Massachusetts Heavy Industries, Inc.,
Title XI Loan Guarantee

MARITIME ADMINISTRATION

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Memorandum

U.S. Department of Transportation
Office of the Secretary of Transportation
Office of Inspector General

Subject: ACTION: Massachusetts Heavy Industries, Inc.
Title XI Loan Guarantee
MA-1999-115

Date: July 20, 1999

Raymond J. DeCarli
Deputy Inspector General

Reply to: JA-40

To: Clyde J. Hart, Jr.
Maritime Administrator

This report presents our observations on the status of the Maritime Administration's (MARAD) Title XI loan guarantee for Massachusetts Heavy Industries, Inc. (MHI) to reactivate and modernize the shipyard in Quincy, Massachusetts. In late 1997, we issued two reports on the loan guarantee. Since then, your staff provided us periodic updates on the status of the project, and in June 1999, we visited the shipyard in Quincy, MA.

We prepared this report because MHI: (1) did not make the June 1999, "interest only" payment on the guaranteed loan, (2) requested approval of a six-month extension to make this payment, and (3) has not secured a shipbuilding project. We conducted our work in accordance with the Government Auditing Standards prescribed by the Comptroller General of the United States.

Construction and reactivation at the shipyard is proceeding. As of June 30, 1999, MHI withdrew $40.4 million of the $55 million guaranteed loan to support shipyard construction and reactivation efforts. However, MHI's estimated completion date for the shipyard has slipped from November 1998 to October 1999. MARAD's Office of Ship Construction is independently estimating what is required to complete the shipyard, and its initial work indicates the completion date may be later than October 1999. The only potential shipbuilding project identified by MHI requires MARAD approval of a Title XI loan guarantee application.
**Results in Brief**

The risk of default by MHI has materially increased warranting action by MARAD. The missed June 1, 1999, payment and the request to defer this payment until December 1, 1999, reflect a major change in the assumptions underlying MHI’s loan guarantee. In order to limit the Government's potential losses, MARAD requires loan guarantee recipients to pay a subsidy rate at the beginning of the loan. The subsidy rate, a percentage of the guaranteed loan, depends on MARAD’s assessment of the applicant’s risk of default. In order to keep the subsidy rate in line with the risk, OMB requires reassessments if actual events differ from the assumptions of the original assessment. Therefore, MARAD should reassess the risk factor rating for MHI’s loan guarantee and make the necessary adjustments to the subsidy rate.

MARAD has not made a decision on MHI’s request for deferral of its June 1, 1999, payment. MARAD asked for specific additional information from MHI that is needed to assess the reasonableness of MHI’s deferral request. A key factor to be considered by MARAD is MHI’s ability to make the payment on December 1, 1999, when both another interest and a principal payment become due. On July 12, 1999, the mortgage holder informed MARAD that it intends to make a demand for payment under the guarantee on or about August 1, 1999, unless MHI’s request to defer the missed payment is approved. On July 16, 1999, MHI provided MARAD with additional information, which MARAD is reviewing. Prior to making a decision on the deferral, MARAD should ensure it has all of the information required by the Title XI program to protect the interests of the United States from the risk of default.

Separately, MARAD has not made a decision on the Title XI loan guarantee application submitted by Intermare, a foreign shipowner, because there are unresolved issues regarding how MHI will implement the shipbuilding project. MARAD requested specific additional information that is needed to determine how MHI intends to satisfy requirements of the Title XI loan guarantee program for the Intermare project. On July 16, 1999, MHI provided MARAD with additional information, which MARAD is reviewing. Prior to making a decision on the Intermare loan guarantee application, MARAD should ensure that MHI provides complete and current information as required by the Title XI program.

MARAD’s Deputy Administrator and Title XI program staff generally concurred with this report and the recommendations.
Background

Title XI of the Merchant Marine Act of 1936 (as amended) authorizes the Secretary of Transportation to make loan guarantees to finance the construction, reconstruction, or reconditioning of eligible export vessels and the modernization and improvement of shipyards. Under this Title XI program, which is administered by MARAD, businesses secure loans in the private sector and repayment is guaranteed by the United States Government. One of the criteria for eligibility for most loan guarantees is that the applicant’s proposed project be economically sound.

On December 19, 1995, MHI submitted to MARAD an application for a loan guarantee of $55 million to reactivate and modernize the closed Fore River Shipyard located in Quincy, MA. The shipyard historically built military vessels and MHI was seeking to reactivate it as an internationally competitive commercial shipyard. Because MHI’s proposal did not include firm shipbuilding contracts, there were questions as to whether it would meet MARAD's criteria that projects be economically sound.

As a result of Congressional interest, the Coast Guard Authorization Act of 1996 contained a provision temporarily amending requirements of the Title XI loan guarantee program. Specifically, the amendment waived the economic soundness requirement for reactivation and modernization of closed shipyards in the United States. MHI’s application for the closed Fore River Shipyard in Quincy, MA, qualified for consideration under the amendment.

Although the amendment waived the economic soundness requirement, it required the Secretary to "impose such conditions . . . as are necessary to protect the interests of the United States from the risk of default." On November 1, 1996, MARAD approved the loan guarantee and issued a $55 million letter commitment to MHI for reactivating the closed shipyard in Quincy, MA.

The letter commitment contained 28 significant provisions to protect the interests of the United States Government including requirements that:

1. The State of Massachusetts deposit $6.6 million in cash, bonds, or a letter of credit to be held in a financing account (this amount equates to the required subsidy rate of 12 percent),

2. MHI have at least $3 million in capital available to ensure its ability to operate as a going concern to support normal operating expenses and routine start-up costs associated with the proposed project,
3. MHI have $2.6 million of its own funds available for use on the project to ensure that MHI stockholders have a personal stake in the project,
4. MHI grant the Secretary a first priority lien on all assets, land, and other real and personal property owned or acquired by MHI to ensure, in case of default on the loan guarantee by MHI, that the United States Government has the right to assume ownership and sell the property to recover its funds, and
5. MHI deposit proceeds from the loan into an escrow account controlled by the Secretary.

Our review of MARAD’s final actions regarding the completion of these requirements disclosed there were no substantial deviations from the letter commitment without compensating controls or justification.

Prior Office of Inspector General Reports
Recommended Additional Actions by MARAD

Our prior reports on the MHI loan guarantee recommended additional actions by MARAD to protect the interests of the United States Government from the risk of default. The first, Report Number MA-1998-007, dated November 7, 1997, evaluated whether MARAD held MHI to the requirements of the letter commitment and followed applicable Title XI loan guarantee regulations. Our report contained three recommendations for MARAD including: (1) reassessing the risk factor rating for MHI's application, and when reassessed, taking appropriate actions, (2) requiring evidence of shipbuilding contracts or alternative sources from which revenues could be generated to repay the guaranteed loan, and (3) ensuring MHI fulfills the remaining requirements contained in the letter commitment.

MARAD generally agreed with the recommendations. However, MARAD did not take action to implement the first two recommendations. With regard to the first recommendation, MARAD, based on a legal opinion by the Office of the Secretary of Transportation’s Deputy General Counsel, dated November 12, 1997, concluded they had no legal authority to reassess the risk factor rating prior to closing. For the second recommendation, MARAD said that the Coast Guard Authorization Act precluded them from requiring MHI's project to meet the economic soundness provision. MARAD also said it was precluded from requiring evidence of viable shipbuilding contracts or alternative sources from which revenues could be generated to repay the guaranteed loans because these requirements were not stipulated in MARAD’s letter commitment.
On December 17, 1997, we issued Report Number MA-1998-048, expressing concern that MARAD was not planning to reassess the risk factor on the loan guarantee prior to closing. MARAD officials stated they were "...sympathetic to MHI's claim that it is difficult to obtain customers without the modernization going forward and being underway. ..." MARAD agreed to reassess the risk but suggested delaying any reassessment of risk until the last quarter of 1998, thereby giving MHI the opportunity to demonstrate that modernization is underway and that MHI is "aggressively marketing its products."

**MARAD's Assessment of Risk Was High and Did Not Change**

In a July 31, 1998, memorandum from the acting MARAD Administrator, we were informed that MARAD had "...completed a reestimation of the risk rating of MHI ... and can find no basis to change our original estimate. ..." The assessment attached to the memorandum showed that the loan guarantee was rated as a high risk.

In order to limit the Government's potential losses, loan guarantee applicants (or in this case the State of Massachusetts) are required to submit to MARAD, at the beginning of the loan, resources to cover a percentage of the loan. This percentage, known as the subsidy rate, depends on MARAD’s assessment of the applicant’s risk of default. MARAD assesses the risk of an applicant’s proposal by assigning points to 10 different factors, weighted by importance. The higher the risk, the larger the subsidy rate. Also, subsidy rates can change over the term of the loan guarantee if the risk changes. In order to keep the subsidy rate in line with the risk, OMB requires reassessments if actual events differ from the assumptions of the original assessment.

MARAD's July 31, 1998, memorandum stated that "The only change in the circumstances underlying our assessment is that MHI has entered into a technology transfer agreement with South Korea's Halla Engineering and Heavy Industries, one of the most advanced yards in Asia." This change would enable MARAD to assign MHI more points for "Historical Experience" but the additional points would not be sufficient to change the overall risk assessment.

The memorandum also stated that MHI was actively pursuing a shipbuilding project with Intermare, a ship owner. An application for a Title XI loan guarantee, for the project with Intermare, was received by MARAD in January 1996. Although there were major outstanding issues regarding this shipbuilding project, MARAD stated there was a reasonable basis to conclude that the proposal was still viable.
The Risk of Default Has Increased

During status briefings provided by your staff, and a visit we made to Quincy, MA in June 1999, we were informed that MHI had defaulted on its June 1, 1999, “interest only” payment. A May 27, 1999, letter to MARAD, from attorneys representing MHI, cited unavoidable delays in reactivating the shipyard. According to the letter, the delays increased costs, and funds for the June 1999 payment were used instead for shipyard construction.

In the May 27, 1999, letter to MARAD, the attorneys for MHI requested approval from MARAD to delay the June 1, 1999, payment for six months (until December 1, 1999). In a written reply to MHI, dated July 7, 1999, MARAD requested MHI provide specific additional information demonstrating that the shipyard will be a going concern after completion of the reactivation. According to MARAD, this information is needed to assess the reasonableness of MHI’s extension request.

A key factor to be considered by MARAD is MHI’s ability to make the payment on December 1, 1999, when both another interest and a principal payment become due. On July 12, 1999, the mortgage holder informed MARAD that it intends to make a demand for payment under the guarantee on or about August 1, 1999, unless MHI’s request to defer the missed payment is approved. On July 16, 1999, MARAD received additional information from the President of MHI. MARAD is currently reviewing the information and has not decided whether the extension request will be approved.

MHI officials continue to identify the Intermare’s shipbuilding project as a potential source of revenue. Intermare's application for a Title XI loan guarantee was submitted to MARAD in January 1996. MARAD has not made a decision on the application because there are unresolved issues regarding how MHI would implement the shipbuilding project. MARAD, as recently as July 7, 1999, requested specific additional information on how MHI intends to satisfy the requirements under the Title XI loan guarantee program for the proposed Intermare contract. On July 16, 1999, MARAD received additional information from the President of MHI which MARAD is currently reviewing.

MHI has not identified other shipbuilding projects from which revenues could be generated to repay the guaranteed loan.
Office of Management and Budget Requires Reestimation When Changes Occur

Office of Management and Budget Circular Number A-11, *Preparation and Submission of Budget Estimates*, paragraph 33.10.(e)(1)(2) recognizes the need to reassess risks of loan guarantees "When a major change in actual versus projected activity is detected." For example, the Circular requires technical/default reestimates be made for all changes in assumptions, other than interest rates.

The purpose of the technical/default reestimates is to adjust the subsidy rate estimate for differences between the original projection of cash flow and the current status, i.e., MHI's June 1, 1999, payment default. The Circular further requires reestimates be done after each fiscal year. Subsequently, “If the reestimate indicates a net increase in the subsidy costs . . . an obligation in the amount of the net increase (including interest) must be recorded against permanent indefinite budget authority available to the program account for this purpose.”

**Conclusion and Recommendations**

MHI's failure to make the June 1, 1999, payment, the request for a six-month extension to make the payment, and lack of a shipbuilding project indicate a material increase in MHI's risk of default. We recommend that MARAD:

1. Reassess the risk factor rating for MHI's loan guarantee as prescribed by OMB Circular Number A-11, and make the required adjustment to the subsidy rate.

2. Ensure it has all of the information required by the Title XI program to protect the interests of the United States from default prior to making a decision on MHI's request to defer its June 1, 1999, payment.

3. Ensure that MHI provides complete and current information as required by the Title XI program prior to making a decision on the loan guarantee application by Intermare.
Management Comments

On July 19, 1999, we met with MARAD’s Deputy Administrator and Title XI program staff regarding our recommendations. These officials generally concurred with this report and our recommendations.

Action Required

Please provide written comments within 15 days on specific actions taken or planned. We appreciate the courtesies and assistance extended by MARAD to our staff during this audit. If I can answer any questions or be of further assistance, please feel free to contact me at (202) 366-6767, or Tom Howard, Deputy Assistant Inspector General for Maritime and Departmental Programs, at (202) 366-5630.