INTERNAL AUDIT REPORT

OPERATIONAL AUDIT
DELTA LOUNGE - TENANT REIMBURSEMENT AGREEMENT

September 2015- January 2018

ISSUE DATE: March 9, 2018
REPORT NO. 2017-27

TABLE OF CONTENTS

EXECUTIVE SUMMARY

Internal Audit (IA) completed an audit of the Aviation Delta Lounge Tenant Improvement Reimbursement for the period September 2015 - January 2018. The objectives of this audit were to determine whether Port staff followed policies, procedures, and the Tenant Reimbursement Agreement (Agreement) requirements.

Delta Airlines (Delta) is the largest global carrier at the Seattle-Tacoma International Airport and has more than tripled their flights at its Seattle hub since 2012. To accommodate the growth, the Port and Delta entered into an agreement to construct a 23,000 square foot lounge for its members and guests. While Delta was responsible for the cost of completing the interior, the Agreement required the Port to reimburse Delta for the cost to construct the shell (exterior) and core utilities.

Port Commission approved a project budget of $13.7 million. Construction began in October 2015 and was completed and fully functional in October 2016. As of January 2018, total construction costs were $24 million, of which $13.2 million was paid by the Port.

In general, Port staff effectively managed the project. Port staff frequently discussed project deliverables with Delta, reviewed change orders, and verified compliance to the Agreement. As a result, Port management did not allow certain charges that reduced the amount paid by the Port.

The Agreement, however, provided Delta with broad decision making and oversight authority. The Port frequently structures these agreements, relying significantly on external resources for expertise and project oversight. The downside with using this approach is that it inherently limits the perceived or actual influence of Port management. Nonetheless, the Port is still responsible for financial overruns and maintains public accountability to complete the project on time.

We identified the following issue:

1) The Tenant Reimbursement Agreement was not written to give Port staff broad oversight authority of decisions made by external parties. However, the Port remained financially responsible for the majority of costs from these decisions. Delegating decision to external parties is not designed to facilitate financial accountability and sound stewardship of public funds.

We extend our appreciation to Port management and staff for their assistance and cooperation during the audit.

Glenn Fernandes, CPA
Director, Internal Audit

RESPONSIBLE MANAGEMENT TEAM
Ralph Graves, Sr. Director of Capital Development
Wayne Grotheer, Director Aviation Project Management Group
Jim Schone, Director Aviation Business Development
Jason Olson, Sr. Controls Manager, Aviation Project Management Group
Alan Olson, Capital Project Manager, Aviation Project Management Group
James Jennings, Sr. Manager, Aviation Properties

BACKGROUND

Delta Air Lines, Inc. (Delta) is the largest global carrier at the Seattle-Tacoma International Airport and has more than tripled their flights at its Seattle hub since 2012. To accommodate this growth, the Port and Delta entered into a Tenant Reimbursement Agreement (Agreement) to construct a 21,000 square foot lounge for Delta's members and guests.

Revised Code of Washington 14.08.120 allows Ports to reimburse airport tenants for tenant improvements to their leased premises, if the reimbursement is paid solely out of funds fully collected from airport tenants. These agreements create a unique contractual relationship between the Port, a government agency, and Delta, a private entity, leveraging the skills and assets of each.

Port Commission approved a budget of $13.7 million and construction began in October 2015. The project was completed and fully functional in October 2016 at a total cost of $24 million. The Port reimbursed Delta $13.2 million to construct the building shell and core utilities. Delta constructed the interior using its own funding.

PCL Construction was selected as the general contractor; ECH Architecture was used to design the structures exterior and interior; Jacobsen Daniels Associates provided project management, and Airport and Aviation Professionals provided financial services.

The lounge interior features wood, water, and movement to create a Pacific Northwest feel. The lounge features 30-foot ceilings with curved paneling and a mezzanine level with an art gallery showcasing artwork from emerging artists and local galleries.

The lounge is situated where the A and B Concourses intersect and on clear days offers views of Mount Rainier. The lounge offers conference tables for dining or meetings, a full-service bar, self-service individual work stations for computing or reading, and a self-service buffet with both cold and hot food options.

AUDIT SCOPE AND METHODOLOGY

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

The period audited was September 2015 - January 2018. We utilized a risk-based approach from the planning phase to the testing phase of our audit. We gathered information through document requests, research, interviews, observations, and analytical procedures. We assessed significant risks and identified controls to mitigate those risks. Our audit included the following procedures:

Design Development Allowance

- Obtained an understanding of the design development allowance and how it was applied.
- Reviewed supporting documentation on expenses charged to the design development allowance for reasonableness, accuracy, and allowability.
- Reviewed project files to determine whether price increases were reasonable, accurate, and included a final “true-up”.
- Determined if add or deduct change order(s) were executed for differences between budgeted and actual costs.

Construction Contingency

- Obtained an understanding of the construction contingency and how it was applied.
- Reviewed supporting documentation on expenses charged to the construction contingency for reasonableness, accuracy, and allowability.

General Contractor Self-Performed Work

- Obtained an understanding of Port monitoring of the general contractor’s self-performed work.
- Reviewed project files to evaluate the bid process of self-performed work.
- Determined if an agreement, similar to agreements with subcontractors, was established.

Budget Allocation

- Obtained an understanding of the Port’s monitoring of payment allocations.
- Re-calculated expenses of tenant reimbursements and non-tenant reimbursements and agreed the charges to PeopleSoft.
- Compared actual tenant reimbursement and non-tenant reimbursement charges to the authorized budget.

SCHEDULE OF FINDINGS AND RECOMMENDATIONS

1) RATING: HIGH

THE TENANT REIMBURSEMENT AGREEMENT WAS NOT WRITTEN TO GIVE PORT STAFF BROAD OVERSIGHT AUTHORITY FOR DECISIONS MADE BY EXTERNAL PARTIES.

The Agreement does not give Port management the authority or ability to be included in the selection process of contractors. However, the Port remained financially responsible for the majority of costs from these decisions. Delegating decisions to external parties, while still maintaining financial responsibility, is not designed to facilitate accountability and sound stewardship of public funds. Below are examples that reflect decisions made externally and the resulting financial impact to the Port.

1. Delta received three bids for design services and selected ECH as the architect, with a bid of $317,245. ECH revised their bid to approximately $900,000; however, Port management questioned their request which resulted in a revised lower estimate of approximately $623,000. Internal Audit estimated that the Port incurred an additional $190,000 as a result of the cost overrun.

   Although not required by the Agreement, Delta did not retain documentation of the two bids that were not selected. Retaining this documentation would have allowed IA and Port Management to assess if other bidders might have anticipated any later changes in their bids.

2. Delta did not follow sound practices and allowed PCL, the general contractor, to review bids, including their own. PCL selected themselves as the successful bidder of "self-performed" work.

   General Contractors may have information, such as budgeted costs and contingency funds that other bidders don't have, giving them an unfair advantage. General Contractors may also claim that they can perform the work at a more reasonable cost than a subcontractor, because they have a more comprehensive understanding of the project. Therefore, implementing strong internal controls is critical to make sure the bidding process is equitable and the successful bidder is accountable for their bid.

   PCL's conceptual estimate for self-performed concrete work was $203,473. However, the revised estimate was $450,536. Internal Audit was not able to determine the additional cost derived from the initial and final estimate.

3. The Agreement included a contingency fund of $912,000 to absorb budget overruns. Although the full contingency fund was expended, the Port was not given an opportunity to assess if it aligned to the original scope of the project or to determine the reasonableness of the charges until after the work had been completed.

Recommendation:

Management should reexamine the Port's Tenant Reimbursement Agreements to assure that the Port's interests are met. Additionally, Tenant Reimbursement Agreements should be written in a manner that gives Port management broad authority when decisions are made that impact the Port financially.

Management Response/Action Plan:

The Tenant Reimbursement Agreement (TRA) process has become an important tool to more quickly and cost effectively deliver projects that tenants request at SEA. Without these types of agreements, the Port would not have been able to deliver this project, as well as many others; in a time frame that met the tenant's needs (Specific responses to audit findings and recommendations are at Appendix B). Yet when public funds are spent, an appropriate level of oversight and documentation is needed.

Although already reflected as a TRA requirement, management recognizes and agrees with the importance of enforcing the requirement for the tenant and their contractor to provide the Port with timely notification of change orders in advance of actual construction. Although there is often tremendous pressure to keep a project moving forward, to this end Properties, AVPMG and Construction Management are taking steps to adjust existing procedures to better support this timely review and approval of change orders and release of contingency funds in the future.

While we welcome the suggestions by this audit for "broad authority" and contractor oversight in TRA projects, we believe that placing additional requirements on the Public Private Partnership process begins to erode the benefits of the mechanism as a nimble and cost effective project delivery method, as well as introduces new liability and risk to the Port for work performed by tenants and their contractors that we are currently shielded from. There is a balance to be struck between the inherent efficiency of tenant administration of the work and Port exercise of detailed control.

By the end of 2018, management will reexamine tenant reimbursement policy to confirm the Port's interests and risks are appropriately reflected in TRA documents and policies. Policy review will also consider documentation requirements and procedures to ensure cost reasonableness.

APPENDIX A: RISK RATINGS

Findings identified during the course of the audit are assigned a risk rating, as outlined in the table below. The risk rating is based on the financial, operational, compliance or reputational impact the issue identified has on the Port. Items deemed “Low Risk” will be considered “Exit Items” and will not be brought to the final report.

Rating	Financial	Internal Controls	Compliance	Public	Port Commission/ Management
HIGH	Large financial impact Remiss in responsibilities of being a custodian of public trust	Missing, or inadequate key internal controls	Noncompliance with applicable Federal, State, and Local Laws, or Port Policies	High probability for external audit issues and/or negative public perception	Important Requires immediate attention
MEDIUM	Moderate financial impact	Partial controls Not adequate to identify noncompliance or misappropriation timely	Inconsistent compliance with Federal, State, and Local Laws, or Port Policies	Potential for external audit issues and/or negative public perception	Relatively important May or may not require immediate attention
LOW/ Exit Items	Low financial impact	Internal controls in place but not consistently efficient or effective Implementing/enhancing controls could prevent future problems	Generally complies with Federal, State and Local Laws or Port Policies, but some minor discrepancies exist	Low probability for external audit issues and/or negative public perception	Lower significance May not require immediate attention
Efficiency Opportunity	An efficiency opportunity is where controls are functioning as intended; however, a modification would make the process more efficient				

APPENDIX B: ADDITIONAL DETAIL – MANAGEMENT RESPONSE

The following reflects specific responses to the examples (1-3) referenced in the finding on Page 6:

1. Regarding the three bids referenced in Example 1, the design scope increased substantially as a result of two significant design changes that were within the project scope authorized by Commission and directed by the Port during the 15% design review. These Port-directed scope changes were financially consequential, but are not referenced in Internal Audit's finding.

> Existing HVAC equipment located nearby did not have sufficient capacity to serve the new SkyClub as was originally planned. This resulted in a protracted design investigation by ECH and their sub-consultants to determine whether the required HVAC equipment could be installed on the roof of the new lounge. It was then discovered that the existing lounge building structure couldn't support the weight of the new HVAC equipment, which led to a further investigation to identify other suitable locations. No fewer than 16 different options were explored before the final site was chosen. This effort lasted over 2 months.
>
> Major components of the electrical infrastructure for the lounge also needed to be moved from their original location in order to accommodate work being completed for two other projects, one of which was already in advanced design.

2. Regarding the sound practice concern referenced in Example 2, the scope and complexity of the concrete work that Delta's contractor self-performed also increased significantly between their original bid at 30% design and when the Preliminary Guaranteed Maximum Price (PGMP) for the project was determined at 60% design. This change was due to unforeseen site conditions related to an operationally constrained work site. The added costs due to actual site conditions were not noted in Internal Audit's assessment.

3. Regarding the contingency fund referenced in Example 3, it is standard practice for all construction projects to have a similar contingency fund to deal with change orders and unforeseen conditions. It is important to note that Delta was not able to utilize these funds until after Port staff determined them to be the financial responsibility of the Port. Although Management does not refute the delayed timing of the Port's review, each Additional Service Request and Change Order Request (ASR/COR) on this project was subjected to the same rigorous review and approval processes that are in place for Port controlled Major Works/Capital Projects. Internal Audit confirmed through their review of the detailed project documentation that many ASR/CORs were found to have no merit by Delta and/or the Port and were rejected in whole, while the final cost of many other ASR/CORs was significantly reduced.