

Jones' American dream divides opinions

Basil Karatzas explains why the US Jones Act is a cabotage market only some love to sail



Basil Karatzas

The recent tragic sinking of the forty-year old containership *El Faro* at significant cost of life off the coast of the Bahamas, while on route to Puerto Rico from Florida, has brought the spotlight once again on the unique Jones Act cabotage industry. The facts and the cause of the shipwreck are presently the subject of several investigations, but the age, maintenance level and the economics of the trade have become hot talking points of many a debate in the industry.

Topic: Protectionism

I Keywords: Jones Act, closed market, cabotage

Background: A near-century old US legislation that grants privileges to US built, registered, crewed and owned ships sits uncomfortably with some modern day thinking

The US Merchant Marine Act of 1920, also known as the 'Jones Act', grants cabotage privileges in the US to vessels that are a) built and b) registered and crewed in the US, and c) owned by US citizens. The primary intent of the law has been for the US to maintain sufficient maritime expertise and know-how in the event of military action overseas.

Effectively, almost all countries in the world with a coastline have effected some version of cabotage laws, granting special privileges to vessels trading in their territorial waters. As such, there is 'nothing new' about the Jones Act market and the cabotage business in the US. However, the rules for a vessel to qualify under the Jones Act market are fairly strict with limited 'loopholes'. One can depend on self-monitoring and vocal resistance for players that may be trying to 'push the envelope', such as by having Jones

Act vessels converted, modified or repaired in shipyards overseas. A limited number of vessels can trade under the 'American flag' only, effectively a 'light' version of the Jones Act where US shipowners can buy foreign-built or bareboat-in foreign vessels, register and crew them in the US and have the right to charter the vessels to the US government (collectively, under "Cargo Preference" provisions).

CLOSER LOOK

Vessels flying the American Flag comprise the sixth largest registry worldwide, a substantial achievement given that the flag is ahead, in absolute numbers of vessels, of seafarer nations with strong maritime traditions and well-established commercial advantages, such as Liberia, Marshall Islands, Hong Kong and Greece. However, a closer look at the market reveals that more than 80% of the market is dominated by tugs and offshore assets, the latter primarily employed in the Gulf of Mexico for oil exploration and production. That means that there are only approximately 270 US-flagged vessels employed in international ocean-going trades, rendering the American Flag and Jones Act markets as negligible when viewed under an international prism.

As a matter of clarification, the commanding majority of vessels (96%) flying the American Flag are Jones Act vessels, meaning that they fully comply with the strictest letter of the law and they are built in the US.

If then the ocean-going capacity of the Jones Act market is a rounding error in the world of international shipping, why then should international players in shipping pay any attention to this cabotage business?

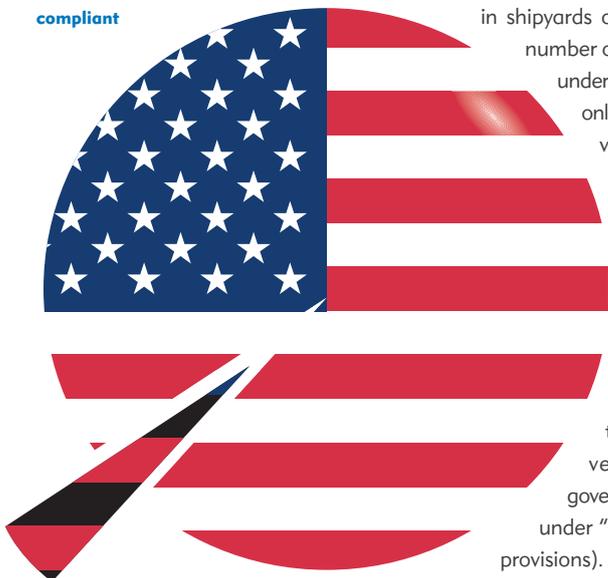
For starters, in the last couple of years, the Jones Act market has created headlines that have grabbed global attention. With the development of shale oil in North America, a 2012-built Jones Act tanker – *American Phoenix*, circa 50,000 dwt, built at BAE Systems in Mobile, AL – was sold late last year for \$155m with a three-plus year charter to oil majors for around \$60,000 pd, on average. By way of comparison, *Maxwell Bay* circa 50,000 dwt, built in 2012 at GSI, China was sold in the summer of 2015 for just \$30m, one-fifth of the value multiple of the Jones Act market.

Looking at the replacement cost, a US-built MR tanker stands at approximately 4.5x of the international benchmark. Jones Act vessels are expensive to build, maintain and crew, and generally they are maintained to a higher standard than those on the average international market.

Freight rates in the Jones Act market have been very strong given that this is a 'protected' market; the shale oil boom has caused the market to skyrocket with the noted case of the *American Phoenix* commanding an incredulous \$120,000 pd charter from a AAA-rated major oil company last year. However, in all fairness, the Jones Act is not always as strong: a vessel like *American Phoenix* historically commands closer to \$55,000 pd charter, but with \$25,000 pd vessel daily operating expense and a capex to match the asset value.

When the international tanker market was in pure survival mode at the tail end of 2014, the stratospheric rates of the Jones Act market attracted attention, envy and some jealousy. Foreign owners argue that the Jones Act market is not remotely cost competitive and a clear example of a protectionist market in a country that worships competition. Those may be fair arguments

96% of American flagged vessels are Jones Act compliant



Top twenty ship registries

Rank	Registry	Vessels
1	Panama	8,170
2	Indonesia	7,780
3	Japan	5,300
4	China	4,040
5	Singapore	3,580
6	USA	3,550
7	Liberia	3,180
8	Marshall Islands	2,880
9	Russia	2,540
10	Hong Kong	2,500
11	Malta	2,050
12	South Korea	1,910
13	Vietnam	1,770
14	Malaysia	1,650
15	India	1,620
16	Bahamas	1,440
17	Philippines	1,430
18	Greece	1,400
19	Italy	1,390
20	Turkey	1,280

Source: Karatzas Marine Advisors & Co

when taken at face value; however, they do not necessarily hold water when one considers the national nature of the business. This is not directly comparable to the international market and the so-called open-registry environment.

ABSOLUTE VS COMPARATIVE

When the transport costs of the Jones Act market are compared to the transport costs of international shipping, then yes, the Jones Act is too expensive on absolute terms. However, when one evaluates the Jones Act within the national nature of the business, comparing the transport cost by sea to the transport cost by rail or pipeline, then the Jones Act market is competitive indeed. It's 20%-40% more expensive than pipeline, but that is compensated by the flexibility of movement by sea vs the one-dimensional movement by pipeline. Transport by rail is typically more expensive than by sea. Thus, when the cost of the Jones Act market is compared to the alternative modes of transportation for the market that it was designed for, then the Jones Act market is as competitive as the commercial and economic market place of the US allows.

A further argument in favour of the costs of the Jones Act market is that vessels in the open registry environment are taxed on the so-called tonnage tax system, which is proportional to the size but not the earnings of a vessel. In the Jones Act market, the shipowner is taxed at a corporate level based on income, which, when one includes certain tax subsidies such the Capital Construction Fund, the tax rate is 10%-20%, typically much higher than in the international market.

Industry body the American Maritime Partnership estimates that 500,000 Americans are directly employed

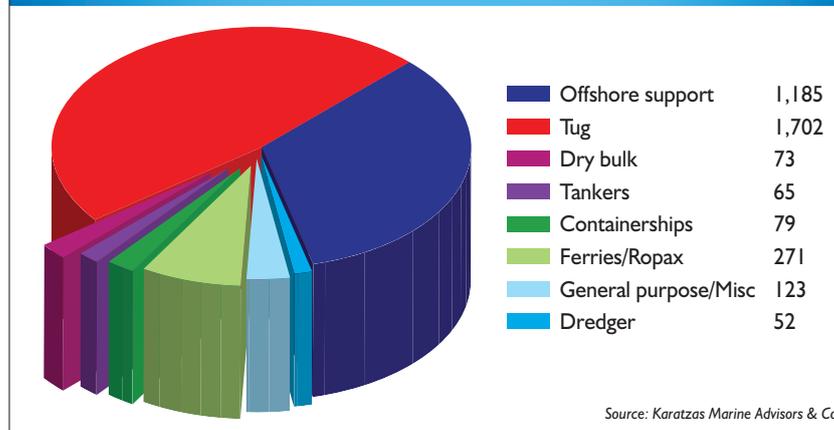
in the Jones Act market earning approximately \$30bn in labour compensation and contributing approximately \$95bn to the country's annual economic output. So while the cost of the Jones Act market is high when compared to international shipping, there has been a significant 'feedback loop' re-enforcement in the US economy.

That said, there are voices even in the US that favour abolishing the Jones Act market under the justification that lower transport costs through the utilisation of foreign flag vessels would greatly benefit the American consumer. This is possibly a fair argument, but mostly for those landlocked states that bear the increased costs but enjoy none of the benefits of the trade. Arizona's Republican Senator John McCain has been a vocal opponent of the law, but he has little to lose in the land-lubbing state of Arizona. For states along the coastal regions with shipbuilding capacity or seafaring tradition, the Jones Act market is almost religiously worshipped for the jobs that it supports and the local economic stimulus.

There are even people who actually go as far as to argue that the Jones Act market ought to be expanded in every possible way, for example mandating that exports of crude oil from the US have to be undertaken by US shipowners with Jones Act tonnage. However, that then pits the Jones Act market directly against international markets, a completely different denominator.

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American flagged fleet by vessel type



Source: Karatzas Marine Advisors & Co

The sinking of the containership *El Faro* has caused some to say that the Jones Act market is overdue a shake-up, where lower newbuilding costs do not necessitate the continued trading of forty-year old vessels. Others see the sinking as just an accident due to operator error with no fault apportioned to it being a Jones Act ship. But whichever way you view it there is no doubt, once again, that the Jones Act market is in the spotlight, for better or for worse. **SN**

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