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To: "Rita Vandergaw" <rvanderg@portofsandiego.org>, "Christine Anderson" <ca...
CC: "Israel, Giora (CarnCorp)" <GIsrael@carnival.com>
Date: 11/27/2007 10:50 AM
Subject: Port of San Diego and Carnival Corporation: Status

Dear Rita, Chris and Bruce,

The purpose of this letter is to summarize the current state of the progress the Port of San Diego (Port) and Carnival Corporation (CCO) have made in moving forward the initiatives originally laid out in the document titled "Sharing the Vision for the Future of the Cruise Industry in San Diego in Cooperation with Carnival Corporation" that we provided to the Port in August 2006. At the time we outlined three specific areas that needed focus. We also established that the Port and CCO would enter into an agreement to achieve the three objectives, thus "creating a long-term agreement and bond for many years." Although the overall "vision" has not necessarily changed, the business environment has recently revealed some changes which affect the "vision." As a result, we need to openly discuss these changes in order to ascertain whether a modified "vision" is now warranted.

In addition to the challenges in improving the cruise infrastructure in San Diego which we discuss below, the Port needs to ascertain whether the $164 million in planned improvements to B Street can be supported through long term cruise industry usage. San Diego's loss of Royal Caribbean's Monarch of the Seas is the equivalent to losing 76% of the passenger growth the Port gained from Carnival Cruise Lines' Elation. We consider this a major development as it relates to our current financial commitments to the Port and future infrastructure use. Irrespective of the lost revenue that would go towards repaying CCO related debt (does not include the fees retained by the Port); this loss will be hard felt by local businesses.

We need to be forthright with you; with respect to the figures the Port suggested on the November 1st conference call, CCO cannot get close to the passenger figures or the new $6 special facility fee that the Port says it needs to justify over $80 million of the total $164 million B Street budget. We do not have the capacity on the West Coast to contribute this usage to San Diego nor can we absorb the proposed 50% increase in the facility fee as part of our overall operating costs. As to the latter, the Port of San Diego is already the most expensive port our brands frequent. Before going into passenger counts CCO is prepared to support and other financial aspects, we would like to first discuss the progress made to date as it concerns the "vision" document.

At the time we issued the "vision" document we highlighted three areas:

* To reasonably upgrade Broadway Pier so that it can be used as an occasional overflow home port pier (currently not suitable for such operations), as well as to serve as a home port during the renovations of B. Street piers / terminals.
* The need to upgrade the current home port cruise pier and terminal on B. Street.
* Identify the location for additional home port piers for future expansion of the port (currently the port is at maximum capacity for

home port operations).

Broadway Pier

CCO agreed to amend the original $8 million loan agreement by increasing it to $12 million in order to allow the Port to upgrade (at its request) the Broadway facility ahead of planned modifications to the B Street Pier. Broadway would serve as an additional berth while B Street is under construction. We also agreed to continue to assess ourselves the special facility fee until the loan is repaid. As part of the amendment CCO added a second preferential berth.

You will agree that the scope of the modifications to Broadway have changed significantly from the original temporary membrane structure for occasional home port operations that required a relatively low capital investment relative to the current situation. Now the Port considers Broadway to be a long term structure to be used for home port operations. Remember one of the initial discussions concerned the use of rented portable tents for Broadway that would be used during the heavy cruise season. We understand that the Port was left with little choice but to build a semi-permanent building. To this end, the increase in our loan from $8 million to $12 million loan was meant to cover the remainder of the Broadway work. The budget would also include deck work which is part of an on-going maintenance program. Thus, we accommodated the Port by changing the majority of the allocations of the original $8 million loan from B Street planned improvements to the new scope for Broadway.

As part of the loan agreement we agreed that should the costs for Broadway go over the $12 million loan, that it would be the Port's responsibility to complete the project. We understand that the Port has agreed to accommodate public sentiment in an effort to improve the overall aesthetics of the new Broadway terminal and as a result the budget has increased. On several occasions the Port has made statements to us that anything in excess of $12 million would be the responsibility of the Port. So it came as a surprise to us that when Dan Wilkens (Port EVP) was asked at the November Port of San Diego Board Meeting how the Port would fund the development overruns, he responded that the Port would look to the City and CCDC and possibly Carnival. Why would the Port communicate a potential Carnival funding request in a public forum before even approaching us about it first? CCO's concern is that Mr. Wilkens' comment will be interpreted as matter of fact by the Commissioners. We would like to clarify that we are not in a position to increase the current Broadway loan. Let's not forget that CCO stepped up and committed an additional 50% over the original loan amount in order to allow the Port to make the necessary improvements it deemed necessary. Looking at it a different way, since the original $8 million was not fully committed to Broadway in the first place, you can conclude that our commitment to Broadway has increased by over 200% since the initial loan agreement was signed in 2005.

Pertaining to the 30% drawings for Broadway, our brands have reviewed the designs submitted. It is my understanding that Carnival Cruise Lines (including Captain Domenico Tringale) gave you additional comments at the November 14th meeting which included some minor modifications to allow easier access to cruise passengers carrying their own bags on and off the ship. We want to be very clear that from our perspective, Broadway needs to available for the winter 2008 cruise ship season (as contractually agreed).

B Street Pier

As we outlined in our "vision" document, we had hoped that modifications to B Street would be able to incorporate the existing terminal building. From various Port communications, we now know that the existing building will be torn down and a new terminal building, able to accommodate two home port ships, will be built in its place. We believe that the Port's decision to proceed in this direction was not just as a result of code requirements but perhaps also as a consequence of a long neglected pier foundation maintenance program which is now in desperate need of repair.

As it concerns the latest designs for B Street, the Port has received our comments to the design review prepared by CH2MHill (CH2) and will review further designs as the Port supplies them. Also, we are in receipt of the Port's initial cost estimate for B Street improvements which equates to $164 million and we would like to comment accordingly. The Port considers the proposed cost for B Street very high due to a number of reasons; about 50% of the budget is attributed to the terminal building and over 15% of the budget is credited to pier improvements. We realize that the Port is asking CCO to contribute funding to the terminal costs only; however, we feel compelled to tell you that based on our working knowledge of building ports around the world, we believe the total budget could be higher. We know that you are considering possibly eliminating the parking garage from the pier plans. We ask that you consider this closely and make the determination whether the parking revenue can justify its construction through long term parking revenues. Although we realize that there are not enough parking spaces in the planned garage to accommodate all cruise ship passengers, a cruise terminal that solely relies on off-site parking will cause problems from an operational and staging perspective. We must keep in mind the considerable traffic issues involved in any cruise port operation.

Funding: Long Term Agreement

The Port's position is that any new financing on B Street will more than likely be incorporated into a "new" agreement which would not include Broadway related debt. Accordingly, the Port's belief is that CCO's loan on Broadway will be repaid before any new commitments are made by CCO on B Street. The Port has said that it will partner with CCO "to develop a mutually agreeable financing program to support the redevelopment of the cruise terminal facility, pier improvements and parking garage on the pier," and as it concerns the B Street renovations, the "vision" document called for at least five sources of financing which are:

1) Revenue from the Lane Field hotel project. This project was awarded and we are uncertain if the Port made an allocation for this revenue as part of the assumptions to fund Port improvements.
2) Revenue from the parking.
3) Revenue from the parking garage across from the Terminal.

4) Retail Revenue. Currently there is no retail from the B Street Pier.

5) A CCO guarantee on head taxes. Which would mean extending the increase of $4.00 agreed to in the interim agreement, with a minimum of XX passengers/year (or $YY/year) for a 20-year period.

From our perspective, CCO is open to the idea of providing some financial support for B Street in the form of revenue guarantees or loans that can be used as collateral in some form of third party bank or public debt financing. Because of the changing business environment and other macro cruise industry challenges (for instance itinerary planning) we can only financially commit to figures in the region of current usage at the Port. One of the challenges that our industry is now facing, which could impact West Coast itineraries, is the recently approved tax in Mexico that will be levied on passengers arriving into Mexico by sea. A per passenger tax of $5 will be assessed at each Mexican port of call - thus multiple charges on extended Mexican itineraries. CCO has yet to communicate how it intends to react to this new tax but more than likely there will be some Mexican ports that will be affected with potential changes in itineraries.

Whether our commitment is enough to assist the Port is making this project financially viable is just one of our concerns. The other concern is that the Port has yet to respond or explain to us whether the additional sources of revenue outlined above are viable alternatives. We are certain of one thing: cruise line industry usage of the planned B Street terminal (in its current form) is not enough to make this project economically viable without further understanding how the Port anticipates funding the entire project and servicing related debt.

Potential location for Third Homeport Berth Site

We acknowledge that the Port is trying to identify locations for additional home port piers as part of its overall future expansion of the Port. To this end, we know that River Consulting was hired some months ago to outline possible pier locations which we believe the Port is in receipt of now. We encourage an active exchange of ideas and information concerning this study and look forward to this process with a potential feasibility assessment for a third homeport berth in the future.

Next Steps

As with any business arrangement, situations will change from time to time that require reassessments. In this case we need to determine whether the long term programs the Port has in place to improve the cruise infrastructure can be supported though cruise line usage. In assessing the current situation on B Street, we believe the next step is to try to achieve an understanding of how the Port plans to make the case to the Commissioners that the planned improvements are economically viable. Clearly we cannot see CCO financing a meaningful portion of the current B Street budget through current cruise line usage at the Port.

Regards,
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Director, Strategic Planning and Port Development

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