INTERNAL AUDIT REPORT

LIMITED OPERATIONAL AUDIT

PIER 66 - NORWEGIAN TENANT IMPROVEMENT PARTNERSHIP

August 2015 - October 2017

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EXECUTIVE SUMMARY

Internal Audit (IA) completed an audit of the Port of Seattle (Port) and Norwegian Cruise Line Holdings LTD. (NCLH) tenant terminal improvement project for the period August 2015 - October 2017. The objectives of this audit were to determine whether Port staff followed policies, procedures, and Lease Agreement (Agreement) requirements.

In August 2015, the Port entered into the Agreement with NCLH to redevelop the Bell Street Cruise Terminal at Pier 66. The redevelopment expanded the facility to accommodate 4,500 passengers, both embarking and disembarking, from a single vessel. The Port was responsible for up to one-half of the project costs not to exceed $15 million.

This Agreement capped the financial risk to the Port at $15 million and relied significantly on external firms to design and construct. Leveraging external expertise is frequently practiced for Port capital projects, but this sometimes could be perceived as transferring accountability. Port personnel understand the intricacies of public service, not only fiscal stewardship, but social and environmental commitments, which may not be fully appreciated or valued externally. Therefore, ultimate responsibility for success and risk of capital projects, regardless if the work is performed externally, remains with the Port.

The Agreement also leased the terminal to NCLH for 15 years until the end of the 2030 cruise season. The partnership between NCLH and the Port is intended to better accommodate future needs and trends in the Alaska cruise market and also benefits both parties by commensurately sharing in certain revenues.

In our opinion, Port staff generally performed effective oversight and management of the project. However, we identified an opportunity that will strengthen internal controls. This issue is discussed in more detail, beginning on page six.

1) Port Management should strengthen its monitoring and approval process of change orders.

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

Glenn C Fernandes

Glenn Fernandes, CPA
Director, Internal Audit

RESPONSIBLE MANAGEMENT TEAM
Ralph Graves, Sr. Director of Capital Development
Stephanie Jones-Stebbins, Managing Director, Maritime
Michael McLaughlin, Director Cruise Operations
Richard Jenkins, Director Seaport PMG

BACKGROUND

Seattle ranks as the number one U.S. West Coast cruise port, in number of passengers, with eleven different ships offering Alaska cruise itineraries. In 2017, the Port hosted over 1 million passengers. In 2018, passengers hosted are projected to increase to approximately 1.1 million. Seattle's cruise industry is thriving and fuels the region's economy. An estimated $2.7 million is infused into the local economy each time a homeport ship docks at the Port.

On August 14, 2015 the Port of Seattle (Port) entered into a Lease Agreement (Agreement) with Norwegian Cruise Line Holdings LTD. (NCLH) to renovate the cruise terminal at Pier 66. The agreement created a unique contractual relationship between the Port, a government agency, and a private entity, NCHL, leveraging the skills and assets of each entity.

The Agreement included a 15 year lease with NCLH with an option to extend the lease for an additional five years. The total cost of the renovation was estimated at $30 million. The Port agreed to invest up to one-half of the renovation costs, not to exceed $15 million, through its property tax levy. The renovation expanded space for processing cruise passengers from 44,000 square feet to 151,000 square feet, including the installation of two new passenger-boarding gangways, and an automated conveyor system that moves passenger luggage from curbside to ship. The facility now accommodates 4,500 passengers, both embarking and disembarking, from a single vessel.

As of August 2017, the Port paid approximately $14 million in renovation costs, $450,000 in fit and finish upgrades, and $68,000 in mitigation costs.

The Norwegian Bliss, currently under construction, will be the largest cruise ship homeported on the U.S. West Coast. The Norwegian Bliss will support 1,716 crew members and 4,004 passengers. It is scheduled to "set sail" from Pier 66 on May 30, 2018.

The Port receives Port Directed Cruise Fees based on the total number of disembarking and embarking cruise passengers at the Bell Street Cruise Terminal. The table below reflects the Port directed cruise fees:

PORT DIRECTED CRUISE FEES (DISEMBARKING AND EMBARKING PASSENGERS) *		
CRUISE SEASON	**PASSENGERS**	**TOTAL CRUISE FEES**
2016	224,308	$3,912,513
2017	234,606	$4,381,379

* Data Source: Billing Worksheet - Accounting and Financial Reporting

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 August 2015 – October 2017. 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:

<u>Payment applications</u>

- Obtained an understanding of the Port's monitoring of pay applications through inquiry and observation.
- Obtained NCLH's general ledger (G/L) project costs and reconciled to pay applications.

<u>Prevailing wages</u>

- Obtained an understanding of Port processes to verify compliance with prevailing wage laws.
- Reviewed general contractor and sub-contractor timesheets and paystubs to verify prevailing wages were paid.

<u>Construction oversight / change orders</u>

- Obtained an understanding of Port management's project oversight.
- Obtained an understanding of how the general manager processed and submitted change orders.
- Reviewed two change orders for reasonableness, accuracy, and allowability for reimbursement.

<u>Marketing allowance</u>

- Obtained an understanding of the marketing allowance and how it was applied.
- Reviewed supporting documentation on expenses charged to the marketing allowance.

<u>Cost/Benefit analysis</u>

- Reviewed the sufficiency and reasonableness of information provided to Port Commission for decision making.

<u>Maritime Museum asset disposal</u>

- Obtained an understanding of the disposal of Maritime Museum assets through inquiry with Port management.
- Verified that disposed assets were removed from the Port's financial records.
- Reviewed documents from the Asset Management Department to determine whether Port policy was followed.

<u>Fit and Finish Allowance</u>

- Reviewed pay applications and supporting documentation to determine if expenses charged to the fit and finish allowance were allowable and complied with the lease agreement.

SCHEDULE OF FINDINGS AND RECOMMENDATIONS

1) RATING: MEDIUM

PORT MANAGEMENT SHOULD STRENGTHEN ITS MONITORING AND APPROVAL OF CHANGE ORDERS

Changes orders (CO's) are a change from the original scope, drawings, plans, or specifications of a project. They may be caused by a change in local building code, unforeseen field conditions, design changes or as a way to account for allowances, refunds or alternates. CO's represent the largest financial risk in a construction project because the changes may not be necessary and/or costs may be inflated. Therefore, approval of both the scope and costs is critical to accuracy of payment requests.

This project included 14 CO's, six of which modified the scope at a total cost of $2.2 million.

Port Management actively reviewed, identified, and corrected monthly pay applications prior to making payment. Management was also engaged and frequently communicated with NCHL regarding the status and milestones of the project.

However, an opportunity exists for Port management to develop a process to review and approve CO's for reasonableness and accuracy. We tested two CO's that represented the largest financial change and identified the following exceptions:

- Eight approved subcontractor CO requests did not include quotes and/or a breakdown of costs to substantiate or support the cost of the CO at a total cost of $98,000.

- NCLH did not re-estimate the costs to determine whether the CO costs were reasonable prior to submitting the CO request to Port Management.

Recommendations:

- Develop a process to review and approve CO's. This process should include a review of documentation to substantiate the request. As a best practice, the Port should require the project manager, in this case NCLH, to provide a re-estimate of the costs to assess reasonableness.

Management Response/Action Plan:

Port management appreciates Internal Audit's review, findings, and recommendations on monitoring and approval of change orders.

Port's tenant Norwegian Cruise Line Holdings (NCLH) retained Bermello Ajamil & Partners as their consultant (Consultant) to design and manage the tenant improvement project at the Bell Street Cruise Terminal. The Consultant worked closely with NCLH's general contractor on implementing the construction under a Guaranteed Maximum Price contract. A series of change orders were executed with the general contractor as more investigative and design work progressed. Some change orders were executed to address field conditions, scope refinement, as well as implementation of additional design requirements imposed by US Customs and Border Protection late in the design process. Port management relied on NCLH through their Consultant team to exercise professional judgment on adequacy of change order supporting documentation from both the general contractor and its subcontractors. Before Port receives invoices for reimbursement and conducts its own reviews, NCLH management has already reviewed, approved, and paid the general contractor.

Port has limited its financial risks by capping Port's allowance reimbursement up to $15M (50% of the estimated project costs of $30 million) through terms of the lease agreement, and currently the total forecast project cost is over $30 million. Port management agrees there are opportunities to further reduce risks and will evaluate incorporation of additional requirements on minimal acceptable back-up documentation and re-estimates for change orders in future tenant improvement agreements. Management will coordinate with Legal and other divisions to ensure consistent application within the Port.

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				