FINANCING JONES ACT VESSEL ASSETS

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Editor's Note: In his Marine Money January 2003 article "Lease Financing for Vessels in the Coastwise Trades," Mr. Cook examined the origins and status of the then non-citizen lease financing controversy. In his Marine Money July/August 2004 article "Why German K/G Funds Can Now Lease U.S. Flag Assets," he reviewed standards imposed by the Coast Guard's February 4, 2004 Final Regulations and predicted significant lease financing opportunities for qualified non-citizen financial institutions in the U.S. coastwise trades. In this article, Mr. Cook and Mr. Ogle review the history and use of the Maritime Administration Title XI loan guarantee and CCF tax deferral programs. They conclude that these programs can be used by non-citizen owner-lessors today to achieve significant reductions in vessel financing costs for projects in U.S. coastal waters.

BACKGROUND

In Europe and the United States, the past decade has seen increasing public attention to a set of traffic congestion, air quality and petroleum usage issues associated with truck and other motor vehicle traffic, and to the use of an alternative water transportation as mode. More recent attention has been given to the carbon footprint issues raised by expanding electrical generation needs, and to a variety of alternative energy sources that have included offshore wind power generation.

The European Union and the United Kingdom have addressed their motor vehicle problems with the Motorways of the Sea and Marco Polo programs and similar water transportation alternatives. In Europe and the U.K., programs for offshore wind farm development have been adopted, targeting production that will meet 20 percent of on-shore electrical needs by 2020. And, offshore wind farms in operation confirm the progress made in meeting these objectives. However, in the U.S. these subjects remain as topics for discussion and debate.

Senior Department of Transportation ("DOT") and Maritime Administration ("MARAD") officials have spoken of the need to move congested highway traffic to under utilized waterways under their America's Marine Highway ("AMH") program. And, the Department of Energy ("DOE") and the Department of the Interior have begun to address offshore wind farm ("Wind Farm") issues. These AMH and Wind Farm projects will require substantial private sector investments in Jones Act maritime assets, in addition to the investments already needed for Gulf of Mexico deep drilling service and supply vessels, and non-contiguous trades fleet replacements. With these financing needs before us, we believe that it now may be time to examine both MARAD programs in the particular context of non-citizen Jones Act leasing.

THE JONES ACT FINANCING SCENE

A brief review of the U.S. citizenship rules that were first imposed in the Shipping Act of 1916 (the "1916 Act"), and of the way in which non-citizen U.S. flag vessel lease financing transactions were structured following the passage of the Merchant Marine Act of 1970 (the "1970 Act"), is helpful in understanding the discussion that follows.

CITIZENSHIP REQUIREMENTS

The 1916 Act was put in place shortly prior to U.S. entry into World War I to ensure that the ownership and control of U.S. flag vessels would remain in the hands of U.S. citizens. Section 2 of the 1916 Act defined the U.S. citizenship requirements. And, section 9 required that MARAD approve all transfers by U.S. citizens of interests in U.S. flag vessels to non-citizens, so that ownership and control of these vessels would remain with U.S. citizens as defined in section 2. Section 27 of the Merchant Marine Act of 1920 (the "Jones Act") reserved the U.S. domestic trades to vessels that were built in domestic shipyards and owned and operated by section 2 citizens.

MERCHANT MARINE ACT OF 1970 & LEASE FINANCING

In the decade following the passage of the 1970 Act, non-citizen lease financing played an important role in the construction of more than $2 billion in U.S. flag tonnage for operation in the U.S. foreign and domestic trades. In these transactions, the U.S. flag vessels were owned by a leasing company affiliate of a section 2 citizen parent such as Citibank or General Electric, demised to an affiliate of a section 2 citizen operator like Marine Transport Lines or Keystone Shipping, and were often time chartered to a non-citizen end user such

as British Petroleum ("BP") or Shell Oil Company ("Shell").

In the 1980's, changes in the tax rules governing lease financing and the dispersal of the U.S. foreign trade fleet eliminated what had been a vibrant market for U.S. citizen operators seeking to acquire vessels in lease financing transactions with companies that met the U.S. citizenship requirements. In an attempt to attract additional equity to this lease financing market, in 1996, Congress acted to allow non-citizen ownership of vessels that were demised to U.S. citizen operators for a period of at least three years in lease financing transactions.

These provisions were amended in 2004, to clarify what had been the 1996 legislation's original intent, and to expressly limit their availability to non-citizen passive investor owners with functions identical to those of the Citibank and General Electric leasing affiliate owner-lessors in the 1970 Act transactions.

PROGRAM & PROJECT VESSEL NEEDS

The AMH program coastal services and the Wind Farm power generating projects will be complex and capital intensive. AMH vessel deliveries must be coordinated so as to initiate a multi-vessel service that is matched with the completion of the related on-shore terminal and interstate highway infrastructure. The Wind Farms will require vessels for offshore turbine tower installations, and for follow-on maintenance, the deliveries for which must be coordinated with the completion of the related on-shore power purchaser infrastructure.

The decisions on the selection and pricing of the vessel assets have not yet been made. Will the AMH Interstate I-95 Corridor (now styled by DOT/MARAD as the "M-95 Corridor") services be developed with separate vessel designs for a primarily domestic roll-on/roll-off ("Ro/Ro") service, and a primarily international container feeder lift-on/lift-off ("Lo/Lo") service, or will a vessel designed for a combination of services be selected and employed? Will the first of the turbine installation vessels ("TIVs") have only the modest water depth capabilities necessary for the first projects, or will they be designed for more robust services in deeper waters? Will the projects involve shipyard prices in the $100 million to $180 million range for the AMH vessels, and perhaps in the $150 million to $300 million range for the Wind Farm installation vessels, and in the $3 million to $5 million range for the Wind Farm support and maintenance vessels? Or, will some other price regime prevail?

MARAD TITLE XI & CCF PROGRAMS

The MARAD Title XI program was a 1938 "mortgage insurance" addition to the Merchant Marine Act of 1936 (the "1936 Act"), which was substantially rewritten in the Federal Ship Financing Act of 1972 (the "1972 Act") which incorporated the current "loan guarantee" terminology.

The Title XI program allows a vessel owner to issue bonds to finance up to 87.5 percent of an owner's shipyard vessel cost with a U.S. Treasury guarantee of the payment of principal and interest, in exchange for the payment of modest investigation and guarantee fees. The program also provides a Treasury-related debt coupon rate (as compared with higher commercial market rates) and terms of up to 25 years (as compared with commercial terms of no more than 12 to 15 years).

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The MARAD CCF program's antecedents were the 1936 Act "capital" and "special" reserve funds that provided tax-exempt status for monies set aside for new vessel construction. The current CCF program incorporates a tax-deferral mechanism that allows a taxpayer to shelter vessel operating and sales income, and portfolio investment income, for periods of up to 25 years in exchange for the taxpayer's commitment to purchase or construct U.S. flag vessels. It may be useful to think of this program as providing the taxpayer the use of both: (i) a "CCF depreciation" election (that allows taxpayer depreciation prior to its vessel asset being placed in service); and (ii) a CCF 401(k) investment account (that allows taxpayer compounding of investment income over the life of its vessel financing).

The importance of the CCF program will depend upon the terms of the vessel financing and the circumstances of the vessel owner. For the Wind Farms' less expensive vessels, with 7 to 12 year loan terms, deposits under the operating income sub-ceiling may provide the greater benefits. In some instances, the program's vessel operating income sub-ceilings may allow the owner to shelter fleet operating income for a project's entire base term. For the AMH Ro/Ro and Lo/Lo and the Wind Farm TIVs, with 20 to 25 year loan terms, the greater benefits may be under the depreciation and investment income sub-ceilings, which may allow the owner to shelter interest rate arbitrage profits over the same project base term. And, in a given transaction, it may be that more than one deposit sub-ceiling will be employed.

While the means for the optimization of CCF benefits and the implementation specifics will vary from owner to owner,

the effect of the CCF program is to provide the owner with an interest free loan of the tax monies that it otherwise would have paid to federal and state taxing authorities over a period that may equal or even exceed the AMH vessel financing term or Wind Farm project base term.

MARAD Title XI and CCF program use provided the basis for the decade of shipbuilding renaissance following the passage of the 1970 Act. But, neither program has enjoyed significant use during the past decade. The Bush Administration opposed authorization and funding for the Title XI program during its entire eight years in office, dismissing it as an unnecessary intrusion in an adequately funded private sector vessel financing credit market. And, while the less well known and understood Title VI capital construction fund program was available for the domestic Great Lakes, non-contiguous and off shore trades, it was not until December 2007 that the Administration dropped its opposition to the extension of the program to the domestic Ro/Ro and Lo/Lo trades.

Over this same period of Administration opposition, there appears to have been little or no analysis of the financing benefits that might be achieved in the situations in which these two programs might be employed singly or together. However, the benefits of both MARAD programs became the subject matter of a study done in connection with the National Shipbuilding Research Program ("NSRP") workshop sessions during 2007 and 2008.

NATIONAL SHIPBUILDING RESEARCH PROGRAM

Background

The Jones Act and the MARAD Title XI and CCF programs are what remain of a comprehensive legislative framework intended to ensure the maintenance of a U.S. owned commercial fleet, and a U.S. based shipbuilding infrastructure, that would support U.S. domestic and international trade in peacetime, and would be available to serve as a military auxiliary in time of war or national emergency. The 1936 Act and the 1970 Act supported such a fleet in our international trades with "differential subsidy" payments that equalized the U.S. owners' vessel operating and capital costs with those of their foreign fleet competitors.

Following the Reagan Administration's termination of these U.S. international trade support programs, most of the owners of this U.S. international trade fleet sold their fleets to foreign shipping lines or simply ceased operations. Now, only the Jones Act remains to support the construction of commercial vessels in U.S. shipyards and the operation of these vessels in domestic trades to which the Department of Defense ("DOD") can look to supply its commercial shipyard and operating vessel needs.

2007 NSRP Workshop

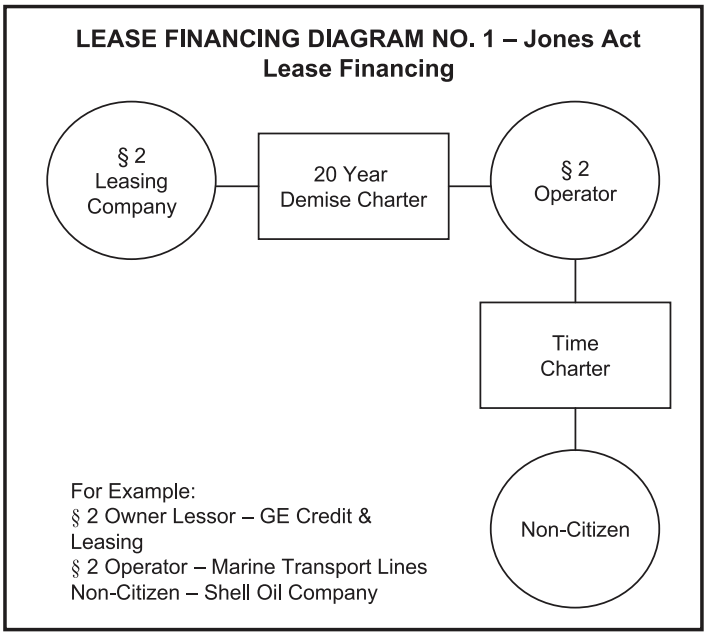
In 2007 and 2008, the DOD sponsored two, by invitation only, NSRP workshops to investigate ways in which U.S. shipyards might reduce their production costs for vessels to be sold to U.S. Jones Act operators that would be useful and available to the DOD in time of war or national emergency.

In the 2007 NSRP workshop, attention was directed to a variety of methods by which shipyard production costs could be reduced, as a means of achieving corresponding reductions in shipyard sales prices for Jones Act operator purchasers. However, during the course of the workshop, the organizers realized that while the shipyard sales price was the vessel "cost" for the DOD purchaser, the cost for a Jones Act private sector purchaser was this shipyard sales price, plus the cost of the purchaser's financing -- the vessel's "fully financed cost." - And, at the conclusion of the workshop, it was agreed that an analysis of available financing alternatives would be required to determine the means by which this "fully financed cost" could be minimized, and that this subject matter analysis remained to be addressed.

2008 NSRP Workshop

In the year that followed, an analysis of available financing alternatives was undertaken, in a variety of structural combinations to try to determine the most effective means for minimizing vessel financing costs. Examples for an owner purchase of a $100 million vessel from a Jones Act shipyard under a variety of commercial and MARAD program alternatives were developed and evaluated. The analysis indicated that the greatest reductions in fully financed vessel costs could be obtained by employing the MARAD Title XI and CCF programs in combination in a structure in which the CCF program was used to shelter investment income, which was compounded over the term of the Title XI financing to produce additional investment income, which was then used to retire the vessel debt.

A summary of these study conclusions was presented at the 2008 NSRP workshop. This presentation indicated that using these MARAD programs in this fashion, employing conservative assumptions, fully financed costs could be achieved that were as much as 18 per cent below the lowest costs that could be achieved in the most competitive of the purely commercial alternatives. The summary also indicated that greater cost reductions could be achieved using more aggressive assumptions, based upon the actual vessel owner experience in prior Title XI and CCF financing transactions. Follow-on work indicated that in some circumstances MARAD program "zero percent" vessel financing could be achieved, and that this MARAD program "zero percent" financing was well suited to use in lease financing transaction structures.



NON-CITIZEN LEASE FINANCING WITH 46 U.S.C. 12119

A party requiring vessel services, or providing vessel services to others, will generally prefer to own rather than lease vessels to meet these needs. Exceptions exist in situations where the party cannot make current use of owner tax benefits, or may wish to use third-party capital to leverage vessel operations. And, an exception exists in the Jones Act trades where a non-citizen party will not be qualified to own or operate qualifying vessel tonnage.

Lease financing was chosen for many Jones Act vessel projects during the 1970s and 1980s. GATX Leasing, General Electric Credit & Leasing Corporation ("GECC") and financial institution affiliates such as Bank of America Leasing and Citibank Leasing provided an active market in U.S. citizen leasing equity for transactions involving non-citizens such as Shell and BP that required vessel services in U.S. domestic trades.

One such transaction serves as the basis for Lease Financing Diagram Nos. 1 and 2.

JONES ACT LEASE FINANCING

Lease Financing Diagram No. 1 illustrates the financing structure for the construction of two Alaska petroleum trade tankers built at National Steel & Shipbuilding Company to meet Shell needs. Here, the "for example" parties were the actual parties to the transaction. Note that both the owner lessor and the operator were section 2 citizens.

Owner lessors that employed the MARAD programs in these 1970s leasing transactions were able to use the Title XI program to leverage their equity investment with low-cost, long-term debt; and use the CCF program to shelter their high-yield portfolio investment income over the long transaction term. MARAD program use in this fashion enhanced the owner lessor's return and provided benefits that could be retained by the owner lessor, or could be shared with the operator or the time charterer of the vessel through reductions in vessel hire charges.

Normally, the use of the Title XI program was critical to achieving the long-term debt maturities necessary to maximize the CCF program tax deferral benefits. Lease Financing Diagram No. 2 illustrates the financing structure for the GECC/Shell transaction as it might have been enhanced by the use of the MARAD programs.

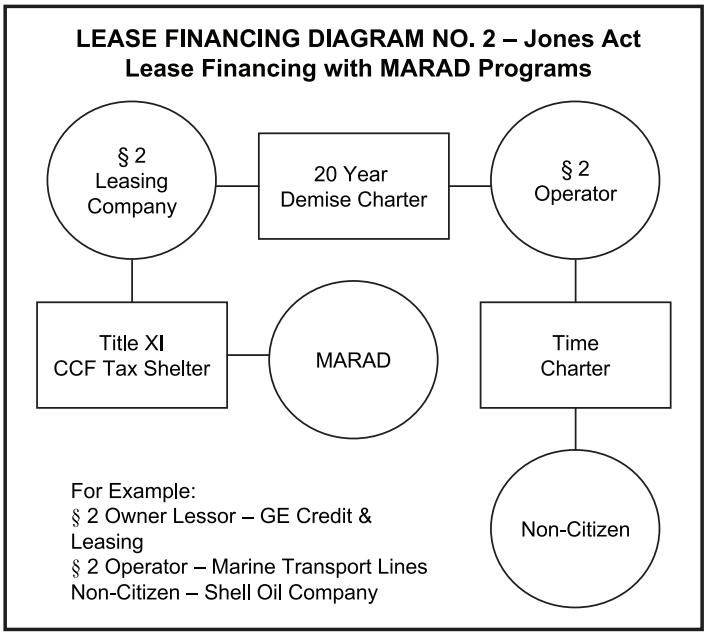
JONES ACT LEASE FINANCING WITH MARAD PROGRAMS

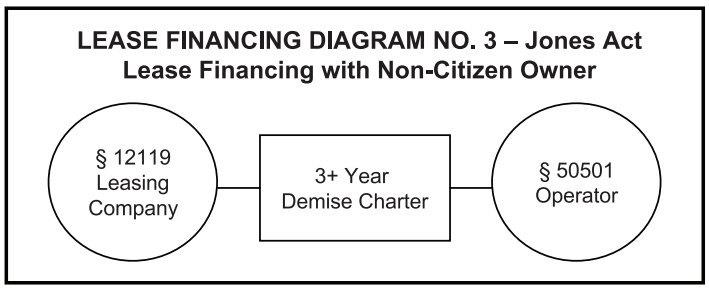
However, as the Shell transaction in Lease Financing Diagram No. 2 was actually structured, only the CCF program was employed, and the GECC CCF program participant shared its program benefits with Shell through reductions in the Shell time charter hire. This structure was chosen because the credit support provided by the Shell "hell or high water" charter provisions allowed financing over an extended charter term at a lower cost than would have been achieved using Title XI.

This Shell variation to the Lease Financing Diagram No. 2 schematic illustrates both the possible use of non-Title XI debt facilities, such as creditworthy charters and DOE loan guarantees, and the importance of an analysis of debt financing alternatives, in conjunction with CCF program use.

JONES ACT LEASE FINANCING WITH NON-CITIZEN OWNER

We have already noted that the qualifications for Jones Act vessel owners were changed in 1996 and again in 2004. Now non-citizen financial institu-





tions may function just as GECC served as a U.S. citizen vessel owner in Lease Financing Diagram Nos. 1 and 2, since ownership of Jones Act qualified vessels by non-citizen leasing companies is allowed under section 12119 of title 46 of the U.S. Code if the vessel is demise chartered to a section 50501 U.S. citizen for a term of three years or more.

JONES ACT LEASE FINANCING WITH NON-CITIZEN OWNER – AKER & OSG

The potential importance of section 12119 leasing is illustrated by the $1.2 billion Jones Act product tanker transaction involving Aker Philadelphia Shipyard and The Overseas Shipbuilding Group ("OSG"). The vessels involved were owned by Norwegian controlled section 12119 leasing companies that demise chartered the vessels to OSG as the section 50501 citizen operator for a term of eight years. The initial OSG time charters were to U.K. and U.K./Netherlands international oil companies. This transaction is illustrated below in Lease Financing Diagram No. 4.

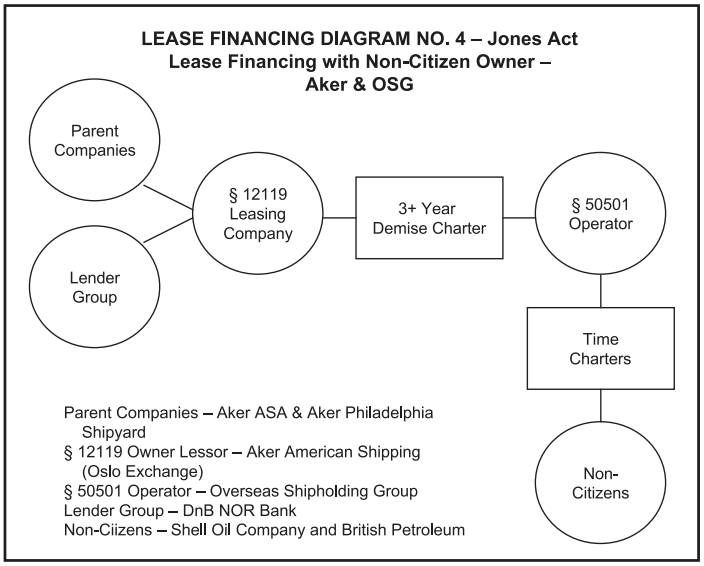
SECTION 12119 LEASING OF TURBINE INSTALLATION VESSEL

The financing structure illustrated in Lease Financing Diagram No. 4 might easily be adapted for a section 12119 non-citizen or private fund lease financing for a $300 million Wind Farm turbine installation vessel as displayed below in Lease Financing Diagram No. 5.

The non-citizen owner lessor in this hypothetical $300 million turbine installation vessel section 12119 leasing transaction in Leasing Diagram No. 5 could expect to employ the MARAD programs in a fashion similar to that which is diagramed in Lease Financing Diagram No. 2 to provide enhanced transaction benefits that might be entirely retained by the owner lessor, or shared with the operator and/or the project power generating party through reductions in lease hire or other services charges.

CONCLUSIONS

The coming decade's projected Jones Act construction for the Ro/Ro, Lo/Lo or combination vessel fleets to meet AMH M-95 Corridor and DOD objectives, and for the TIV and



support vessel fleets for Wind Farm projects will create significant vessel financing needs.

These Jones Act projects will be in addition to the Gulf of Mexico deep drilling service and supply vessels, and non-contiguous container fleet replacements, already under discussion. and should result in an interesting menu of investor options. It seems reasonable to assume that some part of the equity needs for these projects will be met with non-citizen and private fund investments in section 12119 leasing transactions, that will be CCF program qualified and eligible for MARAD and/or DOE loan guarantee program debt.

In assessing these opportunities, it will be important to remember that a shipyard sales price is only the starting point in the computation of an owner's fully financed cost, and that the selection of financing methods can be critical to project profitability and the price at which maritime services can be provided. In this process, an evaluation of the MARAD program financing alternatives will be desirable.