PORT OF SEATTLE
MEMORANDUM

COMMISSION AGENDA
ACTION ITEM

Item No. 6c

Date of Meeting September 30, 2014

DATE: September 25, 2014

TO: Tay Yoshitani, Chief Executive Officer

FROM: Michael Burke, Director, Leasing and Asset Management
Jasmin Contreras, Property Manager, Leasing and Asset Management

SUBJECT: LDC Washington LLC New Lease Agreement for the Terminal 86 Grain Facility

ACTION REQUESTED

Request Commission authorization for the Chief Executive Officer to execute the following agreements between the Port and LDC Washington LLC, substantially as drafted: (1) a new 20-year lease with two 10-year extension options and (2) a Termination Agreement and Release.

SYNOPSIS

The grain terminal at the Port's Terminal 86 has been in operation for 46 years under the current lease agreement, dated March 26, 1968, as amended ("Lease"). The Lease was assigned in 2000 from Cargill to Louis Dreyfus Corporation, a company in Louis Dreyfus Commodities Group. In 2010, as part of its internal reorganization, Louis Dreyfus Corporation assigned the Lease to LD Commodities Seattle Export Elevator LLC, a subsidiary of Louis Dreyfus Commodities LLC (each a company within the Louis Dreyfus Commodities Group) and Louis Dreyfus Commodities LLC entered into a guaranty. The new tenant, LDC Washington LLC (formerly known as Louis Dreyfus Commodities Seattle Export Elevator LLC, hereinafter "Lessee") is also within the Louis Dreyfus Commodities Group and is an affiliate of Louis Dreyfus Commodities LLC. Louis Dreyfus Commodities LLC will enter into a guaranty of the new lease, as well. Since 2000, a Louis Dreyfus Commodities entity has actively and successfully marketed and operated the terminal.

In 2004, the Lease was amended to change the rental structure where the Port received payment based upon tonnage volume with a market share component plus base rent. As a result of this change in how rent is calculated, combined with the ability of the facility to handle large volumes, financial performance improved for the Port from 2004 to 2012. Under the current Lease, Lessee has one remaining 5-year option to extend the term of the agreement through November 15, 2020.

The proposed new lease will replace Lessee's current Lease, and a Termination Agreement and Release ("Termination") will be required to provide certain releases upon the terms and conditions set forth in the Termination agreement, including bringing resolution to an insurance dispute between the Port and Lessee as described below.

LEASE BACKGROUND

In an effort to maximize Seaport net operating income by managing and controlling expenses and shifting all maintenance and capital improvement responsibilities to the leaseholder, the Port restarted lease negotiations with Lessee for a new long-term lease agreement. To assist with these negotiations, Port staff procured a property appraisal in 2011 for Terminal 86, which included a market value opinion based on the continued use of the site as a grain export terminal.

The 2012 drought, one of the most severe and extensive droughts in at least 25 years, seriously affected U.S. agriculture and had a strong impact on key commodities. This drought damaged portions of major field crops in the Midwest, particularly field corn and soybeans.[1] The Terminal 86 facility has been handling mostly corn and soybeans; therefore, the terminal had several months of inactivity and volumes were very low for the 2012/2013 Crop Year (August 2012 to September 2013).

The proposed new lease substantially improves the Port's position in the following areas:

1) With the new lease, the Port will secure a tenant for the grain terminal for the next 20 to 40 years. The number of ship loading export grain terminals (special use facilities) is relatively small. The potential market pool of lessees or owners (buyers) of export facilities is limited due to the handful of multi-national grain trading companies.

2) The proposed lease increases the Port's compensation over the existing Lease. The proposed new lease has a minimum annual rent provision that protects the Port if volumes decline. The minimum annual guarantee (MAG) amount is equivalent to current market lease rates for land on a per-square-foot basis. Having a MAG puts the Port in a better financial position potentially reducing revenue volatility. With the new proposed lease, the Port receives a MAG equivalent to market rentals for that site (in its current industrial use).

3) The proposed lease clarifies and shifts maintenance, repair, and future capital-improvement responsibilities from the Port to the tenant for the term of the lease. On average, the Port's costs for these items over the last 10 years have averaged approximately $842,000 per year.

4) As further described in the *Additional Comments* section below, the current Lease agreement has outdated insurance language. The new agreement resolves present and future insurance disputes and issues.

[1] United States Department of Agriculture: Economic Research Service, July 26, 2013, http://www.ers.usda.gov/topics/in-the-news/us-drought-2012-farm-and-food-impacts.aspx

Proposed New Lease vs. Existing Lease Comparison Summary

Lease Provision	Current Lease	Proposed New Lease
Term	Original term for 20 years with six 5-year options (as amended). The current Lease expires 11/14/2015: tenant has one more 5-year option to extend term to 11/15/2020.	Initial term of 20 years with two 10-year options.
Base Rent	Compensation to the Port based on volume throughput with a low minimum rent requirement of $550,000 annually.	Compensation to the Port based on volume throughput with an Annual Minimum Rent requirement of $1.8 million, as noted below.
Tonnage Rent	Tonnage fee at a fixed $1/metric ton for higher volumes. Limited compensation protection to the Port in low volume years.	Tonnage fee increases by 10% in Year 1 (2014) of the new Lease and provides volume incentives. Future fee increases commence in Year 7 by 2% and will be adjusted annually thereafter
Net Revenue	Average Annual Net cash to the Port is approximately $4.8 million/year (using 2004-2013 volumes and after capital investments and expensed repairs).	Average Annual Net cash to the Port approximately $5.8 million/year (assuming 2004-2013 volumes).
Minimum Rent	Minimum export requirement (approx. $1.06 million) based on percent volumes compared to the Ports of Tacoma, Kalama, and Seattle. This requirement is problematic to administer due to the following: 1) requirement is on a Crop-Year basis (Sept to Oct) and is effective the following year, 2) volume information for one of the grain terminals in Kalama is proprietary; and 3) the requirement does not include newer grain facility volumes.	Annual Minimum Rent requirement of $1.8 million protects the Port in the event of variable volumes. This provision will guarantee a market return to the Port on the land value (6%). The Tonnage Rent provides Lessee a discount incentive to run high volumes through the facility, which would generate additional revenue to the Port.
Rental Increases	The Base Rent increases by CPI every 5 years, but it should not to exceed 10%. The current lease does not provide for other rate adjustments.	Base Rent and the Minimum Rent increase by CPI, not to exceed 10% every 5-year period. Tonnage fees would increase by 10% in year 1 and would stay flat for seven years (same period remaining term of the current lease with extension option) and then a 2% increase every year thereafter.
Termination	The current lease does not address early termination rights for Lessee.	Lessee has the right to early termination in the event that the lessee can demonstrate to the Port that the terminal has no long-term viability as a grain terminal due to circumstances beyond the Lessee's control, such as failure of the Railroad to provide adequate rail service to the terminal. The Port will not have the right to terminate for a Port Major Capital Improvement. The Port is not at risk of not recovering any investment cost in the terminal, as Lessee is responsible for all future improvement costs.
Insurance	Pending dispute on the property insurance deductible owed by Lessee for past spout damage claims. Insurance language is outdated and there is a risk for continued future disputes due to unclear insurance lease language.	The new lease provides better-defined property insurance language with regard to responsibility for the property insurance deductible. Lessee will pay 100% of property losses for any single loss that is below $20,000, subject to a maximum of $100,000 per Agreement Year. The Port and Lessee will share the cost of the loss on a 50/50 basis up to the point where the property insurance deductible is met; however, Lessee will never pay more than $500,000 on a per loss basis for property losses and never more than $1 million in the annual aggregate over the course of the Agreement Year. By executing a new lease, the Port releases Lessee from liability related to past insurance claims ($2 million).
Surety	The Port has a $550,000 bond and a lease Guaranty Agreement. The Lease requires 1 year of the Base Rent.	An affiliate of Lessee having a net worth of no less than $250 million shall provide a guaranty of Lessee's payment and performance obligations under the lease.
Lessee Capital Improvements	Tenant is responsible for all maintenance and repair. The Port is responsible for repairs stemming from "damage and destruction." In the past 10 years, the Port has spent about $7 million in *capital expenses*.	Tenant is responsible for all maintenance, repair, and Capital Improvements, including damage and destruction. The Port will not be required to perform capital improvements at the facility.
Environmental	Outdated environmental language from the 1970s	Updated environmental language to contain new agency requirements. The Port will be responsible for pre-existing hazardous substances prior to March 26, 1968, the effective date of the original Cargill Lease Agreement.

GRAIN TERMINAL BACKGROUND

Terminal 86 Grain Facility

The Lessee operates, manages, and maintains the grain facility. Terminal 86 was constructed in the late 1960s and has been operating as a grain facility since then. Terminal 86 was originally designed to export wheat; today it handles primarily corn, soybeans, and sorghum from the Midwest, as the production of these commodities are primarily concentrated in the northern and Midwestern states.

The Terminal 86 facility receives grain by rail and sets it aboard ocean vessels. Despite its age, the facility has a highly efficient system that can receive, store, sort, blend, and ship large amounts of grain of uniform quality to a diverse international customer base, primarily in Asia. In 2012, China became the largest market for U.S. agricultural exports; the increase is backed by strong sales of soybeans, cotton, and corn.[2]

The grain facility is unique in its ability to load bulk ships directly from rail or via its network of silos (storage towers). Loading the ships directly from railcars reduces handling costs and breakage of product while preserving its quality; the silos enable the product to be received from rail prior to arrival of the ship, reducing costs associated with demurrage of railcars. The silos also allow a variety of types and grades of grain to be received. The ocean vessels can be filled with different commodities and a shipment can be prepared to meet exacting standards by blending various grain grades from the silos.

The grain elevator industry is in a period of rapid change. Over the past 15 to 20 years, the industry has been in a consolidation phase where the small elevators have either closed or merged with other local elevators to become larger units. The margins in the grain business have decreased over the years; hence, larger volumes must be handled by elevator facilities in order to be economically viable. With its array of sophisticated electronic controls and mechanical devices, Terminal 86 is a completely automated grain facility that has the ability to handle large volumes.

Grain Industry Overview

The agricultural sector in the U.S. is one of the most advanced in the world, enhanced by technology, well capitalized, and highly integrated among commodities. Grains are an essential source of food in many developing nations and play an important role in the traditional diets of many developed countries. The grain export system in the U.S. is a large, diverse, and evolving industry including public, private and cooperatively owned and managed facilities and trading entities. According to the North American Export Grain Association, as much as one third of all grain produced in the U.S. moves into export.

Exporting grain is both a competitive and a capital-intensive industry. Since the margin of profit to be earned from moving a ton of grain can be quite small, exporters depend upon moving large volumes very quickly. Companies seek to achieve an economy of scale that lowers their average

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[2] United States Department of Commerce http://www.commerce.gov/news/fact-sheets/2013/02/19/fact-sheet-national-export-initiative

fixed costs per unit of volume handled, provides operating flexibility, increases bargaining power in chartering for shipping, and improves the services they can provide worldwide.[3]

As one of the world's leading exporters of wheat, oilseeds, and cotton, and as one the primary origins for corn exports, the U.S. is a dynamic and essential domestic market for agricultural commodities serving key consumption regions such as Europe, Asia, Africa, and the Middle East. With China buying significant quantities of U.S. grains and oilseeds, structural changes in protein demand will continue to take place.

COMPANY PROFILE

Louis Dreyfus consists of a holding company with actively managed interests in operating companies, such as Louis Dreyfus Commodities, a global merchandiser of commodities, a major asset owner, and an agricultural goods processor. Lessee is a subsidiary of Louis Dreyfus Commodities.

Louis Dreyfus was founded in 1851 and has been instrumental in the development of grain trading throughout the world. It has since expanded its expertise to a wide variety of commodities and participates in various diversified businesses.[4] The Commodities Group, which includes its grain export operations at Terminal 86, conducts business throughout Europe, the Middle East, Africa, Asia, and North, Central, and South America. In 2010, Louis Dreyfus Corporation had a legal reorganization of its domestic agribusiness operations. As part of this reorganization, it formed a new limited liability company, Louis Dreyfus Commodities, a company that holds all of the company's domestic agribusiness operations through a number of affiliates such as the Lessee.

Louis Dreyfus is among the top exporters of wheat, soybeans, and corn. Grains are the company's longest standing business. The company's history and achievements in this platform have helped build its global reputation, and today it is one of the world's largest merchandisers of wheat and corn.[5]

Louis Dreyfus's import and distribution network includes key consumption regions such as Europe, Asia, Africa, and the Middle East, and it manages the movement of grains all around the world from farm to fork using its extensive logistics network. Over the past century, Louis Dreyfus has developed a deep understanding of regional consumer needs and achieved strong access to all key destination markets. Its network of processing and storage and distribution assets across the globe is highly developed and increases its control of product flow from farm to fork.

FINANCIAL IMPLICATIONS

Budget Status and Source of Funds

No funds are needed for this request. The new lease increases the Port's compensation in comparison to the existing agreement. The 2014 Operating Budget revenue was based on the

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[3] North American Export Grain Association, http://naega.org/exporting/
[4] Louis Dreyfus corporate website http://www.louisdreyfus.com/about-us/overview/
[5] Louis Dreyfus corporate website http://www.ldcommodities.com/our-business/regional-footprint/north-america/

existing agreement, so the new lease will create a favorable revenue variance for the last three months of the year, assuming budgeted volume levels are achieved.

Financial Analysis and Summary

<table>
<tr><td>CIP Category</td><td>Not applicable</td></tr>
<tr><td>Project Type</td><td>Not applicable</td></tr>
<tr><td>Risk adjusted discount rate</td><td>Not applicable</td></tr>
<tr><td>Key risk factors</td><td>Tenant does not properly maintain the facility, which is mitigated by:
Lessee has maintenance and repair responsibilities under the lease.
The Port performs periodic property condition audits to evaluate property condition and tenant’s performance of maintenance and repair.
Risk of tenant default, which is mitigated by:
Lessee will provide a lease guarantee by an affiliate of Lessee having a net worth of no less than $250,000,000</td></tr>
<tr><td>Project cost for analysis</td><td>Not applicable</td></tr>
<tr><td>Business Unit (BU)</td><td>Seaport Lease & Asset Management - Grain</td></tr>
<tr><td>Effect on business performance</td><td>The following table summarizes the approximate net increase in revenue to the Port, based on three volume scenarios, generated by the proposed new lease as compared to the existing lease if extended through 2020:
<table>
<tr><th>Revenue Increase (in $000's)</th><th>2015</th><th>2016</th><th>2017</th><th>2018</th><th>2019</th></tr>
<tr><td>Low Volume - 1.3 million metric tons</td><td>$730</td><td>$675</td><td>$675</td><td>$675</td><td>$720</td></tr>
<tr><td>~ Avg Volume - 5 million metric tons</td><td>$550</td><td>$495</td><td>$495</td><td>$495</td><td>$510</td></tr>
<tr><td>High Volume - 6.4 million metric tons</td><td>$482</td><td>$427</td><td>$427</td><td>$427</td><td>$442</td></tr>
</table>
The table does not factor in additional financial benefit to the Port created by shifting responsibility for all maintenance and capital improvements to the leaseholder. The table also does not factor in the fact that the Port is releasing the Lessee from any liability related to past Port Spout Damage Claims in the amount of $2 million. Legal uncertainties make it unclear how much the Port would collect on the claim should the Port continue to press for collection.

The basis for establishing the minimum annual guarantee (MAG) market rate for the lease is described in the memo under the “Synopsis” section.</td></tr>
<tr><td>IRR/NPV</td><td>Not applicable</td></tr>
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Environmental Responsibility

Lessee has a history of operating cleaner rail at Terminal 86. The company started using ultra-low sulfur diesel fuel in its switcher locomotives in 2009 three years before the regulatory requirements to burn this fuel. In 2010, Lessee installed idle-reduction equipment on two of the locomotives. They also worked with BNSF Railway Company to replace three of its switcher locomotives with cleaner and more fuel-efficient engines.

Community Benefits

Lessee maintains a Seattle job base of approximately 50 positions related to multi-shift elevator operations, facility maintenance, and security and local management oversight.

ALTERNATIVES AND IMPLICATIONS CONSIDERED

Alternative 1) – The Port considered having Louis Dreyfus exercise its renewal option, continue with the current lease for the remaining 7-year term, and allow the lease to expire naturally. As market conditions will change in the future, this alternative could put the Port at a risk of negotiating a less favorable agreement. Other major risks with this alternative are 1) the Port may be required to make large capital improvements to the facility due to the age of the facility; 2) the Port may have future insurance deductible disputes due to outdated insurance language in the current lease and due to Terminal 86 being an aging facility; 3) the Port will continue to receive rent under the current rent structure and not benefit from the higher expected rent under the proposed new lease; and 4) the Port will not have a Minimum Annual Guarantee in the event of a downturn in the grain business. *This is not the recommended alternative.*

Alternative 2) – The Port considered doing a request for proposal (RFP) to select competitive proposals from potential tenants to operate and manage the Terminal 86 facility when the current lease expires. According to the Tenth Amendment to Lease, the Port may not solicit or entertain discussions with any other prospective tenant until the current lease terminates. If the Port waited until the lease expiration (year 2020) to start a traditional RFP process for selecting a tenant, it would expose the Port to unknown risks because the RFP offers a pricing snapshot of the current market, a market that is constantly evolving. The RFP takes time to produce, and using the RFP as a systematized process for selecting a tenant could potentially take several months before the Port could secure a qualified tenant. Another disadvantage of the RFP alternative is that there are limited large-scale grain elevator operators that would meet the qualifications the Port is seeking from an operator. *This is not the recommended alternative.*

Alternative 3) – Execute a new lease agreement using updated lease language to clarify responsibilities and obligations between the Port and Lessee on capital improvements, maintenance and repair, damage and destruction, insurance, and incorporate a new tonnage volume rate structure that will include a minimum annual guaranteed component that will maximize asset utilization to create value, additional revenue, and profit for the Port. Concurrently with the new lease, the Port will release the Lessee from any liability related to past Port spout damage claims in the amount of $2 million, and terminate the Standstill and Tolling Agreement dated September 24, 2012. **This is the recommended alternative.**

ADDITIONAL INFORMATION

Summary of Insurance Claim Issue

The proposed new agreement will also bring resolution to an insurance dispute between the Port and Lessee. During the October 1, 2006, to April 30, 2007, timeframe, two separate spouts collapsed at the grain facility and the Port made the repairs in accordance with the *Damage and Destruction* section of the current Lease. The Port repaired the two spouts at a total cost of approximately $3.4 million. At the time of the loss, the Port's deductible/self-insured retention for the property insurance on the facility was $1 million per loss. Under the current Lease, the Port is not responsible for property damage on Terminal 86 for loss or damage that results from a condition of the Premises. The Lease does give the Port the right to apply available insurance dollars following the loss. However, when insurance dollars are not available, which includes the deductible cost, then the Port is not responsible for damage if the damage resulted as a condition of the Premises. The spout damage was a result of the condition of the facility, and the Port pursued reimbursement from Lessee for $2 million for the collective portion of the losses coming within the deductible. The Lessee disputed the claim, as the lease is silent on this matter. The current Lease does not define the amount of property insurance the Port is to carry on the facility; nor does the current Lease put an overall cap on the property insurance deductible or cap what the Lessee is responsible for regarding the deductible on a per loss or annual aggregate basis. Pending a dispute resolution, the Port and Lessee agreed to enter into a Standstill and Tolling Agreement. The Port reviewed the legal issues surrounding the claims with the assistance of outside counsel. The Port then negotiated with the Lessee on insurance requirements for the new agreement and agreed to forgo the $2 million claim recovery against the Lessee in consideration for the other benefits the Port would receive through the new business deal. The new agreement clearly defines the responsibilities and obligations between the Port and Lessee for capital improvements, maintenance and repair, damage and destruction, and insurance.

ATTACHMENTS TO THIS REQUEST

- Final Draft Lease Agreement (substantially as drafted)
- Final Draft Termination and Release Agreement (substantially as drafted)
- Standstill and Tolling Agreement dated September 24, 2012

PREVIOUS COMMISSION ACTIONS OR BRIEFINGS

- None for this new agreement