

NATIONAL SHIPBUILDING RESEARCH PROGRAM

Workshop on Short Sea Shipping

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Building Short Sea Shipping

Vessel Financing & 2007 Concerns Briefing

H. Clayton Cook, Jr., Counsel

Seward & Kissel LLP

INTRODUCTION

The term "Short Sea Shipping" is used to describe a variety of existing services by \$2 million passenger ferries serving metropolitan centers such as New York and San Francisco, to voyages by \$180 million Container and RO/RO vessels serving Hawaii and Alaska.

The financing problems and opportunities for these services will vary from the simple to the very complex. To facilitate our analysis, let's start with a classification of services and then survey current financing sources and possible Congressional initiatives.

DISCUSSION: SHORT SEA SHIPPING "SSS" DEFINED

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

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

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

FINANCING OPTIONS FOR DIFFERENT SERVICES ARE DIFFERENT

The Class 1 ferry vessels may be public or private sector owned. The Class 2 barge units will be generally be private sector owned. Class 1 and Class 2 vessel costs are such that they can generally be financed by established private sector operators.

Some new Class 1 and Class 2 private sector operators will be able to finance vessel debt with engine manufacturers or established banking connections. Others will not. Further, however, finding the equity necessary for vessel ownership will generally be a much more difficult problem.

VESSEL FINANCING OPTIONS

For Class 3 long haul services vessels are and will remain private sector owned. However with vessel costs of \$150 million and more, even established operators will require federal financing assistance under the MARAD Title XI Program or some new financing guarantee program.

New Class 3 long haul operators will require federal financing assistance beyond that available under the Title XI Program as currently administered. Some form of equity insurance should probably be considered.

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.

PROPOSALS FOR DISCUSSION

What can the Congress and the Executive Branch do to facilitate financing for new SSS vessel construction?

- Repeal Domestic Harbor Maintenance Tax
- Reform, expand & revitalize MARAD Title XI program
- Institute MARAD equity insurance program
- Expand & revitalize MARAD CCF tax deferral program

CAPITAL CONSTRUCTION FUND “CCF” PROGRAM REVITALIZATION

- Extend to include Coastwise SSS services
- Extend to include long-term Charter Hire payments
- Extend to allow earnings deposits for all U.S. flag vessels
- Remove from Alternative Minimum Tax

TITLE XI PROGRAM REVISIONS

- Congressionally defined national transportation needs
- Congressionally defined vessel priorities
- Revise "Commitment Letter " procedures
- Establish SSS "Start Up Services" program

LEGISLATIVE PROPOSAL DISCUSSION: PRO & CON

If Congress initiates legislation that includes such Title XI and CCF proposals, will the legislation receive industry support and become available to provide necessary assistance, or will it be blocked by existing operators who are established, or which hope to become established, in SSS services?

CCF & LEASING INTRODUCTION

Many of you may have had only limited, if any, experience with the MARAD CCF Program, or with non-citizen leasing under section 12119.

I'm going to address these topics separately, first, MARAD's Capital Construction Fund Program, and second, non-citizen vessel leasing under 46 U.S.C. 12119 (formerly 46 U.S.C. 12106 (e) and (f)).

MARAD's CAPITAL CONSTRUCTION FUND ("CCF") PROGRAM

The Merchant Marine Act of 1970 authorized a "Capital Construction Fund" tax deferral program that allows vessel owners to purchase vessels and retire vessel debt with pre-tax dollars. While this "CCF" Program does not have significant name recognition, the names of CCF Program participants do.

BP Oil Shipping Co., Exxon, Crowley Maritime, General Electric Credit & Leasing, Matson Navigation Company and National Steel & Shipbuilding Co. all use MARAD's CCF Program.

CCF: GENERAL DISCUSSION

"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 States yards which are so urgently needed to modernize our United States merchant marine."

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

CCF: GENERAL DISCUSSION

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 "CCF depreciation," or perhaps as a sort of shipowner 401(k) account.

ALPHA CORP: FOUR EXAMPLES OF CCF PROGRAM USE

Alpha Corp is an existing Short Sea Shipping vessel operator that employs integrated tug and barge (“ITBs”) roll/on-roll/off units in a U.S. Gulf of Mexico trade. Alpha wishes to expand its operations and to sign shipyard construction contracts for 3 to 5 new ITB units by the by the end of 2011.

Alpha believes that the shipyard price for these ITBs will be approximately \$30 million each, for a total cost of \$90 million to \$150 million. Alpha expects MARAD Title XI debt financing for 80% of the ITB’s cost. But Alpha will still need \$18 million to \$30 million of equity.

ALPHA CORP: FOUR EXAMPLES OF CCF PROGRAM USE

Alpha can make use of the CCF Program to accomplish its ITB acquisition plans in four different ways.

Example 1: Sheltering Current Earnings from Tax

Example 2: Retiring Debt with Before-Tax Dollars

Example 3: Reducing a Shipyard's Price

Example 4: Reducing Charter Lease Hire Payments

ALPHA CORP: TWO EXAMPLES OF CCF PROGRAM USE

Let's examine the first two of these four examples of Alpha's possible use of the CCF Program – showing how Alpha can accelerate its accumulate this needed vessel equity from current vessel earnings.

EXAMPLE 1: SHELTERING CURRENT EARNINGS - 1

Making use of the CCF Program, Alpha deposits \$3 million of current ITB vessel earnings in each of the next five years (2007 to 2011) to be used as the equity in the purchase of 3 of the ITBs.

At the end of year five, this \$15 million, together with \$5.15 million of investment income, will provide \$20.15 million for vessel equity; sufficient equity for this 3 ITB purchase.

If Alpha tried to accumulate this equity without using the CCF Program shelter, it would have accumulated only \$10.76 million; enough for the purchase of only 1.5 ITBs.

EXAMPLE 1: SHELTERING CURRENT EARNINGS - 2

Accumulating Capital with CCF – 3 ITBs

<i>Year</i>	<i>Deposits</i>	<i>Tax on Deposits</i>	<i>Income on Deposits</i>	<i>Tax on Income</i>	<i>Balance at Year End</i>
1	\$3,000,000	-0-	\$ 300,000	-0-	\$ 3,300,000
2	3,000,000	-0-	630,000	-0-	6,930,000
3	3,000,000	-0-	993,000	-0-	10,923,000
4	3,000,000	-0-	1,392,300	-0-	15,315,300
5	3,000,000	-0-	1,831,530	-0-	\$20,146,830

Funds Available for Fleet Expansion: \$20,146,830 – 3 ITBs

Accumulating Capital without CCF – 1.5 ITBs

<i>Year</i>	<i>Deposits</i>	<i>Tax on Deposits</i>	<i>Income on Deposits</i>	<i>Tax on Income</i>	<i>Balance at Year End</i>
1	\$3,000,000	\$1,200,000	\$ 180,000	\$ 72,000	\$ 1,908,000
2	3,000,000	1,200,000	370,800	148,320	3,930,480
3	3,000,000	1,200,000	573,048	229,219	6,074,309
4	3,000,000	1,200,000	787,431	314,972	8,346,767
5	3,000,000	1,200,000	1,014,677	405,871	\$10,755,573

Funds Available for Fleet Expansion: \$10,755,573 – 1.5 ITBs

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EXAMPLE 2: RETIRING EXISTING DEBT - 1

Alpha's existing ITBs have been financed, on a vessel by vessel basis, with long-term vessel associated debt.

While Alpha's annual debt service requirements are substantial, its earnings are such that maintaining this debt service is not seriously burdensome.

(Moreover, with respect to some of the Alpha fleet, vessel depreciation deductions allow a portion of these debt service payments to be made with before-tax dollars.)

EXAMPLE 2: RETIRING EXISTING DEBT - 2

Rather than continuing to make debt service payments from general funds, Alpha will now deposit its ITB vessel operating income under its CCF Program (under the vessel operating income sub-ceiling) in the amount necessary to make its debt service payments (that are not already made with monies that are depreciation tax sheltered).

EXAMPLE 2: RETIRING EXISTING DEBT - 3

Alpha will now make these debt service payments with money taken from its CCF accounts in qualified withdrawals. Acting in this fashion, Alpha's debt service will be made with before-tax dollars. The current debt service cash flow burden will be reduced and Alpha's accumulation of monies for fleet expansion will be correspondingly increased.

EXAMPLE 2: RETIRING EXISTING DEBT - 4

Assume that Alpha has annual debt service (principal repayment) obligations for its ITB vessels that total \$3 million per year.

In order to make these \$3 million payments with after-tax income (Alpha's income is taxed at 40 percent), Alpha must earn \$5 million before-tax. Over a five-year period, Alpha will require \$25 million in before-tax dollars to service its \$15 million debt.

EXAMPLE 2: RETIRING EXISTING DEBT - 5

Making use of the CCF Program, Alpha will need only \$15 million in before-tax dollars to service its debt during the same five-year period. If this savings is deposited and invested in CCF Program accounts, Alpha will have an additional \$13.4 million available for ITB fleet expansion at the end of five years.

This will be enough to allow Alpha to complete its 5 ITB program.

EXAMPLE 2: RETIRING EXISTING DEBT - 6

Retiring Debt with CCF

<i>Year</i>	<i>Deposits (Jan 1)</i>	<i>Tax on Deposits</i>	<i>Debt Payment (Jan 1)</i>	<i>Balance</i>	<i>Income on Deposits</i>	<i>Balance Year End</i>
1	\$5,000,000	-0-	\$3,000,000	\$ 2,000,000	\$ 200,000	\$ 2,200,000
2	5,000,000	-0-	3,000,000	4,200,000	420,000	4,620,000
3	5,000,000	-0-	3,000,000	6,620,000	662,000	7,282,000
4	5,000,000	-0-	3,000,000	9,282,000	928,200	10,210,200
5	5,000,000	-0-	3,000,000	12,210,200	1,221,020	\$13,431,220

Additional funds available for fleet expansion: \$13,431,220

Retiring Debt without CCF

<i>Year</i>	<i>Deposits (Jan 1)</i>	<i>Tax on Deposits</i>	<i>Debt Payment (Jan 1)</i>	<i>Balance</i>	<i>Income on Deposits</i>	<i>Balance Year End</i>
1	\$5,000,000	\$2,000,000	\$3,000,000	-0-	-0-	-0-
2	5,000,000	2,000,000	3,000,000	-0-	-0-	-0-
3	5,000,000	2,000,000	3,000,000	-0-	-0-	-0-
4	5,000,000	2,000,000	3,000,000	-0-	-0-	-0-
5	5,000,000	2,000,000	3,000,000	-0-	-0-	-0-

Additional funds available for fleet expansion: \$0

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EXAMPLES 1 & 2: "EXTRA" EARNINGS

By using the CCF Program, Alpha will now have accumulated an "extra" \$22.8 million from current earnings – a total of \$33.6 million -- enough to fund the equity requirements for Alpha's entire proposed 5 ITB project.

VESSEL LEASE FINANCING & 46 U.S.C. 12119 (formerly 46 U.S.C. 12106 (e) and (f))

A vessel operator will sometimes decide that acquiring a needed vessel by means of a long-term lease will be preferable to purchasing a vessel. This may often be so for a start-up or a rapidly expanding vessel operation because it can:

1. Reduce the operator's capital requirements; and
2. Allow the current use of vessel depreciation deductions by a Leasing Company (which can share these benefits by reducing the operator's lease hire).

VESSEL LEASE FINANCING & 46 U.S.C. 12119

Lease financing was chosen for many U.S. flag vessel projects after the passage of the Merchant Marine Act of 1970. Leasing Company affiliates of institutions like Bank of America, Bankers Trust Company, Citibank, GATX and GE Credit provided an active market in U.S. citizen leasing equity.

LEASE FINANCING DIAGRAM 1: 1970's Leasing with Section 2 Citizen Owner Lessors



For Example:

**§ 2 Leasing Company – Citibank Leasing
or GE Credit & Leasing**

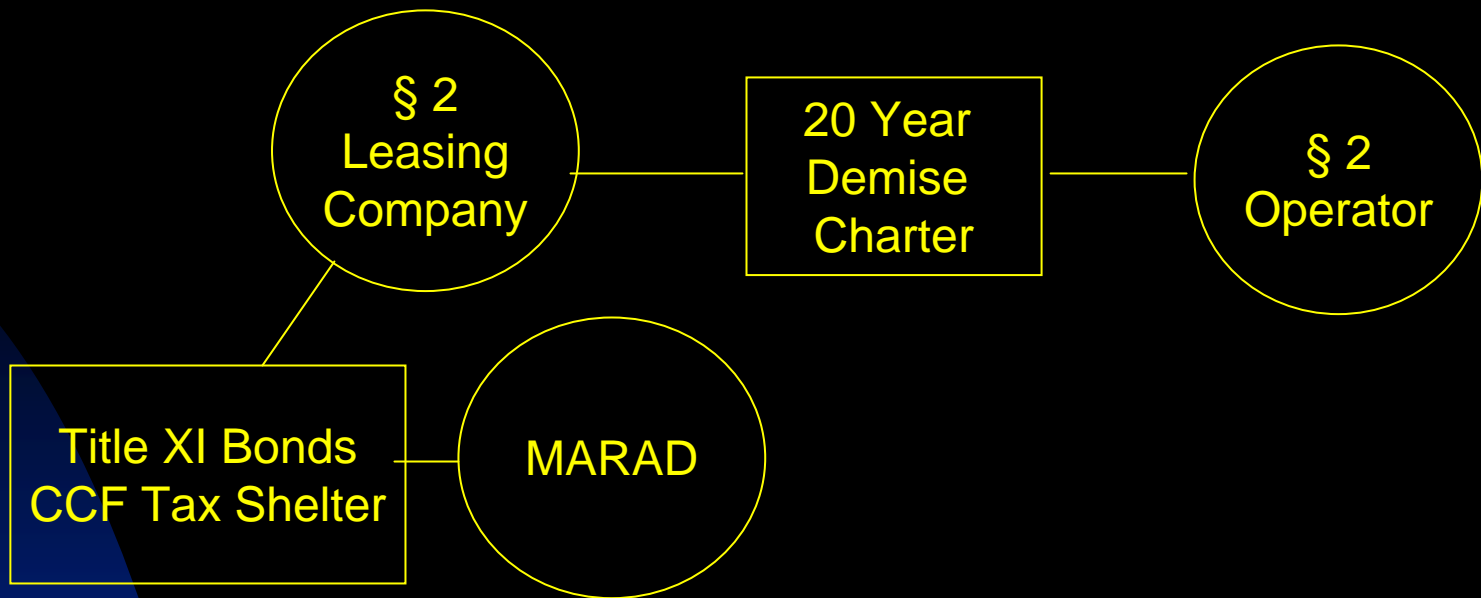
§ 2 Operator – Gamma Marine

LEASE FINANCING & MARAD PROGRAMS

Where the MARAD Programs were employed, the Leasing Company was able to: (i) use the Title XI Program to leverage its equity investment with low-cost long-term debt; and (ii) use the CCF Program to shelter high-yield investment income.

MARAD Program use enhanced the Leasing Company's return, providing benefits that could be shared with the Operator through reductions in vessel lease hire charges.

LEASE FINANCING DIAGRAM 2: 1970s Leasing with MARAD Program Enhancement



For Example:

**§ 2 Leasing Company – Citibank Leasing
or GE Credit & Leasing**

§ 2 Operator – Gamma Marine

LEASE FINANCING: NON-CITIZEN EQUITY

In 1996, the law which governed the qualification of owners of vessels entitled to operate in the Jones Act trades was amended to provide Section 2 citizen Operators with access to non-citizen financial institution Leasing Company vessel owners.

This allowed these non-citizen Leasing Companies to function just as Citibank Leasing and GE Credit & Leasing had functioned as Section 2 citizen Leasing Company vessel owners in the 1970 Act vessel leasing transactions in Diagrams 1 and 2. (This section, originally 46 U.S.C. 12106 (e), was re-codified as 46 U.S.C. 12119 in October 2006.)

LEASE FINANCING: NON-CITIZEN EQUITY

Ownership of Jones Act qualified vessels by non-citizen Leasing Companies is now allowed if the vessel is demise chartered to a Section 2 citizen Operator for a period of three years or more.

LEASE FINANCING DIAGRAM 3: Section 12119 (formerly 12106 (e)) Leasing with Non-Citizen Owner Lessor



For Example:

Owner Leasing Company – DVB Bank USA

§ 2 Operator – Gamma Marine

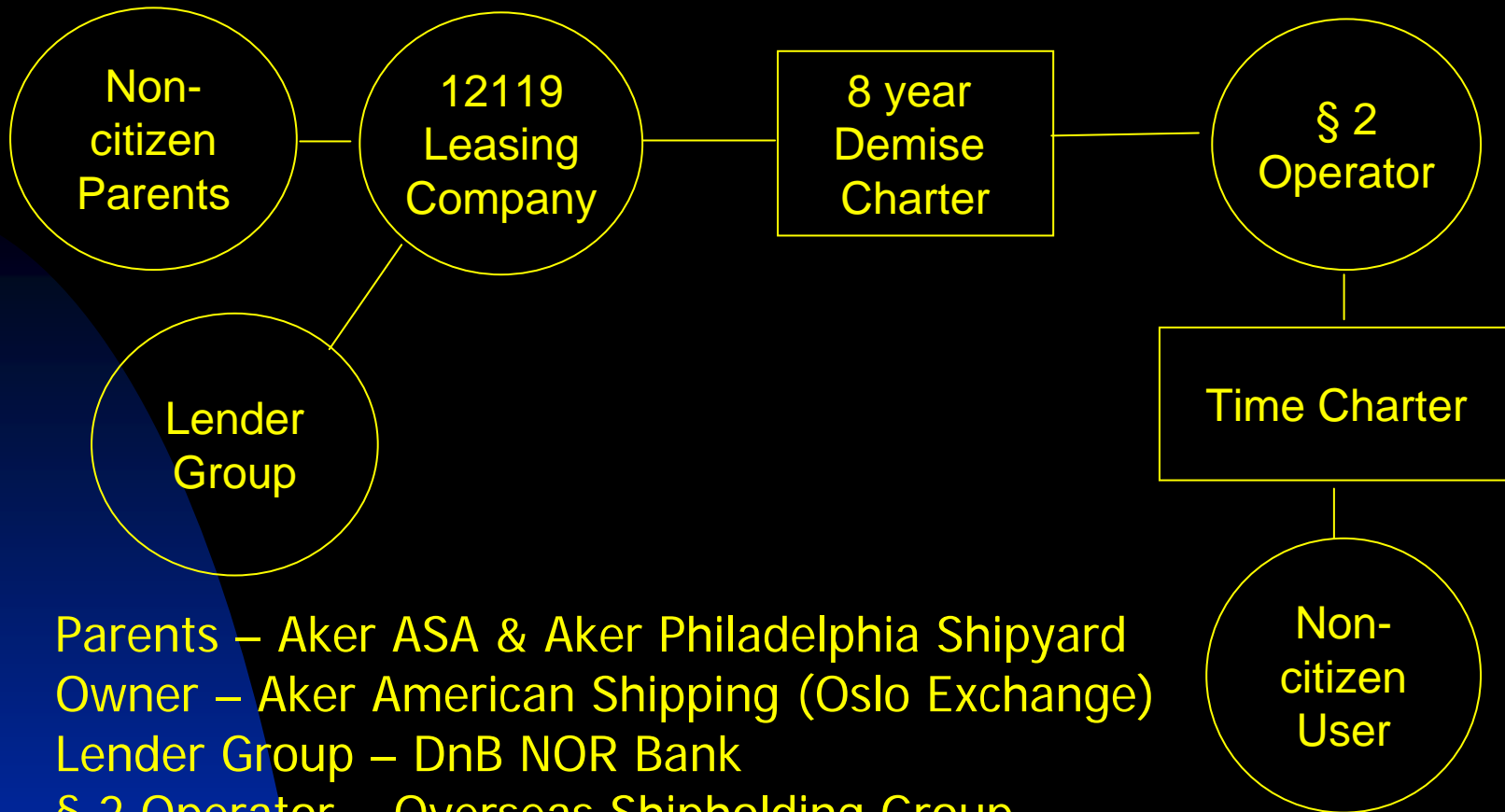
LEASE FINANCING: NON-CITIZEN EQUITY & DEBT

The potential importance of 46 U.S.C.12119 leasing is illustrated by the recent \$1.2 billion Aker 10 tanker Jones Act Section 12119 transaction with Overseas Shipholding Group.

The vessels are to be owned by a Norwegian controlled Leasing Company, that will demise charter the vessels to OSG as the Section 2 citizen Operator for a term of 8 years. The vessels are being built in the U.S. by a Norwegian owned shipyard, with debt financing by a Norwegian led syndicate. The time charters are to United Kingdom and United Kingdom/Netherlands international oil companies.

OSG will be the only Section 2 citizen in the transaction. OSG will have financed the transaction with non-citizen equity and debt.

LEASE FINANCING DIAGRAM 4: Section 12119 Leasing with Non-Citizen Owner Lessor, Lender and Time Charterers



Parents – Aker ASA & Aker Philadelphia Shipyard
 Owner – Aker American Shipping (Oslo Exchange)
 Lender Group – DnB NOR Bank
 § 2 Operator – Overseas Shipholding Group
 Non-citizen Users – British Petroleum and Shell Oil Company

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CONCLUSIONS – CCF PROGRAM 4 BENEFITS

Vessel operators that participate in MARAD's CCF Program can accelerate the accumulation of equity necessary for vessel purchases by:

1. Deferring tax on current vessel operating and associated investment income; and
2. Paying vessel debt with "before-tax" current vessel operating and investment income.

CONCLUSIONS – CCF PROGRAM 4 BENEFITS

Vessel operators can share in the benefits of other MARAD CCF Program participants by:

3. Reducing the operator's "shipyard" price in vessel purchase transactions; and
4. Reducing the operator's vessel demise charter hire rate in vessel lease financing transactions.

These are four reasons why MARAD's CCF Program may deserve your attention and support in Congress.

CONCLUSIONS – Section 12119 Leasing: Non-Citizen Equity

The Jones Act provides a stable Maritime investment environment that is attractive to non-citizen investors.

Changes in U.S. law that allow access to non-citizen Leasing Company ownership under 46 U.S.C. 12119 provide an important new equity source for financing Short Sea Shipping vessel transactions.

CONCLUSIONS – Section 12119 Leasing: Non-Citizen Equity & Debt

The \$1.2 billion 10 vessel Aker Overseas Shipholding Group financing illustrates the potential importance of non-citizen investment.

OSG will have financed the transaction with non-citizen equity and non-citizen debt, and will be the only U.S. citizen in the transaction.

THANK YOU

ADDITIONAL INFORMATION: For background and follow-on reading you may wish to refer to my Marine Money International articles on the MARAD CCF Program and non-citizen vessel leasing in the U.S. domestic trades: Cook, "Financing the US 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, and Cook, "Lease Financing for Vessels Engaged in the Coastwise Trades," Marine Money International, January 2003.