MARITIME LAW EXEMPTION

Exemption Provides Limited Competitive Advantage, but Barriers to Further Entry under U.S. Flag Remain
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Why GAO Did This Study

No large U.S.-flagged cruise ships (ships registered in the U.S. that are U.S.-built, U.S.-owned, and U.S. crewed) are in operation. Foreign-flagged vessels cruising to foreign ports serve most of the U.S. demand for cruises. However, Norwegian Cruise Line (NCL) recently obtained an exemption from U.S. maritime law to operate three foreign-built ships under the U.S. flag in Hawaii. Cruise lines and others have raised concerns over the advantage the exemption might confer to NCL, since foreign-flagged competitors are unable to offer the same itineraries due to the Passenger Vessel Services Act (PVSA), which prevents foreign vessels from transporting passengers solely between U.S. ports. Concerns have also been raised over the effect this exemption might have on future attempts to grow the U.S.-flag cruise vessel fleet, since potential U.S.-flag competitors would need to build ships in the United States, presumably at higher cost.

GAO was asked to (1) review the original intent of the PVSA and rulings and decisions regarding it, (2) determine if the exemption will affect the implementation of the PVSA or other maritime laws, (3) assess the potential effects of the exemption on competition and entry into the U.S. domestic cruise market, and (4) assess the potential economic effects of granting other cruise lines similar exemptions.

The Departments of Homeland Security and Transportation generally agreed with the findings in this report.


What GAO Found

The original intent of the PVSA, enacted in 1886, was to protect the U.S. maritime industry from foreign competition by penalizing foreign vessels that transport passengers solely between U.S. ports. However, several rulings and decisions interpreting the PVSA have allowed itineraries for foreign cruise vessels between U.S. ports that were previously restricted. For example, voyages by foreign vessels between two U.S. ports that include a distant foreign port, and round trip voyages from U.S. ports that include a nearby foreign port and other U.S. ports, do not violate the PVSA.

NCL’s exemption will likely have little impact on how the PVSA or other maritime laws are administered or interpreted because it is specific to three NCL vessels and cannot be applied to any other vessels in any other areas.

The exemption effectively gives NCL a monopoly on interisland Hawaiian cruises—providing consumers with itineraries that were previously unavailable. However, NCL will likely have little power to raise prices on these itineraries because of competition from other vacation options. Because NCL is able to operate foreign-built ships in Hawaii, the exemption provides an additional obstacle for any potential U.S.-flag competitor to enter that market, since that competitor would need to build the ship in the United States at a higher cost. However, independent of the exemption, there were and still are other substantial obstacles for any potential U.S.-flag cruise vessel due to the higher capital and operating costs (e.g., labor costs) associated with the U.S. flag, as compared with existing foreign-flag cruise vessels offering itineraries through a foreign port.

Granting additional exemptions to ease entry into the domestic trade could lead to benefits for port cities, U.S. seamen, and consumers; however, it is unclear how many cruise lines would choose to enter even if they were permitted to operate foreign-built ships under the U.S. flag, because of the higher operating costs associated with a U.S.-flag carrier operating in domestic itineraries and because of uncertain market conditions.

NCL’s Exclusive Hawaiian Itinerary Compared to Itineraries for Foreign-Flag Vessels

<table>
<thead>
<tr>
<th>NCL itinerary with exempted ship.</th>
<th>NCL itinerary with foreign-flag vessel through Fanning Island.</th>
<th>Typical itinerary with foreign-flag vessel from West Coast.</th>
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</tr>
</tbody>
</table>

Source: Norwegian Cruise Line.

7 days–59 daytime hours in port.

7 days–28 daytime hours in port.

11 days–40 daytime hours in port.

United States General Accounting Office
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Abbreviations

CBP        Customs and Border Patrol  
DOT        Department of Transportation  
FTC        Federal Trade Commission  
MARAD      Maritime Administration  
NCL        Norwegian Cruise Line  
PVSA       Passenger Vessel Services Act

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February 27, 2004

The Honorable John McCain  
Chairman  
Committee on Commerce, Science, and Transportation  
United States Senate  

Dear Mr. Chairman:

All of the passengers embarking\(^1\) on large cruise vessels\(^2\) from United States ports, about 6.5 million in 2002, went aboard foreign cruise vessels. The three major carriers in the cruise industry, Carnival Cruise Lines, Royal Caribbean Cruises, Ltd., and Norwegian Cruise Line (NCL) are all foreign corporations operating foreign-built vessels, registered under foreign flags with predominantly foreign crews. Because trips from and between U.S. ports that do not include a stop at a foreign port are prohibited for foreign-flag vessels, these vessels must include at least one foreign port in their itineraries to serve consumers out of U.S. ports.

Wholly domestic itineraries are reserved for U.S. vessels by the Passenger Vessel Services Act (PVSA)\(^3\) and U.S. vessel documentation laws.\(^4\) For example, ferries providing transportation in U.S. ports and steamboats providing service along the Mississippi are U.S.-built vessels, registered under the U.S. flag.\(^5\) The PVSA penalizes foreign vessels that provide transportation between U.S. ports, at $300 per passenger transported. U.S. vessel documentation laws have established the requirements vessels must

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\(^1\)As defined in 19 C.F.R. 4.80a, “embark” means a passenger boarding a vessel for the duration of a specific voyage, and “disembark” means a passenger leaving a vessel at the conclusion of a specific voyage.

\(^2\)In the context of this report, we are defining a “large” cruise vessel as one that has at least 800 passenger berths. This is consistent with S. 127, legislation introduced in 2001 to stimulate the U.S.-flag cruise vessel industry, in which eligible vessels were those that contained no fewer than 800 passenger berths. Other U.S.-flag passenger vessels, including ferries, steamboats, and small cruise vessels, serve a market that is fairly distinct from the market served by large cruise vessels, according to an official at the Passenger Vessel Association.

\(^3\)46 U.S.C. App. 289.

\(^4\)46 U.S.C. Chapter 121.

\(^5\)According to a 2000 Department of Transportation survey, ferries carried about 113 million passengers in the United States in 2000.
meet in order to operate under the U.S. flag and operate in domestic trade.  
These laws require that U.S.-flag vessels providing transportation between two U.S. points must be U.S.-built, owned by U.S. citizens, and operated with U.S. crews. However, no large U.S.-flag, overnight, ocean-going cruise vessels are currently in operation, and no large passenger liners have been built in the United States since 1958. American Classic Voyages, which filed for bankruptcy in 2001, was the last company to operate large overnight cruise ships under the U.S. flag, offering itineraries among the Hawaiian Islands since the late 1970’s.

NCL was recently granted a legislative exemption from the U.S.-built requirement of U.S. vessel documentation law to operate three foreign-built cruise ships in limited domestic itineraries under the U.S. flag. These ships must meet all other requirements to operate under the U.S. flag, including U.S. ownership requirements and operating with a U.S. crew. NCL has created a U.S. subsidiary, NCL America, to meet the U.S. ownership requirements to operate U.S.-flag vessels in domestic trade. Because the U.S.-built requirement is waived and the vessels will be operating under the U.S. flag, these ships will be considered qualified to operate in the domestic trade. These ships are therefore unaffected by the restrictions of the PVSA. However, the exemption limits the markets these ships may serve. NCL is required to keep the ships in “regular service” in Hawaii and is restricted from using the exempted vessels for transporting passengers to ports in the Caribbean, the Gulf of Mexico, or Alaska. NCL is scheduled to begin service in Hawaii in July 2004.

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6Foreign-built vessels can be registered under the U.S-flag to operate in international trade, although these vessels must still meet the ownership, crewing and any other requirements of U.S. vessel documentation laws.


8Two of these ships were partially constructed in the United States as part of “Project America,” while the third ship will be an existing foreign-built vessel. “Project America” was a loan guarantee provided by the Maritime Administration for American Classic Voyages to build two large cruise vessels in a U.S. shipyard for use in Hawaii. American Classic Voyages went bankrupt and NCL purchased the partially built vessels.


10“Regular service” is defined in the exemption as the “primary service in which the ship is engaged on an annual basis.”
Cruise line officials and others have raised concerns over the exemption. The exemption potentially confers a market advantage to NCL, since other foreign-flag competitors are unable to offer the same itineraries as NCL. This exemption may also affect any future attempts to grow the U.S.-flag cruise vessel fleet. As you requested, this report discusses (1) the original intent of the PVSA and how rulings and decisions regarding the act relate to its original purposes; (2) how the exemption provided to NCL may affect the future implementation of the PVSA, U.S. vessel documentation laws, or the Jones Act; (3) the potential effects of the exemption on competition in the passenger cruise industry and entry into the U.S. domestic cruise market under the U.S. flag, and the exemption’s broader economic effects; and (4) the potential economic effects of granting other cruise lines similar exemptions.

To address the original intent of the PVSA, rulings and decisions regarding the act, and how the exemption might affect the future implementation of the PVSA or other cabotage laws, we reviewed and analyzed the PVSA, its amendments and legislative history, U.S. vessel documentation laws, the exemption given to NCL, and other related laws, regulations, administrative rulings, and judicial decisions. We also interviewed officials from the Maritime Administration (MARAD), Customs and Border Protection (CBP), and the U.S. Coast Guard responsible for implementing and interpreting these laws and regulations. To address the potential economic effects of the exemption on competition and entry, and the potential effects of additional exemptions, we reviewed existing studies examining competition and the economic impacts of the cruise industry; and we also interviewed officials from cruise lines, cruise industry associations, union organizations, and ports; representatives from the shipbuilding industry; and other stakeholders. In addition, we analyzed available data on capital and operating cost differentials between U.S.-flag and foreign-flag cruise vessels to determine the extent to which foreign-flag vessels have a cost advantage. Since most of these data are proprietary, we were unable to independently verify them because we have no authority to require access to the underlying data. However, we applied logical tests to the data and found no obvious errors of completion or accuracy. Along with our use of corroborating evidence, we believe that the data are sufficiently reliable for our use. We conducted our work from August 2003 through February 2004 in accordance with generally accepted government...
Results in Brief

The original intent of the PVSA, enacted in 1886, was to protect the U.S. domestic maritime transportation industry from foreign competition; however, the PVSA does not apply to many of the cruises out of U.S. ports because they are international in nature, i.e., from a U.S. port to foreign destinations. Over time, several rulings and decisions interpreting the PVSA have expanded possible itineraries for foreign cruise vessels between U.S. ports. For example, a 1985 federal regulation allows foreign vessels to make round trips from a U.S. port and make stops at other U.S. ports along the itinerary, with passengers allowed to leave the ship and go ashore, so long as a foreign port is included in the itinerary; and passengers do not leave the trip at one of the intermediary ports. For example, foreign vessels may provide cruises originating in a U.S. port such as New York, stop in several U.S. ports along the eastern seaboard, make a stop in Bermuda or Canada, and return to New York without violating the PVSA. However, foreign vessels are still prevented from offering wholly domestic itineraries.

The exemption allowing NCL to operate foreign-built ships under the U.S. flag in wholly domestic itineraries will likely have little impact on how the PVSA, U.S. vessel documentation laws, or the Jones Act—which restricts foreign vessels from transporting cargo between U.S. ports—are administered or interpreted. The exemption is specific to the vessels that NCL will be operating, and does not amend the PVSA, U.S. vessel documentation laws, or the Jones Act, for future implementation of these laws regarding other vessels. In the past, Congress has passed several exemptions from the PVSA, allowing foreign vessels to serve particular regions of the United States, and exceptions to the Jones Act are numerous. These types of specific changes to one law have historically not had any impact on other laws. For example, one exemption from the PVSA allows Canadian vessels to transport passengers between the New York ports of Alexandria Bay and Rochester, but foreign vessels are still prohibited from transporting cargo between these ports by the Jones Act.12

The exemption gives NCL a monopoly on the wholly domestic interisland Hawaiian cruise market and provides consumers with the option for Hawaiian itineraries that have been unavailable since American Classic Voyages’ bankruptcy. Foreign vessels operating in Hawaii are required to stop at a foreign port; and because of Hawaii’s geographic isolation, these vessels need to sail several additional days, precluding them from offering itineraries that compare with NCL’s. Regardless of its advantageous position, NCL will likely have little power to charge higher prices for its exclusive itineraries because of the competition it will face from cruise itineraries offered by other lines that still include Hawaii, similar types of cruises in other areas, and land-based vacations in Hawaii and elsewhere. In addition, because NCL is able to operate foreign-built ships in Hawaii—which are less expensive than ships that might be built in U.S. shipyards—the exemption could provide an obstacle for any potential U.S.-flag competitor to enter that market. However, independent of the exemption, there were and still are other significant obstacles for any potential U.S.-flag cruise vessel due to higher capital and operating costs, such as higher labor costs, associated with operating under the U.S. flag, as compared to existing foreign-flag cruise vessels running itineraries through a foreign port. NCL’s exemption also provides some potential economic benefits, including jobs for the U.S. maritime sector, and tax revenue.

Granting additional exemptions easing entry into wholly domestic trades could lead to employment and tax benefits for ports and port cities, the merchant marine, and consumers; however, it is unclear how many cruise lines would choose to enter wholly domestic trades—even if they were permitted to operate foreign-built ships under the U.S. flag—because of the higher operating costs associated with a U.S.-flag carrier operating in those trades, such as higher labor costs, and because of uncertain market conditions. Any entry that might occur could lead to some economic benefits, such as additional cruise itineraries for consumers, increased business in U.S. ports, and additional U.S. jobs in the maritime sector. However, most cruise ships can avoid the higher labor costs associated with following U.S. labor laws and requirements by operating under a foreign flag and including a nearby foreign port in their itinerary. Because of the close proximity of foreign ports to the coastal regions of the United States, there are few domestic itineraries that would likely be attractive to cruise lines. Hawaii’s relative isolation and the long sailing times associated with including a foreign port make it a uniquely attractive market segment for an all-domestic itinerary; however, entrants with similar exemptions would have to compete with an established competitor, NCL, for limited capacity and unknown demand. Two cruise lines we spoke with said they
would consider entry with similar exemptions on routes in Alaska or on short coastal routes. However, even these attractive markets have factors deterring U.S.-flag operations. For example, in Alaska, foreign vessels making trips out of Vancouver, Canada, may still have a considerable cost advantage. In addition, because similar exemptions to the U.S.-built requirement would allow vessel operators to build cruise ships abroad for domestic use, the potential for the U.S. shipbuilding industry to regain a share of the cruise vessel market would be negated.

The Departments of Homeland Security and Transportation commented on a draft of this report. Both agreed with the findings of the report and provided technical comments that have been incorporated where appropriate.

Background

Over time, cruising has developed into a highly concentrated industry with three primary carriers. At the end of September 2003, two companies, Carnival Cruises Lines and Royal Caribbean Cruises, Ltd., controlled 86.4 percent of the market in North America, with NCL being the next largest cruise provider, holding a little less than 9 percent of the North American market. (See fig. 1.)
Figure 1: Percent of Passenger Embarkations/Disembarkations at North American Ports by Major Cruise Lines, July-September 2003

Note: Other brands under Carnival included here are Princess Cruises, Holland America Line, and Cunard Cruise Line. Celebrity Cruises is included under Royal Caribbean. “Other Cruise Lines” includes Disney Cruise Line and Crystal Cruises.

These companies are foreign-owned and operate foreign-built vessels. Carnival Cruise Lines is incorporated in Panama with its North American ships flying the Bahamian or Panamanian flag. Royal Caribbean is a Liberian corporation, with ships flying the Bahamian or Norwegian flag. NCL is a subsidiary of Star Cruises, a Bermuda corporation headquartered in Hong Kong, with its ships in North America flying the Bahamian flag.

While there are several U.S. companies in the cruise industry, such as Disney and Radisson Seven Seas, these companies also elect to operate foreign-built vessels under a foreign flag in order to operate under the same capital and operating cost structure as their foreign competitors. Currently, there are no large U.S.-flag cruise ships in operation, and no large new cruise ships have been built in the United States since 1958. This use of foreign-built ships is largely due to the higher costs anticipated when building a ship in the United States, rather than in shipyards in Italy,
Germany, and elsewhere that have the infrastructure, expertise, and economies of scale for this segment of the market.\(^{13}\)

Over the past decade, several bills have been introduced into the U.S. Congress with the objective of stimulating the development of a U.S.-flag fleet and growth in the domestic cruise ship trade, the travel industry, and port cities, although none have been enacted. Generally, these bills would have allowed foreign ships either to operate in the domestic trade or to be reflagged with the U.S. flag under certain specified conditions. For example, the U.S. Cruise Vessel Act (S. 127),\(^{14}\) introduced in 2001, would have allowed U.S.-owned, foreign-built cruise ships to enter the domestic market for a limited time if the operators agreed to build replacement vessels in the United States. This law was designed to allow new companies to enter the domestic market with existing vessels and immediately increase the size of the U.S. commercial fleet, thus providing new jobs for merchant mariners. Under the proposal, these foreign-built cruise ships would have been required to fully comply with all applicable U.S. laws, regulations, and tax obligations.

Many federal agencies oversee U.S. maritime policy. For example, in the Department of Transportation, the Maritime Administration’s (MARAD) primary mission is to strengthen the U.S. maritime transportation system—including infrastructure, industry, and labor—to meet the economic and security needs of the nation. MARAD also seeks to ensure that the United States maintains adequate shipbuilding and repair services, efficient ports, and effective intermodal water and land transportation systems. MARAD programs are designed to promote the development and maintenance of an adequate, well-balanced, U.S. merchant marine. MARAD originally financed two of the ships that NCL will be operating in the Hawaiian Islands through MARAD’s Title XI loan guarantee program under a project known as “Project America,” that provided loan guarantees to help construct two new cruise vessels for American Classic Voyages in a U.S. shipyard for use in the Hawaiian Islands. Congress also granted American Classic Voyages a monopoly in the Hawaiian market for the life of the vessels. However, American Classic Voyages filed for bankruptcy in 2001, and the partially completed hull of one ship and parts for the other were

\(^{13}\)Several foreign shipyards have received substantial government subsidies over the years to help develop this industry.

\(^{14}\)In addition to S. 127, two other similar bills have been introduced, S. 1510 and S. 2507.
purchased by NCL for $29 million.\textsuperscript{15} Subsequent to the purchase, NCL obtained the exemption, allowing them to complete these ships in a foreign shipyard and still operate them in Hawaii under the U.S. flag.\textsuperscript{16}

The Coast Guard and Customs and Border Protection (CBP), within the Department of Homeland Security, are generally responsible for administering and enforcing maritime laws and U.S.-flag requirements, including the PVSA and U.S. vessel documentation laws, as well as the Jones Act.\textsuperscript{17} The Coast Guard handles documentation requirements for U.S.-flag ships—such as determining whether vessels meet the U.S.-ownership and crewing requirements in order to operate under the U.S. flag—and U.S.-built requirements in order to operate in domestic trade. Through this process the Coast Guard provides endorsements to vessels defining the type of trade in which they are allowed to engage, e.g., foreign trade, domestic trade, or fishing. The Coast Guard also conducts quarterly inspections on all vessels embarking passengers at U.S. ports. CBP also has a role in administering the PVSA, such as publishing rulings on the legality of proposed itineraries. CBP also has civil enforcement authority under the PVSA, with the ability to levy penalties on any passenger vessel operators engaging in service in the domestic market without the relevant Coast Guard endorsements. The current penalty that can be levied against a ship operator for a violation of the PVSA is $300 per passenger.

The Federal Trade Commission (FTC) is responsible for ensuring that the nation's markets are vigorous, efficient, and free of restrictions that harm consumers. The FTC exists to protect consumers by enforcing federal consumer protection laws and conducting economic research and analysis to inform all levels of government. In this regard, FTC conducted an analysis of competition in the cruise market and the potential competitive affects of a merger between two of the largest cruise lines and issued its

\textsuperscript{15}The partially completed vessels cost $23 million, while the construction plans cost $6 million.

\textsuperscript{16}The first vessel scheduled to be completed under the exemption, the Pride of America, was damaged in the shipyard causing its completion to be delayed. NCL has announced that the existing foreign-built ship that it was allowed to reflag under the U.S. flag, the Pride of Aloha, may take the place of the Pride of America on its scheduled cruises, subject to MARAD approval.

\textsuperscript{17}46 U.S.C. App. 883.
In 1886, Congress passed the PVSA to protect the U.S. domestic maritime transportation industry from foreign competition. To provide this protection, it penalizes foreign vessels that transport passengers solely between U.S. ports. Many cruises provided by foreign vessels are to international destinations and, therefore, are not affected by the PVSA; however, several rulings and decisions interpreting the PVSA have expanded possible itineraries for foreign cruise vessels between U.S. ports that were once restricted. For example, rulings and decisions have found circumstances where voyages between two U.S. ports by foreign vessels do not violate the PVSA when the primary purpose of the voyage is to visit foreign ports. In addition, rulings and decisions have allowed foreign vessels to visit several U.S. ports on an itinerary, so long as a foreign port is included and the vessel disembarks its passengers at the port of embarkation. In these circumstances, the voyages in question are not considered to be domestic transportation between two U.S. points.

The PVSA was originally designed to prevent U.S.-based vessels from facing strong competition in the domestic transportation market from maritime nations, such as Great Britain and Canada. Specifically, there was a concern about competition from Canadian vessels that were transporting passengers across the Great Lakes. The PVSA originally stated “no foreign vessel shall transport passengers between ports or places in the United States, either directly or by way of a foreign port, under a penalty of $2\textsuperscript{18} for each passenger.”


\textsuperscript{19}This amount was later increased by law to $200 per passenger in 1898 and administratively to $300 in 2003 by CBP pursuant to the Federal Civil Penalties Inflation Adjustment Act of 1990. 19 C.F.R. 4.80.
each passenger so transported and landed.” Congress originally thought that the $2 penalty per passenger would discourage this practice.

Some industry associations and U.S. courts view the PVSA, U.S. vessel documentation laws, and the Jones Act, as serving other purposes, including providing a ready fleet in times of national defense, sustaining a U.S. merchant marine, and supporting the U.S. shipbuilding industry. U.S. courts have said that the PVSA and the Jones Act have helped to secure the national defense by maintaining, “a merchant marine of the best equipped and most suitable types of vessels sufficient…to serve…in time of war or national emergency.”20 Because vessels in the domestic trade must be U.S.-crewed, labor groups view the laws as protecting jobs for the U.S. merchant marine. According to data supplied by MARAD, over 1,000 passenger vessels are operating under the U.S. flag, employing U.S. seamen, including ferries, steamboats, and small cruise vessels; however, the last large U.S.-flag overnight cruise vessels ceased operations when American Classic Voyages declared bankruptcy in October of 2001. In addition, because the PVSA and the Jones Act protect the domestic maritime transportation market for U.S.-built ships, they also support U.S. shipyards. While several U.S. shipyards routinely build passenger vessels for U.S.-flag operators such as ferry operators and steamship operators, U.S. shipyards have not built large overnight, ocean-going cruise ships, and the last large passenger liner built in the United States was completed in 1958.

Several administrative rulings and judicial decisions have identified limited exceptions to the PVSA that allow certain vessel operations between U.S. ports by foreign passenger vessels. One significant decision—which has allowed passenger travel between U.S. ports by foreign vessels as long as a distant foreign port is included—was a 1910 Attorney General opinion. This opinion states that an around-the-world cruise that started in New York and touched numerous foreign destinations and ended in San Francisco did not violate the PVSA because the voyage could not be considered domestic trade.21 The Attorney General made this determination on the supposition that the purpose of the trip was not to travel from one U.S. port (New York) to another (San Francisco), but to travel to different locations around the


world. In 1940, a federal court also found that the transportation of passengers on a foreign vessel from New York to Philadelphia that stopped in a foreign port was not “detrimental to the coast wise monopoly sought to be assured to U.S. vessels.” The court said this was not a violation of the PVSA because the vessel, which was originally scheduled to return to New York, was forced to dock at the Philadelphia port because it was carrying perishable cargo, requiring passengers to disembark in Philadelphia. The court found that it was not the purpose of the trip to transport passengers from New York to Philadelphia.

Two regulations and rulings by CBP have also contributed to expansion of the number and variety of itineraries in which foreign-flag vessels can engage, from and between U.S. ports. First, based on the 1910 Attorney General Opinion, CBP, in its regulations, interprets the PVSA to allow a foreign vessel to embark passengers at one U.S. port and disembark passengers at a different U.S. port, so long as the vessel makes a port of call at what the regulations define as a “distant foreign port,” such as Aruba or Curacao. Second, a 1985 CBP regulation allows round-trip cruises from a U.S. port, that touch on a “nearby foreign port”—defined by the regulation as such places as Canada, Mexico, or Bermuda—to visit other U.S. ports and allow passengers to go ashore temporarily, as long as they return to the ship. For example, foreign vessels can embark passengers in New York, make a quick stop in Canada or Bermuda, then cruise to several other U.S. ports and return to New York without violating the PVSA. CBP’s decision to allow these types of itineraries was based on the supposition that the PVSA put some U.S. ports at a disadvantage in competition for tourist business. In its response to opposing comments, CBP stated that it is “of paramount importance in this area to consider the primary object of passengers in taking a voyage,” citing both the 1910 Attorney General Opinion and the 1940 court case as the authority for doing so. Table 1 summarizes these key rulings and decisions regarding the PVSA.

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23 These decisions were made under the previous guise of CBP, the Customs Service, within the Department of the Treasury.

24 A “distant foreign port” is defined by 19 C.F.R. 4.80a as being any port that is not a “nearby foreign port,” which is defined as being any port in North America, Central America, the Bermuda Islands, or the West Indies.

The exemption granted to NCL to be able to operate in Hawaii will likely have little impact on how the PVSA, U.S. vessel documentation laws, or the Jones Act are implemented by CBP and the Coast Guard. NCL's exemption is from the U.S.-built requirement of U.S. vessel documentation laws, which allows NCL to operate foreign-built ships under the U.S. flag in limited domestic itineraries. Therefore, the PVSA will not apply to these vessels, as the PVSA only penalizes foreign vessels carrying passengers between U.S. ports. In addition, the Coast Guard deals with vessels on a case-by-case basis; and this exemption is specific to NCL's three vessels and cannot be applied to any other vessels in any other trades. Furthermore, although Congress has enacted several specific exemptions to the PVSA, allowing foreign vessels to serve particular regions of the United States; no previous exemption has had an impact on the implementation of any other related laws. Exemptions have also been allowed under the Jones Act with no corresponding impact on the PVSA.

The NCL Exemption Did Not Amend the PVSA but Is an Exemption from the U.S.-Built Requirement of Vessel Documentation Laws

In 2003, Congress effectively gave NCL an exemption from U.S. vessel documentation laws in order to operate certain foreign-built passenger vessels in a limited domestic area. Specifically, NCL is allowed to operate the two Project America vessels completed in a foreign shipyard and to reflag one additional foreign-built ship under the U.S. flag, in “regular service” in Hawaii. These ships are not required to meet the U.S.-built

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### Table 1: Key Rulings and Decisions that Have Changed the Types of Itineraries Foreign Vessels Can Operate Out of U.S. Ports

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<tr>
<th>Source</th>
<th>Date</th>
<th>Description</th>
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<tr>
<td>28 Op. Attorney Gen. 204</td>
<td>1910</td>
<td>Allowed passenger travel between U.S. ports by a foreign vessel. The circumstance was an around-the-world cruise that started in New York and ended in San Francisco. Because it was deemed that the ship was not engaged in domestic trade, it was not considered a violation of the PVSA.</td>
</tr>
<tr>
<td>T.D. 55147(19) of June 3, 1960 (95 Treasury Decisions 297)</td>
<td>1960</td>
<td>Allowed passengers traveling on foreign vessels to temporarily disembark at ports in the U.S. provided that the passengers and the vessel do not remain in port beyond 24 hours (the “24-hour rule”).</td>
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<td>T.D. 85-109, 50 Fed. Reg. 26981, July 1, 1985</td>
<td>1985</td>
<td>This decision allows round trip cruises from a U.S. port, that touch on a nearby foreign port, to visit other U.S. ports and allow passengers to go ashore, thus revoking the “24-hour rule.” See 19 CFR 4.80a(b)(2). “Nearby foreign ports” include all foreign ports in North America, Central America, Bermuda, the West Indies (except Aruba, Bonaire, and Curacao) and the U.S. Virgin Islands. See 19 C.F.R. 4.80a(a)(2).</td>
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Source: GAO.
requirement in order to provide service in these limited domestic itineraries and are considered qualified for this purpose; therefore, they are not subject to penalties under the PVSA, since the PVSA only applies to foreign vessels carrying passengers between U.S. ports.

The exemption requires that NCL operate these ships in regular service, as defined in the exemption as the “primary service in which the ship is engaged on an annual basis,” between the islands of Hawaii and specifically prohibits NCL from transporting paying passengers to ports in Alaska, the Gulf of Mexico, or the Caribbean. There may be some ambiguity on what NCLs obligations are for providing regular service to the Hawaiian Islands, as the exemption was silent on service to the East and West coasts, and therefore NCL is not prohibited by the exemption from providing some service to these destinations, as long as the regular service requirement is met. 26 CBP officials declined to speculate on how the regular service provision might be enforced if there is a challenge to the itineraries that NCL operates. Several maritime lawyers we spoke with suggested this requirement might be interpreted to mean that at least 51 percent of the individual vessel’s operations must be conducted in Hawaii. NCL officials told us, however, that their current plans are to use these vessels in the Hawaiian Islands year round.27

26The planned initial voyages of NCL's first ship to be deployed under the exemption, the Pride of Aloha, are on all-domestic itineraries outside of Hawaii between Los Angeles and San Francisco. These voyages are known as repositioning cruises, where a ship will take passengers on cruises while on its way from a shipyard or another trade to its home port. In the case of Pride of Aloha, NCL plans to make some initial cruises on the west coast before heading to Honolulu, Hawaii, and beginning interisland cruises.

27While NCL is not legally restricted from offering cruises on the East and West coasts, as long as the exempted vessels are in regular service in Hawaii, they are not likely to use the exemption to offer non-Hawaiian itineraries for several reasons. From a market perspective, other possible itineraries, for which analysts expect demand to be limited, are relatively close to foreign ports and thus can be served by foreign-flag ships with lower costs. From a business perspective, NCL owns two other large U.S.-built cruise ships, the Independence and the United States, which each carry more than 1,000 passengers, and would likely test the markets with these ships to avoid deploying too much capacity on itineraries with unknown demand. Moreover, using these ships would eliminate the need to challenge the regular service definition tying the exempted ships to Hawaii.
The NCL Exemption Should Not Affect Future Implementation of the PVSA, U.S. Vessel Documentation Laws, or the Jones Act

All of the allowances and restrictions of the exemption are specific to the two Project America vessels and the additional vessel to be reflagged by NCL and do not amend the PVSA or U.S. vessel documentation laws. Coast Guard officials stated that they have already confirmed that the vessel NCL has under construction, and the second vessel NCL intends to construct abroad, are the vessels referred to in the exemption; and NCL has already identified the vessel to be reflagged; therefore, the allowances of the exemption apply only to the three vessels. Coast Guard and CBP rulings regarding these laws are made on a case-by-case basis; and because the exemption is unique to the identified vessels, it should create no precedent on the implementation of these laws regarding other vessels. NCL’s exemption does not allow for further exemptions for other foreign cruise lines to be able to operate foreign-built vessels in Hawaii or anywhere else in the domestic trade. Additional legislation would be required to allow for any further domestic operations by foreign-built vessels.

In addition, this exemption will likely not have any legal impact on the Jones Act and its restrictions on shipping cargo between U.S. points. Although interest groups and labor organizations link the PVSA and the Jones Act philosophically, as being parallel laws for passengers and cargo, respectively, numerous amendments and changes have been made to each law that have not affected the other. For example, in 1920, the PVSA was modified to allow permits to be issued for the transport of passengers by foreign vessels to or from Hawaii, which lasted for 2 years. Furthermore, an exception to the PVSA was made in 1938 to allow for the transport of passengers by Canadian vessels between the New York ports of Rochester and Alexandria Bay. More recently, Congress passed the Puerto Rico Passenger Ship Act, which allows vessels not qualified to engage in the domestic trade to carry passengers between U.S. ports and Puerto Rico and between Puerto Rico ports. None of these exemptions has had an impact on transporting cargo, which would fall under the jurisdiction of the Jones Act, or on justifying the transportation of passengers outside the specific scope of the exemption. Furthermore, the rulings and decisions discussed earlier that have allowed foreign-flag vessels to transport passengers from and between U.S. ports, if a foreign port is visited, do not extend to freight


Exemption Allows NCL to Offer Exclusive Domestic Itineraries and Creates an Additional Barrier to U.S.-Flag Entry, but It Could Generate Economic Benefits

transportation. For example, a foreign ship can pick up passengers in New York, travel to Paris and pick up passengers there, and return to Boston to disembark the passengers without violating the PVSA; however, the same ship cannot take freight cargo from New York, pick up additional cargo in Paris, and drop off the cargo in Boston without violating the Jones Act.

The exemption allows NCL to offer exclusive all-domestic itineraries in Hawaii because no other large U.S.-flag passenger ships currently offer such service, and no other foreign-built ships can offer all-domestic itineraries. However, despite this advantage, NCL will likely have limited ability to exert pricing power on its exclusive itinerary because it will still have to compete with other vacation options. In addition, NCL's exclusive right to operate foreign-built ships in U.S. domestic trade creates an additional obstacle for any large cruise lines attempting to compete in the domestic market under the U.S. flag. NCL is able to complete building the ships abroad at a lower cost than they could be completed in the United States, while any would-be entrant into the domestic market would have to build a ship in the United States and would therefore face a higher capital cost structure than NCL. However, prior to the exemption there were already substantial barriers to U.S.-flag entrants into domestic trade due not only to higher capital costs, but also to higher operating costs associated with the U.S. flag. Potential economic benefits from the exemption include expanded choice of cruise itineraries for consumers, enhanced sustainability of competition in the industry, employment growth, and generation of tax revenues. These benefits are contingent on NCL's continued U.S.-flag operations, which analysts speculate might not be able to compete successfully with lower-cost, foreign-flag operations.
Exemption Gives NCL Exclusive Hawaiian Itineraries but Confers Limited Pricing Power

As previously mentioned, the exemption allows NCL the exclusive right to operate certain foreign-built, U.S.-flag ships on wholly domestic Hawaiian itineraries. No other large U.S.-flag passenger vessels currently operate in domestic trade; and foreign-flag, foreign-crewed cruise ships cannot offer wholly domestic itineraries because of the PVSA. Therefore, although the exemption does not explicitly exclude any carriers from offering these itineraries, no other carriers are able to offer the same itineraries. In addition, prior to obtaining the exemption and prior to the bankruptcy of American Classic Voyages, NCL already had an exclusive itinerary stopping at Fanning Island, in the Republic of Kiribati, the closest foreign port to Hawaii. NCL's agreement with Fanning Island for exclusive access, which lasts for a limited period, already gave NCL the ability to offer 7-day Hawaiian cruises, not feasible for other cruise lines that must include a farther foreign port, like Vancouver, Canada, or Ensenada, Mexico, which are 4 to 6 days sailing time to Hawaii. Figure 2 compares NCL's exclusive 7-day domestic itinerary, scheduled to be available in the summer of 2004, with Hawaiian itineraries of foreign-flag vessels.

31NCL may grant other cruise lines the rights to stop at Fanning Island, and it has already done so for Radisson Seven Seas and Crystal Cruises and has permitted Hapag Lloyd rights for cruises next year.
Because NCL has the ability to offer unique Hawaiian Island itineraries without including foreign ports, NCL's interisland cruises on its exempted ships will allow cruisers to spend more daytime hours in ports than other existing Hawaiian Island cruises. NCL's proposed itinerary for wholly domestic Hawaiian cruises includes 59 daytime hours in port; however, NCL's current 7-day cruise, which includes a stop at Fanning Island, offers only 28 daytime hours in ports. In general, the greater number of hours in port is seen as more appealing to consumers.

While NCL can operate exclusive itineraries, the exemption likely conveys only limited pricing power to NCL, even in the absence of another cruise line offering identical itineraries. According to a comprehensive cruise market analysis conducted by the FTC in 2002, a single cruise itinerary does not constitute a market; rather, competitive conditions should be assessed in the context of a market that includes all vacation options or, minimally, all other cruise options. Therefore, although no cruise lines will

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32We calculated daytime hours in port by adding the number of hours between 6 A.M. and 6 P.M. that the vessel is scheduled to be in port.
compete directly on the domestic itineraries, NCL will continue to face competition from comparable vacation options, such as land vacations and similar cruises in different geographic areas. NCL will also compete with foreign-flag vessels that operate with lower costs on other itineraries that include Hawaii. Those foreign-flag vessels could offer a lower price than NCL, which would make any theoretical attempt at a price increase by NCL unsustainable.

One of the reasons for FTC’s broad market definition is its finding that cruise passengers are highly sensitive to price changes. In other words, an attempt by a cruise line to raise prices above competitive levels likely results in significantly fewer bookings. NCL anecdotally confirmed this finding, citing a decline in its bookings following an attempt to raise prices by about 3 to 4 percent on its 2003 Norwegian Star, 7-day Hawaiian-Fanning Island itineraries—which had no competition from any other cruise line on the same itinerary—after showing strong sales during 2002. From the outset, over a year from sailing dates, sales were slower than in 2002 for the same cruise, and NCL was forced to reduce its prices to fill the ship, resulting in approximately 8 percent lower revenue yields by the sailing date on the 2003 cruises compared with the 2002 cruises.33

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33NCL made no attempt to control for other factors that may have caused slower or reduced bookings in 2003. We confirmed the initial raise in price and subsequent reversion to the old base price.
NCL has a large capital cost advantage over potential competitors, who might attempt to build ships entirely in the United States for operation under the U.S. flag because the exemption permits NCL to complete construction of its U.S.-flag ships in a foreign shipyard at a lower cost than a comparable ship built in a U.S. shipyard. Unless they also receive an exemption from the U.S.-built requirement, cruise lines entering the domestic market would have to build their ships in U.S. shipyards or refurbish an existing U.S. built vessel overseas. Such building costs, based on estimates from Project America, compared with contract costs for foreign-built ships, would likely be much higher. For example, we compared the contract cost to construct the first Project America ship with the total projected cost for NCL's Pride of America, built from the partially U.S.-built hull of the first Project America ship now being completed overseas. The Project America contract cost was between 35 and 54 percent, or $140 to $190 million, higher than total cost projections to complete the Pride of America in a German shipyard, as shown in figure 3. The disparity is likely even larger because the actual costs of the Project America ships were expected to exceed the contract costs. Incorporating adjustments to the Project America contract costs, the cost differential ranges from 71 to 95 percent higher, or $284 to $334 million higher.

NCL purchased the only other large U.S.-built cruise vessels, the United States and the Independence, and has plans to refurbish them.

NCL's Pride of America is expected to cost between $350 million and $400 million dollars, including the portion NCL paid for the hull of the ship. These figures are commensurate with costs for similar size vessels built entirely in foreign shipyards for other cruise lines. The cost differential range reflects the low and high Pride of America estimates, compared with the construction contract cost in American Classic Voyages SEC filing for the Project America ships. All values were adjusted to 2003 dollars.

We used the total project cost on MARAD's Title XI loan guarantee application documentation for these calculations. The total project cost may reflect adjustments to initial contract costs and may include ship costs not paid directly to the shipyard, including independent design and inspection contracts, interest paid to lenders during construction, and supplies purchased by the ship owner directly.
Cruise officials and shipbuilders state that U.S. construction costs are higher than foreign construction costs because U.S. shipyards have not developed technical capability, a reliable supply chain, and economies of scale to build cruise ships competitively. According to one shipbuilder we spoke with, while U.S. shipyards are experienced at building complex cargo and military vessels, cruise ships require wholly different construction techniques; and U.S. shipyards have not developed certain technical capabilities. One official asserted that U.S. shipyards might become competitive if they partner with foreign shipyards to learn the latest technology. In addition, officials from the American Shipbuilders Association acknowledge that, while U.S. shipyards currently have the ability to build the hull and superstructure of a cruise ship, unlike European shipbuilders, U.S. shipbuilders do not have established and reliable supply chains for certain materials and other structures on a
These officials said that they expect that the capital cost differential would be negligible if the U.S. shipbuilding industry grew and realized economies of scale; however, such growth seems unlikely given the current lack of demand for U.S.-built cruise ships and concerns about technical capabilities and undeveloped supply chains. Moreover, ships must be built in order for economies of scale to be realized, so the first ships that would have to be built for any would-be U.S.-flag operation will likely have higher capital costs than NCL's vessels.

While the exemption affords NCL a capital cost advantage over would-be entrants, acquiring financing for U.S. ship construction may not be any more difficult because of the exemption. In theory, financiers would be less willing to provide financing for capital costs to an operator who will compete in a market with an existing competitor who has a lower capital cost structure. However, industry financial analysts we spoke with said that acquiring financing was equally difficult prior to the exemption because of the presence of competing lower-cost, foreign-flag cruise lines and would not necessarily be more difficult once NCL begins providing U.S.-flag service in the Hawaiian Islands. Furthermore, an official from the Office of Ship Financing within MARAD said that, while theoretically the NCL presence in the U.S. domestic market could affect decisions about applications for new vessels, they have not seen and do not expect to see any impact from the NCL exemption. They said that they receive so few applications for large cruise ships that they are unable to determine if the number of applications has declined because of the NCL exemption. Furthermore, no applications for financing of large cruise ships have been denied or withdrawn because of the NCL exemption or NCL's expected presence in the U.S. domestic market.

Late delivery of cruise ships can be very costly to the cruise companies, as they book cruises over one year in advance and would have to refund customers if a ship was not ready to set sail on its intended date.
Prior to the NCL exemption, cruises offered by lower cost foreign-flag vessels already limited the likelihood of cruise lines entering the domestic market. With the possible exception of Hawaii, the close proximity of foreign ports-of-call in Canada, Mexico, Bermuda, and the Caribbean allows foreign-flag ships to serve U.S. cruise demand without meeting the requirements of operating under the U.S. flag and adding significant time or fuel costs to the voyages. Figure 4 shows examples of cruise itineraries between U.S. ports that foreign-flag vessels can offer. The availability of foreign-flag service on U.S. itineraries that include a foreign port-of-call reduces the likelihood that potential U.S.-flag carriers can offer competitive prices because U.S.-flag ships have higher capital and operating costs than foreign-flag ships. In addition to higher ship construction costs discussed earlier, according to an industry trade organization, wage costs on U.S.-flag ships could range between 30 and 100 percent higher than wage costs for a similar foreign-flag ship due to compliance with U.S. labor laws that require minimum wage, overtime compensation, payment of social security tax, and protection and indemnity coverage, which do not apply to foreign-flag vessels. According to NCL officials, wage costs for their U.S.-flag operations will be 100 to 150 percent higher than wage costs for their foreign-flag operations.\textsuperscript{38} Cruise officials also stated that due to regulations pertaining to overtime and labor requirements for U.S. seafarers,\textsuperscript{39} they would likely have to hire more U.S. workers at higher wages to serve the same number of passengers. Finally, U.S.-flag ships are liable for corporate income taxes, while foreign-flag ships typically incorporate in countries where their income is tax-exempt, resulting in an additional cost advantage for foreign vessels. See appendix II for additional information on laws that apply to U.S.-flag ships.

\textsuperscript{38}Data on labor costs are scarce, and available data are difficult to compare across vessels because of variations in worker productivity, on-board amenities, and level of service provided on various vessels. While not entirely comparable, we did check these estimates against estimates of U.S.-crewing costs provided by a small U.S.-flag passenger vessel operator and foreign-crewing costs provided by a potential entrant into the cruise industry and found U.S. labor costs to be approximately 70 percent higher.

\textsuperscript{39}46 U.S.C. 8104.
Potential Economic Benefits May Result from the Exemption

Several economic benefits might be generated as a result of NCL's exemption. These benefits include expanded consumer choice, continued competition in the industry, employment growth and generation of tax revenues.

Exemption Generates New Cruise Itineraries for Consumers

The exemption expands consumer choice by allowing NCL to offer previously unavailable cruise itineraries. Hawaiian interisland cruises without a foreign port-of-call have not been available to potential cruisers since 2001, when American Classic Voyages filed for bankruptcy. As previously noted, following the exemption, NCL will operate exclusive interisland Hawaiian cruises on certain U.S.-flag ships. These new interisland cruises will be provided by cruise ships offering many of the amenities previously available only on foreign-flag ships.
Exemption Could Improve NCL’s Competitive Position in the Highly Concentrated Cruise Industry

The exemption could improve NCL’s position relative to its competitors in the highly concentrated North American cruise market. According to MARAD data from July to September of 2003, Carnival and Royal Caribbean control a combined 86.4 percent of the North American cruise market, while NCL is the third largest firm with 8.8 percent of the market. NCL’s ability to offer unique domestic itineraries, primarily in Hawaii, affords NCL an opportunity to further differentiate itself from its primary competitors. NCL’s differentiation is important because it provides travel agents with an incentive to sell NCL’s products. Officials from the American Society of Travel Agents and cruise lines agree that recommendations by travel agents play a significant role in determining which cruises customers choose to buy. While the share of airline and land vacation purchases made through travel agents has declined in recent years, travel agents still sell approximately 90 percent of all cruises. If NCL only offered the same itineraries as Carnival and Royal Caribbean, travel agents may have an incentive to discontinue sales of NCL products, because travel agents are paid commissions that often increase with the number of cruises sold on a particular cruise line. Without travel agents endorsing its products, NCL could have difficulty competing with Carnival and Royal Caribbean. However, the unique Hawaiian cruise products that NCL can now offer help NCL to continue to be the third major firm in the market. If there are only two major players in a market, there is a much higher probability of the two firms coordinating higher prices, thus hurting consumers. The recent acquisition of P&O Princess Cruises by Carnival Corporation resulted in a reduction from four major competitors to three. The FTC’s decision to not challenge the merger stated that a reduction from three to two major competitors would likely be more problematic for consumers.

As defined by FTC, the North American cruise market includes all cruises marketed to North Americans. The cruises in this market primarily operate in or around North American waters.

Under the FTC’s 1992 Horizontal Merger Guidelines, a market is considered highly concentrated when the Herfindahl-Hirschman Index, or HHI, exceeds 1,800. Using these MARAD data, the HHI for the North American cruise market would be over 4,000.

According to the FTC statement, “Absent extraordinary circumstances, there is a strong presumption that a three-to-two merger of significant competitors in a properly delineated relevant market is likely to harm consumers. In this situation, however, there are now four major firms and a “fringe” of other competitors.” See Statement of the Federal Trade Commission Concerning Royal Caribbean Cruises, Ltd./P&O Princess Cruises plc and Carnival Corporation/P&O Princess Cruises plc, FTC File No. 021 0041.
Other Potential Effects of the Exemption Include Employment Growth and Tax Revenues

NCL's operations resulting from the exemption will create jobs on the exempted ships and where it offers itineraries, and they will likely increase tax revenue. According to NCL's analysis of the Hawaiian market, its expanded operations will generate about 2,400 full-time shipboard jobs and additional shoreside employment in Hawaii. This estimate seems reasonable, because NCL must hire at least 800 U.S. employees per ship for three ships, as well as additional land-based employees. Some of these jobs might be transfers of jobs from other states to Hawaii and, thus, would not represent new benefits to the U.S. economy. An NCL consultant estimates total annual tax revenues from the exemption operations to be $126.5 million, including employee income taxes and social security taxes, airfare taxes, and customs, immigration and ship passenger taxes. In addition, NCL's U.S. subsidiary, NCL America—which will operate the exempted ships in order to meet the U.S.-ownership requirements needed to register the vessels under the U.S. flag—will be liable for corporate income taxes on any profits it earns; and it will be subject to the payment of employer payroll taxes in Hawaii.

NCL estimates passenger expenditures will bring an additional $355 million annually to the regions where NCL operates. This value assumes that all vessels operate at full capacity. These passenger expenditures represent a net benefit to the U.S. economy only when these passengers choose the domestic NCL cruise over a foreign vacation or other foreign spending. To the extent that the passengers' alternatives were a different U.S. vacation or other discretionary spending in the United States, then this expenditure figure only represents a transfer of revenues to the region where the cruise is operating from other U.S. regions.

Realization of Economic Benefits Is Largely Contingent on NCL's Continued U.S.-Flag Operations

Most of the benefits described above will materialize only if NCL continues to operate cruise ships under the U.S. flag. However, as noted above, industry analysts question NCL's ability to operate the interisland Hawaiian cruises profitably. Analysts speculate that these cruises might not be profitable since they will still have to compete with foreign-flag cruises with significantly lower operating costs than NCL, though on different itineraries. Analysts also expressed concern that NCL is deploying too much capacity in Hawaii.

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43This estimate does not include corporate income taxes NCL would be liable for on income earned on these domestic routes.

much capacity for the uncertain Hawaiian market demand. According to Cruise Lines International Association, Hawaiian cruises generated only about 3 percent of the business in the North American cruise market in 2002. NCL plans to grow the Hawaiian market by 23 percent each year for the next 5 years, resulting in Hawaiian destinations comprising 6 percent of the North American cruise market by 2007. This plan is quite aggressive, considering that industry trade groups expect the cruise market in general to grow 10 percent each year. If NCL is not profitable operating the exempted vessels in the United States, analysts speculate that NCL will seek government approval to reflag the vessels and operate them in foreign trades. NCL could continue to serve the Hawaiian market with the refagged vessels, if the itinerary included a stop at Fanning Island or another foreign port. In this case, the exclusive interisland cruise options for consumers would no longer be offered, jobs for U.S. crew and the associated tax revenue would be lost, and NCL would not be liable for U.S. corporate income tax. In addition, if NCL is unable to operate successfully under the U.S. flag in Hawaii, possibly the most desirable market protected under the PVSA, there will be further disincentive for any other cruise line to attempt to operate under the U.S. flag, thus limiting the potential development of the U.S.-flag cruise vessel fleet.

**Unclear if Granting Other Cruise Lines Similar Exemptions Would Lead to Entry by Other Cruise Lines and Resulting Economic Benefits**

Granting similar exemption to ease entry into the domestic trade could lead to additional benefits for ports and port cities, the merchant marine and consumers; however, it is unclear how many cruise lines would choose to enter if they were permitted to operate foreign-built ships under the U.S. flag. For certain unique itineraries, where foreign vessels cannot easily operate with a nearby foreign port, such as in Hawaii, one-way cruises in Alaska, or short 3 to 4-day itineraries on the east or west coasts, some potential exists for U.S.-flag ships to enter the market. However, there are substantial disincentives to operating under the U.S. flag due to (1) operating cost differentials between the would-be U.S.-flag entrant and foreign-flag ships that still offer somewhat similar itineraries, but include a foreign port, (2) labor conditions and ship requirements, and (3) uncertain market conditions. Moreover, entry from additional ships exempt from the U.S.-built requirement could have a negative impact on the U.S. shipbuilding industry and small U.S.-flag cruise ships, though these impacts are likely to be minimal if the U.S.-built requirement is waived only for large cruise ships.
Additional Benefits Could Result from More Entry into the Domestic Markets

Ports and port cities, the merchant marine, and consumers could benefit if additional exemptions to the U.S.-built requirement led to new entrants providing U.S.-flag cruise service. Additional domestic cruises could create more activity for the ports and result in more jobs and increased spending in port cities. U.S.-flag ships also would employ U.S. seamen, adding to the base of trained maritime employees who could serve the country in a time of emergency. Moreover, potential entrants could offer more cruise options and new itineraries to consumers. For example, a 1997 study conducted for the California State Tourism Board found that with similar exemptions to operate foreign-built vessels under the U.S. flag, cruise lines could offer cruise itineraries on the California coast to smaller ports, such as Santa Barbara and Monterey, resulting in more tourist dollars in those areas. However, if new domestic cruises primarily replaced existing foreign-flag service, with minor itinerary changes caused by eliminating foreign ports-of-call, the benefits to ports, port cities and consumers might be minimal. On the east coast, for example, Carnival currently offers cruises on a foreign-flag ship—round-trip from New York including stops in Boston, Massachusetts; Portland, Maine; and Canada. If U.S.-flag vessels replaced the foreign-flag vessels offering east coast cruises and had itineraries running from New York to Portland without the stop in Canada—but including the same ports-of-call as the former Carnival cruise—ports, port cities and consumers would experience very little additional benefit from these cruises. Additional cruises to U.S. ports that foreign-flag vessels continue to serve and cruises to different U.S. ports than foreign-flag vessels currently serve are the only source of benefits to ports, port cities, and consumers.

Even with Exemptions from the U.S.-Built Requirement, Other Substantial Barriers to Entry Might Limit the Number of Potential Entrants into the Domestic Cruising Market

While some potential benefits exist, industry officials said that most cruise lines are not likely to enter the domestic market, even if they could build ships outside of the United States because of operating cost differentials, different ship standards, and uncertain market conditions. As previously noted, U.S.-flag operating costs are significantly higher than foreign-flag operating costs. The wage differential is so great that an official from one cruise line stated that the cruise line would prefer to employ foreign workers for any non-U.S. domestic itineraries offered on a U.S.-flag ship.

The official noted that it would be difficult to hire a separate seasonal U.S. crew to work on a U.S.-flag ship, which may operate domestic itineraries only at certain times of the year. U.S.-flag cruise ships also must meet U.S. building standards, which sometimes conflict with international standards. For example, an industry official cited different wiring configurations required on U.S. ships. One cruise line official stated that the cruise line he represents would not specially build a ship to comply with U.S. standards only to be able to operate the ship in domestic trade, given the existing operating cost differentials. Furthermore, cruise officials and industry analysts question whether U.S.-flag operations can be profitable since lower cost foreign-flag ships can serve similar itineraries and demand is unknown for domestic destinations.

Despite all the expected difficulties and disadvantages, representatives of two cruise lines said they would explore entry into some domestic markets if they were given exemption from the U.S.-built requirement. According to these representatives, they would consider testing the Alaskan and Hawaiian markets, and short coastal cruises because of their unique attributes. In Alaska, one-way cruises are popular and currently cannot be offered from a U.S. port, such as Seattle, due to the PVSA. In Hawaii, the nearest foreign port adds at least 2 days of sailing time to the itinerary. Short coastal cruises on the east or west coasts are attractive because including a foreign port would lengthen the cruise.

However, even these attractive markets have factors deterring U.S.-flag operations. Foreign-flag ships currently serve the one-way Alaskan trade embarking in Vancouver. These operators would still have a competitive advantage over U.S.-flag operators granted an exemption from the U.S.-built requirement and operating out of Seattle. While consumers might face an added land transportation cost to depart from Vancouver rather than Seattle, foreign-flag operators would continue to have a significant operating cost advantage over U.S.-flag ships and thus might offer lower prices. The price advantage of the foreign-flag ships is likely to offset the cost disadvantage to consumers of departing from Vancouver. Moreover, according to one industry analyst, the Port of Vancouver might respond to potential competition from the Port of Seattle by lowering its port fees to retain firms operating less costly foreign-flag ships.

Hawaii’s long distance from most foreign ports creates an especially attractive opportunity for entry under the U.S.-flag, but potential competitors would have to compete with an established operator, NCL, for unknown demand. In addition to NCL’s ability to offer wholly domestic
cruises in Hawaii with the exemption, it has had an exclusive arrangement
for its ships to stop at Fanning Island, the closest foreign port to Hawaii.
With this exclusive agreement NCL has been able to garner the largest
market share of the Hawaiian trade. NCL intends to run three U.S.-flag
ships and one foreign-flag ship regularly in Hawaiian itineraries. As noted
previously, some industry analysts do not think consumers in the Hawaiian
market can support NCL's capacity increase; therefore, success might be
difficult for any additional companies entering the market. In fact, one
cruise line we spoke with is uncertain about continued operations, given
the sales performance of its initial entry into the Hawaiian market.

Finally, while short 3- or 4-day cruises along the east or west coasts of the
United States may hold some attraction for would-be entrants, these
cruises could still face lower cost competition from foreign vessels offering
similar itineraries with a foreign port included. In addition, while there are
some smaller U.S. passenger vessels offering short coastal cruises, the
potential demand for these cruises may not be substantial enough to
sustain large cruise ships.

### Similar Exemptions Could Negatively Affect U.S. Shipbuilding Industry and Small Passenger Vessels

Granting other cruise lines exemptions to the U.S.-built requirement
without strict tonnage requirements could negatively affect the U.S.
shipbuilding industry. If exemptions were granted only for large, overnight
cruise vessels, the U.S. shipbuilding industry would face little, if any,
impact given that no such ship has been completed in the United States
since 1958. However, if the exemptions were broader, including small
passenger ships, U.S.-flag operators of small cruise ships might purchase
less expensive ships from foreign shipyards, exposing U.S. shipyards to
foreign competition that is not subject to the same laws, regulations, and
taxes.

Another potential adverse effect of similar exemptions is the shift of
passengers away from small U.S.-flag cruise lines to domestic cruises on
larger U.S.-flag ships built in foreign shipyards. Small U.S.-flag vessels are
built in the United States and operate under all U.S. laws. A major shift in
their customer base could disrupt this segment of the cruise industry and
negatively affect the shipyards that build these small vessels. However,
industry analysts suggest that there is a very small likelihood that similar
exemptions would affect the small cruise vessels because they serve
different segments of the market. Small vessel operators view their
products as boutique cruises, as compared to mass-market cruises on large
vessels. These boutique cruises are often shorter voyages, including calls in small ports that large cruise ships cannot access due to their size.

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<th>Agency Comments and Our Evaluation</th>
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<tr>
<td>We provided the Departments of Homeland Security and Transportation with draft copies of this report for their review and comment. Both departments generally agreed with the findings in the report and provided technical clarifications, which we incorporated as appropriate.</td>
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We are sending copies of this report to the appropriate congressional committees and to the Secretaries and other appropriate officials of the Departments of Homeland Security and Transportation. We also will make copies available to others upon request. In addition, the report will be available at no charge on the GAO Web site at http://www.gao.gov.

If you have any questions about this report, please contact me at heckerj@gao.gov or at (202) 512-2834. Additional GAO contacts and acknowledgments are listed in appendix III.

Sincerely yours,

[Signature]

JayEtta Z. Hecker
Director, Physical Infrastructure Issues
To address the original intent of the Passenger Vessel Services Act (PVSA) and how pertinent rulings and decisions have affected the implementation of the law, we reviewed the PVSA, its amendments, and its administrative, legislative and judicial history. We also reviewed several listings in the Customs Rulings Online Search System to see how the PVSA is currently interpreted and we conducted interviews with officials from Customs and Border Protection (CBP) and the Coast Guard responsible for documentation of U.S. vessels and for enforcing the provisions of the PVSA, U.S. vessel documentation laws, and the Jones Act.

To ascertain how the exemption provided to NCL might affect future rulings or interpretations on the PVSA, U.S. vessel documentation laws, or the Jones Act, we researched the legislative history of the PVSA, its prior amendments and exemptions, and pertinent CBP rulings to determine what impact they had on future rulings regarding the PVSA or the Jones Act. We also reviewed rulings regarding the PVSA to determine if any amendments of exemptions provided for under the Jones Act had any impact on them. Finally, we conducted interviews with agency officials about the implementation of maritime laws.

To determine the potential effects of the exemption on competition in the passenger cruise industry, entry into the U.S. domestic market, the exemption’s broader economic effects, as well as the potential effects of granting similar exemptions, we reviewed studies on the economic impact of the cruise industry and competition in the industry and conducted interviews with officials from several cruise lines, industry associations, and a full range of cruise industry stakeholders, analysts, and experts. To understand the nature of competition in the industry, we reviewed a merger analysis conducted by the Federal Trade Commission (FTC) in 2002 that examined, in-depth, competitive conditions in the North American cruise industry.1 We also interviewed officials and reviewed internal documents from cruise lines, including Norwegian Cruise Line, Carnival Cruise Lines, Royal Caribbean Cruise Lines, Radisson Seven Seas Cruises, Crystal Cruises, the former American Classic Voyages, and CruiseWest to get their perspectives on the nature of competition in the industry, the effects of the exemption on competition, and the potential of various domestic itineraries. We also spoke with several port authorities, individual U.S.

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1Statement of the Federal Trade Commission Concerning Royal Caribbean Cruises, Ltd./P&O Princess Cruises plc and Carnival Corporation/P&O Princess Cruises plc, FTC File No. 021 0041.
shipyards, and industry financial analysts for further information on the broader economic effects of the exemption and the potential effects of granting similar exemptions. In addition, we gathered information on the capital and operating costs of foreign-flag vessels as compared with U.S.-flag vessels. Since most of these data are proprietary, we were unable to independently verify them because we have no authority to require access to the underlying data. However, we applied logical tests to the data and found no obvious errors of completion or accuracy. Along with our use of corroborating evidence, we believe that the data were sufficiently reliable for our use.

To analyze the effects of the exemption on the potential for entry into the U.S. domestic market, we spoke with industry financial analysts and experts, including officials at American Marine Advisors, G.P. Wild, and J.P. Morgan Chase to obtain perspectives on whether financing for a U.S. built vessel would be more difficult to obtain now that the exemption has been granted. We also spoke with officials within the Maritime Administration to ascertain whether applications or approvals for federal loan guarantees for building large passenger vessels had waned or would be more difficult to obtain as a result of the exemption. We also spoke with officials from the cruise lines and an official representing smaller U.S.-flag vessel operators to get their perspectives on the potential for entry into the U.S. domestic cruise market. To determine the extent of NCLs capital cost advantage under the exemption, we obtained estimates of the final cost to build the first of the exempted vessels from the General Disclosure statement under the Stock Exchange of Hong Kong of Star Cruises Limited, NCLs parent company. We were unable to independently verify these costs because we have no authority to require access to the underlying data. However, we confirmed the accuracy of these figures with officials within NCL and through comparing the figures to publicly available data on the costs of vessels of similar size completed for other cruise lines. We then compared these costs to the original project costs to build the Project America vessels in a U.S. shipyard. We converted all figures to 2003 dollars using the producer price index for ship and boat building and repairing prepared by the Bureau of Labor Statistics.

We also obtained additional perspectives on the potential economic effects of the exemption and of possible additional exemptions from various industry associations, including the International Council of Cruise Lines, Cruise Lines International Association, the Passenger Vessel Association, the American Shipbuilding Association, and the American Society of Travel Agents, as well as officials from the Maritime Cabotage Task Force, the
Maritime Trades Departments of the AFL-CIO, American Maritime Officers, and the Seafarers International Union.

We conducted our work from August 2003 through February 2004 in accordance with generally accepted government auditing standards.
Appendix II

Other U.S. Laws Applicable to U.S.-Flag Vessels on Wholly Domestic Cruises

NCL's Operations Will Subject Them to the Application of U.S. Tax, Labor, and Other Laws Unlike Other Foreign Cruise Lines that Serve the United States

Since NCL's vessels will be undertaking domestic travel under the U.S. flag, NCL will subject itself to numerous other U.S. laws in the areas of tax, labor, immigration, environment and the Americans with Disabilities Act. These U.S. laws do not usually apply to foreign-flag cruise lines because their itineraries are in international waters, either because they include a distant foreign port if they are traveling between U.S. ports, or a nearby foreign port if the voyage is a round trip from one U.S. port, and thus international rather than U.S. laws apply.

NCL Will Be Subject to U.S. Taxation Laws

Because NCL's U.S.-flag Hawaiian operations—operated by its U.S. subsidiary NCL America—will be involved in domestic trade, income derived from those operations would be taxable under the U.S. tax code. The Internal Revenue Code has special rules for “transportation income.” If the transportation income is attributable to transportation that begins and ends in the United States, it is treated as income derived from sources in the United States and therefore fully taxable. If the transportation begins or ends in the United States, but not both, 50 percent of the transportation income is treated as income derived from sources in the United States.\(^1\)

However, the Internal Revenue Code, under 26 U.S.C. 883, also excludes from the gross income of foreign corporations income derived from the international operation of vessels if their home countries grant an equivalent exemption from paying taxes to U.S. corporations. Therefore, the income earned from foreign-flag vessels operated by foreign corporations operating cruises in the United States may not be subject to U.S. corporate income tax.

NCL Vessels under the Exemption Will Be Subject to Several U.S. Labor Requirements

If NCL operates vessels in domestic trade, those vessels will become subject to U.S. labor and documentation laws, which, among other things, require that the officers and unlicensed seamen on a U.S.-flag ship to be U.S. citizens or documented aliens with permanent residence in the United States, and that the crew be subject to minimum wage and collective bargaining laws. U.S. documentation laws under 46 U.S.C. 8103(a) require

\(^1\)Internal Revenue Code Sec. 863(c).
that only U.S. citizens serve as the master, chief engineer, radio officer, and officer in charge on a U.S. documented vessel. Also, each unlicensed seamen must be a citizen of the United States except that not more than 25 percent of that number may be aliens lawfully admitted to the United States for permanent residence. Under the Fair Labor Standards Act, minimum wage laws would apply to the crew, and they would be allowed to engage in collective bargaining under the National Labor Relations Act. In addition, where applicable, higher state minimum wage laws would apply. For example, U.S.-flag interisland Hawaii cruise operations will be subject to the state's $6.25/hour minimum wage, which is $1.10 higher than under federal law. In addition, crewmembers on U.S.-flag vessels are subject to tax at the federal, state, and local levels.

Foreign Cruise Ships Primarily Adhere to International Construction and Safety Standards Rather than U.S. Standards

NCL's U.S.-flag ships will have to adhere to U.S. Coast Guard-approved vessel construction and safety standards. As a general rule, foreign vessels operating in U.S. waters need only comply with international construction and safety standards, as opposed to the often more rigorous U.S. standards. An international treaty, the Safety of Life at Sea Convention sets forth international construction and inspection standards. A foreign vessel from a country that is a signatory to the Convention, would be subject to U.S. inspection only as to the vessel's propulsion and lifesaving equipment. Finally, according to several industry experts and representatives, the application of the American's with Disabilities Act could have significant cost implications for vessels operating in the U.S. domestic trade because of requirements to make the vessels handicap accessible. However, NCL executives stated that these requirements would not add significant costs to their ships, because even their foreign-flag ships adhere to high standards in this regard.
## GAO Contacts and Staff Acknowledgments

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### Staff Acknowledgments

The GAO staff that worked on this report dedicate it to their late colleague, Ryan Petitte, in recognition of the valuable contributions he made. Other key contributors include Jay Cherlow, Michelle Dresben, Sarah Eckenrod, Colin Fallon, David Hooper, Ron Stouffer, and Andrew Von Ah.
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