DOD Leases of Foreign-Built Ships: Background for Congress

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Summary

Prior to the enactment of the FY2008 defense authorization act (H.R. 4986/P.L. 110-181 of January 28, 2008), 10 U.S.C. §2401 stated DOD may not lease a vessel or aircraft for a period of more than five years unless it is specifically authorized by law to make such a lease. Operating under this provision, the Department of Defense (DOD) in recent years used lease options and renewals to lease some foreign-built cargo ships for total periods of almost 10 years—a length of time that some observers argue effectively circumvented a legal requirement that U.S. military ships be built in U.S. shipyards. These observers, particularly the American Shipbuilding Association (ASA), proposed reducing the current five-year legal limit on ship leases to two years for foreign-built ships. DOD opposed the idea, arguing that its ship leases are the most cost-effective way to meet its needs for the ships in question.

Section 1011 of the FY2008 defense authorization act amended 10 U.S.C. §2401 to permit the Secretary of a military department to lease a vessel for a period of greater than two years, but less than five years, only if the Secretary provides a notification of the lease to the House and Senate Armed Services and Appropriations committees (including a detailed description of its terms, a justification for entering it rather than purchasing the vessel, a determination that entering into it is the most cost-effective option; and a plan for meeting the requirement upon the lease's completion), and a period of 30 days of continuous session of Congress has expired.

The House Appropriations Committee, in its report (H.Rept. 111-230 of July 24, 2009) on the FY2010 DOD appropriations bill (H.R. 3326), states:

> LEASING OF FOREIGN BUILT SHIPS
>
> The Committee remains very concerned with the Navy's practice of entering into extended leases for foreign built ships. Historically, these leases have met the intent of long term capital lease restrictions on an individual basis, but the recurring nature of several of the leases violates the spirit and intent of the 1990 Budget Enforcement Act. The Committee recognizes that the ships leased by the Navy fill an important role that must be continued through the near term and well into the future, but believes that ships that fill these roles can provide an economic opportunity for the domestic shipbuilding industry. Two years ago, the Committee received a report from the Navy on their practice of leasing foreign built ships and a plan for ending the practice of leasing foreign built ships by 2012. The basic conclusion of the report was that the dependence on foreign built ships would be significantly reduced by the year 2012, principally as a result of shifting requirements and modifications to existing Department of Defense assets. Since the administration is currently undertaking a review of future requirements, the Committee is extremely interested in how that review will affect the Navy's practice of leasing foreign built ships. Therefore, the Committee directs the Secretary of the Navy to update the report submitted in March 2008 regarding the practice of leasing foreign built ships. The report should include the Navy's updated plan for terminating the practice of leasing foreign built ships to supplement the fleet and using only domestic built ships by 2012. Additionally, the report should include the necessary budget and funding plans that may be required to accomplish this. This report should be submitted no later than March 31, 2010. (Page 166)

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Background

Current Law

Prior to the enactment of the FY2008 defense authorization act (H.R. 4986/P.L. 110-181 of January 28, 2008), 10 U.S.C. §2401 stated DOD may not lease a vessel or aircraft for a period of more than five years unless it is specifically authorized by law to make such a lease.

Section 1011 of the FY2008 defense authorization act amended 10 U.S.C. §2401 to permit the Secretary of a military department to lease a vessel for a period of greater than two years, but less than five years, only if the Secretary provides a notification of the lease to the House and Senate Armed Services and Appropriations committees (including a detailed description of its terms, a justification for entering it rather than purchasing the vessel, a determination that entering into it is the most cost-effective option; and a plan for meeting the requirement upon the lease's completion), and a period of 30 days of continuous session of Congress has expired. (See "Legislative Activity")

Other laws and regulations relating to DOD leases of equipment include 41 U.S.C. §11, Appendix B of Office of Management and Budget (OMB) Circular A-11, OMB Circular A-94, and the Budget Enforcement Act of 1990, which is Title XIII of Omnibus Budget Reconciliation Act of 1990 (H.R. 5835/P.L. 101-508 of November 5, 1990).[1] Another legal provision—10 U.S.C. §7309—states that no vessel to be constructed for any of the armed forces may be constructed in a foreign shipyard.

Recent DOD Leases of Foreign-Built Ships

DOD's Military Sealift Command (MSC), which operates sealift (i.e., cargo transport and prepositioning) ships, in recent years has leased some foreign-built sealift ships for periods of up to 4 years and 11 months. According to the American Shipbuilding Association (ASA), a trade association representing certain shipyards and shipbuilding-related firms,[2] MSC as of June 2006 had renewed the leases of four of these ships for additional periods of up to 4 years and 11 months, providing potential total lease periods of up to almost 10 years.[3]

[1] 10 U.S.C. §2401(a) and (b) state that the secretary of a military department may make a contract for a long-term lease or charter if the secretary has been specifically authorized by law to make the contract. 10 U.S.C. §2401(d)(1)(A) defines a long-term lease or charter as one the term of which is for a period of five years or longer or more than one-half the useful life of the vessel or aircraft.

[2] The ASA (http://www.americanshipbuilding.com) represents six U.S. shipyards owned by General Dynamics (3 yards) and Northrop Grumman (3 yards) that build all of the Navy's larger ships, and several dozen other firms that provide ship systems, components, technology, and equipment.

[3] The four ships, identified by ASA in a June 14, 2006 e-mail to CRS, are all container ships used to preposition military supplies overseas. They are the Capt. Steven L. Bennett (TAK-4296), which ASA says has been leased by MSC since November 1997; the Maj. Bernard F. Fisher (TAK-4396), which ASA says has been leased by MSC since November 1999; the LTC John U. D. Page (TAK-4543; previously designated TAK-4496), which ASA says has been leased since March 2001, and the SSGT Edward A. Carter, Jr. (TAK-4544), which ASA says has been leased since June 2001. The Fisher was built in Denmark; the other three ships were built in South Korea. In the designation "TAK," T means operated by the MSC, A means auxiliary ship, and K means cargo.

American Shipbuilding Association (ASA) Position

Supporters of U.S. shipyards, particularly the ASA, have been concerned that, in addition to the four ships cited above, MSC in the future might renew or extend the leases of other foreign-built ships beyond 4 years and 11 months, and that the Defense Logistics Agency (DLA)—another part of DOD—might also begin leasing foreign-built ships.[4] ASA has argued that leasing a ship for a period of almost 10 years indicates that DOD has a long-term need for such a ship, and that in such cases, DOD should purchase a ship and have it built in a U.S. yard. ASA has argued that leasing a foreign-built ship for almost 10 years effectively circumvents the requirement in 10 U.S.C. §7309 that U.S. military ships be built in U.S. yards. The ASA has supported changing 10 U.S.C. §2401 to limit leases of foreign-built ships to no more than two years, including all options to renew or extend the contract. ASA has said the proposal is intended to encourage DOD, in cases where DOD has a long-term need for a ship, to purchase the ship and have it built in a U.S. yard, rather than lease a foreign-built ship. In a statement issued prior to the enactment of the FY2008 defense authorization act, the ASA stated that

> The Department of Defense (DOD) is purchasing, via long-term leases, foreign-built ships to meet long-term military requirements. The leases in question are 5 years in duration and can be, and have been, renewed for another 5-year period. The length of these leases indicate a long-term military requirement, and results in de facto purchases of the ships in contravention of U.S. acquisition law (Section 7309 of Title 10 USC), which states that ships for the U.S. military shall be built in the United States, and the intent of the Budget Enforcement Act of 1990, limiting leases of capital assets....
>
> The Budget Enforcement Act of 1990 placed a limit on the duration of leasing contracts for capital equipment by the Executive Branch in an effort to impose budget discipline on future year contract obligations by the Government, and to encourage the purchase rather than leasing of capital assets to meet long-term requirements because of the higher cost associated with leasing. To enforce this budget discipline, the Office of Management and Budget (OMB) issued scoring guidelines stating that vessels and other capital assets leased for a period of five years or longer would have to be scored in the budget year in which the contract was entered into, and the budget request in that year would have to include authorization for the total multi-year lease contract. This scoring rule eliminated the budget benefits of leasing versus buying American-built ships. Additionally, in the 1980's, Congress passed restrictions in Defense Appropriations Bills limiting ship and other capital leases to not more than 18-months in duration in an effort to deter leasing and discipline out-year funding obligations.
>
> DOD has been circumventing these leasing restrictions by entering lease contracts of 59-months (one month shy of five years), thereby avoiding triggering the requirement of scoring the entire cost of the lease in the first year as required by the Budget Enforcement Act of 1990. Many of these 59-month leases are being renewed for an additional 59-month period resulting in foreign-built ships operating for DOD for a period of nearly 10 consecutive years.
>
> While the Budget Enforcement Act met its intended objective of ending long-term leases of U.S.-built ships, it has opened the door to leasing foreign-built assets. Most of the ships under lease are used commercial ships of South Korean manufacture that have been modified to meet U.S. military specifications. DOD states that it needs to have the ability to lease

[4] Regarding DLA, ASA points to the following news story: Jason Ma, "Defense Logistics Agency Crafts Concept For Resupply-Ship Program," *Inside the Navy*, November 28, 2005.

> these ships for 59 months to provide the foreign owner of the ship access to private financing to convert a commercial ship to meet a specialized military requirement. U.S. shipbuilders cannot obtain bank financing to build new ships to meet the requirement unless they recover the entire construction cost in the five years of the lease, making the lease payments for newly built ships non-competitive with foreign ships of ten or more years old for which the capital cost has been significantly amortized.
>
> While DOD needs to have the flexibility to lease foreign-built ships to meet shorter-term or emergency requirements, the growing reliance by DOD on this practice is resulting in the de-facto purchase of foreign-built ships to meet special, dedicated, long-term military requirements....
>
> [The ASA recommends] Support [for] an amendment to the DOD FY07 Authorization and Appropriations Bills that will limit the duration of DOD lease contracts of foreign-built ships to two years, including contract options.[5]

DOD Position

DOD has argued that its leases of foreign-built ships are the most cost-effective way to meet its needs for the ships in question, and that limiting such leases to no more than two years would make them much more expensive and difficult to implement, and therefore less cost effective. DOD has opposed changing 10 U.S.C. §2401 to limit leases of foreign-built ships to no more than two years. In a statement issued prior to the enactment of the FY2008 defense authorization act, DOD stated that

> [MSC] charters ships (from the commercial market) to meet the requirements of DoD components and respond to changes in the operational environment. Unfortunately, very few commercial ships with high military utility have been constructed in U.S. shipyards in the past 20 years. Consequently, when MSC has a requirement to charter a vessel, nearly all of the offers are for foreign-built ships. In cases where the need is immediate or subject to change, due to the operational environment or other factors, a commercial charter is the only practical way to obtain the capability. When a requirement for a particular type of vessel is known to be long-term , as was the case with the Large Medium Speed Roll-on/Roll-off [sealift] ships (LMSRs) [that were procured for DOD in the 1990s], the Navy seeks authorization from Congress for a new construction program which can take up to five years for delivery of the first vessel....
>
> In cases where there are long term, consistent requirements that are best satisfied by the construction of new purpose-built vessels, the Navy, upon authorization by Congress, establishes and funds programs such as the LMSRs and the [Lewis and Clark (TAKE-1 class) dry cargo ships], to meet these requirements. We are also moving ahead with the acquisition of the Joint High Speed Vessel [JHSV] as a replacement for the capability currently fulfilled by the WESTPAC EXPRESS Charter....
>
> [DOD] opposes [a provision to limit leases to no more than 2 years], as it would have a severe negative impact on the ability of [MSC] to carry out its mission of providing sealift support for a wide variety of [DOD] activities. To support rapid deployment of military forces, the military services maintain equipment on MSC chartered vessels (some foreign built, converted in U.S. shipyards, all U.S.-flagged and U.S.-crewed) for periods up to five years and budgeted for operational requirements accordingly. MSC also operates vessels

[5] ASA point paper provided to CRS on May 3, 2006.

> chartered for periods up to five years for other unique military requirements. Having to conduct new charter solicitations biennially would greatly reduce the Services' ability to effectively plan and budget resources and would severely limit [regional] Combatant Commanders' ability to maintain mission readiness, especially for our nation's prepositioning force and in support of the Global War on Terror. Additionally, the potential necessity to return the ships to the United States for the purposes of transferring the equipment to a newly chartered ship, as ship charters changed, would severely impact DOD readiness. This constant disruption and transition on a biennial basis would defeat the central purpose of the prepositioning program: forward deployment of fully-loaded ships in strategic locations worldwide that are ready to meet warfighting needs at a moment's notice.
>
> Additionally, such a restriction would adversely impact the U.S. merchant marine industry upon which [DOD] relies to crew surge sealift ships, since any foreign built vessel chartered by MSC must have all reflagging work performed in a US shipyard and, during operation, must be crewed with US merchant mariners. Thus, the charter of foreign-built vessels by MSC has the added benefit of increasing the number of privately owned cargo vessels flying the US flag. Further, any such restriction would be contrary to [DOD's] objectives of supporting a vigorous and competitive domestic ship repair industry.
>
> Restricting the maximum lease/charter period for foreign built vessels to 24 months would not increase the number of U.S.-built militarily useful ships. It would increase the cost for MSC to charter vessels. Responses to informal queries to the owners/operators of MSC chartered ships indicate that the Government would likely have to pay twice as much [per day] for charters if forced from 59-month to 24-month charter periods. This price differential results from the ship owner's ability to amortize capital investment costs over longer periods of time for longer leases.
>
> This restriction would do nothing to encourage U.S. ship construction because building new vessels for DOD use would involve unacceptable lead times for current requirements and require substantial additional funding that is not available. DoD is pursuing a [JHSV] capability based on lessons learned from leased vessels.[6]

Potential Questions for Congress

DOD's leases of foreign-built ships raise several potential questions for Congress, including the following:

[6] DOD point paper provided to CRS on May 25, 2006. Regarding the impact of leases of foreign-built ships on U.S. shipyards and the U.S. merchant marine, DOD also states in this point paper:

> Ships chartered to meet DoD missions are required to be U.S.-flagged and crewed by U.S. merchant mariners. Whenever a foreign-built ship is used for such charters, that ship is required to be converted to U.S. flag, and crewed by U.S. citizen mariners, prior to the beginning of the charter. Moreover, any conversion work needed to bring the foreign-built ship up to U.S.-flag standards must by law, be accomplished in U.S. shipyards. Over the recent past, the reflagging of foreign-built ships to U.S.-flag has resulted in the creation of thousands of jobs for U.S. citizen merchant mariners and millions of dollars of U.S. shipyard work. Presently, 40 percent of privately-owned U.S.-flagged ocean going vessels over 1000 gross tons are foreign-built, including all of the vessels participating in the Maritime Security Program. The proposed legislation would result in exclusion of these and all other foreign-built vessels from competition for longer-term charters. This severe restriction on full and open competition would substantially raise the cost to meet the DoD transportation and prepositioning mission.

- How many additional foreign-built ships might DOD in the future decide to lease, with renewals, for total periods of more than five years?
- If DOD leases of foreign-built ships were limited to no more than two years, including all options to renew or extend the contract, in how many cases would DOD purchase a ship and have it built in a U.S. yard rather than lease a foreign-built ship? What would be the resulting impact on workloads, revenues, and employment levels at various U.S. shipyards, and on U.S. merchant marine employment? Would this impact be in the national security interest?
- What is the comparative cost effectiveness of meeting DOD sealift requirements under current ship leasing authorities, under the proposed two-year limit for leases of foreign-built ships, and through purchase of U.S.-built ships? How much risk would there be of a mismatch between DOD's sealift requirements and DOD sealift capacity if a two-year limit on DOD leases of foreign-built ships resulted in a decision by DOD to purchase U.S.-built ships rather than lease foreign-built ships?
- What are the potential implications, if any, of DOD's leases of foreign-built ships for acquisition of other DOD capabilities, such as capabilities provided by aircraft?

Legislative Activity

Legislative Activity in 2009

FY2010 DOD Appropriations Bill (H.R. 3326)

The House Appropriations Committee, in its report (H.Rept. 111-230 of July 24, 2009) on H.R. 3326, states:

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> The Committee remains very concerned with the Navy's practice of entering into extended leases for foreign built ships. Historically, these leases have met the intent of long term capital lease restrictions on an individual basis, but the recurring nature of several of the leases violates the spirit and intent of the 1990 Budget Enforcement Act. The Committee recognizes that the ships leased by the Navy fill an important role that must be continued through the near term and well into the future, but believes that ships that fill these roles can provide an economic opportunity for the domestic shipbuilding industry. Two years ago, the Committee received a report from the Navy on their practice of leasing foreign built ships and a plan for ending the practice of leasing foreign built ships by 2012. The basic conclusion of the report was that the dependence on foreign built ships would be significantly reduced by the year 2012, principally as a result of shifting requirements and modifications to existing Department of Defense assets. Since the administration is currently undertaking a review of future requirements, the Committee is extremely interested in how that review will affect the Navy's practice of leasing foreign built ships. Therefore, the Committee directs the Secretary of the Navy to update the report submitted in March 2008 regarding the practice of leasing foreign built ships. The report should include the Navy's updated plan for terminating the practice of leasing foreign built ships to supplement the fleet and using only domestic built ships by 2012. Additionally, the report should include the

> necessary budget and funding plans that may be required to accomplish this. This report should be submitted no later than March 31, 2010. (Page 166)

FY2010 Defense Authorization Bill (H.R. 2647)

The conference report (H.Rept. 111-288 of October 7, 2009) on H.R. 2647 does not contain any provisions relating directly to DOD leases of foreign-built ships. The conference report states:

> *Conversion of certain vessels; leasing rates*
>
> The House bill contained a provision (sec. 126) that would permit the Secretary of the Navy to use up to $35.0 million from the Weapons Procurement, Navy, account to lease and convert vessels that have defaulted on construction loan guarantees: (1) that have become the property of the United States; and (2) for which, the Maritime Administrator has a right of disposal.
>
> The Senate amendment contained no similar provision.
>
> The House recedes.
>
> The conferees agree that the Navy should, in trying to make near-term additions to the high speed vessel fleet, consider fully the possibility of using vessels within the control of the Maritime Administration. (Page 687)

Prior-Year Legislative Activity

FY2008 Defense Authorization Act (H.R. 4986/P.L. 110-181)

The text of Section 1011 of the FY2008 defense authorization act (H.R. 4986/P.L. 110-181 of January 28, 2008) is as follows:

> SEC. 1011. LIMITATION ON LEASING OF VESSELS.
>
> Section 2401 of title 10, United States Code, is amended by adding at the end the following new subsection:
>
> `(h) The Secretary of a military department may make a contract for the lease of a vessel or for the provision of a service through use by a contractor of a vessel, the term of which is for a period of greater than two years, but less than five years, only if—
>
> `(1) the Secretary has notified the Committee on Armed Services and the Committee on Appropriations of the Senate and the Committee on Armed Services and the Committee on Appropriations of the House of Representatives of the proposed contract and included in such notification—
>
> `(A) a detailed description of the terms of the proposed contract and a justification for entering into the proposed contract rather than obtaining the capability provided for by the lease, charter, or services involved through purchase of the vessel;
>
> `(B) a determination that entering into the proposed contract as a means of obtaining the vessel is the most cost-effective means of obtaining such vessel; and

> `(C) a plan for meeting the requirement provided by the proposed contract upon completion of the term of the lease contract; and
>
> `(2) a period of 30 days of continuous session of Congress has expired following the date on which notice was received by such committees.'.

FY2008 Defense Appropriations Act (H.R. 3222/P.L. 110-116)

The House Appropriations Committee, in its report (H.Rept. 110-279 of July 30, 2007) on H.R. 3222/P.L. 110-116 of November 13, 2007, stated that it was

> concerned with the Navy practice of bypassing the intent of the long term capital lease restrictions in the way several foreign built military sealift mission ships are leased.... The Committee believes this leasing practice is harming the Nation's shipyards and major ship component industrial base by indirectly denying our shipbuilders the opportunity for additional ship construction. The Committee recognizes that the ships leased by the Navy fill an important role that must be continued through the near term and into the future.... However, the Committee strongly believes that the American shipbuilders must take advantage of this opportunity. Therefore, the Committee directs the Navy to submit a report that outlines a plan to wean itself off the practice of leasing foreign built ships to supplement the fleet and institute the practice of utilizing only American built ships within four years.... (Pages 230-231)

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