 15 ships.

The intent of OMB Circular A-76 is to provide the government with commercial-type services at the lowest cost. The provisions of this circular require that a cost comparison be made between the lowest contractor's offer and the estimated cost if the government performed the service.

Some of the commercial firms believe that all the operation and maintenance of MSC ships should be performed by the commercial sector. Also, some commercial representatives believe that certain provisions of the circular favor the government in its cost estimating procedures. For instance, in determining its overhead costs, the government need only include the cost associated with direct supervisory positions one level higher than the activity under review, and administrative support positions that would be completely eliminated if the function were contracted out.

MSC believes that, since most of the ships in question have previously been operated by MSC, OMB Circular A-76 comparisons actually offer commercial firms and non-government mariners opportunities that did not formerly exist. Additionally, MSC believes the size of the merchant mariner work force is not

necessarily affected by the outcome of the A-76 comparisons since MSC and commercial firms both draw mariners from the same finite pool.

Our examination of the cost comparison favoring the commercial firm showed that the biggest single difference was the size of the crew. The commercial offeror proposed to operate each ship with a smaller crew than MSC. Although MSC's civil service wage rates were lower, they were not low enough to offset the difference in manning. MSC officials told us that in preparing this proposal they misestimated the crew size.

In the cost comparisons which favored MSC, we found that the largest differences were in crew costs, resulting primarily from higher wages and benefits in the private sector. Other items also contributed to the differences such as the high cost of protection and indemnity insurance versus the cost of coverage under the Federal Employee Compensation Act.

Although some commercial representatives believe that certain provisions of OMB Circular A-76 favor the government, the differences due to crew costs are so large, we believe that merely changing some of the circular's provisions and requiring more adjustments in the calculations are not likely to change the outcome of the comparisons.

Given the results of the A-76 studies completed to date, it appears that increasing the number of government-owned vessels operated by commercial firms would likely result in additional costs to the government. If it is decided, as a matter of policy, that such an increase is desirable to support the U.S. maritime industry, it is important that the additional costs be identified and disclosed rather than changing the circular's cost comparison process. Decision-makers can then make informed judgments about the funding amounts as well as the degree of support these funds provide.

Concerns with the Current System  
of Setting Cargo Rates for MSC Cargo

Many members of the merchant marine industry are concerned that the current system of cargo rates, used in MSC shipping agreements, is driving rates too low and carriers are not recovering their costs with obvious adverse effects on the industry. They stated the competition among U.S. flag ocean carriers for DOD export cargo, a major portion of the cargo available to them, is intense. The intensity of this competition is attributed primarily to the overcapacity of cargo space presently existing among U.S. flag carriers.

A number of modifications in the way MSC sets cargo rates have been suggested by members of the maritime industry. Basically, these changes would modify the rate setting process, assign cargo to experienced carriers who own their own ships, allocate cargo to more carriers, and reduce the percentage of cargo allocated to the

lowest bidder. The proposals are intended to aid the U.S. flag carriers. MSC believes that the rates it is paying are compensatory and that the current practices are working well. MSC also notes that its practices assure a reasonable cost to the government, and sees no reason to change them.

The government is faced with two competing objectives: (1) obtaining the lowest cost possible and (2) maintaining a mobilization base. If changes are made, such as modifying the rate system in a manner that results in additional costs, we believe such additional costs should be identified and fully disclosed.

#### Use of Ready Reserve Force Ships

The RRF is a quick response, government-owned merchant ship reserve fleet maintained by the Maritime Administration (MARAD) for use by the Navy in the event of a mobilization or national emergency to transport military cargo. Ships from the RRF are periodically activated by MARAD for MSC and used to transport containerized, roll on/roll off, or break-bulk cargo in support of military exercises, as specified in a Memorandum of Agreement between the Navy and MARAD.

Some ocean carriers say RRF ships are being used in multiple military exercises for what they believe are extended periods of time (defined as over 60 days by the carriers) and are taking

opportunities to carry cargo away from the U.S. flag merchant fleet. They also believe RRF ships, after being activated, were idle for long periods of time awaiting government retrograde cargo or cargo for the next exercise.

MSC acknowledges that RRF ships have been used for increasingly longer periods than in the past and participated in sequential exercises in an effort to save activation costs. It does not, at this time, foresee the need for extended activations in the future.

Beginning in the fall of 1987, MSC began concerted efforts to carry cargo for military exercises in commercial ships whenever possible. Our work disclosed that, from October 1, 1987, through July 15, 1988, six RRF ships were activated, only one of which was operational for longer than 60 days (75 days). This indicates that MSC is addressing the concerns raised by the carriers.

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In summary, Mr. Chairman, MSC's present methods of contracting for ship operation and maintenance and cargo rate setting focus on obtaining the least cost to the government, which is consistent with government procurement policy. If changes are to be made in order to support the U.S. maritime industry, which result in additional costs, it is important that these costs be identified

and fully disclosed. Decision-makers will then be in a better position to make informed judgments about the cost and benefits associated with such a program.

This concludes my prepared remarks and I would be pleased to respond to any questions.



INDUSTRY CONCERNS REGARDING THE POLICIES  
AND PROCEDURES OF THE MILITARY SEALIFT COMMAND

PREPARED BY THE U.S. GENERAL ACCOUNTING OFFICE

August 9, 1988

## PREFACE

At the request of the Subcommittee on Merchant Marine, House Committee on Merchant Marine and Fisheries, the staff of the General Accounting Office (GAO) has gathered information on the positions and views of the Military Sealift Command (MSC) and representatives of the maritime industry concerning MSC's policies and procedures and their impact on the U.S. Merchant Marine. Industry representatives believe that these policies and procedures are adversely affecting the industry.

According to the Maritime Administration (MARAD), since 1970 the number of major U.S. flag liner companies operating in foreign trade has declined from 18 to only five companies. During this time the total number of ships operated by these companies has declined from 475 in 1970 to 105 today.

The purpose of this document is to present a summary of the information and views of both MSC and representatives of the maritime industry.

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**ABBREVIATIONS**

|       |                                 |
|-------|---------------------------------|
| DOD   | Department of Defense           |
| FAR   | Federal Acquisition Regulations |
| FMC   | Federal Maritime Commission     |
| GAO   | General Accounting Office       |
| MAC   | Military Airlift Command        |
| MARAD | Maritime Administration         |
| MSC   | Military Sealift Command        |
| OMB   | Office of Management and Budget |
| PWS   | Performance Work Statement      |
| RFP   | Request for Proposals           |

USE OF COST COMPARISONS IN DETERMINING WHO  
OPERATES AND MAINTAINS MSC SHIPS

This appendix provides information regarding industry concerns with the practices and procedures of the Military Sealift Command (MSC) in making cost comparisons under the provisions of Office of Management and Budget (OMB) Circular A-76, and discusses MSC's position on these concerns.

BACKGROUND

The U.S. Merchant Marine is in a state of decline and relies on MSC for a significant portion of its business. MSC is the single manager operating agency for sealift services within the Department of Defense (DOD) and maintains a work force of nearly 4,000 civil service mariners to operate and maintain certain government-owned vessels. These ships include tankers and cargo vessels, as well as special projects ships such as oceanographic research, hospital, cable laying and repair, and range instrumentation ships. Since 1982 MSC has completed five cost comparisons under the provisions of OMB Circular A-76 to determine whether commercial firms or its own civil service mariners would provide the most economical operation and maintenance of these ships. The results of these cost comparisons are shown in table I.1.

Table I.1: Results of Cost Comparisons Under OMB Circular A-76

| <u>Ship type</u>      | <u>Number<br/>of ships</u> | <u>Low<br/>commercial<br/>offer</u> | <u>MSC<br/>cost</u> | <u>Decision</u> | <u>Date of<br/>decision</u> |
|-----------------------|----------------------------|-------------------------------------|---------------------|-----------------|-----------------------------|
| Tanker                | 3                          | \$44,915,290                        | \$ 28,518,657       | MSC             | 11-12-82                    |
| Oceanographic         | 12                         | 89,985,701                          | 114,789,090         | Contract        | 12-12-85                    |
| Hospital              | 2                          | 14,431,294                          | 8,149,255           | MSC             | 07-02-87                    |
| Cable                 | 5                          | 64,597,225                          | 40,981,142          | MSC             | 10-30-87                    |
| Range Instrumentation | 5                          | 52,119,072                          | 33,218,449          | MSC             | 03-08-88                    |

Additionally, MSC is soliciting commercial proposals for the operation of seven tug boats and is preparing a solicitation for the operation of a cargo vessel.

All of the ships had been operated by MSC prior to the OMB Circular A-76 determinations, except the two hospital ships which were newly converted from former commercial tankers; and one of the range instrumentation ships, which had been operated with a Navy crew.

In the cost comparison for the oceanographic ships, the commercial offeror proposed to crew the ships with 77 fewer mariners than proposed by MSC (447 vs. 524), and included no overtime costs. Although MSC's civil service wage rates were lower than the commercial rates, they were not low enough to overcome the disparity in manning and MSC's inclusion of overtime at historical levels ranging from about 54 percent to about 108 percent of the base wages.

In the cost comparisons which favored MSC, the largest differences were in crew costs, largely because of higher wages and benefits in the private sector. For instance, in one of the comparisons, the overall commercial personnel cost was 15 percent higher than MSC's and was more than 60 percent higher in some positions. Other factors, such as insurance costs, profit and cost of capital also played a part, but their elimination would not have been sufficient to overcome the differences in crew costs.

INDUSTRY CONCERNS WITH MSC ACTIONS  
IN OMB CIRCULAR A-76 DETERMINATIONS

Industry representatives have expressed a number of concerns with the way MSC participates in the OMB Circular A-76 process, as well as with MSC's administration of one contract awarded to a commercial offeror for the oceanographic ships. In the cases of the hospital, cable, and range instrumentation ships, commercial offerors filed bid protests with us questioning the decision of MSC to operate the ships using its own civil service mariners.

Representatives of commercial firms expressed the view that MSC's success in winning four of five OMB Circular A-76 cost comparisons is hastening the decline of the civilian merchant mariner work force. Some believe they cannot win competitions under these procedures and have said that they will not make offers on further solicitations. MSC believes that, since none of the ships in question were operated previously by commercial firms using

civilian mariners, the cost comparisons are actually offering the civilian merchant marine opportunities for expansion.

Additionally, MSC said that the size of the merchant mariner work force is not necessarily affected since both MSC and commercial firms draw from the same finite pool of mariners.

Some commercial representatives believe that certain provisions of OMB Circular A-76 present an advantage to the government in determining the costs it will include in its proposal for comparison with a commercial offer. For instance, in determining personnel costs to be included as part of overhead, the government need only include the costs associated with direct supervisory positions one level higher than that activity under review, and administrative support positions which would be completely eliminated if the function were contracted out. Commercial offerors generally include a full proportionate share of their overhead burden in order to recover the costs of doing business.

Commercial offerors are required to carry large liability insurance policies to cover employee injuries and the risk of lawsuits for large judgments to compensate employees for mental anguish, pain, and suffering. They must therefore include in their offers the cost of large insurance premiums and provide for payment of large deductibles. The government's liability for employee injuries is limited by the Federal Employees Compensation Act. The circular,

therefore, only requires that the government include in its cost determinations an amount equal to .0007 of its personnel costs to cover liability for employee injuries.

On the other hand, certain provisions of the circular result in advantages for commercial offerors. For instance, the Federal Employee Retirement Act of 1986 requires that the government's retirement system costs include only contributions for the basic federal pension in preparing cost comparisons. The circular therefore requires that government and contractor Social Security and thrift plan contributions be excluded in cost comparisons. Since contractors pay social security for all employees and the government pays only for those covered by the new Federal Employee Retirement System, exclusion of these costs results in an advantage for commercial offerors.

#### Costs of MSC's Personnel Pool

MSC establishes the size of its civil service mariner work force at about 125 percent of the shipboard positions to be filled. The excess mariners provide a pool to ensure that all shipboard positions are filled at all times while allowing for normal non-productive activities such as leave, training, travel, discipline, sickness, etc. While many mariners in the pool are unavailable for ship assignment because of these activities, some are in a duty



status ashore awaiting assignment to a ship, and are paid whether they work or not. These factors affected MSC's proposal for hospital ships.

In its cost estimate for the operation of two hospital ships, MSC proposed to augment, as needed, the crews of each of the ships with three full-time equivalent members of the pool who were in a duty status awaiting assignment. The estimate did not include the salary and fringe benefits costs of these pool members because these members were already part of the pool earmarked for the operation of existing MSC ships, and these costs would continue regardless of who operated the new hospital ships.

The low commercial offeror appealed MSC's treatment of the costs of the pool members to the Office of the Chief of Naval Operations. The appeal questioned MSC's omission of these costs on the basis that the crews of the ships would actually be increased by an average of three members each, and the cost of those crew members, including salaries and fringe benefits, should have been included in MSC's proposal as direct personnel costs.

MSC reasoned that the hospital ships were a "new start" and its work force, including the pool, did not yet include personnel to crew the ships. Therefore, it planned to use existing pool members for the augmentation who would be paid whether they worked or not. MSC said the costs to be incurred to enlarge the pool in accordance

with the size of the crews of the new hospital ships were included in its cost estimate. However, its planned use of existing pool employees would not represent additional expenses incurred solely as a result of operating the hospital ships and should not be included in its estimate. The Office of the Chief of Naval Operations agreed and, in its decision on the appeal said that: "Use of the 'pool' is a distinct and inherent advantage of the government in preparing this T-AH (hospital ships) bid. MSC is allowed to use 'pool' mariners without costing their labor and fringe (sic)."

MSC told us that the cost estimate for the hospital ships included the pool costs that would be associated with the crews of the ships, following MSC's normal practice for these costs. MSC said pool costs fall into three categories to cover personnel on paid leave, in training, and awaiting assignment, and are calculated based on historical data. Leave costs are added to the crew's base wages as part of direct personnel costs, training costs are included in "specifically attributable costs," and a proportionate share of the cost of personnel awaiting assignment is included in the calculation of overhead costs.

MSC's treatment of these costs appears to comply with the requirements of OMB Circular A-76. Under the provisions of this circular, costs that would continue to be incurred regardless of who operates the ships are to be excluded from the cost estimate.

Revision of MSC's Proposal  
on Cable Ships

MSC solicited proposals for the operation and maintenance of five cable ships on April 21, 1986. Initial offers were received by MSC's contracting officer on or before the due date of September 19, 1986, and "best and final" commercial offers were received on August 7, 1987. In the interval between initial and best and final offers, MSC issued seven amendments to the request for proposals (RFP); and withdrew, revised, and resubmitted its own proposal. MSC's revision reduced its costs by about \$5.7 million, or 12 percent. MSC stated the revisions were necessary because:

- amendments 9 through 12 significantly revised the performance work statement (PWS) by dividing the ships into two lots, changed the delivery dates and operating schedules, and required that a successful commercial offeror undergo government-furnished training; and
- inflation indices changed, and pay rates and required medicare contributions increased in the period since initial offers were due.

Industry representatives contended that none of the amendments to the RFP subsequent to receipt of initial proposals changed the PWS enough to require the extensive revisions MSC made to its cost estimate and that MSC was therefore in violation of Chief Naval Operations Instruction (OPNAVINST) 4860.7B, which provides:

"475. Revisions to PWS/(Most Efficient Organization)  
Prior to Bid Opening/Announcement of Results

- A. Policy changes as well as evolutions occurring during the solicitation process frequently provide occasions for changes. The nature of the possible changes and nature of the solicitation itself affect the kind of changes which are permissible. The following guidance applies:

\* \* \* \* \*

2. Negotiated Solicitations. Changes may be made to both the (Most Efficient Organization) and the Government estimate up to the date proposals are received. After this time, changes may be made only if amendments to the solicitation, during the negotiation process, change the performance requirements identified in the PWS. In such cases, the Government estimate should be withdrawn, revised to reflect the changed requirement, recertified by the reviewing official, and resubmitted to the contracting officer by the date established for the receipt of amended proposals. No other changes are permissible prior to the announcement of the results of the comparison.

(Underscoring added.)

MSC revised its estimate as necessary to conform to the RFP amendments. The revision also significantly reduced the amount of overtime pay expected during the contract period. The bases for the reduced overtime costs were (1) a new overtime study and (2) a new concept for in-port operations; both of which occurred after initial offers were received. The overtime study was used to reduce normal overtime both in-port and at sea, and the in-port operations concept allowed for different work rules to assign crew members to shifts, avoiding payment of overtime.

MSC states that it is required by both the circular and OPNAVINST 4860.7B to develop cost estimates based on the most efficient and cost-effective organization. It also states that the Secretary of Defense is required by section 502 of the 1981 Department of Defense Authorization Act (P.L. 96-342) to certify to the Congress that the government's cost estimate is based on the most efficient and cost-effective organization before converting a government-operated commercial-type function to a contractor operation. MSC believes it was, therefore, not simply authorized but required to extensively revise its cost estimate on the basis of the latest available information.

Based on information MSC provided, its revisions appear to have been more extensive than required merely to conform to the amendments of the RFP. OPNAVINST 4860.7B states that apart from revisions necessary to reflect changed performance requirements (the amendments of the RFP), no other changes are permitted in the government estimate prior to the announcement of the result of the cost comparison. MSC's revisions reduced the estimate by \$2,111,663 to conform to amendments in the RFP and revised cost factors, and by another \$3,595,720 for the overtime changes. MSC told us that its initial estimate of \$47,663,565 was \$5,645,392 lower than the low best-and-final commercial offer of \$53,308,957. Therefore, the operation of the cable ships would have been retained in-house even if MSC had not revised its cost estimate.

The instruction appears to preclude revisions based on policy changes such as the in-port operations concept used by MSC to support some of its revisions for overtime costs. However, we also noted that section 502 of Public Law 96-342 has been incorporated in OPNAVINST 4860.7B. As a result, there is an apparent conflict within the instruction. On one hand, it requires naval activities to certify that their proposed costs are calculated on the basis of the most efficient and cost effective organization. On the other hand, it requires them to refrain from adjusting the cost calculations when ways to operate more efficiently surface after initial proposals are due. This conflict in the instruction should be resolved by the Navy.

In any event, once MSC recognized that its initial proposal did not reflect its most efficient and cost effective organization for operating the cable ships, its options were limited to cancelling the solicitation or revising its proposal. OMB Circular A-76 requires correction of the government proposal rather than cancellation of the solicitation. MSC considered cancellation and rejected that option, and we have no reason to believe it abused its discretion in this regard.

#### MSC Response to Offeror's Questions

An offeror on the cable ships solicitation complained that MSC did not respond in writing to its questions regarding the costs of government-provided training that would be added to the low

commercial offeror's proposal. The offeror said it is a normal contracting practice for the contracting agency to respond in writing to written questions from offerors when the answers would affect the offers or the agency's award decision.

MSC told us that it did not provide written answers to the offeror's questions because the training costs would be added only to the low commercial offer when comparing it to the MSC proposal. Determination of separate training costs for each commercial offeror would be time-consuming and premature, and would have no affect on selection of the low commercial offer.

We do not believe the offeror was prejudiced by MSC's failure to respond in writing because the requested information did not appear to be necessary in order for the offeror to submit its best and final offer.

Failure to Provide Clarifying  
Information to all Offerors

In its cost estimate for operation of the five cable ships, MSC proposed that an on-shore boiler be leased when the USNS Furman is in port during warm-weather months. This would allow shut-down of the ship's boilers, and result in a crew reduction.

A representative of MSC's comptroller office, who prepared the MSC cost estimate, said that the cost of leasing the on-shore boiler was excluded from MSC's estimate. She said amendment 12 to the RFP made a language change that allowed for direct reimbursement of those costs when ships are in-port in a "special reduced operating status." However, she was unsure if the revised language would allow for reimbursement of the costs or if they should be included in the estimate as an operating cost. She therefore verbally asked the contracting officer whether the costs were reimbursable and received a verbal reply in the affirmative. This information was not specifically communicated to commercial offerors, although it might have had an affect on their offers. Commercial offerors told us they were unaware that lease of an on-shore boiler was an option, feeling themselves constrained by a clause in the RFP that provided "there will be no leased equipment provided by the Government for the performance of this contract." MSC believes the commercial offerors had an equal opportunity to provide for lease of an on-shore boiler in this instance since the amended language was distributed to all potential offerors.

Amendment 12 was distributed to all offerors, and the amended language was to add ships in a "special reduced operating status" to those which would be provided shore power and shore steam at government expense. The USNS Furman was the only ship in the RFP to which the special status applied. Therefore we do not believe



that the other offerors were prejudiced by MSC's failure to direct their attention to the clear language of the solicitation. Additionally, it is not unreasonable for a contracting officer to consider formal clarification unnecessary when only one inquiry is made, and there is no problem readily apparent in the solicitation.

#### Administration of a Contract by MSC

The contractor operating the 12 oceanographic ships (now 11 due to one ship having been rammed while at anchor and subsequently removed from service rather than repaired) has made strong accusations about the way MSC administers the contract. It claims that, as a result, it cannot properly manage its activities, and has severe cash flow problems.

For instance, the contract contains an "off-hire" clause that allows MSC to withhold payment for each day a ship is unable to perform its mission when the contractor is at fault. The contractor contends that MSC places ships off-hire an excessive number of days for failure to perform, without sufficient investigation of causes. Of 345.9 unscheduled off-hire ship days imposed between July 15, 1986, and April 20, 1988, 202.5 ship days (59 percent) were reinstated for payment by MSC as of April 30, 1988. Since the end of January 1988, MSC has instituted a practice of placing a ship provisionally off-hire and allowing the contractor 30 days to provide justification before imposing

deductions. MSC's decision to delay the imposition of off-hire penalties appears to be a reasonable approach to resolving this situation.

PROPOSALS BY OTHERS TO  
MODIFY THE PRESENT SYSTEM

During our review, members of the U.S. Merchant Marine industry suggested revisions to the procedures established by the circular. The proposals are aimed at increasing the commercial operation of government-owned vessels by:

- Reducing the government's advantage by requiring that its proposals under the circular include a proportionate share of applicable overhead costs, including general and administrative expenses and an insurance adjustment; and
  
- Mandating commercial operations by eliminating use of the circular procedures for award of contracts to operate government-owned vessels, and conduct a competition among commercial firms only, which would limit MSC's operation of its ships to those exempted from commercial operation because of special considerations.

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Given the results of the OMB Circular A-76 studies completed to date, it appears that increasing the number of government-owned

vessels operated by commercial firms would result in additional costs. If it is decided, as a matter of policy, that such an increase is desirable to support the U.S. the maritime industry, it is important that the additional costs be identified and disclosed rather than changing the circular's cost comparison process.

CURRENT SYSTEM OF SETTING CARGO  
RATES FOR MSC CARGO

This appendix outlines the concerns industry has with the cargo rate system that MSC uses. It discusses various industry proposals to modify the current practices and MSC's comments on these suggestions.

BACKGROUND

According to the Maritime Administration (MARAD), since 1970 the number of major U.S. flag liner companies operating in foreign trade has declined from 18, to only 5 companies. The total number of ships operated by these companies has declined from 475 in 1970 to 105 today. Also, the total dry cargo deadweight tonnage these ships can carry has declined during this period from 6,112,000 to 2,843,000 tons.

MSC is responsible for the ocean transportation of DOD sponsored cargo. To move this cargo, it uses chartered ships and contracts for space on commercial ships owned and operated by U.S. flag carriers. Contracting for ocean transportation services is done primarily through shipping agreements for containerized and break-bulk cargo. Every 6 months, carriers submit bids offering a fixed price per ton of military cargo for each of the major shipping

routes. Cargo rates, terms, and conditions are determined in accordance with the Armed Services Procurement Act, the Competition in Contracting Act, and the FAR.

Under the current system, MSC awards the lowest bidder up to 75 percent of the cargo to be carried on a designated route, while the remainder of the cargo is carried by the next lowest bidder(s). The percentage of cargo awarded to a particular bidder depends upon the trade route and the number of bidders. MSC also uses tariffs in trade routes which are not covered by shipping agreements. These tariffs are filed by ocean carriers with the Federal Maritime Commission (FMC) and are used by both MSC and commercial carriers.

#### CONCERNS WITH THE CURRENT SYSTEM

Some members of the merchant marine industry claim that the current system of MSC cargo rates is weakening an already weak industry. Among the reasons cited are the intense competition among U.S. flag ocean carriers for DOD export cargo which is a major portion of the export cargo available to them.

The intensity of this competition is being attributed to an overcapacity of export cargo space currently existing among U.S. flag carriers.

In the Second Report of the Commission on Merchant Marine and Defense, dated December 30, 1987, the Commission expressed particular concern about the adverse effects of current contracting practices upon the operators of commercial ships. They said that in order to carry DOD cargo, some ship operators have submitted low bids that may have contributed to their financial failure.

A number of U.S. ocean carriers believe that the current system of shipping agreements (cargo rates) used by MSC is driving rates too low and that carriers are not recovering their costs; this view also is shared by some maritime unions.

Since DOD is the country's largest shipper of export general cargo, its cargo is essential to U.S. carriers importing from abroad. Some industry officials stated that the competition for DOD cargo has forced some ocean carriers to submit bids below their fully distributed costs, noting that a U.S. flag carrier cannot stay in business unless it carries DOD cargo. Carriers engaged in foreign trade must offer a regularly scheduled service between fixed points in order to remain competitive in foreign trade. These carriers believe it is better to carry some cargo at rates below cost rather than to sail half full, and this drives some carriers to bid below costs.

MSC believes the Navy's procurement system is fully consistent with the Shipping Act of 1984's philosophy of replacing government regulation with competitive forces of the marketplace. It cites the following regarding the Navy's procurement system for ocean transportation.

- Ocean transportation, similar to other services, is procured on the basis of full and open competition in compliance with the Competition in Contracting Act. The only modification to this fully competitive policy is in the case of DOD cargoes where a limit on the maximum percentage of cargo has been imposed on a carrier for some major routes. This conforms to Navy policy to ensure the long-term viability of at least two companies on those routes so that competition can always be maintained.
- To the extent possible, the government should do business in the same manner as other commercial users of ocean carrier services. Commercial shippers pay the market rate based on (1) conditions of supply and demand and (2) fluctuations in the rate of foreign exchange.
- Pursuant to section 101 of the Merchant Marine Act of 1936 (46 U.S.C. 1101), MARAD is responsible for promoting the U.S. Merchant Marine. MARAD provides subsidies to offset higher U.S. wages and costs so U.S. flag carriers may remain competitive in the international market. In addition, various cargo

preference laws provide advantages to these carriers over foreign competitors in the carriage of DOD cargoes outbound to help balance their voyages.

--MSC uses commercial carriers to move all of its military cargo. There are no government-owned dry or liquid cargo ships in MSC's fleet engaged in point-to-point service. More than 80 percent of DOD dry cargo tonnage is moved on commercial liner ships annually. The remainder is moved in U.S. commercially chartered vessels.

#### OPINIONS ON VARIOUS MSC PRACTICES AND PROCEDURES

During our review, we obtained opinions on various aspects of MSC's cargo rate system from industry sources who proposed changes to MSC's cargo rate system. We also attempted to obtain the position of the United Shipowners of America regarding these proposals. However, since its members were exploring various alternatives to the present system at the time of our review, United Shipowners of America officials concluded that a firm position on any alternative would be premature and may not be in the best interest of all of its members.

#### Changes to Length of Cargo-Rate Cycle

Some individuals representing the U.S. maritime industry believe increasing the 6-month cargo rate contract cycle to 1 year would



provide more stability in the system. There is no industry consensus, however, on this proposal.

In 1971, MSC shortened the cycle from 1 year to 6 months in response to comments from the carriers that the cycle was too long. MSC believes that the 6-month cycle continues to offer several advantages, to both carriers and the government. According to MSC, this 6-month cycle (1) enhances competition by permitting periodic adjustments in rates to meet changing world economic conditions, as well as domestic and international trade conditions, (2) provides greater flexibility to carriers for adjustments in operating and maritime cost factors, shifts in the balance of trade, and other changing world competitive conditions, and (3) gives carriers the opportunity to improve their competitive position.

Changes in Percentage Allocation  
to Lowest Bidders

One carrier believes the current military procurement system pits carriers in a life and death struggle to be the number one carrier, because it offers 75 percent of the military cargo to the number one carrier. This carrier proposes that the carrier offering the lowest rate on a trade route with more than two bidders get less than 75 percent; this might be accomplished by the "me too" process in bidding which would ensure that other carriers have an opportunity to participate at the winning carrier's rates. For example, if three or more carriers were bidding on a trade

route, the carrier offering the lowest rate would automatically get first call on 50 percent of the cargo and the remaining carriers would split the other 50 percent, provided they agreed to accept the winning carrier's rates. The carrier believes this preserves the competitive incentive and also provides a share of cargo for all carriers and protects the government from paying higher rates to carriers that are seeking only a small portion of military cargo as is sometimes the case.

MSC believes this proposal would violate existing statutory requirements for full and open competition. Specifically, it is concerned that carriers would not have an incentive to offer their best rates, as each would be assured of a substantial volume of cargo regardless of the rate. As a result, each carrier would bid high, increasing the government's transportation costs significantly. MSC also believes the proposal is overly simplistic in that it assumes that all carriers are equal in terms of service and capacity. It also notes that if one of three carriers bidding on a route could carry only 30 percent of the cargo and the next as much as 50 percent, there is actually an incentive for each carrier to bid as high as possible.

Elimination of Best  
and Final Offers

This same carrier also believes that the current practice of asking for best and final offers as part of the cargo rate contract

process should be eliminated and rates should be filed at one time as close as possible to the end of the current cycle. The carrier believes that asking for best and final offers gives bidders too much opportunity to find out what the other original bids are and that a single bid system would eliminate any suspicion of such leaks.

MSC's position is that a negotiated procurement (the present cargo rate contract process which includes asking for best and final offers) and the single bid process (sealed bidding), alluded to above, are significantly different procurement processes. MSC believes the essential element that makes a sealed bidding process inappropriate for the procurement of ocean transportation services is the lack of flexibility and discretion afforded a contracting officer to exercise business judgement in making an award.

In support of its position, MSC cites the following:

- In sealed bidding, MSC would be required by the FAR to reject an offer that fails to conform to the essential requirements of the solicitation. It is immaterial whether the nonconformity occurred by design or mistake, or whether the bidder is willing to modify the bid.
- The FAR requires a contracting officer to make an affirmative finding of responsibility before awarding a contract. In sealed bidding, questions of responsibility are determined primarily on

the basis of all the information submitted or available, up to the time of award. Under a negotiated procurement, a contracting officer can advise, during discussions, all offerors of the standards that each must meet to permit an affirmative finding of responsibility prior to award.

--In sealed bidding, a contracting officer cannot discuss the level of rates offered. This denies a carrier the opportunity to reconsider and modify its rates in a best and final offer.

#### Fulfillment of Bidders' Obligations

Some in the maritime industry believe that the submission of a bid should carry with it an obligation to carry cargo if the bidder is successful and that MSC should require evidence of a bidder's ability to fulfill its obligations before allowing it to bid. (Under the current system, new carriers are not required to establish a record of operating experience in commercial trade for a period of time as a precondition for bidding.) Some industry officials suggest that in order to bid, a company should have 6-months experience, own at least one ship that meets Navy standards, and be capitalized with at least 50 percent U.S.-owned stock. They believe this would be fair to experienced commercial carriers because under the current system, to be eligible to carry government cargo, a carrier must commit its transportation assets to the Sealift Readiness Program, which is designed to be activated in peacetime to meet contingency or less-than-full mobilization requirements.

MSC states it reviews all offers, from common carriers and contract carriers, including those submitted by "new entrants" to determine whether they have the necessary U.S. flag ships, equipment (or the ability to obtain the same in time for contract performance), and the management expertise to perform the contract. It further states the contracting officer relies on demonstrated experience by individuals in a company to ensure the company's ability to perform. It also believe requirements for vessel ownership would negate a company utilizing bareboat<sup>1</sup> or time chartered ships, a common practice in the industry. Furthermore there is no statutory authority requiring unsubsidized carriers to maintain service (carriers receiving operating differential subsidies do incur contractual obligations to provide certain levels of service). In summary, MSC believes the suggested requirements that (1) a company have a prior period of experience, (2) own a vessel, and (3) be capitalized with at least 50 percent U.S.-owned stock would restrain competition rather than improve the efficiency, quality of service, or economy in the U.S. Merchant Marine.

PROPOSALS BY OTHERS TO  
MODIFY THE PRESENT SYSTEM

The Commission on Merchant Marine and Defense recommended that DOD, in conjunction with FMC and MARAD, change the method of solicitation for procurement of ocean transportation services to a

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<sup>1</sup> A ship charter agreement whereby the charterer provides for all operating expenses, including crew, fuel, and maintenance.

stable rate system that is based on the established tariff rates used for commercial shippers. The Commission believes this recommendation would:

- "Provide stability to the merchant marine industry;
- Provide sealift capability to meet mobilization requirements;
- Provide ship operators with rates that more accurately reflect fully distributed costs and provide reasonable rates of return on investment;
- Provide the Department of Defense with comparable and equitable shipping rates available from more than one carrier on the same route;
- Stabilize shipping rates for a longer period of time;
- Encourage U.S. flag carriers efforts to upgrade to new ships and equipment that increase productivity and meet military as well as commercial requirements; and
- Prevent the unsatisfactory service that may result when unproven or speculative carriers 'buy-in'."

MSC does not agree with the Commission's recommendation because it believes rates offered by the carriers in a full and open competition reflect the conditions of the marketplace and, at a minimum, cover the carriers' incremental costs. Thus, it believes use of the recommended tariff system would result in higher costs to DOD from commercial shippers for equivalent services. MSC further states that, at a FMC-sponsored industry conference held

from February 18 to 19, 1988, senior officials of the major U.S. flag carriers and of two major foreign flag carriers, as well as academicians, attributed industry's problems to overcapacity on major routes encouraged by banks, shipyards, foreign governments, and the imbalance of trade. According to MSC, these officials did not include DOD procurement policies, practices, and rates as factors in the industry's decline.

Adoption of a Cargo Rate Program Similar to that of the Military Airlift Command

Some in the merchant marine industry propose adopting a program similar to the one currently being used by the Military Airlift Command (MAC) in the transportation of government cargo by commercial airlines. Under this program, all participating air carriers supply MAC with fully distributed cost data. Using this information, MAC calculates a composite rate based on the costs of all participating carriers and weighted by the percentage of total lift capacity offered by each. MAC then applies a profit factor of about 15 percent. Once the rate per ton mile is computed it is used for all types of planes worldwide.

To participate in the program, a carrier must be qualified through experience and by passing a financial responsibility test. Only U.S. flag aircraft owned by a carrier can participate. The allocation of cargo for each participating carrier is based on the ratio of the cargo-carrying capacity of each participant to the total capacity committed by all participants.

Advocates of the use of a system similar to MAC's for the U.S. maritime industry suggest that such a system (1) provides a fair and reasonable return on investment for air carriers, (2) assures a government cargo rate that is below the commercial rate, and (3) provides essential government support for a defense mobilization asset.

MSC states that, although it and MAC both procure transportation services, basic differences exist in requirements and procedures used by each Command for procuring space for the transportation of their cargoes.

Under the current cargo rate process, MSC awards contracts, similar to a requirements contract, to all technically acceptable and responsible carriers that offer rates; as a condition for award, carriers are required to agree to commit half of their ships to the Navy's Sealift Readiness Program. As ocean shipping requirements arise, cargo is booked, in descending order of cost to the government, to the carrier that best meets the specific requirements at the least cost. Similar to the Navy program, MAC, through its Civil Reserve Air Fleet program, allocates its cargo in exchange for a carrier commitment of airplanes to be called up by DOD. Most airlines use the same types of aircraft, the large passenger types, most needed by MAC in a crisis. Conversely,



according to MSC, the most efficient commercial ships are large non-self-sustaining container ships, which are the least military useful ships in a crisis.

MSC states there are other significant differences between Navy and MAC methodologies and practices which illustrate the fact that MAC's system is not applicable for the procurement of DOD ocean transportation services.

--Most of MSC's cargo is transported in less than shipload lots and is of a continuous regular nature ideally suited for the regularly scheduled service offered by U.S. flag ocean carriers.

--MAC meets its cargo requirements by using either Air Force owned aircraft or charters of entire aircraft for short periods. Scheduled airlines frequently have the ability to make their aircraft available for these short term charters, which can be accomplished in a day or two, whereas regularly scheduled ocean carriers do not have that flexibility. Accordingly, MSC operates a small number of U.S. flag time-chartered commercial dry cargo ships, contracted for under full and open competition, to provide this capability which is not available from commercial operators. Short-term voyage/spot charters for ocean movement of dry cargo are rare.

--MAC establishes rates using the ratemaking principles formerly used by the Civil Aeronautics Board. There is purposely no provision for governmental setting of rates in the foreign ocean commerce of the United States.

Furthermore, MSC states that during 1971-72, the "Sealift Procurement and National Security Study" was issued by senior members and staff of the OMB, DOD, MARAD, and FMC and industry representatives in response to allegations that DOD's procurement system had forced ocean carriers to offer rates below costs. The study found that, overall, DOD cargo rates were compensatory. MSC advised us that subsequently, the FMC performed numerous investigations of the rates charged for carrying DOD cargo to determine if such rates were too low under the standards of the Shipping Act of 1916. No rates were ever found to be noncompensatory and rates were never disapproved. In summary, MSC believes that any analysis of the applicability of the MAC's system to MSC involves complex issues and quick answers may well cause problems.

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The government is faced with two competing objectives: (1) obtaining the lowest cost possible for the government; and (2) maintaining a mobilization base. If changes are made to aid the

maritime industry such as modifying the rate system in a manner which results in additional costs, we believe such additional costs should be identified and fully disclosed.

USE OF READY RESERVE FORCE SHIPS

This appendix discusses the concerns voiced by various ocean carriers regarding the use of Ready Reserve Force (RRF) ships by MSC for extended periods of time during military exercises.

BACKGROUND

The RRF is a quick response, government-owned merchant ship reserve fleet that MARAD maintains for use by the Navy in the event of a mobilization or national emergency to transport military cargo. RRF ships are periodically activated by MARAD for MSC and are used to transport containerized, roll on/roll off, or break-bulk cargo in support of military exercises.

OCEAN CARRIER'S CONCERNS

Some ocean carriers stated they believe that RRF ships used in multiple military exercises for extended periods of time (defined as over 60 days by the carriers) are taking cargo carrying opportunities away from the U.S. flag merchant fleet. They also believe RRF ships were placed in a reduced operating status, in which they were idle for long periods of time awaiting government retrograde cargo or cargo for the next exercise.

Our review showed that from 1980 through July 15, 1988, there were 19 of a total of 46 activations of RRF ships in which the ships remained in operational use for 60 days or more. The periods of

operational use for these ships ranged from 62 to 342 days; 13 ships under 100 days, 3 ships 100-150 days and 3 ships 150-342 days. The majority of ships were used in one exercise each; however, five ships were involved in multiple exercises with one ship serving in six exercises.

We also found that 4 ships of the 19 activated over 60 days were in a reduced operating status for periods ranging from 11 days to 143 days of their operational use. Of these four ships, two were in a reduced operating status for 25 days or less. The remaining two were idle for 85 days of an operating period of 174 days, and 143 days of an operating period of 342 days.

MSC believes that carrying military cargo on RRF ships during military exercises is a valid use of RRF ships. MSC acknowledges that RRF ships have been used for increasingly longer periods than in the past and have participated in sequential exercises in an effort to realize activation cost savings.

Beginning in the fall of 1987, MSC began concerted efforts to carry exercise cargo in commercial ships whenever possible. Our work disclosed from October 1, 1987, through July 15, 1988, six RRF ships had been activated, only one of which had been operational for longer than 60 days (75 days). This indicates that MSC is addressing the concerns raised by the carriers.