The Port of Virginia: Analysis and Issues

Governor Bob McDonnell
and Legislative Leaders

James V. Koch
24 August 2012
My remarks today are divided into three parts:

• A review of our Port’s performance.

• An brief analysis of our Port’s competitive challenges.

• A spreadsheet analysis of the APM Port management proposal. (I do not yet have enough data to do Carlyle Group or Deutsche Bank/RREEF spreadsheets.)
• In a nutshell, the Port of Virginia has yet to recover completely from the effects of the Great Recession.

• Still, all of its current challenges can’t be attributed to the recession. Some of the Port’s challenges relate to: (1) past strategic positioning decisions made by the Port; (2) generous public infrastructure investments made by competitor states; and, (3) more rapid regional economic development in the regions served by our competitors.
Historical General Cargo Tonnage (Marine Terminals Only)

Year | Tonnage
--- | ---
2002 | 12,824,430
2003 | 13,983,616
2004 | 15,964,018
2005 | 16,583,479
2006 | 17,726,251
2007 | 17,833,147
2008 | 14,908,490
2009 | 15,322,702
2010 | 15,615,938
2011 | 9,933,131
2012 | +8.4%

Percent change from 2002 to 2012: +8.4%
Break Bulk Cargo in Tons

<table>
<thead>
<tr>
<th>Year</th>
<th>Tons</th>
</tr>
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<tbody>
<tr>
<td>2005</td>
<td>498,745</td>
</tr>
<tr>
<td>2006</td>
<td>477,641</td>
</tr>
<tr>
<td>2007</td>
<td>369,739</td>
</tr>
<tr>
<td>2008</td>
<td>342,884</td>
</tr>
<tr>
<td>2009</td>
<td>228,905</td>
</tr>
<tr>
<td>2010</td>
<td>253,854</td>
</tr>
<tr>
<td>2011</td>
<td>347,558</td>
</tr>
<tr>
<td>2012</td>
<td>212,139</td>
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Change: -23.73%
Shares of Total Loaded TEU Containers for Selected Ports on the East Coast, 2006-2012

Legend:
- Savannah
- Hampton Roads
- Charleston
- New York/NJ
Shares of Total Loaded TEU Containers for Selected Ports on the East Coast, 2006-2012

- Savannah
- Hampton Roads
- Charleston
• Among the strategic decisions made by our Port has been its relative focus on shipping lines rather than producers and distributors.

• We have signed agreements with many shipping lines. Savannah, on the other hand, has focused more on producers and distributors and boasts about twice as many big-box distributor warehousing operations with the likes of Wal-Mart, Costco, etc.

• Retrospectively, their strategy has worked better than ours.
• However, apart from that focus, some portion of our challenge with respect to Savannah is due simply to the fact that the SE region of the U.S. has been growing more rapidly than Virginia and the mid-Atlantic region. There’s not much we can do about this immediately.
Further, states such as Georgia have made major infrastructure investments related to their ports. Yes, we’ve done this also, but not quite as much, and in particular face challenges moving product and people around the Port of Virginia.

They’ve also been more generous with incentives to encourage businesses to locate in their states.
• However, we’re not without advantages.

• We’re a *deep draft port* and it will be 2018 at least before ports such as Savannah and NY/NJ will come close to matching us. Hence, we’re well positioned to take advantage of deep draft “*Post-Panamax*” traffic that we hope will be coming up the East Coast from Panama after the Canal project is finished in 2014-2015.
• 16 percent of the container fleet world-wide now accounts for 45 percent of all container ship capacity. The trend clearly is toward a smaller number of larger vessels. At first glance, this appears to be very good for us.

• But, so many East Coast ports are deepening their harbors that it is likely some will end up being disappointed because they all will be competing for what probably will be a smaller number of ships.
• And, it remains true that cargo from Asia that lands at Los Angeles or Long Beach usually can make it to the east coast via railroad more quickly than if it travels through the Panama Canal---though the Canal route may be less expensive.

• Further, even after work is finished on the Canal, it won’t be able to handle the 13,000 TEU ships that now land on the West Coast.
Another of our advantages is the Heartland Corridor, which has reduced the time from the Port to Chicago by about one day and also provided us with double stack ability. Norfolk Southern’s 1,400 mile Crescent Corridor (roughly coincident with I-81 inside Virginia) could also prove to be similarly helpful to the Port.
• Nevertheless, reality is that we have been losing market share even with these current advantages. Critical Question: How will we fare when some of these advantages (e.g., deep draft) dissipate?

• Reality also is that Savannah always will be closer to the Panama Canal than we are and NY/NJ always will be closer to Northern Europe than we are. Hence, how will we distinguish ourselves in the future and draw traffic?
Given these circumstances, it is wise for the Commonwealth to consider alternatives.

In this regard, I believe the privatization of port operations in Virginia is a discussable option. I talked about the pros and cons in an opinion piece in the Virginian-Pilot way back on 24 June 2007. After all, some or all parts of 35 ports in the U.S. are privately operated. 56% of TEUs internationally are handled in ports with private operators.
• Let’s shift gears and talk about the APM proposal to manage the Port and use the information about that proposal that has been made public.

• However, since I am going to devote considerable attention to APM, I want first to say a few things about The Carlyle Group and Deutsche Bank/RREEF.
• The Carlyle Group has $156 billion in assets under management and often invests in infrastructure involving transportation. 65% of its investments are in the U.S.

• The Carlyle proposal appears to offer $2.0+ billion in value to the Commonwealth spread over 48 years (this is present value at 5.0%), but I’ve don’t yet have sufficient data on this proposal to develop a reliable spreadsheet.
• Deutsche Bank/RREEF already is in the port management business and via its Maher Terminals, manages a large port facility in Elizabeth, NJ as a part of the Port of NY/NJ.

• The DB/RREEF proposal appears to offer the Commonwealth value of $2.5+ billion (present value at 5.0%), but once again, I don’t yet have sufficient data to support a spreadsheet.
• In 2009, at the invitation of a legislative committee, I did a spreadsheet analysis of the CenterPoint proposal. That analysis concluded that the proposed deal was not particularly advantageous to the Commonwealth.

• Now, in 2012, I’ve performed the same sort of analysis on the public portions of the APM proposal.
• God is in the details on matters such as this. Is the APM proposal superior to the existing operating VPA model? *It appears to be.*

• Would the Commonwealth leave quite a bit of money on the table if it accepted the existing APM proposal? *Probably.*

• Can Virginia negotiate a better deal with APM? *Probably.*
• Full disclosure:

• I have met twice with executive level APM personnel to discuss the proposal and to go over the numbers. The first meeting was at their invitation; the second at my request.

• I have never been an employee of APM, the VPA, or VDOT (until this changed with VDOT about three weeks ago). I have never been compensated by any of these parties in any way in the past.
<table>
<thead>
<tr>
<th>Commonwealth Value Illustration</th>
<th>NPV Range @5% (Millions)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fixed Concession Payments: To contribute to VPA operating costs and debt obligations</td>
<td>$1,100 - $1,300</td>
</tr>
<tr>
<td>Revenues Sharing: Aligns VPA and APMT for future growth of the Port</td>
<td>$380 - $600</td>
</tr>
<tr>
<td>Capital Investment: Comprehensive investment plan in facilities will be undertaken by APMT</td>
<td>$650 - $830</td>
</tr>
<tr>
<td>Tax Benefits: Property Taxes, corporate income taxes and business license fees</td>
<td>$350 - $450</td>
</tr>
<tr>
<td>Ownership of APMTVA: APM Terminals Virginia in the most technologically advanced, environmentally friendly terminal in USA</td>
<td>$540 (Initial Investment)</td>
</tr>
<tr>
<td>Residual Value of APMTVA: Value of continued operations post-concession with APMT</td>
<td>$192</td>
</tr>
<tr>
<td><strong>Total Value to the Commonwealth</strong></td>
<td><strong>$3,162 - $3,912</strong></td>
</tr>
</tbody>
</table>
I utilized the data you’ve just seen and emerged with three major conclusions:

(1) The APM proposal is financially superior to our current VPA operations.

(2) The value of the franchise that APM would inherit is worth substantially more than what I understand APM currently has offered to the Commonwealth.
3) A host of practical and technical details would have to be worked out in order for an APM/Carlyle/DB-RREEF type of proposal to work. If such things cannot be worked out, then such proposals would fail. For example:

* What about existing VPA debt?
* What about the VIT pension fund?
* What performance guarantees must be included in any agreement?
* Will certain jobs be guaranteed?
Spreadsheet Analysis

• I’m going to show you three spreadsheets, all which impose a 5.0% rate of discount on future incomes and costs. They analyze:

(1) The value of the franchise to APM

(2) The value of APM’s offer

(3) The value of VPA continuing its operations
If we discount the future incomes and costs at 5.0% (as APM has done), then:

• The franchise is worth $6.356 billion to APM

• The value of its offer to the Commonwealth is worth $4.292 billion

• Continued VPA operations are worth $2.398 billion to the Commonwealth
However, if we discount the future incomes and costs at 7.0% (more realistic in my view given the risk involved):

• Then, the franchise is worth only $4.090 billion to APM
• The value of its offer to the Commonwealth falls to $3.180 billion
• Continued VPA operations are worth $1.514 billion
<table>
<thead>
<tr>
<th></th>
<th>Future Incomes and Costs</th>
<th>Discounted at</th>
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</thead>
<tbody>
<tr>
<td></td>
<td>5%</td>
<td>7%</td>
</tr>
<tr>
<td>Value of Franchise to APM</td>
<td>$6.356 b.</td>
<td>$4.090 b.</td>
</tr>
<tr>
<td>Value of APM Offer to Commonwealth</td>
<td>$4.292 b.</td>
<td>$3.180 b.</td>
</tr>
<tr>
<td>Value of Continued VPA Operation</td>
<td>$2.398 b.</td>
<td>$1.514 b.</td>
</tr>
</tbody>
</table>
• My analysis suggests that there is room for the Commonwealth to negotiate a more attractive arrangement if it decides to accept one of the management proposals in front of it now.
• However, the APM proposal (and those of The Carlyle Group and Deutsche Bank/RREEF) are attractive for several reasons. Let me summarize several of the most important points:
• All three proposals feature attractive upfront cash and subsequent cash flows over 48 years; they would eliminate lease payments now made to APM; and, they would eliminate some VPA costs.

• These cash flows could enable the Commonwealth to retire VPA debt and perhaps even accomplish other desirable things such as building infrastructure and reducing tolls in Hampton Roads.
• The Commonwealth might well inherit a better, more competitive set of Port facilities in 2060-2062 when the arrangements would end.

• APM proposes to make approximately $2.0 billion in capital investments in the Port; this is worth about $600 million in 2012 dollars.

• DB/RREEF apparently would make investments worth $900+ million in 2012 dollars.

• I am not yet aware of any Carlyle commitment in this area.
Question: What would such investments and the expansion of the current APMT imply for the development of Craney Island, which many view as vital to the Port’s future?

It appears to me that the investments just noted would delay the need to develop Craney Island, or at least to allow that development to occur according to a more leisurely schedule.
• Another advantage relates to risk. Competition among ports is brutal, expensive and full of uncertainty. The Commonwealth in effect would be transferring some of this risk and uncertainty to APM/Carlyle/DB-RREEF.

• Among the risks---Can cargo really grow at 3% or more per year for 48 years? What will the reaction of other shippers be to APM managing the entire Port of Virginia? Will future changes in technology hurt or harm us? How will other U.S. ports develop?
• We must weigh the three proposals against an obvious fourth option---not accepting any of the proposals and having the VPA continue to operate the port via the VIT, etc.

• While the Port has not been performing as well as many would like, some might view continuing and improving the current operation to be more prudent.
Regardless, I believe the Commonwealth can improve upon the offer APM has made. What would constitute improvements?

• More cash up front
• Greater volume payments and profit sharing over the years.
• Firm future plans, including planned investments, for the PMT and NNMT.
• Broadening the scope of the Port beyond TEUs.
There is a sufficiently attractive price and a set of sufficiently attractive conditions that would make the arrangement with APM/Carlyle/DR-RREEP attractive to the Commonwealth. My analysis suggests that the current APM offer is superior to Virginia’s existing situation, but probably could be improved.

I would need to have more data to make any judgment about either the Carlyle or DB/RREEF proposals.
• I have little doubt that APM, the VPA, the Carlyle Group and Deutsche Bank/RREEF might view some of these things differently than I have and therefore suggest different numbers than the ones I have shown you. And, as I gain access to additional data, my own numbers may well move a bit.

• However, I don’t think that any reasonable changes they might make in my analyses would alter the three fundamental conclusions I have presented to you.
• Finally, while I have been working on port-related issues for more than a decade as a part of my *State of the Region* reports, I don’t have a dog in this fight.

• My goal is to assist the Commonwealth in seeing the choices in front of it clearly so that it will be able to make the best possible decision.