



OFFICE OF THE CITY AUDITOR
Long Beach, California

LAURA L. DOUD, CPA
City Auditor

August 24, 2010

HONORABLE MAYOR AND CITY COUNCIL
City of Long Beach
California

RECOMMENDATION:

Receive and file the attached Queen Mary Capital Improvements Audit, and revisit Save the Queen's performance of capital improvements subsequent to its final benchmark deadline of December 31, 2010.

DISCUSSION

In November 2007, the City signed an agreement with Save the Queen (STQ) in which STQ agreed to make \$5,300,000 of capital improvements to the Queen Mary through December 31, 2010 in exchange for the City's waiver of percentage rent under the lease. The agreement requires STQ to complete these capital improvements in minimum increments over three years as follows:

<u>Timeline Benchmarks</u>	<u>Minimum Aggregate Amount of Approved Capital Expenditures</u>
December 31, 2008	\$2,800,000
December 31, 2009	\$4,300,000
December 31, 2010	\$5,300,000

Our prior audit of the Queen Mary Capital Improvements Program, dated June 23, 2009, covered the first incremental period ending December 31, 2008. The attached audit, dated August 24, 2010, addresses the agreement's second incremental deadline, December 31, 2009, requiring the completion of an aggregate of \$4,300,000 in capital expenditures. At the request of STQ, the City granted an extension of the December 31, 2009 deadline to March 31, 2010. Therefore, we verified the amount of capital expenditures made by STQ from January 1, 2009 through March 31, 2010 in accordance with the agreement.

According to our audit, STQ completed \$2,017,000 of capital improvements during the period examined, bringing the total aggregate amount expended to \$3,983,000 through March 31, 2010. While this is \$317,000 less than their \$4,300,000 obligation under the agreement, STQ continues to make significant progress towards completing capital improvements that clearly improve the visitors' experience and contribute to the

preservation of the Queen Mary. As part of its attached response, STQ details additional renovations that have begun since the completion of our audit. It is their intention to meet all remaining capital improvement obligations by the final deadline of December 31, 2010.

The details of our audit can be found in the attached report, along with the response of STQ and City Management. We recommend that City Management closely monitor Save the Queen's performance to ensure that an aggregate of \$5,300,000 in improvements are made by the final benchmark date of December 31, 2010. The City Auditor's Office will continue to work with City Management and the City Attorney's Office to ensure that the City's interests in the Queen Mary are protected.

We would like to thank Save the Queen for the time, information, and full cooperation provided to us during this audit.

TIMING CONSIDERATIONS

This item is not time-sensitive.

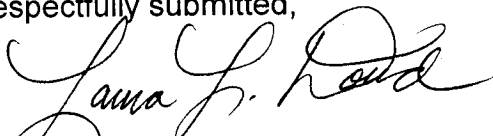
FISCAL IMPACT

As described in the report, Save the Queen's aggregate capital expenditures are \$317,000 less than the required total per their lease with the City. However, Save the Queen has represented it intends to make all improvements required under its lease. The failure of Save the Queen to fulfill its lease obligations would result in a lack of improvements to the City's asset, and undermine the City's goal of improving the visitors' experience and generating additional operation revenue at the Queen Mary.

SUGGESTED ACTION:

Approve recommendation.

Respectfully submitted,



Laura L. Doud, CPA
CITY AUDITOR



**City of Long Beach
Office of the City Auditor**

**Queen Mary Capital Improvements
Audit Report
Phase II**

August 2010

**Laura L. Doud, CPA
City Auditor**

Office of the City Auditor

Audit Report

**Queen Mary
Capital Improvements Audit
Phase II**

August 2010



Audit Staff

City Auditor: Laura L. Doud
Deputy City Auditor: Janet Day
Audit Manager: Terra Van Andel
Senior Auditor: Jessica Machado

Table of Contents

Executive Summary	1
Background	1
History of Queen Mary	1
The City Agreement.....	2
Audit Objective, Scope and Methodology	3
Audit Results	5
Issue #1: STQ completed \$3,983,000 of the required \$4,300,000 in capital improvements by March 31, 2010; resulting in a shortfall of \$317,000.....	5
Issue #2: STQ performed certain improvements that deviated from the Approved Capital Plan; however, City approval was sought.	5
Recommendations	8

Appendices

Management's Response

Save the Queen.....	Appendix A
City of Long Beach.....	Appendix B

Executive Summary

We recently concluded our audit of Queen Mary capital improvements performed in conjunction with the City Agreement (Agreement) dated November 6, 2007. For consideration of \$5,300,000 in approved capital expenditures, the City of Long Beach (City) agreed to grant rent credits to satisfy Save the Queen's (STQ) obligation to pay Percentage Rent through December 31, 2010. The Agreement required STQ to perform a minimum aggregate amount of \$4,300,000 in approved capital expenditures by December 31, 2009. However, at STQ's request, the City granted an extension until March 31, 2010 to complete the required \$4,300,000 in approved capital expenditures.

The purpose of our audit was to ensure that capital improvements were made in compliance with the Agreement during the period of January 1, 2009 through March 31, 2010, which includes determining if STQ performed the required \$4,300,000 in approved capital expenditures. The following briefly highlights the results of our audit:

- Issue #1: STQ completed an aggregate amount of \$3,983,000 of the required \$4,300,000 in capital improvements by March 31, 2010; resulting in a shortfall of \$317,000; and
- Issue #2: STQ performed certain improvements that deviated from the Approved Capital Plan; however, City approval was sought.

Although total aggregate capital expenditures are \$317,000 less than their \$4,300,000 obligation under the agreement, STQ continues to make significant progress towards implementing renovations that clearly improve the visitors' experience and contribute to the preservation of the Queen Mary. Since the completion of our audit, STQ is reporting they have begun additional renovations, and it is their intention to meet all remaining capital improvement obligations by the final deadline of December 31, 2010.

Background

History of Queen Mary

The City of Long Beach (City) purchased the Queen Mary in 1967, and has since leased the operations of the ship to several entities. In February 1993, the City entered into a five-year Lease and Operations Agreement (Lease #22697) with RMS Foundation, Inc. (RMS), a non-profit public benefit California Corporation. Lease #22697 included approximately 9.29 acres of water surrounding the Queen Mary, 11.55 acres of water northwest of the Queen Mary and 43.38 acres of land, including the Dome and Queen's Marketplace.

The Chief Executive Officer of RMS incorporated Queen Seaport Development, Inc. (QSDI), a for-profit California entity, as his operation's profit-making arm in 1995. Later that year, the City entered into Lease and Operations Agreement #24121 (Master Lease) to recognize QSDI as the master lessee of the Queen Mary and extend the

lease to a 20-year term. QSDI then subleased the Queen Mary's operation back to RMS. As master leaseholder, QSDI managed the entire Queen Mary property including its development, and, in October 1998 the lease with QSDI was extended to a term of 66 years.

In March 2005, QSDI filed for Chapter 11 Bankruptcy protection. Subsequently, the Bankruptcy Court approved the sale of the Trustee's right, title, and interest in the Queen Mary Master Lease. In August 2007, the leasehold interest was auctioned to Save the Queen (STQ), the successful bidder at \$43 million, and the sale closed in November 2007.

The City Agreement

Under the Master Lease, the City is due two types of rent: Monthly Base Rent and Percentage Rent, calculated as a percentage of gross receipts. In order to satisfy these obligations, the Master Lease provides for certain types of rent credits through the use of "On-Ship Capital Credits" and use of "Development Costs." However, the City and STQ entered into the City Agreement (Agreement) in November 2007 that allows STQ to make certain approved capital expenditures in exchange for Percentage Rent due to the City.

The Agreement provides that STQ may satisfy its obligations with respect to Percentage Rent through December 31, 2010 by making \$5,300,000 in approved capital expenditures (Approved Capital Plan) under the timeline listed below.

Timeline Benchmarks	Minimum Aggregate Amount of Approved Capital Expenditures
December 31, 2008	\$2,800,000
December 31, 2009	\$4,300,000
December 31, 2010	\$5,300,000

The Approved Capital Plan (Plan) was developed based on a preliminary review of work to be performed. In developing the Plan, the intent of the City and STQ was to enhance visitors' experiences on the Queen Mary, ultimately increasing revenues. Therefore, not all expenditures made with regards to the Plan may be considered true "capital improvements," as capital improvements are typically classified as assets rather than expenses.

The Plan establishes twelve budget categories (Budget Category). Within each Budget Category, budgets are identified for individual line items (Line Item). At the time the Plan was developed, it was understood that actual costs of improvements may vary from the estimated budgeted amounts, and STQ may reallocate funds within Budget Category Line Items. However, as stated in the Agreement, STQ shall seek City approval for variances that either: (i) exceed 15% between Line Items within the same Budget Category, or (ii) reallocates funds to a different Budget Category than set forth in the Plan.

In December 2009, STQ sought City approval for the following:

1. An extension until March 31, 2010 to perform the cumulative amount of \$4,300,000 in approved capital improvements; and
2. A reallocation of funds among Budget Categories (Table 1).

The City granted STQ's request in January 2010. The reallocation of renovation amounts enabled STQ to target improvements specifically to enhance the guest experience aboard the Queen Mary as an attraction and hotel, while maintaining its historical significance and physical integrity.

**Table 1
Budget Category Reallocation**

Budget Category	Budget Category (per Plan)	Reallocation	Revised Budget Category
Queen's Salon	\$ 149,933	\$ (22,683)	\$ 127,250
Britannia/ Grand and Windsor Salons	150,000	55,982	205,982
Exposition Hall	249,920	(202,985)	46,935
Guestrooms	900,750	771,322	1,672,072
Guest Bathrooms	600,077	(500,082)	99,995
Kitchen	806,438	99,878	906,316
Restaurant	281,183	264,181	545,364
Technology	1,125,008	(15,332)	1,109,676
Banquets	169,000	(169,000)	-
Entrance	180,000	(88,133)	91,867
Major Mechanical	500,000	(182,440)	317,560
Miscellaneous	137,691	35,695	173,386
Elevator/Escalator	50,000	(46,403)	3,597
Totals:	\$ 5,300,000	\$ -	\$ 5,300,000

Audit Objective, Scope and Methodology

The objective of our audit was to ensure capital improvements were made in compliance with the Agreement. STQ was to complete a minimum aggregate amount of \$4,300,000 of the total \$5,300,000 in approved capital expenditures by December 31, 2009. However, at STQ's request, the City granted an extension until March 31, 2010 to complete the required \$4,300,000 in approved capital expenditures. Therefore, the scope of this audit was defined as the period from January 1, 2009 to March 31, 2010.

While conducting the audit, we performed the following procedures:

- Reviewed the Agreement, the Plan, and the revised budget including reallocated amounts to gain an understanding of the requirements and expectations of the approved capital expenditures;
- Reviewed the Queen Mary Capital Improvements Audit Report (Phase I Audit) issued by the Office of the City Auditor (OCA) in June 2009;
- Obtained, reviewed, and scheduled copies of invoices and cancelled checks related to capital improvements made in conjunction with the Agreement during January 1, 2009 through March 31, 2010;
- Gained an understanding of internal controls surrounding the processing of payments and invoices for capital improvements made in conjunction with the Agreement;
- Traced cancelled checks for capital improvements made from January 1, 2009 through March 31, 2010 to bank statements, on a sample basis;
- Obtained and reviewed copies of vendor contracts related to capital improvements during January 1, 2009 through March 31, 2010. For those contracts identified, we confirmed the following information:
 - Contract date;
 - Services performed;
 - Payments received by vendor; and
 - Percent completion.
- Observed capital improvements completed in conjunction with the Agreement, on a sample basis;
- Identified partial payments made to vendors for capital improvements made as of March 31, 2010 in conjunction with the agreement;
- Identified appropriate Budget Categories and Budget Category Line Items for capital improvements made, as defined in the Plan;
- Calculated variances, if any, between actual costs of capital improvements and budgeted amounts identified in the Plan;
- Calculated total capital improvements made during January 1, 2009 through March 31, 2010 in conjunction with the Agreement; and
- Identified whether capital improvements made as of March 31, 2010 met the required minimum aggregate amount of \$4,300,000 in approved capital expenditures as defined in the Agreement.

We conducted this performance audit in accordance with Generally Accepted Government Auditing Standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

Audit Results

Issue #1: STQ completed \$3,983,000 of the required \$4,300,000 in capital improvements by March 31, 2010; resulting in a shortfall of \$317,000.

Per the Agreement between the City and STQ, if STQ or Lenders make \$5,300,000 in capital expenditures in accordance with the Plan, the City would grant rent credits to satisfy STQ's obligation to pay Percentage Rent through December 31, 2010. The Agreement required STQ to perform a minimum aggregate amount of \$4,300,000 in approved capital expenditures by December 31, 2009. However, at STQ's request, the City granted an extension until March 31, 2010 to complete the required \$4,300,000 in approved capital expenditures.

Our audit revealed that STQ completed a cumulative amount of \$3,983,000 in capital improvements as of March 31, 2010. Completed capital improvements made by STQ represent actual expenditures for improvements as of March 31, 2010 that have been paid and performed/received. Table 2 depicts a summary of completed improvements by Budget Category as of March 31, 2010.

Additionally, we identified \$78,000 of services and/or products received for which no payment had been made as of March 31, 2010. As such, those amounts have not been included in the total capital improvements of \$3,983,000.

Issue #2: STQ performed certain improvements that deviated from the Approved Capital Plan; however, City approval was sought.

As stated above, the Plan was developed based on a preliminary review of work to be performed. It was understood by both parties that actual cost of improvements may vary from estimated budgeted amounts. However, per the Agreement, City approval should be sought for variances that either:

- (i) exceed 15% between Line Items within the same Budget Category; or
- (ii) reallocates funds to a different Budget Category other than as defined in the Plan.

The Plan establishes twelve Budget Categories. Within each Budget Category, budgets are established for individual Line Items. For example, Line Items within the Queen's Salon are carpet, decorative lighting, stack chairs, artwork, artifacts, etc.

In December 2009, STQ sought City approval for the following:

1. An extension until March 31, 2010 to perform the cumulative amount of \$4,300,000 in approved capital improvements; and
2. A reallocation of funds among Budget Categories (Table 1).

The City granted STQ's request in January 2010. However, the reallocation request was presented at the Budget Category level and did not identify the specific Budget Category Line Items to be adjusted by the reallocation. Therefore, we were unable to determine if Budget Category Line Items exceeded the allowed amount by over 15%.

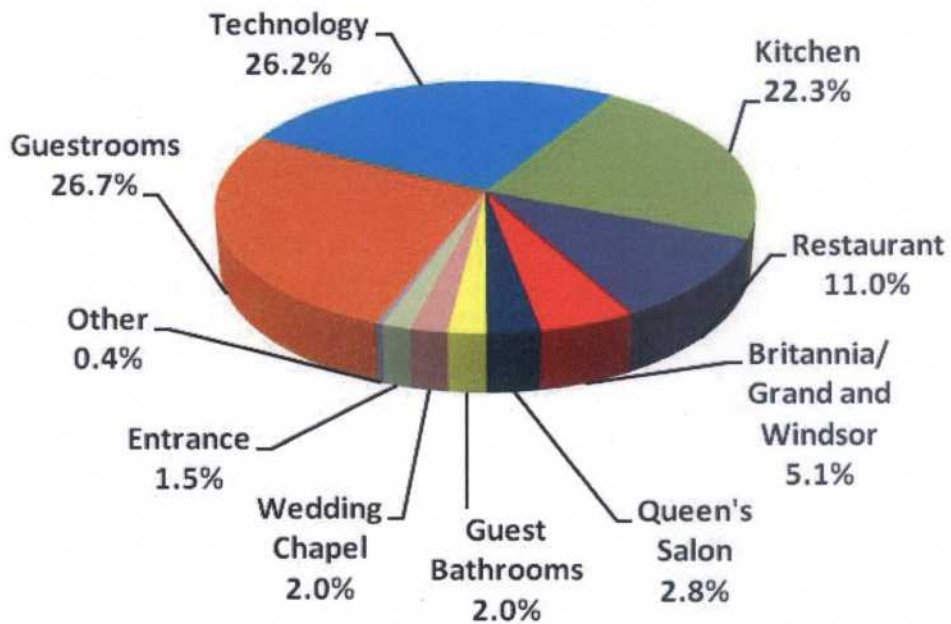
Table 2
Approved Budget Category Amounts
and Capital Expenditures

Budget Category	Approved Category Amount (revised)	Capital Expenditures 10/22/07 - 12/31/08	Capital Expenditures 01/01/09 - 03/31/10	Total Aggregate Amount as of 03/31/10
Guestrooms	\$1,672,072	\$ 346,912	\$ 717,657	\$ 1,064,569
Technology	1,109,676	530,508	512,744	1,043,252
Kitchen	906,316	887,816	-	887,816
Restaurant	545,364	63,332	372,388	435,720
Britannia/Grand and Windsor Salons	205,982	72,177	131,969	204,146
Queen's Salon	127,250	20,665	90,951	111,616
Guest Bathrooms	99,995	6,994	73,813	80,807
Miscellaneous	173,386	6,749	72,493	79,242
Entrance	91,867	14,660	45,174	59,834
Major Mechanical	317,560	12,260	-	12,260
Elevator/Escalator	3,597	3,597	-	3,597
Exposition Hall	46,935	-	-	-
Total:	\$5,300,000	\$ 1,965,670	\$ 2,017,189	\$ 3,982,859

Included in the Guestrooms and Entrance purchases are \$26,790 in nightstand lamps and \$7,775 in frames and display boards. During the audit, we observed these items retained in storage. STQ represents they expect to install these items by September 2010. Therefore, these purchases are included in the total capital improvements of \$3,983,000.

The pie chart below illustrates all capital improvements made from October 22, 2007 through March 31, 2010 by Budget Category. Expenditures of \$15,000 or less are combined in the pie chart as "Other" and include the following Budget Categories: Major Mechanical and Elevator/Escalator. As evidenced below, 86% of capital improvements were performed in the Guestrooms, Technology, Kitchen, and Restaurant Budget Categories.

Total Capital Improvements October 22, 2007 - March 31, 2010



Recommendations

1. Devise a comprehensive plan to ensure that the total amount of \$5,300,000 in approved capital improvements are performed by December 31, 2010 as required by the Agreement. Provide City Management with a progress update within 30 days from the filing date of this report.
2. Obtain advance City approval in writing for variances to the Approved Capital Plan, at the Budget Category Line Item detail, to avoid ambiguity.

Appendix A

Management's Response

Save the Queen

Save the Queen, LLC
c/o Garrison Investment Group
1350 Avenue of the Americas
9th Floor New York, New York 10019
212-372-9500 Fax: 212-372-9525

August 9, 2010

Office of the City Auditor
c/o Terra Van Andel, CFE
Audit Manager

Re: Queen Mary Capital Improvements Audit

To City Auditor's Office:

Please allow this letter to serve as Save the Queen's response to the Capital Improvement Audit Phase II that was prepared in July 2010 by the Office of the City Auditor. Since the initial letter we sent to you in December 2009, we have implemented a number of positive changes at the Queen Mary.

These include, but are not limited, to the following:

- Full renovation of the Grand and Windsor Salons, including new carpet and new drapery
- Full renovation of the Queens Salon, including new carpet and new drapery
- Full renovation of the Promenade Café and Sir Winston's restaurant
- Full renovation of 176 guestrooms and bathrooms, including new carpet, linens, fixtures, and appliances
- Full renovation of the Wedding Chapel
- Full renovation of the Wharf Entry area
- Technological upgrades, including a fully automated parking system, a new property management system and sales and catering systems

We hope that you have had a chance to see all of the positive changes that we have made. We believe we are taking enormous steps towards enhancing the overall guest experience while executing a restoration process that maintains the Queen Mary's historical significance and physical integrity. Per our December 2009 letter we requested an extension so that we could accommodate the transition of our new management team and perform the renovations during our slower months so as to minimize the interruption to our guests.

Since March 2010, we have spent an additional \$1,030,143 in renovations specifically on Guestrooms and Bathrooms, Technology, completing the Wedding Chapel, enhancing the Wharf Entrance area, and renovating the Chelsea Restaurant. See attached Exhibit A for details.

For the remainder of 2010, renovation plans include the completion of the renovation of all Guestrooms and Bathrooms, completion of the renovation of the Chelsea Restaurant, upgrades to the Mechanical HVAC systems, and additional enhancements to the Wharf Entryway. These remaining improvements which are estimated to cost approximately \$693,900, will be completed by December 2010.

The additional dollars that will be spent from March 30, 2010 to December 31, 2010 will be \$1,724,043. According to the Audit, there is a current shortfall of \$317,000 for the 2009 milestone and an additional 2010 requirement of \$1,000,000 for a total requirement of \$1,317,000. Our projected spend of \$1,724,043 is estimated to exceed these obligations by \$407,043.

As of 8/6/2010, Save the Queen needs to spend an additional \$286,857 in order to achieve the \$5,300,000 milestone that was set for the end of 2010.

<u>Budget Category</u>	<u>Budget Amount</u>	<u>Spent to Date</u>	<u>Spent to Date</u>	<u>Remaining</u>	<u>Total Spent</u>	<u>Variance</u>
		<u>Per Audit</u>	<u>8/6/2010</u>			<u>Reallocation</u>
Grand and Windsor Salon	205,982	204,146	0	0	204,146	-1,836
Elevator Escalator Upgrade	3,597	3,597	0	0	3,597	0
Entrance	91,867	59,834	34,365	34,365	128,565	36,698
Guest Bathrooms	99,995	80,807	0	0	80,807	-19,188
Guestrooms	1,672,072	1,064,569	784,382	301,030	2,149,981	477,909
Kitchen	906,316	887,816	0	0	887,816	-18,500
Major Mechanical	317,560	12,260	0	189,585	201,845	-115,715
Miscellaneous Wedding Chapel	173,386	79,243	20,100	0	99,343	-74,043
Queen's Salon	127,250	111,616	0	0	111,616	-15,634
Restaurant	545,364	435,720	169,499	168,920	774,139	228,775
<u>Technology</u>	<u>1,109,676</u>	<u>1,043,252</u>	<u>21,796</u>	<u>0</u>	<u>1,065,048</u>	<u>-44,628</u>
TOTAL	5,253,065	3,982,859	1,030,143	693,900	5,706,903	453,838

We are extremely pleased with the progress made to date and we hope the City of Long Beach shares this sentiment. We look forward to a continued partnership with the City of Long Beach on the iconic Queen Mary.

Please feel free to contact me with any questions or concerns.



Andy Kwon
Vice President
Garrison Investment Group
c/o Save the Queen, LLC

QUEEN MARY

SPENT TO DATE

CHECK DATE	CHECK NO.	AMOUNT	DESCRIPTION
Rooms			
4/27/2010	3449	\$ 26,000.00	Initial funding for mobilization and materials
5/20/2010	3466	\$ 18,525.00	100% Completion
5/20/2010	3468	\$ 13,127.50	Interior Painting, Drywall patching
5/20/2010	3471	\$ 6,181.35	Labor-Moving company
5/20/2010	3472	\$ 118,147.50	Interior Painting, Drywall patching
5/20/2010	3469	\$ 4,540.25	Demo, Carpet & pad installation
5/20/2010	3473	\$ 7,079.63	Labor-Moving company
5/20/2010	3475	\$ 3,432.00	Demo, Carpet & pad installation
5/20/2010	3476	\$ 3,791.03	Labor-Moving company
5/20/2010	3467	\$ 57,720.00	Completion of 74 room renovation
7/29/2010	3538	\$ 4,750.20	Final invoice
Subtotal		\$ 263,294.46	
Technology			
5/13/2010	3460	\$ 17,436.64	Delphi- new installment #1,2,4,5
5/20/2010	3463	\$ 4,359.14	Delphi- new installment #6
Subtotal		\$ 21,795.78	
Wedding Chapel			
5/21/2010	3479	\$ 3,440.85	Phase 3-Chapel demo, carpet & pad installation
5/21/2010	3480	\$ 3,718.00	Demo, Carpet & pad installation
5/21/2010	3482	\$ 6,363.50	Demo, Carpet & pad installation
5/21/2010	3483	\$ 6,578.00	Demo, Carpet & pad installation
Subtotal		\$ 20,100.35	
Entrance			
7/1/2010	3513	\$ 28,486.10	Hotel sign
7/6/2010	3516	\$ 981.56	Installing of awnings
7/6/2010	3517	\$ 3,805.84	Installing of awnings
7/6/2010	3518	\$ 1,091.97	Installing of awnings
Subtotal		\$ 34,365.47	
TOTAL 2009 Budget		\$ 339,556.06	

Final Phase Rooms			
5/20/2010	3464	\$ 131,000.00	TV deposit
5/20/2010	3465	\$ 93,500.00	Initial deposit-Drapery, Bedding, Inserts, Fabrics
5/20/2010	3474	\$ 93,676.45	Carpeting
7/6/2010	3522	\$ 6,785.00	Remediation of water damaged walls in rooms
7/29/2010	3539	\$ 120,000.00	Deposit to start rooms phase 3
7/29/2010	3540	\$ 76,126.56	FF&E Order
Subtotal		\$ 521,088.01	
Chelsea Restaurant			
7/6/2010	3523	\$ 140,000.00	Deposit for Chelsea Chowder renovation
7/29/2010	3541	\$ 10,923.78	Architect (City requirement)
7/29/2010	3542	\$ 18,575.24	Chelsea FF&E
Subtotal		\$ 169,499.02	
TOTAL 2010 Budget		\$ 690,587.03	

TOTAL \$ 1,030,143.09

Costs to Complete	
Chelsea Restaurant	\$ 168,919.98
Rooms Completion	\$ 301,029.99
Entrance	\$ 34,365.47
HVAC	\$ 189,585.00
TOTAL	\$ 693,900.44

Appendix B

Management's Response

City of Long Beach



Date: August 9, 2010
To: Laura L. Doud, City Auditor
From: Dennis Thys, Director, Department of Community Development
Subject: Response to Queen Mary Phase 2 CIP Audit Comments

A handwritten signature in black ink, appearing to read "Dennis Thys", written over the "From:" line of the memorandum header.

Thank you for the opportunity to review the draft audit report and the Response to Comments provided by the City's tenant, Save the Queen (STQ), LLC. We are in concurrence with the Audit Results and Recommendations, and we are in agreement with the comments provided by STQ.

We look forward to continuing improvements being made on the Queen Mary by STQ that will further enhance the guest experience and help to preserve this important and historic City asset for future generations.

We likewise appreciate your efforts and that of your staff in this regard. Please do not hesitate to contact Victor Grgas, Property Services Bureau Manager at extension 8.6705 should you have any questions.