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JOINT LEGISLATIVE AUDIT
AND REVIEW COMMISSION

REPORT TO THE
GOVERNOR AND THE GENERAL ASSEMBLY OF VIRGINIA

Special Report: Review of Recent Reports on the Virginia Port Authority's Operations

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Cover photo of Port of Virginia's Norfolk International Terminal, 2006, provided by Virginia Port Authority. Used with permission.

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COMMONWEALTH of VIRGINIA

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January 11, 2013

The Honorable John M. O'Bannon III
Chair
Joint Legislative Audit and Review Commission
General Assembly Building
Richmond, Virginia 23219

Dear Delegate O'Bannon:

At its November 13, 2012 meeting, the Joint Legislative Audit and Review Commission approved a resolution directing staff to review recent studies evaluating management issues at the Virginia Port Authority and Virginia International Terminals (VIT), and to review VIT's employee compensation levels. This report outlines the findings of our review.

I would like to thank the staff of the Virginia Port Authority and Virginia International Terminals for their cooperation during this study.

Sincerely,

Glen S. Tittermary
Director

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Special Report: Review of Recent Reports on the Virginia Port Authority's Operations

Key Findings

- The Virginia Port Authority's market performance and outlook appear to be more positive than suggested by a recent report when additional relevant factors are considered.
- The Virginia Port Authority does not appear to be financially unsustainable, as a recent report suggested. The authority is positioned to generate a net profit during the next five years, particularly given the projected growth in cargo volume during the period.
- Administrative expenses could be reduced by eliminating duplicative administrative functions shared by the Virginia Port Authority and Virginia International Terminals.
- Virginia International Terminals and Virginia Port Authority executives are compensated at levels higher than most other port authority executives in the United States.

A November 8, 2012 letter from the Chair of the House Appropriations Committee to the Chair of the Joint Legislative Audit and Review Commission (JLARC) requested that JLARC review several reports that had evaluated management issues at the Virginia Port Authority (VPA) and Virginia International Terminals, Inc. (VIT). A November 21, 2012 letter from the Vice-Chair of JLARC to the JLARC Chair requested that JLARC concurrently review VIT's employee compensation levels (see Appendix A for the text of both letters). The Commission approved the study at its November meeting.

Reports Reviewed

Drewry Maritime Advisors, *Port of Virginia Position Paper: State of the Port: Final Report*, October 3, 2012.

KPMG, *Project Norfolk: Due Diligence Assistance*, May 14, 2012.

R.K. Johns & Associates, Inc., *Report on the Container Terminal Performance Metrics of the Virginia Port Authority*, January 13, 2012.

Moffatt & Nichol, *Maintenance Benchmarking Study*, September 15, 2011.

For this review, JLARC staff were provided with reports by Drewry Maritime Advisors (Drewry); KPMG; R.K. Johns & Associates, Inc. (R.K. Johns); and Moffatt & Nichol (Moffatt) (see sidebar). JLARC staff were requested to address whether

(1) the reports fairly and accurately assess the successes and shortcomings of the current operations;

(2) comparisons to ports in other states are made fairly, in light of constraints that give natural advantages to one port over another on certain metrics; and

(3) current organizational structures of the VPA and VIT are sustainable or, instead, hinder VPA's ability to focus on market position.

JLARC staff conducted interviews; collected and analyzed container cargo volume, financial, and salary and benefits data; reviewed reports by bond rating agencies; and reviewed the research literature and consultant reports.

To gain a greater understanding of the complexities of port operations and cargo shipment and confirm some of the conclusions in the consultant reports, JLARC staff retained a nationally recognized expert in port operations recommended by the American Association of Port Authorities (AAPA). This expert has provided consulting services to 67 of the 90 general cargo deep-water ports in the U.S. (including VIT terminals) as well as most Canadian ports. The expert's assistance was sought as a resource to JLARC staff in (1) understanding the port industry, the global container market, and the intermodal market in general; (2) understanding unique factors that impact the VIT terminals market position; (3) confirming VPA and VIT successes cited in the consultant reports; (4) assessing the validity of cost comparisons among various ports; (5) confirming that VIT's projected future cargo growth appears to be reasonable; and (6) understanding VIT's operational reputation in the shipping community. Because the consultant has recently completed work for VIT and disclosed this to JLARC staff, his role as a resource for JLARC staff was limited.

This report primarily addresses the fairness and accuracy of the reported successes and shortcomings of the current operations of the VIT terminals (see sidebar), which are owned or leased by VPA and operated by VIT. As part of this assessment, the report addresses whether comparisons to other ports are made fairly and whether organizational structures at either VPA or VIT impede the success of their operations. The report also addresses executive compensation at both VPA and VIT.

VIT Terminals

In this report, "VIT terminals" refers to the terminals owned and/or leased by VPA and operated by VIT. These terminals include

- Norfolk International Terminal (NIT),
- Portsmouth Marine Terminal (PMT),
- Newport News Marine Terminal (NNMT),
- Virginia Inland Port (VIP), and
- APM Terminals (APMT) leased in July 2010.

CONSULTANT REPORTS ON THE VIRGINIA PORT AUTHORITY'S OPERATIONS HAVE LIMITATIONS

While many of the findings of these studies are accurate and supported, certain limitations impact the completeness and reliability of some findings and should be considered when evaluating their fairness and accuracy. This review noted two primary limitations of these reports: (1) the methodologies used do not ensure comprehensive, definitive, and fully reliable findings, and (2) some analyses relied on comparisons to other ports in an industry in which meaningful and fair comparisons are not easily achievable. For the most part, the limitations are acknowledged in the reports.

The most significant concern with the Drewry report is the broad conclusions reached regarding the operation and performance of VPA and VIT, given the limited methodology used for that review. As the report notes at the outset, the study was a "desk-based" exercise which relied on existing reports on the Port of Virginia as well as Drewry's contacts, databases, and information sources. No interviews were conducted with staff at VPA and VIT. However, because of the complexity and diversity of port operations, structured interviews with staff responsible for those functions would appear essential to gain a complete understanding of the port's unique operations, market, challenges, and strategies to address those challenges, and to reach the conclusions presented in the Drewry report.

The three remaining reports, which focused on financial performance and terminal operations, based much of their analyses on comparisons to terminal operations at other ports. Given the substantial differences among ports and limited availability of comparable data, conclusions reached based on such analyses have limitations. Differences among ports that limit the value of comparisons include the operating model used, physical layout, crane technology, and the local labor market.

Along with these differences that impact the efficiency of operations and costs, the availability of comparable performance and cost data across ports is limited. The highly competitive nature of the ports industry discourages disclosure of full cost data. Moreover, cost and performance data is captured and reported differently across ports, which limits the reliability of comparisons even when this data is available.

The three remaining reports acknowledge these limitations. KPMG states, in referring to its benchmark comparisons to other ports:

> …our work has been completed solely as a desktop exercise based on available information provided by VIT as well as previous experience and comparator data. The benchmark comparisons should be considered as such, and findings presented would need to be further validated through interaction with VIT management as well as through detailed analysis to ensure greater transparency on current operational realities.

In its report, R.K. Johns states, "Comparison of total [selling, general, and administrative] costs for a port can be difficult. Different models with private lease concession holders and operating models make meaningful analysis challenging." The Moffatt report also acknowledges the difficulty in making comparisons across ports due to differences in operating models and data availability, among other challenges.

CONSULTANT REPORTS APPEAR TO FAIRLY AND ACCURATELY ASSESS PORT SUCCESSES

The findings regarding VPA and VIT successes in the Drewry and R.K. Johns reports appear to be fair and accurate. The Drewry report concludes that the tariffs paid by the shipping lines and the services received by the customers from VIT are competitive. These findings were confirmed by JLARC staff interviews with customers of the VIT terminals, who indicated that the prices offered by VIT are competitive. Similarly, customers stated that the service provided by VIT is high quality. All four of the shipping lines interviewed for this review, and which are major customers, stated that the service provided by VIT is very good and that if issues arise, they are resolved quickly.

Both the Drewry and R.K. Johns reports concluded that terminal facilities are of high quality and the terminals are achieving high crane productivity. The shipping lines interviewed by JLARC staff gave VIT high marks for productivity. In addition, a report on port productivity conducted by the Cargo Handling Cooperative Program (a public-private partnership sponsored by the Maritime Administration of the United States Department of Transportation) rated the VIT terminals one of the most productive ports in the United States based on 16 measures.

The Drewry and R.K. Johns reports also concluded that a significant success for VIT has been securing long-term shipping contracts from most of the major shipping lines. These contracts, which guarantee a minimum volume level, provide revenue and volume security over time. According to Drewry, these long-term contracts exceed international industry standards and place VPA in a strong contractual position. There was consensus among those interviewed for this review that securing these long-term contracts was a major accomplishment that substantially strengthened VPA's competitive position.

Moreover, the Drewry and R.K. Johns reports concluded that VPA is well positioned to handle cargo volume growth with the capacity that has been added over the last several years. A review of available data supports the conclusion that VPA currently has excess capacity and, therefore, can handle substantial growth in volume without significant additional capital investment.

VPA MARKET PERFORMANCE AND OUTLOOK APPEAR TO BE MORE POSITIVE THAN SUGGESTED BY DREWRY AND SOME CONCLUSIONS DO NOT APPEAR TO BE FULLY SUPPORTED

Port of Virginia

The Port of Virginia includes not only the VIT terminals but also other privately operated container and other cargo terminals that were not the subject of this review.

The Drewry report is the only one reviewed that discusses the Port of Virginia's market growth and market share trends. Although most of the information reported is accurate, performance data is presented for the Port of Virginia (see sidebar) rather than for the VIT terminals exclusively, which have performed better than the port as a whole. Moreover, the report does not discuss the recent positive trend in performance or the factors that appear to place the VIT terminals in a strong competitive position in coming years. Finally, the report's negative characterization of VPA's position in the intermodal market does not appear to be accurate or supported, and its assessment of VPA's economic development activities does not consider all relevant factors.

Port of Virginia Experienced Larger Volume Declines and Slower Recovery Than Other Top Ports on East Coast

The Drewry report accurately notes that the Port of Virginia as a whole experienced larger declines in container volume during the recession in calendar years 2008 and 2009 than the ports of Savannah and New York and New Jersey (NY/NJ), which are the two largest ports on the East Coast. The Port of Virginia, which is the third largest port, experienced a 16 percent decline in 2009 compared to the ports of NY/NJ and Savannah, which experienced 13 and ten percent declines, respectively (Table 1). Moreover, the ports of NY/NJ and Savannah experienced volume growth that was twice as much as the Port of Virginia in 2010 and 2011. When compared to its primary competitors (ports of Baltimore, Charleston, and Wilmington), the Port of Virginia also experienced larger declines (with the exception of the Port of Charleston) and a slower recovery. At the end of 2011, the Port of Virginia volume had still not returned to its pre-recession volume.

In Contrast to Port of Virginia's Performance, the VIT Terminals Recovered Volume More Quickly Than Ports of Savannah or New York and New Jersey

An evaluation of the performance of the VIT terminals against the top East Coast ports yields different results than those presented for the Port of Virginia by Drewry. Information presented for the Port of Virginia includes volume handled by VIT and another private terminal operator prior to July 2010. Evaluating the performance of only the VIT terminals is critical for understanding the market and financial performance of VPA and VIT.

Table 1: Port of Virginia Experienced Larger Volume Declines and Slower Recovery Than Top Two Ports on East Coast

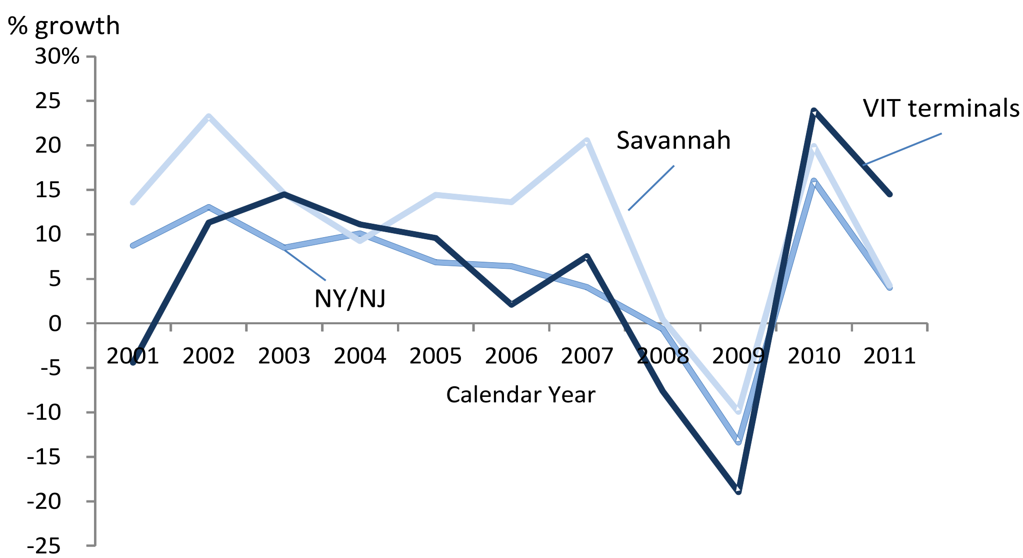
Port	Rank[b]	Container Volume[a] Growth by Calendar Year 2008	2009	2010	2011
NY/NJ	1	0%	-13%	16%	4%
Savannah	2	0	-10	20	4
Virginia	**3**	**-2**	**-16**	**9**	**1**
Charleston	4	-7	-28	16	1
Baltimore	8	0	-14	16	3
Wilmington[c]	10	3	15	18	8

[a] Measured in 20-foot equivalent units or TEUs.
[b] Based on container volume.
[c] Wilmington is a relatively small port and handled only 287,469 TEUs in 2011.

Source: JLARC staff analysis of data provided by the American Association of Port Authorities (AAPA).

Like the Port of Virginia as a whole, the VIT terminals had a greater percentage decline in container volume than the ports of NY/NJ or Savannah in 2009. However, the VIT terminals experienced volume growth in 2010 (24 percent) and 2011 (14 percent) that exceeded the growth rates in both the ports of NY/NJ and Savannah during the two-year period (Figure 1). In 2011, the VIT terminals handled over 1.9 million containers measured in 20-foot equivalent units (TEUs), which exceeded its pre-recession peak in volume.

Figure 1: VIT Terminals Fare Worse Before but Better After the Recession Than the Ports of New York and New Jersey and Savannah



Note: Volume is measured in TEUs.

Source: JLARC staff analysis of AAPA data and data provided by VPA and VIT staff.

APM Terminal (APMT)

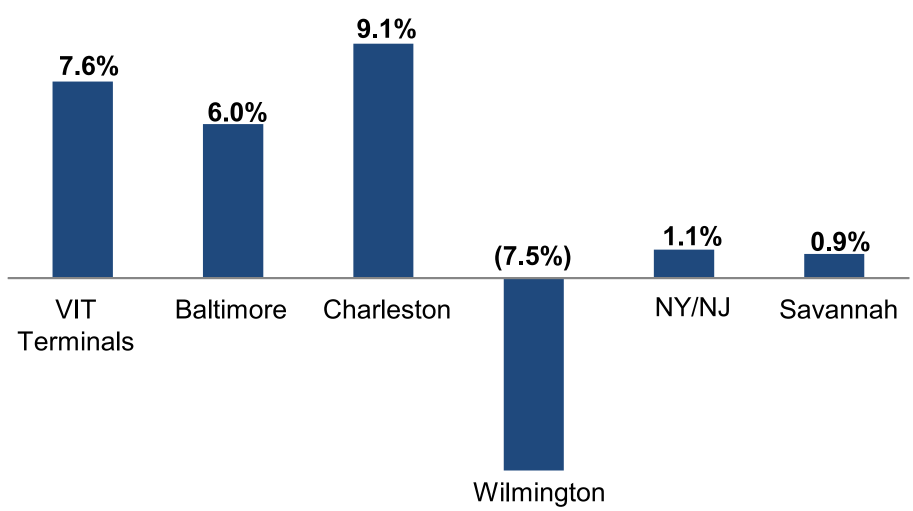
APMT was constructed by a private terminal operator, APM Terminals Virginia, Inc., and opened in 2007. Prior to opening this terminal, APM Terminals Virginia, Inc. leased space at the Portsmouth Marine Terminal and operated a terminal that handled the majority of Maersk's cargo to or from the Port of Virginia. APMT was privately operated until July 2010, when VPA entered into a lease agreement and took over operations. VPA will operate APMT until 2030 under the lease agreement.

Factors unique to the Port of Virginia contributed to the decline in volume at the VIT terminals during the recession and to the strong post-recession growth in volume. One of the factors that contributed to the decline was the loss of business to the new APM Terminal (APMT), which was privately owned and operated until July 2010. In 2008 and 2009, VIT lost significant volume due to the decision by the Evergreen and Maersk shipping lines to move most of their cargo at the Port of Virginia to APMT. A key factor in the VIT terminals' volume growth in 2010 was recapturing these two customers when VIT assumed operation of APMT through a lease agreement. Under this agreement, VIT began handling the Evergreen and Maersk container cargo that had previously been handled by the private terminal operator at APMT.

Drewry Report Does Not Mention Recent Positive Growth Trend

The most current data available indicates that the VIT terminals continue to perform well compared to the other top ports on the East Coast. Its container volume has grown at a much faster rate than the ports of NY/NJ or Savannah during the first ten months of 2012 compared with the same ten-month period in 2011. Volume growth at the VIT terminals grew by nearly eight percent in 2012, while volume at both the ports of NY/NJ and Savannah grew by approximately one percent. Only volume at the Port of Charleston grew at a faster rate in 2012 (Figure 2).

Figure 2: Growth at the VIT Terminals in 2012 Has Exceeded Growth of the Port of Savannah and Other Competitor Ports, With the Exception of Charleston



Note: Growth represents the change in TEUs between the first ten months of 2011 and 2012.

Source: JLARC staff analysis of data provided by VIT and AAPA.

Drewry Report Does Not Discuss VPA and VIT's Intermodal Success, and Does Not Support Its Characterization of Intermodal Position as Weak and Receiving Insufficient Focus

A port's ability to maximize its market share often depends on its ability to develop its discretionary intermodal market. This market is the area located far from a port to which cargo is transported by rail. A port competes for its share of this market with other ports through which the cargo could also be cost effectively transported. For the VIT terminals, the primary intermodal market opportunity includes the Midwestern states of Ohio, Illinois, Missouri, and Michigan. Its primary competitor for this market is the Port of NY/NJ.

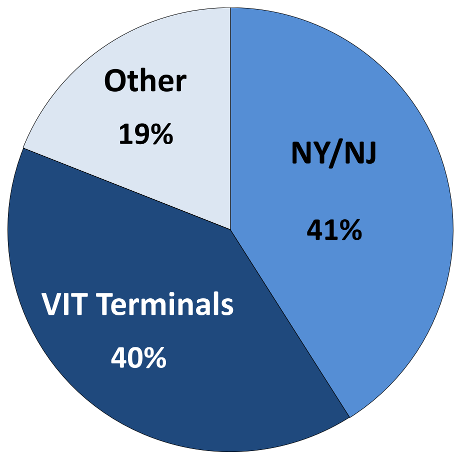
In its report, Drewry concludes that Virginia is in a "weak position" with respect to the discretionary intermodal market and has been preoccupied with day-to-day operations to the detriment of developing this market. Several factors suggest that these findings are not a comprehensive assessment of the VIT terminals' position with respect to this market or VIT's efforts to gain intermodal market share.

VPA and VIT staff reported that the discretionary intermodal market is a critical component of their volume performance. Of note, about 30 percent of the VIT terminals' business is from rail cargo, which is a greater percentage than at other East Coast ports. For example, rail cargo represents approximately 20 percent of the Port of Savannah's business and 12 percent of the Port of NY/NJ's business.

The VIT terminals appear to have successfully competed with the Port of NY/NJ for the Midwest market, despite the Port of NY/NJ's substantially greater total container volume (4.6 million TEUs in 2011). In fact, the two ports have almost the same percentage of the Midwest rail market (Figure 3). Since 2009, the VIT terminals' share of the Midwest market increased by one percent, while the Port of NY/NJ's declined by the same amount.

The VIT terminals also appear competitive in the intermodal market when considering total rail volume measured in rail container lifts, rather than rail destined solely to or from the Midwest (Figure 4). While the VIT terminals appear to have lost some volume to NY/NJ between 2008 and 2010, they have since regained some of the lost volume. In 2007, the VIT terminals had 47 percent of the rail volume moving through the two ports, and this declined to 41 percent in 2010. However, the VIT terminals had 44 percent of this volume in 2011 and 45 percent during the first ten months of 2012.

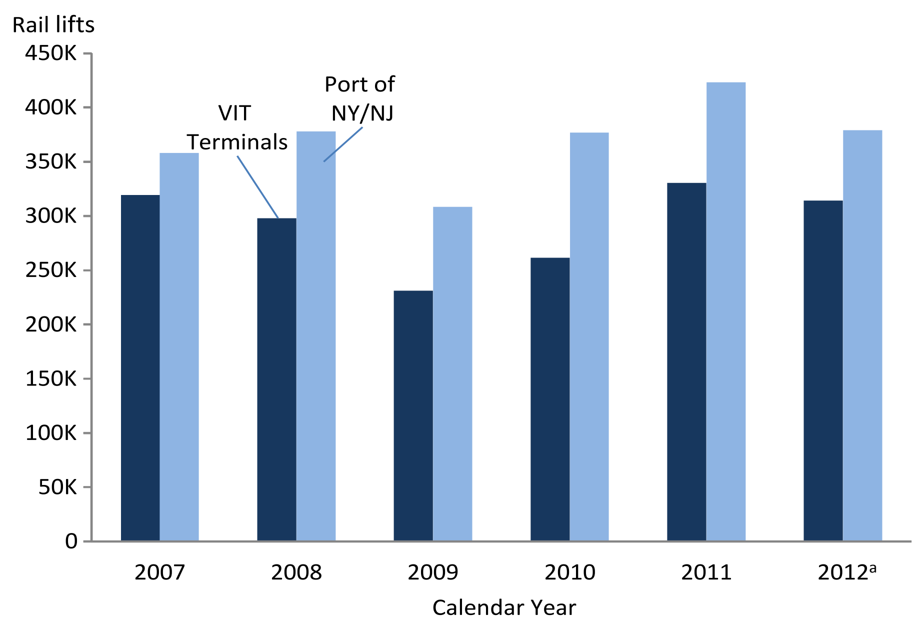
Figure 3: VIT Terminals and the Port of New York and New Jersey Have a Comparable Share of the Midwest Rail Market (2010)



Note: Data represents loaded containers measured in TEUs destined to or from the Midwest. The Midwest includes Ohio, Illinois, Michigan, and Missouri. Other includes other East Coast ports such as Baltimore, Charleston, and Savannah.

Source: VPA staff analysis of PIERS rail market data updated for VIT by Vickerman & Associates, LLC.

Figure 4: VIT Terminals Are Competitive With the Port of New York and New Jersey in Total Rail Volume



Note: Data represents all rail lifts (empty and loaded containers), regardless of destination.

[a] January to October only.

Source: JLARC staff analysis of data provided by VPA and the Port Authority of NY/NJ's website.

One of the explanations for the decline in rail volume at the VIT terminals in 2009 and 2010 is the loss of a significant amount of transatlantic cargo. According to VPA and VIT staff, much of the transatlantic cargo at the VIT terminals moved to a different shipping line that preferred to move its rail cargo through the Port of NY/NJ. There are divergent views as to whether VPA and VIT could have taken further action to minimize this loss of rail business or whether the loss was due to the decisions of shippers (cargo owners) and shipping lines that were beyond the control of VPA and VIT.

While competition for the intermodal market will remain strong, the VIT terminals appear to be well positioned to compete for this market in the future. Both the APMT and NIT terminals now have on-dock rail service (rail onsite within the terminal), which is important to shippers and shipping lines because it saves time and reduces costs. VIT staff reported there is rail congestion at APMT due to limitations in the design of the tracks in the terminal, but staff indicated that customers have not experienced significant negative impacts. Some of the congestion should be alleviated once both Norfolk Southern and CSX railways begin using double-stack trains by 2016. VIT staff are also evaluating other options to alleviate the congestion at APMT.

In addition, rail service from the VIT terminals to other areas is improving. Norfolk Southern, which has historically been the main railway providing service to the terminals, recently completed the Heartland Corridor, which has substantially improved rail service from the VIT terminals to Chicago and Detroit. This improved route reduced travel distance by more than 200 miles to both cities, and it serves double-stack trains, which greatly enhance rail efficiency. CSX has increased the rail cargo it handles from the VIT terminals and anticipates completing its National Gateway project in 2016. This project will improve CSX rail service from the VIT terminals to the Midwest and will also serve double-stack trains. Having both major rail carriers providing enhanced service from Virginia to the Midwest should lead to increased competition between the railways and more competitive rail prices, which will make the VIT terminals a more attractive option for shippers of intermodal cargo.

Conclusion That VPA Has Not Been As Focused on Economic Development as Other Ports Does Not Take Into Account All Factors

The Drewry report concludes that VPA has not focused adequately on economic development as compared with other ports, such as Savannah, and that this has adversely impacted VPA's market growth and share. The report further indicates that VPA has been preoccupied with day-to-day operations and has not been sufficiently focused on the establishment of distribution centers for major shippers. In contrast, JLARC staff's review indicated that both VPA and VIT have been involved in economic development activities, but it was difficult to conclusively determine if they have focused sufficient attention on these efforts. In addition, there are limitations with comparing the success in attracting distribution centers of the ports of Savannah and Virginia because of important differences between the ports.

The Drewry report implies that VPA has primary responsibility for the development of distribution centers. However, the Virginia Economic Development Partnership (VEDP) is the lead economic development entity for the State, while VPA is charged with fostering and stimulating port commerce and promoting the shipment of goods and cargo through the port. The attraction of distribution centers to Virginia is and has been a combined effort by VEDP, VPA, and local economic development offices. Likewise, the attraction of distribution centers to Savannah has been a combined effort by the Port of Savannah and its state and local economic development offices.

Both VEDP and VPA officials indicate that the two entities have a strong working relationship and continually look for opportunities to work together to establish distribution centers or otherwise promote economic development that will benefit the State and the port. VEDP and VPA have recently entered into a memorandum of understanding which outlines areas for greater coordination because efforts were not formally coordinated in the past. In addition to efforts by these entities, the General Assembly has recently enacted port-related tax credits to attract businesses, such as distribution centers, that will use the port.

The Drewry report also implies that Virginia has not had much success developing distribution centers. However, distribution centers are one of VEDP's target development industries, and VEDP staff identified 141 new distribution centers that have been announced in Virginia since 2000. According to VPA staff, almost half are known to be frequent users of the VIT terminals, though it is possible that more of these centers use the terminals.

The Drewry report accurately portrays the development of the distribution centers in Savannah as a significant accomplishment. However, comparing the Port of Virginia's efforts with Savannah's success in developing distribution centers may not be appropriate for several reasons. The Port of Savannah had large undeveloped land tracts that were available to be developed relatively cheaply just outside its port terminal, but such open land is not available near the VIT terminals in Hampton Roads. In addition, the Port of

Savannah and the recently developed distribution centers are within a few miles of I-95, the major north-south interstate corridor on the East Coast. The VIT terminals in Hampton Roads are not as conveniently located for truck transport.

Analysis of cargo data also suggests that the Port of Savannah has not necessarily expanded the region's share of container cargo through the development of distribution centers. Although Savannah's growth in cargo volume over the last decade has been substantial (11 percent between 2000 and 2011), it appears to have been at the expense of the nearby Charleston port, which has had a decline in cargo volume and market share during the same period. The ports of Savannah and Charleston combined had approximately 24 percent of the total East Coast market share in 2000 and have had 26 to 27 percent of the market share since 2004. According to VIT staff and the port expert consulted by JLARC staff, part of this increase from 2000 to 2004 could have resulted from West Coast cargo diverted to the East Coast due to the West Coast port strike in 2002. Shipping lines serving the West Coast diverted container cargo to the East Coast, and the Port of Savannah benefitted because of its southeastern location and recent updates to its facilities.

Another factor that may limit the value of comparisons of the Port of Virginia with Savannah or other ports regarding the development of distribution centers is the geographic needs of shippers that may be beyond the ports' control. According to VEDP staff, major shippers desiring to build two distribution centers to serve the East Coast are most likely to build one in the South to serve the southeastern market and one in a northern location close to the highly populated northeastern market. Savannah is a logical choice for the southern location and New York for the northern location. The Port of Virginia is not as well situated geographically as a location for these shippers. Conversely, Virginia's central location puts the port in a stronger position to attract a distribution center for shippers that plan to have only one East Coast center.

VIT Terminals Seem Well Positioned for Future Volume Growth

While the ports industry is extremely competitive, the VIT terminals appear to be well positioned for future growth. The factors that support this conclusion are not discussed in the consultant reports. One of the major advantages of the VIT terminals is the port's natural water depth. The port currently has a depth of 50 feet and is the only port on the East Coast authorized to dredge to 55 feet. With the trend toward larger container ships, the ability of the VIT terminals to accommodate these bigger ships should be a competitive advantage.

In addition, the Port of Virginia's central location on the East Coast places the VIT terminals in a strong position to serve ships that wish to only make one stop on the East Coast, and the improved rail service to the Midwest mentioned previously strengthens that advantage. Moreover, rail service to Greensboro, North Carolina, began in 2012, and VPA and VIT staff indicate that they are exploring other options for extending rail service into other areas of the Southeast. Finally, the VIT terminals have capacity for growth and can further expand their capacity at a reasonable cost. All of these factors should put the VIT terminals in a strong competitive position over the next several years.

COMPREHENSIVE ASSESSMENT OF FINANCIAL CONDITION LEADS TO MORE POSITIVE CONCLUSION REGARDING LONG-TERM FINANCIAL SUSTAINABILITY

The Drewry report concludes that VPA's recovery has been slower than that of other ports, and that the current port structure is unsustainable because VPA has been losing money. The report also states that this is not a solid financial position that the guardian of the port's assets ought to have. Although the finding that VPA has experienced losses is accurate, a comprehensive assessment of financial data shows that the major drivers of recent losses appear to stem from specific events rather than chronic financial imbalances between revenues and expenses. When controlling for the net financial impact of leasing APMT, VPA's operating margin on core terminal business has been recovering to a greater degree than it appears, and was positive in fiscal year (FY) 2012. In addition, if volume growth continues and terminal capacity is more fully utilized, leasing APMT is expected to have a positive effect on profitability in future years. Bond ratings for outstanding VPA long-term debt indicate that the credit agencies consider VPA's financial outlook to be positive.

VPA and VIT's Operating Revenues Have Followed Predictable Trajectory Tied to Changes in Volume

The total operating revenues of VPA and VIT have closely followed the changes in container volume experienced over the last five years. After reaching a high of $260 million in FY 2008, total operating revenues declined by 20 percent in FY 2009 as volume dropped due primarily to the recession as well as the loss of two customers (Evergreen and Maersk) to a competing terminal operated by APM. Volume, and therefore operating revenue, was relatively stable between FY 2009 and FY 2010.

Cargo volume increased sharply in FY 2011 and FY 2012 as VPA regained the two customers' business it had lost in FY 2009 and captured a significant amount of new business from Maersk by leasing APMT, and as the shipping industry began to recover from the recession. As a result, operating revenues grew by nearly 50 percent between FY 2010 and FY 2012 to reach $310 million and exceed the pre-recession high.

Terminal Expenses Were Reduced During Recession but Core Administrative and Fixed Expenses Have Increased

Because a large portion of ports' expenses is either fixed or semi-fixed, operating costs typically cannot change as much or as fast as cargo volume and revenue. During the past five years, the expenses at the VIT terminals that tend to be more variable, such as terminal operations and maintenance, have followed the trend in revenue associated with the recession and the subsequent recovery. In contrast, administrative expenses as well as fixed costs, such as depreciation, have increased relatively consistently since before the recession.

While VPA and VIT's operating revenues decreased by 20 percent between FY 2008 and FY 2010, core operating expenses (other than the APMT lease costs for purposes of this analysis) declined by only ten percent during the same period. In response to the recession and decline in container volume, VIT substantially reduced terminal operating and maintenance expenses between FY 2008 and FY 2010. During that period, terminal operating expenses decreased by 24 percent and maintenance costs were cut by 17 percent, comparable to the rate of decrease in revenue experienced during that timeframe. Since then, these costs have been accounting for a decreasing percentage of operating revenues, suggesting that terminal operations are still becoming more efficient. As volume declined during the recession, VPA also reduced its administrative expenses by ten percent, excluding the effect of staff transferred to VIT in FY 2009. VPA had reduced its administrative costs by an additional 14 percent by FY 2012.

In contrast, VIT administrative expenses grew by 22 percent between FY 2008 and FY 2010, also excluding the effect of staff transferred from VPA in FY 2009. One major driver of this increase was pension costs, which rose by more than $2 million during the period due to higher unrecognized losses, which have been volatile over time. Salary expenses decreased slightly. The other major driver was information technology (IT) costs, which increased by more than $3 million due to VIT's multi-year replacement of its 20-year-old operating system.

Administrative expenses at VIT grew by an additional 26 percent between FY 2010 and FY 2012 due to increased compensation and IT costs. Higher salary expenses accounted for one-quarter of the total increase. In addition to the cost of continuing efforts to modernize its operating system, IT costs rose when VIT assumed operation of APMT, which has its own operating system and needed to be integrated.

Depreciation costs, which are largely fixed, represent a substantial portion (approximately 15 percent) of total operating costs. Although revenues were declining, depreciation expenses grew by 20 percent between FY 2008 and FY 2010. These expenses subsequently remained stable through FY 2012 as older equipment became fully depreciated and a limited amount of capital assets was purchased.

Lease of APMT Secured Market Position but Substantially Increased Expenses in FY 2011 and FY 2012

The lease of APMT that began in FY 2011 has substantially increased VPA's expenses without generating sufficient additional revenues and cost efficiencies to offset them. As a result, the net impact of assuming the APMT lease has been to lower profitability and create a significant amount of excess capacity in the near term.

Despite the lease's known adverse impact on short-term profitability, there appears to have been broad consensus at the time of the negotiations that it was a good business decision for VPA to enter into the lease. In particular, leasing APMT was expected to remove a competitor from the market and to avoid a price war expected to take place once VIT's long-term customer contracts began to expire in 2015. Engaging in a price war would likely have caused VIT to lose a significant amount of volume and revenue. Beyond a certain level of revenue loss, VPA's ability to meet its debt obligations could have been jeopardized. Leasing APMT also enabled VIT to regain the two customers' business that was lost to APM in 2009, while capturing significant additional volume from Maersk. APMT was also expected to (and does) operate much more efficiently, and therefore economically, than the other VIT container terminals. If volume increases to a high enough level, VIT will pay lower rent per container unit under the lease agreement, which would help further reduce VIT's operating costs per unit. In addition, the lease option to expand APMT provides VIT with substantial additional capacity that will likely be required in the longer term to keep up with anticipated market growth.

However, the near-term effect is that VPA must pay a significant annual cost for additional capacity that is not currently needed. The container volume in FY 2011 and FY 2012 was comparable to the pre-recession peak volume, and, therefore, could have been handled at NIT and PMT. Nonetheless, by assuming the APMT lease, VPA increased its total operating expenses by $32.5 million in FY 2011 and $37 million in FY 2012.

There have also been other costs associated with the decision to enter into the lease agreement. The Portsmouth Marine Terminal (PMT), which VPA planned to close after entering into the lease, had to continue handling containers for an additional seven months because the APMT facility was not fully operational due to a crane accident at the new terminal. The operating cost of handling volume at PMT was nearly three times as high as it would have been at APMT. Further, the closure of PMT required VPA to take an additional $10 million loss for cranes that had been specially modified for the terminal and could not be used at another one, while other PMT assets continue to depreciate. Only one tenant is currently paying rent for space leased at the now-closed PMT. The facility could be leased to a private operator or other types of private sector entities because most of its acreage remains empty.

VPA Profitability Reduced by Recession, Then by Impact of APMT Lease

The operating losses reported by VPA during the past four fiscal years can be largely attributed to the impact of the recession on container volume in FY 2009 and FY 2010, and to the significant negative financial impact of leasing APMT in FY 2011 and FY 2012. As volume continues to increase, the incremental expenses incurred as a result of the APMT lease are expected to be offset by additional revenue and cost efficiencies. While administrative expenses appear to have grown faster than volume and depreciation expense represents a large and fixed cost, these have not been major drivers of VPA's financial position and do not explain the changes in profitability over time. Because the major drivers of past losses are either non-recurring or temporary, there do not appear to be structural financial problems that would undermine the sustainability of VPA and VIT's operations.

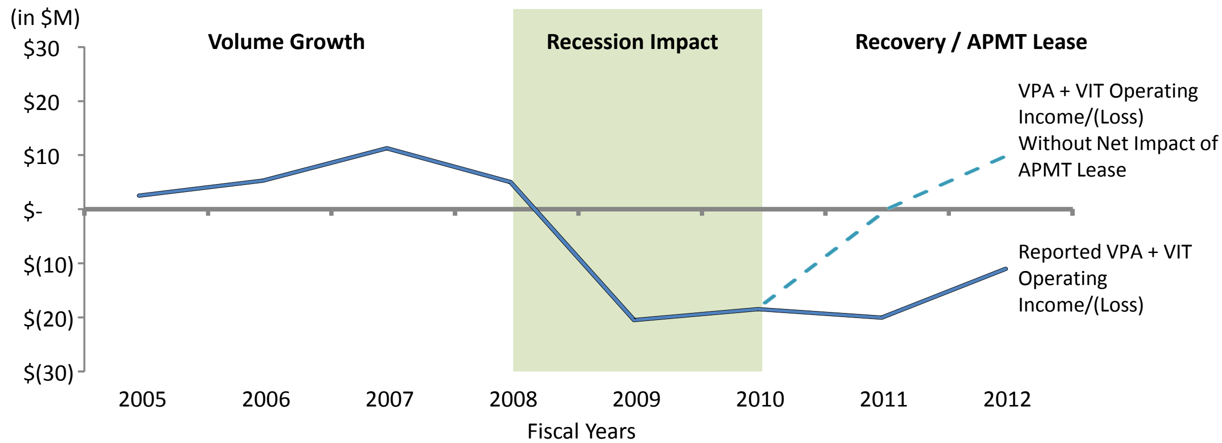
The losses reported in FY 2009 and FY 2010 coincided with the U.S. recession, which slowed container shipments and triggered a 20 percent decrease in operating revenue. With operating expense reductions of only ten percent, this decline in volume and revenue led to substantial operating losses. Volume was relatively stable between FY 2009 and FY 2010, and, therefore, operating losses remained level.

Operating Margin

Operating margin is equal to operating revenues from core business operations less operating expenses incurred to generate operating revenue.

Leasing APMT has had a negative net impact on VPA's operating margin (see sidebar), which masked its recovery since FY 2011 (Figure 5). Although VPA was able to regain the two customers that had been lost to APM in FY 2009, capture a large amount of new business, and benefit from cost efficiencies, these gains have been insufficient to offset the various expenses associated with APMT in FY 2011 and FY 2012.

Figure 5: VPA Operating Margin Significantly Reduced in Short Term by Net Impact of Having Entered Into APMT Lease



Note: Net impact of APMT lease includes APMT lease expenses; depreciation on assets specific to APMT; additional administrative staffing, security, and information technology expenses; operating margin on business from Maersk and Evergreen gained through lease agreement; cost efficiencies gained through use of APMT; and incremental costs incurred by using PMT instead of APMT during FY 2011 for some volume.

Source: JLARC staff analysis of annual financial statements for VPA and VIT.

VPA Expected to Generate Operating Income in One to Two Years With Volume Growth

There appears to be consensus that container volume will continue to grow generally, and at VIT terminals specifically, over the next several years, based on the forecasts of multiple consulting firms. Historical data suggests that container volume grows at a faster rate than the U.S. gross domestic product. Based on this assumption and the implementation of certain operational initiatives, VPA is projecting annual container growth of five percent or more over the next five years. Review of the data and consultation with the national port expert retained by JLARC staff indicate that this is a reasonable assumption. However, unforeseen economic changes in the U.S. or Europe could have a significant negative effect on the shipping industry and, therefore, VPA's ability to meet its volume and financial goals.

Higher operating expenses will be associated with volume growth. However, this growth will generate additional revenue, and VPA will be able to use the capacity that is not currently being fully utilized. A major financial advantage for VPA over the next several years is that its excess capacity can accommodate a substantial amount of additional growth without the need for significant additional capital investment. In addition, the high efficiency of APMT and the lower per unit rent at high volumes should reduce terminal costs per unit. As volume increases, fixed and semi-fixed expenses, such as depreciation and interest expense on long-term debt, can be spread across a broader revenue base, which should enable VIT to improve its profitability.

Based on the VPA assumptions regarding an annual container volume growth of five percent or more and gains in cost efficiencies, VPA is forecasting a positive operating margin starting in FY 2014, and increasing profitability over the following three-year period. Even with a more conservative three percent growth assumption and limited cost efficiencies, VPA could still generate a positive operating margin starting in FY 2015 through FY 2017, which is the end of the period examined for this review. With positive operating margins, VPA's net income would also be positive.

Net Income

Net income is equal to the operating margin plus non-operating revenues, such as federal grants and interest income, less non-operating expenses, such as interest expense on long-term debt, plus transfers from sources such as the Commonwealth Port Fund.

Bond Ratings Reflect VPA's Financial Strength

All of the bonds issued by VPA have a high rating, which reflects the financial strength of both the authority and the State. VPA issues bonds with two types of backing. VPA currently has $238 million in outstanding debt in general obligation bonds, which are backed by the Commonwealth Port Fund (port fund bonds) and further secured by a sum sufficient appropriation from the Commonwealth in the event that the port fund cannot meet required debt service. In addition, VPA has $281 million in facilities revenue bonds, which are backed by revenue from VIT terminal operations.

Commonwealth Port Fund

The Commonwealth Port Fund is a State allocation made each year to VPA. The port fund is defined in statute as a 4.2 percent portion of the Transportation Trust Fund, which is funded by the sales tax, gasoline tax, motor vehicle registration fees, and other sources.

The port fund bonds have consistently maintained a high credit rating. Fitch, S&P, and Moody's give these bonds their second-highest ratings of AA+ (Fitch and S&P) and Aa1 (Moody's). Obligations with these ratings are of high quality and have very strong capacity for payment of financial commitments, thus reflecting the strength and security of the Port Fund and its State backing.

The ratings for the bonds backed by the facility revenues are more relevant for assessing VPA's financial strength because they are based on the credit agencies' assessment of the financial strength of the terminal operations. Facilities revenue bonds are not rated as highly as those backed by the port fund, which is to be expected with the more volatile nature of terminal facility revenue. Still, all three rating agencies give high ratings to the facilities revenue bonds (Table 2).

Strengths cited by the bond rating agencies for the facilities revenue bonds include VPA's strong market position given its natural deep-water port and improved rail connections, a proactive and sound management response to the economic downturn, and a strong position with regard to future capacity. Weaknesses or chal-

Table 2: Facilities Revenue Bonds Receive High Ratings From Rating Agencies

Rating Agency	Latest Rating	Definition of Rating
Fitch	A	‘A’ ratings denote expectations of low default risk. The capacity for payment of financial commitments is considered strong. This capacity may, nevertheless, be more vulnerable to adverse business or economic conditions than is the case for higher ratings.
S&P	A+	An obligation rated ‘A+’, 'A', or ‘A-‘ is somewhat more susceptible to the adverse effects of changes in circumstances and economic conditions than obligations in higher-rated categories. However, the obligor's capacity to meet its financial commitment on the obligation is still strong.
Moody’s	Aa3	Obligations rated ‘Aa1’, ‘Aa2’, or ‘Aa3’ are judged to be of high quality and are subject to very low credit risk.

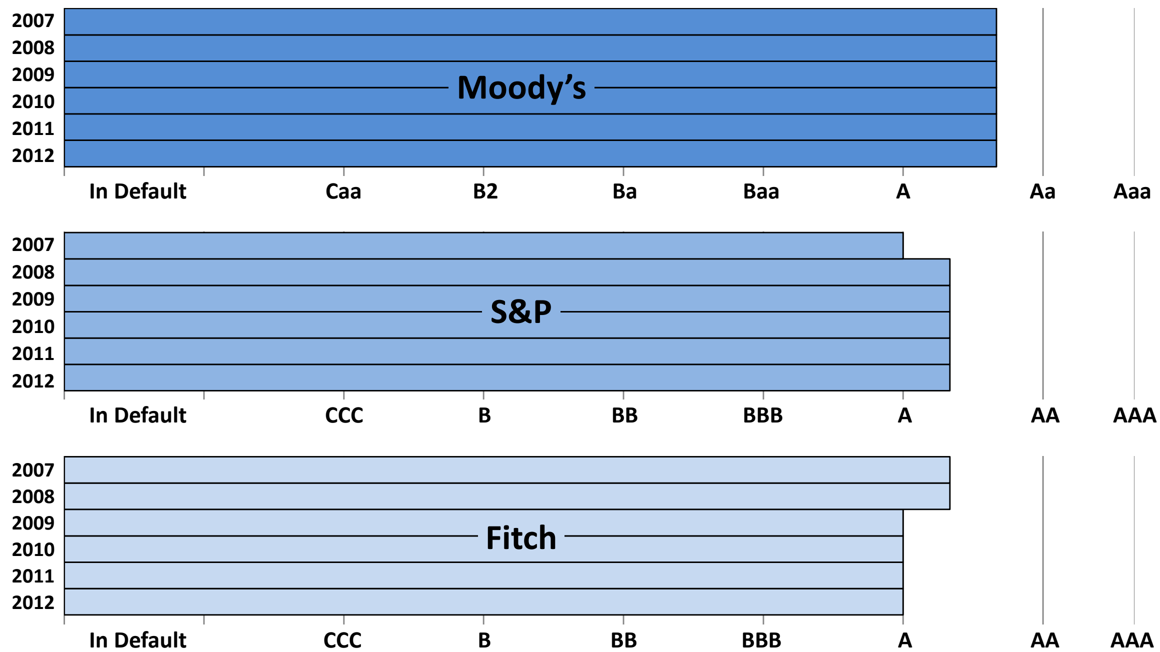
Source: Moody's, S&P, and Fitch bond rating definitions.

lenges cited include VPA’s historically weak liquidity position and the competitive nature of the East Coast container market. VPA’s facilities revenue bond ratings are comparable to revenue bond ratings given to other East Coast port authorities.

Ratings for VPA’s facilities revenue bonds have remained relatively stable since 2007. The only changes include an upgrade by S&P from 2007 to 2008 (A to A+) and a downgrade by Fitch from 2008 to 2009 (A+ to A). S&P cited the authority's consistently sound financial performance, growing container-based trade activity, and its diverse mix of both shipping lines and trading partners as reasons for their decision to upgrade facilities revenue bonds in 2008. Fitch justified the 2009 downgrade by pointing to VPA's weakened financial profile as a result of significant declines in the authority's container volumes and loss of customers and container volumes driven by increased competition from the new APM facility. The Fitch rating has remained the same since the 2009 change, and the S&P and Moody’s ratings for the facilities revenue bonds have remained unchanged since 2008 (Figure 6).

In May 2012, Moody’s placed a negative outlook on its Aa3 rating of VPA’s facilities revenue bonds citing the port's narrowed financial position as well as concerns regarding the port's ability to return operating and financial metrics to historically stronger levels that are more consistent with an Aa rated port. However, Moody’s emphasizes that the negative outlook could be revised to stable if the port meets its budgeted FY 2012 year-end cargo growth targets, resulting in improved debt service coverage. The VIT terminals missed the FY 2012 target for container volume by two percent, but as of December 2012, Moody’s had not reported a downgrade in its rating. Furthermore, Moody’s rating is currently higher than ratings by Fitch and S&P, and a downgrade from

Figure 6: Strong Ratings of VPA Facilities Revenue Bonds Have Remained Stable



Source: JLARC staff analysis of information from Moody's, S&P, and Fitch bond rating agencies.

Moody's would result in a rating at the same level as S&P and still higher than Fitch (Figure 6).

SOME CONCERNS RAISED BY DREWRY REPORT REGARDING PORT ORGANIZATIONAL STRUCTURE ARE NOT WELL SUPPORTED

The Drewry report found that the VPA and VIT organizational structure is suboptimal and has contributed to the negative financial performance experienced in recent years. Drewry further concluded that the organizational structure has led to a preoccupation with day-to-day operations that has left staff with less time to focus on both intermodal market and economic development.

However, JLARC staff have concluded that the current structure does not appear to have been a major contributor to the financial challenges experienced by VPA in recent years. As discussed previously, the decline in container volume and the costs associated with the APMT lease were the major contributors to the losses experienced.

The current organizational structure does appear to have contributed to the financial losses experienced to a minor extent. There are two executive staffs that are both highly compensated. In addition, some of the core administrative functions are duplicative, which increases administrative costs, which in turn increases overall expenses. Executive compensation and administrative inefficiencies are discussed in more detail in the next two sections.

The Drewry report does not provide support for the conclusion that the organizational structure adversely impacted market performance and economic development, and this review did not identify evidence to support this finding. First, the divisions within VIT that are responsible for day-to-day operations of the terminals are completely separate from the marketing and sales division. Further, it does not appear that the current division of marketing and economic development staff between VPA and VIT has impeded economic development activities. Although sharing these staff would be beneficial, there did not appear to be adverse impacts from the current arrangement. Good communication and coordination appears to exist between VIT's marketing and VPA's economic development staff. Moreover, coordination between VPA and VEDP is likely more important to economic development efforts than coordination within VPA and VIT.

Further, the Drewry report did not present any evidence that the current organizational structure has impeded the development of the intermodal market for the VIT terminals. As discussed previously, VIT appears to have effectively developed the intermodal market and seems well positioned for the future in this market.

While this review did not identify instances where the organizational structure had a direct and adverse impact on VPA and VIT's marketing and economic development efforts, staff at both organizations acknowledged that VPA and VIT could benefit from more explicit direction regarding the division of their roles and responsibilities. For example, the VPA/VIT service agreement states that "VIT shall perform sales and marketing functions for the Terminals in accordance with the goals and objectives established by the VPA Board of Commissioners." However, the VPA Board has not formally established these goals and objectives, according to staff at both organizations. Going forward, additional and formalized guidance from the VPA Board could ensure that the mission and efforts of the two organizations are aligned; that their roles, responsibilities, and functions do not overlap; and that each organization can be held accountable for fulfilling its mission.

CONSULTANT REPORT CONCLUSIONS THAT THERE ARE OPPORTUNITIES FOR GREATER COST EFFICIENCY APPEAR TO BE ACCURATE BUT METHODOLOGICAL QUESTIONS LIMIT RELIABILITY OF CONCLUSIONS

The consultant report findings that there are opportunities to reduce costs appear to be supported. Two areas in which the reports appear to accurately present opportunities for cost savings are (1) general and administrative and (2) maintenance costs.

VPA and VIT staff acknowledge that there are opportunities to improve efficiency and have taken actions over the last year to do so. For example, VPA has reduced its security costs by lowering the qualifications required of its security personnel. However, additional opportunities for cost efficiencies remain. JLARC staff analysis of VIT financial data indicates that administrative costs were not reduced in response to the recession. Although VIT reduced administrative staff by 14 positions (12 percent) in early FY 2010, 12 new staff were subsequently hired soon after, in part related to the lease acquisition of APMT. The number of administrative staff has remained consistent through FY 2012, and salary expenses have increased 16.3 percent during the same period.

Moreover, the current organizational structure creates administrative cost inefficiencies. Between VPA and VIT, there are nine executive level staff who were collectively paid $2.9 million in compensation in FY 2012.

As mentioned previously, along with duplication of executive staff, both VPA and VIT have other categories of administrative staff with similar functional responsibilities, such as human resources and finance. Although the roles performed by the administrative staff in each organization do not overlap completely, there likely are opportunities to reduce the overall number of administrative staff and lower administrative expenses.

IT costs are a component of administrative costs that have increased over the last several years. However, several reasons for some of the increase appear valid. VIT is replacing its 20-year-old operating system and has inherited a second operating system with the lease of the APMT facility, which has yet to be integrated with VIT's system.

The KPMG, Moffatt, and R.K. Johns reports all conclude that there are opportunities to reduce maintenance costs. However, as noted in the studies, their analyses of maintenance costs have limitations. The KPMG and Moffatt reports benchmarked these costs against maintenance costs at other ports that have significant operational differences, which limits the usefulness of these comparisons. For example, some of the comparator ports use different types of cranes that have different maintenance costs than those used at the VIT terminals.

Review of the financial data indicates that maintenance expenses were reduced substantially in FY 2009 and FY 2010. The study conclusions that there may be additional opportunities to reduce maintenance costs are likely accurate, but it is difficult to confirm the magnitude of these opportunities without more analysis than provided in the consultant reports.

VIT AND VPA EXECUTIVE STAFF ARE HIGHLY PAID

Although not addressed in the consultant reports reviewed, JLARC staff were requested to review executive compensation. Compensation paid to VIT and VPA executive staff appears to be high when measured against comparable public sector positions. There is insufficient data available to assess whether VIT executive salaries are in line with the salaries paid to executives at private terminal operators, and there is no consensus on whether it is more appropriate to compare VIT executive compensation to public or private sector compensation. In some ports in other states, public sector employees perform the roles and responsibilities that are performed in Virginia by VIT staff. In other ports, these roles and responsibilities are performed by private terminal operators. Neither VPA nor VIT is subject to the Virginia Personnel Act.

Virginia Personnel Act

The Virginia Personnel Act ensures for the Commonwealth "a system of personnel administration based on merit principles and objective methods of appointment, promotion, transfer, layoff, removal, discipline, and other incidents of state employment." (*Code of Virginia* §2.2-2900)

VIT Executive Compensation Is Substantially Higher Than Public Sector Salaries

In 2012, the president and CEO of VIT (president) received compensation of $754,330, which included $537,379 in base salary and a bonus of $192,335. The executive vice president and chief operating officer (COO) of VIT received $309,391 in total compensation. Table 3 shows the 2012 compensation for the VIT executive team.

Compensation received by the top VIT executives has increased substantially over the last four years. Collectively, the base salaries of the president and three vice presidents have risen by 18 percent since FY 2009.

The president's compensation is substantially higher than for comparable public sector positions. The president's base salary in 2012 was 47 percent higher than the highest-paid director of a

Table 3: Cash Compensation for the Four VIT Executive Staff Totaled $1.6 Million in FY12

Position	Base Salary	Bonus	Other Cash Compensation	Total Cash Compensation
President & CEO	$537,379	$192,335	$24,616[a]	$754,330
Executive VP & COO	252,170	54,847	2,374[b]	309,391
VP, Global Sales & Marketing	207,423	51,856	2,172[b]	261,451
VP, Admin. & Finance	195,013	48,753	na	243,766
FY 2012 Executive Totals	**$1,191,985**	**$347,791**	**$29,162**	**$1,568,938**

[a] $24,016 for car allowance plus $600 for membership in a private business club.
[b] Expenses for membership in a private business club.

Source: JLARC staff analysis of compensation data provided by VIT and FY2012 Budget Highlights.

public port agency in the United States based on a 2012 salary survey by the AAPA. Further, his total compensation of $750,481 in 2011 was more than the compensation paid to any State employee that year, classified or non-classified (excluding some State-supported university employees).

It is less clear how the president's salary and other VIT executive salaries compare to compensation of private terminal executives. Information on salaries for comparable positions at private terminal operators is not readily available. VIT retained Mercer to conduct a salary study for executive staff in 2010, but the president was excluded from this study. The study found that the salaries and bonuses for the eight positions analyzed were below the competitive market median. Mercer used general industry data and "transportation and warehousing" data when available, but did not appear to use data from private terminal operators.

In 2004, Mercer provided VIT with information on compensation competitiveness for the president's position as part of the contract renewal process. Mercer analyzed base salaries for the CEO position from companies with similar revenues as VIT. The FY 2006 salary approved by the VIT Board (which took effect July 1, 2005) was within the 2005 salary range developed by Mercer for a comparable private sector CEO, but near the higher end of the range.

In addition to base salaries, the VIT executive team and other high-level staff are eligible for annual bonuses. The president is eligible for two types of bonuses: (1) annual incentive bonuses, and (2) an APMT supplemental bonus. The incentive bonus may be up to 65 percent of base salary and is based on meeting annual goals. The supplemental bonus is based on meeting financial performance targets derived from the APMT lease projections up to a maximum of $220,000. The president's highest bonus was $488,990 in FY 2010 and was 105 percent of his base salary. This bonus included a one-time bonus of $200,000 for successful completion of the APMT lease negotiations and a $288,990 annual performance incentive bonus. He received annual incentive bonuses of $225,498 in FY 2011 and $192,335 in FY 2012.

The three vice presidents and certain other high-level staff are eligible for bonuses with approved targets that range from 20 to 30 percent of salary. The executive vice president and COO received bonuses that exceeded 25 percent of his salary in 2010 and 2011. In 2011, he received a bonus of $153,831 that included a $100,000 one-time bonus for negotiating the APMT lease. The vice presidents of Global Sales and Marketing and Administrative and Financial Services have both received bonuses ranging from 16 to 25 percent of their base salaries for the last three years.

VIT Executives Have Retirement Benefits Similar to State Employees, but President Has Supplemental Plan

VIT administers three main retirement plans, in addition to certain supplemental plans for executives that are in the process of being phased out. The three main plans are a defined benefit plan and a supplemental deferred compensation plan for employees hired before July 1, 2012, and a defined contribution plan for employees hired after July 1, 2012. The defined benefit plan appears to be comparable to the current Virginia Retirement System (VRS) plans for State employees, but provides less generous income replacement at retirement. VIT's deferred compensation plan has a more generous match than the State's 457 plan. The VIT defined benefit plan has been closed, and VIT employees hired after July 1, 2012, are being placed in a defined contribution plan which provides an employer match on employee contributions up to six percent of salary. A six percent employer match is common for defined contribution plans.

Use of SERPs in the Private Sector

According to VIT's outside counsel, the use of SERPs is not uncommon in the private sector. The purpose of a SERP is to ensure that executives are eligible for a comparable level of income replacement from their retirement plan as a company's other employees. Salaries above a certain threshold cannot be counted in calculating pension benefits, which reduces the potential income replacement from these plans for executives with high salaries. SERPs were developed to make up for this difference.

Prior to 2010, the president was eligible for three retirement plans: (1) VIT's regular defined benefit plan, (2) VIT's deferred compensation plan, and (3) the supplemental executive retirement plan (SERP). The rest of the VIT executive staff are only eligible for the defined benefit and deferred compensation plans. For tax reasons, VIT's SERP was terminated in 2010. The VIT Benefits Committee and VIT counsel recommended making a cash payment of the present value of the benefit to the president over three years (2010-2012). The total payout to the president was $3.7 million. When he retires, the president will still receive an annual retirement benefit from VIT's regular defined benefit plan at age 65 (currently estimated to be $126,516, or 23.5 percent of his base salary).

VPA Executives Are Highly Paid

In FY 2012, the VPA executive director received $418,250 in total compensation, which included $350,000 in base salary and $68,250 in a bonus. The senior deputy executive director received $295,760 in total compensation. Table 4 shows the 2012 compensation for the VPA executive team.

State Employee Bonuses

Classified State employees are eligible for three types of bonuses: (1) recognition bonuses (capped at $2,000 per year); (2) bonuses for changes in duties, new skills, retention, or internal alignment (capped at ten percent of base salary per year); and (3) exceptional recruitment and retention incentive bonuses (capped at $10,000). The highest bonus received by a classified State employee in FY 2012 was $10,000.

The VPA executive director had the third highest salary of 58 port authority directors who responded to the 2012 salary survey conducted by the AAPA. The VPA senior deputy executive director had the highest salary of all deputy port directors in the survey. The executive director's salary was higher than all other State positions in 2011 (including all agency heads and cabinet secretaries), except the VRS chief investment officer and some high-level university positions.

VPA executive staff are eligible for higher bonuses than those most other State employees. The executive director is eligible for a bonus up to 50 percent of his base salary and the other executives are generally eligible for bonuses up to 20 to 25 percent of their salaries. Bonuses received by the executive staff in FY 2012 ranged from 13 to 20 percent of salary.

VPA executive compensation has steadily increased over the last four years. Collectively, VPA executive salaries have increased 16 percent since FY 2009, and total executive compensation (salaries and bonuses) has increased 21 percent.

The VPA defined benefit retirement plan generally mirrors the current VRS plans for State employees. The major difference is that VPA does not require an employee contribution as the State now does. In addition, VPA's deferred compensation plan includes a 50 percent employer match up to three percent of salary, which is more generous than the State deferred compensation plan.

Table 4: Cash Compensation for the VPA Executive Staff Totaled $1.3 Million in FY 2012

Position	Base Salary	Bonus	Other Cash Compensation[a]	Total Cash Compensation
Executive Director	$350,000	$68,250	na	$418,250
Sr. Deputy Executive Director	246,313	36,947	$12,500	295,760
Deputy Director	164,370	24,656	3,500	192,526
Deputy Director	165,944	24,891	12,500	203,335
Deputy Director	185,979	27,896	12,500	226,375
FY12 Executive Team Totals	**$1,112,606**	**$182,640**	**$41,000**	**$1,336,246**

[a] Executive allowance.

Source: JLARC staff analysis of compensation data provided by VPA.

Appendix A Study Mandate

JLARC received the following two letters requesting this review:

- Letter dated November 8, 2012, from the Chair of the House Appropriations Committee.
- Letter dated November 21, 2012, from the Vice-Chair of JLARC.

COMMONWEALTH OF VIRGINIA
HOUSE OF DELEGATES
RICHMOND

NOV 08 2012

APPROPRIATIONS COMMITTEE
9TH FLOOR, GENERAL ASSEMBLY BUILDING
CAPITOL SQUARE
POST OFFICE BOX 406
RICHMOND, VIRGINIA 23218
804-698-1590

LACEY E. PUTNEY, CHAIRMAN
ROBERT P. VAUGHN, STAFF DIRECTOR

November 8, 2012

The Honorable John M. O'Bannon, III, Chairman
Joint Legislative Audit and Review Commission
Suite 1100, General Assembly Building
Richmond, Virginia 23219

Dear John:

As you are aware, the House Appropriations Committee heard a series of presentations at its October 15, 2012 meeting on the management of the Virginia Port Authority and Virginia International Terminals. During the presentations the Committee heard many conflicting statements regarding the effectiveness of the current operations and the potential for increased efficiency under alternate private models. During these discussions Secretary of Transportation Sean T. Connaughton referenced three studies that had been commissioned by the Administration to evaluate the management issues at the Virginia Port Authority, and in particular, at Virginia International Terminals.

Other speakers presenting before the Committee cautioned that the studies, which compare Virginia's ports to those in other states, overlooked many of the nuanced differences among them. As a result, they claimed that the reviews were, in large part, akin to comparing apples and oranges.

Therefore, I am requesting that the Joint Legislative Audit Review Commission (JLARC) undertake a review of the three studies of the Port operations which I have attached. In particular, the Committee would like JLARC staff to address:

(1) Whether the studies fairly and accurately assess the successes and shortcomings of the current operations;

(2) Whether the comparisons to Ports in other states are fairly made, in light of constants that give natural advantages to one port over another on certain metrics; and

(3) Whether the current institutional structures of the VPA and VIT are sustainable or hinder VPA's ability to focus on market position.

It is my firm expectation that the Virginia Port Authority and Virginia International Terminals Boards and staff will fully cooperate with JLARC's investigation. Because of the on-going negotiations regarding the Public-Private Transportation Act proposals to enter into a concession agreement for the long-term operations of Virginia's Ports, time is of the essence. The Committee would like JLARC staff to complete its review of the studies by the start of the 2013 Session.

Sincerely,

Lacey

Lacey E. Putney
Chairman

cc: Members, House Appropriations Committee
Mr. Glen Tittermary, Director JLARC

SENATE OF VIRGINIA

JOHN C. WATKINS
10TH SENATORIAL DISTRICT
ALL OF AMELIA AND POWHATAN COUNTIES;
PART OF CHESTERFIELD, CUMBERLAND,
GOOCHLAND, AND HENRICO COUNTIES;
AND PART OF THE CITY OF RICHMOND
POST OFFICE BOX 159
MIDLOTHIAN, VIRGINIA 23113

FLOREAT VIRGINIA SENATUS

COMMITTEE ASSIGNMENTS:
AGRICULTURE, CONSERVATION AND NATURAL RESOURCES
COMMERCE AND LABOR
FINANCE
TRANSPORTATION

November 21, 2012

NOV 27 2012

The Honorable John M. O'Bannon, III
Chairman
Joint Legislative Audit and Review Committee
P.O. Box 70365
Richmond, VA 23255

Dear Delegate O'Bannon:

As a member of the Governor's Legislative Review Panel assisting in the Commonwealth's review of the PPTA proposals for port operations, I have recently been reviewing a wealth of information related to the Port of Virginia's finances and operations. Through my review, I have discovered several apparent actions on the part of the Virginia International Terminals, Inc. ("VIT") Board of Directors related to employee compensation practices that I find concerning and excessive. Therefore, as Vice Chairman of the Joint Legislative Audit and Review Committee ("JLARC"), I would respectfully request that we undertake our own review of this information to verify that the actions and figures discussed below are in fact reflective of what has occurred at VIT over the past several years.

By way of background, while technically a private corporation on paper, VIT is, in practice, essentially an extension of the Virginia Port Authority ("VPA"). VIT was created by the VPA in 1982 to operate the state-owned facilities at the Port of Virginia. The VPA used its broad statutory authority contained in §§ 62.1-132.3 and 62.1-132.8 of the *Code of Virginia* to create VIT. VIT is incorporated under the laws of the Commonwealth as a non-stock, not-for-profit corporation, and it has been granted tax exempt status because it serves an essential government function. VIT's Board of Directors is appointed by the VPA Board of Commissioners, and the VPA Board annually approves the VIT budget. The VPA further regulates VIT through a service agreement.

The VPA and VIT are highly subsidized by the Commonwealth. Each year, the VPA receives a 4.2% allocation from the taxpayer-supported Transportation Trust Fund to the Commonwealth Port Fund. For FY 2013, this allocation will total approximately $37 million. These funds are used to support the capital expenditures at the terminals that VIT operates on behalf of the Commonwealth. Even with this state subsidization, the port operations as indicated by the third party studies seem to have experienced continuing operating losses from 2009 to 2012.

In light of the public nature of VIT, I find certain apparent actions on the part of its Board of Directors related to employee compensation to be extremely troubling, particularly given the overall economic downturn and recent fiscal challenges facing the Port. Specifically, my concerns center around the fact that the salaries and benefits offered to VIT executives and employees appear far in excess of those offered to employees at similar state entities, as well as those offered to individuals in analogous positions at other ports.

I would respectfully request that, as JLARC reviews the outside studies and the pertinent information regarding the financial activities of VIT. Additionally, a review of executive management pay as well as retirement and bonus programs should be given a closer review. It would be particularly helpful if peer organizations be compared with the compensation packages of VIT executive management.

I feel it is tremendously important that VIT's conduct reflect its public nature and purpose. As a beneficiary of state funding, VIT's employee compensation should be equitable when compared to that of other similar state entities.

We must ensure that VIT is acting as a good steward of the Commonwealth's and the taxpayers' fiscal resources. Should you need any additional information regarding VIT, I would ask that you coordinate with the Secretary of Transportation's Office and the VPA Board of Commissioners to ensure access to whatever information you need to complete your investigation.

Should you have any questions or concerns, please do not hesitate to contact me at your convenience.

Sincerely,

John Watkins

JCW/swa

cc: The Honorable Robert F. McDonnell
The Honorable Sean T. Connaughton
Michael J. Quillen, VPA Board of Commissioners
Glen S. Tittermary

Appendix B

Agency Responses

As part of an extensive validation process, State agencies and other entities involved in a JLARC assessment are given the opportunity to comment on an exposure draft of the report. JLARC staff provided an exposure draft of this report to the Virginia Port Authority, Virginia International Terminals, and the Secretary of Transportation. Appropriate technical corrections resulting from their comments have been made in this version of the report. This appendix includes the written responses that were received.

THE PORT OF VIRGINIA

Virginia Port Authority
600 World Trade Center
Norfolk, Virginia 23510-1679
Telephone (757) 683-8000
Fax (757) 683-8500

Rodney W. Oliver
Interim Executive Director

January 9, 2013

Mr. Glen S. Tittermary
Director
Joint Legislative Audit and Review Commission
Suite 1100, General Assembly Building
Capitol Square
Richmond, Virginia 23219

Dear Mr. Tittermary:

Please allow this letter to serve as acknowledgement that the draft report: *Review of Recent Studies of the Virginia Port Authority's Operations* was received on January 4, 2013. I have reviewed the report and provided my comments via conference call with Mr. Hal Greer on January 7, 2013.

Thank you for the opportunity to review and comment on the draft and we look forward to receiving the final report.

Kind regards,

Rodney W. Oliver

Rodney W. Oliver
Interim Executive Director

Virginia International Terminals, Inc.
P.O. BOX 1387 • NORFOLK, VA 23501-1387 • (757) 440-7000

January 9, 2013

JAN 11 2013

Glen S. Tittermary, Director
Joint Legislative Audit and Review Commission
Suite 1100, General Assembly Building, Capitol Square
Richmond, Virginia 23219

Dear Mr. Tittermary:

Thank you for the opportunity to provide written comments on the exposure draft of the Joint Legislative Audit and Review Commission (JLARC) Special Report: Review of the Recent Studies of the Virginia Port Authority's Operations.

We appreciate your staff members taking the time to visit us, and the excellent level of communication we experienced throughout the course of this project. We believe that JLARC staff used their best efforts to gather the information necessary to present a factually accurate report involving what are clearly complex issues.

We believe that the draft Special Report we have reviewed accurately identifies those areas where confusion exists and provides explanations, accompanied by supporting facts, to give readers of the report a clearer picture of the VPA and VIT, past present and future.

Again, thank you for your staff's efforts.

Very Sincerely Yours,

Joseph A. Dorto
President & CEO

Terminal Locations: Newport News Marine Terminal, Norfolk International Terminals
Portsmouth Marine Terminal, Virginia Inland Port

JLARC Staff Note on the Secretary of Transportation's Letter

The following letter from the Secretary of Transportation implies that the analysis of this report was in part completed by Vickerman Associates and that Vickerman Associates was involved in drafting the report. This is factually incorrect. As noted on page 2 of the report, Vickerman Associates' role was specifically limited as a result of their disclosure of prior work for Virginia International Terminals. None of the analysis in this report was completed by Vickerman Associates as part of its assistance to JLARC staff, and Vickerman Associates was not involved in drafting the report or in developing any of the conclusions presented.

COMMONWEALTH of VIRGINIA

Office of the Governor

Sean T. Connaughton
Secretary of Transportation

January 9, 2013

Glen S. Tittermary
Director, Joint Legislative Audit and Review Commission
Suite 1100, General Assembly Building
Richmond, Virginia 23219

Subj: JLARC/Vickerman Report on the Port of Virginia

Dear Mr. Tittermary:

This is in response to your letter of January 4, 2013, which transmitted the exposure draft entitled: *Special Report: Review of Recent Studies of the Virginia Port Authority's Operations.* The 26+ page exposure draft was sent the day after I had the opportunity to provide JLARC staff with the Administration's views on the challenges and opportunities facing the Port of Virginia.

The Special Report is in response to a November 8, 2012, request by Delegate Lacey Putney, Chairman of the House Appropriations Committee. The Chairman requested JLARC review: (1) whether recent studies about the port fairly and accurately assess its successes and shortcomings; (2) whether the comparisons to ports in other states are fair; and (3) whether the current structure of the Virginia Port Authority (VPA) and Virginia International Terminals (VIT) is sustainable or hinders VPA's ability to focus market position. The Chairman's request was clearly made with the intent of having JLARC conduct a fair, honest and unbiased review of the studies completed on the port.

In reviewing the exposure draft and compiling comments on various material errors (See attached), references were noted to a consultant engaged by JLARC to assist in the preparation of the report. In response to inquiries, JLARC staff identified the consultant as Vickerman & Associates, LLC ("Vickerman"), of Williamsburg, Virginia.

Needless to say, we are very concerned by wha~~t is~~ a very real and clear conflict of interest that runs contrary to the letter and spirit of Chairman Putney's request. Vickerman was engaged by the entity subject to the various port studies, VIT, to develop a strategy and business plan for VIT only a few months before being retained by JLARC. This conflict of interest undermines the credibility of the Special Report and its contents.

The relationship between Vickerman and VIT has been reported on by several media outlets.[1] Vickerman presented to the VPA Board of Commissioners on August 22, 2012, a report similar in nature and scope to the pending JLARC Special Report. The relationship between VIT and Vickerman is clear:

> *"The Virginia International Terminals (VIT), with the approval and consent of the Virginia Port Authority (VPA), commissioned Vickerman & Associates to prepare a comprehensive strategic organizational assessment presentation of the VIT operations today and into the future. The scope of services includes a future cargo forecast projection for the Port of Virginia."*

To conduct his work on behalf of VIT, Vickerman stated that "*recent reference studies will be evaluated and integrated into the VIT assessment.*" The studies Vickerman evaluated and integrated into the VIT assessment are the same that JLARC was requested to review:

> *"Using the applicable key performance recommendations outlined in the three most recent evaluations studies of VIT organization and operations:* ***(KPMG, R K Johns and Moffat & Nichol)...****"*

After we initially raised this conflict of interest, JLARC proposed to add a disclosure to the Special Report. It is our understanding that your intent was to use Vickerman in an effort to confirm data independently derived. Unfortunately, based on the foregoing and upon reviewing JLARC's proffered language, our concern of the extensive involvement of Vickerman in drafting the report and the breadth and depth of the conflict of interest is heightened:

> *"The expert's assistance was sought as a resource to the JLARC study team in (1) understanding the port industry, the global container market, and the intermodal market in general; (2) understanding unique factors that impact VIT terminals market position; (3) confirming VPA and VIT successes cited in the consultant studies; (4) assessing the validity of cost comparisons among various ports; (5) confirming that VIT's projected*

[1] ("*VIT has retained Vickerman, the consultant, to prepare a report that Connaughton has requested from VIT that will outline how the company plans to increase cargo and revenue at the commonwealth's ports.*" Inside Business, July 20, 2012; "*VIT has hired John Vickerman, president of Vickerman & Associates, a Williamsburg firm...*" Inside Business, August 3, 2012; and "*Following the presentation on the port proposals, John Vickerman, a consultant to VIT, briefed the Port Authority board specifically on VIT's proposal in a closed session.*" The Virginian Pilot, August 22, 2012.)

> *future cargo growth appears to be reasonable; and (6) understanding the operational reputation of VIT in the shipping community."*

This proposed disclosure highlights, not mitigates, the impropriety of JLARC employing Vickerman. We urge you to reconsider proceeding with the Special Report until this issue is addressed in a manner that meets the intent of Chairman Putney's request.

Sincerely,

Sean T. Connaughton

Cc: The Honorable John O'Bannon, JLARC Chairman
The Honorable John Watkins, JLARC Vice Chairman
The Honorable Lacey Putney, Chairman, House Appropriations Committee
The Honorable Martin L. Kent, Chief of Staff to Governor McDonnell

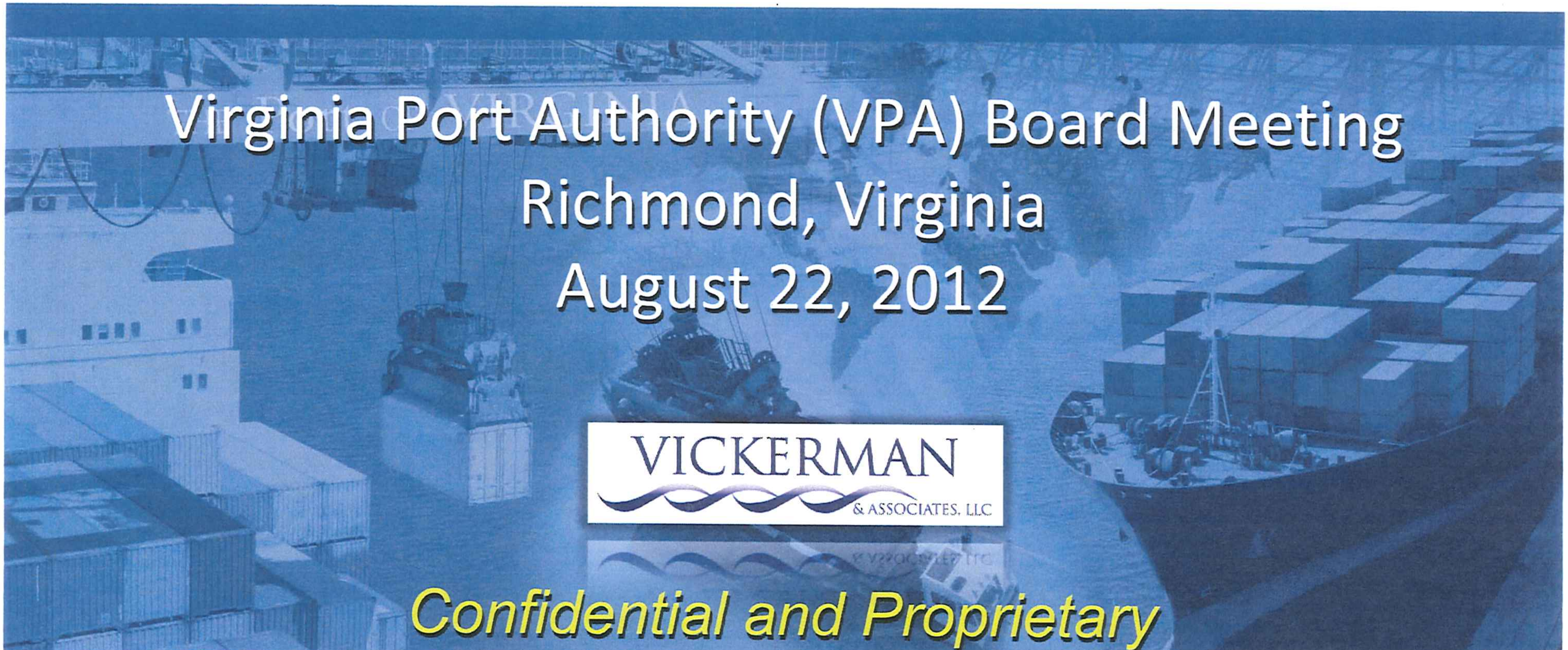
Enclosures

THE PORT OF VIRGINIA

Virginia International Terminals, Inc.

A Long Term Strategy for The Port of Virginia

VIT Conceptual Business Plan



THE PORT OF VIRGINIA

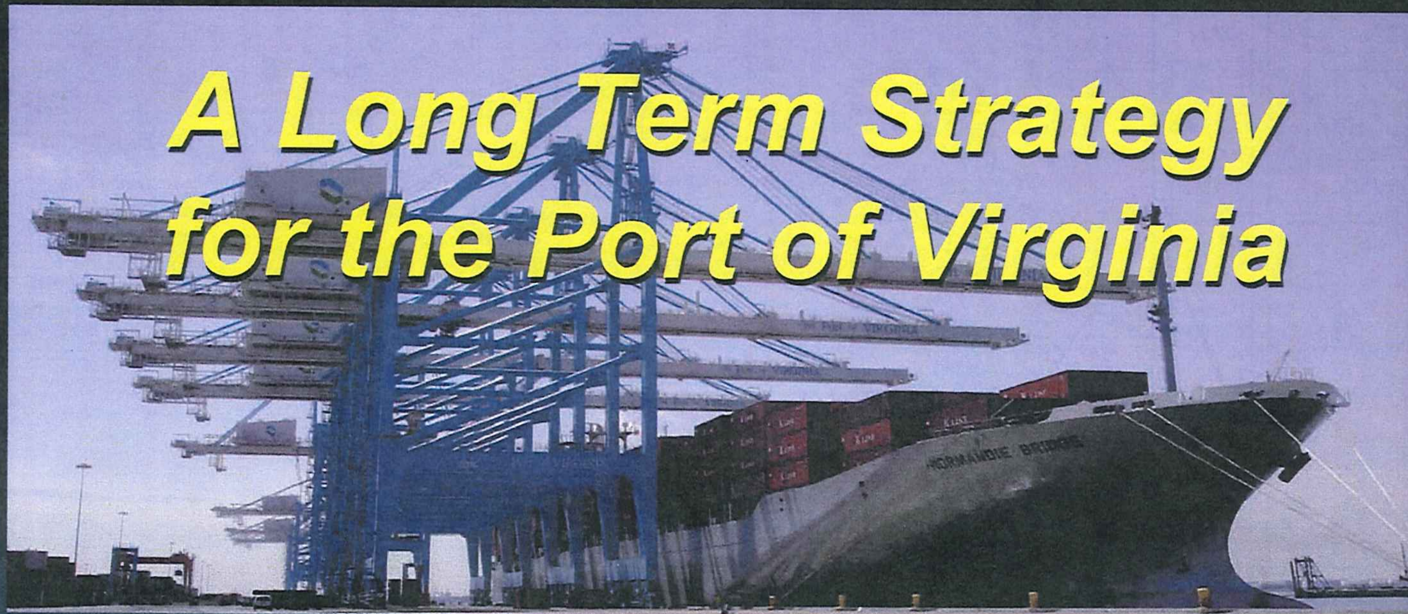
A Long Term Strategy for the Port of Virginia (POV)

Presentation Content

- **Presentation Background and Objectives**
- **Strategic Path Forward for VIT and the Port of Virginia**
  - VIT Organization and Management "*Right Sizing*"
  - VIT Growth Guarantee
  - VIT Financial Breakeven Projection
- **Port of Virginia Short & Long Range Container Forecasts**
  - Global & North American Trade Forecast
  - Port of Virginia Historical Growth and Future Container Forecasts
- **Port of Virginia's Primary Growth Market**
- **VIT Today** - *A History of Success & Innovation*
  - Continuous Innovation
  - Terminal Productivity and Asset Utilization Assessment
  - A Top Ranked Industry Safety Program

VICKERMAN & ASSOCIATES, LLC

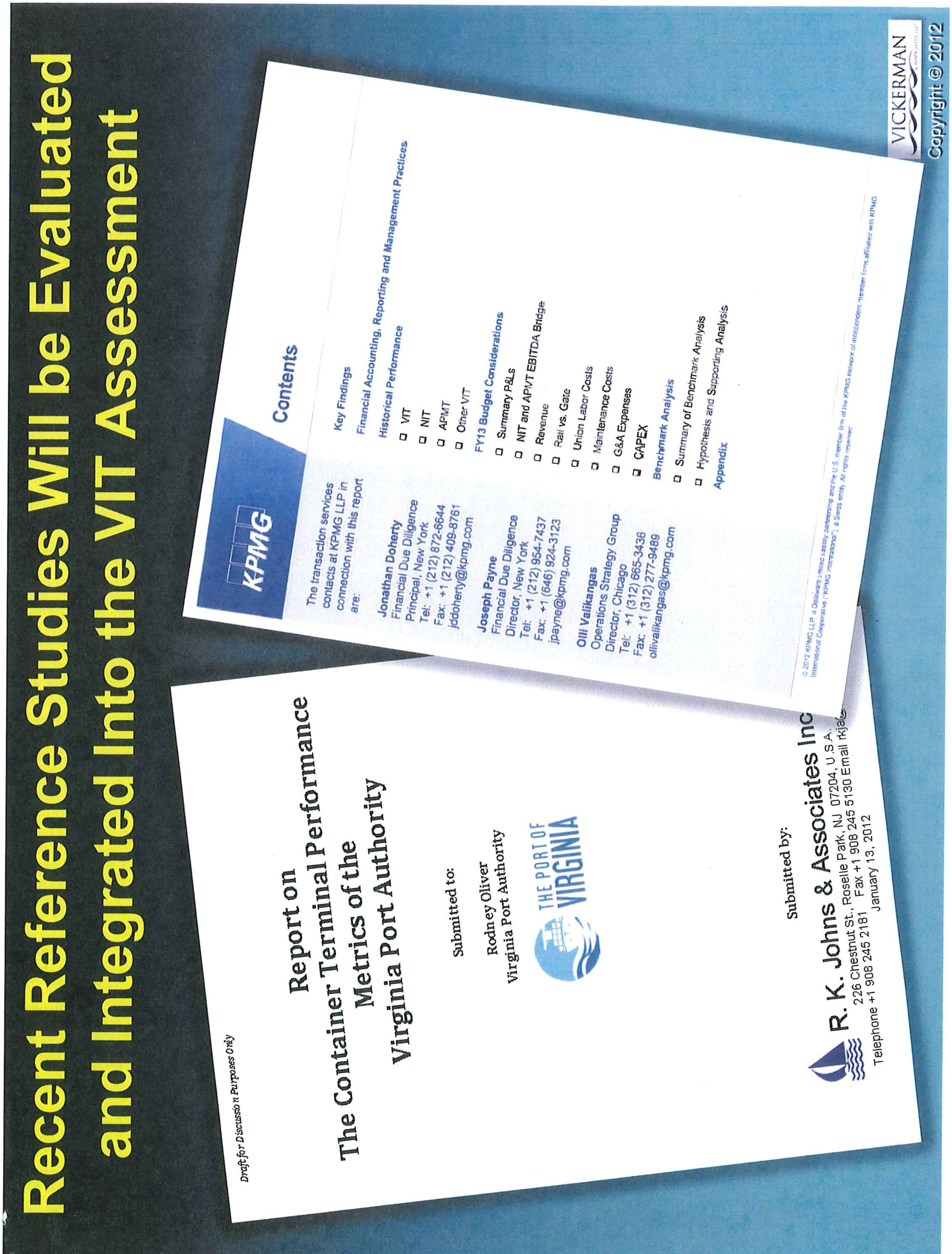
A Long Term Strategy for the Port of Virginia



Presentation Objective

The Virginia International Terminals (VIT), with the approval and consent of the Virginia Port Authority (VPA), commissioned Vickerman & Associates to prepare a comprehensive strategic organizational assessment presentation of the VIT operations today and into the future. The scope of services includes a future cargo forecast projection for the Port of Virginia.

VICKERMAN & ASSOCIATES, LLC



Recent Reference Studies Will be Evaluated and Integrated Into the VIT Assessment
Draft for Discussion Purposes Only
Report on
The Container Terminal Performance
Metrics of the
Virginia Port Authority
Submitted to:
Rodney Oliver
Virginia Port Authority
THE PORT OF VIRGINIA
Submitted by:
R. K. Johns & Associates Inc
226 Chestnut St., Roselle Park, NJ 07204, U.S.A.
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January 13, 2012
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Financial Accounting, Reporting and Management Practices
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Union Labor Costs
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G&A Expenses
CAPEX
Benchmark Analysis
Summary of Benchmark Analysis
Hypothesis and Supporting Analysis
Appendix
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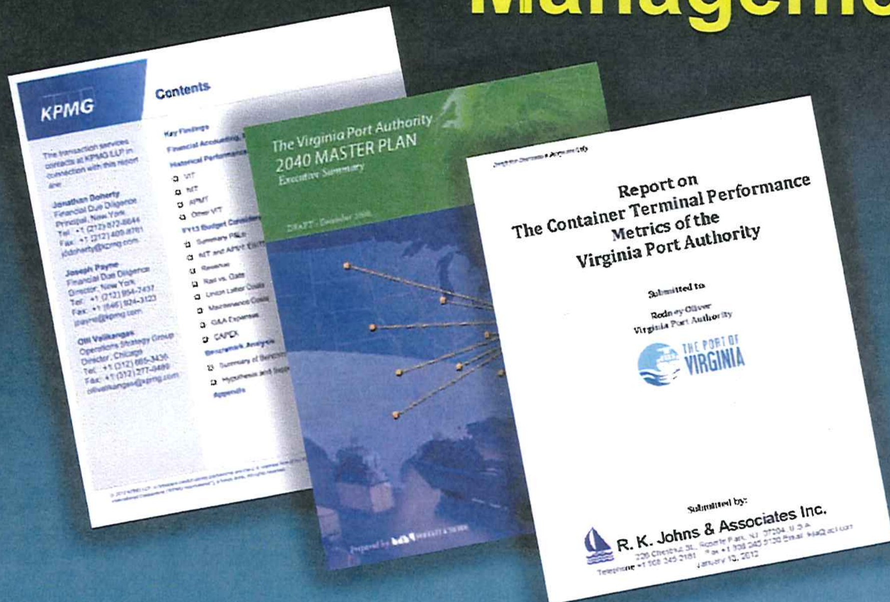
<u>Right Sizing</u> the VIT Organization and Management for the Future



Using the applicable key performance recommendations outlined in the three most recent evaluations studies of the VIT organization and operations: (KPMG, R K Johns and Moffat & Nichol)….

Immediately, VIT will proactively adopt and employ all the appropriate key performance metrics and recommendations in the three reports and will

RIGHT SIZE the VIT management and operational characteristics

Confidential and Proprietary

VICKERMAN & ASSOCIATES, LLC

Review of the JLARC Special Report:

Review of Recent Studies of the Virginia Port Authority's Operations

January 8, 2013

Background

This paper is to review of the JLARC *Special Report: Review of Recent Studies of the Virginia Port Authority's Operations* ("the Report") dated January 4, 2012.

The review of the Report is based on the themes presented in the Report as key findings and detailed comments and observations are included in Appendix C for further elaboration.

Key Review Points

1. ***The Virginia Port Authority's market performance and outlook appear to be more positive than suggested by the study assessing it when all relevant factors are considered.***

   As acknowledged in the Report, by the end of 2011 the volume at the Port of Virginia had not returned to pre-recession levels. The strength of the Port of Virginia relative to other US East Coast peers could be further challenged as our competitor ports up and down the East Coast are racing to address their infrastructure needs and investing in channel dredging.

   While the economic recession played a role in lower cargo volumes, all but one of our East Coast competitors has recovered, and some ports, such as the Georgia Port Authority ("GPA"), even experienced growth during this period. Furthermore, the Port of Virginia cargo volumes have been slow to recover and the market share in relation to East Coast competitors has dropped from 16.9% in 2007 to 15.1% in 2011, as seen in Appendix B. In a competitive landscape, the Port of Virginia is losing market share.

   In relation to the growth statistics noted on page 5 of the Report, the 2010 and 2011 growth percents, 24% and 14% respectively, could not be sourced and don't represent the best way to view VIT's throughput performance during that time. The artificial distinction drawn between VIT and non -VIT managed terminals is not based on comparative data. The APMT-VA containers should be included pre and post lease to account for the overall cargo throughput at the Port of Virginia, which is overseen by VPA. Additionally, the recent increase in growth post 2010 is due to the acquired volume from entering into the lease agreement with APMT, but comes at a significant cost due to the lease payments. This partly explains the recent increase in growth post-2010 but the limited impact on improving the financial profitability.

The declining market share noted in Appendix B should be viewed against the overall excess capacity at the Port of Virginia. This excess capacity has a significant drain on the VPA financials.

The Report does not address the linkage of tariff rate impacts to cargo volumes and overall Port revenue. For example, long term contracts were signed to stabilize cargo volumes, but the overall revenue impact is lower due to heavy discounts on tariff rates.

Overall the Report alludes to third party factors such as rail congestion, shipping line diversion, intermodal development and population growth as reasons for slow container growth and loss of market share. These are general business factors that impact ports and VPA/VIT should be able to deal with these. Ultimately the cargo growth at the Port of Virginia is the responsibility of VPA/VIT's management.

2. ***The Virginia Port Authority appears to be financially sustainable and positioned to generate a net profit during the next five years, particularly given the projected growth in cargo volume during that period.***

Many of the Report findings do not present a complete view of the financial performance of the VPA and the financial contributions that are provided by the Commonwealth. Another observed issue is that the Report often mixes and matches VIT operating cash flow with certain VPA cash flow performance measures. This leads to several key operational items being missed including: other VPA revenues; VPA SG&A, maintenance, and operations expenses; terminal lease obligations; equipment lease obligations; and debt service. A better way of looking at the financial performance of the Port is to review the VPA operating cash flow.

Since 2009, the VPA/VIT has suffered an annual operating income loss, with losses totaling $20.5 million in FY 2009, $18.5 million in FY 2010, $20 million in FY 2011, and $11.2 million in FY 2012. Further, the VPA/VIT is budgeted to lose $8.9 million in FY 2013.

As indicated in Appendix A, the operational cash flows are approximately 22% lower since FY 2007, even though revenues have increased by about 22%. As noted in the Report, the growth in VIT SG&A expenses and the APMT Virginia lease have prominently contributed to this trend. Therefore, as noted previously, the growth in containers and revenue came at the expense of the high lease costs paid to APMT.

After further adjusting the VPA cash flows to account for debt service, the past several years show a positive cash flow position only after CPF contributions have been made to the VPA. Furthermore, a contradiction appears in the Report about the long-term cost savings potential of fully utilizing the technologically advanced and efficient APMT-VA terminal compared to the actual operational decisions of VIT. VIT currently diverts less than 50% of available VIT cargo to APMT-VA and such future diversions would incur extra per container leasing charges.

Such views on VPA financial performance have been further substantiated by external credit agencies such as Fitch, which downgraded the VPA in 2009, and Moody's, which recently placed VPA on negative credit watch for a possible downgrade. In a rating note issued in May 2012, Moody's noted that its rating reflects the modest recovery in cargo volumes following the significant 2009 decline and a substantively weaker financial profile with lower than historical debt service coverage and overall liquidity.

Moody's further stated:

> *"The negative outlook considers and reflects the port's narrowed financial position as well as concerns regarding the port's ability to return operating and financial metrics to historically stronger levels that are more consistent with an Aa rated port. The negative outlook also considers the lack of clarity on the magnitude and related cost implications of VPA's long-term Master Plan, which is being updated and expected to be adopted later this year."*

Additionally, recent financial performance comes despite substantial annual state investment or subsidization of the Port. Each year, the Commonwealth transfers 4.2% of the Transportation Trust Fund to the Commonwealth Port Fund ("CPF"). For FY 2013, this transfer is projected to be approximately $37 million.

3. ***Administrative expenses could be reduced by eliminating duplicative administrative staffing and functions.***

The notion of elimination of duplicative administrative staffing and functions could aid profitability. However, other stronger opportunities exist as described in the reviewed reports that should be evaluated further. The reviewed studies are from maritime industry experts and the methodologies employed in these studies show enough promise to achieve costs savings over and beyond what administrative expense savings alone can provide.

Some examples of these potential cost savings include:

- **Moffat & Nichol.** The report identified a minimum of $9.5 million, or 20%, in estimated cost savings on maintenance at the VIT operated facilities.
- **Drewry.** Pointed to a lower capacity utilization of 53% when compared to a range of 64-75% for other East Coast ports. This capacity utilization reflects the Port's slower recovery, but also a degree of over-investment in terminal infrastructure.
- **KPMG.** Compared performance to six other ports which indicated there are possible cost savings opportunities ranging between $5.8 to $11.9 million in areas such as IT spending, finance employee costs, human resources costs, general and administrative costs, maintenance salaries and benefits, crane maintenance efficiency, and non-labor maintenance costs. Additionally, it was noted that labor cost projections for FY 2013 are optimistic as VPA/VIT has only achieved the FY 2013 projected labor efficiency level once at NIT since July 2008 and never at APMT.

4. ***Virginia International Terminals and Virginia Port Authority executives are compensated at levels higher than most other U.S. port authority executives in the United States.***

VIT and VPA executives are compensated at higher levels than most other U.S. port authority executives and this fact should be explored in more detail.

Additional Comments

1. Data sources are not consistent across various figures/statistics, were selectively used to justify the report's findings without including the full conclusions reached by each consultant study and are not independent due to the VIT providing some of the data.
2. Projected results and reasons for recent Port of Virginia performance were taken at face value and not independently verified.
3. The Report notes that port comparisons are not easily achievable. Each port is unique but comparisons between operating models (Savannah) and competitors (NY/NJ, Charleston, Baltimore) are readily available.

Appendix A: VPA/VIT Historical Financial Results

VPA/VIT Historical Operating Income/Loss

$ Millions	2007	2008	2009	2010	2011	2012
Revenue	249.2	260.2	208.6	209.3	287.7	310.6
Operations and Maintenance	161.9	173.7	144.9	135.2	176.7	183.7
SG&A	38.4	41.3	40.2	44.0	47.9	51.9
Depreciation	38.1	40.6	44.0	48.6	50.6	49.2
Facility Rental	-	-	-	-	32.5	37.1
Total Operating Expenses	238.5	255.6	229.1	227.8	307.8	321.8
Operating Income/(Loss)	**10.7**	**4.6**	**(20.5)**	**(18.5)**	**(20.0)**	**(11.2)**
Operating Income Margin	**4.3%**	**1.8%**	**(9.8%)**	**(8.8%)**	**(7.0%)**	**(3.6%)**

VPA/VIT Historical Operating Cash Flow

($ Millions)	2007	2008	2009	2010	2011	2012	CAGR
VIT Cash Flows							
Revenue	244.2	254.1	203.9	203.5	277.9	297.8	4.1%
Operations and Maintenance	(155.5)	(167.0)	(137.0)	(126.5)	(166.8)	(171.2)	1.9%
SG&A	(17.2)	(18.0)	(20.0)	(24.2)	(28.1)	(29.8)	11.6%
Total Operating Expenses	(172.7)	(185.0)	(157.0)	(150.7)	(194.9)	(201.0)	3.1%
VIT Cash Flow	**71.5**	**69.1**	**46.9**	**52.8**	**83.0**	**96.9**	**6.3%**
VIT Cash Flow Margin	**29.3%**	**27.2%**	**23.0%**	**25.9%**	**29.9%**	**32.5%**	
VPA Cash Flows							
VPA Other Revenues	4.9	6.0	4.7	4.7	6.3	6.5	5.7%
VPA Other Revenues – Grants	-	-	-	1.0	3.6	6.3	n/a
Facility Rental	-	-	-	-	(32.5)	(37.1)	n/a
VPA Maintenance	(4.6)	(4.9)	(6.1)	(6.8)	(8.0)	(10.5)	18.0%
VPA Terminal Operations	(1.8)	(1.8)	(1.9)	(1.9)	(2.0)	(2.1)	2.3%
VPA SG&A	(21.2)	(23.3)	(20.2)	(19.7)	(19.8)	(22.1)	0.9%
VPA Cash Flow	**48.8**	**45.2**	**23.5**	**30.1**	**30.6**	**38.0**	**(4.9%)**
VPA Cash Flow Margin	**19.6%**	**17.4%**	**11.3%**	**14.4%**	**10.8%**	**12.5%**	
Other VPA Cash Flow Adjustments							
VPA Debt Service (CPF, TRB, MELP)	(50.0)	(48.4)	(44.8)	(43.0)	(46.2)	(49.9)	(0.0%)
CPF Contributions	36.5	36.0	32.7	32.8	34.7	36.3	(0.1%)
Adjusted VPA Cash Flow	**35.3**	**32.8**	**11.4**	**19.9**	**19.1**	**24.4**	

Appendix B: Port of Virginia Market Share

Market Share	2007	2008	2009	2010	2011
Ports of Virginia*	16.9%	16.8%	16.5%	15.5%	15.1%
Baltimore	4.8%	4.9%	5.0%	5.0%	5.0%
Charleston	13.9%	13.2%	11.2%	11.1%	10.9%
Wilmington	1.5%	1.6%	2.1%	2.2%	2.3%
NY/NJ	42.1%	42.4%	43.1%	43.2%	43.4%
Savannah	20.7%	21.1%	22.2%	23.1%	23.2%
Total Comparables	100.0%	100.0%	100.0%	100.0%	100.0%
VIT as a percent of Total East Coast TEUs	**11.9%**	**11.8%**	**11.2%**	**11.0%**	**10.8%**

Source: AAPA Statistics, ports shown as percent of total TEUs for ports presented, VIT also shown as percent of total East Coast TEUs for reference

*Includes APMT containers prior to 2010

6

Appendix C: Summarized and Detailed Comments on Report

Data Sourced and Key Findings

- Page 1 – The term "relevant factors" used in the first bullet point of the key findings could contain more specific items. Other relevant factors could include items such as the increase of debt load, the recent notice of credit rating watch, decreasing market share (as seen in graphic from VIT's PPTA submission which shows decrease from #2 in 1997 to #3 currently), operating income loss and fewer days of working capital have been identified as potential concerns by national rating agencies and the VPA Board.
- Page 2 - VPA was compared against its primary competitors, particularly the Georgia Port Authority ("GPA") which has a similar operating model. Differences at each port authority will complicate the comparison, but some of these differences are the result of specific business decisions made by different port authorities. For example, GPA had more open land next to the port for intermodal operations, but the ability to expand the intermodal operations, and subsequently attract additional cargo through the relocation/expansion of local corporations helped divert cargo from Charleston (noted on page 11). The differences in layout and technology also create difficulties in comparison, but these impacts are results of the decisions made the by the individual port authorities to optimize their operations, and therefore should be contemplated when analyzing the performance of VPA.
- Pages 4/5 –VPA/VIT has recently experienced additional competition which has impacted their business performance. It should be noted that the policies and operations of the Port of Virginia allowed APMT to build a private terminal. If VPA did not enter into the lease with APMT, it would still be subject to competition through diverted cargo to the APMT-VA facility. Lastly, the growth at the Port of Virginia (including the period prior to leasing the APMT facility) is still the responsibility of VPA to coordinate the marketing, logistics and other services to enhance the cargo flowing through the region and the overall impact to Virginia's economy.
- Page 8 –Montreal should be considered to be included in the analysis since it is a competitor on the East Coast and has rail operation service to the Midwest.
- Page 14 – Is the view of JLARC and its consultant that "leasing APMT removed a competitor from the market," is a positive outcome? Cost of leasing such facilities should also be considered an important factor.
- Page 16 – On Figure 5, only the line including the lease payment should be shown since that is now a component of VPA's financials until 2030.
- Page 17 – The JLARC should consider being more specific regarding the statement, "Moreover, a major financial advantage for VPA over the next several years will be that its excess capacity can accommodate a substantial amount of additional growth without the need for significant additional capital investment." How much capacity exists? How much growth before additional capital investment is needed? How expensive is the next capital investment? Incidentally, if the forecasted growth does not occur, the excess capacity can be a big drain on the financial resources of VPA.
- Page 17 – A discussion of how the Commonwealth Port Fund structure differs from other port authorities would be helpful. In particular, it should be noted that most port authorities have port-related debt that is predominantly funded by terminal operations, not additional state support.

- Page 22 – Moffat & Nichol has detailed charts showing maintenance history that should help address the statement "but it is difficult to confirm the magnitude of these opportunities without more analysis than provided in the consultant studies".

Local Interviews and Stakeholder Consultations

- All but one of the reports had extensive interviews with VIT/VPA staff and stakeholder consultation.

VIT Performance and Excess Capacity

- Page 3 – It is noted that VPA scored high in terminal productivity, but the views of the customers before and after the APMT-VA facility was in operation are not discussed. It is uncertain how much the inclusion of the APMT-VA and the operational efficiencies at this facility are contributing to these metrics. It should be noted that VPA would currently be using PMT and NIT if APMT-VA was not under lease. Productivity metrics of those facilities would likely reduce the operational efficiencies.
- Page 4 – The statement "VPA currently has excess capacity and therefore can handle substantial growth in volume without significant additional capital investment" needs to be further analyzed. The Report should aim to quantify the excess capacity, substantial growth, and significant investments made. Additional analysis should be contemplated which compares the cost of the lease to the benefits of operating the facility (additional capacity, delays CIMT need, increases operational efficiency, etc.) It should be noted that VPA has the additional capacity but that is due to the lease of APMT-VA.
- Page 4 – The Report does not validate this statement "the study does not discuss the recent positive trend in performance or the factors that appear to place the VIT terminals in a strong competitive position in coming years." An independent analysis would help affirm that the recent trends will provide for a strong competitive position for the Port of Virginia.
- Page 6 – The Report should provide additional justification as to why Port of Virginia grew faster than NY/NJ and Savannah for the first 10 months of 2012. The report currently implies that this recent performance could continue, but no justification for the performance is provided.
- Page 8 – The Report should include a discussion of the lower margin achieved on rail cargo than truck cargo and how that impacts VPA's decisions to increase rail market share.
- Page 9 – What measures can be taken to mitigate the rail congestion at APMT-VA? Has APMT been consulted about the possible design issues?
- Page 10/11 – The Report should address how VPA is taking measures to mitigate GPA's advantages for intermodal cargo, such as greater use of the VPA's inland port, working with the real estate community to maximize investment opportunities in the region and any other measures that have been effective at other ports. An analysis of when GPA started intermodal activities compared to VPA and Charleston would be helpful.
- Page 12 – The APMT lease should not be separated from the financial performance since the lease is integral to achieving the current rate structure and operational efficiency of the port. The lease payment was negotiated to be a high fixed cost with lower variable costs in the long term. Additionally, incremental per box charges will be levied after 500,000 containers are reached at the

APMT-VA terminal, which will further increase the cost of the lease and mitigate the additional operational efficiencies.

- Page 12 – Why is APMT not fully utilized by VPA since it is the lowest cost facility? Containers at NIT have increased by 4.8% per annum since FY 2010, even though the APMT facility provides more profit per container (not including APMT lease) than NIT.
- Page 13 – The noted 50% revenue growth after the recession is misleading since the Port allowed a competitor to enter the market and take cargo only to later to negotiate a lease agreement to regain that lost cargo.
- Page 13 –Contrary to the statement, the Moffat & Nichol maintenance report identified some unnecessary maintenance was performed and suggested it could be cut.
- Page 14 – The following statement "The lease of APMT that began in FY 2011 has substantially increased VPA's expense base and therefore lowered profitability in the near term, while creating a significant amount of excess capacity. Despite the lease's known adverse impact on short-term profitability, there appears to have been broad consensus at the time of the negotiations that it was a good business decision for VPA to enter into the lease," should be quantified in the report by noting the substantial increases, significant excess capacity, adverse impact, and broad consensus described.
- Page 14 – The last sentence notes that volume increases will offset VIT's operating expenses .However, this notion doesn't seem to consider the additional per box rates above 500,000 boxes included in the lease. Furthermore, due to this point, the statement on Page 17, "In addition, the high efficiency of the APMT and the lower per unit rent should reduce terminal costs per unit," appears to be contradictory.
- Page 15 – VPA does have plans for PMT, which include future leases ramping up to $5m (net profit) by FY 2018.
- Page 16 – The statement "Leasing APMT has resulted in substantial costs that have masked the recovery that VPA has undergone since FY 2011," seems misleading. The lease was a result of business decisions that allowed a competitor into the harbor. Additionally, entering into the APMT-VA lease was made as a conscious decision with an associated business plan. The JLARC should consider whether the business assumptions that led to the signing of the APMT-VA lease came to fruition or not.
- Page 16 – Please provide further substantiation for the statement "There appears to be consensus that container volume will continue to grow over the next several years. Historical data suggests that container volume grows at a faster rate than the U.S. gross domestic product." What is the consensus level of growth and who provides this consensus?
- Page 17 – The next five years of projected net income and operating income values should be provided to show the projected increase in profitability. The container growth rate that corresponds with those projected financials should also be clearly noted.
- Page 18 – It should be noted that an upgrade of the debt did not occur after the APMT facility was leased which would have indicated the better long-term prospects of VPA's ability to pay its debt once the lease was signed.

- Page 18 – Regarding the statement, "Weaknesses or challenges cited include VPA's historically weak liquidity position and the competitive nature of the East Coast container market. VPA's facilities revenue bond ratings are comparable to revenue bond ratings given to other East Coast port authorities," please describe further the noted weak liquidity position and how many days working capital are available. In addition, how do these metrics compare to other ports? What are the ratings of other east coast ports? Please provide a table with this data.
- Page 21 –The labor cost projections for FY13 are optimistic (e.g. the Company has achieved labor efficiency projected for FY13 once since July 2008 at NIT and never achieved labor efficiency projected for 2013 at APMT).
- Page 21 – The "duplication of executive staff" comment should be expanded to include specific areas where staff efficiencies can be improved.

Market Share and Cargo Growth

- Page 6 – Regarding the statement "One of the factors that contributed to the decline was the loss of business to the new APM Terminal (APMT), which was privately owned and operated until July 2010. In 2008 and 2009, VIT lost significant volume due to the decision by the Evergreen and Maersk shipping lines to move most of their cargo to the Port of Virginia to APMT," several points should be contemplated by the JLRAC:
    - Drewry made clear in its report the overlap of landlord and operator that exists with the existing VPA/VIT structure. Under the existing VPA/VIT agreement one cannot easily separate VPA and VIT.
    - With the decline in volume, were there corresponding reductions in costs to maintain profitability and what were the days of working capital at VPA?
    - What preparations and steps did VPA take in advance of the APMT facility opening given the signs of the impending decline in container volumes?
    - What was the plan, actions taken and results to replace the lost cargo?
- Page 9 – As noted, a shipping line moved transatlantic cargo from VPA to NY/NJ, a description of VPA/VIT management steps to counter such moves would present a complete picture.
- Page 10 – Regarding the statement, "Norfolk Southern, which has historically been the main railway providing service to the terminals," further elaboration regarding what "main" means in terms of percent of rail volume leaving the port? A figure illustrating Norfolk Southern's share of rail volume for the past 10 years and from which port facilities the rail volume originated would be helpful..
- Page 10 – The statement, "The Drewry report concludes that VPA has not focused adequately on economic development as compared with other ports, such as Savannah, and that this has adversely impacted VPA's market growth and share. The report further indicates that VPA has been preoccupied with day-to-day operations and has not been sufficiently focused on the establishment of distribution centers for major shippers" has been otherwise validated. This issue has been raised by the VPA Board as well as the regional intermodal development has trailed peer developments and performance.

- Page 11/12 – In the JLARC's view, should VPA have reduced rates and expedited the Heartland Corridor to mitigate the North/South preference for distribution centers as noted by VEDP?

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