Pricing Port Facilities and Services...a Paradigm Shift to a Seller’s Market

October 24, 2006
Today’s Objective

To facilitate your before lunch sugar low with a discourse on the application of the kinked oligopoly demand curve theory to emerging ports in the developing world and established gateway ports in the overdeveloped world!
Agenda

- Finish on Time……
- …..And Have Some Fun
- Present the Bad News and the Good News
- What is a Paradigm?
- Pose a Few Questions
- Introduce a Few Concepts
- Facilitate a Discussion of One of the Most Important Tools Ports Have…..Pricing
First, the Bad News

- I am the sole presenter for the next 90 minutes
Now, the good news

• It is indeed a seller’s market
• We will finish on time or early
• Eric and I are committed to making this interesting
• We hope you will participate
What is a Paradigm?
What is a Paradigm?

• A member of the prehistoric Pterodactyl family?

• Two dimes (Brooklynese) as in “I bet a paradimes on Born to Win in the 7th”.

• Webster’s Definition: …3) a set of assumptions, concepts, values, and practices that constitutes a way of viewing reality for the community that shares them....
The Historic Port Paradigm
What do container customers want?

- Their own terminals
- Guaranteed berths
- Guaranteed cranes
- “Room to grow”
- Most favored nation status
How do customers use container terminals?

- Berths: 48-60 hours per week?
- Cranes: 45-50 hours per week?
- The slots: an average of once per week?
- The rail: 2-3 times per week?
- The gates: 50 hours per week?
What do breakbulk customers want?

- Specialized facilities
- Guaranteed berths
- Dedicated space
- “Room to grow”
- Free time
- Value added services
  - Inventory management
  - Damage repair
How do customers use multipurpose terminals?

- **Berths:** 24-48 hours per week?
- **The yard:** multiple weeks?
- **The warehouses:** multiple weeks or a month at a time
- **Yet the ships call every 10 days to 2 weeks**
What are customers willing to pay for

- The lowest rate…
  - In the port
  - At the other port
  - On the coast
The “gorilla” paradox

- **Market Share**
  - Low
  - High

- **Throughput Volume**
  - Low
  - High
The gorilla paradox: Can we afford him?

ROI

High

Low

Capacity consumed

Low

High
What do we mean by a seller’s market?
Evidence of a Seller’s Market

- P&O Ports sells for $6.8 billion
- Financial institutions & private equity firms are investing in ports
  - Goldman Sachs consortia buys Associated British Ports for $5.1 billion
  - Carlyle Group, Macquarie Bank, Babcock and Brown & others have reportedly been pursuing the terminal assets of OOIL, P&O Ports North America and others
- Container shipping lines are signing 10 year terminal service contracts
Pose a Few Questions
So What Does This Mean to the Age Old Port Dilemma?

Financial Self-Sufficiency

Economic Development
Questions

1. How many of your ports have DEEP POCKETS, i.e. financial resources and capital formation are not significant issues?
2. How many of your ports have a clear practical mission statement?
3. How many of your ports measure management’s performance against the mission statement?
4. How many of your ports have an active strategic planning process?
Questions

5. How many of your ports have:

- Capital investment plans driven by a strategic plan?
- Business plans driven by strategic action plans?
- Financial plans (not budgets) driven by strategic plans?
Questions

6. How many lines of business do your ports have? For example: container, cruise, real estate.

7. How many of your ports measure profitability in terms of:
   - Cash flow before debt service
   - Net free cash
   - By line of business
Questions

8. How many of your ports have a pricing strategy based on:
   • The port’s strategic and financial plans?
   • Line of business profitability?
   • Last year’s performance
   • The tariff?
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The gorilla paradox: Can we afford him?

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What Are We Selling? What Should Would We Be Selling?

The Theory

- Value, i.e. market access
  - Capacity
  - Time is money
  - Reliability
  - Cost effectiveness

The Practice

- Infrastructure & economic development
- At or below fair market value, i.e. the value the customer extracts or realizes
- At or below:
  - Full cost
  - Direct cost
  - Variable cost
Introduce Some Concepts
1. Profitability?
2. Do We Want/Do We Need to be Profitable?
3. Profitability Drivers
4. Where to Focus
5. How Do We Make it Work?
1. Profitability?

2. Do We Want/Do We Need to be Profitable?

3. Profitability Drivers

4. Where to Focus

5. How Do We Make it Work?
Profitability is not

✓ Market share
✓ Economic development as historically practiced in the industry
✓ Covering variable costs
✓ Net income
Profitability is: Net Cash Available for Investment

Operating Income
+ Non cash charges
+ Depreciation

Operating Cash flow

- Interest Expense & Income
- Payments in lieu of taxes
- Principal Repayments

Net Internal Cash Available for Investment

+ External Funding Sources (Taxes, Grants, Gifts, etc.)

Net Cash Available for Investment
1. Profitability?

2. Do We Want/Do We Need to be Profitable?

3. Profitability Drivers

4. Where to Focus

5. How Do We Make it Work?
Do We Want/Need to Be Profitable?
Do We Want/Need to Be Profitable

**Do We Want to be Profitable**
- It sounds good in today’s seller’s market
- It provides flexibility
  - To focus on what we think is important
  - Lessens strings attached to external financing
- It is more predictable

**Do We Need to Be Profitable?**
- Legislative mandate (e.g. Canada Marine Act)
- Board policy
- Market reality: We are on our own
  - No parental support
  - Poorly positioned for grants
  - No external funding sources, e.g. taxes
1. Profitability?

2. Do We Want/Do We Need to be Profitable?

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5. How Do We Make it Work?
Profitability Drivers

Revenue Side
- Strategy
- Market fundamentals
- Customers
- Competitors
- Politics
- Regulation
- Volume

Cost Side
- Capital investment costs
- Operating costs
- Financing costs
- Asset utilization
What are the Real Costs?

<table>
<thead>
<tr>
<th>Infrastructure</th>
<th>Terminal</th>
<th>Life Cycle Costs</th>
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</thead>
<tbody>
<tr>
<td>• Dredging</td>
<td>• Previous improvements</td>
<td>• M&amp;R</td>
</tr>
<tr>
<td>• Permits &amp; mitigation</td>
<td>• As built costs</td>
<td>• Customer Service</td>
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<tr>
<td>• Planning &amp; engineering</td>
<td>• Replacement Cost</td>
<td>• Regulatory &amp; environmental</td>
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<tr>
<td>• Off-sites</td>
<td>• Debt service costs</td>
<td>• Leasehold improvements</td>
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<tr>
<td>– Road</td>
<td>• Return on investment</td>
<td>• Financial</td>
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<tr>
<td>– Rail</td>
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<tr>
<td>– Utilities</td>
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Some of the Wild Cards Affecting Port Profitability

Payment in Lieu of Taxes

Mitigation Costs

Federal Funding

Security

Norbridge
1. Profitability?

2. Do We Want/Do We Need to be Profitable?

3. Profitability Drivers

4. Where to Focus

5. How Do We Make it Work?
A Systemic Approach To Pricing Requires

- Sustained commitment driven by senior management leadership and accountability
- A cross-functional team
- A good financial and management information system
- An evolutionary rather than revolutionary approach
Cross-functional team

- CEO: leadership/accountability
- Finance: thought leadership
- IT: data, implementation
- Marketing & Sales: market realities
- Operations: asset utilization
- Engineering: asset investment requirements
What are the pricing options?

<table>
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<tr>
<th>Port</th>
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What are the options-practical vs theoretical?

- **Customer**
  - Low
  - High

- **Analytical Scope**
  - Low
  - High

- **Info Req’mt**
  - Low
  - High

- **Port**
  - Low
  - High

- **Complexity**
Potential Pricing Opportunities

- Terminal component
- Day of week
- Time of day
- Asset utilization with escalating floor
- Terminal/component sharing
- Operating investments vs capital investments
Density + Velocity + Pricing = Long-Term Viability

• We need to consider pricing on a vertical rather than a horizontal basis
• We need to consider pricing on a time rather than a facility basis
What are the some of the practical issues?

- **Assets**
  - Types: dedicated, discreet use of shared, shared
  - Values
  - Allocation basis
- **Linking asset use to asset allocation**
- **Corporate allocations**
- **Information = A^3**
  - Availability, Accessibility, Accuracy
1. Profitability?

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How do we make it work?

• Clear, articulated purpose
  – Strategically
  – Tactically by Line of Business
• Accountability:
  performance is rewarded based on the bottom line
• Consistency
• A phased-approach
  – Where are we losing the most
  – What do we control
  – What are the market circumstances
  – Contract renewal
Have a contingency plan

• Can we **afford** to lose this customer?
• Can we **afford** to keep this customer?
• What do we do if we lose this business?
  – Who is the next best customer(s)?
  – What are the diversification opportunities?
  – How do we reduce costs?
  – Sale?