THE PORT OF LOS ANGELES

AUDIT COMMITTEE

Report to the
Board of Harbor Commissioners

"FOR INFORMATION ONLY"

DATE: JANUARY 31, 2013

TO: THE AUDIT COMMITTEE OF THE BOARD OF HARBOR COMMISSIONERS

SUBJECT: COMPARISON OF THE PORT OF LOS ANGELES AND THE PORT OF LONG BEACH FINANCIAL PERFORMANCE

BACKGROUND INFORMATION:

In a staff report presented at the Audit Committee Meeting of the Board of Harbor Commissioners on December 17, 2012, staff compared the operating performance of the Port of Los Angeles (POLA) against ports both within the United States as well as in Europe and Asia. One of the report's referenced studies came from a 2008 United States Department of Transportation (DOT) study of U.S. ports. A question arose regarding one component of the report, why POLA showed weaker financial performance than the Port of Long Beach (POLB). This memo reviews the DOT data along with more recent financial information and concludes that in terms of financial performance, the POLB performs at about the same level as the POLA when certain aspects of operations are normalized to allow for an equitable comparison.

In the previous report, staff used as measuring tools to benchmark performance, Return on Assets, Return on Equity, Earnings Before Interest Depreciation and Amortization (EBIDA) and Debt Service Coverage. The DOT used several other common financial ratios, of which operating margin is perhaps the most relevant. This report will assess financial performance of the two ports using the first mentioned metrics as well as the operating margin. An operating margin is calculated by dividing the operating income, defined as an entity's operating revenues less its operating expenses with the difference divided by its operating revenues. In formula form, it is:

$$\frac{\text{Operating Revenues} - \text{Operating Expenses}}{\text{Operating Revenues}} = \text{Operating Margin}$$

Using the above formula, the greater the quotient, the more profitable the measured entity. The quotient is normally expressed as a percentage.

Disparate Data – Although the POLA and the POLB have similar primary sources of revenues and customer bases, the two still have pronounced differences when considering the nature of the ports' operating expenses. These dissimilarities result from the different business commitments of each port. Through a closer examination of the differences and of the recent changes to financial payments between the POLB and the City of Long Beach (COLB), we can see that financial performance of the two ports when the different operations are normalized are much closer than the historical DOT data would suggest.

The chart below provides a quick summary of which entity pays for what service.

	Paid by POLA	Paid by POLB	Paid by COLB
Tidelands Activities			
Cruise Terminal	X		X
Marina	X		X
Public Beaches	X		X
Public Parks	X		X
Police Services	X	X	X

While the POLA performs at well above the average U.S. port in terms of operating margin, the DOT study indicated that for Fiscal Year (FY) 2006 the Operating Margin for POLB was 54.4% while that for the POLA was 35.0%. Two items of note, the DOT data includes depreciation as part of its "Operating Expense" and the DOT issued the report in late 2008 using fiscal year 2006 data. Because the definition within the POLA's bond indentures does not include depreciation in "operating expenses", this review will take depreciation out of operating expenses in the calculation of the operating margin. Without depreciation, the operating margin for FY2006 would have been 78.6% for the POLB and 58.9% for the POLA.

The difference in Operating Margin between the POLA and the POLB results primarily from the expenditures the POLA undertakes relating to tidelands activities. The State of California granted the COLB control over the tidelands area of Long Beach in 1911. As a result, all revenues and expenditures dealing with the tidelands area trust funds are held in the COLB's Tidelands Operating fund, an umbrella fund that expends for police, fire, lifeguards, recreation beach maintenance, repairs, replacement, and construction of capital assets that relate to the tidelands areas. These expenses are not charged to the POLB but rather the COLB shoulders those expenses related to the tidelands. To summarize, the POLB manages the industrial or wholesale aspect of port operations while the COLB manages the visitor serving or retail aspects of the business, which includes the maintenance of the beaches, the cruise terminal, the marinas, and the waterfront. This is contrary to the situation in the City of Los Angeles wherein all costs related to its tidelands in San Pedro are borne directly by the POLA. The tideland activities at the POLA also relate to the management of marina activity, cruise terminal management, recreation beach maintenance, and the construction and replacement of capital assets within the tidelands area as well as how police services are used.

With respect to police services, the POLA has its own police force while the POLB contracts with the COLB for such services. Although the POLB pays the COLB for police services, the COLB expends for police services in areas that are not covered by the POLB yet still fall within the tidelands responsibility of the COLB. In contrast, the POLA bears the full cost of policing its tidelands areas and its police force also assists with enforcement in the neighboring communities, resulting in a lower police cost at the POLB versus that at the POLA. Finally, with a variety of land benefitting the community such as parks and recreational land at the POLA, the cost of maintenance differs.

The following analysis focuses on the main components of the amount paid for tidelands activity at the COLB and the cost of maintaining tidelands property at the POLA.

Causes of the Difference

The following key items create the contrasts in Operating Margin between the two San Pedro Bay Ports:

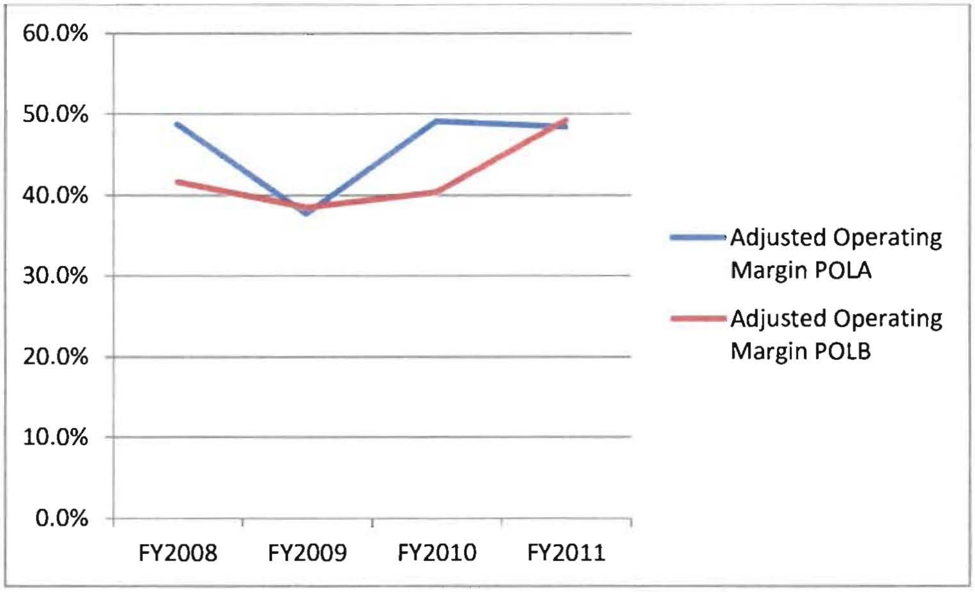
1. *Separation of Business Related to the Tidelands Trust* – The COLB has within its budget expenses incurred to "account for the operations and development of the Tidelands area harbor district, commonly referred to as the Port of Long Beach", as noted in its latest available FY 2010-2011 Comprehensive Annual Financial Report (See Attachment). The amount expended for this activity by the COLB between FY 2009-2011 averaged $94.1 million a year over those three years, not including depreciation. This expenditure cover costs that are similar to what the POLA expends for like activity, including monies for marinas, police services, and cruise terminal activity.

2. *Different Maintenance Needs* – In the Construction and Maintenance (C&M) area of the ports, maintenance requirements differ because of the need for upkeep of greenbelts at the POLA that do not exist at the POLB. If we consider just the greenbelt aspect of POLA's maintenance, we can conservatively assume that approximately 12% of POLA C&M is devoted to such landscape maintenance. This 12% comprises of the cost of gardeners and the operating expenses associated with landscaping at POLA. In FY2012, the total operating expense of the C&M division at the POLA was $26.4 million. Twelve percent of this total results in $3.1 million that the POLA expends that the POLB does not.

The Operating Revenues for the POLB for Fiscal Year Ending (FYE) 9/30/2011 totaled $345.4 million with stated Operating Expenses to be $81.4 million, for the POLA for FYE 6/30/2012, it was $400.5 million and $199.8 million respectively. Taking all this into consideration, we can assess the Operating Margins on a normalized basis as follows:

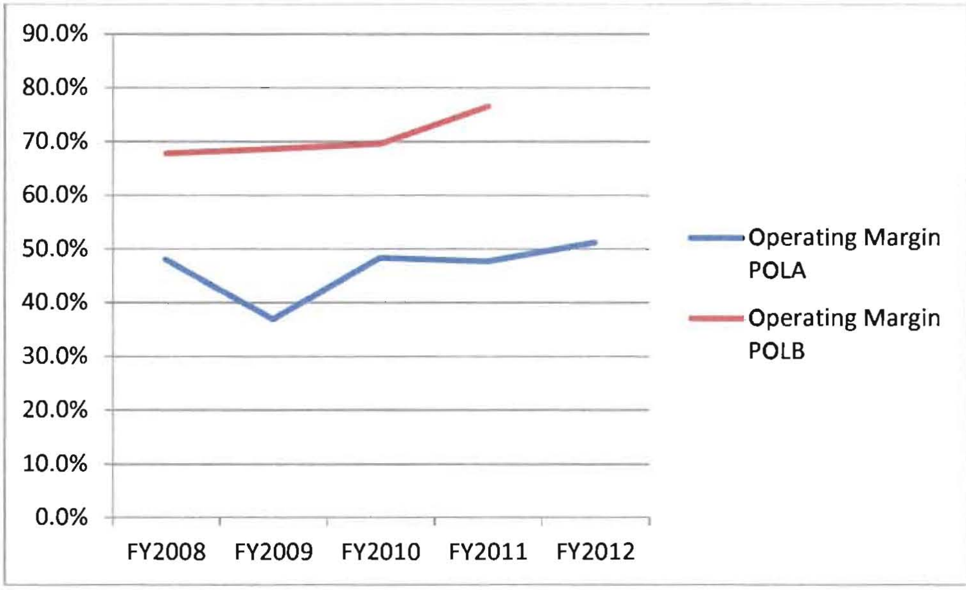
Normalized Expenses		**FY2011** (in millions)
POLB Total Stated Operating Expense		$81.4
Add:	Tidelands	+$94.1
POLB Normalized Operating Expense		**$175.5**
POLB Operating Revenues		$345.4
POLB Normalized Operating Margin		**49.2%**
		FY2012 (in millions)
POLA Total Operating Expense		$199.8
Subtract:	C&M	-$3.1
POLA Normalized Operating Expense		**$196.7**
POLA Operating Revenues		$409.8
POLA Normalized Operating Margin		**52.0%**

With the adjustments for the very different ways in which the ports and the two respective cities follow Tidelands obligations, the trend in operating margin remains relatively consistent. A comparison of the operating margins of the two ports since FY2008 in graphic form is below. However, as we have seen from the normalization above, if one makes the adjustment for the Tidelands expenses for the POLB, the results would show that the POLA and POLB operate at similar levels of efficiency in terms of operating margin.



Compare the above against the non-normalized ratio in the graph below. The gap between the POLA and the POLB has remained consistent.

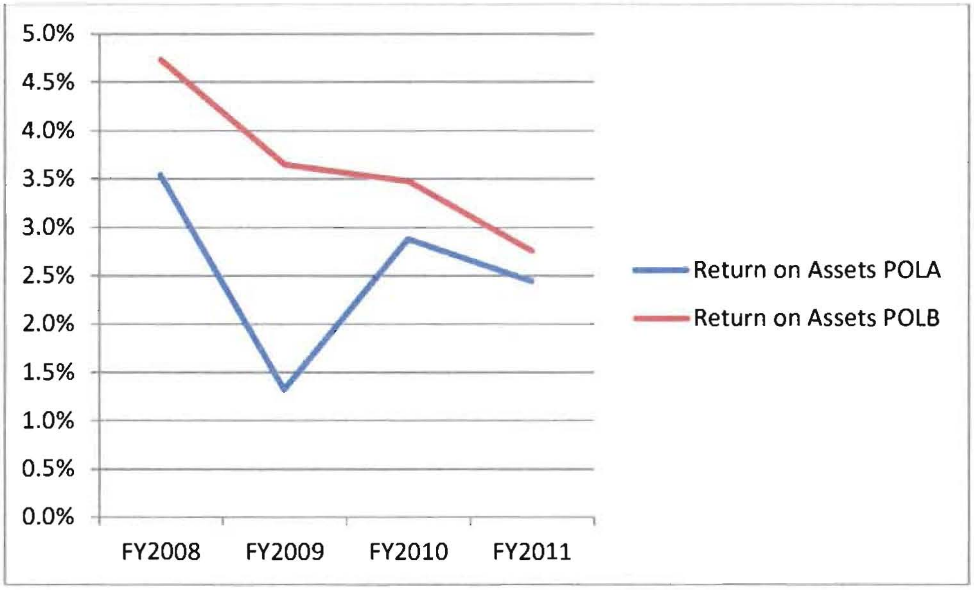
Note that FY2012 data is not yet available for the Port of Long Beach as its fiscal year ends on September 30.



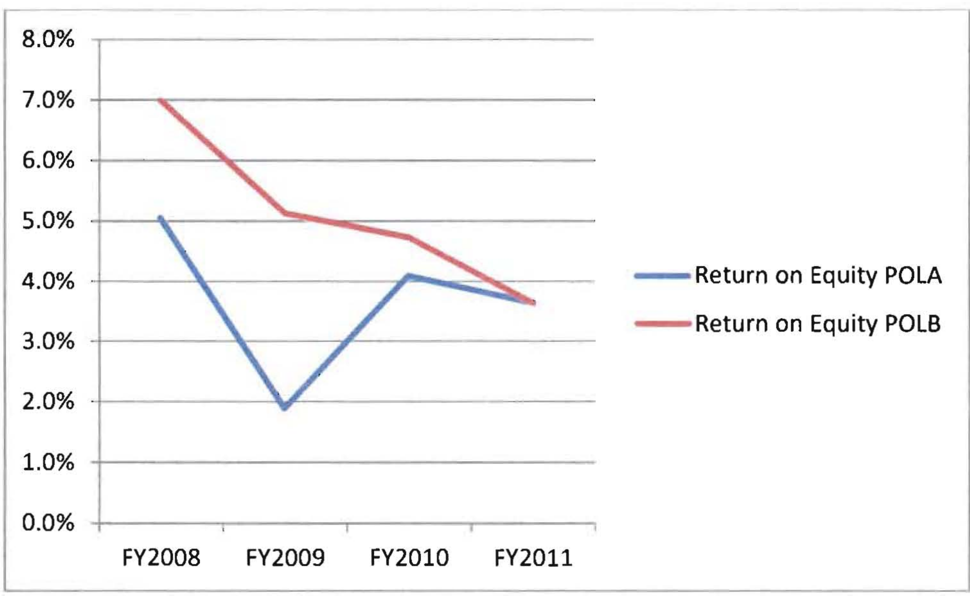
Broader Comparisons

When we consider performance more from a bottom line and balance sheet measure, that is either return on assets or return on equity, we see a greater convergence of performance.

In the case of return on assets, the data indicates that the POLB is declining in efficiency. This has less to do with its operations and more to do with the governance at the COLB. Over the course of the last several years, the COLB has enacted legislation requiring the POLB to remit a greater amount of its revenues to the COLB. The COLB has passed a resolution in which oil revenues as well as a percentage of gross revenues now must be paid from the POLB to the COLB. The POLB categorizes its oil revenues as non-operating, so it does not affect the operating margin but does flow to the bottom line. As a result, the bottom line net income of the POLB continues to decline given those remittances. For example the top line revenues at the POLB was $359 million in FY2008 with a net income of $160 million versus the POLA's top and bottom lines respectively of $426 million and $125 million. By FY2011, the POLB's total operating revenues were $345 million with a net income of $96 million compared to the POLA's $401 million and $96 respectively.



In the case of return on equity, given the changes to the POLB's net income result, a similar trend has resulted.



<u>Summary</u> – Although the financial metrics of the two ports seemingly converge by certain measures, changes in how revenues are distributed at the POLB as well as the different business models under which the two ports operate will continue to drive the differences at the two ports. Establishing any benchmark comparisons of the two ports must consider those changes and differences to arrive at a balanced study.

For this review, adjusting for just the most readily identifiable expenses show that as each port manages the various businesses under its responsibility, the operations of POLA are similar to the POLB in terms of financial efficiency. Differences in financial performance between the two ports, whether positive or negative, have tended to be driven more by broad governance factors rather than those stemming from economic or business ones.

Geraldine Knatz

GERALDINE KNATZ, Ph.D.
Executive Director

MC:KP
Author: K. Pan