



# City of Rochester Involvement With the Fast Ferry Operation

## Report of Examination

Period Covered:

September 19, 2001 - April 15, 2005

2006M-21



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# State of New York Office of the State Comptroller

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## Division of Local Government Services and Economic Development

July 2006

Dear City Officials:

One of the Office of the State Comptroller's top priorities is to identify areas where local governments can improve their operations and provide guidance and services that will assist local officials in making those improvements. Further objectives are to develop and promote short-term and long-term strategies to enable and encourage local government officials to reduce costs, improve service delivery and to account for and protect their governments' assets.

The reports issued by this Office are an important component in accomplishing these objectives. These reports are expected to be a resource and are designed to identify current and emerging fiscally related problems and provide recommendations for improvement. The following is our report on the City of Rochester — Involvement With the Fast Ferry Operation.

This audit was conducted pursuant to the State Comptroller's authority as set forth in Article V, Section 1 of the State Constitution, and Article 3 of the General Municipal Law. The report contains opportunities for improvement for consideration by the City Council.

If we can be of assistance to you or if you have any questions concerning this report, please feel free to contact the local regional office for your county listed at the back of this report.

Respectfully submitted,

*Office of the State Comptroller  
Division of Local Government Services  
and Economic Development*



## State of New York Office of the State Comptroller

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# EXECUTIVE SUMMARY

In 1998, former Mayor Johnson<sup>1</sup> and the Common Council of the City of Rochester (City) began the process of bringing a fast ferry service between Rochester and Toronto, Canada. This process led to the September 2001 selection of a private operator, Canadian American Transportation Systems, LLC (CATS), to manage the Port of Rochester and operate a fast ferry service between the two cities. The capital requirements of this operation required the direct investment of \$15.3 million of financing by the City and New York State.

CATS commenced fast ferry service in June 2004, and discontinued it 11 weeks later in September. The operation was plagued by a variety of problems, including higher-than-planned operational costs, less-than-expected ridership, mechanical breakdowns, and an accident while docking in New York City (while en route to Rochester). The accident delayed the start of operations by several weeks. When CATS failed to pay its bills as they came due, a creditor began an arrest proceeding under maritime law, which is similar to a foreclosure under real estate law. In January 2005, the City created the Rochester Ferry Company (RFC) to purchase the ferry at a Federal foreclosure auction, and to oversee the operation of a ferry service. In February 2005, RFC purchased the ferry at auction with a bid price of \$32 million.

The City's operation of the ferry was plagued by many of the same problems as CATS' operations. In early January 2006, current Mayor Duffy proposed and the Common Council adopted policies that permanently suspended ferry operations. In May 2006, the City agreed to sell the ferry to Euroferries, Ltd. for \$29.8 million, leaving taxpayers with \$20 million in remaining debt on the Fast Ferry Project (Project). As of the release of this report, the sale has not been finalized.

### **Scope and Objectives**

The objective of our audit was to review the City's involvement in the Project. Specifically, our audit sought to answer the following questions regarding City officials' actions from September 19, 2001 to April 15, 2005:

- Did City officials provide adequate due diligence when approving and monitoring the Project?
- Were appropriate safeguards in place to protect the public's interest?

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<sup>1</sup> At a number of points this report refers to "the Mayor," which was Mayor Johnson through December 31, 2005. Mayor Duffy took office on January 1, 2006.

## **Audit Results**

We recognize that new opportunities for economic growth can present some risks that are hard to predict exactly. Sometimes government officials need to accept some level of risk to achieve potentially significant results. However, the City started the fast ferry service with a start-up company whose principals had never before performed these services. This type of project, with individuals who have no track record in the field, required a significant level of due diligence by City officials. We have tried to be careful in this audit to avoid second-guessing the decisions made by City officials based on information that has become known since the project began. Rather, we tried to review what City officials knew, or what they reasonably should have known, at the time they made decisions, and to evaluate the information they had and the actions they took in initiating the ferry service.

As a result, we found that there were a variety of clear warnings that were known, or should have been known, by City officials during the approval process of the ferry project. These red flags should have alerted City officials to the extremely risky nature of this venture, and should have caused them to increase their review of various aspects of the Project's plan before proceeding and committing public funds to the Project.

For example, the City requested proposals for a two ferry operation and accepted the only formal response they received, a proposal from CATS that included a more than \$100 million plan. However, shortly after the City accepted the proposal, CATS changed its plan to include only one ferry. Despite this significant change in project scope and the fact that the City received only one proposal, the City did not call for a new round of competitive proposals.

Also, City officials obtained two reviews of CATS' plan from outside consultants that contained several critical and cautionary statements, yet we found no evidence that City officials heeded the warnings in the evaluations. Those evaluations highlighted a number of concerns with the plan, including the mismatch between vessel capacity and demand, serious deficiencies in the financial model included in the proposal, concerns about CATS' existing equity, low profit margins, the lack of enthusiasm by the Toronto market, and unrealized time savings in comparison with other transportation options. Despite these strong cautions, City officials did not perform any further analysis of the subsequent plans.

Further, CATS revised its business plan several times during the start-up process. For example, a version dated January 2002 showed total resources and expenses of \$62 million, including \$10 million in funding from Canadian government sources. When the Canadian funding did not materialize, CATS issued a new \$57.7 million plan without making any actual changes to the Project. For example, CATS reduced the pre-launch/reserves expenses in the plan from \$20 million to \$15.2 million. However, City officials did not provide us with any written documentation that explained which specific expenses that CATS eliminated in the revised plan, or what – if any – action they took to ensure that CATS' plan was still viable with \$5 million less in funding.

Additionally, City officials should have heeded several red flags with regard to the Project's equity position. One of the red flags was the fact that another public agency, the Rochester Genesee Regional Transit Authority (RGRTA), experienced difficulty in attempting to verify a portion of the Project's equity. Rather than supporting that effort to verify CATS' plan, which also was required by the City's

\$1.3 million loan agreement with CATS, City officials replaced RGRTA with the Rochester Urban Renewal Agency (RURA), a City-controlled agency, as the conduit for the loan. City officials then did not verify CATS' equity prior to releasing the loan.

From our efforts, we know that such verification would, at best, have been extremely difficult. We were unable to verify \$1.7 million in equity contributions that CATS' partners claimed. In reality, CATS had an inadequate amount of equity at the start of the Project. As a result, the Project was undercapitalized and therefore ill-equipped to meet pre-launch expenditures, unforeseen events, and deviations from the business plan. For example, CATS indicated that it would set aside \$3.5 million of the equity contribution from part of the positive cash flow expected from the first three years of operations – an optimistic projection at best for a risky start-up venture. Of course, the positive operating cash flow never actually materialized. Furthermore, if this equity had materialized, it was earmarked for reserves committed to protecting the senior lender, and not for operations. Thus, CATS would not have been able to use the \$3.5 million for unforeseen events and deviations from the business plan, both of which occurred.

We also found that a commitment letter from the City to CATS stipulated that City officials would contract with outside legal counsel who would be charged with ensuring the City's lien on the ferry was enforceable and in compliance with relevant law, and overseeing the loan process to ensure that CATS fulfilled specific contractual obligations. The commitment letter called for CATS to pay for this oversight. However, the City did not retain outside legal counsel for this purpose. This lack of oversight allowed CATS to spend over \$2.8 million more than the Project's budgeted amounts without the City's knowledge. Also, the City was unaware that CATS had obtained \$7.4 million in short-term loans to finance operations during the pre-launch phase of the Project. This short-term financing was not anticipated in the business plan and was indicative of the Project's growing financial problems. Because City officials provided no oversight, they apparently were not aware of this red flag.

We found that City officials used more than \$975,000 of additional City funds on behalf of the Project, funding that was not publicized and was not included in the business plan. Some of these funds were provided to CATS against the express resolutions adopted by the City Council. All of this funding was done in a manner – including funneling payments to CATS through a third-party contractor – that would appear to be an attempt to hide the transactions from outside scrutiny.

Finally, City officials did not thoroughly investigate assertions and representations made by a CATS affiliate before making concessions under a lease agreement which allowed that affiliate to retain the lease on the port after CATS failed. Prior to entering into the license and lease contract, City officials made no attempt to determine the value of the economic benefits provided under the contract, thereby making it difficult to demonstrate that the City acted in the public's interest by entering into the contract.

### **Comments of Local Officials**

The results of our audit and recommendations have been discussed with City officials and their comments, which appear in Appendix A, have been considered in preparing this report. Except as specified in Appendix A, City officials generally agreed with our recommendations and indicated they had initiated corrective action.

# Introduction

## Background

In 1998, former Mayor Johnson<sup>2</sup> and the Common Council of the City of Rochester (City) began the process of bringing a fast ferry service between Rochester and Toronto, Ontario, Canada. This process led to the September 2001 selection of a private operator, Canadian American Transportation Systems, LLC (CATS), to manage the Port of Rochester (Port) and operate fast ferry service between the two cities. The capital requirements of this operation required the direct investment of \$15.3 million of financing by the City and New York State.

For at least the past 10 years it has been the goal of a number of civic and business leaders to have fast ferry services from Rochester to Toronto. In 2000, the City issued a request for proposals (RFP) to manage the Port and operate a fast ferry service between Rochester and Toronto. The City solicited statements of qualifications and interests from 39 prospective operators; however, only four organizations responded. The City requested proposals for a two-ferry operation from the four organizations but received only one proposal, from CATS. A second organization declined in writing to submit a proposal due to its concerns regarding the amount of capital required for shore infrastructure. The City's former Port Project Manager stated that that organization also told him that their main concern was the lack of any government subsidy from the City, Monroe County, the City of Toronto, or the Toronto Port Authority. Another organization objected to the proposal process initiated by the City, complained of being treated in a discriminatory manner, and complained that the City used their organization's confidential and proprietary information, materials and sources to draft the request for statements of qualifications and interest, and RFPs. There was no written response from the fourth organization, but the City's former Port Project Manager told us that that organization was unable or unwilling to meet the City's specifications requiring two vessels, and the one vessel it would have proposed would not have met specifications.

The original proposal submitted by CATS included the operation of two ferries at the Port with costs of more than \$100 million. Through negotiations with City officials concerning financing of the ferries, CATS decided to change its proposal to a single ferry operation for the Port. The City agreed to this change and in September 2001 it awarded CATS the exclusive rights to manage the Port and operate a fast ferry service between Rochester and Toronto. Although the City

<sup>2</sup> At a number of points this report refers to "the Mayor," which was Mayor Johnson through December 31, 2005. Mayor Duffy took office on January 1, 2006.

executed a License, Lease and Management Agreement (LLM) with CATS, the estimated cost of the Project was still uncertain. We found a number of different project cost estimates in the financial records presented to us by CATS. CATS submitted at least two different single ferry proposals to the City, one for \$62 million and another for \$57.7 million, with the final agreement among the parties being the \$57.7 million proposal. The \$57.7 million proposal estimated that \$42.5 million would be for the acquisition of the ferry, and \$15.2 million for reserves and pre-launch expenses.

CATS purchased a fast ferry vessel from Austal, an Australian shipbuilding company. The shipbuilding company began construction of the ferry in 2002, and delivered it to CATS in April 2004. Following a series of delays and mishaps, CATS initiated the ferry service in June 2004.

CATS' plan was to secure financing for the ferry operations through a combination of private bank loans, loans from the City, loans and grants from various State agencies, an investment by the shipbuilder, and private funding from Dominick DeLucia (DeLucia) and Brian Prince (Prince), the principal owners of CATS. The final ferry financing proposal included:

Source	Type	Amount
ABN AMRO Bank <sup>1</sup>	Loan	\$26,700,000
DaimlerChrysler (the ship's engine builder)	Loan	\$6,300,000
Rochester Urban Renewal Agency (RURA), from the State Infrastructure Bank (SIB)	Loan	\$6,600,000
City of Rochester	Loan	\$1,300,000
Empire Opportunity Fund <sup>2</sup>	Grant	\$2,500,000
Community Capital Assistance Program (CCAP), from the New York State Senate <sup>2</sup>	Grant	\$2,433,333
RESTORE NY, from the New York State Assembly <sup>3</sup>	Grant	\$2,466,667
Austal Ships (shipbuilder)	Reduction in purchase price	\$2,100,000
Dominick DeLucia and Brian Prince (principals of CATS)	Equity	\$7,300,000
<b>Total</b>		<b>\$57,700,000</b>
<sup>1</sup> Export Finance Insurance Corporation (EFIC) guarantor of \$22.5 million		
<sup>2</sup> Through the Empire State Development Corporation (ESDC)		
<sup>3</sup> Through the Dormitory Authority of the State of New York (DASNY)		

CATS halted ferry service from Rochester to Toronto on September 7, 2004 after only 11 weeks of operations. According to newspaper reports, continued operating losses and the insolvency of CATS are cited for the discontinuation of service.

When CATS failed to pay its bills as they came due, a creditor began an arrest proceeding under maritime law, which is similar to a foreclosure under real estate law. In January 2005, the City created the Rochester Ferry Company (RFC) to purchase the ferry at a Federal foreclosure auction, and to oversee the operation of a ferry service. In February 2005, RFC purchased the ferry at auction with a bid price of \$32 million. The Export Finance and Insurance Corporation (EFIC), a loan-guaranteeing arm of the Australian government, provided \$40 million in financing to RFC to enable it to purchase the ferry.

RFC's operation of the ferry was plagued by many of the same problems as CATS' operations: low ridership, and higher-than-planned operational costs. In early January 2006, current Mayor Duffy proposed and the Common Council adopted policies that permanently suspended ferry operations. In May 2006, the City agreed to sell the ferry to Euroferries, Ltd. for \$29.8 million – leaving taxpayers with \$20 million in remaining debt on the Project. As of the release of this report, the sale has not been finalized.

## **Objectives**

The objective of our audit was to review the City's involvement in the Project. Specifically, our audit sought to answer the following questions regarding City officials' actions from September 19, 2001 to April 15, 2005:

- Did City officials provide adequate due diligence when approving and monitoring the Project?
- Were appropriate safeguards in place to protect the public's interest?

## **Scope and Methodology**

During this audit we examined the financial records of the City and CATS, and actions taken by City officials relative to the Project, for the period September 19, 2001 to April 15, 2005.

We conducted our audit in accordance with generally accepted government auditing standards (GAGAS). More information on such standards and the methodology used in performing this audit are included in Appendix C of this report.

**Comments of  
Local Officials and  
Corrective Action**

The results of our audit and recommendations have been discussed with City officials and their comments, which appear in Appendix A, have been considered in preparing this report. Except as specified in Appendix A, City officials generally agreed with our recommendations and indicated they had initiated corrective action.

The City Council has the responsibility to initiate corrective action. Pursuant to Section 35 of the General Municipal Law, the City Council should prepare a plan of action that addresses the recommendations in this report and forward the plan to our office within 90 days. For guidance in preparing your plan of action, you may refer to applicable sections in the publication issued by the Office of the State Comptroller entitled *Local Government Management Guide*. We encourage the City Council to make this plan available for public review in the City Clerk's office.

## Failure to Exercise Due Diligence

A formal RFP process should be open and fair, encourage competition, and provide the municipality with the best services at the best possible price. During the RFP process, if the municipality changes the scope of the project or requirements for formal bids, it should ensure that all bidders are given the opportunity to submit new bids that fulfill the changed requirements. Also, the municipality should evaluate and rate proposals to ensure that the bidders have the ability, capacity, and skill to perform the scope of work, and have appropriate experience in accomplishing similar services. It is incumbent on the municipality to properly evaluate the proposal and take into consideration all risks – financial and otherwise – that might have an impact on the outcome of the proposal.

Once a municipality accepts a bid and awards a contract to a vendor, it is important for the municipality to adequately manage the contract to ensure that the vendor exercises prudent use of public moneys when acquiring quality goods and services at the lowest possible cost. This prudent contract management includes properly reporting costs associated with the contract in the municipal budget to allow taxpayers full knowledge of the contract's progress. When information is not available to allow taxpayers to develop an informed analysis of the municipal budget, it significantly increases the opportunity for mismanagement of public funds.

Good management practices should have prompted the City to reopen the process after CATS significantly modified its proposal (from operating two ferries at the Port to a single ferry operation with reduced project costs), especially because the City had initially received only one proposal. The change from a two ferry operation to a one ferry operation was a significant change in the scope of the Project and should have been resubmitted for proposals, particularly in light of the fact that one of the other vendors had not submitted a formal proposal because their plan was to operate a one ferry system.

In addition, during the RFP process, the City did not adequately evaluate CATS' ability, capacity, and skill to perform the scope of work, nor did it adequately evaluate CATS' business plan, or DeLucia's and Prince's experience in accomplishing similar services. The City also did not adequately address the results of two consultant reports which identified serious risks to the business plan and viability of the Project, and it did not adequately assess the Project's equity position and financial stability.

After the City selected CATS to operate the ferry, City officials mismanaged the Project by:

- Insisting that the Project move forward without adequately assessing its value to taxpayers by not subjecting critical statements made by hired consulting firms to further analysis
- Allowing a loan agreement that left the City and its associated entity (RURA) with unrecoverable third- and fourth-priority liens
- Making City purchases on behalf of the Project and by not clearly identifying those purchases as being for the Project (which made it nearly impossible for taxpayers to identify the true cost of the Project and the extent of the public subsidy)
- Not including adequate contingency amounts in the Project's budget to handle unforeseen costs.

As a result of insufficient private funding, the Project had a very high risk of failure. When the Project did fail, the City did not have a self-sustaining ferry service, it lost City and State moneys, and it had to pay Project-associated legal settlement costs with City funds. Additionally, the City lost millions by buying the ferry, attempting to unsuccessfully run the ferry service, and then — after facing the same difficulties as CATS did — selling the ferry.

### **Solicitation of Competition**

In December 2000, the City solicited RFPs to operate a fast ferry service with two ferries between Rochester and Toronto, and to lease a terminal later known as the “Port of Rochester.” The RFPs were mailed to CATS and three other entities. In response to the RFPs, the City received one proposal from CATS. Though good management practices dictate that they should have done so, the City did not make any additional attempts to seek competitive proposals or any other form of competition. In this case, in light of the use of significant sums of public moneys, it would have been in the public's interest to consider the reasons why only one proposal was submitted and, if appropriate, reject the single proposal, adjust the RFP, and re-solicit for proposals.

CATS' initial proposal included an operating schedule based on two vessels. However, CATS began and ended the ferry service in 2004 with the use of only one vessel. CATS' original proposal also included a financial plan based on total sources and uses of \$120 million versus the \$57.7 million plan that was adopted as the final plan. Modifications

of this nature from the original proposal and RFP specifications puts other potential competitors at a material disadvantage because they were not afforded an opportunity to compete on the amended plan.

With only one response to the RFP and a significant change in the original proposal, it was incumbent upon City officials to carefully consider and assess the proposal. The failure of City officials to effectively solicit competition for license and lease contracts resulted in the award of a contract that was not in the public's interest and the loss of millions of taxpayers dollars.

## **Business Plan**

A business plan is a documented expression of the facts concerning a business with a forecast of the desired future direction. It is like a roadmap or guidebook concerning where the business wants to go. A business plan usually covers one to five years of historical facts, and one to five years of projections into the future. The two main uses are for guidance in decision-making by the owner-manager and for presentation to a financial institution when applying for a loan. A business plan is especially important for a start-up business because it sets the course of actions necessary for survival of the business. The main elements to include in a business plan are an executive summary with a description of the firm and its future; profiles of the owner and managers; product description; a description of the industry; marketing plans; and a financial plan.<sup>3</sup>

The fast ferry service was a very high risk project for the City. CATS was a start-up business, and even though they contracted with outside consultants, neither of its principals had any experience in the boating or ferry industry. This reality should have prompted the City to take extraordinary steps to alleviate as much risk associated with the Project as possible. To that end, the City – which was the lead agency on the Project – should have ensured that CATS presented a sound business plan, and the City should have exercised appropriate caution and due diligence through a thorough analysis of the plan and associated risks. This investigation would have included a critical review of planned revenues and expenses for the Project, and any consultant reports on the plan, particularly if such reports identified risks or other concerns. Also, because there were changes to the plan as time progressed, the City should have reviewed those changes to ensure that they were reasonable, particularly when changes in projected revenues and expenses occurred. Further, given the risky nature of the Project, the amount of equity to be contributed by CATS' owners was crucial for

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<sup>3</sup> *The Language of Small Business* (<http://www.small-business-dictionary.org/default.asp?page=content>)

the protection of public moneys dedicated to the Project. Therefore, the City should have given top priority to verifying that the equity contributed through companies owned by DeLucia and Prince was reasonable, and that the equity had actually been contributed.

The basis of CATS’ business plan was a document known as “Sources and Uses.” This document summarized how CATS would obtain the necessary financial resources and how those resources would be spent.

<b>Uses</b>	<b>Amount</b>
Reserves and pre-launch	\$15,200,000
Vessel cost	\$42,500,000
<b>Total Uses</b>	<b>\$57,700,000</b>
<b>Sources</b>	
<b>Asset-Based Financing (to be repaid by CATS)</b>	<b>Amount</b>
ABN AMRO Bank	\$26,700,000
DaimlerChrysler (the ship’s engine builder)	\$6,300,000
<b>Subtotal Asset-Based Financing</b>	<b>\$33,000,000</b>
<b>Public Sector Financing</b>	
CATS New York State grant	\$7,400,000
CATS State Infrastructure Bank (SIB) loan	\$6,600,000
CATS City of Rochester loan	\$1,300,000
<b>Subtotal of Public Sector Financing</b>	<b>\$15,300,000</b>
<b>Equity Reserves</b>	
CATS and equity partners (paid to date)	\$1,700,000
CATS and equity partners*	\$5,600,000
Austal (the shipbuilder)	\$2,100,000
<b>Subtotal Equity</b>	<b>\$9,400,000</b>
<b>Total Sources</b>	<b>\$57,700,000</b>
*CATS and equity partners Dominick DeLucia and Brian Prince will provide \$3.5 million in additional accumulated Senior Lender reserves over a 36-month period from operating cash flow beginning at the commencement of operations. Separately, CATS and the equity partners will provide \$2.1 million in cash equity prior to the commencement of operations.	

CATS’ business plan contained detailed estimates of revenues and expenses, cash flow projections, and other business assumptions. We reviewed the business plan presented by CATS and identified the following concerns:

Evaluation of the Plan — City officials did not exercise appropriate caution and due diligence before committing public resources to the plan despite apparent risks. When asked for evidence of analysis by the City, we were provided with a market analysis report and an evaluation of CATS' proposal done by two separate consulting firms. The market analysis report was dated January 2001 and the proposal evaluation was dated February 2001, which was far in advance of the business plan that CATS would later implement. The evaluation of CATS' proposal raised major concerns about the proposal, which included:

- CATS' failure to have the necessary financial commitments
- A serious mismatch between vessel capacity and demand
- Serious deficiencies in the financial model included in the proposal
- Concerns about CATS' existing equity in the company as of February 2, 2001.

With an evaluation such as this, it was incumbent upon City officials to carefully consider and address each of the concerns in the proposal. Although CATS officials responded to the concerns, CATS of course had a vested interest in the Project and its response could not be considered objective. City officials did not independently determine the validity of CATS officials' responses, nor did they take any other action to address the concerns raised. As indicated in this report, questionable or deficient financial practices and concerns about the amount of equity provided by CATS' owners ultimately resulted in the rapid demise of the Project.

The market analysis report also identified other potential problems that plagued the subsequent ferry operations including high operational costs, low profit margins, reliability issues experienced by existing ferry operations, the lack of enthusiasm by the Toronto market, and unrealized time savings in comparison with other transportation options. Despite these clear indications of the risky nature of the venture, City officials did not perform any further analysis to evaluate the risks, and develop a strategy to manage those risks.

Changes to the Plan — CATS revised its business plan several times during the start-up process, with varying versions of the Sources and Uses document, and other supporting documents. For example, a version dated January 2002 showed total sources and uses of \$62

million, including \$10 million in funding from Canadian government sources. When the Canadian funding did not materialize, CATS eventually replaced the January 2002 version with the \$57.7 million Sources and Uses document shown earlier in this report. The new plan reduced the amounts budgeted as reserves, secured additional public sector (State and City) financing, and reduced the total amounts shown on the Sources and Uses document from \$62 to \$57.7 without making any actual changes to the Project. For example, CATS reduced the pre-launch/reserves expenses in the plan from \$20 million to \$15.2 million. However, City officials did not provide us with any written documentation that explained which specific expenses that CATS eliminated in the revised plan, or what – if any – action they took to ensure that CATS’ plan was still viable.

Equity — Because of the high-risk nature of the Project, City officials should have subjected the equity portion of CATS’ plan to an intense ongoing evaluation. Without conclusive evidence that equity was actually provided and applied toward the Project, City officials would have no way of assuring themselves that the public’s interest was protected.

Additionally, City officials should have heeded several red flags with regard to the Project’s equity position. One of the red flags was the fact that another public agency experienced difficulty in attempting to verify a portion of the Project’s equity. The Rochester Genesee Regional Transit Authority (RGRTA) was the initial public agency designated to be the pass-through agency for the \$6.6 million State Infrastructure Bank (SIB) loan. Before it would release the loan, RGRTA required CATS to provide documentation to support the availability of \$9.4 million in private equity including \$1.7 million that, per the business plan, it had already spent on pre-launch costs. Instead of insisting that CATS present the documentation – which also was required by the City’s \$1.3 million loan agreement with CATS – City officials replaced RGRTA with the Rochester Urban Renewal Agency (RURA), a City-controlled agency, as the conduit for the loan. Furthermore, City officials did not verify CATS’ equity prior to releasing either loan.

From our efforts, we know that such verification would, at best, have been extremely difficult. Ideally, DeLucia and Prince should have contributed cash to CATS’ accounts, paid expenses with CATS accounts, and should have recorded all individual expenditures in CATS’ accounting records. Instead, CATS officials claim that DeLucia made expenditures on behalf of CATS through his own personal accounts and then credited himself with equity in a bulk manner

(e.g., \$450,000 and \$945,000 credits to equity for “expenses”). Furthermore, CATS officials claim that Prince advanced moneys to DeLucia’s personal accounts (instead of CATS’ accounts) to be used for the Project’s pre-launch costs. CATS officials told us that they had no written record of these advances, but they believed the advances were approximately half of the amount credited to DeLucia’s equity for pre-launch costs. CATS records show that the \$1.7 million in DeLucia’s equity account was later split equally between DeLucia and Prince.

While DeLucia and Prince provided us with documentation of approximately \$5 million in expenses, we could not confirm if all the charges were related to the Project. Many invoices did not clearly show the reason for the invoice or show CATS as the company that received the service. Because DeLucia and Prince own numerous other businesses and because details on many documents were redacted, we have no way of verifying that the invoices were, in fact, for expenses paid on CATS’ behalf. In addition, many invoices were submitted without accompanying proof of payment.

In reality, the actual business plan that the City accepted allowed CATS to have an inadequate amount of equity at the start of the Project. As a result, the Project was undercapitalized and, therefore, ill-equipped to meet pre-launch expenditures, unforeseen events, and deviations from the business plan. Although equity of \$9.4 million may appear to be an adequate amount of private equity for the Project, a closer analysis reveals concerns, such as:

- CATS indicated that it would set aside \$3.5 million of the equity contribution from part of the positive cash flow expected from the first three years of operations – an optimistic projection at best for a risky start-up venture. Of course, the positive operating cash flow never actually materialized. Yet, in grant applications submitted to the Empire State Development Corporation (ESDC) and the Dormitory Authority of the State of New York (DASNY), CATS represented that the \$3.5 million was part of \$9.4 million in “secured” sources of funds. Obviously, CATS’ description of the \$3.5 million as a secured source of funds was misleading. Furthermore, if this equity had materialized, it was earmarked for reserves committed to protecting the senior lender, and not for operations. Thus, CATS would not have been able to use the \$3.5 million for unforeseen events and deviations from the business plan, both of which occurred. It also was not available for pre-launch costs.

- Austal’s equity ownership interest of \$2.1 million was not in the form of cash. Instead, it was a reduction of the price the shipbuilder would charge CATS and, therefore, it was not available for pre-launch expenses.
- \$1.7 million in equity provided by CATS and its equity partners already had been spent for expenditures incurred by the operation to date, and it provided no resources for future needs. Though this amount was necessary to finance budgeted pre-launch costs, we found that many of the pre-launch expenses supporting this expenditure were not included in the budget.
- Though the remaining \$2.1 million to be supplied by DeLucia and Prince (CATS’ “equity partners”) was due prior to the commencement of ferry operations, we found no specific date requirement for this investment. CATS officials deposited \$2.1 million into a CATS account on June 25, 2004, just prior to closing, and therefore the funds were not readily available to meet pre-launch expenses.

Short-Term Financing — CATS lacked sufficient financial resources from equity to meet pre-launch expenses as they came due. To meet this need, CATS obtained a secured line of credit loan agreement from Austal in March 2003 in the amount of up to \$7.4 million, which was roughly the same amount of State grants that the Project received. When CATS received grant money earmarked for payments on the ferry, CATS wired the funds to Austal. CATS did this to show that it was making payments to the shipbuilder for the ferry. Generally, within three days, Austal wired the same amount back to CATS as an advance under the line of credit agreement. CATS was to repay the entire credit line amount (\$7.4 million) at the closing date on the ferry, when CATS obtained permanent financing from ABN AMRO Bank.

We could not determine to what extent City officials were aware of this line of credit. We could not find the line of credit included in any of the Sources and Uses documents, business plans, or loan applications provided to us by the City. The City did have CATS’ audited December 31, 2003 financial statements that included the amount then outstanding on the line of credit (about \$4 million), with an attached note explaining the line of credit. City officials told us that they do not know when the City received the audited financial statements, or who received the documents. Former Mayor Johnson and former City Corporation Counsel Linda Kingsley told us that

they were unaware of any line of credit agreement, while CATS representatives claimed that the City knew all along about the line of credit agreement. CATS representatives told us that, in fact, it was a former City official's idea for them to secure such a loan from Austal.

Even if CATS officials did not openly disclose the line of credit, the City's claim to not know about it demonstrates the City's lack of understanding regarding the Project's financing. Had City officials scrutinized CATS' business plan as they should have, they would have realized that without some type of short-term financing, CATS lacked sufficient resources to fund pre-launch costs. The short-term financing also came at a cost of approximately \$300,000 in interest, which CATS did not include in its business plan.

No Project Oversight — A May 24, 2004 commitment letter from the City to CATS indicated that the \$1.3 million loan to CATS was subject to certain terms and conditions. Among other things, the letter stipulated that the City would hire – and CATS would pay for – outside legal counsel for the purpose of ensuring that the City's lien on the ferry was enforceable and in compliance with all relevant laws. Also, the outside legal counsel was to oversee the loan process, which included reviewing the commitment letter, preparing closing documents, closing the transaction, and confirming that all necessary paperwork had been filed to secure the City's security interest in the ferry. The commitment letter called for CATS to prepare and submit the following documents, prior to closing:

- A revised, detailed financial projection, which included an updated Sources and Uses document
- Evidence of CATS' expenditures of \$8,946,000 in pre-launch costs
- Evidence of CATS' inability to fund the reserve account through equity, grants, and/or cash flow from operations.

However, the City did not retain outside counsel for this purpose. City officials claimed that, although it was a requirement of the loan, CATS refused to pay for outside counsel and the City choose not to engage outside counsel at its own expense. This lack of oversight, which resulted partially from the City's failure to retain the outside counsel, contributed to City officials not discovering the serious cost overruns and unbudgeted purchases, and diminished their ability to take necessary corrective actions to address problems as they developed.

On June 4, 2004, City officials sent a letter to CATS requesting the documents described in the May 24, 2004 commitment letter.<sup>4</sup> However, CATS did not provide any of the requested documents. Instead of halting the loan closing process, personnel from the former Deputy Mayor's Office determined that the City would not need the items required by the loan document from CATS prior to closing. The City completed the loan process with CATS on June 30, 2004. Even if CATS had submitted the requested documents, the City's request was so late in the process, it left little time for a meaningful review of this important and complex material. Had the City reviewed CATS' claimed investment in 2002 when it was requested by RGRTA, the City would have undoubtedly seen red flags concerning the Project's finances.

City officials told us that because the City's monetary risk was less than that of ESDC, DASNY and SIB, the City expected these other agencies to provide the due diligence that was necessary for their grants and loans to CATS. According to ESDC, DASNY and SIB officials, they did receive certain documents – such as commitment letters and affidavits – from CATS that indicated that DeLucia and Prince had made equity contributions. However, they did not obtain any further documentation to support these documents, nor did they verify or obtain conclusive evidence concerning the actual amount of equity contributions made by DeLucia and Prince. The City did not take any further steps to verify that its reliance on these other agencies to perform the due diligence was reasonable.

In fact, CATS used the \$1.3 million loan from the City for a reserve fund to secure the position of more senior lenders. Although this use of the funds was permitted under the loan agreement – if CATS could show it was incapable of funding the reserve – CATS' inability to finance such reserves should have been a red flag to City officials.

Without appropriate oversight, CATS was able to spend more than \$2.8 million over what had been budgeted for pre-launch expenses. CATS' overspending was apparently accomplished without the City's knowledge because the City failed to monitor CATS adherence to its budget and business plan. CATS estimated pre-launch expenses at approximately \$7,780,000. However, as the Project progressed, CATS did not adjust the pre-launch estimates in the Sources and Uses document to reflect known changes, nor did CATS secure any additional funding to cover the unbudgeted spending. Although we

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<sup>4</sup> These were some of the same documents that the outside counsel would have obtained from CATS, had the City hired the outside counsel as was called for in its commitment letter to CATS.

were unable to categorize all pre-launch expenses – due to CATS’ inadequate accounting records and insufficient detail in the budget – we found that CATS did not include all expenditures in the Project’s accounting records, which would result in even larger discrepancies when compared to the budget. For example, we found the following additional pre-launch expenses that exceeded the budget:

<b>Expense Category</b>	<b>Approximate Amount Over Budget</b>
Consulting	\$575,000
Training	\$100,000
Travel and entertainment	\$200,000
Legal and professional services	\$600,000
Closing costs	\$600,000

We also found several items that CATS did not budget for at all, including:

- Political lobbying and campaign contributions – \$230,000
- Interest and fees paid to Austal on the line of credit – \$300,000
- Design planning for ferry – \$200,000

These items alone resulted in unbudgeted spending in excess of \$2.8 million. The funding sources available for the Project did not provide a margin for these unplanned expenditures nor did CATS secure additional funding to cover these expenditures. Because the City did not provide or retain independent oversight for the Project, these cost overruns were able to occur and to continue without detection by the City. Had City officials scrutinized CATS expenditures, they would have had serious concerns about CATS’ ability to conform to its own business plan.

### **Poor Project Management**

City officials accepted a loan agreement that left the City and its associated entity (RURA) with unrecoverable third- and fourth-priority liens, and provided additional City funding to the Project using methods that appear to be attempts to hide the transactions.

Insufficient Security for Loans Made to CATS — In September 2002, CATS applied for a \$6.6 million loan from SIB to finance the Project. SIB approved the loan and executed a loan agreement with RURA

to allow the pass-through of the loan from the City to CATS. During the City's 2002-2003 fiscal year, the City received the \$6.6 million loan from SIB, and then re-loaned the money to CATS. The City recorded the receipt and disbursement of the SIB loan in the urban renewal fund. The \$6.6 million loan to CATS was supported by a loan agreement between RURA and CATS. In 2004, the City loaned an addition \$1.3 million to CATS from the City's urban renewal fund. The \$1.3 million loan was supported by an agreement between the City and CATS. Both the \$6.6 million and the \$1.3 million loans to CATS were supported by an inter-creditor agreement by and among CATS, the City, RURA, ABN AMRO Bank, and EFIC. The inter-creditor agreement provided RURA with a third-priority lien for the \$6.6 million loan, and the City had a fourth-priority lien for the \$1.3 million loan. As a result of foreclosure proceedings against CATS, neither the City nor RURA was able to recover any part of the \$7.9 million that they loaned to CATS.

RURA and the City clearly did not act in a prudent manner by obtaining third- and fourth-priority liens, respectively, on the loans. Knowing that it had third- and fourth-priority liens, the City was aware that it was exposed to significant financial risk. The City failed to minimize this risk by verifying that DeLucia and Prince established capital and developed a sound business plan. At the very least, RURA and the City should have obtained additional security before making the loans.

The failure to secure sufficient collateral is yet another example of the City's failure to protect the public's interest, and in this case, it resulted in the loss of millions of dollars of public moneys.

Additional City Funding — In addition to the loans, we found that the City made more than \$975,000 in additional payments for items and services for CATS' use with City funds, or funneled the cash to CATS for its use through a third-party subcontractor. The manner in which City officials handled these transactions makes it appear that they intended to hide the transactions from public scrutiny.

At the request of CATS, the City purchased approximately \$497,000 of equipment for use by the ferry operator during the City's 2003-2004 fiscal year. These purchases were financed by an appropriation for furniture, fixtures and equipment known as the "FF&E budget." The FF&E appropriation was part of the City's capital expense and capital improvement program components of the 2003-2004 annual budget. In these documents, the appropriation is identified as part of a \$1.2 million line item for port construction and amenities.<sup>5</sup> Nowhere

<sup>5</sup> The City's budget is a complex document. The 2003-2004 budget was more than 550 pages; the capital portion of the budget was in excess of \$21.5 million.

in the budget did City officials identify CATS as being connected with this appropriation. Examples of equipment purchased included a telephone system, eight baggage carts, a forklift, 11 Pocket PCs, 22 computers, computer printers, ticket printers, office furniture for CATS' offices, a point-of-sale system, two ovens for the ferry, a walk-in cooler, display cases, and 24 radios.

The City acquired the equipment through its procurement process and did retain ownership of these assets. The equipment was identified with City asset tags and a physical inventory of the assets was performed after CATS shut down service. Though the items remain assets of the City, we found that the majority of the items were placed in storage and have not been used by the City. The City plans to sell these items; however, we did not determine the current value of these assets. But, it is reasonable to assume that the City will not recover its investment in these items. The City did not have a contract with CATS that stated that it was the City's responsibility to provide this type of equipment for use by the ferry operator. In addition, the LLM agreement specifically excluded FF&E as a City responsibility in connection with terminal improvements.

In February 2004, CATS requested that the City purchase and install a fuel storage system at the Port for the fast ferry operation. CATS agreed to reimburse the City the estimated cost of the fuel system (\$421,000). The City Council passed an ordinance<sup>6</sup> that authorized the Mayor to enter into an agreement with CATS for funding for the construction of the fuel system in the first instance, while obligating CATS to reimburse the City for the full cost of the fuel system, up to \$421,000. However, the actual agreement that the former Mayor signed with CATS on October 25, 2004 required the company to reimburse the City only \$210,500. The Mayor signed this agreement well after the completion of the fuel facility, and without the City Council authorizing the amendment of the amount that CATS was to reimburse the City. This situation occurred even though the City was in possession of several documents which stated that CATS would reimburse the City for the full amount. The City actually paid a total of \$440,000 for the fuel system. CATS paid the City only \$210,500 (the amount called for in the agreement signed by the former Mayor) and did not reimburse the City for the full amount (\$421,000), as was intended by the City Council's ordinance. Thus, the net amount paid by the City for the fuel system was \$229,500.

On August 15, 2003, the City entered into a consulting agreement for professional services with LaBella Associates (LaBella), a contractor that did various work for the City. According to the agreement, the

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<sup>6</sup> Ordinance No. 2004-63

City would pay LaBella \$665,000, which included a provision for a sub-consultant. The sub-consultant would be paid \$250,000 in 12 monthly installments of approximately \$20,800 each.

In May 2004, LaBella paid CATS a lump-sum payment of \$250,000 for sub-consultant work performed by CATS for shore infrastructure consulting related to the Project. The City reimbursed LaBella for this expenditure, essentially paying CATS through LaBella.

To receive payment from the City, LaBella provided a copy of the invoice that it received from CATS which stated that CATS had provided “consulting services regarding [the] Rochester Port Terminal.” The invoice did not include details as to what type of work CATS actually performed, or the time charged to this task. The only supporting documentation provided with the invoice was two printouts: one from CATS showing weekly payments to one of its operational officials and to one of its consultants, and a printout showing payments made to Hornblower Marine Services (HMS).

Though these individuals and HMS worked on many aspects of the Project, we found no discernable differences in the monthly amounts paid to them by CATS before and after August 2003 (the date of the sub-consulting agreement), nor could we find any indication that their duties had changed. In addition, the CATS operational official told us that the amounts claimed as part of this sub-consultant agreement were, in fact, for duties performed during the normal course of the work that he and the consultant performed for CATS. Similar to CATS’ operational official and consultant, we found no discernable differences in the monthly amounts paid to HMS by CATS before and after the date of the sub-consulting agreement, nor could we find any indication that the services provided by HMS had changed as a result of the sub-consultant agreement. Because we found no differences, we believe that the duties of these individuals and HMS had no bearing on the August 2003 agreement and, therefore, CATS used their time and work charged to the Project as a means to claim reimbursement from the City through LaBella.

The lack of detail supporting this transaction does not allow us, nor would it have allowed the City, to assess whether the payment was reasonable and within the scope of the contract. If CATS did do work for the City, the City should have paid CATS directly, and not have funneled the payment through LaBella.

## **Lack of Adequate Planning**

It is important for municipalities to develop comprehensive, realistic operational plans for any new services. Because the ferry operations had experienced fiscal stress, it became even more important for City officials to develop an effective business plan after they assumed ownership of the fast ferry services. Although City officials told us that they developed their own business plan, CATS felt that the City's business plan closely resembled its own business plan. Because RFC had not received authorization from CATS – in the form of a contract, payment or other agreement – to use its business plan, CATS threatened to sue the City for its unauthorized use of the plan.

CATS filed a “notice of claim”<sup>7</sup> against the City and RURA in which it preserved its right to sue the City for, among other things, use of CATS' business plan. Because City officials wanted to prevent drawn-out bankruptcy proceedings that would delay the sale of the ferry – which they felt would occur if CATS' lawsuit went forward – the City entered into a court-mediated settlement agreement with CATS in February 2005. The settlement agreement called for the City to make payments totaling \$1.2 million to CATS' affiliates and its creditors, as follows:

- \$700,000 paid into a fund dedicated to partially refund creditors of CATS
- \$400,000 paid to Maplestar, an affiliate of CATS
- \$100,000 paid to Charlotte Harbor Group, LLC (Charlotte), a subsidiary of Maplestar.

Given the amount that the City has already paid out in settlement costs (and the \$20 million in debt that it will expend following the sale of the ferry), it is clear that City officials should have researched the reasons that CATS' business plan failed and either adopted a new business plan that was radically different from CATS' business plan, or addressed the shortcomings in the plan used by CATS.

## **Recommendations**

1. When considering the commitment of City funds or resources for economic development projects, City officials should ensure full and fair competition on proposed projects, including when a proposed project changes materially.

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<sup>7</sup> The purpose of a “notice of claim” is to inform the defendant that the plaintiff is preserving its right to sue the defendant, and it informs the defendant as to the nature of the claim. Also, if there are any time limits for the filing of a claim and commencement of a suit, filing a notice of claim preserves those rights, but does not absolutely require the suit to go forward.

2. City officials should diligently evaluate any proposed financial agreements before obligating City resources. An appropriate level of due diligence includes on an ongoing basis:
  - Clearly identifying the risks in any financial plans, including the risk that key financial information in the plans may not be objective or reliable
  - Engaging qualified, independent professionals to assist in evaluating financial risks for complex and significant proposals
  - Obtaining complete and detailed written disclosure for all financial procedures.
3. City officials should ensure that the City makes payments in accordance with duly executed contracts that are supported by properly itemized invoices.
4. City officials should protect the City's interest by requiring a sound business plan and a reasonable amount of private equity, and by obtaining appropriate priority liens and collateralization for loans.
5. The Mayor should seek the City Council's prior approval before agreeing, in writing, to changes to specific terms in an agreement previously authorized by the City Council.
6. When providing services that are beyond their normal scope of operations, City officials should create adequately researched and planned operational plans.

## Failure to Protect the Public's Interest in the Ferry Terminal

In September 2001, the City entered into a License, Lease and Management (LLM) agreement with CATS. Pursuant to the LLM agreement, the City granted to CATS the exclusive right and license to operate a fast ferry service, leased the Port of Rochester to CATS, and gave CATS the exclusive right and authority to manage the Port. In December 2003, CATS entered into a sublease with its affiliate, Maplestar Development Company, LLC (Maplestar).<sup>8</sup> Pursuant to the sublease, Maplestar leased certain areas inside and outside a terminal building located at the Port. In February 2004, the City entered into a Non-Disturbance and Attornment (NDA) agreement with itself, CATS, and Maplestar. Pursuant to the NDA agreement, the City recognized the sub-tenancy of Maplestar and made other agreements with CATS and Maplestar. The LLM agreement included a 40-year lease term, and required CATS to pay the City lease payments of \$1 per year.

NDA Agreement — The original ferry terminal lease between the City and CATS included a provision that the lease would be voided in the event that CATS failed to operate the ferry. As permitted under the lease, CATS sublet the terminal to an affiliate Maplestar. This sublease did not affect the City's right to regain control of the terminal in the event of CATS' non-performance to operate the ferry. However, in February 2004, former Mayor Johnson signed the NDA agreement which removed the clause requiring CATS' principals to be operating the ferry to keep the 40-year lease.

City officials told us that this change was prompted by claims from Maplestar that it could not get bank financing to build within the terminal building if the stipulation remained. City officials did not provide us with any documentation to prove that they investigated this assertion, or explored other alternatives to finance the terminal improvements. We could not determine what, if any, consideration the City received in exchange for this change in terms.

Because Maplestar is a separate entity from CATS, the principals of CATS, through their ownership of Maplestar, were able to retain the lease on the port after CATS failed.

<sup>8</sup> In addition to being defined as a CATS affiliate in the December 2003 sublease, Maplestar also is defined as an affiliate of CATS in the February 2005 settlement agreement (refer to the "Lack of Adequate Planning" section for further information).

Fair and Adequate Consideration for License and Lease — Prior to entering into license and lease contracts, prudent management practice dictates that the City obtain fair and adequate consideration. A City official told us that in addition to the \$1 per year lease payment, the City received other economic benefits as follows:

- Leasehold improvements made by Maplestar at the Port of Rochester terminal building for various vendors (shops and restaurants) that rent space from Maplestar. Such improvements will revert back to the City at the termination of the 40-year lease.
- Maintenance and upkeep of the property provided by CATS.
- Operation of the terminal building for use by the public.

However, City officials made no attempt to determine the value of the economic benefits mentioned, thereby making it unclear as to what the value was, and whether the City received fair and adequate consideration.

The failure of the City to determine the value of benefits received under license and lease contracts makes it difficult to demonstrate that the City has acted in the public's interest by entering into the contracts.

## **Recommendations**

7. City officials should thoroughly investigate assertions or representations made by the contracting party, and possible alternatives, before making concessions under a lease agreement.
8. City officials should prepare a cost-benefit analysis to support that the City is receiving fair and reasonable value before entering into licensing and leasing agreements that delegate the City's rights to major assets for a significant period of time.

## **APPENDIX A**

### **RESPONSE FROM LOCAL OFFICIALS**

The local officials' response to this audit can be found on the following pages. The City's response makes reference to certain page numbers that were included in our draft report. The formatting of the final report resulted in changes in the report page numbering.



## City of Rochester



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July 6, 2006

██████████  
██████████  
Office of the State Comptroller  
The Powers Building  
16 West Main Street, Suite 522  
Rochester, NY 14614

Re: Comptroller's Report 2006M-21

Dear ██████████

We have received your Report 2006M-21 entitled "City of Rochester, Involvement with the Fast Ferry Operation, Report of Examination, Period Covered: September 19, 2001 - April 15, 2005." Please accept this letter as the requested response from the City of Rochester ("City").

This Report covers the City of Rochester's involvement in the fast ferry project from its inception, through the failure of the initial private owner ("CATS") and up to the point at which the City decided to purchase the ferry. The Mayor at the time, William Johnson, and most of the City officials principally involved in the fast ferry project are no longer in office. The current Mayor, Robert Duffy, assumed office after the time frame covered by the Report and shut down the ferry service shortly after taking office in January, 2006.

We have endeavored to cooperate with your examination and, to our knowledge, have responded as fully as possible to all of your requests for information. We have also reviewed a draft of the Report and provided additional information that we believed to be useful.

However, the City is currently at a disadvantage in responding to this Report. Almost all of the officials of the administration of Mayor William Johnson in office during the time period covered by the Report and who were principally involved in the fast ferry operation are no longer with the City and one of them is deceased. Some of these individuals who were available were interviewed by you, others were not. In addition, one of the first decisions made in January, 2006 by the new administration of Mayor Robert Duffy was to close the ferry service and sell the vessel. This decision was

based on an assessment of the prospects for the service as it came to the new administration at that time. It did not involve an in-depth review of the history of the service during the years earlier time period covered by your Report, as that was generally no longer relevant to the decision.

Under these circumstances, we do not believe that it would be beneficial for us to attempt a detailed factual response to the Report. However, there are places in the Report where it appears that the unsupported allegations of individuals with a bias toward a particular outcome, such as CATS personnel or unsuccessful bidders, are accepted at face value. It is difficult to evaluate these allegations and to rely on them does not appear consistent with the auditing standards referenced in the Report.

See  
Note 1  
Page 37

It is our intention to consider the Report and its recommendations where appropriate to improve on-going City administration and operations. In that spirit, we will confine our response to those items that we believe have continuing impact.

There is one general comment which we believe is appropriate. To our knowledge, the former City officials involved in the fast ferry project were motivated by the strong belief that this project would greatly benefit the City and region. Whatever criticism may be appropriate about the manner in which these individuals attempted to implement the project, as far as we can tell, they believed that the end result would be in the public interest.

The following are comments about issues raised in the Report which we believe have continuing impact:

- Throughout the Report, we believe that the respective roles of the State of New York ("State") and the City are not made clear and occasionally misstated. This needs to be clarified if the City and the State are to benefit from the criticisms in the Report. Examples are:
  - ▶ While the City supported the change from Rochester Genesee Regional Transit Agency to the Rochester Urban Renewal Agency as the conduit for the State loan, this was a decision that was controlled and made by the State. (Page 5, Final Paragraph).
  - ▶ As set forth on page 8 of the Report, the public funds provided to the CATS project came from the City (\$1.3 million Loan) and the State (\$6.6 million Loan and \$7.4 million in grants from three sources). The City accepts responsibility for administration of the City loan. However, the State did its own due diligence and controlled the terms for the funds it provided, including the loan that was passed

See  
Note 2  
Page 37

See  
Note 3  
Page 37

through the Rochester Urban Renewal Agency. This practice continues today for other projects and, to the extent that the Report finds fault with some aspects of the way the State funds were administered, it should be directed to the appropriate State agencies. (Page 10-Final Paragraph; Page 17-Paragraph 4; Page 18-Final Paragraph).

- The Report appears to find fault with the use of third and fourth priority liens for the public loans and the use of the City loan to fund a senior loan reserve fund. As noted above, those decisions were made by State agencies for the State loans. While it may or may not be appropriate to criticize this practice in this particular project, it is not appropriate to criticize it as a general matter. One important purpose of public funding of projects intended to foster economic development is to take less secure positions in order to attract private capital and make possible the project and the general economic benefit to the community. The lien priorities and use of funds found in the CATS project are often used by the State, City and other municipalities throughout the state and country. Without these tools, the economic development process would be significantly limited. (Page 10-Final Paragraph; Page 17-Final Paragraph; Page 18-Final Paragraph).

See  
Note 4  
Page 37

- There were two major decisions underlying the fast ferry project. The decision to support the CATS proposal and the decision by the City to purchase the vessel and operate the service. The Report does not clearly distinguish these decisions and the consequences that resulted from them. This results in some confusion in connecting the Report's criticisms to the ultimate problems and financial loss.

See  
Note 5  
Page 38

The decision to support the CATS proposal and its ultimate failure resulted in the City losing some of its investment in the harbor infrastructure (much of this is of continuing value) and project support and its \$1.3 million Loan. However unfortunate, this is a relatively small part of the eventual loss. If you accept the potential benefit of the ferry project, this loss could be considered worth the risk.

See  
Note 6  
Page 38

The second decision by the City to purchase and operate the ferry is the source of the significant ultimate financial loss. This occurs less from the cost of purchasing the vessel, most of which will be recovered in the sale, than in the substantial operating losses.

The Report is directed to the first decision and actions that supported the CATS proposal. However valid the criticism of that decision and those actions, the Report is not correct in attributing the ultimate substantial financial loss to them.

Our response to the recommendations in the Report is as follows:

Recommendations on Pages 21-22

1. We support this recommendation and believe that the new Duffy administration has in place the procedures and commitment to provide full and fair competition in the proposed economic development projects, including when the proposed project changes materially. However, by their very nature, economic development projects that involve government support often will not attract robust competition. If they did, the government would probably not be involved. These situations require attention to the recommendations discussed below.

2, 4 & 6. These recommendations all deal with the adequacy of the due diligence, business and financial planning and expertise that support economic development projects and the commitment of public funds. We support this recommendation. It is what the new Duffy administration did after the time period covered by the Report with respect to the status, proposed additional investment and continuing operation of the fast ferry project and it is the basis on which the service was discontinued and the vessel sold.

It should be noted, however, that even after diligently complying with all of these recommendations, there will be economic development projects that fail. The essence of public economic development activity is the ability to take some risks that private capital will not take. We should not so constrain the ability to invest public funds with conservative analysis or after the fact review that those necessary risks are not taken. By the very nature of these projects, you will always be able to find some reason not to *do them or to criticize them after the decision to proceed.*

3. We support this recommendation and believe that the new Duffy administration has in place the procedures and commitment to disburse funds only in accordance with duly executed contracts that are supported by appropriate invoices.

5. We support this recommendation and believe that the new Duffy administration has in place the procedures and commitment to obtain City Council's approval where required before changing agreements previously authorized by Council. Mayor Duffy and Council President Giess have a written understanding with respect to such changes.

July 6, 2006  
Page 5

Recommendations on Pages 24

7 & 8. We support these recommendations and believe that the new Duffy administration has in place the procedures and commitment to properly and fully evaluate the representations and cost-benefit analysis that are basis for lease agreements. In addition, City Council enacted in May, 2006 an amendment to the Municipal Code with respect to lease of real estate. This requires all leases for longer than one year to be approved by a 3/4 vote of the Council and sets forth detailed requirements for review and justification of the leases.

Very truly yours,



Thomas S. Richards  
Corporation Counsel

TSR:bkd

xc: Robert J. Duffy, Mayor  
William Sullivan, Chief of Staff

## APPENDIX B

### OSC COMMENTS ON THE CITY'S RESPONSE

#### Note 1

We assume the “unsupported allegations” refer to statements made by the one or more organizations that did not respond to the City’s RFP (see page 9), and a statement concerning CATS’ representation about a former City official’s idea for CATS to secure a loan from Austal (see page 21). Although these statements were made by outside parties, we did not base any of our conclusions, findings or recommendations solely on these statements. Rather, we included the statements in the report because we believe they are relevant, that they have a logical relation with, and importance to, those issues in question. We also have complied with all GAGAS requirements, including the requirement for obtaining sufficient, competent and relevant evidence necessary to provide a reasonable basis for the findings and conclusions in our report.

#### Note 2

The City acted as the lead agency for the Project. As stated in the report, it was the City that began the process of bringing a fast ferry service to Rochester, and it was the City that executed the LLM allowing CATS to manage the Port of Rochester and operate a fast ferry service. While we acknowledge the decision to replace RGRTA with RURA was ultimately a State decision, as the lead agency, the City’s request for the change was the basis for the decision.

#### Note 3

While most of the public financing for the fast ferry originated with the State, once RURA accepted the \$6.6 million loan from the SIB for the Project it created a responsibility for the City to provide the due diligence required to protect the public’s interest. When RGRTA was in a similar position, it did not ignore this responsibility or rely on others to provide the effort necessary to protect the public’s interest. As the lead agency, the City must take responsibility for ensuring that the public’s interest is protected, particularly in relation to the \$7.9 million in loans that originated with, or passed through, City controlled entities, the LLM agreement, and several other agreements with CATS.

#### Note 4

Our recommendations address the conditions encountered during a particular audit. Due to the high-risk nature of the Project, which was outside of the normal expertise and core services delivered by the City, we believe the use of third- and fourth-priority liens was not prudent. We do not agree that the City was without responsibility for the State loan that passed through RURA. Providing adequate due diligence and insisting upon higher priority liens would have been preferable to taking unnecessary risks with public moneys.

## Note 5

Our report focused on the City's decision to become involved with CATS in the initial fast ferry operation. The report asks and answers the questions of whether the City provided adequate due diligence, monitoring and safeguards prior to and after making the decision to become involved with CATS. Our report's focus is on the adverse consequences of the City's actions. While we also mention the City's operation of the ferry in 2005, we do so to illustrate some of the consequences of the decisions made to imitate the ferry service without proper due diligence.

## Note 6

Our report clearly states that the City's losses were not limited to the \$1.3 million referred to in the City's response. The additional funding supplied to CATS, the court-mediated settlement agreement with CATS, and the agreements with CATS and its affiliate Maplestar to manage the Port of Rochester all represent further taxpayer dollars expended by the City – beyond the \$1.3 million directly loaned by the City.

## APPENDIX C

### AUDIT METHODOLOGY AND STANDARDS

We examined the financial records of the City and CATS, and actions taken by City officials relative to the Fast Ferry Project, for the period September 19, 2001 to April 15, 2005.

To accomplish the objectives of this audit and obtain valid audit evidence, our procedures included the following steps:

- We interviewed the former Mayor of Rochester, former and current officials of the City including legal counsel, the Budget Director and the Finance Director, CATS' CFO and legal counsel, former CATS employees, and the former Chair of RGRTA. We were unfortunately unable to interview the former Deputy Mayor of Rochester who played a significant role in project, due to his untimely death. We informed CATS' legal counsel that we would be willing to meet with Dominick DeLucia and/or Brian Prince if they wanted to contribute input. No such meeting was requested.
- We reviewed CATS' business plan, financial records, reports, budgets, project documents, studies, contracts, agreements, court proceedings, newspaper articles, and correspondence related to the Project made available to us by the City, CATS, and various State agencies.
- Bank statements and wire advices were provided to us for more than 20 CATS bank accounts. There were a few individual statements missing, but the lapse of time may have contributed to CATS inability to provide them to us. We did make several requests for the bank statements for the Royal Bank of Canada, which was used for a significant portion of operations, but CATS claimed to be unable to provide those statements. We did not ask for, nor were we provided with, the personal statements of CATS' owners which would have been necessary to adequately assess their equity contributions.
- We reviewed CATS' audited financial statements dated December 31, 2003 and a draft audit report for the six months ended June 30, 2004. We also contacted Dansa and D'arta, the CPA firm used by CATS, and with CATS permission we requested and received all workpapers related to the audited financial statements and the draft audit report.
- We reviewed legal papers filed with the U.S. District Court, Western District of New York, with respect to foreclosure proceedings against CATS, and the related settlement agreement between and among CATS, CATS' owners and affiliates, ABN AMRO Bank, EFIC, the City, and RURA.
- We obtained copies of the original LLM agreement, the sublease between CATS and Maplestar, the NDA agreement, the SIB loan application, the \$6.6 million SIB-RURA loan agreement, the \$6.6 million RURA-CATS loan agreement, the \$1.3 million City-CATS loan agreement, the ship contract between Austal and CATS, grant disbursement agreements between ESDC and DASNY and CATS, and grant applications and related correspondence pertaining to the grant agreements.

- We held discussions and corresponded with representatives of the ESDC, DASNY, SIB, the New York State Thruway Authority, and the New York State Department of Transportation.
- We interviewed the City’s Purchasing Agent and various City officials in the Law Department, the Economic Development Department, the Department of Environmental Services, and the Finance Department concerning issues related to the solicitation of RFPs for the Project; the fair and adequate consideration for the license and lease granted to CATS; and the loans made by RURA and the City to CATS.

We conducted our audit in accordance with generally accepted governmental auditing standards (GAGAS). These standards require that we plan and conduct our audit to adequately assess those municipal operations within our audit scope. Further, those standards require that we understand the municipality’s management controls and those laws, rules, and regulations that are relevant to the municipality’s operations included in our scope. An audit includes examining, on a test basis, evidence supporting transactions recorded in accounting and operating records and applying such other auditing procedures, as we consider necessary in the circumstances. We believe that our audit provides a reasonable basis for the findings and recommendations contained in this report.

## APPENDIX D

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