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Cargo preference legislation has the objective of assisting the U.S. maritime industry by giving the U.S.-flag fleet a larger share of the market in transporting imported oil. Cargo preference costs would be in the form of higher prices for oil and oil products and involve complex market forces and regulatory actions for 8 years in the future. Estimates must take into account the differential between the transport cost of U.S.-flag shipping and foreign-flag shipping. Estimates of costs presented by seven witnesses varied because they were not developed on a comparable basis. Even when adjusted to a common time frame, estimates varied by as much as a factor of 10. By selecting the most realistic estimates from component parts, averaging some factors, and making its own estimates of others, GAO estimated that the legislation would add between 0.15 and 0.23 cents per gallon to the price of imported oil. The total cost in 1985 will also depend on the amount of oil to be imported and estimates for this amount vary widely. GAO's estimates for total annual costs of the legislation were higher than those of the Maritime Administration because of: differences in calculating inflation factors, exclusion of present subsidy costs, transport price differentials, and the effect of imported oil prices on domestic oil prices. (HTW)

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Mr. Chairman and Members of the Committee. Thank you for the opportunity to testify before your Committee on the cost of proposed cargo preference legislation.

We were asked by the Chairman of the House Committee on Merchant Marine and Fisheries to assess the estimates of the costs of cargo preference legislation that had been presented to that Committee by seven different witnesses. The Chairman also requested our independent analysis of the cost of that legislation.

In response, we produced a report entitled "Costs of Cargo Preference," which was released on September 9. That report presents our analysis and results in some detail. At this time, I will merely summarize those findings and explain the primary differences between our estimates and those from other sources.

First, however, I would like to discuss some of the more general issues involved so that you can get a better feeling for how we approached this analysis.

Cargo preference legislation has the objective of assisting the U.S. maritime industry by giving the U.S.-flag fleet a larger share of the market in transporting our imported oil. To the extent that U.S.-flag capacity exists or is built, there is no question that such legislation could accomplish this objective, since it would be specifically mandated. The question is just how much this would cost.

Current aid to the maritime industry is mainly in the form of subsidies for construction and operation of ships. Except for loan guarantees, subsidies of this sort are paid by the Government and are subject to the budget process. For cargo preference, as with other sorts of import restrictions, nothing shows up in the budget except administrative costs. The costs are borne by consumers. In the case of cargo preference for imported oil, the costs would take the form of higher prices for oil and for goods produced from oil.

To the extent that cargo preference is a substitute for these other forms of aid, it might allow reductions in direct subsidies, such as the construction differential subsidy. But whatever savings might be achieved in that manner, they will not affect the cost to consumers of the cargo preference legislation. Even if those savings were translated into a tax reduction, there is no reason to expect that the distribution of the tax cut would be the same as the distribution of the costs of cargo preference. Therefore, our analysis concentrated on the costs to the consumer resulting from this proposed legislation.

Whereas the cost of direct subsidies is fairly straightforward, a considerable degree of uncertainty accompanies any estimates of the cost of cargo preference. The costs we must estimate are more abstract than, say, the costs of building a house for which there are exact blueprints. Estimating the costs of cargo preference involves assessing complex market forces, trends, and regulatory actions 8 years in the future. The analysis requires estimates not only of the cost of U.S.-flag shipping 8 years from now, but also the cost of foreign-flag shipping--we have to estimate the transport cost differential between these two alternative means of transporting oil. This is why we have presented a range of estimates, not just a single number.

The effectiveness of government regulation is particularly relevant to the cost estimates. Cargo preference would pose several difficult regulatory problems, and to the extent that these problems are not solved costs will increase. Cargo preference would put upward pressure on transport rates, with existing regulations and subsidies serving to complicate the picture. Some witnesses assumed a total absence of additional regulation and consequently arrived at high cost estimates. MarAd, on the other hand, consistently assumed perfect regulation at several stages of the analysis. By "perfect regulation" I mean the ability to eliminate all excess profits while avoiding costs to the industry due to excessive regulation and, in addition, recovering all subsidies in excess of those needed. In practice, perfect regulation is as difficult to achieve as the "perfect competition" of the economics textbooks. In our analysis, we assumed that regulation would prevent inordinate rate increases, but we also included some costs due to regulatory problems which are, in practice, unavoidable.

With all of the controversy surrounding the cargo preference issue, I was gratified to see a recent letter from the Federal Trade Commission stating that "The Commission's Bureau of Economics has analyzed various estimates submitted to Congress and, based on that appraisal, the Commission has concluded that the study done by the General Accounting Office is a reasonable estimate of that cost."

Summary of GAO Estimates

When we reviewed the various estimates which had been provided, we found, first of all, that they were not developed on a comparable basis. They had been stated in different terms, with different assumed inflation factors, reference years, and so on. To correct for this lack of comparability, we adjusted them all to a base of costs measured in 1977 dollars and applying to 1985, a year in which the legislation could be fully in effect. This did not, of course, eliminate the variation in estimates. These "adjusted" estimates varied widely--the highest was 10 times as large as the smallest. We then separated each of the estimates into its component parts, determined what we considered to be the most realistic estimate of each part, and then put the component parts together to make our estimates.

Basic to all of the estimates is the "transport cost differential." This is the difference between the cost of importing oil in U.S.-flag ships under cargo preference and the cost of importing oil in foreign-flag ships. This "transport cost differential" is composed of the operating cost differential and the capital cost differential. The operating cost differential is about one-fourth of the total transport cost differential, the capital cost differential accounting for the balance. Because there was substantial agreement among the witnesses on operating cost differentials, we used a simple average of these estimates.

It is understandable that the major source of variation in the estimates was the capital cost differential. It is difficult to predict capital costs due to the present glut in the world tanker market and the uncertain prospects for recovery by any given date. Our report describes the technical details of making these estimates, and I will not repeat this analysis in my testimony. We then analyzed how higher transport costs would affect the price of imported oil. The result was a range of estimates, with our minimum being somewhat higher than MarAd's and our maximum being considerably higher. Our estimates were, however, considerably lower than some which had been provided.

Using this approach, we estimated that the cargo preference legislation would add between 0.15 and 0.23 cents per gallon to the price of imported oil.

Estimating the total cost in 1985, however, also required us to estimate the amount of oil which will be imported in that year. Here again, there is a variety of estimates. Using an 8 million barrels per day figure yields an annual cost of $240 million. In our July 25 report on the Administration's proposed National Energy Plan we explained why we believe that imports are likely to be at least 10.3 million barrels of oil per day in 1985. At that level of imports, the cost would be higher--about $300 million per year in 1985. There have been some higher estimates--CRS estimated imports at 11.8 million barrels per day, again assuming enactment of the energy plan. If the President's energy plan is <u>not</u> fully enacted, then imports could be higher, with consequent increases in the cost to consumers of cargo preference.

The latest estimate from Data Resources, Incorporated, is 13.05 million barrels per day, assuming no stringent energy plan. This would translate into $390 million per year.

Besides these direct transport costs, however, the American consumer may also face an increase in the price of domestically-produced oil, as the price of this oil adjusts to the price of imported oil. Some of this increase could be suppressed by price control, at least in the short-run, or could be recovered by well-head taxes, but if a full adjustment of domestic prices were permitted, it would cost consumers an extra $310 million, using our mid-range estimate.

Why GAO's Estimate is Higher than MarAd's

The latest figures on annual costs that we have seen from the Maritime Administration are $110 million a year and $170 million a year for imports of 8 million and 10 million barrels of oil a day, respectively. There are many differences in our analyses--some large and some small. It might be helpful to the Committee for me to review these differences briefly.

1. First, a minor point--MarAd's cost figures are in 1976 dollars, whereas ours are in 1977 dollars. The inflation factor adds about 7 percent if MarAd's figures are brought up to date.

2. Second, MarAd has deducted $64 million and $71 million, respectively, from its two estimates to exclude past subsidized U.S. ship construction costs that could be recovered. Without disputing the accuracy of these figures, we do not believe they should be subtracted from the estimated cost of cargo preference to consumers. Regardless of what is done with other subsidy programs, consumers of oil will still have to bear the costs of higher transportation costs resulting from cargo preference.

3. Third, we disagree with MarAd's estimates of the transport price differential. MarAd equated transport cost and price, implying the complete absence of market factors in determining what shippers would pay. In our analysis, however, we recognized that, during most or all of the

prospective period under review, the U.S.-flag tanker tonnage available would probably be less than the amount mandated by the legislation and that this would result in upward pressure on the prices of U.S.-flag tankers services. Since this pressure could be relieved by the waiver powers the legislation gives the Secretary of Commerce, we did not agree with the high excess profits predicted in some of the other studies. Nevertheless, recognizing the difficulty of the regulatory problem, GAO judged that, at a minimum, an allowance of 10 percent above efficient transport cost would have to be added to account for excess profits and/or inefficient assignment of vessels to import routes.

4. Perhaps the largest single discrepancy between our analysis and MarAd's is that we discussed the effect of imported oil prices on the price of domestically-produced oil. This, we stated, might cost consumers an additional $310 million per year. While this is not a direct cost, as is the increased transportation cost, we believe it to be a likely consequence of the legislation.

Why Some Estimates are Higher than Ours

As I pointed out earlier, a number of the other estimates were considerably higher than ours. There are two basic reasons for this. First, some thought that cargo preference would create a situation of excess demand for U.S.-flag ships--that there would be too few tankers to satisfy the 9.5 percent requirement and that owners could greatly increase their shipping rates. We found it more reasonable to assume that in such a situation shipping rates would be regulated to prevent inordinate rate increases.

The second reason why some of the other estimates were higher than ours is that costs were included for predicted retaliation by maritime nations that would lose some of their market. We did not include any cost for retaliation for two reasons. First, we knew of no good way to estimate the probability or extent of such retaliation. Second, if retaliation did occur it could take any number of forms. That is, retaliation could affect the price of imports other than oil, or could affect U.S. exports. Since we have targeted our estimates to the cost to consumers due to higher oil prices, we did not see fit to include such costs. As with any restrictions on international trade, however, there is always the possibility of retaliation in some form.

Mr. Chairman, that concludes my prepared statement. My colleagues and I would be happy to try to answer any questions you have.