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**INDEPENDENT STATE AUDITOR'S REPORT
ON CERTAIN ACTIVITIES OF THE
MASSACHUSETTS PORT AUTHORITY
JULY 1, 2002 TO JUNE 30, 2005**

**OFFICIAL AUDIT
REPORT
APRIL 19, 2006**

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Our review of the Massachusetts Port Authority (Massport) was conducted to evaluate the adequacy of its internal controls over certain administrative costs, including payroll, travel, credit card, conference, and consultant expenses; revenue management, including parking, lease, advertising, and other fees; contract administration; and equipment purchase and surplus property disposal processes. Our objectives were to determine whether these administrative expenses were appropriate, allowable, and in compliance with applicable laws, rules, and regulations; that revenues were being properly accounted for; and that property and equipment acquisitions and dispositions were adequately controlled. Finally, we evaluated the corrective actions that Massport had taken regarding the findings in our prior audit report (No. 2002-0508-2A).

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1. PRIOR AUDIT RESULTS RESOLVED: LEASE MANAGEMENT SYSTEM IMPROVED

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Our prior audit found that Massport's system for lease management needed improvement. Specifically, we found that a lack of vigorous lease management, as well as miscommunication between Massport's Business Development Office and Billing Department, were contributing to errors in billing and collecting the appropriate lease rental fees. We recommended that Massport expedite the implementation of its Common Lease Management System (CLMS) to ensure the accuracy and timeliness of its billings for lease rental fees. During our follow-up review, we determined that Massport has fully implemented CLMS, and our test of the system data indicated it was timely, accurate, and in accordance with the lease terms.

2. NO-BID DEVELOPMENT AWARD AND FAVORABLE LEASE TERMS COST MASSPORT MILLIONS IN POTENTIAL RENTAL INCOME

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On November 18, 1999, Massport's board authorized that a development agreement and ground lease be executed for the construction and operation of a 650- room hotel for Parcel F-2, a part of the Commonwealth Flats Designated Area (CFDA) of the South Boston waterfront. Massport designated this parcel to be suitable for hotel development and solicited and received competing proposals to develop this site from two area firms. However, in March 2000, the board authorized the award of a no-bid development agreement with the same developer for two adjacent parcels, Parcels G and J, and designated these parcels as suitable for a 465-unit residential apartment complex with a 520-space parking garage. These development rights were granted by Massport without seeking any competing proposals; were not publicly advertised; and were awarded as a no-bid, sole source agreement. As a result, Massport was precluded from the opportunity to evaluate competing proposals and strive to obtain the highest reasonable fees from the selected developer. Moreover, the lease terms granted for these no-bid parcels, as well as the sale of hotel development rights for \$4 million by the developer to a third party, unjustly rewarded the developer at Massport's expense.

3. HIGH RISK INTEREST RATE SWAP INVESTMENT COULD RESULT IN INCREASED INTEREST COSTS **9**

Our audit revealed that, as part of its program to manage its funded debt, Massport entered into a 10-year interest rate swap agreement in July 2002 that could expose Massport to greater interest expenses if interest rates rise prior to the swap agreement's expiration in 2012. Under the terms of this agreement, Massport agreed to swap a notional amount (the specified dollar amount on which exchanged interest payments are based) of \$100 million of its fixed rate debt in exchange for the obligation to pay a counterparty a variable interest rate based on the Bond Market Association Municipal Swap Index. We noted that Massport's financial advisor, after reviewing current market conditions, recommended that Massport enter into a five- to seven-year contract. However, the swap contract signed by Massport was extended from a recommended five- to seven-year term to a 10-year term, thereby exposing Massport to millions of dollars in potential additional interest expenses if interest rates rise during this extended contract period.

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We reviewed the charges made to Massport's corporate credit cards and determined that some employees were routinely charging the corporate credit cards for their own personal expenses. Although these employees subsequently reimbursed these personal charges to Massport, prudent business practices advocate that Massport adopt and enforce a policy that prohibits the use of its credit cards for any charges that are not directly related to Massport-related business.

INTRODUCTION

Background

The Massachusetts Port Authority (Massport) was established by Chapter 465 of the Acts of 1956 of the Massachusetts General Laws, as amended. Massport owns and operates the Boston Logan International Airport, Lawrence G. Hanscom Field, Maurice J. Tobin Bridge, and the facilities comprising the Port of Boston. The Port of Boston facilities consist primarily of piers, buildings, and land located in several of the city's neighborhoods, including Boston proper, South Boston, East Boston, and Charlestown. In addition, under a Memorandum of Understanding dated April 15, 1999, among Massport, the City of Worcester, and the Worcester Airport Commission, Massport assumed the operational control of the Worcester Regional Airport. Ultimately, Massport may seek to acquire ownership of this facility in order to develop a more efficient and effective regional airport network system.

Massport continues to implement several short-term and long-term development programs to revitalize the port of Boston and thereby stimulate economic development for Massachusetts and the surrounding region.

Massport is governed by a seven-member board. Each member is appointed by the Governor for a seven-year term, with the term of one member expiring on June 30th of every year. An Executive Director, who is appointed by and reports directly to the board, carries out the management of Massport operations.

Payments in-Lieu of Taxes

Although Massport is a tax-exempt entity under the laws of the Commonwealth, it has agreed to make payments in lieu of taxes (PILOT) to the cities of Boston and Chelsea, and the Town of Winthrop. For the fiscal year ended June 30, 2005, these payments, which include annual escalation provisions for inflation based on the consumer price index, totaled approximately \$12.02 million.

Passenger Facility Charges

In 1993, Massport received approval from the Federal Aviation Administration (FAA) to impose a \$3 per passenger facility charge (PFC) at Logan Airport. PFCs collected by Massport can be used to fund eligible capital projects under the Aviation Safety and Capacity Expansion Act of 1990. In

February 1998, Massport received approval from the FAA to increase its maximum PFC collections to \$927.4 million, whereas the projected expiration date for this fee remains October 1, 2017. The FAA has approved Massport's use of these fees for such capital items as preliminary and final design cost, construction and financing for eligible residential soundproofing, Terminal E modernization, roadways, elevated walkways, and the International Gateway Project.

Massport collected approximately \$35.3 million in PFCs for the fiscal year ended June 30, 2005, and since inception Massport has collected approximately \$405.8 million in PFCs.

Fiscal Year 2004 - 2008 Capital Program

On February 12, 2004 Massport's board approved a \$1.91 billion capital improvement program that represents a comprehensive and coordinated capital improvement and financial master plan for all Massport facilities. Similarly, in 1995 Massport instituted a major capital program to repair, modernize, and revitalize the physical plant at Logan Airport and to improve the infrastructure at each Massport facility. The 2004 - 2008 Capital Program is designed to continue this effort by dedicating \$1.14 billion to implement several security initiatives, as well as provide for airfield enhancements, improve its public parking facilities, and upgrade Massport facilities.

Capital Financing and Debt Management

As of June 30, 2005 the outstanding funded debt of Massport issued pursuant to the 1978 Trust Agreement and the PFC Trust Agreement totaled approximately \$1.6 billion. This debt comprises a series of revenue bonds and commercial paper. In addition, in prior years Massport defeased (redeemed) certain bonds by placing the proceeds of new bonds in an irrevocable trust with the Trustee to provide for all future debt service payments on the old bonds. At June 30, 2005, the balances for these defeased bonds totaled \$383.1 million.

As part of its debt management program, and in an effort to lower the interest rates paid on some of its funded debt, Massport has included interest rate swap agreements as part of its overall debt strategy. Under the current interest rate swap in effect, Massport has agreed to pay a variable rate on \$100 million of its debt to a designated counterparty in exchange for receiving a fixed rate on the same principal amount from the counterparty. This swap agreement in effect created a "synthetic" refunding of variable rate debt while assigning its fixed-rate debt obligation to the designated counterparty.

Board Members

Massport is administered by a seven-member Board appointed by the Governor to staggered seven-year terms. Members serve without compensation. Massport's Chief Executive Officer serves at the pleasure of the board and is responsible for implementing the decisions of the board and its agenda. As of June 30, 2005 the members of the board were as follows:

John A. Quelch, Chairman
James M. Coull, Vice-Chairman
Lois J. Catanzaro
Paul D. Foster
John F. Monahan, Jr.
Susana M. Sega
Ranch Kimball

Audit Scope, Objectives, and Methodology

The scope of our audit included a review and analysis of controls and procedures over Massport's administrative and operating expenses. Our audit, which covered the period July 1, 2002 to June 30, 2005, was conducted in accordance with applicable generally accepted government auditing standards for performance audits, as issued by the Comptroller General of the United States, and included such procedures and tests considered necessary by the Office of the State Auditor to meet these standards.

Our audit objectives were to:

- Review and evaluate the adequacy of Massport's internal controls over administrative expenses.
- Test certain administrative expenditures, including payroll, travel, conferences, and credit card expenses, and consultant payments to determine whether these costs were appropriate, reasonable, and allowable.
- Review and evaluate revenue management, including parking receipts, lease and rental income, advertising revenue, and other fees.
- Evaluate Massport's system of contract administration, including contract bidding, awarding, and monitoring procedures.
- Review and evaluate Massport equipment purchases, rentals, and disposal process for surplus property.

- Determine what corrective actions Massport has taken regarding our prior audit report (No. 2002-0508-2A).

To achieve our audit objectives, we examined Massport's system of internal controls over administrative expenses, as well as contract files, paid invoices and supporting documentation, minutes of board meetings, equipment purchase and disposal policies, and applicable laws and regulations. In addition, we interviewed appropriate Massport personnel.

Our review indicated that, except as noted in the Audit Results section of this report, Massport had adequate internal controls over administrative and operating expenses and complied with applicable laws, rules, and regulations for the areas tested.

AUDIT RESULTS

1. PRIOR AUDIT RESULTS RESOLVED: LEASE MANAGEMENT SYSTEM IMPROVED

Our prior audit (No. 2002-0508-2A) of the Massachusetts Port Authority (Massport) found that Massport's system for lease management needed improvement. Specifically, we found that a lack of vigorous lease management as well as miscommunication between Massport's Business Development Office and Billing Department were contributing to errors in the billing and collection of appropriate lease rental fees. Moreover, a new Common Lease Management System (CLMS) was not yet fully implemented and behind schedule. We recommended that Massport expedite the implementation of CLMS to ensure the accuracy and timeliness of its billings for lease rental fees.

During our follow-up review, we determined that Massport has adequately corrected the cited deficiencies noted in our prior audit by fully implementing CLMS. Moreover, our analysis of CLMS data indicated that tested billings were timely, accurate, and in accordance with the lease terms.

2. NO-BID DEVELOPMENT AWARD AND FAVORABLE LEASE TERMS COST MASSPORT MILLIONS IN POTENTIAL RENTAL INCOME

As part of Massport's effort to maximize revenues through development of its Port Properties, in June, 1997 Massport issued a Request for Proposals (RFP) for Parcel F-2, a part of the Commonwealth Flats Designated Area (CFDA) of the South Boston waterfront. Massport designated this parcel to be suitable for hotel development and solicited and received competing proposals to develop this site from two area firms. On November 18, 1999, Massport's board authorized that a development agreement and ground lease be executed for the construction and operation of a 650-room hotel with underground parking with Corcoran Jennison Inc., and its designated entity, South Boston Waterfront LLC (the developer).

However, in March 2000, Massport's board authorized the award of a no-bid development agreement with the same developer for two adjacent parcels, Parcels G and J, and designated these parcels as suitable for a 465-unit residential apartment complex that included a 520-space parking garage and ground floor retail space. The development rights were granted without seeking any competing proposals; were not publicly advertised; and were awarded as a no-bid, sole source agreement. The board reasoned that the successful development of these three

parcels (F-2, G, and J) was somehow dependent on a single developer overseeing the entirety of the envisioned mixed-use concept of hotel, residential, and retail favored by Massport. Although Massport will receive an initial base annual rent of \$232,500 per year or \$500 per unit/per year, we noted that the 95-year Ground Lease for Parcels G and J signed by Massport on December 29, 2003 granted extremely favorable terms to the developer, as discussed below:

- No rent will be charged for the 520-space parking garage for the first 12 years. Thereafter, Massport will receive only 20% of the garage's gross revenues greater than \$3.12 million, adjusted each year until the 33rd year, when Massport will receive 20% of all the gross parking revenues. Based on an estimate of \$200 to \$300 per month per space, we estimate that these parking spaces will generate between \$15 million to \$23 million, and possibly as much as \$30 million to \$45 million, adjusted for the 5% annual increase in revenues, to the developer and \$0 rental income to Massport for the first 12 years of this lease. However, we noted that under a separate agreement between the developer and an adjacent hotel tenant, the developer is renting 155 parking spaces on a monthly basis to the hotel tenant at the prevailing Boston monthly market rate, increased by 5% each year. In addition the developer will receive 20% of all revenues in excess of the monthly market rate realized by the hotel tenant.
- No rent will be charged for the first 14 years for approximately 20,000 square feet of ground floor retail space. Thereafter, Massport will receive only 4% of gross revenues. We estimate that the developer will realize approximately \$400,000 per year (\$20/foot) in rental income, or \$5.6 million, unadjusted for annual increases, over the first 14 years of this lease, whereas Massport will receive \$0 in rental income for this space.
- Massport will receive approximately 1/3rd of 1% (0.35%) of any gross proceeds resulting to the tenant from the sale of his lease to a third party. It was not possible to estimate a value of this lease to a third party; however, considering the generous terms afforded to all future master tenants during the 95-year term of this lease, the value to a willing buyer could be significant. Again, Massport did not ensure that it would share fairly in the future cash windfalls that might be realized by this developer or any successor owner of this site resulting from the sale of the lease for this property.

Furthermore, we determined that for more than six years, the developer was unable to secure a national hotel tenant for Parcel F-2, as required under his development agreement with Massport. During this time Massport received no rental income or development fees on this parcel and expended millions of dollars to relocate an existing tenant from this site and to negotiate the terms of this lease with the developer and a successor developer. However, in January 2003, Massport allowed this developer to sell his development rights for this parcel to a new hotel developer for \$4 million. Once again, Massport did not share in these sale proceeds

and did not seek reimbursement from the developer for the \$1.5 million Massport paid to relocate an existing tenant from the site on behalf of the developer.

We question Massport's business rationale in granting such generous lease terms to this developer. Moreover, Massport's use of a no-bid process to unfairly award the development rights for the apartments and garage project to the developer does not seem to be justified, given that both of these projects will ultimately be built by separate entities, not a sole source. Indeed, two developers, acting through co-operating development and easement agreements, will be able to accomplish Massport's original planned mixed-use concept for these parcels.

Finally, and most importantly, Massport's decision not to seek bids precluded it from the opportunity to evaluate competing proposals and strive to obtain the highest reasonable fees from the selected developer.

Recommendation

In order to ensure that all development projects are awarded in a fair, open, and competitive manner, Massport should:

- Require that all future proposed development awards be granted based on a competitive RFP basis. This process should mirror the procedures established in Chapter 30B of the General Laws and should include the initial proposed lease payment terms as a major factor for consideration when selecting the successful developer.
- Prohibit the use of no-bid sole source awards for any and all future real estate development projects.
- Improve its lease and development-negotiating strategy to ensure that Massport is receiving its fair share of all revenues to be realized in the future development of all its property.

Auditee's Response

Massport identified several reasons why coordinated development of these three parcels by the same developer was in Massport's interest. Massport utilized the services of an independent consultant when setting the terms of the ground lease for Parcel's G and J, and Massport is confident the terms matched or exceeded market.

Rent was deferred on the parking garage to facilitate the development of a larger underground garage than would have been built if immediate rent payments had been required. As a result, Massport has the immediate market benefit of a large facility, and very substantial revenue opportunity in the future.

Massport expected that the developer would have to offer substantial rent concessions to initial retail tenants to commit to the building because the area was and still is in an early stage of development. Massport will realize more revenue from the residential units if the retail space is quickly built out and occupied. The deferred ground rent was intended to accomplish this outcome.

The developer sold the hotel development rights after the property had been fully permitted, at substantial expense to the developer. Massport estimates that the developer may have received little or no profit from this transaction, after taking substantial risk and then producing a very capable hotel developer and operator, to the future benefit of Massport.

Massport rarely uses a no-bid process for disposition of real estate, but reserves the right to do so in situations such as this one, where Massport determines it is in its best interests to do so.

Auditor's Reply

The fact remains that the lack of a competitive bidding process, poor planning and generous lease terms has cost the Authority millions in potential rental income. It is the responsibility of Massport not a consultant, to set the terms of the ground lease and to ensure that they are in the best interest of the taxpayers. We see no justification for Massport not sharing in the gross proceeds of the parking garage and retail space to be realized by the developer over the next 12 to 14 years.

A significant amount of public and private funds have been invested in the infrastructure of the Commonwealth Flats Area (roads, bridges, MBTA Silver Line) as well as the new Mass. Convention Center, Federal Courthouse, and several offices; hotel; apartment; and condominium projects. For Massport to assert that this site was anything less than a prime waterfront development area is misleading.

Moreover, there are no circumstances that we can envision where a public agency such as Massport, could justify awarding a no-bid real estate development contract. No-bid contracts often result in extremely generous terms for the favored developer and extremely unfair terms to the public landlord i.e., Massport. Without the benefit of a competitive process, it is impossible to determine the cost consequences of Massport's strategy. Therefore, we reaffirm our recommendation to prohibit the use of no-bid, sole source awards for any and all future Massport real estate development projects. Finally, we reiterate the need for Massport to improve its lease and development practices to ensure that Massport will receive its fair share of all revenues to be realized from the future development of its property.

3. HIGH RISK INTEREST RATE SWAP INVESTMENT COULD RESULT IN INCREASED INTEREST COSTS

Our audit revealed that Massport, as part of its program to manage its funded debt, entered into a 10-year interest rate swap agreement in July 2002 that could expose Massport to greater interest expenses if interest rates rise prior to the swap agreement's expiration in 2012. Under the terms of this agreement, Massport agreed to swap a notional amount (the specified dollar amount on which exchanged interest payments are based) of \$100 million of its fixed rate debt in exchange for the obligation to pay a counterparty a variable interest rate based on the Bond Market Association (BMA) Municipal Swap Index. The interest rate received by Massport from the counterparty is fixed at 4.05% for 10 years, whereas the variable rate to be paid by Massport will vary weekly, depending on market conditions, and contains no cap on the future variable rate Massport will pay. The initial variable rate payable by Massport at the inception of the swap contract was approximately 1.38%. Thus, initially this agreement was very favorable to Massport.

Prior to entering into this swap agreement, Massport consulted with its financial advisor who, after reviewing current market conditions and the terms governing the bonds to be pledged to this swap, recommended that Massport enter into a five- to seven-year contract. The advisor reasoned that this was a prudent term for the swap because the pledged bonds were callable and subject to redemption by Massport in the next 5.5 to 7.5 years. The purpose of the swap was to provide an interest rate hedge for this debt until such time that it could be retired. However, the swap contract signed by Massport was extended from the financial advisor's recommended five- to seven-year term to a 10-year term. Massport's decision to increase the term of this swap for an additional 3 years was based on their ability to receive an additional 34 basis points of interest by issuing a 10-year rather than 7-year swap. Our conclusion is based on the fact that, if rising interest rates ever increased the BMA to its prior 17 year high of 7.89% reached in December, 1990, Massport would be in the unfavorable position paying the higher interest rate of 7.89% to the counterparty while receiving only 4.05% from the counterparty. If the BMA were to reach 7.89% then Massport interest payments to the counterparty under this SWAP agreement would be approximately \$8 million, while it would receive approximately \$4 million from the counterparty. Thus, Massport would lose approximately \$4 million per year unless it decided to terminate the contract. Unfortunately, the payment required to buyout the counterparty's future

stream of payments due at these higher interest rate levels could result in tens of millions of dollars in losses to Massport.

Recommendation

Due to the volatile nature of the derivatives market for interest rates, Massport should exercise extreme care in participating in any future interest rate swap agreements. Instead, Massport should strictly limit the amount of variable rate debt that it issues, thereby eliminating the risk that rising interest rates will lead to directly higher debt-service costs, which is inherent with this type of floating rate debt. By confining its debt issuances to fixed rates, Massport will be able to better manage its budgeted debt-service needs.

Auditee's Response

While Massport's Financial Adviser initially recommended a swap term of 5-7 years, by the time the Authority was ready to bid the swap in June, the shape of the yield curve had changed. On June 11th, the Financial Adviser recommended a 10 year term. The analysis accompanying this recommendation concluded that Massport would be compensated an additional \$2,380,000 for taking on the additional three years of risk, more than enough to offset any expected potential losses from rises in the BMA rate. To date this swap has lowered Massport's debt service by \$9.7 million dollars, exceeding our expectations.

The Auditor recommends that Massport should refrain from participating in future interest rate swaps, should strictly limit the amount of variable rate debt and confine its debt issuance to fixed rate debt. This opinion overlooks the historic fact that, over the long haul, variable rate debt has always been less costly than fixed rate debt. Massport has a history of using financial hedges in a conservative and profitable manner.

In October 2004, the Authority adopted a Financial Hedging Policy. That policy and the existing swap have been assigned a Standard & Poor's DDT rating of 1 out of 5, where 1 is the lowest risk. Standard and Poor's recommends that a debt portfolio include not less than 70% fixed rate debt, not more than 20% variable rate debt and not than 10% hedged debt. As of June 30, 2005, Massport's debt portfolio consisted of 80% fixed debt, 14% variable, and 6% hedged. Clearly this portfolio is well within the stated guidelines for a public agency.

Auditor's Reply

We reiterate that due to the volatile nature of interest rate derivatives, Massport should exercise extreme care in participating in any future interest rate swaps. Massport's decision to extend this swap agreement for an additional 3 years of interest rate risk was based on receiving an extra 34 basis points, or 1/3 of 1% annually. Although this swap contract has generated positive cash flows to the Authority, this situation appears poised to change. The BMA paid by Massport has

risen from the initial contract rate of 1.38% to the current rate of 3.22% as of February 15, 2006. With more than 6 years remaining on this swap contract and interest rates continuing to rise, Massport may soon be faced with a negative cash flow and an increase to their annual debt service. In fact, the BMA now exceeds its 10-year average of 3.20%. If the BMA ever exceeds 4.05% during the agreement period, any “gains” realized to date by Massport will begin to disappear. If the BMA reaches its 17-year high of 7.89%, it is possible that the Authority may face substantial losses on this SWAP agreement.

4. CONTROLS OVER MASSPORT-ISSUED CREDIT CARDS NEED TO BE STRENGTHENED

Our review of charges made to Massport’s corporate credit cards revealed that some employees were routinely using these corporate credit cards to pay for their own personal expenses. Although we found that the employees subsequently reimbursed these personal charges to Massport, prudent business practices advocate that Massport adopt and enforce a policy that prohibits the use of Massport-issued credit cards for any charges that are not directly related to Massport business.

During the period of our review, we determined that approximately \$31,656 in total charges were made to these credit cards. We tested 19 charges totaling \$7,878 made to these corporate cards, of which \$4,334 (55%) were determined to be personal charges, whereas only \$3,544 (45%) in charges were related to Massport business. Most of these personal charges were incurred for restaurants, hotels, and airline tickets.

We reviewed Massport’s travel and business expense policies and procedures, as revised on May 21, 2001, and noted that these policies do not address the proper use of these corporate credit cards. Specifically, these travel policies should, but do not currently, restrict the use of these credit cards to Massport business purposes only.

Recommendation

Massport should immediately revise its formal travel and business expense policies and procedures to prohibit the use of Massport-issued corporate credit cards for employee personal expenses. Finally, these revised policies should provide for disciplinary action, including revocation of credit card privileges, for violators.

Auditee's Response

We note that there are only four Massport issued credit cards, the Authority will revise and implement a formal business expense policy that prohibits the use of Massport issued credit cards for personal use.

Auditor's Reply

We agree with Massport's decision to revise and implement a formal business expense policy for the use of Massport issued credit cards for personal use.