INTERNAL AUDIT REPORT

LEASE AND CONCESSION AGREEMENT AUDIT

CRUISE TERMINALS OF AMERICA (CTA)

January 01, 2013 – December 31, 2015

Original issue Date: May 9, 2016 –Report No. 2016-04

Re-issued report with revised management response March 24, 2017

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 Maritime Cruise 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 Maritime Cruise 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.

Revised Management Response

Management agrees with Internal Audit recommendation. In the future, before lease agreements are presented to commission for approval, management will include a key control process that ensures proposed agreements are only approved when risk is set to an acceptable level and the Port is in compliance with applicable Laws ad Port policies or procedures and any deviations are documented and explicitly presented to decision makers.

In addition, as a result of this audit finding a formal process will be performed and documented before the start of each remaining cruise season through the remaining term of the CTA lease to evaluate any risk to the port. Although the annual rent the port receives from the cruise business is greater than 14million the concern of risk to the Port should be based on a month's rent for which CTA pays the port during the cruise season. CTA collects the Ports per passenger tariff fees from the cruise lines for each ship call during a particular month May through Sept. CTA retains roughly 12% of those fees and forwards balance to the port by the 15th of the following month . CTA's lease, restated as a result of the NCL agreement at P66, now only pertains to T91 cruise operations.