POTEN & PARTNERS

US Tonnage Tax
A Feeble Attempt to Boost a Wilting Industry

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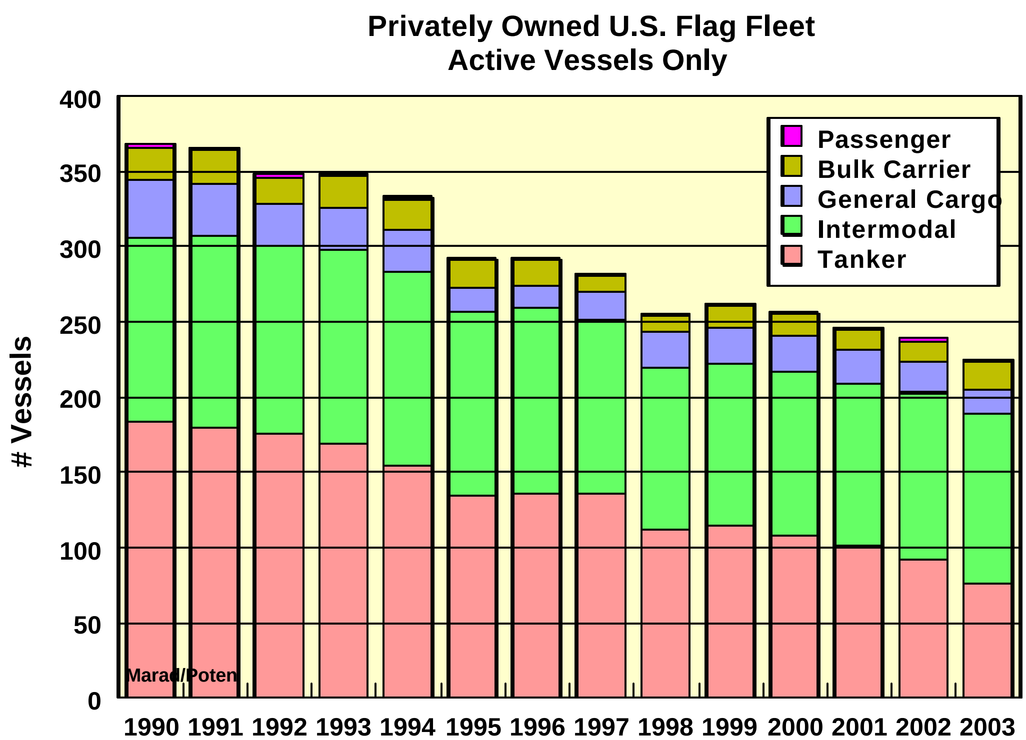
Marad has issued an RFP to American shipping companies for up to five clean US-flagged tankers under its Product Carrier Program within the Maritime Security Act of 2003. The first response is due July 2nd. The historical mission of the U.S. government in supporting the maritime interests of the nation was to have a cadre of seafarers and a viable shipbuilding program in place in case of national emergencies. For this reason, U.S. flag vessels had to be built in the United States and manned by U.S. citizens. This case is no different. The MARAD product carriers will be used to carry petroleum products for military supply in case of war or national emergency. Outside of that mission, the ships will be trading in the foreign market and American owners are wondering whether the subsidies offered by the US government will be enough to compete internationally.

The program provides subsidies up to $50 million per vessel to be built in US shipyards. The government contribution is supposed to keep building costs for US shipping companies competitive with international yards. But there are taxes and operation costs to be considered as well. The US government is attempting to address one of those issues by changing the tax structure. Currently, owners pay taxes on profits. A proposal that would place a flat tax on tonnage and reinstitute deferral of income taxes is slowly making its way through Congress. The bill is an amendment to the American Jobs Creation Act, intending that by taxing owners on tonnage rather than earnings, it will lower costs and create a more competitive edge for US-flagged ships and American shipbuilders and seafarers in the foreign market.

The legislation is said to be gaining momentum, though the exact form has not been mentioned. What also has not been in discussion is the cost of a US crew per day to operate a medium-size product carrier compared to a foreign crew. The difference in operating costs could be as much as $2 million for US-flagged ships versus foreign flagged.

The following chart attests to the lack of the success of the U.S. maritime program (intermodal refers mostly to container and ro-ro carriers). The low cost in operating a foreign flag vessel compared to the high costs of manning a US-flagged ship has slowly chipped away at the US fleet.



Not the First Attempt to Build the Fleet

The MARAD proposal is not the first time the US government has tried to build up a US-operated commercial shipping fleet. During the first and second World Wars, the United States embarked on a massive build up of the merchant marine to support military campaigns in Europe and Asia. During World War II, Henry J. Kaiser applied the Ford principle of assembling automobiles to ships. Over 2,700 Liberty ships were built, each capable of carrying over 9,000 tons of cargo. The world record for building a Liberty vessel was less than 10 days from keel laying to launching. The United States could build and fill ships with cargo faster than they were lost.

Several programs were set up to maintain a U.S. flag presence to support the nation in times of national emergencies. One was the long-standing cabotage law, the Jones Act, which restricts the movement of cargoes between U.S. ports to U.S. flag vessels. Jones Act trades have their own unique rate structure that reflects the underlying costs of U.S. flag vessels. Too many U.S. flag vessels in relation to cargoes would cause rates and profit margins to fall, and too few vessels would create small fortunes for their owners.

Oil is the most important cargo moving between U.S. ports. The primary trade routes are crude oil from Alaska to U.S. refineries and clean products from the U.S. Gulf to the Northeast. The falloff in Alaskan output created a surplus for U.S. flag crude carriers until in recent years when single hull phase out requirements under OPA'90 trimmed the fleet to a point where ship replacement was necessary. The U.S. Gulf to US East Coast trade was dealt a deathblow in 1980 when President Reagan permitted the exports of U.S. refined products. This gave oil companies a choice of exporting refined products to Mexico and Europe in non-U.S. flag product carriers or in U.S. flag product carriers to the US East Coast. This exposed the protected Jones Act trade to competition from foreign product carriers.

To protect U.S. flag tankers in foreign trade, a number of programs were initiated. One was cargo preference for Public Law 480 for grain cargoes to foreign nations. A percentage of these cargoes was reserved for U.S. flag bulk carriers whose rates for carrying the grain reflected their higher capital and operating costs. Grain exporters have long opposed this program because Public Law 480 funds spent on reimbursing higher cost vessels reduced the quantity of grain exports.

Another program was construction and operating subsidies that balanced the construction and operating costs of U.S. flag vessels operating in foreign trade to the equivalent costs experienced by foreign owners. The construction subsidy program was terminated some years ago. The operating subsidy program is in effect being phased out by the US government by not entering into new contracts.

The last remaining support for the U.S. flag fleet is actually a shipbuilding program known as the Title XI program that allows for financing of up to 87.5% of the shipyard cost for terms of 25 years. Title XI financing essentially provides a U.S. government guarantee on the underlying debt. Since buyers treat these securities as government-equivalent debt, individuals building commercial vessels in U.S. yards are virtually assured of long-term, low-interest debt regardless of the shipping risks that an owner may face.

A Band-Aid on an Amputated Arm

The capital and operating cost structure of the U.S. flag fleet is prohibitively expensive. Manning costs of U.S. flag vessels are the highest in the world and may get higher if crew size has to be expanded to handle the administrative requirements from the increased regulatory load such as the recent ISPS code. Construction costs are also the highest in the world with 115,000 dwt Aframax tankers being priced for the Alaska trade at a cost that is about four times the cost in Far Eastern yards.

We feel that the proposed tonnage tax and bringing back tax deferrals are equivalent to a band-aid on an amputated arm. It simply doesn't address the overwhelming construction and operating cost differentials that U.S. owners must contend with in competing with foreign flag operators. More drastic changes must be put in place.