

**PORT OF SEATTLE**  
**MEMORANDUM**

**COMMISSION AGENDA**

**Item No.** 6i

**ACTION ITEM**

**Date of Meeting** September 11, 2012

**DATE:** September 4, 2012

**TO:** Tay Yoshitani, Chief Executive Officer

**FROM:** Michael McLaughlin, Director, Cruise and Maritime Operations

**SUBJECT:** Second Amendment to the Cruise Facility Lease Agreement

**ACTION REQUESTED:**

Request Commission authorization for the Chief Executive Officer to execute the Second Amendment to the Cruise Facility Lease Agreement between the Port of Seattle (Port) and Cruise Terminals of America (CTA) to exercise the "Extension Period" set forth in Article 3.

**SYNOPSIS:**

The Port and CTA have negotiated an amendment to the Cruise Facility Lease Agreement to exercise provisions set forth in "Article 3: Term" extending the term an additional seven (7) years and adjusting rental amounts set forth in "Article 4: Rent". The extension would commence on January 1, 2013, and terminate on December 31, 2019.

Following receipt of notification from CTA of its interest in extending the agreement, the Port indicated its interest in extending. However, as allowed by the terms of Section 3.2, the Port also indicated its intention to "renegotiate the rental amounts set forth in ARTICLE 4." The Port and CTA have now agreed on a revised rental structure for the Extension Period. In addition to the new financial terms which provide for an average incremental increase of 4% to 6% in net proceeds to the Port compared to the current lease and a much simplified, straightforward, and easy to verify method for calculating rent, the new amendment includes a (proposed) new Allowance to deal with costs of repair and/or improvements of the cruise facilities.

This new allowance, defined as the "Per Passenger Allowance" (PPA), will replace the Improvement Allowance that was available to CTA only during "the initial term of [the] Agreement." The PPA is a variable amount dependent on the number of annual cruise passengers processed throughout the term of the extension period. The PPA provides a reserve fund based on pennies per passenger which grows over time. By projecting future business volumes, the PPA is estimated to total around \$500,000 over the term of the extension. The value of the PPA will be calculated based on the number of cruise passengers over the Extension Period. The PPA will accrue at a rate of Eight Cents (\$0.08) per passenger up to (and including)

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five million (5,000,000) passengers and at a rate of Five Cents (\$0.05) per passenger for each passenger above five million.

The PPA will be earned and available to the tenant only in arrears and shall not be available in advance or otherwise in expectation of future passengers. Either party may perform work under the new allowance. The parties shall consult with one another regarding potential projects towards which the PPA will be applied, and the final decisions regarding how the allowance will be applied and who will undertake the work will be made by the Port.

These changes are fully described in proposed Second Amendment to the Cruise Facility Lease Agreement. A draft copy is attached.

### **BACKGROUND AND JUSTIFICATION:**

The current lease agreement with CTA, which commenced in 2006, includes the Pier 66 Bell Street Pier Cruise Terminal and Smith Cove Cruise Terminal located at Terminal 91. CTA manages the day-to-day operations of the Port's cruise terminals.

The Port has contracted with CTA to manage cruise operations since May 2000 when the Port began its homeport cruise business. CTA has been an essential partner in the Port's success in the cruise business over the years. Consistently over the initial seven years of the current agreement, the Port has retained a strong market share serving the cruise industry as a homeport for several brands offering Alaska cruise itineraries. In 2000, the Port accommodated 36 cruise vessels and 120,000 passengers. Our record performance year was 2010 with 223 vessel calls and 931,000 passengers processed through Port cruise facilities. On average, the Port has served over 200 cruise vessel calls annually during this period with between 750,000 to 930,000 cruise passengers being processed through Port facilities each season. The 2012 season looks to be another very strong year with 202 vessels and potential total passenger counts exceeding record levels.

The increase in annual cruise business has been dramatic and sustained, and the popularity of Alaska as a cruise destination remains high. With the Port's cruise business achieving maturity over the last decade, the predictability in expenses is better understood today than it was when this lease began. At the start of this lease in 2006, the extension-option was understood to be a future opportunity for the Port to continue with CTA operating the Port's cruise facilities and to adjust the revenue-sharing model as appropriate based on increased market share as a homeport serving the cruise industry.

The new PPA allowance provides a mechanism to deal with unexpected costs of facility repairs, improvements at both terminals to meet changing customer needs, and replacement of essential equipment. It also allows the Port to increase the rent percentage paid to the Port, with CTA accepting greater risk associated with the coverage of operating expenses.

Much of the Port's continued success in serving the cruise industry comes down to the performance of our facilities and the CTA team which manages operations at the cruise

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terminals. As a gauge of the return on the significant investments the Port has made in its cruise facilities, the value of this industry to our local economy continues to grow with over 4,000 jobs, annual state and local taxes in excess of \$18 million, and an estimated infusion of \$2,000,000 to the region each time a cruise ship docks in Seattle.

As the Port's cruise terminal operator, CTA has done an excellent job making sure the cruise ship schedules are met consistently, passengers are processed in a safe and secure manner and the Port's facilities are properly maintained in compliance with the lease, the USCG Facility Security Plan, the Department of Homeland Security Customs and Border Protection procedures, our customer's expectations and the high standards of the cruise industry.

In light of these demonstrated results, our continued commitment to serving this industry as a homeport, the strong business relationship that has developed with CTA and the Port's focus on growing this business – staff recommends exercising the extension period.

### ***Budget Status and Source of Funds:***

The proposed 2013 Operating Budget (currently in process) is based on the increased cruise revenue expected from the revised rent calculation in the CTA lease extension based on the 2013 passenger projections. The new "Per Passenger Allowance" will be included in the 2013 Plan of Finance. The Per Passenger Allowance will be more than offset by the increased revenues resulting from the change in the rent calculation in the lease extension.

The source of funds for the Per Passenger Allowance when it is spent will be the General Fund since the PPA is deposited in the General Fund when it is collected.

### ***Financial Analysis and Summary:***

<b>CIP Category</b>	N/A
<b>Project Type</b>	N/A
<b>Risk adjusted discount rate</b>	N/A
<b>Key risk factors</b>	<ul style="list-style-type: none"><li>• All provisions in the current lease remain in effect except for the change in the rent formula (article 4 in the current lease) and the creation of the new "Per Passenger Allowance". The combined impact of these changes results in higher net proceeds to the Port of 4% to 6% each year as compared to the current lease.</li><li>•</li></ul>

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<p><b>Key risk factors, cont.</b></p>	<ul style="list-style-type: none"> <li>• Under the proposed lease extension, CTA assumes more of the risk (for all operating expenses, and some components of revenue) than under the current lease. This provision could motivate the tenant to defer repairs and needed improvements to the building. This risk is partially mitigated by the creation of the new “Per Passenger Allowance” which accrues based on the number of cruise passengers through the cruise facilities during the lease extension term. The Per Passenger Allowance is available to supplement the acquisition or replacement of essential equipment for cruise terminal operations during the term of the lease extension, based on advance approval by the Port.</li> <li>• Under the proposed lease extension, the Port will no longer have visibility to expenses incurred by CTA to run the business and hence less ability to monitor the profitability of the business. This risk to the Port is partially mitigated by maturity of the cruise business in Seattle and the understanding the Port has gained over the past 10 years regarding the cost to operate the terminals.</li> </ul>																																				
<p><b>Project cost for analysis</b></p>	<p>N/A</p>																																				
<p><b>Business Unit (BU)</b></p>	<p>Seaport Cruise Services</p>																																				
<p><b>Effect on business performance</b></p>	<p>The proposed terms of the CTA lease extension provide an average incremental increase of 4%-6% in net proceeds to the Port compared to the current lease. The simplifying rent formula facilitates more effective management oversight and a straight forward rent calculation based primarily on verified cruise passenger volumes and Port-directed cruise fees.</p> <p>Incremental benefit - compared to current lease provisions:</p> <table border="1" data-bbox="456 1266 1476 1415"> <thead> <tr> <th><b>NOI (in \$000's)</b></th> <th><b>2013</b></th> <th><b>2014</b></th> <th><b>2015</b></th> <th><b>2016</b></th> <th><b>2017</b></th> <th><b>2018</b></th> <th><b>2019</b></th> <th><b>TOTAL</b></th> </tr> </thead> <tbody> <tr> <td>Incremental Revenue</td> <td>659</td> <td>668</td> <td>678</td> <td>689</td> <td>699</td> <td>711</td> <td>758</td> <td>4,862</td> </tr> <tr> <td>less: New Allowance</td> <td>(65)</td> <td>(65)</td> <td>(65)</td> <td>(65)</td> <td>(65)</td> <td>(65)</td> <td>(44)</td> <td>(436)</td> </tr> <tr> <td><b>NOI After Depreciation</b></td> <td><b>\$593</b></td> <td><b>\$603</b></td> <td><b>\$613</b></td> <td><b>\$623</b></td> <td><b>\$634</b></td> <td><b>\$645</b></td> <td><b>\$714</b></td> <td><b>\$4,425</b></td> </tr> </tbody> </table> <p><i>Forecasted revenue is based on future annual performance comparable to the expected passenger volumes at 100% standard occupancy of confirmed vessel calls for the 2013 cruise season. Forecasted funding of the new Per Passenger Allowance is based on passenger volumes of approximately 820,000 per year. Actual results will vary dependent on the specific mix of vessels and corresponding passenger volume each cruise season.</i></p>	<b>NOI (in \$000's)</b>	<b>2013</b>	<b>2014</b>	<b>2015</b>	<b>2016</b>	<b>2017</b>	<b>2018</b>	<b>2019</b>	<b>TOTAL</b>	Incremental Revenue	659	668	678	689	699	711	758	4,862	less: New Allowance	(65)	(65)	(65)	(65)	(65)	(65)	(44)	(436)	<b>NOI After Depreciation</b>	<b>\$593</b>	<b>\$603</b>	<b>\$613</b>	<b>\$623</b>	<b>\$634</b>	<b>\$645</b>	<b>\$714</b>	<b>\$4,425</b>
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<p><b>IRR/NPV</b></p>	<p>N/A</p>																																				

### ALTERNATIVES CONSIDERED AND THEIR IMPLICATIONS:

1. **Do Nothing:** The current lease with CTA will expire at the end of 2012. This would require the Port to seek out a new terminal operator for the 2013 cruise season and beyond, negotiate a new agreement or manage the cruise terminal operations in-house which would require a significant increase in staff resources. In either scenario, the Port could face a significant risk of declining customer-satisfaction and level-of-service provided to the cruise industry

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2. **Approve the Second Amendment to Cruise Facility Lease Agreement:** Approval of the Second Amendment, as envisioned by the current agreement, includes an increase in the proposed rental amount; the creation of a new allowance to fund future maintenance, repair and improvements of the cruise terminal facilities, and the simplification of lease language. It will eliminate problems previously experienced in managing the agreement and will ensure continued smooth operation of the cruise terminals protecting our market share as a homeport serving the cruise industry. **This is the recommended alternative.**

### **OTHER DOCUMENTS ASSOCIATED WITH THIS REQUEST:**

- Second Amendment of Cruise Facility Lease Agreement – Final Draft

### **PREVIOUS COMMISSION ACTIONS OR BRIEFINGS:**

- December 11, 2005 – The Commission approved the Cruise Facility Lease Agreement.
- April 11, 2006 – The Commission approved the First Amendment of Cruise Facility Lease Agreement.