

CARGO PREFERENCE BILLING AND PAYMENT PROCESS

Maritime Administration

Report Number: FI-2004-057

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Memorandum

**U.S. Department of
Transportation**

Office of the Secretary
of Transportation
Office of Inspector General

Subject: **ACTION:** Cargo Preference Billing
and Payment Process
FI-2004-057

Date: May 5, 2004

From: Alexis M. Stefani 
Principal Assistant Inspector General
for Auditing and Evaluation

Reply to
Attn. of: JA-20:x61496

To: Maritime Administrator
Assistant Secretary for Budget and Programs/
Chief Financial Officer
General Counsel

This report presents the results of our review of the issues surrounding a recent invoice of \$379 million submitted by the U.S. Department of Agriculture's (USDA) Commodity Credit Corporation¹ to the Maritime Administration (MARAD). MARAD is required to reimburse USDA for "excess" ocean freight costs that food assistance programs incur to comply with cargo preference statutes. Cargo preference is the legal requirement that a percentage of cargo shipped internationally, as a result of Federal Government involvement, be transported on U.S.-flag vessels. Commodity Credit Corporation collects MARAD's reimbursement and returns the funds to the food assistance programs administered by USDA and the U.S. Agency for International Development (USAID). The funds can then be used to provide additional food assistance.

MARAD has not made a payment for excess ocean freight since 1995, when MARAD paid \$35 million due for Fiscal Year (FY) 1992. The current invoice covers amounts due for FY 1994 through FY 2000 and has been in process since July 2003.² In part, the delays are due to an antiquated manual billing and payment process, but they primarily reflect a fundamental dispute between USDA and MARAD over how to calculate the amount of excess ocean freight owed. In 2001, USAID's Office of Inspector General reported on other procedural problems

¹ Commodity Credit Corporation is a Government-owned and operated entity that was created to stabilize, support, and protect farm income and prices. It also helps maintain balanced and adequate supplies of agriculture commodities and aids in their orderly distribution.

² In some years, no "excess" ocean freight payment is due.

associated with the cargo preference reimbursement process.³ Timely payments are important to support the programs goals—delivering more food assistance, supporting America’s farmers, and increasing the amount of cargo shipped on U.S.-flag vessels.

In light of the long period of non-payment, the continuing payment dispute, and the large amount in question, the Office of Management and Budget requested that we review the cargo preference dispute between MARAD and USDA and assess to what extent MARAD is liable for the \$379 million invoice from USDA. Officials from MARAD also requested we review the matter. We performed the review in accordance with Government Auditing Standards for attestation engagements in reviewing management’s assertions. Our objective was to describe the nature of the cargo preference dispute between MARAD and USDA and to provide assurance that the payment MARAD is proposing, \$164 million, was supportable and reasonable. Exhibit A describes our scope and methodology.

BACKGROUND

U.S. cargo preference laws are part of a statutory program to support the privately owned and operated U.S.-flagged Merchant Marine. The objective is to ensure that U.S. vessels and seamen are available when needed to support national defense requirements. From 1954 to 1985, the cargo preference requirement stipulated that at least 50 percent of certain U.S. Government-generated cargoes be shipped on U.S.-flag vessels. In 1985, Congress amended the laws to increase this requirement from 50 percent to 75 percent for commodities shipped under certain food assistance programs.

The difference in ocean freight costs between using U.S.-flag vessels and non-U.S.-flag vessels is referred to as Ocean Freight Differential (OFD). Commodity Credit Corporation pays all shipping costs, including the OFD associated with shipping the first 50 percent of cargo on U.S.-flag vessels. MARAD reimburses Commodity Credit Corporation for the additional OFD associated with shipping more than 50 percent of cargo on U.S.-flag vessels. This cost is called the Incremental Ocean Freight Differential (Incremental OFD). Commodity Credit Corporation bills MARAD on a quarterly basis for reimbursement of Incremental OFD, and MARAD routinely pays those bills. Reimbursement of these costs is not in dispute.

In any fiscal year in which shipping costs exceed 20 percent of total program costs,⁴ MARAD is also required to reimburse USDA for shipping costs that

³ Audit of USAID Cargo Preference Reimbursements under Section 901d of the Merchant Marine Act of 1936, dated March 30, 2001, audit number 9-000-01-003-P

⁴ Total Program Costs are total shipping costs plus the value of commodities.

exceed 20 percent of the program costs. This is referred to as “20 percent excess ocean freight.” The Commodity Credit Corporation is supposed to bill MARAD annually for the 20 percent excess ocean freight for those years when the excess provision applies. It is the calculation of the 20 percent excess ocean freight that is in dispute.

Both the Incremental OFD and 20 percent excess ocean freight payments are intended to reimburse the food assistance programs for a portion of the added costs of using U.S.-flag vessels. Commodity Credit Corporation returns the reimbursed amounts to the food assistance programs. This allows both USAID, which is responsible for the majority of annually appropriated food assistance, and USDA, which also supplies food overseas, to deliver more food.

FINDINGS AND RECOMMENDATIONS

We found that MARAD owes at least \$164 million for FY 1994 through FY 2000 and perhaps more, depending on how the payment dispute is resolved. MARAD may also owe additional amounts for FY 2001 through FY 2004, which have not yet been calculated or billed. The \$164 million amount should be disbursed immediately because MARAD owes at least this amount. This interim payment is reasonable as it reflects MARAD’s calculation methodology, the payment methodology used in the past. MARAD has also asserted that supporting documents (i.e., the underlying billings) are proper.

The reconciliation of USDA’s invoice for \$379 million and MARAD’s payment of \$164 million will require a legal determination by the Department of Transportation (DOT) General Counsel as to the appropriate method for calculating the amount owed. We anticipate an expeditious opinion from the General Counsel. In the interim, properly documented billings should be paid using the same rationale as this payment of \$164 million.

This protracted dispute must be resolved. Steps also need to be taken to ensure more timely submission of invoices and reimbursements in the future. In this regard, MARAD believes that the implementation of a commercially available electronic payment system could substantially lower freight costs and expedite the payment of invoices. MARAD, USDA, and USAID need to reexamine the billing and payment process to identify ways to accelerate the process. We are also recommending that MARAD report to the Secretary within 60 days on the agency’s progress implementing the recommendations in this report.

Calculating Excess Ocean Freight

We found that three alternative methodologies exist to calculate the 20 percent excess ocean freight, but a legal opinion is required to determine the proper methodology or, alternatively, whether discretion exists as to which method to apply. The differences relate to whether Incremental OFD payments that MARAD makes to USDA during the year should be deducted:

- From the total amount owed for 20 percent excess ocean freight,
- From shipping costs before calculating the 20 percent excess ocean freight amount, or
- Not at all.

The dispute centers on language contained in the Cargo Preference Laws and a 1987 Memorandum of Understanding (MOU) between MARAD, USAID, and USDA. The MOU indicates that when calculating the 20 percent excess ocean freight payment, the amount of Incremental OFD that MARAD had previously reimbursed to USDA should be deducted from the calculation. We have read the MOU and conclude that the text is ambiguous because it does not clearly describe where in the calculation Incremental OFD should be deducted. Also, it is not clear that the Cargo Preference Laws call for Incremental OFD to be deducted. In the case at issue, the cost to the Federal Government is not reduced simply because part of the cost (the difference between using U.S.-flag vessels and foreign-flag vessels) is borne by MARAD in the form of Incremental OFD.

MARAD believes that payments for Incremental OFD should be deducted from the total amount owed for 20 percent excess ocean freight. This methodology results in a lower reimbursement for 20 percent excess ocean freight than the methodology favored by USDA. MARAD points to the MOU as the basis for its methodology, but as indicated above, we believe the MOU is ambiguous.

USDA agrees that payments for Incremental OFD should be deducted. However, USDA's methodology deducts the Incremental OFD from shipping costs before calculating the 20 percent excess ocean freight. This methodology results in a higher reimbursement for 20 percent excess ocean freight. Like MARAD, USDA points to the MOU as the basis for its methodology.

Yet another possible method of calculating excess ocean freight is plausible. The Cargo Preference Laws do not contain an explicit provision directing that Incremental OFD previously paid by MARAD be deducted when calculating the 20 percent excess ocean freight amount. Not deducting the Incremental OFD results in the highest reimbursement for 20 percent excess ocean freight—higher than both MARAD's and USDA's methodologies.

The payment of \$164 million that we recommend is based on MARAD's methodology. We agree that this interim payment is reasonable because, by both MARAD's and USDA's calculations, MARAD owes at least \$164 million. Additionally, this is the same methodology used to calculate the prior payment, and MARAD and USDA have reviewed and agreed that the underlying documentation is accurate. A legal determination as to the appropriate methodology is needed to determine what additional amount is owed. DOT's General Counsel is currently reviewing the issues to determine the methodology that should be used to calculate 20 percent excess ocean freight. We anticipate an expeditious opinion from the General Counsel. In the interim, properly documented billings should be paid using the same rationale as this payment of \$164 million.

Timely Billings and Payments in the Future

In our opinion, the processes for reimbursing the Incremental OFD and the 20 percent excess ocean freight take far too long. The reimbursement process for Incremental OFD takes several years to complete. To illustrate, MARAD received and paid invoices in March 2004 for Incremental OFD for the period July 2001 through September 2001 and the period January 2003 through March 2003.

The amount due for 20 percent excess ocean freight cannot be determined until all costs are reported for the fiscal year. It also takes several years to process the 20 percent excess ocean freight payments. For example, USDA's initial invoice for FY 2000 was not received until July 2003, and it was found to be incomplete and was returned to USDA. Both MARAD and USDA estimate that a reimbursement is due for FY 2000 of \$126 million or \$156 million, respectively. MARAD has also not received invoices for FYs 2001, 2002, and 2003.

MARAD officials believe that implementing an automated system would expedite the payment of invoices and substantially lower shipping costs. They recommend using a commercial system used by the Department of Defense called PowerTrack. According to Department of Defense officials, PowerTrack has significantly accelerated the payment process while improving its transportation management. However, USAID officials were concerned that USAID's shipping costs could increase using this particular system. In addition, neither MARAD, USAID, nor the Department of Defense could readily provide an analysis of the system's costs and benefits. We believe the cargo preference program clearly needs to reexamine its processes to eliminate the extensive delays and that an automated system could be part of the solution. An economic and operational analysis would be needed to determine whether this system or another would be cost-beneficial.

RECOMMENDATIONS

We recommend that the MARAD Administrator:

1. Pay USDA \$164 million immediately.
2. Pay any additional amount due to USDA in accordance with the methodology identified by DOT's General Counsel and, if necessary, take the appropriate steps to revise the MOU accordingly.
3. Explore, in coordination with USDA and USAID, ways to expedite the payment process, including implementing an automated payment method.
4. Report to the Secretary within 60 days on MARAD's progress implementing these recommendations.

OTHER MATTERS

In addition to the issues surrounding the invoice submitted by USDA for 20 percent excess ocean freight, a proposed rulemaking to update and clarify MARAD's cargo preference regulations is being considered. MARAD's proposed rulemaking, among other matters, seeks to define the type of vessels subject to cargo preference requirements for U.S.-flag vessels. Although these regulations are not directly germane to the payment dispute, they would affect the conduct of cargo preference responsibilities of MARAD, USDA, and USAID.

The proposed rulemaking and its antecedents have proven to be controversial and stem from current and past litigation. They appeal to U.S.-flag vessel operators because they will result in stricter compliance with the minimum cargo preference for each class of vessels and, therefore, increased carriage on U.S.-flag vessels. However, USDA and USAID are concerned because the proposed rulemaking will reduce their discretion to select cargo vessels, resulting in higher costs and, ultimately, reducing the amount of funds available for purchasing commodities.

MANAGEMENT COMMENTS

Responsible MARAD officials provided oral comments on a draft of this report. They stated that they agreed with the report's findings and recommendations.

ACTION REQUIRED

In accordance with Department of Transportation Order 8000.1C, within 30 days, please provide the specific actions taken or planned, including specific target dates to implement the recommendations.

We appreciate the courtesies and cooperation of MARAD representatives during this audit. If you have any questions concerning this report, please call Ted Alves, Assistant Inspector General for Financial and Information Technology Audits, at (202) 366-1496 or Alvin Brown, Program Director, at (202) 366-4350.

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EXHIBIT A. SCOPE AND METHODOLOGY

An Office of Management and Budget (OMB) official requested that we review the cargo preference dispute between MARAD and USDA and assess to what extent MARAD is liable for the \$379 million invoice from USDA. Officials from MARAD also requested our assistance to review the matter. On April 23, 2004, MARAD presented an Ocean Freight Differential Issue Paper to DOT senior management and the OMB official. Our objectives were to:

- Review the nature of the cargo preference dispute between MARAD and USDA, and
- Provide assurance that MARAD's proposed payment of \$164 million was supportable and reasonable.

We conducted this engagement in accordance with Government Auditing Standards. We applied attestation standards published by the American Institute of Certified Public Accountants for review of management's assertions.

We reviewed MARAD's assertions contained in its Ocean Freight Differential Issue Paper. Our scope was limited to reviewing the assertions made by management. Those assertions are the responsibility of management. Our responsibility is to comment on those assertions, based on our review. This report provides no basis for any other conclusions other than those discussed here.

In performing our review, we made inquiries, reviewed relevant documents, held meetings, and interviewed MARAD senior executives, USAID procurement officials, as well as Department of Defense officials from the Office of the Inspector General and the Defense Finance and Accounting Service. Additionally, we discussed the legal issues with our Counsel.

We reviewed the Cargo Preference Laws, a Comptroller General's decision of February 1955 (B-95832), and the 1987 Memorandum of Understanding between MARAD and USAID.

We reviewed the \$379 million dollar invoice and attachments submitted by USDA. We observed MARAD's process for evaluating the invoice. Using total shipping, total Incremental OFD, and total value of commodities determined from MARAD's records, we recalculated the amounts due using the methodologies of USDA, MARAD, and no deduction of Incremental OFD. Our focus was to determine the degree of risk for overpayment.

Exhibit A. Scope and Methodology

We compared the methodology for calculating the March 15, 2004 invoice with the methodology for computing payment on an invoice for 20 percent excess ocean freight in 1992 to ensure consistency in payment methodology by MARAD. MARAD computed the current invoice using the same methodology that it used to pay the 1992 invoice. We also talked to USDA officials to determine what methodology was used to calculate past invoices. Their methodology was different than MARAD's, but they consistently submitted invoices calculated in USDA's manner. However, payment was made using MARAD's calculation method.

We held discussions with management at MARAD and USAID concerning PowerTrack. We conducted internet searches and read both Department of Defense Inspector General and General Accounting Office reports related to PowerTrack to obtain an understanding of the advantages and disadvantages related to implementation of the payment system. Additionally, we discussed the systems costs and benefits with a project manager at the Department of Defense.

We also contacted USAID Office of Inspector General to gain an understanding of the audit work performed to support its 2001 audit of USAID's cargo preference reimbursements.

We conducted our fieldwork from March to May 2004.

EXHIBIT B. METHODOLOGIES TO CALCULATE 20 PERCENT EXCESS OCEAN FREIGHT

Despite the provisions in the Cargo Preference Statute and MOU signed by both parties, MARAD and USDA cannot agree on a methodology for calculating 20 percent excess ocean freight. Further, the Act and the MOU are ambiguous regarding the role of Incremental OFD when calculating the 20 percent excess cargo freight amount due from MARAD. Because the law and the MOU are ambiguous, this dispute requires a legal interpretation.

The Food Security Act of 1985 amends the cargo preference statute, which required MARAD to reimburse USDA for the amount of shipping costs that exceed 20 percent of shipping costs plus the value of commodities.

Specifically, the Act states,

SEC. 901d. 46 U.S.C. App. 1241h (a) The Secretary of Transportation shall finance any increased ocean freight charges incurred in any fiscal year which result from the application of section 901b. (b) If in any fiscal year the total cost of ocean freight and ocean freight differential for which obligations are incurred by the Department of Agriculture and the Commodity Credit Corporation on exports of agricultural commodities and products thereof under the agricultural export programs specified in section 901b(b) exceeds 20 percent of the value of such commodities and products and the cost of such ocean freight and ocean freight differential on which obligations are incurred by such Department and Corporation during such year, the Secretary of Transportation shall reimburse the Department of Agriculture and the Commodity Credit Corporation for the amount of such excess. For the purpose of this subsection, commodities shipped from the inventory of the Commodity Credit Corporation shall be valued as provided in section 403(b) of the Agricultural Trade Development and Assistance Act of 1954 (7 U.S.C.1733(b)).

In 1987, USDA, MARAD, and USAID signed the MOU explaining the responsibilities of all the parties in regards to cargo preference reimbursements.

However, this provision is ambiguous on whether to deduct Incremental OFD from shipping costs before calculating 20 percent excess ocean freight—USDA’s methodology—or to deduct Incremental OFD from 20 percent excess ocean freight at the end of the calculation—MARAD’s methodology. Each party believes that its calculation complies with this MOU.

According to the MOU:

MARAD shall pay to CCC [Commodity Credit Corporation] the amount, if any, by which the total of the ocean freight and OFD [ocean freight differential] borne by CCC exceeds 20 percent of the total value of the commodities shipped, ocean freight and OFD for all USDA/CCC programs for each of the fiscal years beginning in 1986 (last six months), and thereafter.

Any amount of Incremental OFD paid to CCC by MARAD for each fiscal year shall be deducted from the OFD computation in paragraph 1 above.

Assume the following were true for one fiscal year.

Value of Commodities	\$70.00
Shipping Costs	\$30.00
Incremental OFD	\$2.00

Program costs would equal the value of commodities plus shipping costs or \$100.00 (\$70.00 + \$30.00).

Each methodology would result in the following.

MARAD

MARAD believes that payments for Incremental OFD should be deducted from the total amount owed for 20 percent excess ocean freight. MARAD determines the amount of shipping costs that exceeds 20 percent of program costs (shipping costs plus the value of commodities) and then deducts any amount previously reimbursed as Incremental OFD from that amount to determine the amount due to USDA for 20 percent excess ocean freight.

	Shipping Costs	\$30.00
Less	20% x (Value of Commodities + Shipping Costs) (.20 x [\$70 + \$30])	<u>(\$20.00)</u>
Equals	20% Excess Ocean Freight	\$10.00
Less	Incremental OFD	<u>(\$2.00)</u>
Equals	Amount Due to USDA for 20% Excess Ocean Freight	\$8.00

USDA

USDA deducts Incremental OFD from shipping costs before calculating the 20 percent excess of ocean freight to determine the amount due to USDA for 20 percent excess ocean freight.

	Shipping Costs	\$30.00
Less	Incremental OFD	<u>(\$2.00)</u>
Equals	Net Shipping Costs	\$28.00
Less	20% x (Value of Commodities + Net Shipping Costs) (.20 x [\$70+\$28])	<u>(\$19.60)</u>
Equals	Amount Due to USDA for 20% Excess Ocean Freight	\$8.40

No Deduction of Incremental OFD

The Cargo Preference Laws, as amended, do not explicitly state that Incremental OFD should be deducted when calculating the 20 percent excess ocean freight amount.

	Shipping Costs*	\$30.00
Less	20% x (Value of Commodities + Shipping Costs) (.20 x [\$70 + \$30])	<u>(\$20.00)</u>
Equals	Amount Due to USDA for 20% Excess Ocean Freight	\$10.00
*No deduction of \$2 for Incremental OFD		

Exhibit B. Methodologies to Calculate 20 Percent Excess Ocean Freight

EXHIBIT C. MAJOR CONTRIBUTORS TO THIS REPORT

THE FOLLOWING INDIVIDUALS CONTRIBUTED TO THIS REPORT.

<u>Name</u>	<u>Title</u>
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