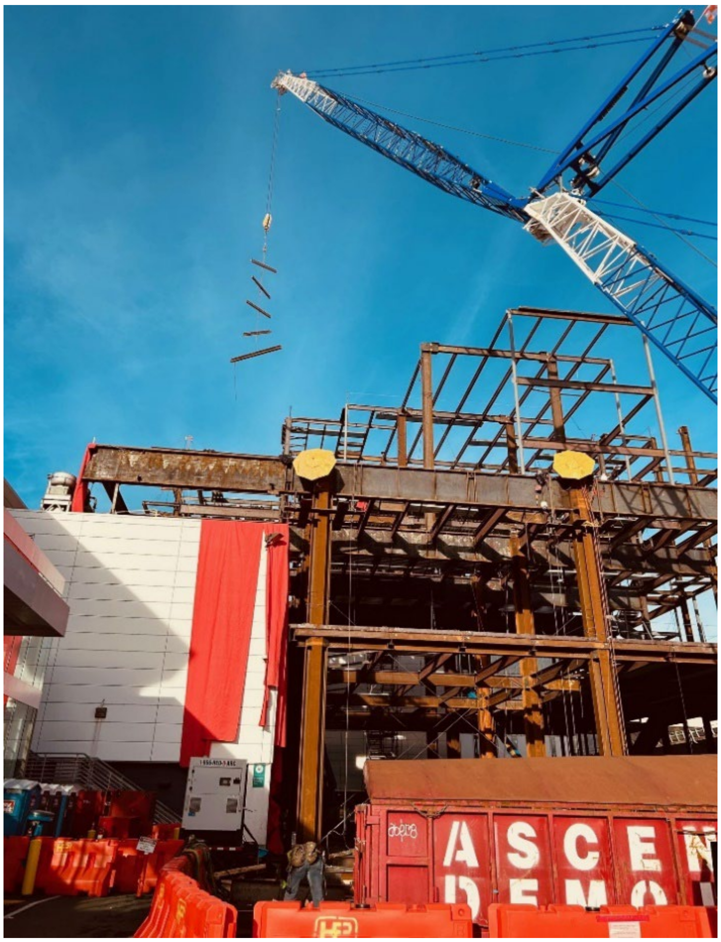
INTERNAL AUDIT REPORT

Operational - Capital Audit
Concourse A Building Expansion for Lounges - Delta TRA



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INTERNAL AUDIT

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Executive Summary

We completed an audit of the Concourse A Building Expansion for Lounges - Delta TRA Project for the period November 2021 through January 2024. The audit was performed to provide a systematic and independent examination of the quality of the Port's monitoring of the Project, determine if best practices are being followed, verify compliance with contractual requirements, and identify potential risks that may affect the Project's schedule and budget.

Delta Air Lines (Delta), in partnership with the Port of Seattle (Port), designed and is constructing an addition to the shell and core of the Concourse A building, located at the Seattle-Tacoma International Airport (SEA), which will house Delta's second Sky Club. The Project is being performed through a Tenant Reimbursement Agreement (TRA) between Delta and the Port. Delta is responsible for the Delta Lounge interior buildout costs while the Port is responsible for the remaining Project costs. Upon completion, there will be a new Delta Sky Club lounge and an updated *Club at SEA* lounge. The new building will add approximately 52,000 square feet and will include more than 36,000 square feet of new leasable space.

The TRA is being administered as a Guaranteed Maximum Price (GMP) contract in the amount of approximately $133.7 million, of which $111.5 million is the Port's responsibility. As this is a cost based GMP Agreement, the Contractor has the ability to move amounts between line items in the Schedule of Values, and it is warranted that a final GMP cost reconciliation audit be performed prior to final payment.

Overall, we determined that the multiple Port departments involved are actively monitoring the progression of the Project and following current Port procedures. We did identify opportunities for the Port to improve processes for this Project and future TRA projects. These opportunities are listed below and discussed in more detail beginning on page six of this report.

1. **(High)** An implicit agreement between Hensel Phelps and the Port's Risk Management Department settled on $10 Million in Commercial General Liability Insurance (GLI) at an estimated cost of $559,500. Hensel Phelps subsequently materially overbilled the Port for $100 Million in GLI, at a cost of $1,120,784.
2. **(Medium)** Hensel Phelps' Request for Reimbursement Submittal (RRS) for General Requirements did not include adequate supporting documentation.
3. **(Medium)** The Port has an opportunity to revise its procedures on future TRA projects in order to decrease the potential of reimbursing unallowable or duplicate costs within General Conditions.

We would like to extend our gratitude to the Port's Project Management Group, Engineering Construction Management team, Diversity in Contracting team, and the Risk Management team for their assistance and expertise during the engagement.

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Background

Delta, in partnership with the Port, designed and is constructing an addition to the shell and core of the Concourse A building that will house Delta's second Sky Club. The Project is being performed through a TRA between Delta and the Port. Delta is responsible for the interior buildout costs of the Delta lounge, within the new building shell, while the Port is responsible for the remaining Project costs. Upon completion, there will be a new Delta Sky Club lounge and an updated *Club at SEA* lounge. The new building will add approximately 52,000 square feet and will include more than 36,000 square feet of new, leasable space. The total contracted amount off the Project is approximately $133.7 million. The Port's responsibility was originally estimated at approximately $90 million which subsequently increased to $111.5 million.

The Scope of Work of this project includes:
1. Adding approximately 52,000 square feet that will provide shell space for two lounges and associated building systems.
2. Reconfiguring existing space to provide: additional leasable office area, an entry foyer, a replacement restroom, and vertical circulation.
3. Demolishing an existing airport building and constructing a new building to house the relocated Aviation Maintenance Department Passenger Loading Bridge.
4. Providing temporary restrooms for the Port's common use lounge in order to keep the lounge operational during construction.

In addition, the Project required enabling work so that Concourse A could remain operational during the underground utility work and construction. This included the relocation of a Maintenance Department Passenger Loading Bridge shop, vendor receiving, compactors, emergency dispersal area, a portion of the Airport Operational Area fence, employee bus turnaround, and maintenance vehicle parking.

The Project, specifically authorized by Delta, represents a strategic response to shifting passenger demand from the South Satellite to Concourse A following the opening of the International Arrivals Facility. With insufficient space to meet this demand, the Port agreed to permit Delta to design and construct the lounge addition in undeveloped space.

This project is identified as a Tier Two project under the Port's Sustainable Evaluation Framework. The project team examined sustainability concepts, including a triple-glazed electrochromic façade, all-electric appliances, low-flow water fixtures, signage for public transportation, an employee breakroom, and three new electric vehicle charging stations.

There were three budget adjustment requests during the Project based primarily on the progression of the Project's status (a more accurate cost estimate as the design reached 100%), lack of a final GMP, escalation in materials, and delays in construction.

Audit Scope and Methodology

We conducted the engagement 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 conduct an engagement to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our engagement objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our engagement objectives.

In some instances, we used judgmental sampling methods to determine the samples selected for our testing. In those cases, the results of the work may not represent the population as a whole.

The period audited was November 2021 through January 2024 and included the following procedures:

<u>Women and Minority Business Enterprise (WMBE) Utilization Goals</u>

- Obtained an understanding of how Port management was monitoring Hensel Phelp's (Hensel) compliance with utilization goals.
- Obtained a list of subcontractors and their contract values.
- Identified subcontractors who met the WMBE qualifications.
- Calculated the total WMBE subcontractors compared to the total Eligible Tenant Improvement value.

<u>Insurance Test</u>

- Identified subcontractors participating in the Contractor Controlled Insurance Program (CCIP).
- Reviewed their contracts and bid packages to ascertain the inclusion of General Liability Insurance (GLI).
- Verified the removal of participating subcontractors' GLI from the CCIP amount in the GMP.
- Collaborated with the Port's Director of Risk Management to review final insurance documents, determined whether insurance coverage met the Port's requirements, and assessed the potential for cost reductions.

<u>General Requirements/General Conditions</u>

- Obtained an understanding on how the Port was monitoring HP's compliance with the agreement regarding General Conditions (GC) and General Requirements (GR).
- Obtained supporting documents for GC and GR charges.
- Reviewed evidence to assess the allowability of charges.
- Determined whether GCs were billed on a reasonable percentage of project completion basis.

Schedule of Observations and Recommendations

1) Rating: High

An implicit agreement between Hensel Phelps and the Port's Risk Management Department settled on $10 Million in Commercial General Liability Insurance (GLI) at an estimated cost of $559,500. Hensel Phelps subsequently materially overbilled the Port for $100 Million in GLI, at a cost of $1,120,784.

Per *Exhibit E- Minimum Insurance Requirements* in the Tenant Reimbursement Agreement (TRA), The Commercial General Liability insurance (GLI) "per occurrence" limit is required to be a minimum of $15 million. Per discussion with Risk Management, the intent of the Port was to have contractors maintain $15 million in GLI, not materially more and that it will reimburse insurance costs up-to the required coverage limits. However, the contract wording says, "not less than" rather than "will be", allowing General Contractors to meet this provision in form rather than as intended by Risk Management.

Prior to approval of the Final Guaranteed Maximum Price (GMP), Hensel inquired whether the Port was willing to decrease the Commercial GLI "per occurrence" limit from $15 million to $10 million. Justification for the request was that Hensel felt the Port's insurance limits were high and costly for subcontractors to obtain. Through email discussion, the Port's Risk Management team agreed to the request, thereby creating an implicit agreement that the estimated cost would be $559,500 for the $10 million in Commercial GLI.

During the Project, however, Hensel submitted insurance invoices totaling $1,120,784, which included general liability insurance limits of $100 million "per occurrence". The Port has deferred reimbursement of the submitted insurance costs until final approval from Risk Management.

We also noted, that for the final agreed to GMP, the Port's estimator used Hensel's proposed insurance costs of $1,725,182. If Risk Management's estimate was used, the final GMP could have potentially been $1,165,685 million less.

Contractor Controlled Insurance Program (CCIP)

Hensel utilized a CCIP on this Project. The purpose of a CCIP is to consolidate insurance coverage for all parties on a job site into one blanket policy controlled by Hensel. A CCIP eliminates the need for individual contractors, and subcontractors, to obtain coverage on their own and provides Hensel comfort that sufficient coverage is in place. Although there are benefits, there are also risks to the Port when a CCIP is used.

In order to address the risks associated with CCIPs, with the assistance of the Port's Project Management Group, we made multiple requests to obtain subcontractor bid documents and subcontracts. Although there are "Right to Audit" clauses in both the Agreement between Delta and Hensel, and the TRA, Hensel refused to provide the documents citing that they "did not see the need," although we explained the audit reasons for the requested documents. Accordingly, our audit scope was limited, and we are unable to conclude whether subcontractor contracts included additional insurance that was being passed on to the Port, any insurance credits were properly passed on to the Port, or that other risks, described in **Appendix B,** did not occur.

Recommendations:

1.1 Contract insurance language should be updated to outline both minimum and maximum insurance requirements that will be reimbursed, thereby preventing the Port from incurring costs for additional insurance coverage.

1.2 TRA language should be updated to specifically describe the documents that are subject to audit and consequences if those documents are not provided when requested.

1.3 Risk Management should make the determination on what the final reimbursable insurance cost should be. Additionally, the total GMP should be adjusted accordingly.
1.4 When estimating a GMP, Port estimators should use amounts recommended by Risk Management instead of amounts proposed by contractors.

Management Response/Action Plan:

The following is a general portion of the response to all recommendations.

The project team includes: AV Project Management Group, AV Project Controls, Port Risk Management, Port Engineering - Construction Management, AV Business & Properties, and AV Commercial Management. Other necessary departments may be added to this team as the process proceeds.

A multi-year initiative to reevaluate and change the aspects of the TRA process is underway with Port stakeholders. Some of the measurable improvements are expected to be implemented in 2024 and others in 2025. The recommendations of this internal audit will be incorporated into this effort.

Management Response to Item #1: The project team agrees with the recommendation in improving future TRA contract language and will work with other project delivery groups and Risk Management to establish clear guidelines as they relate to acceptable insurance requirements and thresholds.

DUE DATE: 12/18/2024

2) Rating: Medium

Hensel Phelps' Request for Reimbursement Submittal (RRS) for General Requirements did not include adequate supporting documentation.

General Requirements (GRs) are also called direct costs which include Hensel Phelps' staff costs performing various functions for the job, including performing security, setting up barricades... etc. It also includes related equipment purchases and rentals. Article 4.2 of the Agreement between Hensel and Delta specified costs that are reimbursable, while Article 4.4 listed items that were not reimbursable. The current contracted amount for GRs is $3,237,881. Of that amount, the Port's portion is $2,326,281 for work on the core and shell. As of December 2023, Hensel billed $536,477 in GRs, of which $417,743 has been reimbursed.

During our engagement, we noted that Hensel submitted Job Cost Detail Report printouts from its accounting system, instead of actual invoices to support GR costs. In accordance with standard practices and Exhibit D §3 of the TRA, which states, in part, "Reasonable documentation establishing that Tenant has incurred all costs for which reimbursement is sought," monthly RRSs should include copies of invoices or other supporting documentation for each GR expense. Without actual invoices, it is difficult for the reviewer to ensure requested expenses are appropriate, belong to the specific project, invoiced to the contractor, align with project expectations, and requested amounts and dates are accurate.

Recommendations:

2.1 RRS approvers should obtain proper documentation, in order to reconcile GR costs previously reimbursed and require supporting documentation for future reimbursement requests.

2.2 Standard Operating Procedures should be updated to reflect the need for actual invoices as adequate support for reimbursement requests.

Management Response/Action Plan:

The Project Team will work with Aviation Departments that generate TRAs to determine the required documentation for reimbursement for General Requirements. Standard Operating Procedures will be updated to require adequate backup documentation to support reimbursement requests.

DUE DATE: 09/24/2025

3) Rating: Medium

The Port has an opportunity to revise its procedures on future TRA projects in order to decrease the potential of reimbursing unallowable or duplicate costs within General Conditions.

General Conditions (GCs) describe how a contractor will fulfill the requirements of a project. GCs also cover a contractor's indirect costs, such as staff salaries, safety, computers, and site management costs. The range of components that may be included in GCs heightens the potential that those costs may be also billed elsewhere in the contract, or otherwise unallowable if not properly vetted and monitored. The Port's portion of GC reimbursable costs is approximately $6.6 million.

Article 4 of the Agreement between Hensel and Delta outlined allowable and non-allowable GCs, however, the Agreement allowed Hensel to submit its proposed GC Costs as a lump sum amount, without requiring documentation supporting the components in its Final Guaranteed Maximum Price (GMP) proposal. During our meeting with the Port's Cost Estimator, we learned that professional judgment was used to determine the GC line item on the GMP instead of reviewing cost components. We note that there are benefits to using lump sum GCs, including reducing the documentation that needs to be reviewed monthly Reimbursement Submittal. However, there are limitations, such as:

- A contractor may try and save money in the short term by reducing staff at the expense of proper management.
- A contractor's direct costs may increase, and if the contingency is built in to the GMP as a separate line item (as the case on this project), the Port would pay all of the increase in direct costs and receive no savings in the lump sum general conditions.
- A contractor may be reluctant to spend more, although necessary, general condition money to get more supervision or engineering support if it looks as if the general conditions budget were in jeopardy.
- A contractor may attempt to shift general condition costs to direct construction costs by requiring subcontractors to pick up some of those costs in their contracts.
- A contractor may move "cost of work" line-item amounts into the GC line item, knowing that there would not be scrutiny of the costs.
- A contractor may attempt to bill all GCs early in the Project.

Given the risks previously mentioned, a better business practice would be for the Port to either reimburse actual GCs or require a contractor to include documentation supporting the components of GCs prior to negotiating a GMP.

Recommendations:

3.1 Although we suggest GCs to be reimbursed on a cost basis, if the Port continues to allow TRAs to use lump sum GCs, Port management should, at a minimum, require a detailed expected scope of work in the GC costs prior to agreeing to a GMP.

3.2 Port management should reimburse no more than the approved GC line item agreed in the GMP (plus any GC increase that may occur from Change Orders). If the General Conditions line item is increased on the Schedule of Values, the Port should require justification prior to approving the change.

Management Response/Action Plan:

The project team agrees with the recommendations. TRA contract language will be modified to require, at minimum, a detailed scope of work in General Conditions costs, prior to agreeing to Final GMP. Standard

Operating Procedures will be updated to require justification of an increase in General Conditions prior to approving the change.

DUE DATE: 12/18/2024

Appendix A: Risk Ratings

Findings identified during the audit are assigned a risk rating, as outlined in the table below. Only one of the criteria needs to be met for a finding to be rated High, Medium, or Low. Findings rated Low will be evaluated and may or may not be reflected in the final report.

Rating	Financial/ Operational Impact	Internal Controls	Compliance	Public	Commission/ Management
High	Significant	Missing or partial Controls	Non-compliance with Laws, Port Policies, Contracts	High probability for external audit issues and / or negative public perception	Requires immediate attention
Medium	Moderate	Partial controls or controls not functioning effectively	Partial compliance with Laws, Port Policies Contracts	Moderate probability for external audit issues and / or negative public perception	Requires attention
Low	Minimal	Functioning as intended but could be enhanced	Mostly complies with Laws, Port Policies, Contracts	Low probability for external audit issues and/or negative public perception	Does not require immediate attention

Appendix B: Contractor Controlled Insurance Program (CCIP) Risks

The following risks are associated with CCIP as described by HPM Audit & Contract Services.[1]

A way to overcharge involves the General Contractor including the agreed to CCIP cost in subcontract values and includes it as a line item in the Schedule of Values. The General Contractor adds a percentage to the low bid subcontractor's price for the CCIP insurance that is actually being purchased by the General Contractor even though the General Contractor has no intention of paying this amount to the subcontractor. The Owner is then asked to pay the General Contractor upfront most, or all, of the CCIP amount. The Owner is not aware that the General Contractor has included a similar amount in the subcontracts as well. The General Contractor then requires the subs to bill all of this extra insurance in their first pay application. The General Contractor collects this insurance amount from the Owner in addition to the CCIP amount disclosed in the pay application, pays the sub only the subs actual cost, not the CCIP amount that the sub was asked to bill, and therefore collects twice, or close to twice, the CCIP estimated amount from the Owner very early in the project. If the Owner catches on at the end of the project, then the total CCIP cost is reconciled, but the General Contractor has had the Owners money for a year or more.

A second issue is requiring the subs to provide proof of additional insurance. On this last point we have seen recently where smaller subs who did not meet the GL requirements of a certain General Contractor were required to buy insurance at higher limits. This additional insurance was then added to the subs bid, thereby increasing the bid, and increasing the cost to the Owner.

Another risk associated with CCIP is determining whether insurance credits received from subcontractors are tabulated properly and that the total of these credits are the same as the contractors charge for the CCIP program. HPM provided the following example of an overcharge:

> *A subcontractor indicated that recently they had turned in a bid with insurance of approximately $1,000,000. The insurance credit offered was $50,000, making the net subcontract bid of $950,000. When the subcontract was issued to this subcontractor, they were confused by the fact that the gross subcontract was $1,050,000 and the CCIP credit was now $100,000. While the net subcontract amount was still the same amount of $950,000, the changed items did not make sense to the subcontractor. It appears as if the contractor is trying to justify a higher cost of insurance to bill the owner. Assuming all things being equal, the contractor can make more money on the CCIP program by increasing the apparent cost of the subcontractor insurance.*

Without inspecting the original subcontractor bids and subcontractor contracts, this sort of deception is hard to detect.

[1] HPM Audit & Contract Services Newsletter, *Contractor Controlled Insurance Program Cost*, Volume 19, No.2, July 2006
HPM Audit & Contract Services Newsletter, *Some New CCIP Overcharges*, Volume 21, No.1, March 2008