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Cargo Preference: Compliance with and Enforcement of Maritime's Buy American Laws

Russia's actions to reduce gas exports to Europe show the risk of allowing an opposing power to gain control of essential contributors to a nation's economy. America's NATO allies are now scrambling to establish alternative sources of energy and revisit policies, such as Germany's decision to sundown its nuclear generating capacity, that led to an increased dependence on Russian gas.

The United States could find itself in a similar situation regarding its maritime industry. Since the nation's founding, Americans have gone to sea for trade, to harvest resources from the oceans, and to advance the country's interests. By building and repairing ships, training mariners, operating shipping networks, and sustaining ports and waterways, the U.S. maritime industry makes possible the economic benefits of access to the sea.

Recognizing the value of a strong maritime industry, China undertook a methodical effort—supported by more than $15 billion annually in government support—to establish the world's largest navy, coast guard and shipping fleet, gain control of ports worldwide, and become the world's largest shipbuilding nation. Today, Chinese companies own more commercial ships than any other country, almost doubling second place Greece. More than 7,000 large commercial ships are registered in China, just slightly below first-place Panama. China holds more than half the global orderbook for constructing large commercial ships and builds nearly all the world's shipping containers. Through its Belt-and-Road initiative, China has access and significant control over marine terminals and other infrastructure around the world.

China's domination of the maritime industry has benefitted US consumers by lowering prices for imported goods and subsidizing infrastructure improvements at overseas ports. However, it also creates vulnerabilities. During a confrontation between the United States or its allies and China, Beijing could use its control over the maritime shipping and transportation sector to impose costs and punish its opponents. Outside of military conflict, China's government could direct its companies, which lack the independence of US firms, to discriminate in favor of Chinese interests through pricing, scheduling, insurance, or quality of service. The gas shortfalls being experienced today by Europe and recent supply chain backlogs may pale in comparison to the impact from a concerted effort by the Chinese maritime industry to disrupt the US economy.

US policy decisions since the end of World War II contributed to this vulnerability. Fewer than 200 large commercial ships now fly the US flag and fewer than 10 commercial ships are under construction in US shipyards. American shipping companies faced tax and other regulatory disadvantages that led the largest to sell out to foreign buyers decades ago.

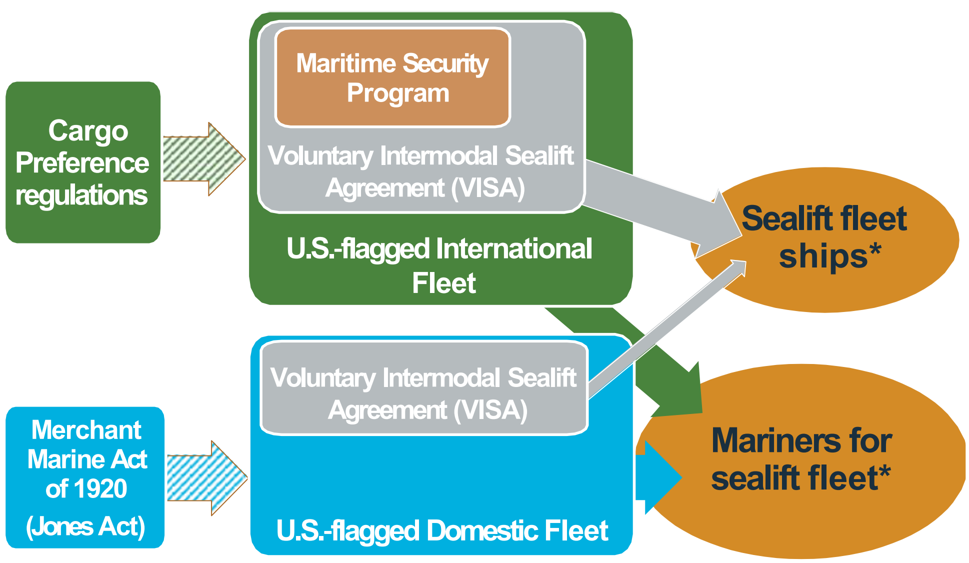
To effectively compete, the United States will need to break with maritime strategies that assume commercial and national security contributions of the maritime industry are largely distinct. Instead, the United States should adopt a new approach that recognizes the inherent linkage between the two and fosters a healthier commercial industry that can support U.S. national security. A new comprehensive strategy is even more important now given the growing threat posed by Chinese maritime power, the urgent need for new approaches to shipbuilding and the repair of U.S. government ships, and the need for viable solutions for strategic sealift gaps.

Restoring sealift capacity

A framework of regulation, law, and government programs governs and shapes the U.S. maritime industry. Most relevant to this hearing is the shipping fleet and its ability to support US sealift demands during a crisis or conflict, including the potential of Beijing reducing US access to Chinese flagged or owned vessels. By supporting the US shipping fleet, the United States can insulate itself from Chinese pressure.

As depicted in the figure below, in the U.S. domestic commercial shipping fleet, the Merchant Marine Act of 1920, also known as the Jones Act, requires ships conducting commerce between U.S. ports to be U.S.-built, U.S., owned, and operated by crews of U.S. citizens or permanent residents. In the international commercial fleet, the Maritime Security Program (MSP) provides stipends to U.S.-flagged ship operators to help cover the higher cost of following U.S. regulations, and Cargo Preference rules require that U.S.-flagged ships carry all DoD and 50 percent of other U.S. government cargoes. Ships participating in MSP are enrolled in the Voluntary Intermodal Sealift Agreement (VISA), which requires participating vessels to be made available for surge sealift operations during wartime or other crises. VISA also includes other vessels from the domestic and international fleets, but they do not receive a stipend.

Contributors to US surge sealift capacity



Shipping operators are reticent to operate under U.S. flag due to higher costs and a resulting lack of competitiveness that reduces cargo throughput. Outdated taxes and regulations—especially related to mariner wages and repair duties—should be reformed to help reduce expenses. To improve efficiency and encourage shipping, the government should also fund enhancements to intermodal links and deter cargo diversion. And because shipping companies will need more sailors to operate a larger U.S.-flagged fleet, merchant marine recruiting and retention should be improved through new initiatives to ease of credentialing and licensing and establishment of a Merchant Marine Reserve.

Maritime Security Program and cargo preference

The current MSP offers a stipend to about 60 U.S.-flagged ships. At a relatively low cost compared to acquiring, crewing, and maintaining additional government ships, the MSP provides DoD access through VISA to commercial vessels, mariners, and associated global intermodal networks. By supporting the operation of U.S.-flagged ships in commerce around the world, the MSP also contributes to U.S. tax revenue and commercial access. However, the government could improve the program's effectiveness by stabilizing the MSP stipend, expanding MSP to cover sealift shortfalls and replacement of aging government- owned ships, and bringing specialized ship types into the MSP that are expensive for the government to buy and maintain.

However, the MSP stipend is generally not sufficient to cover the costs of maintaining a ship under US flag. Preference cargo, which generally can command higher rates compared to commercial cargo, makes up the difference. While government vendors and agencies are required to comply with Cargo Preference rules, avoidance is rampant.

For example, defense contractors have difficulty identifying how all the elements of their supply chain arrive in the United States for manufacturing or assembly. This is a challenging problem, but recent efforts by the Department of Defense (DoD) to understand its supply chains should help identify the methods being used to move materials and parts from overseas suppliers to US defense contractors.

The Defense Logistics Agency (DLA) often circumvents Cargo Preference rules to save costs in the name of national security. While in general this would allow more funding to go to other defense programs and logistics needs, as a working capital fund, the DLA is also incentivized to reduce costs and reallocate the savings to internal priorities.

Food aid is sometimes shipped on foreign-flagged ships to allow more dollars to be spent on aid, but this undercuts the purpose of the Cargo Preference program, which is to support the US shipping industry. Circumventing cargo preference merely privileges one industry at the expense of another.

By reducing the circumvention of cargo preference rules, the US government could make operating under US flag more attractive for carriers. With a larger base of preference cargo to ship, the MSP fund could eventually be applied to a larger number of carriers and expand the size of the program, and the US flag fleet.

Tanker security program and cargo preference

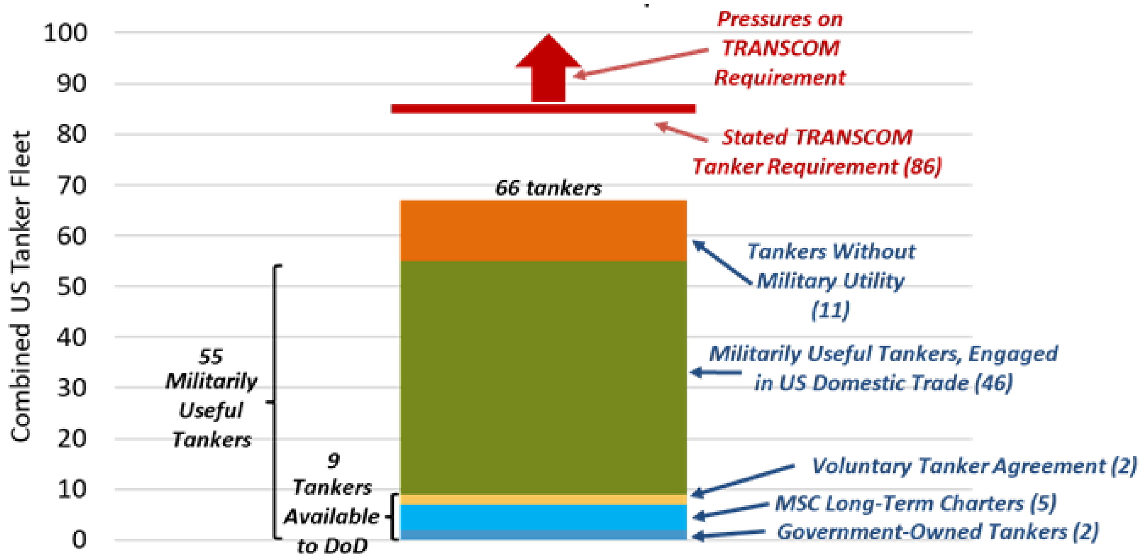
In the 2016 Mobility Capabilities Requirements Study, the US Transportation Command (USTRANSCOM) identified a requirement of 86 tankers necessary for the strategic sealift of fuel in a large contingency.[1] Additional tankers are necessary to support US Navy Consolidated Logistics (CONSOL) tanker at-sea fuel transfer requirements.[2] However, DoD only has access to about 9 US-flag militarily useful tankers that it could call upon in a contingency, exclusive of tankers in the domestic trade.[3]

Current US-flagged fleet is far less than TRANSCOM requirement

[1] Lieutenant General Stephen Lyons, U.S. Army, Deputy Commander of USTRANSCOM, “Logistics and Sealift Forces,” statement before House Armed Services Committee Subcommittee on Seapower and Projection Forces, March 22, 2016, p. 3.

[2] US Navy forces require lightering, CONSOL, or Modular Fuel Delivery System-equipped tankers to transfer fuel afloat to other tankers, to Combat Logistics Force ships, and to other vessels, respectively. For more information on this demand, please see: Timothy A. Walton, Ryan Boone, Harrison Schramm, *Sustaining the Fight: Resilient Maritime Logistics for a New Era* (Washington, DC: Center for Strategic and Budgetary Assessments, 2019), pp. 41-43, 77-83, https://csbaonline.org/uploads/documents/Resilient_Maritime_Logistics.pdf. and Bryan Clark, Timothy A. Walton, and Seth Cropsey, *Seapower at a Crossroads: A Plan to Restore the US Navy’s Maritime Advantage* (Washington, DC: Hudson Institute, 2020), pp. 40, 41, 44, https://s3.amazonaws.com/media.hudson.org/Clark%20Cropsey%20Walton_American%20Sea%20Power%20at%20a%20Crossroads.pdf.

[3] Figure 32 in Timothy A. Walton, Ryan Boone, Harrison Schramm, *Sustaining the Fight: Resilient Maritime Logistics for a New Era* (Washington, DC: Center for Strategic and Budgetary Assessments, 2019), p. 78, https://csbaonline.org/uploads/documents/Resilient_Maritime_Logistics.pdf.



Source: Figure 32 in Timothy A. Walton, Ryan Boone, Harrison Schramm, *Sustaining the Fight: Resilient Maritime Logistics for a New Era* (Washington, DC: Center for Strategic and Budgetary Assessments, 2019), p. 78, https://csbaonline.org/uploads/documents/Resilient_Maritime_Logistics.pdf

The DoD faces a gap of approximately 76 fuel tankers to meet surge sealift requirements. The newly established Tanker Security Program (TSP) will help address this gap. But like the MSP, tankers participating in the TSP require preference cargo to be economically viable. Moreover, the TSP is small and would require more cargo if it is to expand to meet the 76-tanker gap.

DLA Energy purchases the majority of its bulk fuel contracts for deliveries to Defense Fuel Support Points (DFSPs) Outside the Continental United States (OCONUS) from foreign refineries. Purchasing fuel from foreign refineries closer to DFSPs allows DLA Energy to buy fuel that is not only in some cases slightly less expensive than fuel from US refineries, but also allows DLA Energy to minimize transportation costs, as the fuel can come from closer refineries than farther, US ones. This approach has allowed DLA Energy, a working capital fund organization, to minimize costs passed on to the US military services and defense agencies.

DLA's approach has also had the unintended pernicious effect of reducing the amount of preference cargo available to US-flag tankers and in turn reducing the number of US tankers and crews available to support critical US Department of Defense (DoD) requirements. It also creates a peacetime business environment misaligned with the threat environment. For example, DLA Energy has historically purchased most of the bulk fuel contracts for the Western Pacific solicitation from refineries in Japan, the Republic of Korea, and Singapore—refineries that would likely be subject to Chinese business control, coercion, or attack in a potential conflict with the People's Republic of China.

Hoping requisite numbers of foreign tankers and their crews will be available in a conflict to substitute for US tankers is imprudent. Global spare tanker capacity significantly fluctuates, and a large and growing portion of commercial tanker fleets are Chinese controlled or subject to Chinese coercion or might not want to participate in a Sino-American confrontation.

To start to address this major gap in US tankers, one of the easiest and lowest-cost options is to source a greater proportion of DLA Energy bulk fuel contracts from US refineries and to continue to require that fuel be transported to the greatest degree possible on US-flag tankers participating in the Maritime Administration Voluntary Tanker Agreement (VTA).[4]

This requirement would end the current penny-wise, pound-foolish approach of purchasing most OCONUS bulk fuel contracts from foreign refineries and would provide three major benefits. First, more US-flag tankers could join the US commercial fleet since there would be more preference cargo to support their operations. By participating in the VTA, these tankers could engage in commerce in peacetime and be requisitioned, if necessary, by the US government during contingencies. Second, the proposed approach would provide more jobs to US mariners and their supporting maritime industry personnel and provide additional revenues to US-flag tanker companies (and tax receipts to the US government from those

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[4] The Voluntary Tanker Agreement (VTA) is an agreement that facilitates cooperation between tanker operators and the government (and grants shipowners anti-trust immunity for cooperating amongst themselves) if the government determines it necessary to requisition tankers in contingencies. Another complementary option to increase the number of US-flag tankers is to increase the number of Tanker Security Fleet slots, increase their stipend to match the operating differential between US and foreign-flag vessels, and eliminate regular Tanker Security Fleet participants' access to preference cargo fuel to have these tankers operate in international trade, while other US-flag tankers transport preference cargo and meet domestic trade requirements. As another option, DoD can long-term charter additional tankers to serve as prepositioned reserves afloat that can move to areas of need. And lastly, the US Congress could mandate a requirement in which a gradually growing proportion of US energy exports would need to be lifted on US-flag tankers. For a further discussion of this topic, please see: Timothy A. Walton, "Resilient refueling beyond Red Hill", *Real Clear Defense*, March 14, 2022, https://www.realcleardefense.com/articles/2022/03/14/resilient_refueling_beyond_red_hill_821616.html; and Timothy A. Walton, Ryan Boone, Harrison Schramm, *Sustaining the Fight: Resilient Maritime Logistics for a New Era* (Washington, DC: Center for Strategic and Budgetary Assessments, 2019), pp. 81-82, 118, https://csbaonline.org/uploads/documents/Resilient_Maritime_Logistics.pdf.

companies and from their personnel). Third, the proposed approach would increase sales of fuels by US refineries and in turn support jobs, revenues, and tax receipts at these refineries.

Recommendations

The US Congress should introduce legislation that mandates that DLA Energy, starting in FY 2023, purchase no less than 50 percent of tanker-delivered OCONUS bulk fuel contracts from US refineries and that all tanker-delivered fuel be transported on US-flag tankers participating in the Voluntary Tanker Agreement. The requirement should increase to eventually mandate that DLA Energy purchase no less than 100 percent of tanker-delivered OCONUS bulk fuel contracts from US refineries, and no less than 25 percent of pipeline-delivered OCONUS bulk fuel contracts from US refineries, and that all tanker-delivered fuel be transported on US-flag tankers participating in the Voluntary Tanker Agreement.

To reduce circumvention of Cargo Preference rules, the US Congress should require that DoD complete a survey of defense contractors to determine how well they understand the shipping used within their supply chains. The report should include a plan to gain a complete understanding of the overseas materials and part used in US weapon systems and the shipping used to obtain them. The Congress should also require that DLA provide a report on its use of foreign-flagged vessels, the reasons for doing so, and how the resulting savings were repurposed.

Conclusion

In a future military or diplomatic confrontation against China, the United States could experience economic disruptions like those imposed by the Covid-19 pandemic's impact on supply chains or the energy shortfalls befalling Europe today. Some of these effects may be unavoidable, given the Chinese maritime industry's size and influence. However, the best insulation against the worst disruptions is to improve the health of the US maritime industry, which depends on effective enforcement of cargo preference rules.