



INTERNAL AUDIT REPORT

OPERATIONAL AUDIT

CRUISE RELATED INVESTMENTS

APRIL 2017 – JUNE 2018

ISSUE DATE: SEPTEMBER 18, 2018

REPORT NO. 2018-09

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EXECUTIVE SUMMARY

Internal Audit (IA) completed an audit of Cruise Related Investments for the period April 1, 2017 through June 30, 2018. The objectives of the audit were to assess the accuracy of financial and operational results presented to the Commission, to assess the reasonableness of assumptions used in the economic impact models and to evaluate the cost of cruise programs and the impacts to cruise profitability and operating results.

Financial results are audited on an annual basis, by Moss Adams LLP, our external auditor. Accordingly, our work placed dependence on work performed by Moss Adams. With the exception of the issue noted below, we concluded that financial and operational results presented to the Commission, were accurate in all material respects. We also concluded that the economic models used were reasonable.

Port management is committed to providing Seattle cruise passengers with a “Best in Class” experience and challenges themselves to be the leader within the cruise industry. Consistent with this vision, the Cruise Luggage Valet Program (program) was introduced as a complimentary service to cruise passengers disembarking from Seattle. The program delivers cruise passenger luggage directly to the airport, and provides them with opportunities to enjoy the city without their luggage, while bringing economic benefit to Seattle. The program also provides benefit to the airlines and to the cruise terminal area, by potentially reducing congestion.

The Port’s Cruise Luggage Valet Program, while innovative, does not generate revenue. As participation in the program increases, expenses also rise. Therefore, when requesting funding authorization from the Commission, information should be accurate and assumptions refined to reflect an accurate measurement of economic impact. We identified the following issue that, as the program evolves, will facilitate informed and sound decisions.

- 1) Port Management did not correctly utilize all data available when presenting the economic benefit of the Baggage Valet Program to the Commission. This resulted in a potential overstatement of the economic benefit to the Seattle area.

This issue is discussed in more detail on page seven.

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



Glenn Fernandes, CPA
Director, Internal Audit

RESPONSIBLE MANAGEMENT TEAM

Stephanie Jones Stebbins, Managing Director, Maritime
Michael McLaughlin, Director, Cruise Development and Maritime Marketing

BACKGROUND

Seattle cruise business hosts more passengers than any other Port on the West Coast of the United States with 11 different ships offering Alaska cruise itineraries. In June 2018, the Norwegian Cruise Line Bliss, a mega-ship capable of carrying 4,200 passengers, began offering port calls from Seattle to Alaska. In 2019, a larger ship, the Royal Caribbean Ovation of the Sea, capable of carrying 4,800 passengers, will provide service from Seattle to Alaska.

Revenue from the cruise industry in 2008 was approximately \$9.4 million and has grown to \$17.6 million in 2017. In 2017, Seattle hosted over one million cruise passengers which generated approximately \$17.6 million of revenue. Net operating income, before depreciation, was \$8.6 million, with approximately \$9 million in operating expenses (see table below).

Description	2014	2015	2016	2017	YTD* 8/31/2018
Total Revenues	\$12,993,430	\$14,413,620	\$15,421,861	\$17,595,810	\$15,355,398
Operating Expenses	(6,379,375)	(6,676,782)	(7,095,636)	(8,996,721)	(6,506,822)
NOI (before Depreciation)	6,614,055	7,736,838	8,326,225	8,599,089	8,848,576
Depreciation	(5,435,699)	(5,305,601)	(5,243,861)	(5,923,932)	(4,259,674)
Net Operating Income (NOI)	\$1,178,356	\$2,431,237	\$3,082,364	\$2,675,157	\$4,588,902

* YTD Revenues & Expenses do not include accruals and are not reflective of year-end results. Cruise revenues taper off significantly after cruise season, whereas expenses continue to be incurred.

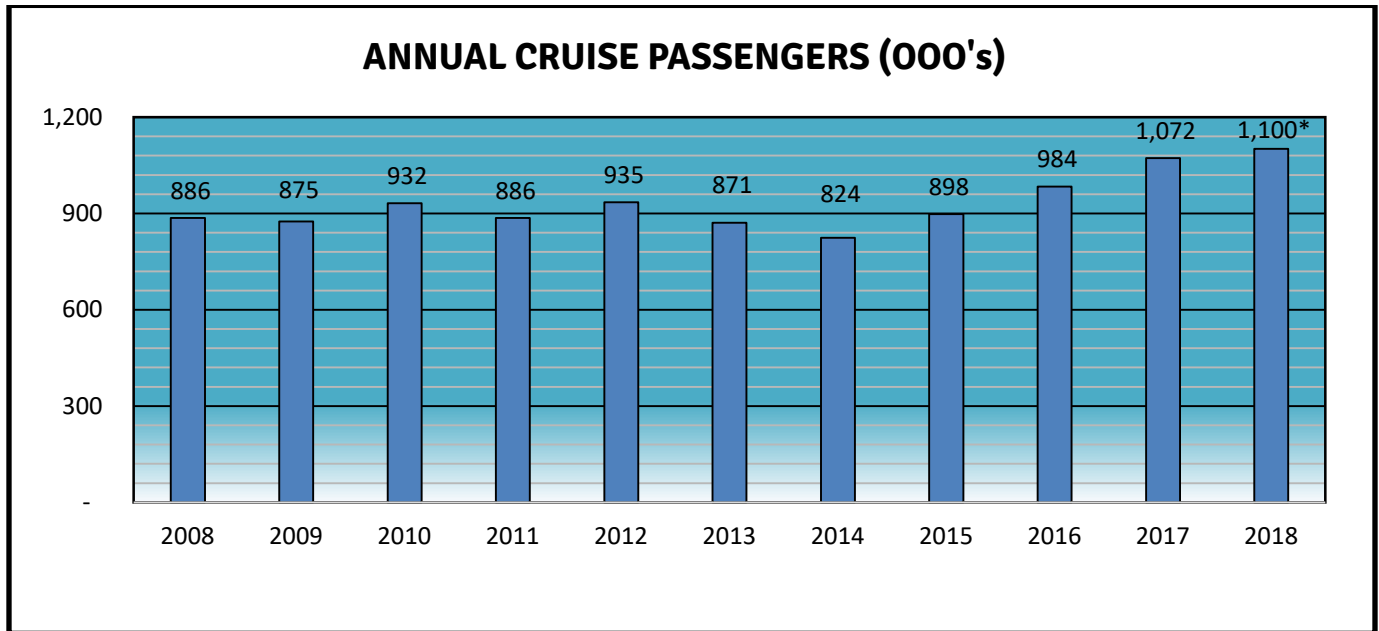
The Port operates cruise terminals at Pier 66 and Pier 91. Pier 66 was recently renovated and included expanded space for processing cruise passengers from 44,000 square feet to 151,000 square feet, installation of two new passenger-boarding gangways, and an automated conveyor system that moves passenger luggage from curbside to ship. The facility now accommodates 4,500 passengers, both embarking and disembarking, from a single vessel. Pier 91 is located north of the Seattle waterfront and is approximately 2 miles from the Space Needle and the city's retail core.

In 2017, the Port offered complimentary valet service to cruise passengers disembarking in Seattle. The cruise lines had previously provided this service to their passengers for a fee. Cruise passengers place their luggage outside the cabin door and it is delivered directly to the airport, thus giving passengers opportunities to enjoy the city without their luggage.

In 2017, actual costs of the program were approximately \$545,000 and as of August 2018, actual costs were approximately \$700,000. As participation increases, costs also increase with no impact to Port revenue.

Cruise Related Investments
April 2017 – June 2018

The table below reflects the number of cruise passengers from 2008 through 2018:



Data Source: Port of Seattle Cruise Facts 2018

* Estimate

Note: Passenger volume in the cruise industry is measured in both embarking and disembarking cruise passengers. Disembarking cruise passengers would be approximately 50% of the numbers provided above.

AUDIT SCOPE AND METHODOLOGY

We conducted this 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 April 2017 through June 2018 and included the following procedures:

Economic Impact Study

- Reviewed the 2013 Port of Seattle Cruise Economic Impact Report.
- Reviewed the 2014, 2015, and 2016 Annual Economic Impact Updates.
- Obtained an understanding of the assumptions used to develop the Economic Impact Model.
- Reviewed 2017 passenger and crew survey results.

Financial Impact, Reporting, and Governance

- Reviewed 2017 and 2018 Operating Revenues and Expenses.
- Discussed 2018 Budgeted Expenses and Revenues with management.
- Reviewed Commission Presentations and Reports regarding the Port's Valet Program.

SCHEDULE OF FINDINGS AND RECOMMENDATIONS

1) RATING: MEDIUM

Port Management did not correctly utilize all data available when presenting the economic benefit of the Baggage Valet Program to the Commission. This resulted in a potential overstatement of the economic benefit to the Seattle area.

The Commission memos, dated February 27, 2018 and March 23, 2018, indicated that the program generated more than \$4 million in economic impact to Seattle, before the participants travelled to SeaTac Airport. The information, as presented, incorrectly concludes that all 63,321 participants stayed in Seattle, spent \$63.64 on average, and generated an economic impact of more than \$4 million.

On August 11th, 13th, 18th, and 20th of 2017, the Port's Business Intelligence Team surveyed 1,253 passengers at the Terminal 91 balconies, as they disembarked from Cruise Ships. The survey results identified that approximately 64 percent of passengers that used the Baggage Valet Program, went directly to the Airport. While available, Port management did not use the results from this information, in their presentation to the Commission.

Additionally, the program assumes an individual will spend \$63.64 in Seattle. This number comes from a methodology created by Visit Seattle, utilizing restaurant and retail segment credit card data, to identify what the average person spends in Seattle during a six hour stay. The methodology also includes an assumption that the individual will spend approximately \$17.63 in transportation costs, from downtown Seattle to SeaTac Airport. Transportation costs are incurred by cruise passengers, regardless of whether they participate in the valet program. Therefore showing this as incremental economic benefit to the region is incorrect. An adjusted economic benefit based on Visit Seattle's projections would be approximately \$46.01 per passenger.

By adjusting the assumptions to reflect the approximately 36% of participants in the Baggage Valet Program that stayed in Seattle, and by adjusting the estimated spend in Seattle based on Visit Seattle's projections, a more realistic economic benefit to the Seattle area in 2017, would be approximately \$1,059,000.

The program has other benefits including: a benefit to airlines, a potentially reduction in congestion, and a best in class experience for cruise customers, but these are independent of the economic benefit as presented to the Commission.

Recommendations

Management should assure that Commission presentations are accurate and that they utilize all relevant information that is available, to facilitate sound and informed decision making. We also recommend re-evaluating the assumptions used in future economic benefit models.

Management Response/Action

The Maritime Division and the Cruise team will ensure we use the best available data as we move forward. As the program matures, we will continue to refine the program as well as refine the ways we can measure impacts. We are committed to reporting those as accurately as possible and, in the future will not include transportation costs or the estimates for spending by the portion of passengers that went to the airport unless we have reliable data showing that they spend incremental money that would not have been spent without the program. We appreciate the review as we strive to improve our program.

Appendix

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				