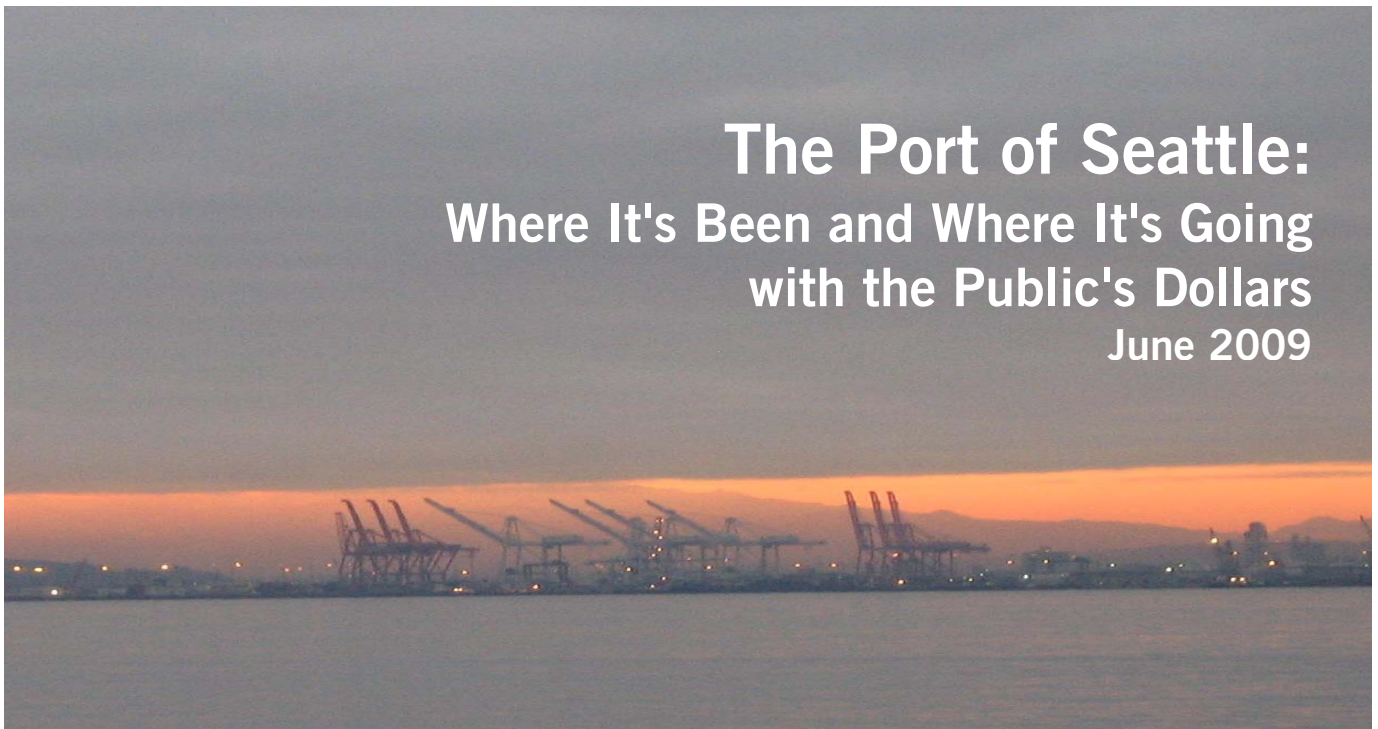


The Port of Seattle:
Where It's Been and Where It's Going
with the Public's Dollars
June 2009



Municipal League of King County
Municipal League Foundation

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The Municipal League of King County is a nonpartisan volunteer organization that has worked to ensure good government that is open, effective and accountable since 1910. Please visit us at www.munileague.org.

In 2008 we convened a committee of citizens to study the Port of Seattle. We wish to thank and acknowledge the hard-working volunteers who spent a year meeting, attending briefings and studying issues related to the Port:

Bruce Carter, Chair
Jane Bogle
Nancy Burkhalter
Paul Chilcote
Ted Collins
Bob Dowdy
Andrew Drake
Kathy Elias
Bartow Fite
Joe McGovern
Jay Lapin
Adam Lloyd
Mike Repass
Pat Sainsbury
Russ Segner
Lucy Steers
Gordon Strand
Rex Wardlaw

We wish to acknowledge the support of our Municipal League intern Sophia Le.

Many thanks are also due to the Port of Seattle staff and Commission. Numerous staff members made themselves available to brief us, answer our questions, and provide documents for our review. We also received briefings and information from former staff and Commissioners, the Washington State Public Ports Association and the City of Seattle.

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Executive Summary

The Municipal League Foundation Port of Seattle study committee met for over a year to review the Port's business activities, finances and governance, its use of public resources, its economic sustainability, and its transparency and accountability to the public. Our focus has emphasized the non-aviation Port activities which receive most of the subsidy from the annual tax levy. The history of citizen advice and feedback to the Port of Seattle is extensive and many of the points we raise today have been made before by the League and others. Our intent, consistent with the Municipal League's mission, is to stimulate public dialogue about what we expect as citizens and taxpayers and highlight areas for governmental improvement.

The Port of Seattle Commission and the CEO have committed to reform of the Port's decision-making to provide greater transparency and accountability with high ethical standards. We hope that the recommendations in this report will be helpful in that endeavor. Many of the issues addressed in this report are within the scope of the Port's current Century Agenda program. We believe that our recommendations should be considered with theirs and adopted as a useful tool in rebuilding public confidence in this institution which is vital to the economy of our region. The League will continue to monitor and comment on the administration of the Port.

This report discusses our findings and recommendations in four broad areas:

- 1. Mission.** The Port of Seattle's currently stated mission is overly broad and gives insufficient guidance on what activities the Port should engage in and when public resources should be used. The Port's core mission should focus on providing infrastructure for commerce in freight, passengers and the maritime industry while seeking to promote new economic development.

Recommendation: The Port Commission should revisit its mission statement and refocus it on core activities that do not duplicate the functions of general purpose government or the private sector.

- 2. Use of Public Resources.** The rationale for the Port's use of public resources is often not well justified to the Commission or the public.

Tax Levy. The Port's reliance on its public taxing authority has grown dramatically in recent years and levy revenues have been committed to broad "community benefit" purposes outside the core mission. Appropriate uses for the levy are limited, we believe, to infrastructure development to expedite the flow of commerce and to mitigating environmental damage from Port activities.

Recommendation: The tax levy should be utilized in a more transparent manner in Port projects, with taxpayer funding sought in specified amounts for particular projects when internally generated funding sources are fully committed. Substantial non-core projects should be submitted to the voters.

Real Estate. The Port has amassed hundreds of acres of prime real estate, many of which are underutilized, undevelopable or suffering from deferred maintenance.

Recommendation: The Port should annually review its investments in real estate to determine the value of each of its holdings, the return on each holding and whether the assets are being employed in a manner that is economically beneficial for the public. Uneconomical properties and properties not needed for the core mission should be sold or transferred to other governments.

- 3. Accountability and Transparency.** The Port justifies nearly all of its decisions on broad claims of “economic impacts.” References to large numbers of jobs created or taxes generated are meaningless without analysis of the related costs that produce such benefits and the forgone opportunities that might have been sought.

Recommendation: When making major investments or entering into long-term contracts, the Port staff should revise its processes to present the costs and benefits of all viable options for Commission and public consideration. All activities should be evaluated for consistency with the core mission.

- 4. Culture and Governance.** In the past, the Port’s hybrid functions as a quasi-governmental and quasi-private entity have led to a culture that has raised significant issues about uncompetitive deal-making, poor accountability, cronyism and ethical lapses.

Recommendation: The Commission should reaffirm its emphasis on public interest and ethics by making an ethical culture and transparent best practices an explicit Commission oversight function and a key management responsibility of the CEO and senior executives.

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Introduction

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The Port's Mission

The Washington State legislation that authorizes port districts states as their enabling purpose:

*"Port districts are hereby authorized to be established in the various counties of the state for the purposes of acquisition, construction, maintenance, operation, development and regulation within the district of harbor improvements, rail or motor vehicle transfer and terminal facilities, water transfer and terminal facilities, air transfer and terminal facilities, or any combination of such transfer and terminal facilities, and other commercial transportation, transfer, handling, storage and terminal facilities, and industrial improvements."*¹

This statement is fairly specific with respect to what kinds of activities were originally envisioned for ports. Since the enabling legislation was written, ports have significantly broadened their scope of activity. The Port of Seattle, for example, has included general purpose economic development, office development and management, hospitality services, job development for low income individuals and environmental restoration among its recent activities.

The Port Commission's 2003 mission statement is very succinct yet as broad as it could be: **Creating Economic Vitality HERE**. This mission can be interpreted to allow just about anything, but provides little guidance on what the Port should be doing.

¹ RCW 53.04.010

Additional goals and objectives in various Port documents and plans enumerate a range of activities far beyond the enabling legislation. Little guidance is given on what core activities the Port of Seattle should engage in; how broadly economic development may be construed; when tax levy resources, rather than internally generated revenues, should be used; or when the Port may compete with private enterprise. The mission statement is so broad that it fails to distinguish between the activities to be promoted by the Port as a special district and the general government investments better left to the state, county, city and other specialized agencies.

The 1990 mission statement that the Port still refers to is somewhat more detailed:

The Port of Seattle's primary mission is to be a leader in providing services and facilities to accommodate the transportation of cargo and passengers by air, water and land; to provide a home for the fishing industry; and to foster regional economic vitality and a quality life for King County citizens.

The Port will also pursue other opportunities if they enhance its ability to achieve its primary mission or if they preserve scarce land resources – marine or aviation – of unique value for Port uses.

In accomplishing its goals, the Port will work as a partner with other public and private entities. The intent is to complement, rather than duplicate or compete with, the functions of general-purpose governments or the private sector.

In 2008 the Port embarked on a new strategic planning process called the Century Agenda, intending to update its mission and strategy in time for its 100th anniversary in 2011. In addition to its original focus on services and facilities for the transportation of cargo and passengers, the Port's agenda now includes more general economic development, real estate, environment, social responsibility and increasingly broad areas that overlap general government, the private sector and other special-purpose governmental entities.

These broad areas of focus provide great leeway to engage in many activities that stray far beyond the original purpose of the Port of Seattle and might be considered by some as a distraction. The Port's discretionary taxing power allows it to fund activities that normally fall to general government units which may lack funding resources.

As we outline throughout this report, the breadth of the Port's present activities makes it difficult for the public to judge which investments are appropriate uses of the Port's public resources and how the Port should be held accountable to its mission. A particularly thorny issue about appropriate Port activity was raised recently by the decision to acquire an Eastside rail line to preserve for transportation purposes a corridor that would otherwise likely be abandoned.

Burlington Northern Santa Fe Eastside Rail Corridor. There is little disagreement that the BNSF Eastside Rail Corridor is a unique regional asset and should remain as an intact right-of-way. It has a number of transportation potentials ranging from a somewhat passive bicycle and pedestrian pathway to that of a significant north/south Eastside transit function. To lose this rail corridor as a single ownership would be a great loss of opportunity for the region. The change in ownership from the BNSF to a public agency is an obvious and worthwhile regional goal.

The issue is not whether to put the BNSF Eastside Rail corridor into public ownership, but how to determine whether the proposed purchase by the Port of Seattle is consistent with its mission and how the Port arrived at the seemingly high purchase price of \$107 million (\$2.5 million/mile). The Port has argued that the corridor could be an important “backup” freight corridor in case of a natural disaster that interrupted freight traffic on the mainline. This argument may appear to make sense, except that when that has happened before, the BNSF did not use this corridor, but sent their traffic south through the Columbia Gorge. Furthermore, the Eastside Rail Corridor is not currently able to take any trains without substantial repairs that would presumably take as long to repair as most any problem that would require an alternative other than the Columbia Gorge route. Finally, many of the proposals currently being discussed for future use of the Eastside Rail Corridor, such as pedestrian and bike trail uses, are largely incompatible with heavy freight rail uses.

How did the Port arrive at the \$107 million price? Port and King County officials, acting within their rights, refused to provide their appraisal. The Port also elected not to disclose information about whether BNSF had rail-banked any property to any public agency in the past five years at a price exceeding the per-mile Eastside Corridor price. The Port stated it possessed no documents reflecting the assessed value of the right-of-way.

We believe that comparison of public bodies buying “rail-banked” right-of-ways is a reasonable method to determine the Eastside corridor’s value. A cursory sampling of recent West Coast railroad right-of-way transfers or “donations” from railways to public ownership suggests that the \$107 million price for the 41-mile Eastside corridor may be quite high. For example:

1. In 1998, the BNSF had rail-banked and “donated” its East Lake Sammamish line, adjoining the Eastside BNSF corridor south of Redmond, to the Cascade Land Conservancy for \$1.5 million or \$129,000 per mile. The “donation” price was 14% of the \$10,632,900 assessed value. CLC later sold it to King County for \$2.9 million which involved CLC’s costs of holding the property and defending title. Inflating the CLC purchase price to 2007 value, the purchase price becomes \$333,400 per mile.
2. *The News Tribune* recently reported that the City of Tacoma is on the verge of acquiring part of an abandoned line from BNSF for use as a pedestrian and bike trail. The BNSF would donate a portion of the right-of-way that cuts through the University of Washington, Tacoma. The BNSF, in trade, wants the city to close part of a street that now crosses its main line at a grade level crossing beneath Interstate 705.
3. According to *The Columbian* of Vancouver, Wash., the BNSF has agreed to sell about 18 miles of track to the Port of Vancouver for \$3.1 million (\$170,000/mile). The Port will get 17 acres of land currently owned by BNSF, along with the rail, switches, ties and ballast collectively valued at \$6 million. The right-of-way is already within the port proper, but BNSF or its corporate ancestors have owned and maintained it for more than a century.
4. The Port of Coos Bay, Ore., has agreed to pay as much as \$16 million for the 111-mile line (\$144,000/mile) that reaches the port from Eugene, Ore. The line hasn’t seen service since September 2007 when its current owner, RailAmerica’s Central Oregon & Pacific, shut it down because of unsafe tunnel conditions.
5. In August 2008 the Union Pacific Railroad agreed to sell a 32-mile branch line to the Santa Cruz County Regional Transportation Commission for \$14 million. The line

extends from Watsonville to Davenport via Santa Cruz, Calif., along the Monterey Bay coast. The price is down \$5 million from the original 2005 offer due to \$4 million needed for repairs (\$437,500/mile). (Source: *Trains* magazine)

The above examples run the gamut from a trade (i.e., a street closure) to a range of \$144,000 to \$437,500 per mile. In contrast the purchase price for the Eastside Rail Corridor's 41 miles is \$107 million, or approximately \$2.5 million per mile. Our research suggests that the value, if calculated at the midpoint of this range, should be closer to \$290,000 per mile or about \$12 million. Additionally, since the date of the agreement with BNSF, the value of King County real estate has declined significantly. We believe that if the Commission determines a clear nexus with its mission, the Port should seek a lower price consistent with the market for rail-bank "donations" to public agencies.

What is the value to the seller, BNSF? Currently it is negative. That is, the corridor is basically a liability because the BNSF is now paying taxes, insurance, maintenance and other costs. Yet there is no revenue (at least for the Woodinville-Renton section) and no short term prospect for revenues without significant capital re-investment. The BNSF would not be abandoning the line if it had potential to generate significant profits. Could the railroad sell off the corridor piecemeal for the estimated sale price? Unlikely, as such a sale would require approval by the Surface Transportation Board and would almost certainly be opposed by officials and citizens of the region. Additionally, the sale of hundreds of individual parcels and easements would generate huge transaction costs and years of legal effort that a reasonable owner would most probably want to avoid. Donating the entire line to the public would provide BNSF with a considerable tax write-off. If the BNSF agreed to use Port funds for needed rail improvements in the region (e.g., expanding the Stampede Pass tunnel to provide for double-stack railcars), some costs could be justified as strategic for freight mobility. But that apparently is not now the case.

The proposed BNSF Eastside Rail Corridor acquisition by the Port is an example of the kind of recent activity that has at best a tenuous relationship with the Port's mission and at worst seems poorly analyzed as an investment and lacking in accountability to the public interest.

We urge the Port Commission to revisit its multiple activities and establish a well-defined core mission statement for the Port of Seattle against which key future decisions can be evaluated.

Use of Public Funding and Resources

Until the recent economic slowdown, the Port was benefiting from a booming global economy that drove increasing freight and passenger business activity. Sharply rising property values and strong new construction in King County drove the property tax base higher too, yielding ever greater revenues from the tax levy. The Port made hundreds of millions of dollars of investments in land acquisitions and public infrastructure in support of Seattle's maritime industries and waterfront-related real estate ventures.

In comparison to competing seaports along North America's West Coast, Seattle may be challenged to remain competitive in expanding to meet growth going forward. In spite of a favorable geographic location relative to global markets, Seattle lacks adequate land to expand seaport terminals, lands are high in cost, there is growing truck and rail access congestion to and from marine terminals and lower cost alternatives exist elsewhere in Puget Sound, in Canada and elsewhere along the West Coast. Although some expansion in capacity can be

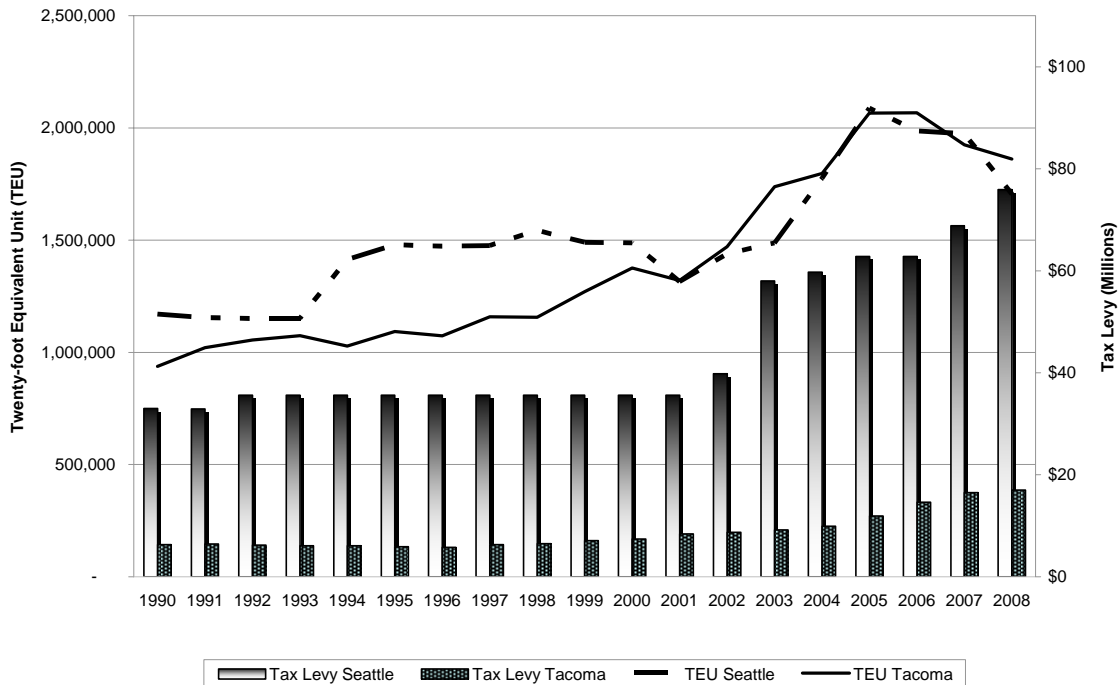
attained on the existing leased terminals, future terminal expansion would involve dramatically greater expense than for competing seaports. In addition to periodic West Coast long-range cargo forecasts (such as the recently completed WPPA Port Systems Study), we recommend periodic third-party reviews of competing West Coast port organizations, including Vancouver, Prince Rupert, Tacoma, Oakland and Los Angeles/Long Beach to determine whether the use of public resources to support and expand maritime and real estate business activity in Seattle makes economic sense in the years ahead.

Due to its very broad mission statement, the Port has over the years wandered into numerous activities that are peripheral to its core mission. Having the luxury of a non-voted tax levy and few mechanisms for holding the Port accountable for its use of public resources, the Port has gradually increased its reliance on the tax levy and has entered into investments and contracts that do not consistently generate a positive return. According to the Port's own figures, the Seaport lost money in five of the last 10 years. Without the subsidy from the tax levy (\$65.8 million in 2007), the bottom line for the Seaport and Real Estate Divisions would likely have shown a loss in all 10 years -- even if we assume that some of the levy-funded activities would not have been undertaken in the absence of levy funding. The extensive Port land holdings are not on the public property tax rolls and the economic benefits of Port activities are not always easy to determine.

We are troubled that the levy process lacks transparency and that the levy itself resembles a general subsidy to cover shortfalls across the Port's activities. We believe that the Port uses the tax levy to offset the fact that revenues in the Seaport and Real Estate Divisions continue to be insufficient to cover on-going capital costs and expenses. We do not think taxpayers should be satisfied with the general assertion that the levy is justified because the Port contributes to economic activity. We believe the levy should be used for those activities and investments of the Port that cannot reasonably be made self-sustaining by sound business practices and that are justified by specified benefits to the community, (and only after those activities and investments have been analyzed to ensure costs do not exceed benefits).

The Port's tax levy revenue, most of which is devoted to non-aviation activities, has in recent years increased significantly faster than business activity or job growth. The levy has increased by 136% since 2001, an average annual increase of 11% -- this also far exceeds tax levy revenue growth at the Port of Tacoma. The following graph shows the growth in container cargo shipping traffic (TEUs) and in the tax levy revenues at the Ports of Seattle and Tacoma.

Tax Levy TEU Comparison for Ports of Seattle and Tacoma



The graph indicates that the Port of Seattle currently collects more than four times the annual tax levy revenue than is collected by the Port of Tacoma even under similar millage rates. Since the Port of Tacoma’s TEU container traffic is comparable with Seattle’s, one would expect that the corresponding taxpayer contributions would be somewhat similar. Although the two ports are not perfectly comparable and Seattle’s business is more diverse than Tacoma’s, the magnitude of the difference suggests that the Port of Tacoma may be dramatically more cost-effective in the economics and management of its seaport assets.

Tax Levy Utilization

The Port’s present policies are not effective in identifying which activities are eligible for levy funding. We are critical of the Port’s current policies under which use of the levy to fund a project is indicated under the following conditions:

1. *There is a long lag between capital costs and project revenues; or*
2. *The project’s financial return will not support revenue bond financing; and*
3. *The project generates significant economic or other community benefits for taxpayers.*

The “Long Lag” Criterion. The first criterion, which requires a “long” lag between an investment and the realization of a return on the investment, does not indicate how long the lag should be in order to qualify the investment for levy financing. Since most capital projects involve a lag between investment and return on investment, the lack of specificity in the policy would result in most capital projects being eligible for financing from the levy regardless of their merits or consistency with the Port’s mission.

The Financial Return Criterion. The second criterion states that levy funding is appropriate if the rate of return on a project is less than the “current cost of debt” and implies that revenue bond financing cannot be justified for a project with such a low rate of return. If a project that is directly related to the Port’s main business functions has a rate of return that is lower than the cost of debt, then clear criteria are needed to determine whether such a project should be undertaken at all.

The Economic or Community Benefits Criterion. The third criterion for the use of levy funding simply states that the project should generate “significant economic benefits for taxpayers.” This condition is so broad that it is of little use in identifying projects that can be funded through the levy. Since the Port identifies a principal objective to promote economic development, it could be argued that everything the Port does confers “economic benefits for taxpayers.” There is no specification of how “significant” the benefits have to be in order to qualify for levy funding. In fact, the greater the economic benefits conferred, the less a given project would seem to qualify for levy funding, since projects conferring large economic benefits are more likely to be cost-effective and eligible for funding from the net revenues they generate. This criterion says little more than that levy funding can be used for general Port purposes.

It is possible that the second and third criteria are intended to capture projects of a more specific nature, projects which the Port characterizes as “public purpose projects.” These projects, which include the Port’s environmental clean-up efforts and the airport’s noise abatement project, are related to the Port’s core business purposes. If this is the intent of the levy use criteria, it should be more narrowly stated so that it is clear what type of project the levy is intended to be applied to. However, the Port has also strayed into public purpose or community investments that are only tangentially related to its core mission and appear to encroach onto the purview of general government; examples include the recently terminated subsidy of the Odyssey Maritime Museum, Port Jobs low-income job development, and the proposed purchase of the Eastside Rail Corridor. We acknowledge that some of these projects may have been required by development conditions imposed upon the Port by city or state government, but believe in such a case they probably should have been funded out of project budgets.

We are also concerned about the Port’s use of levy-backed general obligation debt rather than debt secured by the Port’s revenues. We support the Century Agenda Funding Panel’s proposed principle that the Port “...should be primarily funded through self-sustaining enterprises that are at the core of its mission.”

Current financial policies provide little constraint on the ability of the Port to use levy funding to finance its activities. The Port is currently reviewing these policies. In undertaking this review, the Port should be guided by the following two principles.

1. Levy funding of activities conferring public benefits that are not directly related to the Port’s core business activities may sometimes be appropriate. The Port’s current environmental mitigation efforts, its freight mobility project and its airport noise abatement projects fall into this category. However, public benefit projects with a lifetime cost in excess of a threshold amount to be defined by the Commission, or projects with only a tenuous relationship with the Port’s core business functions, such as the Eastside Rail Corridor, should not be funded through the levy unless approved by a vote of the people.
2. When debt financing is required in order to fund capital improvements, the default financing option should be the use of revenue bonds. General obligation bond financing

of projects directly related to the Port's core business functions should not be permitted unless it can be convincingly demonstrated that the use of revenue bonds would not be financially prudent. The counsel of independent financial advisors should be sought in making the determination that the use of revenue bonds is not feasible.

Refinancing Debt

Port staff continuously monitors conditions in financial markets to take advantage of opportunities to refinance outstanding bonds at lower interest rates. Normally when bonds are refinanced, the refunding bonds are of the same type as the outstanding bonds to be refunded - revenue bonds are used to refinance revenue bonds, general obligation bonds are refinanced by general obligation bonds. Yet there have been two instances in recent years in which the Port used general obligation bonds to refinance outstanding revenue bonds originally issued to finance core container cargo facilities. The effect of these two refinancings was to shift the burden of paying debt service on the bonds from the Port's revenues to the property owners of King County. The fact that the Port had issued the original bonds as revenue bonds indicated that the Port's revenues were sufficient to guarantee payment of principal and interest on the bonds. The higher level of security provided by taxpayer-backed general obligation bonds was therefore not necessary. The rationale for replacing revenue bonds with general obligation bonds is therefore unclear. The refinancings also had the effect of increasing the financial resources available to the Port, since the revenues that were used to pay principal and interest on the revenue bonds prior to the refinancings were now available for the Port's other purposes.

In 1999 the Port issued \$217.4 million in Special Facilities Revenue Bonds to finance a portion of the Terminal 18 project. Holders of the Special Facilities Bonds had no claim on the Port's general revenues for payment of principal and interest and the bonds were not considered liabilities of the Port and did not appear on the Port's balance sheet. In 2006 the Port issued general obligation bonds to refund Series A of the Special Facilities Bonds, of which \$59.4 million were outstanding. The minutes of the meeting on October 25, 2005, at which the Port Commission approved the refinancing, quote Port officials as stating that the use of general obligation bonds produced greater refunding savings than would have been achieved if the bonds were refinanced with another issue of Special Facilities Bonds.

While this statement is correct, the Port did not address the issue of whether similar savings could have been realized by issuing first-lien revenue bonds, which are secured by the Port's revenues. The effect of the Port's use of general obligation bonds to refinance the Special Facilities Bonds was to increase the Port's net revenues. The Port realized this benefit because the burden of paying debt service on these bonds was transferred from the Port's general revenue stream to the property owners of King County.

In 2004 the Port issued \$298.8 million in general obligation bonds. More than half of the bonds (\$167.5 million) provided financing for a number of capital improvement projects. The remaining \$131.3 million of bonds refinanced bonds issued in 1994 to finance the Terminal 5 expansion project, including \$39.5 million in revenue bonds. Again the effect of the refinancing of revenue bonds was to relieve the Port of the obligation to pay debt service on the refunded revenue bonds from its own revenues and to increase the obligation of King County property owners to pay debt service through the Port's tax levy. In the minutes of the meeting of November 25, 2003, at which the refinancing was approved, there is no indication that there was any discussion of the rationale for substituting general obligation bonds for revenue bonds in this refinancing.

The Port has adopted criteria for determining when general obligation bonds should be issued. One of the criteria states that general obligation bonds may be issued to finance a project when the project's internal rate of return is not high enough to justify the use of revenue bonds. In the two cases discussed above, the projects in question had already been financed with revenue bonds, indicating that the projects had a high enough rate of return to justify revenue bond financing. The justification for using general obligation bonds to refinance the revenue bonds is therefore questionable. In the 2004 refinancing it was argued that, since the Port was already planning a large general obligation bond financing, it was more efficient to combine the refinancing of the 1994 revenue bonds with the general obligation financing, rather than going forward with a relatively small stand-alone revenue bond refinancing. However, this gain in efficiency was realized by shifting responsibility for future debt service payments from the Port's revenues to the taxpayers of King County. There is no indication that this tradeoff was explicitly addressed.

Public Ownership of Prime Real Estate

We are concerned that the public policy rationale for the Port's continued ownership of its extensive real estate holdings is not regularly reviewed and justified. The Port's Real Estate Division owns several hundred acres of vacant King County real estate that are held in public trust to return economic benefits to the community. While Port-related business overall is calculated to generate thousands of jobs and millions in tax revenues in the region, the actual return on investments in many of the Port's land holdings appears to be negative.

Some of the Port's land holdings are vacant or underutilized, with some requiring costly infrastructure investments. Some of the properties have extensive deferred maintenance needs. The City of Seattle's restrictive zoning on other Port-owned property makes it difficult or expensive to achieve industrial or commercial development that is competitive in the regional market. The Port holds some 200 acres of such under-utilized real property assets. The vacant properties have been an economic disappointment, generating very little in terms of rents to the Port, leasehold taxes for state and local government or jobs and business development for the King County community. However, the Port currently holds these properties with no regular assessment of what steps are necessary to obtain cost-effective economic development of the property or whether continued public ownership is justified.

Although the Port's building occupancy remains high, the 2009 Port of Seattle budget includes continuing losses for the Real Estate Division after allowing for depreciation and it projects continuing losses through 2012. This continues a string of losses from commercial properties and under-utilized properties forecast for the 2005-2009 five-year period when the tax levy funding for commercial properties was four times as great as the business funding.

Since the Port's valuable real estate assets have been showing and are projected to continue to show negative returns, detailed analysis of holdings should be implemented.

The Commission has previously received detailed recommendations on this issue. In June 2001 the Commission adopted the Harbor Development Strategy 21 with procedures and criteria emphasizing the use of Port real estate assets for the maximization of financial value, positive revenue contribution, and financial return.² Included in the HDS 21 recommendations was the Portfolio Management and Analysis Process regarding Port properties, which we are

² Harbor Development Strategy 21, p.18, ¶ 4, p.20, Pier 48 ¶ 3, Shilshole Uplands ¶ 2.

showing as Attachment B to this report.³ These excellent guidelines require in-depth annual assessment of assets under management but have never been regularly implemented by Port staff. We recommend that the Commission require the staff to start reporting on the basis of the previously-adopted guidelines.

We acknowledge and appreciate that the new CEO has begun taking steps toward more systematic assessment and management of the Port's real estate holdings. He has formally established a new Real Estate Division under a real estate director. The new director has made significant progress by closing the Harbor Island Marina, managing the long-overdue disposition of Terminal 48, establishing a rental roll for centralized management of rental properties, and beginning to pursue the development of unused property.

We encourage the Port to prepare analyses to determine the value to the taxpayers of having the Port continue to own non-core properties which fail to make a positive revenue contribution to the Port's traditional core maritime, aviation and fishing businesses. We also urge that the Seaport and Real Estate divisions be tasked with developing a plan wherein future projects are funded from internally generated cash flows. In the absence of such a plan, we believe that the culture of dependence on the levy will continue indefinitely.

To illustrate, we cite two examples below of properties that have generated little Port or local government revenue under continuing Port ownership.

Terminal 91 Uplands. The failed development of the 57-acre Terminal 91 uplands north of Seattle's Magnolia Bridge -- which have remained unutilized, generating virtually no jobs, economic activity or tax revenues for the past eight years -- is a particular disappointment. The Port has invested and written off some \$7 million in studies and impact statements pursuing a mixed use development that is not allowed under the current industrial zoning. The Port's vision for the property as a mix of commercial and industrial uses may be the most practical given the cost of developing the needed infrastructure, but the conflict with the City of Seattle's zoning has resulted in an extraordinarily expensive slow-motion Port/City badminton match in which the public has been the loser. Both the Port and the City of Seattle should be faulted for failing to work together to create tax-generating economic development and family wage jobs on this prime site in the heart of the City of Seattle. We commend the current efforts of elected officials of the Port and the City of Seattle to work together to establish and implement a plan for the development of the Terminal 91 uplands at an early date.

Tsubota Steel site. Another significant failure in the real estate program is reflected in the April 2005 purchase and the subsequent administration of the Tsubota Steel property on the west side of 15th Avenue West, just north of the Magnolia Bridge. The 3.4-acre u-shaped property was purchased at a price of \$5.5 million for the announced purpose of supporting a proposed future Seattle Monorail station, Seattle's future reconstruction of the Magnolia Bridge or improved access to the T-91 uplands and the nearby National Guard Armory, a possible future industrial site. The purchase removed the site from local tax rolls, substituting the Port's lesser leasehold excise tax for property taxes.

The Monorail project was ended by Seattle's voters in November 2005, Seattle decided the Magnolia Bridge replacement should be south of the present span (not involving Tsubota site) and the property was not included in the T-91 upland proposal. For the intervening years, this property held without a purpose has not been reviewed and assessed by the Commission as

³ Harbor Development Strategy 21, pages 21 and 22

required under the adopted HDS 21 policies. The Port's annual leasehold excise tax payments to the state in lieu of property taxes amounted to only \$35,200 last year while \$71,000 in real estate taxes would now be collected if the property were privately held (and much more if it were redeveloped).

Port staff has stated that it is general policy not to sell real estate holdings; instead the Port prefers to hold them for development and to generate lease revenues. However, given that numerous property holdings are sitting under-utilized and generating little or no public benefit, proceeds from the sale of capital assets could be utilized in lieu of levy funding.

All of this suggests that the Port's HDS 21 policy for in-depth annual review of underutilized property must be renewed and enforced. The Port needs to comply with its previously-adopted policies requiring comprehensive annual parcel-by-parcel analysis of its holdings that would allow the Commission and the public to know the cost of holding them and policy considerations indicating whether particular parcels should continue to be held in public ownership.

The Commission should regularly assess whether the Port's and the public's costs of holding the property and the future economic benefits from continuing to hold the property outweigh the public benefits, including local tax revenues, that would flow from disposition of the property.

Accountability and Transparency

In 1993 the Municipal League published its report *Enhancing the Port of Seattle's Accountability to the Public*. The key findings and recommendations of the report related to: 1) setting goals and measurable objectives and preparing public reports on how these conform to the Port's strategic direction; and 2) developing a performance orientation that tracks and reports divisional and project-specific measures in brief annual reports to the public. We conclude that the Port has not followed these earlier Municipal League recommendations and that regular public reporting about particular Port strategies, projects, and performance results is still lacking.

We also conclude that the Port has no consistent policies or standards on when and how much to subsidize general public benefits such as trails or environmental projects and how to involve the public in such decisions involving indirect or diffuse benefits to the economy. We believe that when substantial Port resources are to be committed to general government operations only indirectly benefiting the core mission, the Commission should seriously consider encouraging community assessment and scrutiny by placing the issue on the ballot.

The Port Commission sometimes departs from its core mission into investments that have not been thoroughly analyzed in terms of cost and the likely economic benefits of the project. As discussed earlier, the proposed acquisition of the BNSF Eastside Corridor is a recent example that we have found troubling. While there may be good public policy reasons for the purchase, the Commission has not identified its strategic purpose to the Port. Furthermore, the due diligence in establishing the economic value of the purchase and the rationale for setting the purchase price has not been made available to the public by the Port or King County.

We do recognize that the Port of Seattle is a hybrid entity subject to both the political pressures of a government and the market pressures of a business and that some decisions may be made for political or competitive reasons that do not lend themselves to complete transparency. Nevertheless improved analysis and publication of information supporting major investments and contracts should be a routine practice. While we appreciate the Port's advance online publication of its agenda and the opportunity to comment at Commission meetings, the supporting memoranda are often insufficient for the public to make an informed judgment about the wisdom of a proposed action. We urge that the Commission briefing papers regarding unprivileged matters be attached to the online agenda of Commission meetings.

Financial Analysis and Competitive Port Comparisons

We find that there is often a disappointing absence of rigor in the Port's decision and approval processes regarding the economic sustainability of a project. We are concerned that staff presentations to the Commission for policy approval advocate a particular approach without fully specifying the costs, benefits and bottom-line impacts of different approaches considered by the Port or utilized by competing peer ports. Additionally, non-competitive negotiated contract awards were often used rather than the more time-consuming public bidding process. The incidence of these non-competitive contract awards has now been reduced under a January 2009 procurement policy promoting competition and advance planning.

We believe the Port of Seattle should develop a more rigorous review process for significant financial commitments. The Port should consider a review process that breaks each new significant financial commitment down into phases or "gates." Every proposed investment should be required to meet certain standards at each gate review before it is allowed to proceed. The first gate would address whether the opportunity is consistent with the Port's mission and strategic plan and would identify at a high level various alternatives to the proposed financial commitment and the methods that peer ports are utilizing to resolve similar issues. Subsequent gates which should involve presentation to the Port Commission for decision should include such factors as a financial analysis of the proposed investment including the effect on the bottom line for each alternative being considered (including revenues, costs, capital investment etc), an evaluation of the proposal's return on investment (and magnitude of other benefits, such as job creation potential or social/environmental mitigation/enhancement) as compared to other viable alternatives.

If a project does not meet the Port's financial criteria, a specific economic development justification should be required rather than a generic reference to the Port's unfailingly optimistic economic impact study. If a significant non-competitive contract award is planned, this should be justified in detail. Once the Commission made a selection among the alternatives, staff should develop a detailed implementation plan for the investment selected. Because gate reviews move from concept to detail, the organization ends up focusing its resources on the most important opportunities.

If significant revisions occur during or after project completion, there should be a comparison of the actual bottom line with the assumptions and projections used to approve the commitment at the outset. This kind of a disciplined process would introduce a consistent approach to all significant financial commitments, enhance clarity of purpose, improve accountability and provide an opportunity for continuous adjustment and improvement.

The process for approving a potential project would be for the staff to prepare a memorandum defining the work statement, the strategic objectives, possible alternatives and the

recommended action, the financial implications, the economic impact, the environmental/community impacts, the “triple bottom line” summary (overall impact), and the project schedule. The Municipal League has been concerned that important information pertinent to the decision-making process is often not included. Specifically, the memorandum should include the following:

- Disclosure of all relevant costs
- Justification for single-source supplier selection where applicable
- Comparison with other ports regarding the recommended approach and the anticipated financial outcome
- Rationale for the source of funds, particularly where levy funds are to be used directly or indirectly through general obligation bonds
- Specific justification for projects which do not meet the Port’s own financial criteria. A simple reference to the Port’s current economic impact study (where we believe the numbers are inflated, as discussed in a later section) is inadequate.

We illustrate these issues with a brief discussion of two projects recently approved by the Commission:

Long-term agreement with Carnival Corporation (CCCL) for use of the T-91 Cruise Terminal for 10 years. We acknowledge the objective of providing stability to the Port’s growing cruise business by protecting at least 50% of revenue over the next 10 years, but we have the following reservations regarding the analysis presented in the memoranda requesting Commission authorization:

- How does the forecasted financial return resulting from the revised tariffs compare with other cruise terminal operations, particularly Vancouver?
- The memorandum compares net present values between the original tariff and those resulting from the agreement. In both cases, these values are calculated ignoring the capital costs associated with the development of T-91 as a cruise terminal and any other capital costs associated with the cruise business. While this gives a fair comparison of the impact of the tariff change (and this was clearly the objective), it gives a misleading impression as to the magnitude of the Port’s anticipated bottom line losses under the cruise business plan. If these losses or gains were re-calculated and provided to the Commission and the public at the time of such a decision, it should stimulate closer scrutiny, bolder Port action to limit costs going forward or a mechanism to obtain revenue support from the establishments benefiting from their economic bonanza.
- The memoranda should have addressed the option of a competitive approach for obtaining stevedoring services, as is used in Vancouver, versus the negotiated agreement with Cruise Terminals of America LLP, under which the Port provides the capital in the pier and terminal, reimburses all costs and assumes all risks, while giving up a significant percentage of the revenues.

T-18 expansion project including the northern apron upgrade. This project has been ongoing for over 10 years, and project costs are now over \$250 million. The project fell far short of meeting the Port’s own criteria for the internal rate of return (IRR), the latest estimates being an IRR of 5.7% and a negative \$81.5 million net present value (NPV). Much of the funding has come from the tax levy or general obligation bonds backed by the levy. We believe that where major projects are clearly not justified under the Port’s internal criteria for NPV and IRR, and in particular where the use of taxpayers’ money is being proposed, there needs to be a detailed and convincing case made to justify the project based on other considerations. A casual

reference to the Port's current economic impact study (Martin report) is insufficient. The Commission and the public should be informed of the forecast sustainable economic benefits that are expected.

Finally, we support regular reviews of competitive factors such as: staffing levels, compensation levels, job creation, pricing of customer contracts, return on land holdings, local tax benefits, profitability of various business lines, and labor productivity. It appears that the Seaport staffing level for the Port of Seattle exceeds staffing for comparable functions at the Port of Tacoma. The Port is unable to produce the most recent such review of its staffing conducted approximately 10 years ago, so we recommend that the Commission direct such a study at an early date.

Economic Impacts of the Port

The Port primarily relies for its accountability to the public on periodic reports of economic impacts conducted by an outside consultant. These reports enumerate calculations of direct and indirect job and tax benefits generated by the Port and by secondary organizations. The reports do not calculate the costs that go with these benefits: tax levy funds required to subsidize Port activities, costs to the public of holding land off the tax rolls, or forgone commercial activity that might take place if the private sector were employing the land and infrastructure the Port owns.

The Port has periodically retained Martin Associates as consultants to evaluate the economic impact of its activities on the community. Martin is a respected firm that has conducted similar studies for many other ports in North America. The most recent report for the Port of Seattle covered 2007 and was released in February 2009. The report is a model of transparency, with the methodology and assumptions being clearly explained. Nevertheless, the Municipal League has reservations about using the optimistic impacts described in the report to justify significant expenditure of public funds.

We believe that the assumptions made by the Martin reports result in substantially overstated benefits, and we are concerned because these optimistic numbers are used, with little more detail, to justify projects requiring taxpayer funds. A particularly egregious example is claiming the full economic benefit generated by visitors using the airport. Visitors do not come to Seattle because of the airport; rather the airport is one link of a multifaceted network of infrastructure (including hotels, restaurants, ground transportation, etc.) that enables a visitor to fulfill the purpose of the trip, whether it is for business or pleasure. An objective assessment of the benefit that should be assigned to the airport would likely yield a much smaller percentage of the total. As airport visitors are 53% of the claimed jobs impact and 32% of the revenue impact for the entire Port of Seattle, this is no small matter. This type of thinking permeates the report and many other examples could be cited.

Commission discussion and voting sometimes suggest that the Martin report justifies overlooking analytical procedures of developing alternatives, maximizing revenues or minimizing costs. We believe that the Martin report provides useful information for port-to-port comparisons, but general references to the report should not be used for failing to conduct a rigorous analysis of the costs, benefits, profit or subsidy and forecast economic development resulting from available options for achieving a particular result. The Port staff needs to be responsible for their economic and financial analyses, but we believe that general references to the Martin optimism provide little real accountability.

Culture and Governance

It has often been noted that ports in Washington are hybrid entities with characteristics of both government and business. In the case of the Port of Seattle, its hybrid nature as a quasi-governmental and quasi-private entity have led to a culture that has borrowed not the best of each sector but some of the worst: uncompetitive deal-making, poor accountability, cronyism and ethical lapses.

In 2008 the State Auditor and a Port-appointed Special Investigatory Committee found evidence of fraud, poor compliance with state and federal law, improper ethical practices, lax oversight and poor internal procedures in the contracting and procurement areas. Under new management, the Port has begun to address these identified failures:

Response to State Auditor's findings of fraud and lax oversight. In August 2008 the Port of Seattle Commission approved Resolution 3605 which made changes to how the Commission delegates its authority throughout the organization. The new framework strengthened Port Commission oversight of the Port's capital construction programs and clarified how staff members must gain approvals on Port projects.

Response to McKay Special Investigatory Committee: In December 2008 an extensive compliance and ethics program and new employee training were instituted, as were new procurement policies and processes.

The Municipal League, in its letter dated October 6, 2008, made a number of observations and recommendations for enhanced governance and accountability at the Port. We understand those suggestions are under consideration and a draft plan responding to many of those recommendations is being developed. In this report we summarize the key points raised in the earlier letter.

Mission Statement. A revised Mission Statement for the Port should include an express commitment to best practices and ethics in the conduct of the affairs of the Port.

CEO Responsibility. The CEO should be made expressly accountable for compliance and ethics issues by including that responsibility either in Resolution 3605 or as part of setting the annual expectations for the CEO of the Port.

Ethics Code and Hotline. All employees of the Port should be held accountable for integrity and transparency in their dealings, by including in the ethics code of the Port language such as:

It is a violation [of the Ethics Code] for any employee to recklessly provide false, misleading or incomplete information in response to a question or request for information received in the employee's capacity as a Port of Seattle employee.

The ethics code should also be enhanced and clarified by strongly encouraging each Port employee to immediately report to a hotline any concerns about possible violations of ethics codes or other practices or policies of the Port, or any situation which poses a significant economic or environmental hazard for the Port of Seattle. In addition, the procedures relating to the hotline should be simplified and expanded to encourage employees and others to call the

hotline with any concerns they may have about ethics or business practice issues relating to the Port.

Training. Enhanced training should be conducted for Port employees on ethics and business practice issues to be sure that they fully understand their accountability for the ethics and business practice policies of the Port and how to raise and resolve any ethics and business practice concerns they may have.

Monitoring and Oversight. The Port should consider establishing a Chief Ethics and Compliance Officer to unify oversight of the ethics and business practices of the Port. The Port should also consider conducting a comprehensive assessment of compliance risks faced by the Port and its employees.

In addition, the Port should consider conducting a periodic survey of Port employees, to measure the level of employee satisfaction with the organization's ethics and business practices.

A renewed emphasis on public interest and ethics should be achieved by making an ethical culture and transparent best practices an explicit Commission oversight function and a management function of the CEO and senior executives

Conclusion

In conclusion, we believe that the Port Commission and new management at the Port of Seattle are beginning to address many of the issues enumerated in this report. We offer our report to encourage improved focus, continued strong oversight, full disclosure of business decisions and decision-making criteria, reporting of actual versus predicted financial performance, and an emphasis on continuous improvement in business practices.

Attachment A

The Port of Seattle's Use of the Tax Levy: Background and Issues

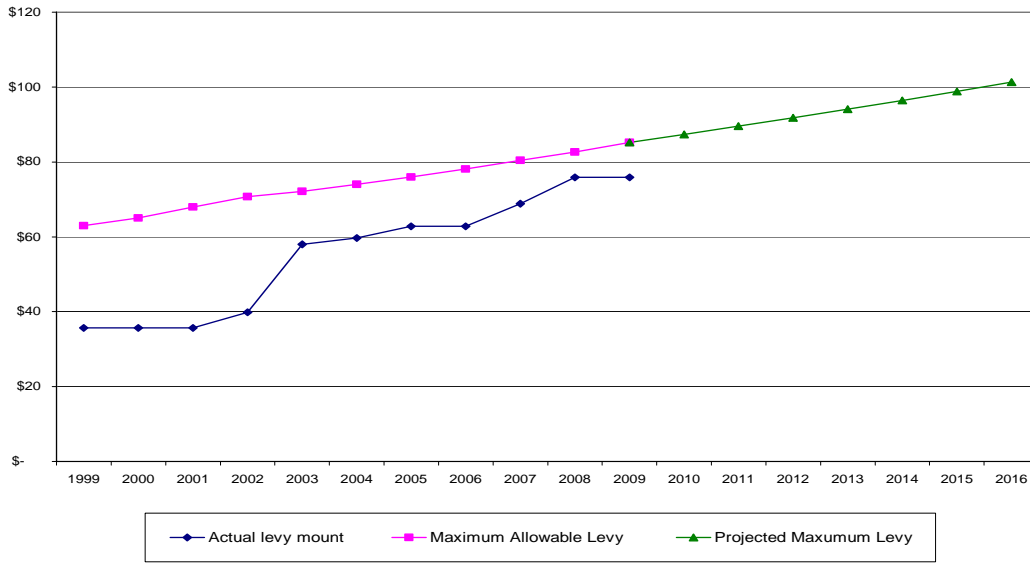
The Washington State Legislature established Port Districts in 1911 to reduce the influence of the railroads and private interests on the waterfront. The Ports were authorized to provide waterfront facilities and levy a property tax upon voter approval of a "scheme for harbor improvements". The Port was authorized to issue general obligation bonds for the improvements upon approval of 60% of the voters. Through time, there has been a gradual reduction in voter control over the taxing authority. In 1921, Ports were authorized to issue general obligation bonds up to 1% of assessed valuation without voter approval. In 1941, the Legislature allowed Port issuance of revenue bonds without a vote of the people, and a 1943 amendment authorized revisions of the scheme for harbor improvements without a vote of the people. In 1941, the Ports were authorized to create airports and broad powers to pursue economic development, tourism and trade centers have followed. The cumulative effect has been to reduce public control while enabling the port to move quickly on a wider range of projects.⁴

The Port of Seattle is presently authorized to impose a levy of up to \$0.45 per \$1,000 assessed valuation for "general Port purposes." However, the Port is constrained in the amount of funding it is able to raise through the levy by statutory limits on the property tax enacted through Initiative 747 in 2001. The amount of funding that can be raised in any year is limited to the highest amount levied in the three prior years, plus 1% and an allowance for new construction. Tax levies that exceed this limitation can be authorized by King County voters. If a taxing district has levied less than the maximum allowable amount in any year since 1987, it is able to "bank" the unused portion of the levy and use it at a later date. Since the Port did not use all of its levy authority in several of the years after 1987, it had accumulated substantial banked levy authority, which it has used in recent years to increase its tax levy by amounts far in excess of what would have been allowed under the statutory limitation. With new construction averaging about 2% of assessed valuation over the past several years, the maximum amount of the Port's levy has increased by about 3% per year.

In 2009 the Port originally proposed a levy totaling \$84.0 million, which would have brought the levy very close to the maximum allowed under the statutory limit (\$85.2 million). Facing negative publicity in the media for what amounted to a tax increase in the midst of a recession, the Port scaled back its 2009 levy to the 2008 level of \$75.9 million. The graph below shows the actual and maximum allowable levy amounts from 1999 through 2009 and projects the maximum allowable levy through 2016, assuming an annual increase of 3%. The graph below shows how the Port has been able to sharply increase the amount of the levy by using its banked levy authority. For several years prior to 2002, the amount of the levy remained constant at \$35.7 million. From 2001 through 2008, the Port's levy has increased by 113%, an average annual increase of 11%.

⁴ League of Women Voters, Washington State Public Port Districts: Governance Issues, 1992, p. 11-12.

**Actual and Maximum Levy Amounts:
1999-2009 Actual, 2010-2016 Projected**



Uses of the Levy in 2008 and 2009

State law authorizes the Port to use the proceeds of its tax levy for “general Port purposes”. While this authorization would allow the Port to use levy money for virtually any purpose, the Port has chosen to restrict its use of the levy to the funding of capital improvements (either directly or through the payment of debt service on general obligation bonds issued to fund its capital program) and to payment of the costs of programs providing “community benefits”. Since 2001 the Port has had a policy of limiting the portion of the levy that is used to pay debt service on general obligation bonds to 75% of total levy proceeds.

The table below shows the sources and uses of levy funding in the adopted 2008 budget, in the Port’s preliminary budget proposal for 2009 and in the Port’s adopted budget for 2009.

**Sources and Uses of Levy Funding
(In \$000s)**

	2008 (adopted)	2009 (proposed)	2009 (adopted)
SOURCES			
Projected Tax Levy Collection	\$75,899	\$84,010	\$75,899
Prio Year Levy Fund Balance	<u>23,106</u>	<u>36,800</u>	<u>36,800</u>
Total Projected Sources	<u>\$99,005</u>	<u>\$120,810</u>	<u>\$112,699</u>
USES			
Debt Service			
Existing G.O. Debt Service	\$40,434	\$40,422	\$40,422
Projected New G.O. D.S.	14,092	17,350	17,350
Total Projected G.O. Debt Service	<u>\$54,526</u>	<u>\$57,772</u>	<u>\$57,772</u>
Committed Capital Expenditures	<u>\$10,145</u>	<u>\$32,476</u>	<u>\$32,476</u>
Expenditures for Community Benefit Programs			
Seaport Freight Mobility	\$7,540	\$6,705	\$6,705
Environmental Expense	4,336	4,232	4,232
Port Jobs	46	46	46
Aviation NOISE Projects	12,275	9,075	650
Total Expenditures for Community Benefit Programs	<u>\$24,197</u>	<u>\$20,058</u>	<u>\$11,633</u>
Other Capital Expenditures	<u>\$0</u>	<u>\$4,000</u>	<u>\$4,000</u>
Total Projected Uses	<u>\$88,868</u>	<u>\$114,306</u>	<u>\$105,881</u>
Projected Ending Balance (in 2008 adopted budget)	\$10,137	\$6,504	\$6,818
Projected Underexpenditure in 2008 (in 2009 proposed budget)	\$26,663		
Projected Ending Balance (in 2009 proposed budget)	\$36,800		

The table indicates the Port did not use all of the levy funding that was available to it in 2008. Available levy funding includes not only the amount of funding from the levy in a given year, but also unexpended levy proceeds carried forward from the prior year. In 2008, \$23.1 million in unused levy funding from the prior year was expected to be available. The 2008 budget showed a projected ending balance of \$10.1 million, which was expected to carry forward to 2009. The 2009 budget documents actually show a much greater amount (\$36.8 million) carrying forward to 2009. This indicates that at the time the 2009 budget was being prepared actual expenditure of levy money in 2008 was expected to lag behind the 2008 budget estimates by \$26.7 million. Slightly more than half of this under-expenditure (\$14.1 million) is attributable to the fact that the Port was unable to issue general obligation bonds in 2008, due to the crisis in credit markets. It is not clear where the remaining under-expenditure of \$12.6 million accrued, but since the Port had no choice but to spend \$40.4 million for debt service on outstanding general obligation bonds, the remaining under-expenditure must have occurred in the \$10.1 million budgeted for "Committed Capital Projects" and in the \$24.2 million budgeted for community benefit programs. In percentage terms, the under-expenditure of \$12.6 million in these categories represents 36.7% of the amount budgeted.

The table also shows that the 2009 proposed budget assumed a substantial increase in the amount of levy funding planned to be spent in 2009 over the amount budgeted in 2008. The 2008 adopted budget called for levy expenditures of \$88.9 million; the proposed 2009 budget showed levy expenditures of \$114.3 million, an increase of 28.6%. The percentage increase in proposed levy expenditures rises to 83.8% when the amount proposed for 2009 is compared

with the \$62.2 million actually expected to be spent in 2008, taking into account the projected under-expenditure. Facing strong criticism in the media and from citizen groups, the Port Commission ultimately decided to leave the amount of the 2009 levy at the \$75.9 million adopted for 2008, a reduction of \$8.1 million from the proposed level. This reduction was absorbed by deferring \$8.4 million in airport noise reduction projects for the Highline School District from 2009 to 2011. All other uses of levy funds were left unchanged.

The increase in levy funding in the adopted 2009 budget will go to support capital expenditures, either directly or through payment of debt service on general obligation bonds issued to finance capital projects. Levy funding for "Community Benefit Programs" is actually projected to decline sharply from 2008 to 2009, largely as a result of the deferral of the Highline School District noise reduction project.⁵ Capital costs and general obligation debt service payments funded from the levy increase from \$64.6 million in the adopted 2008 budget to \$94.6 million in the adopted 2009 budget. Again, the increase is really much larger when the under-expenditure of 2008 levy funds is taken into account. The 2008 adopted budget document lists capital projects totaling \$146.4 million (including \$103.0 million for the eastside rail corridor) that are proposed for levy funding, either directly or through general obligation bond financing. In the 2009 budget, this amount increases to \$179.7 million, including \$107.0 million for the rail corridor. Direct funding of capital projects in the 2009 budget totals \$36.5 million, or \$26.3 million more than in the 2008 budget. Funding of capital projects with general obligation bonds is projected to increase general obligation debt service by \$17.4 million in 2009; in the 2008 adopted budget general obligation debt service was projected to increase by \$14.1 million.⁶

While some of the projects proposed for levy funding seem to be consistent with the Port's policy of using levy funds to support community benefit projects, such as the Green Port Initiative, the rationale for using the levy to fund other projects is less clear. For example, the 2009 budget shows levy funding for \$1.5 million of the \$3.1 million budgeted for the Terminal 18 project. The \$1.5 million figure corresponds to an element of the project designated as "S. End Fendering." Presumably this is the element to be funded by the levy. There are two other elements of the project ("Complete Const. Issue" at \$865,000 and "Complete R.E. Issues" at \$157,000) which are not proposed to be funded through the levy. It is not clear what characteristics of the "S. End Fendering" portion of the project make it eligible for levy funding while the others are funded from non-levy sources.

⁵ The adopted 2008 budget included \$24.2 million in levy funding for Community Benefit Programs. As noted above, actual expenditures for these programs in 2008 was probably much lower than this amount. The amount in the adopted 2009 budget for levy funding of Community Benefit Programs is \$11.6 million.

⁶ The figures in the Port's table of Sources and Uses of Levy Funding suggest that the amount of capital expenditures supported by the levy in 2009 is actually greater than \$179 million. The increase of \$17.4 million in general obligation bond debt service would support the issuance of about \$185 million in 25-year bonds at an interest rate of 8%. In addition the table shows \$36.5 million of capital expenditures directly financed with levy funding.

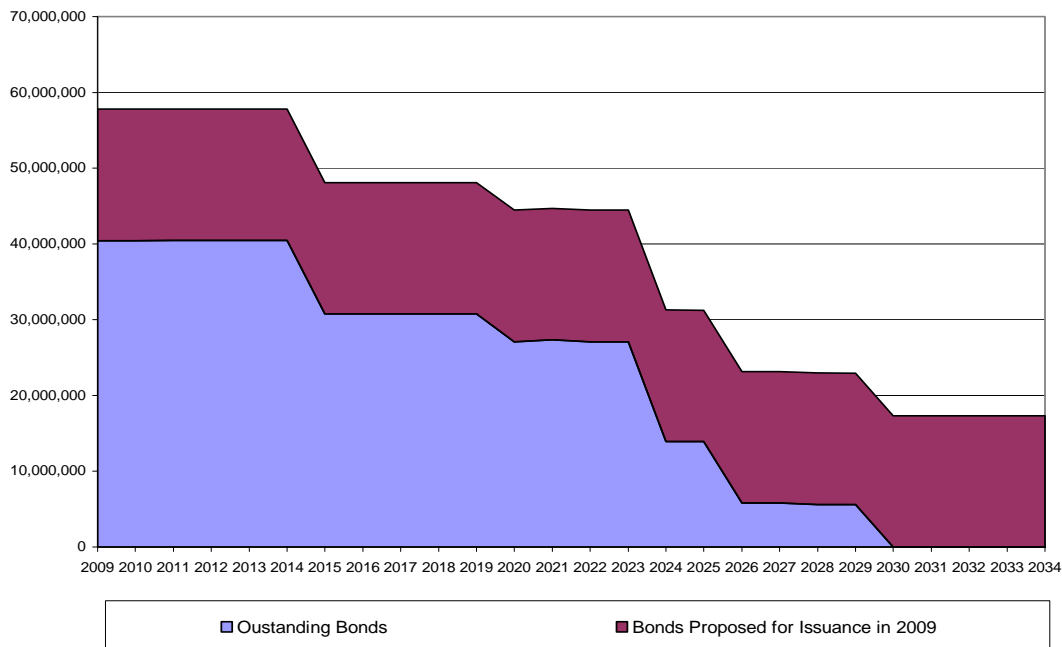
The Port's Debt Structure

The Port is authorized to use two types of bond financing to fund its capital improvements: general obligation bonds and revenue bonds. Funding for the payment of principal and interest on general obligation bonds comes from the Port's property tax levy. Debt service on revenue bonds is paid from the Port's revenues.

General obligation bonds. The Port is authorized to issue general obligation bonds without a vote of the people in an amount up to 0.25% of the assessed valuation of all property in King County. In addition, with the approval of 60% of the voters the Port could issue general obligation bonds in an amount up to 0.75% of assessed valuation. The Port's 2009 Budget and Business Plan (Preliminary) states that the Port could have outstanding a total of \$960.7 million in general obligation debt without a vote of the people (or \$562.9 million more than the \$397.8 million outstanding at the end of 2007). With the approval of 60% of the voters, the amount of general obligation debt that could be outstanding rises to \$2,882.2 million.

In issuing general obligation bonds the Port has obligated itself to raise sufficient funding through the tax levy to pay debt service on the bonds as long as the bonds are outstanding. In 2008, debt service on outstanding general obligation bonds was \$40,434,297. The adopted 2009 budget assumes that the issuance of additional general obligation bonds in 2009 will add \$17,350,000 to annual debt service. The chart below shows annual debt service on general obligation bonds from 2009 through 2034, including the debt service on bonds assumed to be issued in 2009.

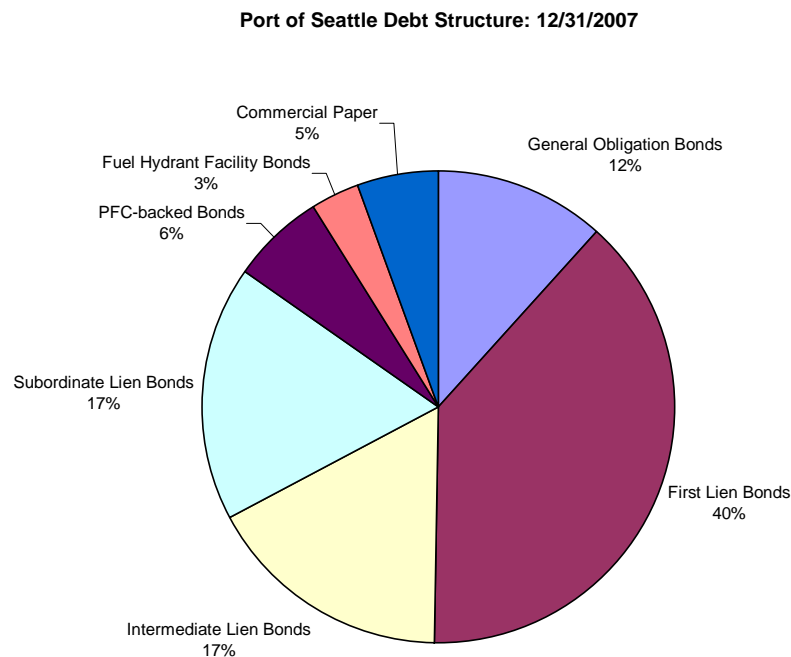
General Obligation Bond Debt Service: 2009-2034



Revenue bonds. General obligation bonds backed by the tax levy actually constitute a small portion of the Port's total outstanding debt. Most of the Port's debt has been issued in the form

of revenue bonds. In issuing revenue bonds, the Port commits to its bondholders that it will make available for the payment of debt service its net revenues after payment of costs of operations and maintenance. There are three types of revenue bonds currently outstanding, which differ in the priority of their claim on the Port's net revenues. First-lien bonds have the first claim. At the end of 2007 there were \$1,316,310,000 of first lien bonds outstanding. Intermediate lien bonds in the amount of \$573,445,000 and subordinate lien bonds with a par value of \$592,560,000 were also outstanding. In addition, the Port had issued bonds secured by specific sources of payment, rather than by the Port's net revenues. Passenger facility charges secured \$218,760,000 of bonds issued for improvements at the airport. Lease payments from the operator of the Port's airport fuel facility secure \$116,785,000 in fuel hydrant special facility revenue bonds. Finally, the Port also had outstanding \$186,250,000 of commercial paper.

The graph below shows the various components of the Port's debt structure and their relative shares.



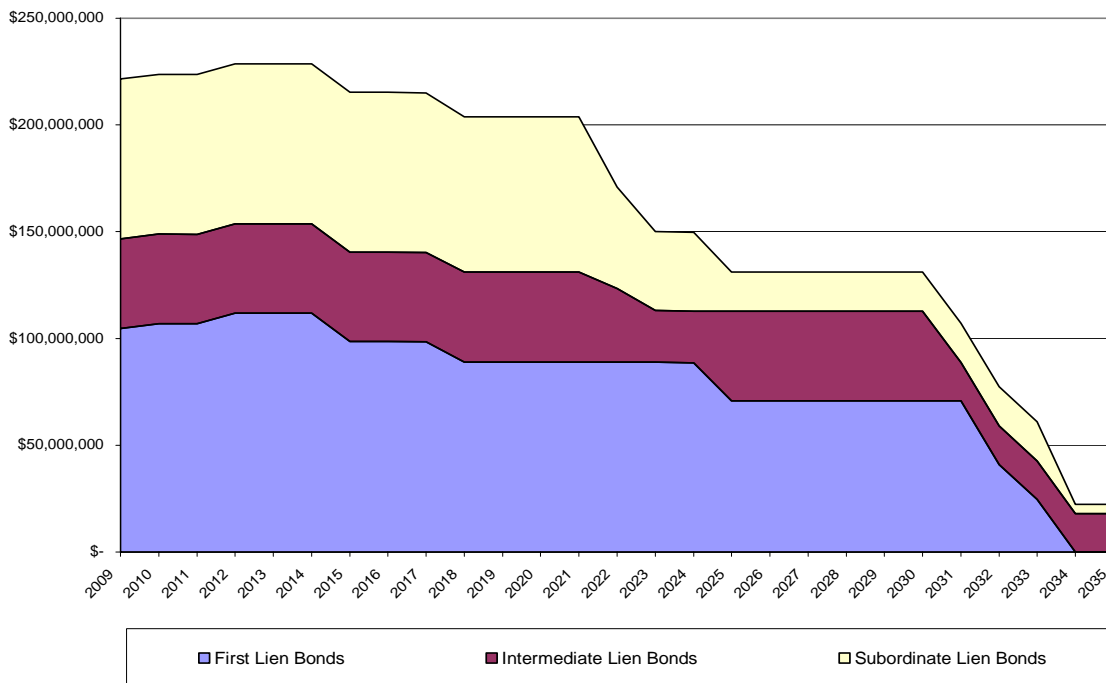
When it issues revenue bonds, the Port makes a commitment to its bondholders to maintain a specified debt service coverage ratio as long as the bonds are outstanding. The debt service coverage ratio is defined as the ratio of net revenue available for debt service payments in any given year to the amount of debt service payable in that year. Net revenue is defined as gross revenues minus operating and maintenance costs. Coverage is calculated within the framework of the "flow of funds," which differs from the standard accounting framework in that it does not take into account non-cash revenues and expenses, such as depreciation. The coverage ratio is one of the key indicators of credit quality. High coverage ratios provide greater security to bondholders that they will receive the principal and interest payments to which they are entitled. The required coverage ratio on the Port's first lien bonds is 1.35. In computing this ratio, the

Port is allowed to offset its operating expenses by the amount of its tax levy revenue that is not used for debt service payments. For intermediate lien bonds the required coverage ratio is 1.1, which is computed after payment of operating and maintenance expenses and debt service on first lien debt. For subordinate lien bonds, net revenues available after paying operating and maintenance expenses and debt service on senior lien and intermediate lien bonds need only be equal to the amount of debt service payable. However, in order to issue additional subordinate lien bonds, the Port must show that future debt service is covered 1.5 times by available net revenues.

The Port has decided that in the future it will use first lien bonds for the seaport and for general system purposes. Intermediate lien bonds will be used to fund aviation capital projects. The subordinate lien will be reserved for variable rate bonds. In its financial planning, the Port as a matter of policy targets higher coverage ratios than those required in its bond covenants. The Port plans to meet or exceed a coverage ratio of 1.80 on its first lien bonds and 1.40 on all of its outstanding revenue bonds. In 2007, the Port realized coverage ratios of 3.10 on its first lien bonds, 13.05 on its intermediate lien bonds, and 4.04 on its subordinate lien bonds. Net revenues of \$271.4 million were sufficient to cover total revenue bond debt service 1.89 times.

The chart below shows annual debt service payments on the Port's outstanding revenue bonds from 2009 through 2035.

Debt Service on Outstanding Revenue Bonds: 2009-2035



Financing Policies

In the Port's 2008 budget, three criteria are stated for determining whether a given project or activity should be considered for levy funding. The same policies are used to determine whether general obligation bonds should be issued for project financing. According to these policies, use of the levy to fund a project is indicated under the following conditions:

1. There is a "long lag between capital costs and project revenues"
2. "The project's financial return will not support revenue bond financing (i.e. the internal rate of return, or IRR, is less than the current cost of debt)"
3. "The project generates significant economic or other community benefits for taxpayers."

A project is considered eligible for levy funding if it meets **either** the first **or** the second **and** third criterion. In reality, the Port's stated policies are not very effective in distinguishing between activities that are eligible for levy funding and those that are not.

The "Long Lag" Criterion. The first criterion, which requires a "long" lag between an investment and the realization of a return on the investment, does not indicate how long the lag should be in order to qualify the investment for levy financing. Since most capital projects involve a lag between investment and return on investment, the lack of specificity in the policy would result in most capital projects being eligible for financing from the levy. It is possible that this policy was meant to apply to the specific features of the Port's leases for the use of its maritime facilities, which require low payments from the lessee in the first five years of the lease period, with sharply escalating payment in subsequent five-year periods. If maritime projects are funded with debt, lease payments might not be sufficient to cover debt service payments in the early years of the lease. Thus, the Port argues, the use of revenue bond financing for such projects would be problematic. If this was the intent of the "long lag" criterion, the policy could have been stated in terms which applied more specifically to these conditions, rather than being so broadly stated. Furthermore, once the crossover point is reached at which lease payments exceed debt service costs, it should be possible to refinance the general obligation bonds originally issued to finance the project with revenue bonds. The Port's policy statements do not address this possibility.

The "IRR vs. Cost of Debt" Criterion. The second criterion states that levy funding is appropriate if the rate of return on a project is less than the "current cost of debt" and implies that revenue bond financing cannot be justified for a project with such a low rate of return. If a project that is directly related to the Port's main business functions has a rate of return that is lower than the cost of debt, then it is questionable whether such a project should be undertaken at all. The Port claims that it requires a rate of return that is 2-3 percentage points higher than the cost of debt when it analyzes prospective capital projects. A project with a rate of return lower than the cost of debt would not pass this screen. Again it is possible that this criterion is really intended to capture projects of a more specific nature, projects which the Port characterizes as "public purpose projects". These projects, which include the Port's environmental efforts and the airport's noise abatement project, are only tangentially related to the Port's basic business purposes. If this is the intent of this criterion, perhaps it could be more narrowly stated so that it is clear that it applies to this type of project.

This criterion implies that revenue bond financing should not be used for projects which have a rate of return lower than the cost of debt. This implication is questionable. Not every project in a revenue bond financing needs to be cost-effective. What matters are not the costs and benefits of the individual projects, but the sufficiency of the Port's overall revenues to support

the payment of debt service on the all outstanding revenue bonds. When bond investors consider purchasing bonds, one of the key indicators that they look to as a measure of the issuer's ability to pay principal and interest on the bonds is the debt service coverage ratio. In 2007 the Port's coverage ratio on its first-lien revenue bonds was 3.1. This means that for every dollar of debt service on its first-lien revenue bonds that was payable in 2007, the Port generated more than three dollars of net revenues after payment of operating and maintenance expenses. This is higher than the industry average and much higher than both the Port's 1.80 planning target and the 1.35 coverage ratio that the Port commits to maintain in its bond covenants. If all of the general obligation bonds outstanding in 2007 had been issued as first-lien revenue bonds, the first-lien coverage ratio in 2007 would still have been in excess of 2.0 and the coverage ratio on all revenue bond debt service would have been above the Port's target of 1.40. This is not to suggest that all of the projects that have been funded with general obligation bonds should have been funded instead with revenue bonds. Substituting revenue bonds for general obligation bonds would lower coverage ratios, and lower coverage could have a negative impact on the Port's credit rating. Furthermore, the Port's financial planning needs to take into account not only current coverage ratios, but also projected future coverage, given the timing and magnitude of the Port's borrowing needs. Nevertheless, the Port understates the potential use of revenue bond financing when it implies that projects with low rates of return cannot be funded with revenue bonds. The high coverage ratios on its revenue bonds recorded by the Port in recent years suggest that the Port could have relied more heavily on revenue bonds, and less on general obligation bonds, in financing its capital needs.

In its financial planning the Port takes into account not only the overall debt service coverage ratios for the organization as a whole (including the Airport, the Seaport and the Real Estate Divisions), but also the coverage ratios for the individual divisions separately. It has established a coverage target of 1.5 for the Seaport and Real Estate Divisions. It should be noted that the use of division-specific coverage targets in financial planning is purely a policy choice on the part of the Port. There is nothing in statute or in the Port's contractual obligations to its bondholders that requires to Port to limit its use of revenue bonds to achieve a specific coverage target at the division level. The only measure of coverage required by the Port's bond covenants is one which takes into account all of the Port's revenues and debt service requirements. Since the Port's use of division-specific debt service targets is a matter of policy, it is within the power of the Port to change the policy. It is the recommendation of this review that the Port do so in a way which limits the use of general obligation debt.

The "Economic or Community Benefits" Criterion. The third criterion for the use of levy funding simply states that the project should generate "significant economic benefits for taxpayers". This condition is so broad that it is of little use in identifying projects that can be funded through the levy. Since the Port views its principal mission to be the promotion of economic development, it could be argued that everything the Port does confers "economic benefits for taxpayers." There is no specification of how "significant" the benefits have to be in order to qualify for levy funding. In fact, the greater the economic benefits conferred, the less a given project would seem to qualify for levy funding, since projects conferring large economic benefits are more likely to be cost-effective and eligible for funding from the net revenues they generate. This criterion says little more than that levy funding can be used for general Port purposes.

ADDENDUM

Statement of Financing Policies (Excerpted from the Port's 2008 Preliminary Budget)

Tax Levy

Projects should meet two criteria to be eligible for tax levy funding: 1) a long lag exists between capital costs and project revenues or the project's financial return will not support revenue bond financing (i.e. the internal rate of return, or IRR, is less than the current cost of debt) and 2) the project generates significant economic or other community benefits for taxpayers. Each year, a tax levy request will be made for the funding of specific capital projects, certain environmental expenses, and other community investments. Once designated as levy funded, projects may be levy funded through completion. Information regarding the use of levy funds can be found in section IV Tax Levy.

General Obligation Bonds

Projects eligible for general obligation (G.O.) bond financing should meet three criteria: 1) a long lag exists between capital costs and project revenues or full payback from other sources of capital, or financial return is insufficient to support revenue bond financing (Internal Rate of Return ["IRR"] less than the current cost of debt) and 2) the project generates significant economic benefits for taxpayers. Because General Obligation Bonds are paid from the tax levy, many projects that qualify for levy funding may also be G.O bond funded.

Revenue Bonds

Projects should earn the current cost of debt (in IRR terms) or fund projects that can be included in the airlines' rate base to be eligible for revenue bond financing. A target senior lien revenue bond coverage ratio of 1.8 times and 1.4 times coverage on all revenue bond debt will be maintained for capital planning purposes, but will be reviewed annually in light of changing circumstances such as critical funding needs or changes in the airport-airline operating agreement. An adequate cash flow margin (cash flow after debt service) will also be maintained for planning purposes.

Attachment B

Portfolio Management and Analysis Process

(From Port of Seattle Harbor Development Strategy 21, adopted June 26, 2001)

Purpose

- To inform good decision making about Port properties by providing and analyzing information on business factors and the real estate context.
- A management tool to identify and highlight tradeoffs and opportunity costs among business options and real estate values.

Principles

- All properties should be included.
- Portfolio management reviews should be presented to the Port Commission annually, as part of the budget process.
- Properties should be evaluated on a rolling review cycle, with every property assessed at least every 5 years.
- The frequency and depth of review should be determined by business/property characteristics

Use longer cycle (up to 5 years) for:

- Stable businesses with long-term leases
- Fully developed, stable real estate assets

These properties could be evaluated using a “short form” format, recognizing that such a “short form” analysis may turn up issues that would require subsequent “long form” analysis.

Use shorter cycle (1 to 2 years) for:

- Underperforming businesses
- Properties with expiring leases
- Properties that are vacant or about to become vacant
- Critical properties in flux should be put on “watch list” and reviewed annually

These properties would require a “long form” analysis, i.e. a more detailed evaluation.

Evaluation Process

1. Evaluate Current Business Prospects & Performance

Business Outlook

- Relationship to core business - how mission-critical?
- Growth and revenue potential
- Is business affected by cyclical versus structural changes?
- Potential for process improvements
- Capital investments and major maintenance needs

Performance Measurement

- Financial Performance - covers all costs?
 - Is there an imputed subsidy rate? Does the business cover operating expense, corporate allocations, depreciation?
- Business-to-land market value
 - What is the land value and how does it compare with the business income?
- Annual holding cost -- opportunity cost of current activities, practices
 - Revenue foregone on vacant or underutilized property
 - Costs associated with holding site -- debt service, maintenance
 - Other?
- Economic benefits -- based on Port standardized economic impact measures to be developed for the Triple Bottom Line
- Community and environmental benefits assessment -- based on Triple Bottom Line measures

2. Analyze Business/Real Estate Options

Identify Options:

- Hold land in current use
- Hold with interim uses
- Disposition
- Property redevelopment
- Relocation of business to other sites
- Other business/real estate uses

Analyze Options:

- Business and Real Estate Issues
 - Identify criteria, strategic priorities (i.e. maritime uses, waterfront, etc.)
 - Identify range of business uses
 - Real estate analysis of property
- Performance Measurement of Alternative Options Measured Against Status Quo and Minimum Thresholds/Targets
 - Potential financial returns
 - Economic benefits - based on Port-standardized economic impact measures
 - Community and environmental benefits

3. Develop Property-Specific Plan for Management of the Asset

- For underperforming properties:
 - Develop improved performance plan

- Exit strategy
- For “holding” properties:
 - Planned holding period and action plan for period
 - Develop exit strategy
 - Properties noted on “hold list” -- list should be prioritized by strategic value and relative performance and reevaluated annually in light of changing market conditions.