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Current Developments in Short Sea Vessel and Infrastructure Financing: SEA 21, CCF Extension and 12106(e) lease financing

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INTRODUCTION

The term ”Short Sea Shipping” is currently used to describe a host of different vessel services varying from short trips by $2 million passenger ferries providing services for metropolitan centers such as New York and San Francisco to voyages of several thousand miles by $150 million container and RO/RO vessels serving Hawaii and Alaska. The financing problems and opportunities for these services can vary from the simple to the very complex.

In this presentation I will attempt an introductory classification and survey of current financing sources and then discuss the DOT/MARAD SEA 21 initiatives and additional equity sources.

DISCUSSION: SHORT SEA SHIPPING "SSS" MIGHT BE

Ferry vessel based services for passenger and passenger vehicle traffic serving metropolitan areas, or offshore locations (Class 1);

Barge based short or intermediate range services mostly for 20 and 40 foot international trade container boxes and but some for 53 foot domestic trailers (Class 2); or

Container and RO/RO vessel based long haul services, with RO/RO services for 53 foot domestic trailers or trailers and cabs and sometimes passengers (Class 3).

DISCUSSION: SHORT SEA SHIPPING “SSS” MIGHT BE:

The MARAD & DOT SSS focus is principally freight based, viewing water transport as a part of an integrated national freight transportation system, seeking to integrate water transport with and to supplement existing interstate highway and rail transportation facilities.

FINANCING OPTIONS FOR DIFFERENT SERVICES ARE DIFFERENT

Class 1 & 2 ferry and barge based services most frequently use publicly owned existing terminal facilities, or new facilities financed by state and federal authorities without difficulty.

The ferry vessels may be public authority or private sector owned. The barge units will be generally be private sector owned. Vessel costs are such that they can be easily financed by established private sector operators. New private sector operators may debt finance with engine manufacturers or established banking connections. Finding the equity necessary for vessel ownership is often a more difficult problem.

VESSEL FINANCING OPTIONS

Class 3 RO/RO and container vessel based long haul services most frequently use publicly owned existing terminal facilities, or new facilities financed by state and federal authorities. The vessels have been and are likely to remain private sector owned. Vessel costs are such that private sector vessels for established operators will generally require federal financing assistance. New operators will require federal financing assistance.

VESSEL FINANCING OPTIONS

For Class 1 & 2 vessels, in the absence of Title XI, engine manufacture financing may be the practical financing solution. Engine manufacturer Caterpillar offers a good example.

- Loan terms up to 10 to 12 years
- Principal amortization up to 15 years
- Loan amounts up to 80% of vessel costs
- Financing during the construction period
- Competitive interest rates, either fixed or variable
- Flexible repayment plans

VESSEL FINANCING OPTIONS

Caterpillar per vessel guideline limits are $80 million. Of course, it may take more than one vessel to establish a viable service. At Caterpillar the maximum exposure per customer has been approximately $125 million. Caterpillar would probably be willing to participate in an attractive larger project if it were presented.

THE VESSEL FINANCING OPTIONS

For Class 3 vessels costing $100 or more, or where several $100 million vessels may be needed to establish a viable service, federal assistance such as that provided by MARAD's Title XI Program will probably be required.

INTEGRATED NATIONAL TRANSPORTATION SYSTEM

The MARAD and DOT SSS focus is principally freight related, viewing water transportation as a part of an integrated national transportation system, seeking to integrate water transportation with existing interstate highway and rail transportation facilities.

"How many 53 foot units can a water service remove from I-95?" High speed Class 3 services between appropriate port pairs appear to have the greatest potential for removing substantial numbers of 53 foot units.

POSSIBLE SEA 21 PROPOSALS

What can the federal government, MARAD, Federal Highway Administration (FHWA) and DOT, do to assist in establishing such new Class 3 services? This appears to have been the principal focus of the ongoing SEA 21 studies. Will DOT/MARAD propose any or all of

- Domestic Harbor Maintenance Tax Repeal
- Revitalized Title XI Debt financing guarantees
- MARAD CCF extension to domestic Coastwise services
- A "TIFIA" program for terminals in the $20 to $60 range

SEA 21 DISCUSSION

If the SEA 21 package includes these proposals, will they become available to provide necessary assistance, or will they be blocked by existing private sector operators who are established, or who hope to become established, in these Coastwise services?

Let's first examine the CCF Program and its possible extension. Then, I have asked Bob Kesteloot and Gene Miller to lead follow-on discussions on the domestic harbor maintenance tax and Title XI initiatives.

THE CCF PROGRAM

The CCF Program extension is the most important and most controversial of these four proposals, and the most in need of maritime industry support.

The CCF Program was viewed as the most important part of the Merchant Marine Act of 1970.

"It is believed that these provisions will do more than anything else in the bill to help the ship operating, and therefore the shipbuilding industry to build ships in United Ships yards which are so urgently needed to modernize our United States merchant marine."

S. Rep. No. 91-1080, at 43 (1970)

THE CCF PROGRAM: TWO USES

Accumulating Equity: The CCF Program can be used by an operator to accelerate the accumulation of equity necessary for for the purchase of vessels for fleet expansion.

Reducing Lease Financing Costs: The CCF Program can be used by an operator to reduce lease hire charges where lease financing is used for the acquisition of vessels for fleet expansion.

THE CCF PROGRAM: CITIZENSHIP

"Any citizen of the United States owning or leasing one or more eligible vessels may enter into an agreement with the Secretary under, and as provided in, this section to establish a capital construction fund with respect to any or all such vessels."

Section 607(a), Merchant Marine Act, 1936, as amended.

THE CCF PROGRAM: TAX DEFERRAL

The CCF Program allows a taxpayer (which enters into a contract with MARAD) to shelter income from current taxation in exchange for the taxpayer's commitment to purchase or construct a new U.S. flag vessel or vessels at some future date. It may be useful to think of the Program as providing the taxpayer with the use of a "super" accelerated depreciation, or perhaps as a sort of U.S. flag vessel owner 401(k) account.

THE CCF PROGRAM: ACCUMULATING EQUITY

The CCF Program allows a U.S. operator to set aside earnings from its vessel operations free of tax in order to accumulate the capital required for planned new vessel construction.

In the example below, Alpha's accumulation of additional capital is the result of a straightforward deferral of tax on current operating and investment income. This is the classic use of the CCF Program as contemplated by Congress when the 1970 Act programs were enacted.

THE CCF PROGRAM: ACCUMULATING EQUITY

Alpha Corp and Beta Corp, established U.S. flag passenger ferry operators, each wish to add six new passenger ferry vessels to their fleets during the next five years. If Alpha and Beta each set aside $1 million from current vessel earnings for each of the next five years for the to purchase new vessels at the end of year five, and Alpha makes use of a CCF and Beta does not, Alpha will have accumulated $6.72 million for fleet expansion and Beta will have accumulated only $3.59 million. Alpha will be able to acquire six new passenger ferries. Beta will be able to acquire only three.

THE CCF PROGRAM: ACCUMULATING EQUITY

Alpha Corp with CCF

Year	*Deposits*	*Tax on Deposits*	*Income on Deposits*	*Tax on Income*	*Balance at Year End*
1	$1,000,000	-0-	$100,000	-0-	$1,100,000
2	1,000,000	-0-	210,000	-0-	2,310,000
3	1,000,000	-0-	331,000	-0-	3,641,000
4	1,000,000	-0-	464,100	-0-	5,105,100
5	1,000,000	-0-	610,510	-0-	6,715,610

Available for Fleet Expansion $6,715,610

Beta Corp without CCF

Year	*Deposits*	*Tax on Deposits*	*Income on Deposits*	*Tax on Income*	*Balance at Year End*
1	$1,000,000	$400,000	$ 60,000	$ 24,000	$ 636,000
2	1,000,000	400,000	123,000	49,440	1,310,160
3	1,000,000	400,000	191,016	79,406	2,024,770
4	1,000,000	400,000	262,477	104,991	2,782,256
5	1,000,000	400,000	338,226	135,290	3,585,191

Available for Fleet Expansion $3,585,191

Alpha has accumulated $6,715,610 and is able to purchase six vessels.

Beta has accumulated $3,585,191 and is able to purchase three vessels.

THE CCF PROGRAM: REDUCING LEASE FINANCING COSTS

An operator wishing to acquire its vessels in lease financing transactions can achieve CCF Program lease hire savings by negotiating a sharing in the CCF Program benefits that the leasing company can achieve by using the Program to shelter investment income. This is an adaptation of the CCF Program to allow its use in lease financing transactions that was developed for use by Citicorp and Bankers Trust Company in the mid-1970s.

An operator can achieve lease hire savings in excess of 10 percent in some situations.

THE CCF PROGRAM: EQUITY AVAILABLE

Today there is more than $1.9 billion *already deposited* in taxpayer CCF Program accounts *set aside* for shipbuilding. If the CCF Program were extended to domestic Coastwise services, some portion of this $1.9 billion would become available to provide equity for vessel purchases and lease financing for SSS projects.

These CCF projects could be for the existing CCF Program fundholder, or for another Coastwise qualified owner or operator that is not a current CCF Program participant.

More importantly, as our examples have shown, the CCF Program would be a powerful tool for for the accumulation and attraction of needed capital for new and expanding Coastwise services.

THE CCF PROGRAM: H.R. 2190

In May 2003, the Shipbuilders Council of America sponsored the introduction of H.R. 2190, legislation to authorize the extension of the CCF to domestic Coastwise services.

The H.R. 2190 legislation was carefully drafted to entirely exclude all inland waterway services. However, H.R.2190 was immediately attacked by the American Waterways Operators, the inland waterways operators trade association. AWO, whose inland waterways services were expressly excluded, objected to CCF Program availability for Coastwise services arguing that it would result in massive Coastwise vessel overbuilding.

Other maritime sector trade associations also opposed the SCA initiative, apparently believing that it might somehow advantage competitors.

START UP OPERATIONS & EQUITY CAPITAL

In addition to the anticipated SEA 21 proposals listed, a program is needed to attract leasing capital for vessels used in start up operations. One approach would be MARAD equity guarantees available to owners of vessels leased to operators engaged in start up Coastwise services. The owners would be allowed to purchase “equity guarantees” much as Title XI guarantees are now purchased.

The program would be open for transactions entered into for some limited period (as a means of “jump starting” desirable Coastwise transactions), and limited to vessels certified by the Department of Defense as militarily useful.

START UP OPERATIONS & EQUITY CAPITAL

Another important source of lease financing equity is that now available under 46 U. S. C. 12106(e) and (f).

Section 12106 was enacted to allow Coastwise operators to access non-citizen leasing equity sources in addition to section 2 citizen sources such as G E Credit and Boeing Capital. Ownership of Coastwise qualified vessels by non-citizen lessors is allowed if the vessel is demise chartered to a section 2 citizen for a period of three years or more.

U.S. Coastwise operators can now lease vessels from German K/G and other non-citizen leasing company owners.

WHAT’S AHEAD & CONCLUSIONS

DOT, MARAD and FHWA have developed an important set of SEA 21 proposals. These proposals include expanded MARAD Title XI and CCF Programs which are intended to facilitate the establishment of new Coastwise services.

Will our maritime industry leaders join in providing industry wide support for these SEA 21 MARAD Title XI and CCF Program expansions, and assist in their enactment?

Or will some of our established operators oppose these SEA 21 proposals and target them for defeat?

Short Sea Shipping’s near term success or failure will probably depend upon the answers to these two questions.

IN CLOSING

THANK YOU.

Copies of materials referenced in this presentation are available upon request from cookhc@sewkis.com.

Cook, “Financing the U.S. Market via MarAd’s ‘CCF’ Program,” Marine Money International (June 2002)

Cook, “Why German K/G Funds Can Now Lease U.S. Flag Assets,” Marine Money International (July/August 2004)

H.R. 2190, 108th Cong. 1st Sess. (2002)

Testimony of the Honorable William G. Schubert before the House Armed Services Committee concerning Maritime Administration Authorization for FY 2003 (March 14, 2002)