

**AAPA Law Review Committee
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**Pricing Issues in Marine Terminal Agreements
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I. Preliminary Issues. Port authorities/districts: The setting in which they operate

- A. Ports are governmental entities, yet are run more like a business than almost any other type of government.
- B. Ports compete in a marketplace against other ports for cargo, whether bulk, breakbulk, or containers. They behave like marketplace competitors vying for business.
- C. Because they are public entities governed by either elected officials or officials who are appointed by elected officials, they often make decisions that are not necessarily driven by market considerations. Ports sometimes make decisions based on factors that the private sector will usually not consider. Examples of such factors are job creation, environmental benefits to the community, prestige/community pride, and economic development.
- D. Ports, as governmental entities, must also operate in an environment in which their actions are subject to public scrutiny and business is conducted in a more transparent manner than the private sector. The business conducted by the governing boards is subject to Sunshine Laws and the documents within the organization are more often than not subject to public inspection and review through disclosure laws.

II. Port Land Agreements: The types of agreements used by ports and their advantages and disadvantages

- A. Long-term use agreements, either leases or licenses.
 - 1. Advantages: Provides certainty and predictability regarding utilization of port facilities and income streams (depending to some degree on the structure of the rent or use fees negotiated). These predictable revenue streams assist a port if it has to issue bonds to finance capital projects, as dependable revenue gives bond purchasers more confidence that the port has a more stable financial base. Longer term deals also

make it easier for tenants to be willing to assist in making capital investments in the facility, easing the investment burden on the port.

2. Disadvantages: The port could be locked in for an extended period of time with an income stream that doesn't reflect market conditions (depending on the rent structure). This is true only if the escalation clauses in the agreement are kept low and don't allow for periodic market rate adjustments. Smart tenants will negotiate a cap on any increases, whether the rent/fees are stated in the lease or in a public schedule/tariff of rates. If the industry is going to experience a prolonged period of growth and profitability, restrictions on the degree of rent/fee escalation will prevent the port from sharing in the upside of the business benefits reaped by the tenant.

B. Short term use agreements, either leases or licenses.

1. Advantages: In a rising market, allows for more frequent market rate adjustments for use of the port-owned land and facilities. If there's competition for the space, it's a seller's market that will increase the port's profits. Short term agreements also allow the port to add provisions that might not have been considered in previous agreements, such as changes in environmental laws or terminal security programs.

2. Disadvantages: If the market goes bad, the facility will remain empty after a tenant's lease expires, earning zero rental revenue for the port. If the port has to adapt the facility to different uses by subsequent tenants, there could be costs associated with preparing the facility for use by the prospective new tenants.

C. Single occurrence or project contracts for limited or one time shipments.

D. Tariffs (publicly "posted" rates for use of facilities available to the public for use, along with conditions attached to the use).

1. Advantages: Rates and terms of use can be changed quickly to reflect market conditions and new legal requirements.

2. Disadvantages: A one-sized fits all set of conditions may not adequately reflect the realities facing a particular user of the facility. Limitations of liability provisions are more stringent under FMC regulations than they would under separately negotiated use/lease agreements. Pricing of services and facilities are sometimes averages or a

blended calculation of costs over different locations and may not necessarily reflect the true cost for providing services at a particular facility.

III. Pricing Methods for land use agreements

- A. Charge by unit of land occupied by the tenant (typically per acre or per square foot).
- B. Charge on a throughput basis. Rent is assessed based on the volume of cargo that passes through the terminal. This is similar in concept to percentage rent that is often seen in retail leases. There are many ways this kind of rent can be structured, but typically there will be a minimum base rent or a minimum annual guarantee of volume, with an amount assessed against each unit of cargo. There can be breakpoints set at different levels, often with the idea of providing an incentive to the tenant to bring more cargo through the terminal.
- C. Charge based on tariff specified rates for such items as equipment rental, water and electricity consumed, labor provided, dockage, wharfage, and (in the Pacific NW) service and facilities charges.

IV. Pricing Factors

- A. Recover costs of investment. The port will want to charge enough to be able to at least recover the cost of its investment.
- B. Achieve a targeted rate of return. The port, like most businesses, will want to reach a pre-determined targeted rate of return on the investment made in the facility.
- C. Competitor pricing. Ports compete with each other and need to be mindful of what the competition is charging. This is especially critical when two ports are competing to obtain a particular maritime customer.
- D. Supply and demand. Is there a demand for a limited supply of land or facilities? If so, that creates a seller's market that can allow the port to be more aggressive in the amount of rent/fees it seeks from tenants/users. The Ports of Los Angeles and Long Beach find themselves in this situation. On the flip side, an oversupply of land or a dearth of potential tenants will allow the tenants to negotiate lower rates.

- E. Loss leader. A port may choose to price a facility at rates that are lower than its targeted rate of return because of non-business factors, such as the number of jobs that will be created. In some cases, a port will be creating a new market and will be forced to charge low rates in order to lure maritime customers to the port. The Port of Seattle faced this situation in creating its cruise business seven years ago. The cruise business is now thriving and generates a large economic benefit to the community.
- F. Ancillary costs. A port may feel pressure to lower its rates depending on whether or not inland transportation costs for cargo once it leaves its terminals is high relative to other ports.
- G. Cross subsidies. Some ports receive revenues from sources other than rent from tenants. Revenues from commercial real estate holdings, toll facilities, and other non-maritime sources could lessen the pressure to charge maximum rates of return on maritime leases and use agreements.

IV. Structuring Rent/Use Fees

- A. Rent can be structured in any number of ways. The total rent over the term of the lease (with escalation estimated) can be spread out over the term of the lease on a straight line basis. This method would only be seen on relatively short term agreements where the rent would normally reflect the fair market rental for the property. Rent can also be structured so that it's backloaded. In other words, the rent is lower at the beginning of the lease, but increases at steeper rates as the lease term progresses. This method works well for the tenant because it allows the tenant the ability to settle into its location and to grow its business without facing heavy rent payments while its business is growing. The disadvantage for the port is that the investment won't break even until fairly late in the lease and the ultimate targeted rate of return won't be made until the final years of the lease, depending on the steepness of the rental increases at the end.
- B. Escalation of rents/use fees. Any lease over one or two years should have a means of escalating rent to reflect the increase in land values. The most common ways of escalating rents include market rate adjustments and relying on escalator clauses that track a governmental index such as the Consumer Price Index or Producer Price Index.

V. Selected resources for attorneys on pricing issues

- A. Milton R. Friedman, Friedman on Leases (5th Edition), Practising Law Institute (New York, 2004)
- B. Jerome D. Whalen, Commercial Ground Leases (2nd Edition), Practising Law Institute (New York, 2006)
- C. Commercial Lease Law Insider--A monthly newsletter with articles on commercial leases from a landlord's viewpoint
- D. Current Leasing Law and Techniques (Matthew Bender & Co., 2006)
- E. David A. Schaller, "Port Pricing and the Marine Terminal Conference System" (AAPA, 1996)