Port of Seattle

Real Estate Management and Selected Programs

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Washington
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Introduction

This audit of the Port of Seattle was conducted under the Washington State Auditor's Office performance audit authority granted by citizens' approval of Initiative 900 in 2005. It is the second performance audit of the Port. Our first audit, conducted in 2006-2007, focused on how effectively the Port manages its construction contracts, with a particular emphasis on the Third Runway project at Seattle-Tacoma International Airport.

This audit examined the Port's real estate management and leasing transactions and practices. We looked at sales and purchases of Port property since 2004, and we looked at current and original leases back to when tenants first moved into Port properties. In addition to those performance-related issues, we assessed the Port's internal controls and compliance with laws and requirements for promotional expenses and marina moorage collections, and its contract with the nonprofit Port Jobs organization.

Initiative 900 called for audits of the "largest, costliest governmental entities first." Given the scale of the Port's operations, it fit that category. We conducted this audit with the help of two contractors – Thompson, Cobb, Bazilio and Associates, and IMS Worldwide Inc., which provided port-related real estate management expertise.

The Port of Seattle is the seventh-busiest maritime port in the country for processing containerized and bulk cargo. It also operates SeaTac Airport, maintains cruise ship terminals and vessel mooring facilities, hosts Seattle's fishing fleet, provides recreational and commercial boat moorage, and leases facilities to industries and businesses. The Port's annual operating revenues approach a half-billion dollars, and it employs 1,700 people.

Scope and objectives

When we set the scope of our first performance audit of the Port, we focused on construction management with the intent to subsequently audit real estate and leasing practices. Our interest in the real estate operation in this audit is based on its large size and complexity, on concerns raised by citizens, and on suggestions from Port commissioners about programs that could benefit from a performance audit.

Our audit of real estate and leasing centered on three fundamental questions:

- Did the Port pay or receive fair market value when it purchased or sold property? We reviewed two major real estate purchases and two property sales dating back to 2004.
- Did the Port establish lease rates at fair market value? We examined 21 current leases managed by the Real Estate and Seaport divisions. We selected them based upon interviews with Port commissioners and staff and on our assessment of risks associated with various leases. We reviewed transactions through the life of each lease.
- Does the Port effectively manage billings and collections related to shipping terminals and moorage fees at Fishermen's Terminal? We looked at these collection activities because the facilities are an important part of Port property management.

As part of our ongoing responsibility to audit the Port's compliance with finance-related laws and regulations, we looked at how the Port monitored and measured the benefits of its promotional activities; how it managed contracts with Port Jobs, a nonprofit organization; and how effectively the Port reported losses resulting from fraud, misuse and abuse of public resources.

Summary of results and recommendations

Since 2005, the Port has taken steps to become more accountable and open to the public. It hired a new chief executive in 2007 and restructured parts of its organization to create more accountability. The Port Commission has taken steps to establish stronger oversight of Port operations and has embarked on a major effort to update the long-term strategic plan that guides its operations.

Some of the changes were the direct result of our first performance audit, which found insufficient Port Commission oversight of contracting practices and inadequate safeguards to protect public funds from misuse, misappropriation and abuse. Subsequently, the Port Commission adopted a resolution re-asserting its authority over Port administration. Port executive management created a new division to oversee procurement and strengthened the internal audit function.

Based on this audit's review of the Port's real estate and leasing management functions over the past six years, we found the Port can improve how it buys, sells and leases its property and generates revenue, serves the community and invests in its future. These are our major conclusions, which are reflected in 10 specific recommendations:

- The Port should regularly analyze its current and future property needs within the context of a long-term strategic plan. To support this effort, the Port needs to complete its strategic planning process, called the Century Agenda, to include specific real estate and leasing goals and objectives.
- The Port should review its property management-related organizational structure and clarify the responsibilities among the Real Estate Division, Seaport Division and support operations. This would lead to more consistent property management practices.
- Decisions about property sales, purchases and leases should be informed by thorough financial and risk-based analyses. Up-to-date appraisals and competitive marketing should be used to obtain the most favorable transaction terms.
- The Port's financial analyses of proposed leases or renewals were inconsistent, incomplete and sometimes inaccurate. Although we found no evidence that this was deliberate, Port personnel have not consistently communicated to the Commission all the information it needs about the costs, benefits and alternatives associated with proposed leases.
- The Port did not regularly establish lease rates at fair market value or did not use appraisals, competitive marketing or comparisons to similar properties. Moreover, we noted inconsistencies in lease rates and rent increases for similar property types. As a result, the Port received less lease revenue than it could have for some leases.

- The Port's controls over collections at Fishermen's Terminal and from users of its cargo terminal cranes need to be strengthened.

- The Commissioners effectively oversee the Port's promotional expenditures to ensure they achieve economic development objectives. The Port did not effectively manage its contracts with the nonprofit Port Jobs between 2006 and the first quarter 2009 to ensure it received the services it purchased. The Port lacked the legal authority to purchase some of the services provided by Port Jobs, although state law was revised in 2010 to permit some of the activities in the future. The Port paid Port Jobs and also required construction contractors to pay as a condition of working for the Port. Between 2006 and 2009, Port staff did not report losses to the State Auditor's Office as required by law.

We also noted other less significant issues related to the management of leases and have separately communicated them to Port officials in a management letter.

Audit Results and Recommendations

1. Strategic Planning and Organization

Port of Seattle needs to finish its strategic plan

In 2008, the Port Commission and Port executive launched a far-reaching effort to update its nine-year-old strategic plan. Called the Century Agenda, this planning effort began when the Commission created four advisory panels made up of individuals from business, governments and the community. Their assignment was to inform the Port on emerging issues with the potential to affect its future. The Port Commission amended and adopted the guiding principles developed by the panels and is using them to set specific goals and objectives for the updated strategic plan, scheduled for completion in 2011.

Several principles apply to real estate and land use and call for the Port to use its property holdings to financially sustain its core maritime/transportation mission; to enhance economic development; to create jobs; and to be a responsible steward benefitting the community and the environment. That generally reflects tenets of the Port's 2001 strategic plan, known as Harbor Development Strategy 21. The older plan is in effect pending completion of Century Agenda.

However, Harbor Development Strategy 21 lacks key provisions that are necessary to guide the Port on how to best capitalize on its real estate portfolio and carry out the broad principles identified above. It left out specific goals, timelines and performance measures.

Recommendation 1

We recommend the Port complete its Century Agenda as soon as possible and include the following elements:

- Specific goals and objectives to use real estate holdings to achieve financial security and promote economic development and community stewardship. The Port needs to set priorities and clarify the sometimes conflicting direction of Strategy 21's guiding principles. For example, the importance of generating revenue may conflict with the need to provide financial incentives to attract job-creating industries. The absence of priorities can create inconsistent and unclear decisions that do not align with long-term goals. These conditions may have contributed to the unexplained inconsistencies in lease rates and rate hikes discussed in Section 3.

- Identification of the specific types of businesses and industries – outside of traditional air- and sea-related companies – that the Port wants to secure and maintain as short- and long-term tenants.

- Goals and objectives that describe how the Port can best use its real estate to compete with other West Coast ports for tenants, industries and importers/exporters.

Commission should clarify responsibilities of Real Estate, Seaport divisions

The Port established a new Real Estate Division in 2008 to improve the port's management of its real estate properties. The new division was assigned to manage facilities and properties not associated with cargo, cruise ship or airport operations. The Seaport Division, which had held responsibility over all non-maritime properties, retained management of shipping container operations, seaport marketing and operation of cruise and industrial properties. The Airport Division's responsibilities were not changed.

Although the Port established the Real Estate Division to address deficiencies in the management of its real estate portfolio, Port management has not clearly established which division is responsible for which tenants. Based on our interview with Port employees, confusion occurs over which properties are assigned to the Real Estate and Seaport divisions. The assignments were initially based on whether properties were water-oriented and, thus, assigned to the Seaport Division, or whether they were land-oriented, falling under the oversight of the Real Estate Division. We found instances in which the Seaport Division was managing land-oriented property and the Real Estate Division was managing water-oriented property.

Current policies and procedures do not provide clear, consistent direction or ensure accountability. The two divisions do not use consistent approaches to manage their assigned properties and Port policy lacks overarching guidance. It is difficult to hold either division fully accountable given that neither has clear responsibility over key functions that are necessary to manage Port properties. Despite the Port's intent to confine real estate operations within two divisions, several key real estate management functions remain outside each division's direct authority. These include financial and accounting services related to real estate functions, project management, facility planning, maintenance and environmental services.

Recommendation 2

To ensure clear and consistent real estate management, we recommend the Port clarify the responsibilities of the Real Estate and Seaport divisions and improve the enforcement of its policies and procedures.

It is equally critical for senior managers to improve oversight of Port property transactions and to monitor employees' compliance with new policies and procedures.

Commission should strengthen its real estate oversight

In our performance audit of the Port's construction management program, we found that the Commission needed to exercise greater oversight and decision-making on construction and professional services contracts. The Commission earlier had ceded much of its authority to the Port's then-chief executive officer, who was not required to report to the Commission on key matters, including construction and professional services contracts. We also concluded that Port staff needed to provide the Commission with more complete and accurate information so it could fulfill its oversight role.

Acting on our audit recommendations, the Port Commission in 2008 adopted Resolution 3605 to reassert its authority over construction and professional services contracts. The resolution also redefined some of what it delegates the current chief executive officer, requiring increased reporting to the Commission. However, the resolution did not address real estate management.

Recommendation 3

We recommend the Commission assert the same level of authority over real estate transactions that it established in Resolution 3605 for construction management. In this audit, we identify conditions in which Port managers do not always provide complete and accurate information that the Commission needs to make sound real estate decisions. The Commission needs to ensure staff collect, track and convey key information related to the cost and benefits of the leases to the Commission.

In the long-term, an updated strategic management plan approach may call for further reorganization of these divisions to ensure that policies, procedures and daily operations contribute to achieving the Port's vision and goals.
As the Port updates its strategic plan, it may want to reassess its division of responsibilities over real estate property management.

2. Property Purchases and Sales

Improvement seen in Port property transactions

Since 2004, the Port has purchased two sizeable pieces of property and sold two others. We examined all four in this audit, recognizing that two occurred in 2004 and 2005 and were not overseen by the Port's current administration and Commission. Our audit, which focused on whether the sales and purchases prices were based on fair market value, found that the two more recent transactions, earlier this year and in 2008, went considerably better than the two earlier ones.

Specifically:

- In 2004, the Port sold shipping Terminal 106E to a private company and received about $4.1 million less than the property's fair market value.
- In 2005, the Port paid market value for the Tsubota Steel plant site but the Commission decided to buy the parcel without considering important information that could have influenced the decision.

In contrast:

- In 2008, the Port received fair market value when it sold the Pier 48 facility to the state Department of Transportation for $11 million.
- In early 2010, the Port purchased a rail corridor in East King County, originally agreeing on a purchase price of $107 million that was based on an outdated appraisal. Recognizing market conditions had changed, the Port ultimately renegotiated the purchase for $25 million less.

Port sold Terminal 106E below market value

In 2004, the Port sold Terminal 106E, a complex of two warehouses on 28 acres near Diagonal Avenue and East Marginal Way in Seattle, for $18.85 million. A Port appraisal valued the parcel at $27.7 million, but reduced that value to $23 million to reflect costs the buyer would need to pay for site improvements. Port staff incorrectly subtracted the improvement costs a second time and recommended a lower sale price of $19 million to the Commission, which approved the sale. Subsequent negotiations with the buyer reduced the price to $18.85 million.

The Port Commission also bypassed its own policies and procedures by declaring the property surplus to its needs on the same day the sale was approved. Port policies require a thorough evaluation of whether property was still needed before being declared surplus. In addition, the Port did not market this property to solicit other potential buyers. We identified the same marketing issue in current Port practices related to real estate leases.

Port paid fair price for Tsubota parcel, but overlooked risks

In April 2005, the Port purchased a 3.4-acre property known as the Tsubota Steel parcel, a former industrial site, for $5.5 million. In addition, the Port paid $402,000 to a third party who acted on behalf of the Port in negotiations so the Port would not be identified as a potential buyer.

We found Port staff did not fully assess or document environmental and other risks associated with the purchase and did not present a thorough analysis of the advantages, potential liabilities, alternative uses, limitations and ongoing ownership costs to the Commission. As a result, the Commission decided to purchase the property without key information that potentially could have influenced the decision. The Port had planned to use the property for a 57-acre development project, but those plans never materialized.

In addition, the Port Commission did not receive accurate and complete information on this transaction. For example, staff presented the Port real estate development manager's recommendation to purchase the property by using the third party to the Commission in an executive session. But we found no record of a discussion about how the third party was selected or how the $402,000 fee was established. This condition was similar to issues we identified in our construction-related performance audit. Since then, the Commission has adopted a resolution strengthening its oversight of construction.

We identified similar issues in this audit related to lease management that are described in the next section of this report. We encourage the Commission to maintain strong, transparent authority over all Port operations, including property purchases, sales and leases.

Port saved $25.5 million in purchasing Eastside Rail Corridor

The Port purchased the Eastside Rail Corridor near Lake Sammamish from the Burlington Northern Santa Fe Railway in spring 2010. The Port wanted the parcel for its freight transportation or regional transit potential.

The initial $107 million sale price was based on an appraisal commissioned by King County more than four years earlier. It did not reflect substantial declines in property values that had occurred since then. While performing fieldwork for this audit, we identified this issue and discussed our concerns with Port management.

The Port eventually renegotiated the property purchase from $107 million to $81.5 million, a reduction of $25.5 million that reflected the drop in real estate prices. The Port's authority to purchase this property is in litigation. This audit did not evaluate the issues raised in the legal action.

The Port needs to ensure it uses current appraisals when it buys and sells property.

Port successfully handled Pier 48 sale

The Pier 48 sale involved a dilapidated pier and warehouse, the underlying submerged land and an upland parcel. The property was sold "as is" in 2008 for $11 million to the state Department of Transportation, and the Port retained the right to repurchase the upland parcel at the appraised market value if the Department decides to sell it within 15 years.

Under the threat of legal action by the Department to condemn the land, the Port carefully developed an estimated value to maximize the property's sale price. It effectively addressed a weak negotiating position by identifying the property's unique value to the Port. Because the parcel could help mitigate the environmental effect of projects on adjacent property, it had substantially greater value to the Port than to potential purchasers. The Port was able to demonstrate this value to the Department, which substantially increased the estimated value and final sale price.

Through careful negotiations and consideration of the property's unique value to the Port's operations, it successfully ensured it received a fair market price from the Department.

Recommendation 4

To strengthen its oversight of property sales and purchases, we recommend the Port Commission adopt and enforce policies that require staff to perform and document the following efforts :

- Regularly and thoroughly analyze the Port's current and future property needs in the context of the goals and objectives of a long-term strategic plan. These ongoing analyses should clearly describe the justification for all purchases and sales. Properties with no current or future need should be declared surplus and made available for sale. The Port should not declare property surplus simply to expedite a sale.
- Review in detail all property value appraisals and determinations by Port staff involved in the property sale or purchase. This should also include a concurrent review by the Port's chief financial officer to ensure the appraisal is fully understood. When it buys and sells property, the Port should use current appraisals to establish and negotiate a good fair market price.
- Perform complete financial and risk analyses of the purchase that include remediation costs, potential ownership costs and environmental conditions.
- Scrutinize information from staff to ensure it is adequate and complete and decide on purchases and sales in an open public meeting.
- Effectively market and advertise the availability of Port property to allow multiple purchasers an equal opportunity to buy it in order to achieve the best purchase price.

3. Port Property Leases

Property leases generate significant revenue for Port

Property leases help cover Port operating costs and reduce the tax burden on King County property owners. In 2008, the Seaport Division generated $95.1 million, principally from waterfront property leases it manages. The Real Estate Division generated $17.6 million from lease revenue.

We reviewed 21 of the 244 leases the two divisions collectively manage. We selected the leases based on interviews, reviews of documents and an assessment of risk. In some cases, the same tenant occupied a property through multiple lease periods. In these cases, we reviewed all of the leases involved, which included as many as three leases on a single property. These leases are shown in Appendix E.

Our evaluation was designed to determine how well each division established fair market value, set lease rates, marketed the properties, selected tenants and negotiated lease terms. We also looked at the review and approval of leases, lease agreement content and lease administration. We identified many opportunities for the Port to improve its leasing policies and practices.

Port should align leasing practices with its strategic plan

The Real Estate Division needs clear direction on how to use the assets it manages to help the Port reach its mid- and long-term vision. We found the Division primarily focuses on a short-term strategy of generating revenue without considering whether the makeup of tenants enhances economic development and creates jobs. The Division evaluates all of its leases based on its perception of today's market rates, demand for space, the current cost of proposed rent concessions or tenant improvements, and the perceived cost and benefit of rejecting a lease proposal and waiting for a better offer.

The Port does not have an asset management plan, which is critical tool used by successful real estate managers to meet long-term goals. Its asset management planning should directly connect with the update of its strategic plan and at the same time, it should detail how the Port will effectively manage its property in the context of long-term goals. The Port's current strategic plan does not give adequate guidance on managing leases over the mid- and long-term.

An asset management plan would enable Port real estate managers to evaluate leasing opportunities and consider whether the property use, lease terms, property improvements and other incentives that accommodate tenants are consistent with the Port's long-term interests.

Lease rates have not always reflected fair market value

We identified several leases for which the Port relied on insufficient and outdated market data and, as a result, unknowingly negotiated lease rates that were below fair market value or did so without a documented justification.

We found that Port managers did not use effective methods to market property and collect and evaluate complete and timely information needed to keep abreast of market conditions and consistently set lease rates in keeping with those conditions. As a result, the Port did not generate as much revenue as it could from leasing Port-owned property.

Sound real estate management requires the use of detailed current market data to evaluate lease proposals and determine the best strategies and processes to negotiate leases with diverse prospective tenants with myriad needs. During our audit, we identified these specific issues:

- **Lease rates, credits and other adjustments were made inconsistently**

Port real estate managers did not use a uniform process to determine lease rates for Port property. This caused instances in which initial lease rates and adjustments to those rates were inconsistent for similar properties. We found instances in which rates for similar properties differed by 20 percent to 70 percent without explanation. These differences in the initial rates were compounded by inconsistent rent adjustments.

For example, the lease rate for one property was adjusted annually based on the Consumer Price Index, while the rate for another property with very similar characteristics was adjusted just once in seven-and-half years. The rate for a third property was not adjusted at all during its five-year term. In some of these leases, the rationale for credit amounts was not sufficiently documented.

- **Properties were not competitively marketed to prospective tenants**

We found the Port has not developed marketing strategies and rate-setting procedures to promote competition and to generate multiple offers for space it wishes to lease. Such strategies lead to transparent negotiations, increased rates, fewer concessions to tenants, and clearer employee understanding of how to use competition.

For example, the Seaport Division does not have an overall real estate marketing strategy, particularly for properties vacant for more than six months. The Port disbanded a Business Development group responsible for marketing these types of properties a few years ago when the economy was strong and most Seaport Division properties were occupied. Despite current economic conditions and longstanding vacancies, the Port has not re-activated this important responsibility.

The Division also did not widely market two of 10 leases reviewed, limiting the number of companies that competed to lease Port properties. Although rates were very low for one lease, the Port did not provide other firms the opportunity to lease at potentially higher rates.

For a second lease, the Port determined the market rate was between 45 cents and 50 cents per square foot. But when the tenant refused that amount, the Port agreed on 40 cents instead of marketing the property to find tenants willing to pay the market rate. Consequently, the Port relinquished between $500,000 and $1 million in potential revenue over the 10-year term of the lease.

- **Port real estate managers relied on inadequate market information**

Knowing a property's value per square foot is critical in determining lease rates and calculating the potential rate of return. Independent real estate appraisals and careful property comparisons can provide this information. However, the Real Estate Division's efforts to obtain detailed market information were limited. It commonly estimated a property's fair market rent through informal contacts with brokers familiar with specific property types and locations, or by using general industry publications and market reports published by real estate brokerage firms. These sources did not provide precise information about property values, particularly higher-valued parcels located on or near the water.

The Seaport Division established some lease rates based on what other Port tenants paid in rent for similar properties. However, those rates, which had been negotiated in past years, did not reflect current market value or the properties' proximity to water. For example, we identified negotiations for warehouse leases that were influenced by low rates paid by other Port tenants and by rates in areas well outside the Port's boundary. Although the Port periodically uses appraisals to determine fair market rents for larger and longer-term leases, it does not routinely use them for smaller, shorter term leases.

The Seaport Division, which manages 45 leases, obtained only seven appraisals from 2001 through 2009. Four of these were conducted between 2001 and 2006 and estimated the values at $14 to $25 per square foot. A 2007 and 2009 appraisal estimated property values at $28.50 and $32.50 per square foot respectively. This wide range in estimated values shows how important it is for the Port to obtain current market information specific to individual properties. Without it, the Port is at risk of inconsistent lease rates that are less than fair market value.

Port real estate managers acknowledged their divisions' processes may over-emphasize the opinions of staff, local real estate experts and industry publications. They also agreed documentation was lacking to show how market information affected decisions for individual leases.

- **Financial analyses of proposed leases were inadequate**

Beyond information needed to establish fair market rents, a thorough financial analysis of a potential property lease is also necessary. An analysis commonly used in the industry considers the fair market value of a piece of property, costs to improve it, credits for relocating tenants and other costs of preparing property for lease or obtaining a tenant. It compares these costs and the resulting revenues to those expected under different potential uses for the property. Doing this allows owners to determine whether property is underperforming in its current use or is suitable for investments to change that use and increase the property's rent potential. We found Port real estate staff did not prepare adequate financial analyses needed to enable the Division managers or the Port Commission to fully evaluate the benefits and disadvantages of leases before approving them. Some analyses were incomplete, inconsistent or inaccurate although we found no evidence that these departures were deliberate.

Real estate managers did not sufficiently document financial analyses and did not obtain independent third-party review to make sure they were accurate, complete and consistent.

Port real estate policies require the divisions to prepare financial analyses but they are not specific enough and should be revised so they share a common definition of what costs and considerations must be reflected. Our review of Seaport Division's lease financial analyses found they were not well documented and did not account or accurately account for the fair market value of existing land, buildings and improvements included in the lease as required by Port policy. Also, anticipated revenue as well as projected benefits on the investments for some leases was overstated.

In the Real Estate Division, we found financial analyses varied significantly in detail and were not well documented. For example, the Division evaluated new lease proposals primarily on the current net present value of projected rental income and expenditures, including tenant improvements. However, it did not consider the value of the Port's investment in the property, which it treated as a past cost. This practice is inconsistent with a comprehensive long-term perspective and strategy for each asset and the Port's own policy. In some cases, the lease analyses compared future cash flows of the proposed lease to the alternative of offering it to other prospective tenants. For lease renewals, the Division either did not perform financial analysis or only cursorily compared costs and the benefits of renewing a lease versus marketing the property to other potential tenants.

During the audit, the Real Estate Division began using a uniform and relatively sophisticated financial analysis template, which should better support the Division's decision making on individual leases and assist with the Division's overall asset management strategy.

- **Certain leases do not receive Commission oversight**

Port policy requires Commission approval of leases only if they are longer than five years. Shorter lease periods are approved administratively. Consequently, a tenant can renew its lease every four and a half years without Commission review or approval. Therefore, the same tenant can occupy a property for a significant number of years without direct Commission oversight. An unprofitable short-term lease that is extended again and again over long periods of time can cause the Port to collect less in rent than it otherwise could. Port Commissioners should also review and approve short-term leases that are extended beyond five years.

We also found some instances in which Seaport Division staff omitted or misstated details of lease terms and conditions. For example, the information did not accurately describe rent adjustments and lease options or disclose details about rent increases or tenants' leasing history.

- **Leasing decisions were not well documented**

Most Seaport Division lease files lacked key information. Some employees kept detailed files of lease negotiations, while others did not keep any records, working files, notes or correspondence. Some files did not demonstrate whether or how the Division assessed the financial strength of prospective tenants. Other files lacked documentation to show how the Division determined the amount of rent credits, including a $1 million rebate to one tenant and a $250,000 credit to another.

The Real Estate Division's documentation of how its staff evaluated business terms, proposals and counter-proposals varied widely. We found no documentation for some leases, while documentation for others consisted mostly of e-mails between members of the negotiating team or staff members who reviewed part of the transaction. Files often lacked market information to support recommendations for new or renewed leases. Documented sign-offs for legal, environmental and other Port divisions for leases not subject to Commission approval were inconsistent and difficult to verify because they were done through a combination of printed material and e-mail.

The Port does not have a centralized, uniform system for documenting and tracking lease approvals, which increases the risk that some leases were not reviewed and approved as required. These reviews and approvals are critical to ensuring the Port maximizes its revenue and return on investment, and avoids significant legal and environmental risks.

- **The Port needs policies and procedures to direct how it negotiates and manages leases**

The Port does not have clear policies and procedures that guide real estate staff and managers to successfully market Port property to attract tenants, to obtain current and detailed market information to successfully negotiate fair market rental rates and to prepare and use comprehensive financial analyses that assure its leases result in acceptable returns on the Port's properties. Those conditions significantly contributed to the lease-related issues described above.

The Port should adopt policies and procedures that establish rental rates based on prevailing market conditions. As an example of insufficient policies, Port Policy "RE-1" says rental rates will be set to achieve an acceptable rate of return on the fair market value of the property and that rates for Port-owned property will be comparable to those charged for non-Port owned property. However, this policy can be used to justify a wide range of rates.

Recommendation 5

Port Commissioners should establish a comprehensive strategy for each real estate asset and operating procedures to ensure prospective transactions are evaluated against those strategies. Specifically, the staff should:

- Develop a written asset management plan and strategies for each real property consistent with the Port's overall real estate strategy.
- Establish and document its desired business terms before negotiations are initiated for large complex transactions.
- Measure, evaluate and document the proposed business terms against whether the property use, lease terms, property improvements and tenant incentives are consistent with the Port's long-term interests.
- Use standardized analytical tools to assess the degree to which the proposed tenancy fits in with the Port's asset management plan.

Recommendation 6

Port Commissioners should establish policies and procedures designed to ensure:

1. Rental rates reflect fair market value and consistent lease pricing.
2. Financial analyses enable the Commission to negotiate acceptable rates of return.

Procedures to set rental rates should require staff members to:

- Treat similar properties consistently and follow the private sector practice of adjusting rental rates over the term of the leases.
- Obtain Commission approval for any lease whose rent does not reflect the prevailing market rate and provide a rationale consistent with the Port's strategic goals and mission.
- Obtain Commission approval for leases that are extended or renewed for combined periods that exceed five years.
- Establish methods to formalize and document the type and frequency of market analyses required for each lease. These methods should address the risks associated with changes in market conditions and over-reliance on third-party brokers.
- Establish a comprehensive marketing strategy that exposes properties to the greatest number of potential tenants.
- Suspend negotiations with a prospective tenant who is unwilling to pay fair market rent, and aggressively market the property to other potential tenants.
- Fully document all lease decisions.

Financial analysis procedures should require Port staff to:

- Prepare financial analyses of leases and capital projects early in the process when internal discussions begin. The financial analyses should consider all costs associated with a given asset so the Port can measure its performance against the asset management plan. The Port should continue to develop, improve and use rigorous, standardized financial analysis tools.
- Prepare a written narrative that describes all relevant facts and assumptions used in the analysis, including the basis for revenue assumptions, tenant selection, land and asset values and evaluation of alternatives.
- Require property managers and analysts to discuss and evaluate alternatives for the use of the land/assets.
- Calculate the projected benefits of the lease using both an "all in" approach (includes new capital expenditures, fair market value of all land and all existing assets, and all lease revenue) and an operational costs-and-revenue approach.

- Develop an independent review system that reports to the Commission. The individual who does this should review and verify information provided to the Commission regarding property transactions. This party would provide in writing:
    - A narrative describing all its relevant facts and assumptions, the method of evaluation, alternatives studied, and the overall conclusion of the financial analysis.
    - An independent review of the financial data prepared by the Division and verification as to its completeness and accuracy for major transactions.
    - A recommendation to approve or reject the proposal.

4. Cargo crane management and Fishermen's Terminal

Seaport Division should improve oversight of cranes

The Port leases its 18 cranes and other equipment to shipping terminal operators to transfer cargo containers to and from ships. The Seaport Division manages the equipment leases, which generate part of the Division's $95.1 million in annual lease revenue. The lease rates for this equipment varies from a fixed monthly rate for some cranes to a fixed hourly rate and variable hourly rates based on the amount of use. Leases for other equipment used to move containers are billed on a "per lift" basis.

We found the Seaport Division over-relies on operators' cargo crane use reports for billing and does not adequately monitor crane maintenance.

For rates based on use, the Division relies on electronic entries recorded and maintained by operators to determine how much to bill them. Division staff does not review or audit those records to verify their accuracy. This creates a risk that operators will underreport use and the Port will receive less revenue than it should.

Seaport Division management acknowledged those risks during our audit work, and said it was considering options to ensure its billings accurately reflect use. Those options include regular audits by independent third parties, alternate methods of payment and software that records crane movement and verifies use.

The crane lease agreements require tenants to pay for and perform scheduled maintenance following the crane manufacturers' requirements. Tenants must record all maintenance performed and provide the records to the Seaport Division for review. The lease agreements also require the Port to inspect cranes at least annually and to allow the Seaport Division access to the cranes to conduct these inspections. But, the Division stated because of limited staff and workload constraints, it did not inspect any cranes in 2008 and inspected only one in 2009. The Port also does not review maintenance records unless a crane has a mechanical problem.

Depending on size, cranes can cost millions of dollars. Regular inspections and oversight to ensure cranes are properly maintained is crucial to extending how long the cranes can be used as well as potentially affecting worker safety.

Improved safeguards needed at Fishermen's Terminal

Fishermen's Terminal is home to the North Pacific fishing fleet and provides moorage for fishing vessels and commercial and recreational boats. Moorage rates vary depending on a vessel's length and type of use. Rates are highest for recreational boats and lowest for active fishing boats. Customers pay monthly or daily. The Terminal generates approximately $1.4 million annually from moorage.

In 2008, Fishermen's Terminal began using the Marina Management System (MMS), which was intended to make the moorage fee collection process more efficient. During the audit, we identified internal control weaknesses that make those fees vulnerable to misuse and misappropriation. We did not find any evidence that either occurred.

Terminal employees enter information such as vessel name, slip location, length of vessel and moorage classification for all the vessels moored and use the system to calculate moorage rates into MMS. They then transfer the data to the Port's main accounting system, which bills customers each month.

Port employees who use MMS log into the system with their own user identification and password. This is designed to control who has access and can enter information in customer accounts.

We found that nine of the 10 Terminal employees can access MMS along with another 10 employees in accounting and other operations. In addition, no supervisory review and approval is required for billing rate adjustments to customer accounts. That raises the risk that customers' payment and account information can be manipulated.

Although contained in MMS, the reports it generates for monitoring billings and collections do not contain vessel length or moorage classifications. These two pieces of information are crucial to determine whether the correct rate is being charged.

The Port should limit the number of staff members who have access to MMS and should ensure employee duties are properly segregated so no individual can receive payments, record them and adjust the records.

Recommendation 7

To better safeguard its assets and income related to the Seaport's leased cranes, we recommend the Commission revise its procedures to require Port staff to:

- Verify that reported container crane use is accurate. The most practical verification method is to periodically compare longshoreman/operator use data with data reported by the operator through the Seaport Division's Crane billing system.
- Inspect the cranes annually. The Port should consider hiring or contracting for crane specialists to do the inspections if it determines that reprioritizing the current staff's workload will not enable it to do so with current staff.
- Audit crane logs, reports and records of maintenance performed.

Recommendation 8

To better safeguard its billings and receipts at the Fishermen's Terminal, we recommend the Port:

- Segregate duties to ensure the same employees cannot enter customers, make adjustments to customer accounts, and receipt payments from customers in MMS.
- Require supervisory review of adjustments to customer accounts in the MMS that affect billing rates.
- Restrict access to make adjustments and apply payments to customer accounts to employees who need it as part of their regular job duties. The Port has reports containing vessel length and moorage classification for use when reviewing billing information for accuracy.

5. Accountability and compliance with laws and regulations

We reviewed three Port programs or activities:

- Spending for promotional activities.
- Contracts with the nonprofit Port Jobs organization.
- Reporting losses to the State Auditor's Office.

We evaluated whether the Port has opportunities to improve these areas and whether it is complying with state law and its own policies. We selected these activities based on an assessment of risk, the results of past audits and citizen concerns. The audit period was 2006 through the first quarter of 2009.

Port effectively manages, monitors promotional spending

The Port spent $3.1 million from 2006 to 2008 to promote trade, tourism and economic development. These activities are authorized by state law, which allows only Ports to spend money on items such as meals, refreshments, lodging, transportation, entertainment and souvenirs in connection with business meetings, social gatherings and ceremonies.

We found the Port spent its promotional funds properly and used best practices to communicate the intended uses of promotional funds. The Port Commission was actively involved in developing promotional project budgets and staff provided it, and the public, accurate, timely and complete information about results.

Port management sets promotional spending at a line-item level and identifies specific activities and expected results. Port executives attend department meetings in which business and customer needs are discussed. Executives at the division level review decisions on how to address those needs. Each promotional spending account is reviewed, and the accounts most eligible for reductions are identified at the executive level. The budget development process also includes public meetings and budget workshops for Commissioners.

The results of promotional activities are reviewed in the Port's quarterly performance reports. The Public Affairs Division monitors attendance at Port events and tracks international advertising efforts. The Container Marketing Department in the Seaport Division tracks customer retention and acquisition efforts. The Aviation Division maintains detailed records of promotional events and marketing efforts it coordinates with airlines. The Commission receives high-level information on promotional expenditures and briefings on major events, and the commissioners are invited to participate in promotional activities.

Port lacked statutory authority for contracts with Port Jobs

We found the Port did not effectively manage its 2006, 2007 and 2008 contracts with Port Jobs, a nonprofit organization, to ensure it received the services it purchased. The Port also lacked legal authority to purchase some of the services provided by Port Jobs, although in 2010, the Legislature revised state law to allow some of these activities. We also found the Port may have increased the cost of its construction projects by requiring companies to contribute to Port Jobs.

State law allows ports to contract with nonprofit organizations to support economic development. In 1993, the Port created an organization, now called Port Jobs, to address concerns about the skill level of applicants for Port employment and about the limited number of living-wage jobs available to King County residents. Today, with funding from the Port, the City of Seattle, King County and other organizations, Port Jobs coordinates job training and social services for low-income residents, and supports public policies intended to increase residents' access to living-wage jobs.

The Port's involvement with Port Jobs was three-fold:

- Contracts for services. The Port had two service agreements with Port Jobs that were renewed annually. The Port paid Port Jobs $365,000 per year during the audit period.
- Mandatory contributions by contractors. The Port required construction companies who received public works contracts of at least $1 million to contribute 20 cents per labor hour directly to Port Jobs. Contractors' contributions averaged about $215,000 annually.
- In-kind donations of office space. The Port provided Port Jobs free office space at Sea-Tac Airport and at the Port's headquarters on Pier 69 in Seattle. These donations were valued at about $520,000 for the three years.

State law governing public ports' economic development activities in effect during this time stated: "It shall be in the public purpose for all port districts to engage in economic development activities. In addition, port districts may contract with nonprofit corporations in furtherance of this and other acts related to economic development." The law was amended in 2010, but this statement remains in the law.

While port districts could contract with nonprofit organizations for economic development, the law did not specifically authorize support for education or social service programs. Some education programs, such as career-specific job training, may be linked to economic development strategies and outcomes. However, programs that primarily deliver social services are not within the Port's authority. (Appendix C contains background documents and laws regarding the Port's legal authority).

Port supported services not allowed under state law

During the period covered by this audit, Port funding supported these educational and social service programs through Port Jobs. The Port lacked the legal authority to support these programs at the time:

- Financial Tools for the Trades (2007).
- Women in Construction (2007).
- Career-Workplace Exploration in the Skilled Trades (2006, 2007 and 2008).
- Apprenticeship Opportunities Project (2006, 2007 and 2008).
- Center for Working Families (2007).
- Low-Income Car Ownership Project (2007).

- Free Tax Preparation for Individuals (2007).
- Working Wheels (2006).
- Women in Apprenticeship Study (2006).
- Financial Education and Mentoring Project 2006).

The following factors make it difficult to know what the Port's funding of Port Jobs specifically supported:

- Although Port contracts show which third parties were supposed to receive money from Port Jobs, the contracts do not specify how the money was to be spent by these third parties. Without such requirements, the Port cannot verify or control the types of services it is supporting.
- The contracts did not clearly identify the deliverables due to the Port, and the Port paid Port Jobs without assessing whether required services had been provided.

Port required contractors to contribute to Port Jobs

Between 2006 and 2008, construction companies directly donated about $638,000 to Port Jobs under the Port's requirement that contractors receiving public works contracts of at least $1 million donate 20 cents per labor hour. Payments totaled:

- $270,685 in 2006.
- $241,695 in 2007.
- $125,647 in 2008.

Neither the law in effect at the time nor the Legislature's 2010 revision permits the Port to raise money for a nonprofit corporation. Similarly, the Port lacks the authority to require contractors to donate to a nonprofit.

Port officials concede they probably paid higher costs than necessary for public works projects, as contractors likely included the cost of the donation in their bids.

After learning of a citizen's concern in January 2008, the Port commissioned an audit to determine whether the revenue generated by contractors' contributions was used for its intended purpose. The audit report, issued on August 20, 2008, determined the Port had set no criteria on how the 20 cent-per-hour contribution was to be used by Port Jobs. The report also noted internal differences of opinion among Port officials about whether the Port was legally permitted to support Port Jobs activities.

Port provided more than $500,000 in free office space and general support to Port Jobs

Port Jobs has offices at Port headquarters and at SeaTac Airport. During the period covered by the audit, the Port provided in-kind support valued at $520,707 in the form of free office space and general office support to Port Jobs. Support totaled:

- $174,195 in 2006.
- $167,941 in 2007.
- $178,571 in 2008.

The amount of in-kind support provided to Port Jobs was not consistently disclosed to the Commission or included in agreements with Port Jobs. In 2006, Port staff members informed the Port Commission that it was providing in-kind support to Port Jobs, but the value of the support was not disclosed to the Commission or stated in the agreements with Port Jobs. In 2007, only $66,000 of the in-kind support was disclosed. In 2008, the amount of in-kind support provided to Port Jobs was disclosed but not stated in the agreements.

Port failed to follow prudent business and accounting practices

We identified several additional shortcomings in the Port's dealings with Port Jobs that contradict prudent business and public-sector accounting practices:

- The Port paid Port Jobs before it received documentation that contracted services had been provided.
- The Port allowed Port Jobs to occupy Port facilities before signed agreements were in place. The 2006 service agreement was not signed until February 2006. The 2007 agreements were not signed until July 2007, and the 2008 agreements were not signed until September 2008.
- Port Jobs staff rather than Port employees prepared contracts for services. Our discussions with Port personnel indicated they perceive Port Jobs to function as a department within the Port rather than as a legally separate organization.
- The Port funded social services programs for low-income residents that were outside the scope of activities permitted by state law, such as free income-tax preparation.

2010 legislation expands the range of permitted economic development activity

Our auditors informed Port staff of concerns about the legality of the Port's contracts with Port Jobs. Shortly thereafter, legislation was introduced in the state House of Representatives to permit the Port to support certain economic development activities that were not specified in the original law.

Substitute House Bill 2651, which took effect June 10, 2010, added the following language to the law:

"Economic development programs may include those programs for job training and placement, pre-apprenticeship training or educational programs associated with port tenants, customers, and local economic development related to port activities that are sponsored by a port, operated by a nonprofit entity and are in existence on the effective date of this section."

The new law also requires annual reports from nonprofit contractors to document the number of workers and businesses served and other tangible outcomes.

During public hearings, supporters said the bill was designed to respond to the draft audit finding by clarifying the authority of the Port to contract for some of the existing programs provided by Port Jobs, and particularly to support such initiatives as pre-apprenticeship and skills training.

Recommendation 9

We recommend the Port revise its policies and procedures to establish and enforce safeguards against inappropriate spending. The revised procedures should:

- Limit funding of Port Jobs to programs that are clearly within its legal authority as stated in the 2010 legislation
- No longer require construction companies to contribute to Port Jobs as part of their construction contracts.
- Ensure its agreements to clearly identify the scope of work and all related deliverables.
- Require Port Jobs and its partners to document all deliverables have been provided before payments are made.
- Disclose to the Port Commission the nature and value of all in-kind support to Port Jobs or other nonprofit organizations. These amounts should be reflected in the Port's agreements with these groups.
- Disallow any organization to operate from Port facilities unless an agreement is in place authorizing them to do so.

Port failed to report losses of public funds, assets as required

State law requires state agencies and local governments to immediately report all known or suspected losses of public funds or assets to the State Auditor's Office. The law does not set a dollar threshold for reporting. The Port has a policy to ensure compliance with state law but Port department managers have not reported losses as required.

Port managers reported 41 losses estimated at$107,000 to Port police – but not to executive management, internal auditors or our Office – from January 2006 through March 2009. In addition, the Port terminated four employees for other losses. Appendix C includes relevant laws and policies for loss reporting and Appendix D has details of specific losses.

Our Office is responsible for investigating misappropriations of public resources and has established an online loss-reporting process for all government agencies. When governments do not immediately notify our Office, our staff cannot act quickly and assure the public that losses have been properly investigated, restitution agreements made and law enforcement agencies notified.

In previous audits, we noted the Port did not comply with state law in this area and have recommended Port executives develop an effective reporting system. For this audit, we reviewed three departments we judged to be the most susceptible to misappropriation of property:

- Information and Communication Technology: Although the Port has policies on reporting losses, the Department was unaware of them and did not have its own policies.
- Aviation Maintenance Department: The Department required employees to report lost equipment to their managers, but did not require managers to report to the executive managers, internal auditors or our Office.
- Marine Maintenance Department: Before June 2007, Department managers were unaware of the state law regarding loss reporting. Once they became aware, they updated policies and procedures. However, they did not communicate them to employees.

Overall, we found:

- The Port did not have consistent loss-reporting policies across all departments.
- The policy for reporting losses did not clearly state to whom employees should report.
- The departments did not adequately communicate policies to employees and managers and did not make sure employees followed the policies.
- Some Port executives believed they were not required to report small losses to the State Auditor's Office.

Recommendation 10

We recommend the Port Commission clarify and enforce policies on loss reporting to ensure compliance with state law

Specifically, the Commission should:

- Amend current Port policies to require all departments to report all known or suspected losses to executive management, the Port's internal auditor and the State Auditor's Office. The policy also should require the Port Police Department to check with these parties to ensure they have been notified when losses are reported to that Department.
- Monitor compliance with Port policies to ensure they are followed.
- Use a standard loss reporting form to notify executive management, the internal auditor and the State Auditor's Office.

Appendix A: Initiative 900 Elements

Initiative 900, approved by Washington voters in 2005 and enacted into state law in 2006, authorizes the State Auditor's Office to conduct independent, comprehensive performance audits of state and local governments. Specifically, the law directs the State Auditor's Office to "review and analyze the economy, efficiency, and effectiveness of the policies, management, fiscal affairs, and operations of state and local governments, agencies, programs, and accounts."

The law identifies nine elements we must consider within the scope of each performance audit. We evaluate the relevance of all nine elements to each audit.

The table below indicates how the elements are addressed in the Port of Seattle audit:

I-900 Element	Addressed
1. Identification of cost savings	Yes
2. Identification of services that can be reduced or eliminated	No
3. Identification of programs or services that can be transferred to the private sector	No
4. Analysis of gaps or overlaps in programs or services and recommendations to correct gaps or overlaps	Yes
5. Feasibility of pooling information technology systems within the Port	Yes
6. Analysis of roles and functions of the Port, and recommendations to change or eliminate Port roles or functions	Yes
7. Recommendation for statutory or regulatory changes that may be necessary for the Port to properly carry out its functions	Yes
8. Analysis of Port performance data, performance measures, and self-assessment systems	Yes
9. Identification of best practices	Yes

Appendix B: audit Methodology

In 2005, voters gave the State Auditor's Office authority to conduct independent performance audits of local governments to promote accountability and the cost-effective uses of public resources. Consistent with this authority, we conducted this performance audit in accordance with generally accepted government auditing standards as developed by the U.S. Government Accountability Office. 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 conducted the audit as follows:

During the **planning phase** we interviewed Port staff, commissioners and citizens to identify specific property transactions and practices to audit. We interviewed personnel at the Seaport and Real Estate Divisions, and staff in several other departments, including finance and internal audit. We also reviewed the work performed by other external auditors.

During the **fieldwork phase** we gathered and analyzed audit evidence to develop the issues identified during the planning phase. Specifically, we:

- Analyzed business processes and practices related to strategic planning, the establishment of fair market value, and the management of information necessary to manage properties and those responsible for them. Part of this work included examining the Port's information systems and how well they supported the management of leases and tenants.
- Compared processes and practices to best practices, state laws and Port policies, as required.
- Reviewed records and other evidence to understand transactions and assess performance, including the prices paid and received for property and the quality of the analysis of property transactions and the information presented to the commissioners.
- Reviewed appraisals obtained by the Port and how the Port used them to make purchase, lease and sale decisions. In such instances, our work was limited to assessing how effectively the Port used the appraisals in its decision-making. We did not audit the accuracy, completeness or basis of the appraisals themselves, which were performed by licensed appraisers.

We conducted this audit with the assistance of two contractors – Thompson, Cobb, Bazilio and Associates, and IMS Worldwide Inc. These audit and consulting firms have significant knowledge of leading industry practices for managing, purchasing and selling port real estate. They have extensive experience with entities that are similar to the Port of Seattle in size, scope and operations.

Policies on property purchases and sales

The Port's policies "Acquisition and Sale of Any Interest in Real Property" (AV/MAR) RE-4 as of 11/08/94 regarding the acquisition and sale of any interest in real property state:

"All property to be sold by the Port must be declared surplus prior to sale by resolution of the Port Commission.

Port properties will usually be a part of the Port's Comprehensive Scheme of Harbor improvements at the time they are considered for sale. If property is in the Comprehensive Scheme, the Comprehensive Scheme must be modified prior to sale by resolution of the Port Commission to declare the property no longer needed for Port purposed and surplus to Port need."

When establishing the property value, Port staff should use processes that allow it to understand and accurately determine the value of its property. These processes should include the use of accurate property appraisals and due diligence reviews. This includes understanding and accurately presenting the impact of environmental hazards and remediation costs on the value of the property.

Regarding the valuation of property and the reconciliation of differing appraisals, Port policy states:

"Surplus real property should be sold for not less than fair market value as established by a Port-retained appraiser with the qualifications set forth in Section II above, provided, however, it is recognized that a sales price may need to be negotiated based on estimates of value made by Port retained and purchaser retained appraisers."

Contracts with Port Jobs

State Law

RCW 53.08.245

"It shall be in the public purpose for all port districts to engage in economic development programs. In addition, port districts may contract with nonprofit corporations in furtherance of this and other acts relating to economic development."

RCW 42.24.080, states in part,

(1) All claims presented against any…municipal corporation…by personas furnishing materials, rendering services or performing labor, or for any contractual purpose, shall be audited, before payment, by an auditing officer…. Such claims shall be prepared for audit and payment on a form and in the manner prescribed by the state auditor. The form shall provide for the authentication and certification by such auditing officer that the materials have been furnished, the services rendered, the labor performed as described, or that any advance payment is due and payable pursuant to a contract...and that the claim is a just, due and unpaid obligation against the municipal corporation…. No claim shall be paid without such authentication and certification.

RCW 43.09.200 requires adequate records be maintained to show how revenues and expenses served a public purpose. It states in part:

"..all receipts, vouchers, and other documents kept, or required to be kept, necessary to isolate and prove the validity of every transaction.."

Loss Reporting

State Law

RCW 43.09.185:

"State agencies and local governments shall immediately report to the state auditor's office known or suspected loss of public funds or assets or other illegal activity."

RCW 43.09.260, states in part:

"..It shall be unlawful for any local government or the responsible head thereof, to make a settlement or compromise of any claim arising out of such malfeasance, misfeasance, or nonfeasance, or any action commenced therefor, or for any court to enter upon any compromise or settlement of such action, without the written approval and consent of the attorney general and the state auditor."

Port of Seattle Policy

Port Policy Executive EX-18 Fraud Awareness & Prevention, Loss of Public Funds & Assets, states in part:

II. Details:

A. Purpose

2. To comply with RCW 43.09.185, that requires State agencies and local governments to immediately report any known or suspected loss of public funds or assets to the State Auditor's Office (SAO).

B. Requirements

1. Losses required to be reported – Irregularities that reasonably leads a Port employee to suspect a loss of Port funds or assets due to misappropriation or fraud, must be reported in accordance with this policy. This includes all suspected losses, including those that have occurred in the past but only recently become apparent.

2. Materiality of reportable losses – All suspected and known losses shall be reported in accordance with this policy, regardless of amount. The full exposure to the Port can only be determined by a thorough investigation.

3. Losses not required to be reported – Consistent with SAO guidance, the following are not considered losses reportable under this policy. However, those in leadership positions for the related operations are responsible to monitor such activities for unreasonable irregularities and take action in accordance with this policy as necessary.

a. Normal and reasonable "over and short" situations from cash receipting operations. These transactions are to be recorded in the accounting system as miscellaneous income and expense, respectively, and monitored by cashier for any unusual trends.

b. Reasonable inventory shortages identified during a physical count. These inventory adjustments are to be recorded in the accounting system and monitored accordingly.

C. Fraud Response Committee

7. At the point it is suspected or known that a loss of public funds or Assets or fraud has occurred, the Internal Audit Manager shall Immediately notify the SAO in accordance with RCW 43.09.185.

Appendix D: Details of Property Losses

The following losses totaling $107,000 were reported to Port of Seattle police between January 2006 and March 2009:

- Information and Communications Technology: $36,900 worth of assets, including 29 computers.
- Aviation Maintenance: $25,300 worth of assets, including copper wire, aluminum window frames and a pressure washer.
- Construction Services: $20,800 worth of assets, including copper wire and three drills.
- Aviation Facilities and Infrastructure: $8,500 worth of assets, including a projector.
- Seaport Maintenance: $6,100 worth of assets, including steel cables and copper pipes.
- Harbor Services: $2,600 worth of assets, including four computers.
- Seaport Administration: One laptop and accessories valued at $2,165.
- Labor Relations: One computer estimated at $1,500.
- Aviation Security: 300 blank security badges estimated at $1,200.
- The Police Department: Two handguns estimated at $1,100.
- Aviation Landside: $608 lost when customers did not pay for airport parking.
- Aviation Project Management: Three digital cameras valued at $260.
- Engineering Services: Two rain jackets and a pair of boots valued at $110.
- Aviation Planning: Two computer chips valued at $40.

In addition, the Port managers:

- Terminated two employees for falsifying time cards in 2008. The losses totaled $395. The Port recovered $297 by deducting the falsely reported hours from one employee's vacation leave balance. The Port provided restitution agreements to our Office on June 30, 2009 for these employees. The Port was aware of these falsified timesheets in July 2008. The State Auditor's and Attorney General offices did not approve these agreements as required by state law. The Port did not seek repayment for the remaining $98 from the second employee.
- Terminated one employee for falsifying information in order to obtain a vanpool participation voucher valued at $20. The Port did not seek reimbursement.
- Terminated one employee for allowing an airline employee to use a Port-issued parking card. The airline employee used the parking card to exit the airport parking garage without paying. The Port was unable to determine the amount of loss and did not seek reimbursement.
- Delayed its reporting of losses to the State Auditor's Office. For example, the Port failed for almost two years to report the October 1, 2007 loss of a pipe threading machine valued at $1,200. The loss was reported to us on July 6, 2009.

Appendix E: Leases examined in Section 3

Seaport Division

We examined the following **Seaport Division** properties and associated leases and amendments:

- SSA Terminals 859 at Terminal 25
- Cruise Terminals of America 975
- Cruise Terminals of America first Amendment
- Long-Term Preferential Berthing Agreement
- Customer Support Amendments
- Trident Seafoods 154
- Carnitech Agreement 1010
- Carnitech Agreement 1517
- City Ice Agreement 1481
- City Ice Agreement 594

Real Estate Division

We examined the following **Real Estate Division** properties and associated leases:

- Department of Homeland Security (Office Space) T102
- Marine Terminals Corporation at T102 (Commercial)
- Puget Sound Institute at T102 (Office and Laboratory)
- Starbucks (Office Space and Warehouse) at T102
- Virtuoso, Ltd. (Office Space) T102
- Republic Parking Garage at P66
- Republic Parking Surface Lot at P66
- Carlson Insurance (Office Space) at FT
- Mad Anthony's Restaurant at FT
- Mad Anthony's Restaurant at Pier 66
- M.T. Housing, Inc. (Industrial Use) at T91

Appendix F: Port of Seattle Response

November 24, 2010

The Honorable Brian Sonntag
Washington State Auditor
P.O. Box 40021
Olympia, Washington 98504-0021

Dear Auditor Sonntag,

Attached please find the Port of Seattle's response to the 2009 performance audit of real estate management and selected program performance. We appreciate the opportunity to provide our feedback.

The Port of Seattle Commission is an elected body ultimately responsible for establishing policy for the organization, doing so only after discussion in a public meeting. As a result, the commission must approve the port's final response to any audit involving policy or recommendations suggesting commission action, and must do so in public. Current SAO procedures prevent such discussion, as responses must be submitted to your office prior to publication of the audit report.

Port staff members have prepared a thorough response to the recommendations made in the report. However, as commissioners must both finalize the port's response in public session and determine responses to policy recommendations, the Port of Seattle Commission may provide additional responses to those recommendations specifically directed to them at a later date.

Sincerely,

Bill Bryant	Tay Yoshitani
Commission President	Chief Executive Officer

Port of Seattle Response
Performance Audit of Real Estate Management and Selected Program Performance

Overall response:

The performance audit conducted in 2009 by the State Auditor's Office covers events that date back as far as 2004. The Port of Seattle is a very different organization in 2011, with a new CEO, a new board of commissioners, two new divisions, and a centralized procurement process. Commission oversight of port operations is more robust.

The Port of Seattle Commission is an elected body ultimately responsible for the port's performance, and the commission as a body must approve the port's final response to any audit involving policy or recommendations suggesting commission action in public. Because SAO procedures require that public discussion only be held once the audit is finalized and released, further response may be provided by the commission at a later date.

Commissioners and staff members appreciate the opportunity to work with the State Auditor's Office during this performance audit.

SAO Recommendation No. 1 - We recommend the Port complete its Century Agenda as soon as possible and include the following elements:

- Specific goals and objectives to use real estate holdings to achieve financial security and promote economic development and community stewardship. The Port needs to set priorities and clarify the sometimes conflicting direction of Strategy 21's guiding principles. For example, the importance of generating revenue may conflict with the need to provide financial incentives to attract job-creating industries. The absence of priorities can create inconsistent and unclear decisions that do not align with long-term goals. These conditions may have contributed to the unexplained inconsistencies in lease rates and rate hikes discussed in Section 3.
- Identification of the specific types of businesses and industries – outside of traditional air- and sea-related companies – that the Port wants to secure and maintain as short- and long-term tenants.
- Goals and objectives that describe how the Port can best use its real estate to compete with other West Coast ports for tenants, industries and importers/exporters.

Port Response to Recommendation No. 1: At the commission's direction, the scope and timeline of the Century Agenda were extended to ensure that the new strategic plan fully addresses the challenges facing the Port of Seattle in the coming decades. While the Century Agenda process remains underway, commissioners have used the real estate and land use guiding principles already developed to evaluate real estate transactions since August of 2009, when they were formally adopted. The Century Agenda process will be completed as planned in 2011, the port's centennial year.

SAO Recommendation No. 2 - To ensure clear and consistent real estate management, we recommend the Port clarify the responsibilities of the Real Estate and Seaport divisions and improve the enforcement of its policies and procedures.

It is equally critical for senior managers to improve oversight of Port property transactions and to monitor employees' compliance with new policies and procedures.

Port Response to Recommendation No. 2: CEO Tay Yoshitani established the Real Estate division in 2008 to bring more focus to managing the port's real estate portfolio. Responsibilities within the relatively new division continue to evolve. This recommendation is timely and managing directors of the Seaport and Real Estate divisions have begun work to further clarify roles and responsibilities.

SAO Recommendation No. 3 – We recommend the Commission assert the same level of authority over real estate transactions that it established in Resolution 3605 for construction management. In this audit, we identify conditions in which Port managers do not always provide complete and accurate information that the Commission needs to make sound real estate decisions. The Commission needs to ensure staff collect, track and convey key information related to the cost and benefits of the leases to the Commission.

In the long-term, an updated strategic management plan approach may call for further reorganization of these divisions to ensure that policies, procedures and daily operations contribute to achieving the Port's vision and goals. As the Port updates its strategic plan, it may want to reassess its division of responsibilities over real estate property management.

Port Response to Recommendation No. 3: The Port of Seattle Commission establishes policy for the organization and will determine final response to this recommendation after further review and discussion. Because SAO procedures require that public discussion only be held once the audit is finalized and released, further response may be provided by the commission at a later date.

Resolution 3605 does establish authority and protocols for real estate transactions in sections two and three of the document.

SAO Recommendation No. 4 - To strengthen its oversight of property sales and purchases, we recommend the Port Commission adopt and enforce policies that require staff to perform and document the following efforts:

- Regularly and thoroughly analyze the Port's current and future property needs in the context of the goals and objectives of a long-term strategic plan. These ongoing analyses should clearly describe the justification for all purchases and sales. Properties with no current or future need should be declared surplus and made available for sale. The Port should not declare property surplus simply to expedite a sale.

- Review in detail all property value appraisals and determinations by Port staff involved in the property sale or purchase. This should also include a concurrent review by the Port's chief financial officer to ensure the appraisal is fully understood. When it buys and sells property, the Port should use current appraisals to establish and negotiate a good fair market price.

- Perform complete financial and risk analyses of the purchase that include remediation costs, potential ownership costs and environmental conditions.
- Scrutinize information from staff to ensure it is adequate and complete and decide on purchases and sales in an open public meeting.

- Effectively market and advertise the availability of Port property to allow multiple purchasers an equal opportunity to buy it in order to achieve the best purchase price.

Port Response to Recommendation No. 4: The Port of Seattle Commission establishes policy for the organization and will determine final response to this recommendation after further review and discussion. Because SAO procedures require that public discussion only be held once the audit is finalized and released, further response may be provided by the commission at a later date.

As noted by the auditors, port real estate sales or purchases are relatively rare - four instances in seven years. Commissioners and staff members discuss these transactions repeatedly while they are under consideration, and staff members provide all information requested by the port's governing body.

During the annual budget process, commissioners discuss and approve long-term plans for port real estate assets. Property is rarely sold; rather, when there is no immediate use to support port business operations, land is leased under long-term agreements so that the port receives ongoing revenue from the property. While final decisions on sale, purchase, or lease agreements are made in public session, discussions regarding active negotiations are protected by Washington law and may happen in executive session.

When auditors first asked about the Eastside Rail Corridor transaction, CEO Yoshitani noted that negotiations with BNSF Railway and possible partner agencies were already underway. The port was committed to placing the corridor into public ownership, and these negotiations ultimately lowered the purchase price and included multiple partners in the transaction. These efforts preceded the audit fieldwork and are not the result of auditor recommendations.

SAO Recommendation No. 5 - Port Commissioners should establish a comprehensive strategy for each real estate asset and operating procedures to ensure prospective transactions are evaluated against those strategies. Specifically, the staff should:

- Develop a written asset management plan and strategies for each real property consistent with the Port's overall real estate strategy.
- Establish and document its desired business terms before negotiations are initiated for large complex transactions.
- Measure, evaluate and document the proposed business terms against whether the property use, lease terms, property improvements and tenant incentives are consistent with the Port's long-term interests.
- Use standardized analytical tools to assess the degree to which the proposed tenancy fits in with the Port's asset management plan.

Port Response to Recommendation No. 5: The Port of Seattle Commission establishes policy for the organization and will determine final response to this recommendation after further review and discussion. Because SAO procedures require that public discussion only be held once the audit is finalized and released, further response may be provided by the commission at a later date.

As noted under Recommendation 1, the Century Agenda process will be completed in 2011, but commissioners adopted the recommended land use and real estate guiding principles in 2009 and use those to evaluate real estate transactions. In addition, plans for the port's real estate portfolio are evaluated and approved annually during the budget process.

Port staff members evaluate management plans for specific assets regularly, through the annual budget planning process, during lease negotiations, and when vacancies occur. As discussed with auditors, the port has specific competitive process and financial analysis expectations for long-term (more than ten years) lease negotiations. Real estate staff members have proposed additional policy guidelines for these leases.

Documentation of early lease discussions could be improved. The division has used a standardized lease analysis template since mid-2009 to better analyze and track the business terms and financial return to the port for all new lease transactions.

SAO Recommendation No. 6 - Port Commissioners should establish policies and procedures designed to ensure that (1) rental rates reflect fair market value and consistent lease pricing, and (2) financial analyses enable the Commission to negotiate acceptable rates of return.

Procedures to set rental rates should require staff members to:

- Treat similar properties consistently and follow the private sector practice of adjusting rental rates over the term of the leases.

- Obtain Commission approval for any lease whose rent does not reflect the prevailing market rate and provide a rationale consistent with the Port's strategic goals and mission.
- Obtain Commission approval for leases that are extended or renewed for combined periods that exceed five years.
- Establish methods to formalize and document the type and frequency of market analyses required for each lease. These methods should address the risks associated with changes in market conditions and over-reliance on third-party brokers.
- Establish a comprehensive marketing strategy that exposes properties to the greatest number of potential tenants.
- Suspend negotiations with a prospective tenant who is unwilling to pay fair market rent, and aggressively market the property to other potential tenants.
- Fully document all lease decisions.

Financial analysis procedures should require Port staff to:

- Prepare financial analyses of leases and capital projects early in the process when internal discussions begin. The financial analyses should consider all costs associated with a given asset so the Port can measure its performance against the asset management plan. The Port should continue to develop, improve and use rigorous, standardized financial analysis tools.
- Prepare a written narrative that describes all relevant facts and assumptions used in the analysis, including the basis for revenue assumptions, tenant selection, land and asset values and evaluation of alternatives.
- Require property managers and analysts to discuss and evaluate alternatives for the use of the land/assets.
- Calculate the projected benefits of the lease using both an "all in" approach (includes new capital expenditures, fair market value of all land and all existing assets, and all lease revenue) and an operational costs-and-revenue approach.
- Develop an independent review system that results in reports to the Commission. The individual who does this should review and verify information provided to the Commission regarding property transactions. This party would provide in writing:
    - A narrative describing all its relevant facts and assumptions, the method of evaluation, alternatives studied, and the overall conclusion of the financial analysis.
    - An independent review of the financial data prepared by the Division and verification as to its completeness and accuracy for major transactions.
    - A recommendation to approve or reject the proposal.

<u>Port Response to Recommendation No. 6</u>: The Port of Seattle Commission establishes policy for the organization and will determine final response to this recommendation after further review and discussion. Because SAO procedures require that public discussion only be held once the audit is finalized and released, further response may be provided by the commission at a later date.

<u>Rental and lease rates</u>: The direction to establish lease rates that are both consistent and pegged to fair market value seems contradictory; by its nature, fair market value changes often and if lease rates are to be pegged to those fluctuating values, they will not be consistent. Current policy is to consider first, how use of a facility contributes to the port's overall mission of job generation and economic development; and second, how best to achieve the greatest short- and long-term value to the organization for specific properties.

<u>Financial analysis</u>: The port uses the incremental cash flow analysis model – a well-established financial model used widely in both the public and private sectors. The incremental cash flow model includes all of the cost and revenue components prescribed by the auditors except fair market value. The port rarely sells a real estate asset; fair market value is typically considered relevant when a sale is under consideration. The financial analysis provided to commissioners and executives has been accurate and correct under the model currently used.

The auditors prefer a different model used by other agencies, including some ports, but have not provided guidance as to how a change in the model would result in better decision making or provide more accurate information to commissioners.

The port will improve documentation of financial analysis performed for leases that do not require commission approval and of evaluations considered by property management staff. The port has, and staff members follow, policies regarding providing written details, reviews, and recommendations of the financial analysis performed. Commission memos used to brief commissioners prior to final action contain only the key components of the analysis performed, but commissioners may ask (and often do) for additional information which staff members readily provide.

<u>SAO Recommendation No. 7</u> - To better safeguard its assets and income related to the Seaport's leased cranes, we recommend the Commission revise its procedures to require Port staff to:

- Verify that reported container crane use is accurate. The most practical verification method is to periodically compare longshoreman/operator use data with data reported by the operator through the Seaport Division's Crane billing system.
- Inspect the cranes annually. The Port should consider hiring or contracting for crane specialists to do the inspections if it determines that reprioritizing the current staff's workload will not enable it to do so with current staff.
- Audit crane logs, reports and records of maintenance performed.

<u>Port Response to Recommendation No. 7</u>: The port is currently updating the automated crane billing process and will use that opportunity to implement additional audit procedures as recommended by the auditors.

Currently, the port conducts annual inspection and certification of all port-owned cranes, and conducts a structural inspection of those cranes every five years. Though there is no evidence to suggest that tenant maintenance of cranes has been lacking or caused additional costs to the port, inspection procedures will be reviewed to determine how they might be improved.

SAO Recommendation No. 8 - To better safeguard its billings and receipts at the Fishermen's Terminal, we recommend the Port:

- Segregate duties to ensure the same employees cannot enter customers, make adjustments to customer accounts, and receipt payments from customers in MMS.
- Require supervisory review of adjustments to customer accounts in the MMS that affect billing rates.
- Restrict access to make adjustments and apply payments to customer accounts to employees who need it as part of their regular job duties. The Port have reports containing vessel length and moorage classification for use when reviewing billing information for accuracy.

Port Response to Recommendation No. 8: Effective internal controls for billing and receipts at all port facilities are a priority, as is good customer service. Fisherman's Terminal operates 24 hours a day, seven days a week, and customers and tenants sometimes need to pay bills or conduct other business outside of regular business hours; because of that, many staff members were authorized to perform those tasks. However, in light of auditor recommendations, duties have been segregated to the extent practical, supervisory review has been strengthened, and system access has been restricted.

SAO Recommendation No. 9 - We recommend the Port revise its policies and procedures to establish and enforce safeguards against inappropriate spending. The revised procedures should:

- Limit funding of Port Jobs to programs that are clearly within its legal authority as stated in the 2010 legislation
- No longer require construction companies to contribute to Port Jobs as part of their construction contracts.
- Ensure its agreements to clearly identify the scope of work and all related deliverables.
- Require Port Jobs and its partners to document all deliverables have been provided before payments are made.
- Disclose to the Port Commission the nature and value of all in-kind support to Port Jobs or other non-profit organizations. These amounts should be reflected in the Port's agreements with these groups.
- Disallow any organization to operate from Port facilities unless an agreement is in place authorizing them to do so.

Port Response to Recommendation No. 9: In early 2010, the Washington State Legislature passed legislation clarifying the port's ability to participate in programs such as Port Jobs. The new contract with Port Jobs is clear about the scope of work expected and reflects all in-kind support. On new construction contracts, companies are no longer required to contribute 20 cents per hour toward the pre-apprenticeship program designed to develop a workforce skilled in the trades.

SAO Recommendation No. 10 - We recommend the Port Commission clarify and enforce policies on loss reporting to ensure compliance with state law

Specifically, the Commission should:

- Amend current Port policies to require all departments to report all known or suspected losses to executive management, the Port's internal auditor and the State Auditor's Office. The policy also should require the Port Police Department to check with these parties to ensure they have been notified when losses are reported to that Department.
- Monitor compliance with Port policies to ensure they are followed.
- Use a standard loss reporting form to notify executive management, the internal auditor and the State Auditor's Office.

Port Response to Recommendation No. 10: The Port of Seattle Commission establishes policy for the organization and will determine final response to this recommendation after further review and discussion. Because SAO procedures require that public discussion only be held once the audit is finalized and released, further response may be provided by the commission at a later date.

The loss of port property or resources is always a serious matter. In 2008, the port implemented Executive Policy EX-18, which establishes protocols for fraud awareness and prevention, and for reporting the loss of public funds and assets. In 2010, the port's newly-formed Workplace Responsibility Office developed a code of conduct, read and signed by all port employees; two of the policies included in that document supersede EX-18 and further clarify employee responsibility for fraud awareness and prevention and loss prevention. The Port of Seattle Police Department provides a monthly report that details any damages to port properties or losses to internal auditors.

The Workplace Responsibility Office is currently working with the port's internal audit, legal, risk management, information technology, and police departments to streamline reporting procedures and further train staff members.

Appendix G: State Auditor's Response

The Port of Seattle's response to the audit findings and recommendations is shown in Appendix F. The State Auditor's Office provides the following comments to that response.

Regarding the Port's response to Recommendation 4

The State Auditor's Office communicated concerns about the purchase price to Port officials on October 9, 2009. On November 2, 2009, the Port responded: "It is premature to reach conclusions with regards to an event that has not occurred." On January 13, 2010, Port officials told the State Auditor's Office that the price had been reduced after several days of negotiations, which began in late October 2009.

Regarding the Port's response to Recommendation 6

The State Auditor's Office believes that leases of similar properties initiated at similar points in time should have rent rates that are consistent and in line with fair market value.

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