CHANGES IN THE SHIPPING INDUSTRY AND THE EFFECT ON PORTS

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1. General background of shipping industry today

2. How these issues play out in the leases/use agreements with MTOs and carriers

3. The intersection of terminal operations, the Shipping Act, and FMC oversight (Mr. Longstreth and Mr. Benner to cover)

4. The intersection of politics and the Shipping Act: community opposition to particular activities and MTOs (Mr. Longstreth and Mr. Benner to cover)
2008-The Great Recession begins.

How was the Pacific carrier business affected?

a. Consumer demand in the US dropped.


c. Result: Steep drop in cargo volumes crossing the Pacific.

d. Too many ships chasing not enough cargo.

e. In general, an oversupply of capacity (cargo space) chasing too little demand (cargo).

f. The consequence of this oversupply is ruinous price competition on freight rates.
How did the carrier industry respond?

One of the key strategies: Cut costs.

Cutting costs occurred in different ways. Two important strategies:

Achieve economies of scale by building bigger ships (referred to in the industry as “Ultra Large Container Ships” or “ULCS.”)
ULCS achieve greater fuel and labor cost savings and drives down the throughput cost for containers, but requires a massive capital investment.

This in turn led to an arms race among competitors.

Once Maersk announced its intention to build ULCS, other carriers followed suit.
Effects on ports:

Bigger ships meant changes within the port industry.
One of the key features of the Concorde SST: It required a much longer runway than conventional jet planes.

As a result, there were only a handful of airports in the world where the Concorde could take off and land.
The ULCS coming into service present a similar problem to ports.

There are a limited number of terminals on the west coast that can handle them.
Infrastructure demands posed by ULCS:

- The dock aprons need reinforcing to handle the weight and mass of the ULCS.
- The container cranes need to be bigger and have a longer span to reach the containers loaded on the outside edge.
- Because of the need for higher speed and efficiency on the cranes, these newer larger cranes have greater electrical needs, meaning the port needs to invest in a new substation.
- ULCS require a 54’ dredge depth, meaning many ports have to undertake berth deepening.
- For those ports with shallow approaches, that means channel deepening on the approaches into the terminal as well.
- For ports with bridges without adequate clearance, that means an expensive exercise to raise the bridge (as in Long Beach and New York/New Jersey).
Other issues created by ULCS:

- ULCS can discharge a large number of containers all at once. This means the receiving yard needs to have enough space and equipment to move the containers quickly.

- This also puts pressure on the gates into and out of the terminal, creating a higher likelihood of congestion inside and outside the gates.

- Such congestion creates downstream effects such as congestion on streets and highways near the terminal as well as higher levels of air pollution.

- This creates pressure on the terminal operator to find a way to relieve congestion by extending gate hours, an expensive proposition.
Other measures taken by carriers
Consolidations within the carrier alliances:
2 years ago:

94% of U.S. volumes to/from Asia came on one of the four major alliances: 20.4 Million TEUs
2017:

Pacific carriers went from 20 3 years ago to 13 today.
Carrier alliances went from 4 to 3.
The effect on ports of the thinning out of the carriers and the reduction in the number of shipping alliances:

- Larger ships means fewer vessels and therefore reduced vessel calls at the ports.
- Vessels calling on fewer ports.
- What's immediately apparent is that on the west coast we have too many acres of container terminals and not enough demand for those acres.
- Utilization at many of these terminals, especially in the Pacific Northwest, is low (50% or less in some cases).
- Note the terminal closures in Seattle, Portland, and Oakland as evidence of the disruption.
How does this affect leases or use agreements at ports?

Rent:

Seattle and Tacoma historically used land rent as the basis for rent with items such as IY lift fees charged on a volume basis.

A number of ports on the west coast use container volumes as the basis for calculating rent (similar to percentage rent clauses in retail leases).

The marine terminal operator ("MTO") will pay as rent an amount for each container lifted on and off the facility. There is typically a minimum annual guarantee ("MAG") of container volume (also referred to as “minimum quantity guarantee” or “guaranteed annual minimum”). If the MTO fails to reach the MAG by the end of the year, the MTO must pay the port the shortfall. If the MTO handles more than the MAG, there’s typically a reduced per container fee.
Area-based rent versus volume based rent

Area-based rent:

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<th>Pro</th>
<th>Con</th>
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<td>1. Rent is paid 1 month in advance.</td>
<td>1. There’s no upside—when MTO business is great, the rent remains unchanged.</td>
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<td>2. It’s easy to see cash flow into the future.</td>
<td>2. In bad business years, the MTO may struggle with rent payments because there’s no opportunity to vary the rent (flip side of Pro #3).</td>
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<td>3. The rent is unaffected if the MTO’s business is not prospering—You get the same rent regardless if the MTO handles only 1 container or 20 million.</td>
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### Volume-based rent:

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<td>1. Provides an opportunity to increase rent when MTO's business is</td>
<td>1. Rent is paid 1 month (or more) in arrears.</td>
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<td>good (and exceeding the MAG).</td>
<td>2. Cash flow is hard to predict because of variability of volumes</td>
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<td>2. Depending on how the deal is structured, it may provide an</td>
<td>from year to year.</td>
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<td>incentive to drive more cargo through the terminal.</td>
<td>3. Rent is variable based on container volume.</td>
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<td>4. Shortfalls can become negotiable—temptation to ask for</td>
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<td>rollovers.</td>
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<td>5. Depending on the situation, the carriers/MTOs and the alliances</td>
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<td>they’re in could manipulate cargo moving through different</td>
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<td>terminals (see LA/Long Beach).</td>
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The Hanjin bankruptcy

All of these elements came into play during the recent Hanjin bankruptcy in the Ports of Long Beach and Los Angeles.
Other parts of a lease that are affected by these factors:

The tenant entity. Beware of shell entities like LLCs that are the proposed tenant. Those entities are created to shield the parent companies from liability and they can declare bankruptcy and walk away from the lease. Get security or put language in place that will give some protection to the port.

Premises size—automation will reduce the size of the area needed for container yard activities. Longshore labor has significant concerns about this so it remains to be seen how far this will go in the near future.

Lease security. Lease security is at most a speed bump if a tenant wants to get out of a lease.
Improvements. In terms of guaranteeing the long-term viability of a tenant, make sure they have skin in the game. The larger the investment the tenant makes in a facility, the better the long-term prospects for that tenant to stick things out in tough times. Be careful about investment in cranes. If title to tenant-purchased cranes remain with the tenant, those cranes can be moved.

Assignment and subleasing. This issue raises many of the same questions regarding the viability of the tenant. Be wary of assignments to LLCs or other shell entities. If you give consent to an assignment, make sure the assignor remains liable for full performance.

Note that a guarantee is not foolproof. In both Seattle and Long Beach, their leases with Total Terminal International were guaranteed by Hanjin Shipping, which filed for bankruptcy and is gone.
Questions?