
Office of Inspector General

REAUTHORIZATION OF THE MARITIME ADMINISTRATION

Maritime Administration

Report Number: MA-2000-093

Date Issued: June 21, 2000





Memorandum

**U.S. Department of
Transportation**

Office of the Secretary
Of Transportation

Office of Inspector General

Subject: ACTION: Reauthorization of the Maritime
Administration, MA-2000-093

Date: June 21, 2000

From: Alexis M. Stefani
Assistant Inspector General for Auditing

Reply to JA-40
Attn of:

To: Maritime Administrator

On May 16, 2000, at a hearing before the Committee on Commerce, Science, and Transportation, U.S. Senate, we provided testimony on the Reauthorization of the Maritime Administration (MARAD). A copy of our statement is attached for your information. Our testimony addressed the following three issues:

- (1) The approval and subsequent default on the Title XI loan guarantee for the Quincy Shipyard in Massachusetts;
- (2) MARAD's growing inventory of obsolete vessels and actions needed to scrap them; and
- (3) The need for improved controls related to the administration of contracts for maintaining Ready Reserve Force (RRF) vessels.

Our testimony was based on recent reports, dating from November 1997 to September 1999, on the Massachusetts Heavy Industries (MHI), Inc. Title XI Loan Guarantees (Report Numbers MA-1998-007, MA-1998-048, MA-1999-115, and MA-1999-127); our March 10, 2000 report on the Maritime Administration's Program for Scrapping Obsolete Vessels (Report Number MA-2000-067); and on our reports on the Ready Reserve Force Ship Manager Contracts, dating from September 1991 to May 2000 (Report Numbers AV-MA-1-034, AV-MA-3-013, and MA-2000-096). A copy of our written statement is attached.

Quincy Shipyard

Since 1997, we have issued four reports related to the loan guarantee. Our primary concern throughout has been the absence of any firm contracts to build ships once the shipyard is completed. There was always a six-ship foreign deal requiring another MARAD loan guarantee dangling as a possibility - but it never materialized and

always appeared doubtful as a source of future revenue for the shipyard. MARAD was responsive to the majority of our recommendations, but stated the congressional directive to waive the economic soundness criteria prevented it from acting on our recommendations to require evidence of contracts or sources of income.

Ship Scrapping

We also testified that MARAD has made limited progress in disposing of its obsolete vessels. It currently has 114 vessels awaiting disposal that require continued maintenance at taxpayer expense. It expects to have 155 vessels awaiting disposal by the end of fiscal year (FY) 2001. MARAD is under a legislative mandate to dispose of these vessels by September 30, 2001. MARAD will not meet this mandate. Since 1995, it has sold 22 vessels, and only seven of those have been scrapped.

In our March 10, 2000 Report Number MA-2000-067, we recommended that MARAD: (1) seek legislative approval to extend the 2001 disposal deadline for its obsolete vessels and eliminate the requirement to maximize financial returns on vessel sales; (2) continue to pursue programs to improve scrapping sales and identify alternative disposal methods; and (3) develop a proposal for submission to Congress seeking approval and funding to pay contractors for scrapping, targeting the 40 "worst condition" vessels first. MARAD concurred with our recommendations.

However, MARAD's proposed legislation did not seek approval to eliminate the requirement to maximize financial returns or to seek approval to pay contractors to scrap the 40 "worst condition" vessels. Instead, in its FY 2001 authorization request, MARAD proposed a five-year extension "to develop and **begin implementing** a plan to dispose of these ships." In our opinion, as stated in our testimony, it is unacceptable to **begin** disposal within five years considering the condition of some of the ships, the environmental risks, and the costs to maintain them. Therefore, we are now recommending that MARAD develop a disposal plan and substantially dispose of these ships **within five years**. In this plan, MARAD should:

- (1) identify viable disposal methods such as selling vessels to other countries for non-military uses and paying contractors for vessel scrapping;
- (2) set milestone dates for disposing of its obsolete vessels within five years; and
- (3) target the "worst condition" vessels first.

If legislation is required to implement the disposal plan, we recommend that MARAD seek legislative approval to proceed with this plan.

Ready Reserve Force Maintenance Contracts

In our testimony pertaining to the administration of maintenance contracts for MARAD's Ready Reserve Force, we stated that we have participated in a joint law enforcement task force led by the Federal Bureau of Investigation for the past several years. The investigation focused on bribery, fraud, and kickbacks involving maintenance of Military Sealift Command ships and MARAD's Ready Reserve

Force. In August 1999, the Department of Justice announced 23 indictments and informations, as a result of the investigation. Two MARAD employees pleaded guilty to accepting unlawful gratuities from contractors, and MARAD and the Navy took action to debar or suspend 22 companies and individuals.

We recently performed an audit to evaluate the adequacy of MARAD's control systems related to maintenance contracts. However, we found that the administration of contracts with ship managers and general agents needed improvement. We recommended that MARAD: (1) instruct regional employees on existing procedures for processing invoices and provide sufficient oversight to ensure that these procedures are followed; (2) provide detailed, self-explanatory work statements, specifications, or descriptions on all work orders; (3) periodically review open and inactive work orders to identify those that should be closed, and reprogram any remaining funds; and (4) reinstate periodic reviews of ship manager procurement actions, including documentation justifying sole-source subcontractor awards and indications of split purchases. MARAD concurred with our recommendations. Based on our findings, reflected in Report Number MA-2000-096, MARAD has agreed to strengthen its controls for administering ship managers' contracts.

In accordance with the Department of Transportation Order 8000.1C, we would appreciate receiving your response within 30 days. If you concur with the recommendation to develop a disposal plan and substantially dispose of these vessels within five years, please indicate the specific actions taken or planned and target dates for completion of this action. If you do not concur, please provide your rationale. Furthermore, you may provide alternative course of action that you believe would resolve the issue.

If I can answer any questions or be of further assistance, please feel free to contact me at (202) 366-1992, or Thomas J. Howard, Deputy Assistant Inspector General for Maritime and Departmental Programs, at (202) 366-5630.

Attachment

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Mr. Chairman and Members of the Committee:

We appreciate the opportunity to be here today to discuss the reauthorization of the Maritime Administration (MARAD). Our statement focuses on three issues:

- (1) The approval and subsequent default on the Title XI loan guarantee for the Quincy Shipyard in Massachusetts,
 - (2) MARAD's growing inventory of obsolete vessels and actions needed to scrap them, and
 - (3) The need for improved controls related to the administration of contracts for maintaining Ready Reserve Force (RRF) vessels.
- **Title XI Loan Guarantee to Massachusetts Heavy Industries (MHI) / Quincy Shipyard Fails**

Title XI of the Merchant Marine Act of 1936, as amended, established the Federal Ship Financing Guarantee Program. Under Title XI, businesses secure loans in the private sector, and the U.S. Government guarantees repayment in the event of default.

As of April 2000, Title XI guarantees totaled approximately \$4 billion and covered approximately 81 individual shipowners operating 600 vessels and 8 shipyard modernization projects. Of the approximate \$7 billion in Title XI guarantees issued since 1985, MARAD has experienced only two defaults—a vessel for \$1.7 million, and MHI. The goal of the MHI / Quincy Shipyard project was to bring the once prominent shipbuilding industry back to Massachusetts.

On December 19, 1995, MHI submitted an application for a \$55 million loan guarantee to MARAD to reactivate and modernize the former Fore River Shipyard in Quincy, Massachusetts. MARAD was required to ensure the economic soundness of the loan guarantee application prior to its approval. In other words, MARAD had to see that MHI could produce the income necessary to repay the loan. Because the application did not include any firm shipbuilding contracts, MARAD questioned the economic soundness of MHI's proposal and rejected the application.

As a result of Congressional interest in the MHI / Quincy project, the Coast Guard Authorization Act of 1996 contained a provision waiving the Title XI economic soundness requirement for reactivation and modernization of closed shipyards in the United States. This provision was enacted only for one year and expired in

1997. Under this provision, MARAD concluded that the MHI application qualified for a Title XI loan guarantee. On November 1, 1996, MARAD approved the loan guarantee and issued a \$55 million letter commitment to MHI.

Prior to closing on the loan guarantee, MARAD appropriately took a number of actions to protect the Government's interest. MARAD identified 28 significant requirements for MHI to complete, including granting a first priority lien on all assets to the Secretary of Transportation and establishing a MARAD-controlled escrow account for disbursing the loan.

In June 1999, MHI missed its scheduled loan payment and asked to defer that payment until December 1999. With the lender's concurrence, MARAD approved the deferral.

MHI made progress on the shipyard modernization until August 1999, when a dispute arose with the general contractor. MHI had torn down and refurbished buildings, purchased and began installing equipment, and made repairs to reactivate cranes. Approximately \$47 million was spent out of the escrow fund to cover these and other expenses. However, the shipyard is not operational and considerable work remains to be done. The drydocks have not been repaired, equipment is still in crates, and machinery has been exposed to the elements. The Environmental Protection Agency (EPA) has advised MARAD that there are environmental problems in the shipyard that require remediation. MARAD estimates that cleanup costs could approach \$1 million.

When it became apparent that MHI did not have the resources to make its future loan payments, MARAD again acted to protect the Government's interest. In September 1999, MARAD froze the balance in the escrow account and conducted an inventory of all assets at the shipyard.

In January 2000, after MHI missed its December 1999 payment, the bank made a payment demand on the loan guarantee. MARAD paid \$59.1 million to settle the guarantee on February 25, 2000. However, the ultimate loss to the Government, and, ultimately the taxpayer, will be offset by the balance in the loan escrow account (\$12 million), the original subsidy provided by the State of Massachusetts (\$6.6 million plus accrued interest), the loan guarantee fees (\$2.6 million), and whatever amount is recovered through liquidation.

Although MARAD has a first priority lien, the amount that can be recovered through liquidation cannot be determined at this time. First, the value of the shipyard and equipment is uncertain so MARAD has initiated an independent appraisal. Also, the resolution of MHI's plea to reorganize because of bankruptcy could impact MARAD's ability to recover additional funds.

Even before the loan guarantee was approved, this Committee asked us to review MARAD's actions to ensure taxpayer interests were protected. Since 1997, we have issued four reports related to the loan guarantee. Our primary concern throughout has been the absence of any firm contracts to build ships once the shipyard is completed. There was always a 6-ship foreign deal requiring another MARAD loan guarantee dangling as a possibility—but it never materialized and always appeared doubtful as a source of future revenue for the shipyard. MARAD was responsive to the majority of our recommendations, but stated the Congressional directive to waive the economic soundness criteria prevented it from acting on our recommendations to require evidence of contracts or sources of income.

- **MARAD's Inventory of Obsolete Vessels Is Growing, A Realistic Disposal Plan Is Needed**

MARAD currently has 114 obsolete vessels awaiting disposal that require continued maintenance at taxpayer expense. MARAD is under a legislative mandate to dispose of its obsolete vessels by 2001 in a manner that will yield financial benefits. MARAD will not meet these requirements.

Environmental dangers associated with these old, deteriorating ships increase daily. The so-called "worst condition" vessels are about 50 years old and have been awaiting disposal 22 years on average. These vessels contain hazardous materials such as PCBs, asbestos, and fuel oil. Some vessels have deteriorated to the point where a hammer can penetrate their hulls. In addition, the inventory of obsolete vessels awaiting disposal is increasing, and MARAD expects to have 155 by the end of fiscal year (FY) 2001.

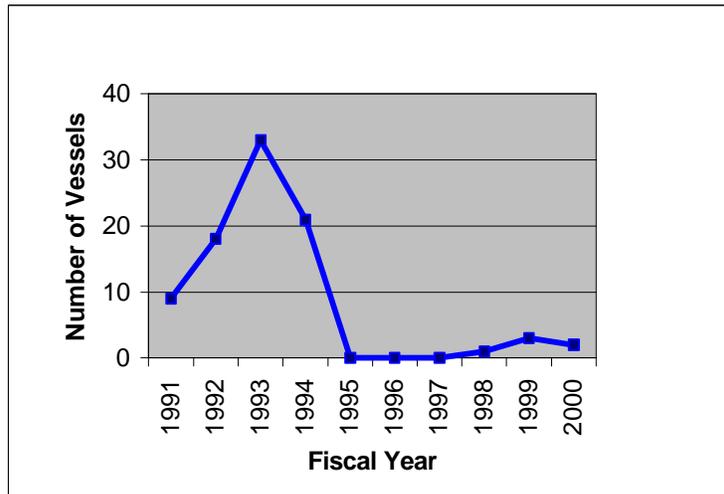
Vessels Awaiting Disposal at Suisun Bay Reserve Fleet



MARAD stopped selling vessels overseas for scrapping in 1994 due to EPA restrictions. In 1998, the Administration placed a moratorium on all sales of vessels for scrapping overseas. Although the moratorium expired in October 1999, MARAD has refrained from exporting obsolete vessels.

Since 1995, few vessels have been scrapped because there is limited domestic scrapping capacity. Although MARAD sold 22 vessels to domestic scrappers, only 7 have been scrapped. Last month two additional vessels were towed to scrapping sites. The remaining 13 vessels are still in MARAD's Fleet, and recent contractor defaults raise a question as to whether these vessels will be removed. This represents a significant change from 1991 through 1994 when 80 ships were sold overseas at an average price of \$433,000 per vessel. Recent sales yielded between \$10 and \$105 per vessel.

MARAD Vessels Scrapped



The current approach of selling obsolete vessels for domestic scrapping will not work in today's marketplace. MARAD cannot compete with a Navy pilot program that is paying contractors to scrap obsolete warships while it is asking contractors to pay to scrap its vessels. A program similar to the Navy's would require about \$500 million to scrap the 155 vessels MARAD expects to have for disposal in 2001.

While MARAD has been pursuing ways to improve scrapping sales, its ability to explore creative solutions for disposing of vessels is constrained by the requirement to maximize financial returns. Also, the programs and alternatives MARAD is pursuing have capacity limitations and, therefore, do not have the potential to significantly reduce the backlog of vessels in a timely manner. These

alternatives include: coordinating with the Navy and a west coast company on a proposal for a potential scrapping site; participating in interagency work groups to look for innovative ways to improve the ship scrapping process; and requesting approval from EPA to sell vessels to overseas markets.

We recently recommended that the Maritime Administrator seek legislative approval to obtain an extension on the disposal mandate and eliminate the requirement to gain financial returns on vessel sales. We also recommended that MARAD develop a proposal seeking authority and funding to pay contractors to scrap vessels, and target the “worst condition” vessels for priority disposal.

In its authorization request for FY 2001, MARAD proposed a 5-year extension “to develop and **begin implementing** a plan to dispose of these vessels.” We do not believe it is acceptable to begin disposal within five years considering the condition of some of the vessels, the environmental risks, and the costs to maintain them. In our opinion, the legislation should require MARAD to develop a disposal plan and substantially dispose of these vessels **within 5 years**.

- **Internal Controls Over Maintenance Contracts for RRF Vessels Need to Be Strengthened**

Since 1996, we have participated in a joint law enforcement task force led by the FBI. The task force investigated bribery, fraud, and kickbacks involving contracts for vessels in the Military Sealift Command and MARAD’s Ready Reserve Fleet.

In August 1999, the Department of Justice announced 23 indictments and informations, as a result of the investigation. Two MARAD employees pleaded guilty to accepting unlawful gratuities from contractors, and MARAD and the Navy took action to debar or suspend 22 companies and individuals.

In light of the problems identified in the investigation, we reviewed MARAD’s internal controls for the ship manager program. We found that MARAD implemented effective policies and procedures relating to the award of the ship managers’ contracts. However, the administration of these contracts and those covering general agents needed improvement.

Specifically MARAD:

- Advanced \$63 million to general agents without supporting documentation that costs were incurred,
- Allowed ship manager contractors to issue numerous noncompetitive subcontracts without required documentation, and

- Did not consistently ensure payments were for actual costs incurred and were related to the work performed.

MARAD agreed to strengthen its controls for administering ship managers' contracts. MARAD officials must now follow through on the actions they agreed to take.

TITLE XI LOAN GUARANTEE TO MASSACHUSETTS HEAVY INDUSTRIES (MHI) / QUINCY SHIPYARD FAILS

Title XI of the Merchant Marine Act of 1936 (as amended) authorizes the Secretary of Transportation to make loan guarantees to finance the construction, reconstruction, or reconditioning of eligible export vessels and the modernization and improvement of shipyards. Under this Title XI program, which is administered by MARAD, businesses secure loans in the private sector, and repayment is guaranteed by the U.S. Government. One of the criteria for eligibility for most loan guarantees is that the applicant's proposed project be economically sound.

Original Modernization Proposal Did Not Meet Title XI Criteria

On December 19, 1995, MHI submitted to MARAD an application for a loan guarantee of \$55 million to reactivate and modernize the closed Fore River Shipyard located in Quincy, Massachusetts. The shipyard historically built military vessels, and MHI was seeking to reactivate it as an internationally competitive commercial shipyard. Because MHI's proposal did not include firm shipbuilding contracts, there were questions as to whether the shipyard would generate sufficient revenue to repay the guaranteed loan. MARAD concluded that

the criterion that projects be economically sound was not met and rejected this application.

Congress Waived Economic Soundness Criteria

As a result of Congressional interest, the Coast Guard Authorization Act of 1996 contained a provision temporarily amending a key requirement of the Title XI loan guarantee program. Specifically, the amendment waived the economic soundness requirement for reactivation and modernization of closed shipyards in the United States. MARAD concluded that MHI's application for the closed Fore River Shipyard qualified for consideration under the amendment.

Although the amendment waived the economic soundness requirement, it required the Secretary of Transportation to "impose such conditions . . . as are necessary to protect the interests of the United States from the risk of default." On November 1, 1996, MARAD approved the loan guarantee and issued a \$55 million letter commitment to MHI for reactivating the closed shipyard.

MARAD Acted to Protect the Government Interest Prior to Loan Guarantee Approval

The letter commitment contained 28 significant provisions to protect the interests of the U.S. Government including requirements that:

1. The State of Massachusetts deposit \$6.6 million in cash, bonds, or a letter of credit to be held in a financing account (this amount equates to the required subsidy rate of 12 percent);
2. MHI have at least \$3 million in capital available to ensure its ability to operate as a going concern to support normal operating expenses and routine start-up costs associated with the proposed project;
3. MHI have \$2.6 million of its own funds available for use on the project to ensure that MHI stockholders have a personal stake in the project;

4. MHI grant the Secretary of Transportation a **first priority lien on all assets**, land, and other real and personal property owned or acquired by MHI to ensure, in case of default on the loan guarantee by MHI, that the U.S. Government has the right to assume ownership and sell the property to recover its funds; and
5. MHI deposit proceeds from the loan into an escrow account controlled by the Secretary of Transportation.

MARAD Recognized the Loan Guarantee to MHI Was High Risk

In order to limit the Government's potential losses, Title XI loan guarantee applicants (or in this case the State of Massachusetts) are required to submit to MARAD, at the beginning of the loan, resources to cover a percentage of the loan. This percentage, known as the subsidy rate, depends on MARAD's assessment of the applicant's risk of default. The higher the risk, the larger the subsidy rate.

MARAD assesses the risk of an applicant's default by assigning points to 10 different factors, weighted by importance. Also, subsidy rates can change over the term of the loan guarantee if the risk changes. To keep the subsidy rate in line with the risk, the Office of Management and Budget requires reassessments if actual events differ from the assumptions of the original assessment.

On November 7, 1997, prior to closing on the loan guarantee, we reported that MARAD had held MHI to the requirements of the letter commitment and followed applicable Title XI loan guarantee regulations. Our report recommended MARAD: (1) reassess the risk factor rating for MHI's application, and when reassessed, take appropriate actions; (2) require evidence of shipbuilding contracts or alternative sources from which revenues could be generated to repay the guaranteed loan; and (3) ensure MHI fulfills the remaining requirements contained

in the letter commitment. While MARAD generally agreed with the recommendations, it was unable to implement the first two recommendations.

Based on a legal opinion by the Office of the Secretary of Transportation's Deputy General Counsel, dated November 12, 1997, MARAD concluded it had no legal authority to reassess the risk factor rating prior to closing. MARAD also said that the Coast Guard Authorization Act precluded it from requiring MHI's project to meet the economic soundness provision and was precluded from requiring evidence of viable shipbuilding contracts or alternative sources from which revenues could be generated to repay the guaranteed loans because these requirements were not stipulated in MARAD's letter commitment.

On December 17, 1997, we reported (Report Number MA-1998-048) our concern that MARAD was not planning to reassess the risk factor on the loan guarantee prior to closing. MARAD agreed to reassess the risk but suggested delaying any reassessment of risk until the last quarter of 1998, thereby giving MHI the opportunity to demonstrate that modernization is underway and that MHI is "aggressively marketing its products."

In a July 31, 1998 memorandum from the acting MARAD Administrator, we were informed that MARAD had "... completed a reestimation of the risk rating of MHI and can find no basis to change our original estimate. . . ." The assessment attached to the memorandum showed that the loan guarantee was rated as *high risk*.

MARAD's July 31, 1998 memorandum also stated that "The only change in the circumstances underlying our assessment is that MHI has entered into a technology transfer agreement with South Korea's Halla Engineering and Heavy Industries, one of the most advanced yards in Asia." This change would enable

MARAD to assign MHI more points for "Historical Experience," but the additional points would not be sufficient to change the overall risk assessment. The memorandum also stated that MHI was actively pursuing a shipbuilding project with Intermare, a ship owner.

An application for a Title XI loan guarantee, for the project with Intermare, was received by MARAD in February 1996. Although there were major outstanding issues regarding this shipbuilding project, MARAD stated there was a reasonable basis to conclude that the Intermare proposal was still viable.

Risk of Default by MHI Materially Increased

In June 1999, MHI defaulted on its \$1.55 million "interest only" payment owed to Fleet National Bank. A May 27, 1999 letter to MARAD, from attorneys representing MHI, cited unavoidable delays in reactivating the shipyard. According to the letter, the delays increased costs, and funds for the June 1999 payment were used instead for shipyard construction. MHI's attorneys requested approval from MARAD to delay the June 1, 1999 payment for 6 months (until December 1, 1999). In a written reply to MHI, dated July 7, 1999, MARAD requested MHI provide specific additional information demonstrating that the shipyard will be a going concern after completion of the reactivation. According to MARAD, this information was needed to assess the reasonableness of MHI's extension request. MARAD received this information in late July and early August 1999.

MHI's failure to make the June 1, 1999 payment, the request for a 6-month extension to make the payment, and lack of a shipbuilding project indicated a major change in MHI's risk of default.

On July 20, 1999 (Report Number MA-1999-115), we recommended that MARAD:

1. Reassess the risk factor rating for MHI's loan guarantee as prescribed by OMB Circular Number A-11, and make the required adjustment to the subsidy rate.
2. Ensure it has all of the information required by the Title XI program to protect the interests of the United States from default prior to making a decision on MHI's request to defer its June 1, 1999 payment.
3. Ensure that MHI provides complete and current information as required by the Title XI program prior to making a decision on the loan guarantee application by Intermare.

In its August 6, 1999 response to our report, MARAD advised us that it would reassess the risk factor rating by December 1, 1999. According to MARAD, this would "allow sufficient time for the shipyard modernization to be completed and for MARAD to determine whether MHI will be able to finalize the Intermare shipbuilding contract on a viable basis."

On July 12, 1999, the mortgage holder informed MARAD that it intended to make a demand for payment under the guarantee on or about August 1, 1999, unless MHI's request to defer the missed payment was approved. On August 6, 1999, MARAD approved the deferral of MHI's missed June 1, 1999 "interest only" loan payment to December 1, 1999.

Work on Shipyard Modernization

On August 17, 1999, MHI's general contractor (and its subcontractors) for the shipyard modernization project walked off the job because of payment disputes of \$3 million. The general contractor claimed it had not been paid since April 1999, when only a partial payment was made. On August 30, 1999, MARAD: (1) declared contractor default and formally terminated MHI's general contractor for

the shipyard modernization project, and (2) called on the surety company to perform under the terms and conditions of the performance bond.

In a September 15, 1999 report (Report Number MA-1999-127), we recommended that MARAD take action to immediately freeze the uncommitted balance in MHI's escrow account, conduct a physical inventory of all assets and property owned by MHI, and ensure the assets and property are safeguarded from loss or unauthorized disposition. MARAD agreed with our recommendations and took the necessary actions.

MHI Failed to Make Loan Payments and Bank Called Loan Due

On December 1, 1999, MHI missed its deferred "interest only" payment, as well as its regularly scheduled principal and interest loan payment to Fleet Bank. During the 30-day grace period, MARAD approved an extension to January 29, 2000 to make the payment. During this period, MHI continued to request additional extensions. On January 28, 2000, Fleet National Bank made a demand for payment under the MARAD guarantee.

On February 25, 2000, MARAD paid off the Fleet Bank loan of \$59.1 million and ordered MHI personnel to vacate the shipyard. MARAD immediately recovered \$12 million from MHI's escrow account and applied \$6.6 million plus accrued interest that was deposited by the State of Massachusetts and the \$2.6 million in loan guarantee fees to the payoff, thereby lowering MARAD's exposure to \$36.6 million. This exposure will be further reduced because MARAD has first priority lien in liquidation proceedings. The value of the shipyard, and equipment in it, is unknown at this time. On May 8, 2000, MARAD contracted to have the shipyard real estate and equipment appraised.

After paying off Fleet Bank, MARAD presented a claim to MHI for \$47 million, plus accrued interest, on the principal amount.

On March 13, 2000, MHI sought bankruptcy protection under Chapter 11 of the U.S. Bankruptcy Code. MHI has until July 11, 2000, to propose a reorganization plan in U.S. Bankruptcy Court. However, MARAD is scheduled to ask the Court to permit it to foreclose on MHI.

Last week, the EPA advised MARAD that there are environmental problems in the shipyard that require remediation. MARAD estimates that cleanup costs could approach \$1 million.

MARAD IS MAKING LITTLE PROGRESS SCRAPPING ITS OBSOLETE VESSELS

The Merchant Ship Sales Act of 1946 created the National Defense Reserve Fleet (NDRF), a Government-owned and administered Fleet of inactive, but potentially useful, merchant and non-military vessels to meet shipping requirements during National emergencies. MARAD administers the Fleet, and the Department of Defense provides the funding to maintain the Fleet. The Federal Property and Administrative Services Act gave MARAD responsibility for disposing of all Federal Government **merchant-type** vessels of 1,500 gross tons or more. The National Maritime Heritage Act of 1994 required MARAD to dispose of obsolete vessels in the Fleet by September 30, 1999, in a manner that *maximizes financial return to the United States*, but the Act was amended to extend the original disposal date by 2 years, from 1999 to 2001.

Current Inventory and Age of Vessels

As of April 30, 2000, 114 obsolete vessels were designated for disposal because the majority of them are no longer operational. Ninety-one of the 114 vessels are slated for scrapping. The remaining 23 vessels will be disposed of through the fish reef program, used by a state or Federal agency, or held for useful parts and equipment.

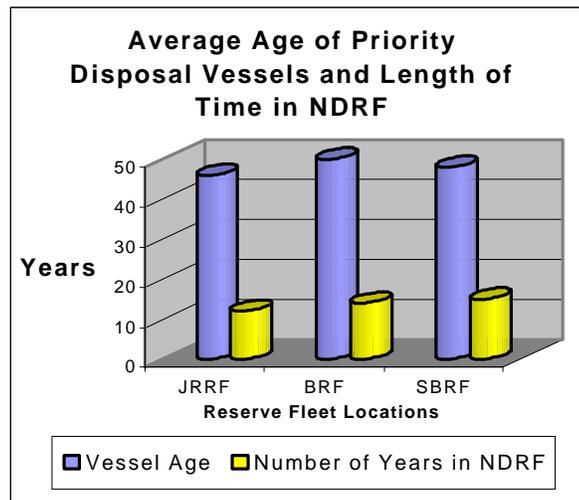
MARAD maintains the inactive vessels in the water at the following locations:

- James River Reserve Fleet (JRRF) at Ft. Eustis, Virginia (61 vessels);
- Beaumont Reserve Fleet (BRF) in Beaumont, Texas (9 vessels); and
- Suisun Bay Reserve Fleet (SBRF) in Benecia, California (42 vessels).

The Coast Guard holds two vessels in Mobile, Alabama.

As shown in the following chart, the average age of the 114 obsolete vessels is 48 years. These vessels have been in the Fleet for an average of 15 years.

Average Vessel Age



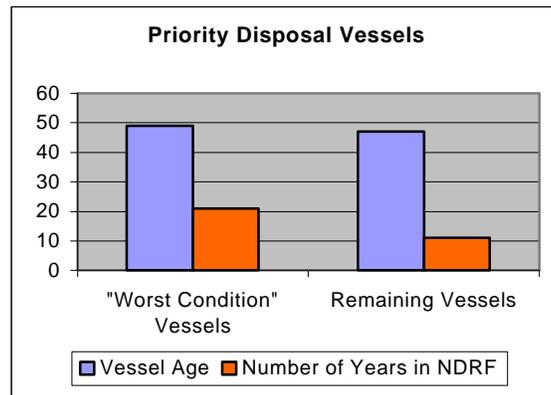
Obsolete Vessels Pose Environmental Risk

The 114 obsolete vessels currently awaiting disposal pose environmental risks because they are deteriorating, contain hazardous materials, and contain oil that

could leak into the water. These vessels are literally rotting and disintegrating as they await disposal. Some vessels have deteriorated to a point where a hammer can penetrate their hulls. They contain hazardous substances such as asbestos and solid and liquid polychlorinated biphenyls (PCBs). If the oil from these vessels were to enter the water, immediate and potentially very expensive Federal and state action would be required.

In 1999, MARAD identified the 40 “worst condition” vessels. These vessels were classified as “worst condition” due to their severe deterioration and threat to the environment. As of April 30, 2000, 3 of the 40 had been moved out of the Fleet to domestic scrappers.

Worst Condition Vessel Ages



The remaining 37 “worst condition” vessels have been in MARAD’s Fleet for an average of 22 years, are in particularly bad condition, and may require additional or special maintenance. Our inspection of 11 of the original 40 “worst condition” vessels revealed corrosion, thinning, and rusting of the hull; asbestos hanging from pipes below deck; lead-based paint easily peeled from the ship; solid PCBs (in cabling); and in some instances, remnants of liquid PCBs in electrical equipment.

Deteriorating Vessel at James River Reserve Fleet



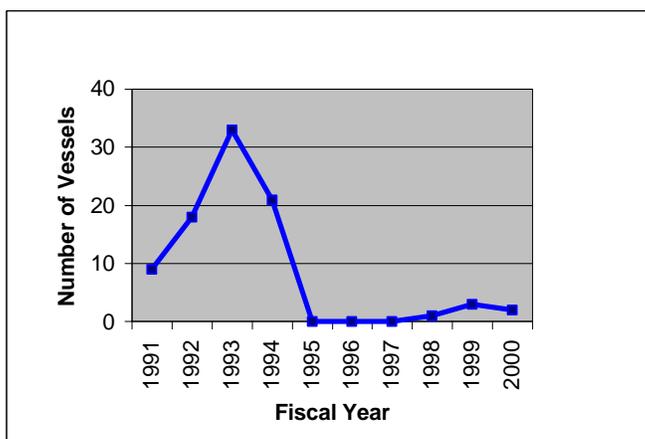
Costs to maintain these vessels will likely increase due to their deteriorating condition, leaks, and the need for additional time-sensitive maintenance. For example, MARAD spent \$1.3 million to maintain 1 of the 40 “worst condition” vessels over the past 2 years. This vessel is over 35 years old, contains hazardous substances including asbestos, and it deteriorated to the point where oil leaked into the water requiring costly environmental clean-up. MARAD has applied over 20 patches to leaks, removed hazardous materials, deployed containment booms, and pumped oil out of the vessel. The vessel is disintegrating to a point where it will not be seaworthy much longer. Monitoring efforts for this vessel are ongoing.

Loss of Overseas Market and Limited Domestic Capacity Reduced Scrapping Progress

Although MARAD has sold 22 vessels since 1995, only 7 have been scrapped. Two other vessels have been towed to scrapping sites. The remaining 13 vessels sold are still moored in MARAD's Fleet, requiring continued maintenance at U.S. Government expense.

As shown in the following chart, this rate of progress is a significant change from previous years when vessels were sold to overseas scrappers.

MARAD Vessels Scrapped



Between 1991 and 1994, MARAD sold 80 vessels overseas for scrapping at an average price of \$433,000 per vessel. During the past year, vessel sales yielded between \$10 and \$105 per vessel. On October 25, 1999, MARAD sold three vessels for \$10 per vessel. The most recent sale was for two vessels at \$105 per vessel on December 21, 1999.

MARAD suspended the sale of vessels to overseas scrappers in 1994 because the EPA prohibited the export of Government-owned ships containing PCBs.

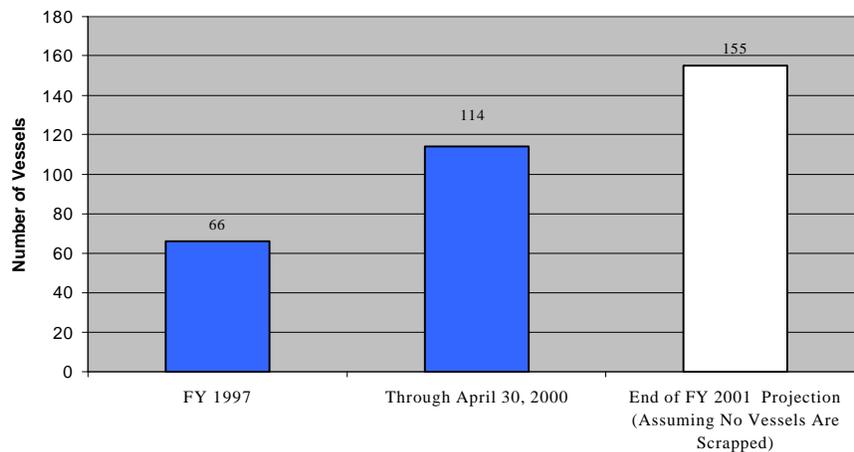
In September 1998, an Administration moratorium halted all sales of Government-owned vessels for scrapping overseas. As a result, MARAD has been relying on the domestic market, but capacity in the domestic market is limited. In the 1970s, there were 30 U.S. contractors in the ship scrapping industry. Over the past 19 months, however, only four companies have bid on MARAD's scrapping contracts and passed MARAD's technical compliance review to scrap vessels. Additional companies are not attracted to this industry because of the low profits currently available. Scrap steel prices in the United States are low and contractors must comply with environmental regulations. According to scrapping company

officials, the number of vessels that a contractor can scrap at one time is approximately 1 to 5 vessels.

The Number of Vessels Awaiting Disposal Is Increasing

The number of obsolete vessels has almost doubled over the last 2 years. MARAD expects its inventory of obsolete vessels awaiting disposal will increase to 155 vessels by the end of FY 2001, as shown in the following chart.

Vessels Awaiting Disposal



This projected increase is due to additional vessel transfers from the Navy, downgrades of other NDRF vessels to obsolete status, and the inability to sell ships for scrap. Of the 155 vessels, 132 will be targeted for scrapping. Although the remaining 23 vessels are slated for other forms of disposal, some of these may be transferred into the scrapping category in future years if they cannot be disposed of through other means.

The Navy's Pilot Project May Be a Model for MARAD

The Department of the Navy experienced a similar inability to sell its combatant vessels for domestic scrapping. In 1998, Congress authorized and appropriated funding for a Navy pilot project for the disposal of obsolete warships. Under the

pilot project, the Navy is not subject to a legal requirement to maximize financial returns on its obsolete vessels. On September 29, 1999, the Navy awarded four contracts amounting to \$13.3 million for the scrapping of four warships.

The purpose of the Navy project is to quantify the costs associated with ship scrapping, which could lead to the disposal of 66 warships. If MARAD were authorized to implement such a project, it could cost as much as \$515 million to dispose of the obsolete vessels that MARAD expects to have by the end of FY 2001.

Alternatives Offer Potential but Will Not Solve the Problem

While MARAD has been pursuing ways to improve scrapping sales, its ability to explore creative solutions for disposing of vessels is constrained by the requirement to maximize financial returns. Also, the programs and alternatives MARAD is pursuing do not have the potential to significantly reduce the backlog of vessels awaiting disposal in a timely manner. We have identified some additional alternatives that MARAD has not pursued that may have the potential to contribute to the goal of disposing of obsolete vessels.

Programs to improve scrapping sales and alternatives MARAD is pursuing include: coordination with the Navy and a West Coast Company on a proposal for a potential scrapping site; participation in interagency work groups to look for innovative ways to improve the ship scrapping process and establish consistent procedures; donation of vessels designated for disposal for uses such as museums and the fish reef program, given legislative or executive approval; and coordination with the Navy on its program to sink vessels in deep water after hazardous materials are removed.

MARAD may be able to explore alternatives that have the potential to assist in disposing of some of its vessels such as: selling vessels to other countries for non-military uses, given legislative approval and approval from the EPA to sell vessels to overseas markets that are capable of scrapping them in an environmentally compliant manner. According to MARAD, selling vessels overseas for non-military uses would require a change in the law that only allows MARAD to sell vessels for disposal or non-transportation use. However, legislation was passed in 1996 for four vessels to be sold on a competitive basis for operational use. One vessel was sold in 1999 and bids on two vessels are currently under review. The fourth vessel requires an EPA approval, which MARAD requested April 1999.

During the moratorium on overseas sales from 1998 to January 1, 1999, MARAD could not request any exceptions for exporting vessels. However, since January 1, 1999, it could have requested exceptions to this prohibition through the Chair of the Council on Environmental Quality. To obtain an exception, MARAD would have to ensure that vessels sold overseas would be scrapped in an environmentally sound and economically feasible manner. MARAD, however, has not requested any exceptions to sell vessels overseas.

Recommendations Based on Recent Audit

In our March 10, 2000 audit report, MA-2000-067, we recommended that the Maritime Administrator:

1. Seek legislative approval to extend the 2001 mandate to dispose of obsolete vessels and to eliminate the requirement that MARAD maximize financial returns on the sale of its obsolete vessels.
2. Continue to pursue programs to improve scrapping sales and identify alternative disposal methods that can contribute to the goal of reducing the number of obsolete vessels awaiting disposal, to include working with the

Navy on the results of its studies on the environmental impact of sunken vessels.

3. Develop a proposal for submission to Congress seeking approval and funding for a project to pay contractors for vessel scrapping. The proposal should include a plan to target the “worst condition” vessels first, identify funding and staffing requirements, and provide milestone dates to dispose of all obsolete vessels.

MARAD concurred with our recommendations. In its FY 2001 authorization request, MARAD proposed a “five year extension [in the deadline that] will provide MARAD with additional time to develop and begin implementing a plan to dispose of these vessels.” Considering the condition of some of the vessels, the environmental risks, and the costs to maintain them, we find the MARAD proposal unacceptable. **MARAD must develop and implement a disposal plan** for its obsolete vessels once legislative approval is obtained for an extension.

MARAD also needs to obtain legislative approval allowing it to eliminate the requirement to maximize financial returns on vessel sales. This would then allow MARAD to seek funding for a pilot program, similar to the Navy’s, whereby it would pay for vessel scrapping. MARAD should focus first on disposing of its “worst condition” vessels and so state that in its plan.

MARAD should also continue to coordinate with the Navy on its disposal programs and seek legislative approval to sell vessels in the Fleet that are still operational, but will eventually become obsolete, to overseas companies for continued use. MARAD should also request exceptions from EPA to sell vessels to overseas scrappers that meet the environmental standards. A requirement for MARAD to report on its progress should be included in all legislative mandates.

Recent Legislative Actions Propose Different Solutions But MARAD Has Yet to Develop a Plan for Either

On April 5, 2000, a Bill was introduced in the House of Representatives to authorize funding for a ship scrapping pilot project for MARAD that would allow MARAD to pay qualifying U.S. shipyards to scrap its obsolete vessels. Such a program would help MARAD dispose of some of its vessels by generating interest among existing U.S. companies. Furthermore, this program would provide jobs for qualified workers in the areas selected. The Navy's current project would provide a model for MARAD. However, the average time to scrap a MARAD vessel is 4 to 6 months, and additional time would be required to implement such a program, while these vessels continue to be maintained at Government expense. MARAD's rate of progress indicates that this would serve as a long-term solution.

On May 1, 2000, a Bill was introduced in the Senate on MARAD's FY 2001 Authorization, to include a 3-year extension on disposing of its obsolete vessels and to allow for the disposal of MARAD's 39 "worst condition" vessels in foreign countries. The 3-year extension will provide additional time for MARAD to develop a plan to dispose of its vessels, which is a requirement in this proposed bill. As noted earlier, MARAD did not develop an implementation plan during its original extension from 1999 to 2001. In a February hearing, Congressmen noted that MARAD did not prepare a plan to dispose of its vessels during the original extension, and questioned whether MARAD would develop such a plan during this second extension.

The allowance for MARAD to again sell vessels overseas for scrapping would assist in disposing of its "worst condition" vessels that require high maintenance. However, MARAD would still be required to request approval from EPA to sell these vessels to overseas markets that are capable of scrapping them in an environmentally compliant manner. Additionally, the environmental and worker

safety and health concerns in some countries remain and could continue to prohibit this practice. According to MARAD officials, it has coordinated with a scrapping company in Mexico that reportedly meets the environmental requirements and standards for its workers, although MARAD has not pursued this as a viable option due to the continual environmental and worker safety and health concerns.

INTERNAL CONTROLS OVER MAINTENANCE CONTRACTS FOR READY RESERVE FORCE (RRF) VESSELS CAN BE IMPROVED

In 1976, a Memorandum of Agreement between MARAD and the Department of Defense established the RRF as a component of the National Defense Reserve Fleet. MARAD is responsible for maintaining the RRF vessels in a heightened state of readiness so that they can be activated in 4 to 30 days to meet shipping requirements during National emergencies. As of March 2000, the RRF was composed of 91 militarily useful vessels with an estimated value of \$1.58 billion.

MARAD administers RRF vessel acquisition, upgrade, activation, maintenance, operations, and subsequent deactivation through ship manager contracts and general agency agreements. Ship manager contracts are awarded to ship management companies, through competitive bids, to maintain vessels in the RRF. General agency agreements are issued to ship management companies and are usually used when a new vessel is acquired or a ship manager contract is terminated.

Three MARAD regional offices (Norfolk, Virginia; New Orleans, Louisiana; and San Francisco, California) administer the ship managers' contracts and general agency agreements. During the period of our audit, 57 vessels were maintained under ship manager contracts, and 32 vessels were maintained under general

agency agreements. Two vessels, assigned for training purposes, were not maintained by either a ship manager or a general agent.

Fraud Identified in Department of Defense and MARAD Ship Managers' Contracts

The Federal Bureau of Investigation (FBI), Defense Criminal Investigative Service and the Naval Criminal Investigative Service initiated an investigation in 1994 to look into potential kickbacks between ship managers managing Military Sealift Command vessels and their subcontractors. The FBI named their investigation "Operation Octanova." MARAD was not the initial focus of the investigation, but we joined the investigation in 1996 because MARAD and the Military Sealift Command use the same contractors.

The investigation identified fraud and kickbacks involving contracts to maintain RRF vessels. In August 1999, the Department of Justice announced Federal indictments and informations of 2 companies and 21 individuals, including 2 MARAD employees. One MARAD employee in Beaumont, Texas subsequently pleaded guilty to accepting a large screen television and a videocassette recorder from a contractor. The contractor inflated invoices by the costs of the items given to the employee. A second MARAD employee in Norfolk, Virginia, also pleaded guilty to soliciting and accepting over \$10,000 from an undercover agent who he believed was a potential ship repair contractor. The employee agreed to assist the contractor in being awarded a future contract. Also, in October 1999, we announced that a former MARAD employee had been charged for receiving \$60,000 in unreported income to "put in a good word" for a ship repair company, which was subsequently awarded Navy contracts. This former MARAD employee also pleaded guilty.

As a result of the investigation, MARAD and Department of the Navy took aggressive debarment and suspension actions against 6 companies and 16 individuals. Also, a ship manager voluntarily withdrew from the program and numerous ship manager employees were convicted for accepting kickbacks to influence the award of subcontracts. In many of the kickback schemes, contractors recouped the money by submitting fraudulently inflated invoices.

Failure to Implement Controls Over Ship Managers' Contracts Create Vulnerabilities

During the joint investigation, we initiated an audit on RRF Ship Managers' Contracts, and in a report issued on May 12, 2000, we found that MARAD implemented effective policies and procedures relating to the award of ship manager's contracts. However, this was in sharp contrast to its failure to implement controls for the administration of these contracts. We found that MARAD has not adhered to established procedures and practices for administering the ship managers' contracts and general agency agreements.

Specifically, we found MARAD was not following existing procedures to ensure that payments to general agents and ship managers were for actual costs incurred, related to cited work orders, and did not duplicate previously paid invoices. For example, MARAD's Central and Western Regions paid \$63.7 million during fiscal years 1998 and 1999 to general agents without supporting documentation that costs were incurred. Work orders did not adequately describe the work authorized, making it difficult for MARAD personnel to validate payments during the invoice review process. Work orders were not closed timely, allowing the opportunity for ship managers to use funds from open work orders for unrelated work.

Finally, we reported that MARAD was not ensuring that ship managers justified the award of non-competitive subcontracts. We found a high percentage of

subcontractor awards that did not comply with the Federal Acquisition Regulation. Ship Managers often awarded subcontracts non-competitively, without required documentation justifying awards. Unjustified non-competitive awards create the potential for improper business dealings between ship managers and subcontractors and increase the potential for kickbacks. Therefore, MARAD has limited assurance that Federal funds are expended in a manner that is most advantageous to the Government.

When MARAD personnel do not follow existing procedures, they compromise their ability to ensure that Federal funds are expended for items received or for work authorized and performed. The control weaknesses we identified contribute to an environment where there is an increased risk of fraud occurring.

MARAD Agreed to Strengthen Controls Over Ship Managers' Contracts

In light of the recent joint investigation and audit on MARAD's controls over ship managers' contracts, MARAD has agreed to strengthen its procedures and practices for administering ship managers' contracts and general agency agreements. Specifically, MARAD agreed to:

1. Instruct regional employees on existing procedures for processing invoices and provide sufficient oversight to ensure that these procedures are followed.
2. Provide detailed, self-explanatory work statements, specifications or descriptions on all work orders.
3. Periodically review open and inactive work orders to identify those that should be closed, and reprogram any remaining funds.

4. Reinstate periodic reviews of ship manager procurement actions, including documentation justifying sole-source subcontractor awards and indications of split purchases.

MARAD must now follow through on the actions they agreed to take.

Mr. Chairman, this concludes our statement. I would be pleased to answer any questions.

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**Department of Transportation
Office of Inspector General**

Summaries of Related Audit Reports

Status Update Massachusetts Heavy Industries, Inc. Title XI Loan Guarantee
(Report Number MA-1999-127, September 15, 1999)

This report presents our observations on the status of the Maritime Administration's (MARAD) Title XI loan guarantee for Massachusetts Heavy Industries, Inc. (MHI).

On August 6, 1999, MARAD concurred with our conclusion that the risk of default by MHI had increased materially. MARAD suggested deferring the risk reassessment until December 1999.

Additional significant events recently occurred. Specifically:

- On August 1, 1999, MHI missed a payment of \$258,880 to the city of Quincy, Massachusetts. MHI is in arrears on a loan balance of \$7.8 million to the city of Quincy obtained through the Housing and Urban Development program.
- On August 6, 1999, MARAD approved the deferral of MHI's missed June 1, 1999 "interest only" payment of \$1.55 million to December 1, 1999. As a result, MHI will be liable to pay Fleet National Bank approximately \$5.1 million on December 1, 1999.
- On August 17, 1999, MHI's general contractor (and its subcontractors) for the shipyard modernization project walked off the job because of payment disputes of \$3 million.
- Based on discussions with representatives of MHI and its general contractor, MARAD concluded that MHI was unable to resolve its differences with its contractor. MARAD noted that each of the parties to the contract had declared the other in default of its obligations under the contract. Based on information provided by MHI and its general contractor, MARAD concluded that the general contractor might be in breach of material contract promises.
- On August 30, 1999, MARAD: (1) declared a "Contractor Default" and formally terminated MHI's general contractor for the shipyard modernization project and (2) called on the surety company to perform under the terms and conditions of the performance bond. As a result, work on the shipyard stopped and the estimated completion date has slipped for an indeterminate amount of time.

- As of September 14, 1999, MHI had not provided MARAD any new or updated applications for shipbuilding projects. The potential shipbuilding project with Intermare is in question.

These events have reinforced and made more serious our previously reported concerns. Taken together, these events will delay completion of the shipyard for an indeterminate period of time and further increase the risk of default by MHI on the guaranteed loan.

As of September 14, 1999, approximately \$12 million remained in the escrow account. Of this amount, approximately \$5 million is committed to pay for equipment ordered but not yet received at the shipyard. According to MARAD, this amount is not in dispute. In the event of default by MHI, MARAD could use the funds remaining in the escrow account to reduce the Government's loss on the loan guarantee.

In order to protect the interests of the United States, we recommended that MARAD immediately:

1. Freeze the uncommitted balance in MHI's escrow account until negotiations relating to the performance bond are concluded.
2. Conduct a physical inventory of all assets and property owned or acquired by MHI for the shipyard.
3. Ensure that the assets and property identified in the inventory are safeguarded from loss or unauthorized disposition. This is important because, in the event of default on the guaranteed loan, the United States Government has a first priority lien on all assets and property owned or acquired by MHI.

Massachusetts Heavy Industries, Inc., Title XI Loan Guarantee
(Report Number MA-1999-115, July 20, 1999)

We prepared this report because MHI: (1) did not make the June 1999 "interest only" payment on the guaranteed loan, (2) requested approval of a 6-month extension to make this payment, and (3) has not secured a shipbuilding project.

Construction and reactivation at the shipyard is proceeding. However, MHI's estimated completion date for the shipyard has slipped from November 1998 to October 1999. Initial work completed by MARAD's Office of Ship Construction estimates the completion date may be later than October 1999. The only potential shipbuilding project identified by MHI requires MARAD approval of a Title XI loan guarantee application.

The risk of default by MHI has materially increased warranting action by MARAD. The missed June 1, 1999 payment and the request to defer this payment until December 1, 1999, reflect a major change in the assumptions underlying MHI's loan guarantee.

MARAD has not made a decision on MHI's request for deferral of its June 1, 1999 payment, nor has MARAD made a decision on the Title XI loan guarantee application submitted by Intermare for a proposed shipbuilding project at MHI, because there are unresolved issues regarding how MHI will implement the shipbuilding project. MARAD is reviewing additional information provided by MHI needed to determine the reasonableness of the deferral request and how MHI intends to satisfy requirements of the Title XI loan guarantee program.

MHI's failure to make the June 1, 1999, payment, the request for a six-month extension to make the payment, and lack of a shipbuilding project indicates a major change in MHI's risk of default. We recommended that MARAD:

1. Reassess the risk factor rating for MHI's loan guarantee as prescribed by OMB Circular Number A-11, and make the required adjustment to the subsidy rate. Ensure it has all of the information required by the Title XI program to protect the interests of the United States from default prior to making a decision on MHI's request to defer its June 1, 1999, payment.
2. Ensure that MHI provides complete and current information as required by the Title XI program prior to making a decision on the loan guarantee application by Intermare.

**Management Advisory on Massachusetts Heavy Industries, Inc.,
Title XI Loan Guarantee**

(Report Number MA-1998-048, December 17, 1997)

MARAD provided a status report for three recommendations made in a Management Advisory Report, Number MA-1998-007, dated November 7, 1997.

1. MARAD did not plan to reassess the risk factor (Recommendation 1) based on a legal opinion made by the Office of the Secretary of Transportation's Deputy General Counsel, which concluded MARAD has no legal authority to reassess the risk factor rating for MHI's application prior to closing. Further, MARAD, not the Commonwealth of Massachusetts, is liable for additional funds if subsequent reassessments identify increased risk.
2. MARAD is precluded from requiring evidence of viable shipbuilding contracts or alternative sources from which revenues can be generated (Recommendation 2) because these requirements were not stipulated in MARAD's letter commitment.

3. As of December 11, 1997, MARAD officials indicated that MHI had substantially fulfilled all of these requirements. The remaining requirements (13) contained in the letter commitment that were not complete at the time of the report (Recommendation 3).

Office of Management and Budget Circular Number A-11, *Preparation and Submission of Budget Estimates*, paragraph 33.11(e)(1)(3), recognizes the need to reassess risks “when a major change in actual versus projected activity is detected.” Since the risk would appear to be greater now than when the original calculations were made, we believe MARAD must reassess the risk factor immediately after closing and obtain, from its permanent indefinite appropriation, additional funds necessary to cover additional risk identified by the reassessment.

As of December 11, 1997, MARAD officials indicated that MHI had substantially fulfilled all of these requirements. Other than obtaining legal opinions on MHI’s performance bonds, MARAD needs to finalize documentation and work out minor issues before closing.

MARAD officials stated they were “ . . . sympathetic to MHI's claim that it is difficult to obtain customers without the modernization going forward and being underway” MARAD agreed to reassess the risk but suggested delaying any reassessment of risk until the last quarter of 1998, thereby giving MHI the opportunity to demonstrate that modernization is underway and that MHI is "aggressively marketing its products." We understand MHI’s difficulty in obtaining customers before it has the capacity to build ships. However, in our opinion, the change in risk, prudence, applicable regulations and circulars requires a formal reassessment of risk immediately after closing.

**Management Advisory Report on Massachusetts Heavy Industries, Inc.,
Title XI Loan Guarantee**

(Report Number MA-1998-007, November 7, 1997)

We reviewed the loan guarantee process to determine if (1) MARAD held MHI to the requirements in the letter commitment and followed applicable Title XI loan guarantee regulations and (2) the related tanker construction project qualifies for a Title XI loan guarantee.

On November 1, 1997, MARAD issued a \$55 million letter commitment to MHI to reactivate the closed shipyard in Quincy, Massachusetts. Twenty-eight of the requirements contained in the letter to protect the interest of the U.S. Government were categorized as significant. At the time of the report, 15 of these requirements were completed and 13 were not complete.

The following requirements were designated as the five most important. As of November 5, 1997, MHI had not completed these five requirements.

1. Provide working capital of \$3 million- MHI had not demonstrated, through applicable financial documents, that it had the required working capital.
2. Demonstrate availability of capital contribution of \$2.6 million- MHI proposed using \$2.6 million of incurred costs that included attorney and accountant fees. MARAD contended that the funds should have a direct impact on the project and should not include costs such as attorney and accountant fees. We agree with MARAD on this position.
3. Assign first priority lien on collateral to MARAD- MHI proposed dividing the shipyard property and providing MARAD with a first priority lien on area 1. In our opinion, MARAD should require first priority lien on all of the property.
4. Enter into a reserve fund and financial agreement- MARAD and MHI have not reached an agreement on the provisions of the financial agreement. In our opinion, MARAD should not deviate from the standard financial requirements.
5. Place funds in escrow with specific withdrawal procedures- MHI proposed making withdrawals for items that have not been fully paid for, have not been delivered and are still subject to prior claims. MARAD had not taken a final position on fund withdrawals. In our opinion, MARAD should not deviate from the standard escrow fund withdrawal procedures.

MARAD's first estimate of risk factored in a construction contract. This contract has not materialized and MHI has shown no proof of future contracts, increasing the cost of default: appraisal values provided to MARAD by MHI may not represent the amount that could be recovered in the event of default. Additionally, MARAD agreed in the letter to assume responsibility for any additional funds needed as a result of an increase in the risk of default.

We recommend that MARAD.

1. Reassess the risk factor rating for MHI's application excluding the related tanker construction project. Based on the results of the reassessment, take appropriate action within the limits of MARAD's legal authority.
2. Prior to closing, require evidence of shipbuilding contracts or alternative sources from which revenues could be generated to repay the guaranteed loan.
3. Ensure MHI fulfills the remaining requirements contained in the letter commitment.

Report on the Program for Scrapping Obsolete Vessels
Maritime Administration

(Report Number MA-2000-067, March 10, 2000)

The audit objectives were to evaluate MARAD's progress in meeting its legislative mandate to dispose of obsolete vessels in the National Defense Reserve Fleet by September 30, 2001; identify what action MARAD has taken toward meeting the mandate; and identify potential alternatives to assist MARAD in achieving its goals. We determined that MARAD will not meet its legislative mandate to dispose of its obsolete vessels by 2001 and maximize financial return to the United States. This is due to the prohibitions on selling vessels overseas for scrapping, a limited domestic ship scrapping market, and competition from the Navy's pilot project, which pays contractors to scrap ships.

We found that the obsolete vessels awaiting disposal pose environmental risks because they are deteriorating, contain hazardous materials, and contain oil that could leak into the water. We also reported that the number of vessels awaiting disposal is increasing, from 110 vessels to 152 vessels projected to be awaiting disposal by the end of FY 2001 (numbers have increased to 114 and 155, respectively since this report was published). Although we noted that MARAD had been pursuing ways to improve scrapping sales, the alternatives do not have the potential to significantly reduce the backlog of vessels awaiting disposal in a timely manner. We identified some additional alternatives that MARAD had not explored that may help to dispose of its obsolete vessels including: (1) selling vessels to other countries for non-military uses, given legislative approval; and (2) requesting approval from the EPA to sell vessels to overseas markets that are capable of scrapping them in an environmentally compliant manner.

We recommended that MARAD:

1. Seek legislative approval to extend the 2001 mandate to dispose of obsolete vessels and to eliminate the requirement that MARAD maximize financial returns on the sale of its obsolete vessels.
2. Continue to pursue programs to improve scrapping sales and identify alternative disposal methods that can contribute to the goal of reducing the number of obsolete vessels awaiting disposal, to include working with the Navy on the results of its studies on the environmental impact of sunken vessels.
3. Develop a proposal for submission to Congress seeking approval and funding for a project to pay contractors for vessel scrapping. The proposal should include a plan to target the 40 "worst condition" vessels first, identify funding and staffing requirements, and provide milestone dates to dispose of all obsolete vessels.

A draft of this report was provided to the Maritime Administrator on February 8, 2000. MARAD concurred with the recommendations and indicated the actions planned or underway to implement them.

Report on the Ready Reserve Force Ship Managers' Contracts

Maritime Administration

(Report Number MA-2000-096, May 12, 2000)

The audit objective was to evaluate MARAD's procedures and controls relating to the requirements, specifications, award, and administration of the ship managers' contracts. This audit was initiated during a joint investigation by the Department of Transportation, Office of Inspector General for Investigations; the Federal Bureau of Investigations; and the Department of Defense. The investigation identified fraud and kickbacks involving contracts to maintain Ready Reserve Force vessels.

We determined that MARAD has implemented effective policies and procedures relating to the requirements, specifications and award of the ship managers' contracts. However, we found a sharp contrast between MARAD's implementation of procedures and controls for awarding ship managers' contracts and their procedures and controls for administering ship managers' contracts and general agency agreements. We determined that MARAD has not fully adhered to their established procedures and practices for administering the ship managers' contracts and general agency agreements. Specifically, we noted that MARAD's failure to follow internal controls created vulnerabilities for fraud and that MARAD's lack of effective procedures to ensure ship management companies justify sole source awards created the potential for kickbacks.

To address our concerns, MARAD needs to strengthen its controls by implementing effective procedures and practices for administering ship managers' contracts and general agency agreements. We recommended MARAD:

1. Instruct regional employees on existing procedures for processing invoices and provide sufficient oversight to ensure that these procedures are followed.
2. Provide detailed, self-explanatory work statements, specifications or descriptions on all work orders.
3. Periodically review open and inactive work orders to identify those that should be closed and reprogram any remaining funds.
4. Re-instate periodic reviews of ship manager procurement actions including documentation justifying sole-source subcontractor awards and indications of split purchases.

Report on the Audit of Ship Manager Contracts
Maritime Administration

(Report Number AV-MA-3-013, August 25, 1993)

The audit objective was to evaluate MARAD's administration of the ship managers' contracts in the regions using selected items in the Quality Assurance (QA) Plan. The items selected for review were (1) initial deliverables, (2) specifications, and (3) invitations for bid. We found MARAD followed procedures in the Federal Acquisition Regulations and the request for proposal in awarding the ship manager contracts. However, there were noted inconsistencies in the administration of contracts and monitoring of ship managers' performance in the regions reviewed.

We recommended that MARAD Headquarters:

- (1) Require the regions to implement the QA Plan for monitoring ship managers' performance,
- (2) Provide sufficient guidance and oversight of regional contract administration with emphasis on the use of the QA Plan for monitoring contractor performance, and
- (3) Establish general specifications and invitations for bid to facilitate the monitoring of ship managers' performance under the QA Plan. MARAD agreed with the finding and recommendations.

Report on the Audit of Activation of the Ready Reserve Force
Maritime Administration

(Report Number AV-MA-1-034, September 5, 1991)

The audit objectives were to evaluate the availability of (1) crew members to man the vessels, (2) shipyards to complete the activation work, (3) tugs to move the vessels, (4) supplies to fill ship stores, and (5) fuel to power the vessels. Additionally, we evaluated (1) the ability of the fleet to obtain the necessary certifications from the American Bureau of Shipping, the United States Coast Guard, and the Federal Communications Commission; (2) the ability to move vessels to shipyards in specific timeframes; and (3) the feasibility of performing dock trials on the vessels during periods of industrial assistance.

As a result of the activation of the Ready Reserve Force in support of Operation Desert Shield/Storm, we focused on actual activation work rather than testing the potential activation of the RRF as originally planned. We found Government and industry personnel associated with the activation of the RRF vessels achieved the activation requirements mandated by U.S. Navy's Military Sealift Command.

Nonetheless, 78 percent of the vessels were not activated within the prescribed readiness periods to be available to load cargo in support of Operation Desert Shield/Storm.

We recommended that MARAD:

1. Amend contractual agreements to require ship managers and general agents to provide retention crews on selected RRF vessels to assist in maintenance, activation, and operation;
2. Finalize the reserve concept study and establish competent and dedicated personnel necessary to operate RRF vessels,
3. Develop a comprehensive plan to systematically activate the RRF vessels and request appropriate funding for activation,
4. Require newly acquired RRF vessels to be adequately tested in order to identify and correct mechanical problems prior to placing the vessels in the fleet.

MARAD officials fully concurred with the finding and recommendations.

Additional information, including selected audit reports summarized above, can be found on the DOT-Office of Inspector General website (<http://www.oig.dot.gov>).

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