





Saving the Last “American” Cruise Ship

By Roger D. Blair and James Mak

When Sir Walter Scott wrote “what a tangled web we weave, when first we practice to deceive,” he was describing machinations within a nasty love triangle. But he might have been referring to the labyrinth of laws and regulations ostensibly intended to protect America’s capacity to project power overseas in time of war. We get ahead of ourselves, though; first, some background.

The Passenger Vessel Services Act of 1886 reserves transportation of passengers between domestic ports to U.S.-built, U.S.-flagged (meaning, registered) and U.S.-crewed ships. The PVSA now applies to commuter ferry

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service, riverboat gambling and excursions, coastal passenger transportation and cruise tourism. A companion law enacted in 1920, commonly referred to as the Jones Act, set the same requirements to the far bigger business of cargo shipping. And the rationale for both is familiar – in the words of the U.S. Maritime Administration, “to assure reliable domestic shipping service and the existence of a maritime capability that is completely subject to national control in times of war or national emergency.”

But the requirement to use American-built ships staffed with American workers immensely increases the cost of shipping. So owners (including American companies) do whatever they can to circumvent the regulations. And, in the case of cruise ships, they’ve been very successful. While the cruise business is growing by leaps and bounds, only one U.S.-flagged ship, the Norwegian Cruise Line’s *Pride of America*, is still in service. The story of how its owners and unions have been waging political war to keep it in service at the expense of tourists, port workers, taxpayers and Hawaiian tourism is a cautionary tale for anyone naïve enough to take the Maritime Administration at its word.

CRUISE TOURISM IN HAWAII

Cruising was a latecomer to Hawaii. Before the 1980s, big passenger ships occasionally visited the islands, but there were no overnight cruises within Hawaiian waters. Then, a subsidiary of American Classic Voyages, the company that resurrected pleasure travel by steamboat on the Mississippi River, began offering inter-island itineraries using two rela-

tively small (23,000 ton) ocean liners. The SS *Independence* was placed in Hawaii service in June 1980 and was joined two years later by the SS *Constitution*. Both vessels had been built three decades earlier for transatlantic travel. And by the 1980s they were the only remaining ocean-going passenger ships that were both U.S.-built and U.S.-flagged.

In spite of ACV’s effective monopoly on inter-island cruising, however, time eventually caught up with the old ships. In 1996, the *Constitution* was retired, to be followed five years later by its twin.

PROJECT AMERICA

ACV sought to replace them with modern ships expressly built for cruising. At the time, no large passenger ships had been constructed in the United States in four decades. But in 1997, Daniel Inouye, a Democratic senator from Hawaii, persuaded the Department of Defense to subsidize cruise ship construction as part of a larger Clinton administration initiative nominally intended to promote commercial shipbuilding in the United States and to wean uncompetitive, high-priced U.S. shipyards from virtually total dependence on military construction.

American Classic Voyages committed to buying two 72,000-ton cruise ships from the private shipyard in Mississippi – by no coincidence, the home state of Trent Lott, the Senate majority leader. The Maritime Administration (that is, U.S. taxpayers) guaranteed 87.5 percent of the construction costs, enabling ACV to finance the ships at well below market interest rates. As an extra sweetener to the deal, ACV was permitted to use a foreign-built cruise vessel to serve Hawaii while the new ships were being built.

But in October 2001, ACV filed for Chapter 11 bankruptcy, citing a sharp decline in business after the Sept. 11 terrorist attacks.

ROGER BLAIR and JAMES MAK teach economics at the University of Florida and the University of Hawaii (Manoa), respectively.

Work on the “Project America” ships came to a screeching halt. Ship 1 was between 37 and 50 percent complete, and parts for Ship 2 had been ordered. All told, the suspension of construction cost the taxpayers \$185 million.

THE NCL COMES TO HAWAII

The Norwegian Cruise Line capitalized on ACV’s demise in 2001 by starting its own Hawaii-based cruise business, offering week-long interisland cruises on the *Norwegian Star*, a foreign-built and foreign-flagged ship. To comply with the protectionist provisions of the law, the *Norwegian Star* had to make a stop at a foreign port during each cruise. NCL elected to make a lengthy side trip to Fanning Island, a Pacific atoll of 13 square miles and 1,600 residents in the Republic of Kiribati. This “touch-and-go” detour took nearly four days of the seven-day cruise, including a six-hour layover at Fanning Island.

To make lemonade from the sour restrictions of the law, NCL cagily cut a deal with Kiribati that granted the company exclusive visitation rights; this effectively prevented other foreign cruise liners from entering the inter-island Hawaii market. The agreement, extended to 2007, stipulated that NCL would assist in the transportation of mail and cargo, employ Kiribati residents on board and build facilities on the island.

By 2002, NCL had two ships deployed in Hawaii. In addition to the *Norwegian Star* (permanently based in Hawaii), it assigned the *Norwegian Wind* to spend much of the year in Hawaii to provide longer (10 or 11 day) cruises with the obligatory side trips to distant Fanning Island. With no competition in sight, NCL was able to charge three times

more for the island cruises than it could manage in the fiercely contested Caribbean market.

PULLING STRINGS

Buoyed by this early success, NCL was eager to find a way to offer interisland cruises without the pointless detour to Fanning Island. The company purchased the partially completed Project America vessel and the parts for the second vessel in late 2002, then hauled them to a shipyard in Germany to have the ships finished there. To employ the two foreign-built vessels in strictly domestic service in Hawaii, of course, NCL needed to obtain a waiver from the law. NCL approached Senator Inouye for help.

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It is not all that unusual for Congress to grant such exemptions to offshore U.S. islands. Indeed, one of the political virtues of most economic regulation is that it gives members of Congress ways to make new friends and succor old ones. In 1984, for example, Congress granted a waiver to allow foreign-crewed, foreign-built, foreign-flagged cruise ships to transport passengers between the U.S. mainland and Puerto Rico, if no U.S. flag carriers were available to provide the same service. In return for Inouye’s support, NCL agreed to the senator’s demands that NCL employ an all-U.S. crew on the exempt ships and create a U.S. subsidiary (NCL America) to operate them as U.S.-flagged vessels.

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Inouye inserted a provision in the Omnibus Appropriations Act of 2003 that allowed NCL to complete the two Project America ships in Germany. These two ships and an additional foreign-built cruise ship would then be registered in the United States and permitted to operate purely in domestic service.

Inouye's initiative did face opposition. Since the waiver would give NCL an enormous advantage over its potential rivals, the trade association representing the major international cruise lines countered with a proposal to allow three more foreign-built cruise ships to operate in Hawaii under the U.S. flag. Any cruise line would be eligible.

But Inouye (and NCL's lobbyists) outmaneuvered these rivals. Key lawmakers from Florida and Alaska (with their own friends in the cruise industry) agreed to support Inouye's version as long as the three ships would never be permitted to compete with locally powerful foreign-flagged cruise lines by operating in the Caribbean, the Gulf of Mexico or Alaska. Inouye's more restrictive version of the waiver became law in February 2003.

COMPETITION STILL REARS ITS UGLY HEAD

Since NCL had made money in Hawaii in spite of the Fanning Island detour, it apparently expected to coin the stuff once it could offer more attractive itineraries on spanking new ships. The *Pride of Aloha* (the entirely foreign-built ship that was part of the bargain brokered by Inouye) began exclusive inter-island service in July 2004.

But from the very beginning, NCL had trouble recruiting, training and retaining the required all-U.S. staff. During the first couple of months in operation, the annualized employee turnover rate for the *Pride of Aloha* was more than 50 percent. And as NCL ac-

knowledged, the service was, to say the least, ragged. So Congress, with a little magic from the lobbyists, changed the law again in 2006 to permit one-quarter of the staff to be resident aliens.

Nonetheless, service complaints persisted. And to further tarnish NCL's image in Hawaii, the *Pride of Aloha* failed a health inspection by the Centers for Disease Control and Prevention in December 2007.

The company was also plagued by excess capacity in Hawaii. With the deployment of the *Pride of Hawaii* in June 2006, it had quadrupled its pre-waiver cruise capacity. Each of the three *Prides* could carry some 2,000 passengers – more, apparently, than the market would bear at premium prices.

NCL put the principal blame for its resulting financial difficulties on depressed fares attributed to an “unprecedented” increase in competition from foreign-flagged cruise ships on the U.S. West Coast-Hawaii route. To comply with PVSA regulations without a waiver from Congress, these ships were making brief stops in Ensenada, Mexico in much the spirit of NCL's earlier excursions to Fanning Island.

On its face, NCL's claim wasn't particularly credible. It seems unlikely that many people contemplating a seven-day interisland cruise beginning and ending in Hawaii would consider a five-day inter-island cruise sandwiched between two five-day voyages on the high seas to be a plausible alternative.

Whatever the reason for NCL's troubles, though, it's clear that the interests of both cruise customers and the Hawaiian tourism industry lie in keeping the touch-and-go loophole open. Choice is always good for consumers. And it is hard to believe that even a small fraction of the 98,000 passengers who took long cruises from the U.S. West Coast to Hawaii in 2007 would have opted for NCL



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interisland cruises if the touch-and-go option hadn't been available.

MAKING HAWAII SAFER FOR NCL

Mounting financial losses finally prompted NCL to announce that it would reflag the third and largest vessel, the *Pride of Hawaii*, and redeploy her to Europe in February 2008. Meanwhile, NCL and U.S. maritime unions had been pressing Washington to tighten the interpretation of the PVSA to get foreign-flag carriers off the West Coast-Hawaii run. And the lobbying bore some fruit. In November 2007, the Customs and Border Protection Service (CBP) proposed a requirement that a foreign-flagged vessel carrying passengers between U.S. ports must (a) stop at a foreign port for at least 48 hours, (b) spend at least half as much time in foreign ports as in U.S. ports, and (c) allow passengers to disembark at the foreign port(s).

While Hawaii's Congressional delegation, maritime officials, and local labor unions all support the proposed change, the state's Republican governor, Linda Lingle, has dissented. She estimated that the loss of the international cruise ships to Hawaii – assuming (plausibly) that domestic cruise ship calls would not increase – would amount to \$80 million annually in sales of goods and services.

Later, in February 2008, while CBP was still mulling its decision, NCL decided to pull a second of its three U.S.-flagged vessels from the Hawaii market. NCL said it still expected the state to support the proposed rule change. Indeed, in a warning to Hawaii, NCL's chief executive explained that "no one has taken seriously enough that ships, once here, can go away again." He added, "The focus in Hawaii should be on making sure that our one ship remains here."

Sen. Inouye reaffirmed his support for fed-

eral protection for the last American cruise ship – *Pride of America* – from "unfair foreign competition." He also revealed that the Customs and Border Patrol Service was considering a narrower compromise rule that would apply only to "Hawaii waters and will require that one-third of the time a foreign-flag ship spends in port on a Hawaii itinerary be spent in a foreign port." The idea was to placate opponents from the mainland cruise ports (think Seattle) that aren't visited by U.S.-flagged cruise ships.

But even a cursory analysis suggests that Hawaii can't be isolated within the cruise market this way. Cruise tourism is a footloose industry. Consider, for example, the Alaska cruise market. Foreign-flagged ships that sail to Hawaii from the West Coast during most of the year move to Alaska during the summer. At the end of the short Alaska season (mid-May to mid-September), they come back to Hawaii. Indeed, in May 2006, NCL sent its own foreign-flagged *Norwegian Wind* to Alaska and returned her to Hawaii in September. If foreign ships could not profitably come back to Hawaii because of tighter CBP rules, the number of ships that could profitably sail in Alaska would also be cut. In sum, the two markets are linked on the supply side.

For Hawaii, the worst-case situation would be one in which a decline in demand forced NCL to shut down its last American cruise ship in Hawaii, even as a more restrictive PVSA reduced the number of visits by foreign-flagged cruise ships. In August, the White House sent the bureaucrats back to the drawing board, claiming it presents no compelling public need. NCL continues to press for relief

SHOULD THE PVSA BE REPEALED?

The nominal case for protecting a national merchant marine is its logistic value in time

of war. Cunard's ocean liners did, after all, serve Margaret Thatcher well during the 1982 Falkland Islands war, ferrying troops to those remote specks in the South Atlantic after Argentina closed the airport. Perhaps U.S.-flagged cruise ships could some day be pressed into similar service on Washington's behalf.

It's a bit hard to flesh out that hypothetical chain of events, though. The Pentagon chartered airliners to move troops, and in a rare emergency in which air travel was impractical but seaports were open, it would charter for-

operate the vessels under the U.S. flag, but, vaguely, for "at least three more years."

In sum, then, it is hard to rationalize the PVSA on national security grounds. And it is equally hard to see how a more protectionist PVSA would benefit American consumers or port cities. It would only force the foreign-flagged cruise ships bound for Hawaii from the West Coast to depart from Ensenada or Vancouver – as some already do – denying business to the ports of San Diego, Los Angeles and Seattle. And since the repositioning

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eign ships. We don't think partly foreign-owned NCL, which was able to reflag two of its three U.S. cruise ships without asking anyone's permission, would provide a more reliable source of emergency transit. Note, too, that none of NCL's *Pride* vessels were built in the United States, and thus did not contribute to maintaining America's shipbuilding capacity in the unlikely event that foreign shipyards and foreign-flag ships refused American offers of lucrative contracts.

It is interesting to note that when American Classic Voyages declared bankruptcy in 2001, the Maritime Administration, which was the financial guarantor, seized two 224-passenger coastal vessels that had been built in the United States along with the two unfinished cruise ships. After years of being mothballed, these two ships reportedly have been sold to a European consortium for about \$20 million – a loss to U.S. taxpayers of more than \$60 million. The buyer agreed to

would also make the cruises less convenient for American customers, it would mean less cruise tourism for Hawaii.

Of course, the PVSA also protects the nation's commuter ferry services, like the extensive ferry system in Seattle, from foreign competition. But most ferry systems are publicly owned and heavily subsidized – and thus unlikely takeover targets by foreign investors.

The law also protects the American owners of river gambling boats in the Midwest, as well as a couple dozen cruise-to-nowhere gaming vessels operating from U.S. ports. But it is hard to see how protecting these vessels enhances the security of the United States.

Economists have long preached that shielding incumbent businesses generally leads to less service, higher prices and lower quality. NCL's experience – indeed, the long, dreary tale of sustaining an American cruise business in Hawaii with a lot of help from the taxpayers – only confirms that conclusion. **M**