INTERNAL AUDIT REPORT

LEASE AND CONCESSION AGREEMENT AUDIT

CRUISE TERMINALS OF AMERICA (CTA)

January 01, 2013 – December 31, 2015

ISSUE DATE: MAY 9, 2016
REPORT NO. 2016-04

EXECUTIVE SUMMARY

AUDIT OBJECTIVES AND SCOPE

The purpose of the audit was to determine whether:

1. Maritime Cruise Operations and Finance monitoring controls were adequate and effective to ensure:
   - Cruise Terminals of America completely and accurately reported percentage rent to the Port.
   - Capital and Per Passenger maintenance allowance expenses were reviewed and approved.

2. Lessee complied with significant lease provisions, as amended.

We reviewed and analyzed records for the period January 01, 2013 – December 31, 2015. Details of our audit's scope and methodology are on page 6.

BACKGROUND

The Port of Seattle owns cruise terminals at Piers 66 and 91. Cruise Terminals of America (CTA) has entered into a lease agreement with the Port to lease and operate the cruise terminal facilities in exchange for percentage rent payable to the Port. The lease agreement establishes a landlord tenant relationship between CTA and the Port.

Prior to May 2003, the Port of Seattle contracted with CTA to manage the Port's cruise operations. In 2003, Port Management and CTA transitioned the management agreement to a lease agreement. In 2005, the Port and CTA entered into a new lease agreement that provided greater financial benefit to the Port in exchange for an extended lease term to CTA. In 2012, the Port and CTA amended the agreement to simplify certain lease provisions, further advance the Port's financial benefit and extend the term of the lease thru December 31, 2019.

In 2015, according to portseattle.org/cruise, cruise ship terminals at Pier 66 and Terminal 91 served seven major cruise lines including Carnival, Celebrity Cruises, Holland America Line, Norwegian Cruise Line, Princess Cruises, Oceania Cruises and Royal Caribbean. Each ship call brought approximately $2.5 million to the local economy. Overall, the Seattle cruise industry generates approximately 3,647 jobs and $441 million in annual business revenue.

AUDIT RESULT

Monitoring controls performed by Maritime Cruise Operations and Finance are designed appropriately and operating effectively. The lessee materially complied with significant provisions of the Lease Agreement. Management's preventative controls over the lease process are not adequate. See Finding 1.

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TRANSMITTAL LETTER

Audit Committee
Port of Seattle
Seattle, Washington

We have completed an audit of Cruise Facility Lease Agreement between the Port of Seattle and Cruise Terminals of America. We reviewed information for the period January 01, 2013 – December 31, 2015.

We conducted the audit in accordance with Generally Accepted Government Auditing Standards and the International Standards for the Professional Practice of Internal Auditing. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

We extend our appreciation to the management and staff of Maritime Cruise Department, Maritime Finance & Budget, and Accounting and Financial Reporting for their assistance and cooperation during the audit.

Kirangi

Joyce Kirangi, CPA, CGMA
Internal Audit, Director

AUDIT TEAM	RESPONSIBLE MANAGEMENT TEAM
Margaret Songtantaruk, Senior Auditor	Michael McLaughlin, Director Cruise & Maritime Operations
Joseph Anderson, Internal Auditor	Marie Ellingson, Cruise Services Manager
	Debbie Stave, Manager Maritime Finance & Budget
	Rudy Caluza, Director, Accounting and Financial Reporting

BACKGROUND

The Port of Seattle owns cruise terminals at Piers 66 and 91. Cruise Terminals of America (CTA) has entered into a lease agreement with the Port to lease and operate the cruise terminal facilities, in exchange for percentage rent payable to the Port. The lease agreement establishes a landlord tenant relationship between CTA and the Port.

Prior to May 2003, the Port of Seattle contracted with CTA to manage the Port's cruise operations. In 2003, Port Management and CTA transitioned the management agreement to a lease agreement. In 2005, the Port and CTA entered into a new lease agreement that provided greater financial benefit to the Port in exchange for an extended lease term to CTA. In 2012, the Port and CTA amended the agreement to simplify certain lease provisions, further advance the Port's financial benefit and extend the term of the lease thru December 31, 2019.

Internal Audit conducted a limited scope review of the CTA management services agreement with the Port of Seattle in 2008. The report noted the Port's monitoring system was inadequate. We performed a second audit of the CTA agreement in 2011 of the period beginning January 1, 2009, through December 31, 2010. The report noted:

- Lessee did not report gross revenue in accordance with the lease agreement.
- Lessee contracted shuttle and parking services to its affiliates without seeking Port approval
- Port of Seattle management did not properly administer the terms of the agreement with CTA due to the agreements complex provisions.

In 2015, according to portseattle.org/cruise, cruise ship terminals at Pier 66 and Terminal 91 served seven major cruise lines including Carnival, Celebrity Cruises, Holland America Line, Norwegian Cruise Line, Princess Cruises, Oceania Cruises and Royal Caribbean. Each ship call brought approximately $2.5 million to the local economy. Overall, the Seattle cruise industry generates approximately 3,647 jobs and $441 million in annual business revenue.

Maritime Cruise Operations, in conjunction with Maritime Finance & Budget, and Accounting and Financial Reporting (AFR), has primary responsibility at the Port of Seattle for administering and monitoring the agreement to ensure compliance by CTA.

FINANCIAL HIGHLIGHTS

AGREEMENT YEAR	PERCENTAGE RENT PAID	T91 FACILITY CHARGE	TOTALS
2013	$11,575,806	$1,235,469	$12,811,275
2014	$11,491,310	$1,146,758	$12,638,068
2015	$12,998,190	$1,093,904	$14,092,094
TOTALS	**$36,065,306**	**$3,476,131**	**$39,541,437**

Data Source: PeopleSoft Financials

HIGHLIGHTS AND ACCOMPLISHMENTS

During the course of the audit, we noted that Maritime Cruise Operations and Finance achieved the following significant accomplishments.

- Amended and simplified key provisions within the Cruise Facility Lease Agreement, which eliminated the need for the Port of Seattle to monitor CTA's detailed accounting records.
- Built and maintain strong working relationships with Cruise Terminals of America management through the establishment of weekly and quarterly operations and finance meetings.

AUDIT SCOPE AND METHODOLOGY

We reviewed information for the period January 1, 2013 – December 31, 2015. We utilized a risk-based audit approach from planning to testing. We gathered information through document requests, interviews, observation, and data analysis, for Internal Audit to obtain a complete understanding of the significant provisions of the agreement between the Port of Seattle and Cruise Terminals of America and the respective operations.

We applied additional detailed audit procedures to areas with the highest likelihood of significant negative impact as follows:

1. We performed control test procedures to evaluate the design and effectiveness of the two key monitoring controls performed by Maritime Cruise Operations and Finance that ensure:
    - Cruise Terminals of America completely and accurately reported percentage rent
    - Capital and Per Passenger allowances are appropriately administered

2. We verified the lessee materially complied with significant lease provisions, as amended through execution of audit procedures that confirmed:
    - Lessee completely and accurately calculated and reported Percentage Rent and the Terminal 91 Facility Surcharge to the Port
    - Lessee maintained Insurance coverage in full force at specified amounts.
    - Lessee obtained and had in force Rent Security (i.e. Surety) at specified amount

- Lessee materially remitted all Percentage Rent payments timely
- Lessee timely provided its annual plan to the Port of Seattle
- Maritime Operations appropriately administered the Maintenance Allowance

CONCLUSION

Monitoring controls performed by Maritime Cruise Operations and Finance are designed appropriately and operating effectively. The lessee materially complied with significant provisions of the Lease Agreement. Management's preventative controls over the lease process are not adequate. See Finding 1.

SCHEDULE OF FINDINGS AND RECOMMENDATIONS

1. THERE IS NO FORMAL PROCESSS TO EVALUATE WHETHER LEASE AGREEMENT RENT SECURITY IS ADEQUATE TO PROTECT THE PORT FROM RISK OF LOSS.

The Port of Seattle has leased its cruise terminals to Cruise Terminals of America (CTA) to operate the cruise business. To secure tenant's full performance of the agreement, including payments of rent and other amounts, the Port under Article 5 of the lease agreement requires CTA to obtain rent security of $300,000. That rent security amount has remained constant since inception of the first Cruise Facility lease in 2003, and we verified that CTA was in compliance.

Per state law and Port Policy, the amount of the rent security required from a tenant varies and is dependent on total amount of rent payments. CTA's percentage rent and fees paid to the Port were approximately $12,811,275, $12,638,068, and $14,092,094 for the years ending 2013, 2014, and 2015 respectively.

- RCW 53.08.085 - Lease of Property - Security of Rent - requires rent security of one-sixth the total rent, but not less than one year's rent or more than three years' rent with the port commission having the discretion to adjust or waive rent security.

- Port Procedure RE-2 - provides a guideline that agreements of five years or more shall require rent security of six months' rent with the Executive Director or designee having the discretion to adjust the amount or form of security in appropriate circumstances.

Based on the above state law and Port procedure, we determined that CTA's rent security was less than the established guidelines and the deviation from those guidelines was not documented or expressly approved by the Port Commission in connection with the 2005 Cruise Facility Lease Agreement.

We found Port management had no process or established controls to reassess the adequacy of the rent security or reexamine compliance with state and Port requirements related to rent security in connection with the 2005 Cruise Facility Lease Agreement. The lack of formal process to reassess risk and reexamine compliance allowed management to overlook the significance of the Cruise Facility Lease Agreement rent security provision.

Recommendations

We recommend Port management:

1. Evaluate the lease process and strategically design and implement key control(s) to ensure that agreements are only approved when:
    - Risk is set to an acceptable level
    - The Port is in compliance with applicable laws and Port policies or procedures and deviations are documented and explicitly presented to decision makers.

2. Amend the agreement language if determined necessary.

Management Response

We appreciate the auditors' observations and recommendations. RCW 53.08.085 and Port Policy RE-2 provide for discretion to adjust or require a security deposit by the Port Commission or CEO, respectively. When the Commission approved the original agreement with CTA, the amount of the security was approved accordingly. A subsequent action just a few years into the agreement merely changed the instrument from a management agreement to a lease. A second subsequent action afterward extended the lease agreement for an additional two years. Neither of the two actions occurring during the term of the original agreement was intended to renegotiate the full substance of the agreement. Rather, they resulted in refinements to the financial and operational benefit of the Port. Nevertheless, we value the insight offered by the auditor. Upon possible negotiations toward a new agreement when the current one expires, management will ensure full diligence to update a risk assessment to inform any required adjustments to the security deposit amount.

Port management acknowledges that the Port Commission does not appear to have been expressly notified of the amount of the lease security when it acted to approve the updated Cruise Facility Lease Agreement on December 13, 2005. While it has been over ten years since the Port Commission acted to approve the lease, the November 2, 2005 memorandum requesting authorization for the agreement does not reference the amount of the security.

However, this lease security amount was expressly approved by the Port Commission when it acted to approve the prior lease with the same tenant, Cruise Terminals of America, LLC ("CTA"). The Port originally selected CTA as a management agent for the opening of the Port's cruise terminal at Pier 66, and the parties signed Management Agreement on March 24, 2000. Primarily in order to realize on operational efficiencies with the opening of a second cruise terminal, the Port elected to convert that management agreement into a lease. And the resultant Cruise Facility Lease Agreement was presented to and approved by the Port Commission on March 11, 2003. In connection with that Commission action, Port management clearly indicated that the lease security was $300,000.

The lease in question – the second Cruise Facility Lease Agreement – was not a new deal. On the contrary, the term of the first Cruise Facility Lease Agreement extended for over two more years, through December 31, 2007. Instead, the revised lease agreement was brought to the Port Commission in the middle of the term of that first agreement with the stated purpose of providing "an increase in net proceeds to the Port." Although cast as a new lease, the December 21, 2005 contract was not a wholesale remaking of the agreement between the Port and CTA. Instead, the revised lease primarily improved the financial return to the Port, extended the term of the agreement, and made provisions for the relocation of the Port's second and third cruise berths at Terminal 30. The new lease – intentionally – did not re-examine the other terms. As such, Port management believes there was a clear appreciation, and tacit approval, of the lease security amount by Port Commission when it acted to approve the revised Cruise Facility Lease Agreement on December 13, 2005.

And in any event, Port management believes that the lease security is adequate for the risks *associated with this lease agreement. It is the Port that establishes the tariff rates charged to the cruise lines utilizing the leased facilities. While leasing the cruise facilities, CTA essentially acts as a conduit, paying the vast majority of those tariff proceeds to the Port as rent. And given that CTA is a partnership of three of the most stable and well-represented business partners in the Port's waterfront business, the risk of CTA somehow absconding with the tariff proceeds without paying the Port is trivial. Port management held this belief when the original Cruise Facility Lease Agreement was submitted to the Port Commission for approval on March 11, 2003 and continues to hold that belief today.*