OFFICE OF THE CITY CONTROLLER

# HOUSTON AIRPORT SYSTEMS

# LIMITED SCOPE CONTRACT COMPLIANCE AUDIT WITH HAS DEVELOPMENT CORPORATION (HASDC)


Ronald C. Green, City Controller

David A. Schroeder, Acting City Auditor


Report No. 2010-16

OFFICE OF THE CITY CONTROLLER
CITY OF HOUSTON
TEXAS

RONALD C. GREEN

April 12, 2010

The Honorable Annise D. Parker, Mayor
City of Houston, Texas

SUBJECT: 2010-16 Houston Airport Systems (HAS) Limited Scope Contract Compliance Audit with HAS Development Corporation (HASDC) (Ordinances 01-0724; 01-0725; 2004-1083; 2004-1084, respectively)

Dear Mayor Parker:

The Controller's Office Audit Division (Audit Division) has completed a limited scope contract compliance audit involving the technical service agreements (TSAs) between HAS and HASDC, including any other agreements involving these parties. The timeline for this project was from October 29, 2009, through March 19 of 2010, and therefore straddled the transition between the previous and current administrations. The initial Audit Notification letter that was distributed, listed four audit objectives for this engagement as follows:

- Determining whether the City/HAS is being compensated as outlined in all contracts between HAS, HASDC, and any other related parties named therein (this includes reimbursements for expenses incurred on behalf of HASDC);
- Determining whether HAS policies, procedures, and process documentation are in place that adequately support the compensation paid to HAS pursuant to the contracts including activity eligible for reimbursement;
- Indentifying and assessing the HAS internal control structure that surrounds the processes for the primary contract activities; and
- Determining whether the City of Houston/HAS has potential obligations through any of HASDC's entity relationships derived from the contracts.

To briefly summarize, there are two main components of the TSAs that generate revenues to HAS:

(1) Reimbursement for technical services provided by HAS employees; and
(2) Profitability of the project(s) via net operating revenues or future liquidated equity.

Related to the first component, this report identifies some internal control issues surrounding the reimbursement of HAS employees time for services identified in the TSAs that totaled approximately $3,000 in unbilled activity. While the total amount of unreimbursed activity was not quantified because of scope limitations, the impact and magnitude of the findings noted in the report are assessed as a low risk. The assessed risk rating was based on consideration of: the findings compared to the overall scope of services, dollar magnitude of billings and services, potential long-term benefit to HAS and the City for successful execution of technical services and future business development, and factoring in the corrective actions taken by management.

The second (profitability) component is fed by the need for continued HAS technical services with incentives to participate that support project success. HAS provides a name brand representing intellectual capital along with a U.S. presence, which allows access to additional lending sources, while protecting the interest of its non-monetary investment through operating and budgetary decision-making input. Nothing came to our attention during the course of our work that did not appear to be in compliance with the agreements relating to this element.

We appreciate the cooperation and professionalism extended to our auditors by relevant personnel during the course of the audit, which included; HAS Interim Director, HAS Deputy Director of Finance & Administration, HAS Strategic Planning Deputy Assistant Director, HAS Financial Reporting, HASDC President, HASDC Legal Counsel, and ADC/HAS Corporation.

Respectfully submitted,

Ronald C. Green

Ronald C. Green
City Controller

xc: City Council Members
Waynette Chan, Chief of Staff, Mayor's Office
Eric Potts, Director, Houston Airport Systems
Alfred Moran, Director, Administration and Regulatory Affairs Department
Michelle Mitchell, Director, Finance Department

## TABLE OF CONTENTS

## EXECUTIVE SUMMARY

The Controller's Office Audit Division (Audit Division) has completed a limited scope contract compliance audit of the contract between HAS and HASDC including any other agreements involving these parties. The timeline of for this project was from October 29, 2009, through March 19 of 2010, and therefore straddled the transition between the previous and current administration.

## BACKGROUND

The Houston City Council adopted Ordinance No. 2001-724 on August 1, 2001 and this ordinance authorized an agreement between the City and Airport Development Corporation (ADC), a Canadian corporation where the Houston Airport System (HAS) would provide technical services to ADC in connection with the operation of the airport in Quito, Ecuador. In addition, HAS would also provide technical services to ADC in connection with the development of a new airport just outside Quito. The ordinance also authorized the City to create a non-profit corporation to be used by HAS through which it would provide the services covered by the agreement between the City and ADC. ADC, a Canadian corporation was part of a consortium (or group of companies) that was seeking an agreement to operate the existing airport in Quito and to construct a new airport in Quito. In order to acquire this concession, ADC sought HAS's expertise in airport management and development.

On the same date that the Houston City Council adopted Ordinance No. 2001-724, they also adopted Ordinance No. 2001-725. This authorized the Mayor to execute a technical services agreement with the non-profit corporation through which HAS would provide the services specified on the agreement between ADC and HAS in Ordinance No. 2001-724. That non-profit named HAS Development Corporation (HASDC) was incorporated as a 501(c)(3) non-profit corporation in December 2001.

On March 6, 2002, the City entered into a technical service agreement (HAS TSA) with HASDC to provide HASDC technical services for HASDC airport and aviation projects. These included services related to airport planning, design, management, operation and administration. To provide these services, HAS would deploy such personnel as it shall determine appropriate and may employ additional persons or contract with third parties (with City Council approval when required by ordinance or City Charter) to provide such services.

In consideration for the services provided under this TSA, HASDC shall pay the City (solely for the benefit of HAS) two major categories of revenues as follows:

1. Reimbursement; which includes the following:
   - All costs of personnel providing services to HASDC (multiplied by an agreed upon multiplier of 1.8) ***plus;***
   - Reimbursement for all out of pocket expenses and travel incurred by HAS in carrying out its obligation ***plus;***
   - All costs and expenses of third parties incurred by HAS in order to provide services under this TSA.

In addition, under the TSA, HASDC also agrees to pay the City (solely for the benefit of HAS) all Net Revenues of the Corporation.

2. Net Revenues; includes the following:
   - The amount by which all receipts of HASDC from sales of services and any investment return during such period exceeds all expenditures during such period in accordance with an approved budget;

NOTE: Such payments are to be made (no less than) annually but HASDC may set aside (at the discretion of its Board of Directors) funds for necessary capital reserves and investments. The term of this HAS TSA was initially through June 30, 2011 and has been extended through 2031

- Realization of the equity interest in the affiliated entities as they flow up to HASDC upon a liquidating event

NOTE: A study referred to in a previous report prepared by the contracted firm of Bracewell, Giuiliani LLP (the Quito Valuation Extract), indicated the potential value of the equity interest of HASDC to HAS was expected cash flows beginning in 2017 of $1.4M to $6M per year with an estimated Net Present Value of $29.5M.

In 2004, lenders who provided financing for the Quito Project, in order to protect their interest, requested an assignment of the HAS TSA. Because the TSA applied not only to the Quito Project but other projects in which HASDC sought to use HAS's services, it was determined that separate technical service agreements should be created for the Quito Project and all other HASDC approved projects. For this purpose, City Council passed Ordinances 2004-1083 and 2004-1084 on October 20, 2004. Ordinance 2004-1083 authorized an amendment to the HAS TSA (First Amended HAS TSA) that would apply to all approved HASDC projects other than the Quito Project. This amended TSA is commonly referred as the "First Amended HAS TSA" or the "Multiple Airport Project TSA". Ordinance 2004-1084 authorized and approved a separate technical services agreement between HAS and HASDC for the Quito Project. This TSA is commonly referred as the "Quito TSA".

In 2009, the Partnership (in which HASDC is a partner under the Multiple Airport Project TSA) acquired interest in the concession to complete the project to expand and modernize two airports in Costa Rica. These are the Juan Santamaria International Airport in San Jose, Costa Rica and the Daniel Oduber Quiros International Airport in Liberia, Costa Rica.

NOTE: The ownership and financing structure between the resulting two TSAs was different, but the general underlying compensation components were similar (e.g. Reimbursement for HAS employees and Net Revenue). One difference to note was the Estimated Value of the Multiple Airport TSA. It used a "Cash Flow to Capital Value" model and estimated the liquidity value between $50M - $180M

## SCOPE AND OBJECTIVES

The initial Audit Notification letter that was distributed, listed four audit objectives for this contract compliance audit as follows:

- Determining whether the City/HAS is being compensated as outlined in all contracts between HAS, HASDC, and any other related parties named therein. (this includes reimbursements for expenses incurred on behalf of HASDC)
- Determining whether HAS policies, procedures, and process documentation are in place that adequately support the compensation paid to HAS pursuant to the contracts including activity eligible for reimbursement.
- Indentifying and assessing the HAS internal control structure that surrounds the processes for the primary contract activities.
- Determining whether the City of Houston/HAS has potential obligations through any of HASDC's entity relationships derived from the contracts.

The scope of the audit was based on the initial original agreements starting in 2001 up to 2009 between HAS and ADC, along with the financial relationship between HAS and HASDC (Non-Profit Corporation created by authority of the first and second TSA). While the scope was, originally, to include all agreements between HAS and HASDC, the first two concession contracts supported by the Multiple Airport Project TSA were awarded in 2009. As of the time that we performed fieldwork and reporting associated with this audit, the 2009 financial statements for HASDC, which include activity associated with the Multiple Airport Project TSA, had not been issued. Therefore, our substantive work focused primarily on the Quito Project TSA, which resulted in a scope modification in relationship to the entities (Quiport, ADC/HAS Management, LTD, ICAROS, and HAS Development Capital Corporation or HASDCC)

Further, we note previously reported points of interest that had an impact on our scope as follows:

- A local television station reporting under payments and/or lack of billing to HAS in respect to reimbursements for HAS employee time and travel that totaled approximately $20,000;
- Perceptions as to whether the non-profit entity (HASDC) should be reported as a component unit of the City

In response to the concerns just expressed, the mayor's office under the previous administration contracted with the law firm of Bracewell & Giuiliani (B&G) in 2009, who examined the legal structure of HASDC and its relationship with HAS. Their report concluded that the structure, while complex and multi-layered, was not unusual for an entity involved in international business development and offshore contractual relationships. While several entities in between the source of services (HAS) relative to the end-user (Quito, etc.) presents a complex business arrangement, this structure was purposely developed to shield the City from liability, address foreign labor laws, and provide tax advantages, while also providing incentive for involvement (80% return on labor investment and multi-million dollar yield upon liquidation). This same mechanism created as a legal shield, creates an apparent barrier for transparency.

Recommendations from the B&G report were to:

- Restructure the HASDC Board of Directors (BOD) to have a mayoral appointed (non-city or non-HAS) director, while maintaining HAS presence on the BOD in a non-voting consulting capacity;
- Modify the TSAs regarding distribution of net revenues to set some parameters to ensure some cash flow to HAS as a result of profitability from operations

The previous administration in a meeting before City Council on September 14, 2009 made the following assertions for corrective actions:

- Provide a policy to limit a revolving door policy for former City employees to benefit from vendor/contractor relationships;
- Create a policy and procedure on billing of HAS services to provide better internal controls to ensure efficient use of resources and timely payment for all goods/services provided by HAS, including a cap of 2 full-time employees (FTEs) per year

We expanded our scope, therefore, to include:

- Follow-up to the media's reporting of the specific underpayments to HAS for services performed; and
- Follow-up on status of recommendations provided by the B&G report; and
- Follow-up on the previous administration's commitment to City Council on corrective actions

## PROCEDURES PERFORMED

In order to obtain sufficient and appropriate evidence to conclude on the audit objectives identified above, the audit team performed the following procedures:

- Reviewed all agreements between the City of Houston/HAS and HASDC regarding consulting services provided by HASDC to ADC and others
- Reviewed HASDC's audited financial statements for the years 2003 through 2008
- Conducted interviews with relevant HAS, HASDC, and ADC/HAS management personnel and staff (including their legal counsel) to gain an understanding of the relationships between the City/HAS and HASDC and between HASDC and ADC
- Reviewed the controls and processes for billing of services by HAS to HASDC and to determine if billings for services were properly supported
- Reviewed billings for services to determine if they were recorded as revenues in SAP and determine whether the billings were collected and deposited in HAS accounts
- Reviewed employee advances paid by HAS to determine if any of them were related to HAS-HASDC business
- Reviewed employee advances paid by HASDC to determine if time spend by HAS employees was properly charged to and paid by HASDC

Our audit procedures were designed to meet the audit objectives identified above and to provide recommendations for improvement where appropriate. Departmental management is ultimately responsible for establishing and maintaining a system of internal controls over the primary contract activities as an integral part of the overall internal control structure. The objective is to provide management with reasonable, but not absolute assurances that the administration of primary contract activities complies will all applicable procedures, contract requirements and laws.

Due to the inherent limitations found in any system of internal controls, errors or irregularities may occur and not be detected. In addition, projection of any evaluation of the system to future periods is subject to the risk that procedures and controls may become inadequate due to changes in conditions, or that the degree of compliance with procedures/controls may deteriorate.

**CONCLUSIONS**

Based on the procedures performed in relationship to the audit objectives outlined above, we conclude that:

- HAS is being compensated as outlined in the Quito TSA, except for activities related to business development. A review selected travel requests indicated that work done by HAS employees (and classified as business development) on behalf of HASDC, was not billed and charged to HASDC. This totaled approximately 56 hours or $ 3,182. We could not accurately extrapolate the ***total*** unbilled business development hours by HAS employees because the total (complete) population of potential HASDC travel could not be reasonably defined. The unbilled amount identified in regards to business development for the testing population represented approximately 0.1% of the total amount of activities billed ($1,795,895 vs. $3,182). In its research back to 2007, the local media reported approximately $20,000 of unbilled business development revenue.
- Net revenues have been distributed to HAS by HASDC as per TSA agreement, however, they have been minimal ($45,829 to date), while at the end of calendar year 2008, HASDC had a cash balance in excess of $1M. Since the freeze on provision of HAS employees to perform services under the technical agreement, HASDC has reported a need to retain a higher level of cash reserves.
- At the time of initiating our fieldwork, HAS had limited policies and procedures in place to ensure that time spent by its employees consulting/working on HASDC projects was adequately approved and included appropriate supporting documentation.
- As of the time of this report, internal controls have been sufficiently designed, documented, and implemented, but not tested. The related internal controls were initially supported by unverified, customer provided, invoices. However, in Oct 2009, HAS management in charge of HASDC work started attesting and signing off (approving) total billable hours. This was followed by HAS adopting (in Feb. 2010) Organizational Policy and Procedure I-188 to provide policy and procedural guidance to HAS employees engaged in activities related to HASDC. This policy includes approval of work to be performed and maintenance of timesheets as well as inclusion of business development time in the scope of work to be reimbursed.

In relationship to the objectives resulting from follow-up of other items identified in the "Scope and Objectives" section of this report we not the following as of the date of this report:

- The current Board of Directors for HASDC and its structure has not changed
- There has been no limit set to FTEs of HAS employees. The auditors do not consider this a risk, due to the fact that HAS receives 80% return on investment for services.
- There has not been any additional policies limiting former HAS employees from future employment in any of the affiliated entities. Per conversation with the previous Chief Administrative Officer, this was due to a decision to impose a reasonable scope of authority, which does not potentially limit the employment opportunities of City employees seeking work outside of municipal government.

**NOTE:** For additional information regarding the findings and issues noted, please see the "DETAILED FINDINGS" Section.

**FINAL SUMMARY, OTHER CONSIDERATIONS, AND COMMENTS**

- We do not automatically conclude that lack of transparency equals exposure to greater risk and liability. As the B&G report concluded, the City/HAS has no legal or financial liability outside of the agreement to provide services as requested and available per the language of the TSAs. However, rights can be assigned by HASDC, (with BOD approval) which poses no financial liability to the City, but may impact the equity position affecting HAS upon liquidation.

- There can be a negative perception that the HAS activities associated with the HASDC TSAs and affiliated entities are not consistent with City's overall mission. In response, HAS serves the interests of the City by providing a point of entry and departure of passengers and freight that creates a conduit for economic growth. A concurrent mission is to improve marketing the image of the City to accommodate an expanding capacity for international trade and business. HAS is an enterprise fund that operates like that of a for-profit entity and, as such, has restrictions on providing money to the General Fund, which supports a significant portion of the City's day-to-day operations. The Recital section of all the TSAs support a broad mission for HASDC, and therefore, the activity reviewed by the Audit Division does not appear to violate any of the parameters identified.

- A difficult risk to quantify is the estimated future benefit to HAS resulting from the distribution of equity based upon a liquidating event as supported by assumptions using different models for each Project TSA. The City addresses this risk by its representation on HASDC BOD. The level of risk can be best measured by the risk appetite (conscious strategic decision-making) of the BOD (which includes City representation) as expressed through its voting rights on by-laws and the budgetary approval process. The assumptions used in estimating the liquidated value were deemed to represent a known and widely accepted model, without validating the numerical assumptions themselves. Therefore, we recommend continued limited access of HASDC affiliate financial information should be made available to the Office of the City Controller's Audit Division and expanded footnote disclosure should be included in the HASDC financial statements.

- HAS has been adversely affected by lost revenues due to a hold on HAS employees to perform services until resolution of the Quito Political Event as well as the determination by HAS if the current moratorium on new projects will be lifted. Results of this audit and subsequent decisions and/or corrective actions are also contributing factors. As mentioned earlier in this report, technical services have provided approximately $1.8M of revenue to HAS from 2001 – 2008, yielding a net profit of close to $800,000. During the last six months of 2009, and contrasting to the same period in 2008, billings through HASDC for HAS employees has decreased from approximately $243,000 to $168,000.

The Audit Division would like to thank all parties involved who have provided assistance and granted access to interviews, documentation, and other relevant data pertinent to obtaining sufficient and appropriate evidence to conclude on our audit objectives. These included; HAS Interim Director, HAS Deputy Director of Finance & Administration, HAS Strategic Planning Deputy Assistant Director, HAS Financial Reporting, HASDC President, HASDC Legal Counsel, and ADC/HAS Corporation. While our function requires this cooperation, it is with the knowledge and understanding that these operational units have concurrent functional responsibilities.

Nat Uresti

Nat Uresti, CPA
Auditor-In-Charge

David Schroeder, CPA
Acting City Auditor

# DETAIL FINDINGS, RECOMMENDATIONS, AND CORRECTIVE ACTIONS REPORTED

## I. UNBILLED BUSINESS DEVELOPMENT

### BACKGROUND

HAS and HASDC have a Technical Services Agreement (TSA) whereas HAS will provide airport operations technical services to HASDC. For these services, HASDC will pay HAS all costs of personnel providing services to HASDC (multiplied by an agreed upon multiplier of 1.8) plus reimbursement for all out of pocket expenses and travel incurred by HAS in carrying out its obligation plus all costs and expenses of third parties incurred by HAS in order to provide services under this TSA.

### FINDING

One of the substantive tests performed was to review employee requests for 10 travel advances planned to be funded by HASDC. The audit objective was to determine if time spent by HAS employees attributable to HASDC was properly billed. The time spent on these trips could not be traced to the monthly billings. It was determined by HAS management that 6 of these were for trips that had been cancelled, with no advances being paid to the employees. HAS also determined that time spend on the other 4 trips was considered business development and therefore did not bill this time to HASDC. We performed an estimate of the potential unbilled services from our test population and noted approximately 56.5 hours or $3,183 of potential unrecovered employee costs.

| Employee | Text | Estimated Hrs not billed | Rate* | Amount |
|---|---|---|---|---|
| RW | Travel to Liberia to conduct due diligence hours on billing (HASDC) | **16** | $56.60 | $905.60 |
| TB | HASDC meeting in Chicago-Due diligence on Midway Airport hours on billing | **11** | $87.94 | $967.34 |
| SG | HASDC meeting in Chicago-Due diligence on Midway Airport hours on billing | **13.5** | $43.45 | $586.58 |
| BB | Qualifications interview for HASDC in Grand Rapids hours on billing | **16** | $45.21 | $723.36 |
| | Total Estimate of Unbilled Activity | **56.5** | | **$3,182.88** |
| *** - The billing rate is a fully loaded cost of the employee (base pay, benefits, etc.)** | | | | |

**NOTE:** While the estimate fairly presents the unbilled amounts related to the population tested, we could not accurately extrapolate because the total (complete) population of potential HASDC travel could not be reasonably defined.

### RECOMMENDATION

HAS should bill HASDC for all time spent on TSA related work and/or travel including business development going forward.

### CORRECTIVE ACTIONS REPORTED

Since the inception of this audit, HAS wrote and adopted Organizational Policy and Procedure (OPP I-188) that requires billing for all time worked on HASDC projects, including HASDC marketing or business development.

## II. LACK OF POLICIES AND PROCEDURES OVER INTERNAL CONTROLS

**BACKGROUND**

HAS and HASDC have a Technical Services Agreement (TSA) whereas HAS will provide airport operations technical services to HASDC. As one compensation element for these services, HASDC pays HAS: all costs of personnel providing services to HASDC (multiplied by an agreed upon multiplier of 1.8) ***plus;*** reimbursement for all out of pocket expenses and travel incurred by HAS in carrying out its obligation ***plus;*** all costs and expenses of third parties incurred by HAS in order to provide services under this TSA. Payments for these services must be made to HAS on a monthly basis by HASDC.

**FINDING**

When reviewing support for the monthly billings by HAS for these services, it was noted that there was no support for the total hours worked and billed by HAS employees on behalf of HASDC. Upon further inquiry, it was indicated that HAS had no formal polices or procedures in place to document/record/retain records signifying the number of employee hours spend on HASDC related business. However in Oct 2009, HAS management (in charge of HASDC work) started vouching (attesting) and signing-off (approving) billable hours. According to HAS, the billings were prepared based on the amount of employee work hours provided by HASDC to HAS. The customer (HASDC) should not trigger billing itself based on self-reported consumption of vendor's services.

**RECOMMENDATION**

HAS should develop processes and procedures to properly document the work performed by its employees for the benefit of HASDC. This should include customer's requisition of services and the related approval to procure, (customer purchase order). The process should ensure; that HAS services are being provided as an approved request by the customer and that HAS is properly and timely reimbursed for all out of pockets costs as per the TSA.

**CORRECTIVE ACTIONS REPORTED**

Since the inception of this audit, HAS wrote and adopted Organizational Policy and Procedure (OPP I-188) that requires; customer requisition for services, proper approval and documentation of all work by its (HAS) employees, including preparation of timesheets (to include expenses) when an employee performs work for HASDC.

## III. UNDISTRIBUTED NET REVENUES

**BACKGROUND**

Under the TSA, another component of compensation involved HASDC agreeing to pay the City (solely for the benefit of HAS) all Net Revenues of the Corporation. Net Revenues being defined as the amount by which all receipts of HASDC from sales of services and any investment return during such period exceeds all expenditures during such period in accordance with an approved budget. Such payment shall be made no less than annually and includes discretionary budget authority that considers necessary capital reserves and investments.

**FINDING**

Since the time HASDC was incorporated in December 2001, minimal Net Revenues have been distributed to HAS ($45,829). As of the last audited financial statement (calendar year 2008), HASDC shows a cash balance of over $1M dollars on hand.

**RECOMMENDATION**

HASDC should review its approved budget to determine whether it is appropriate or necessary to maintain $1M in reserves.

**MANAGEMENT RESPONSE/
CORRECTIVE ACTIONS TAKEN**

As of Feb 28, 2010 HASDC had cash/receivables of $1.1 million, of which $586,020.96 was 'unrestricted' cash. HASDC management presented the BOD with three scenarios in the 2010 Budget of cash needs depending on how and when the HAS support and Quito Political issues are resolved as well as the continuation of extraordinary expenses associated with the 'reviews' and incorporation of the impact of the new HAS Operations Order revoking marketing support of HASDC.