C-11/94

Memorandum

CONCURRENC
RTG SYMBO
C-10
INITIALS/SIG
DATE
11/9
RTG SYMBO
C-10
INITIALS/SIG
RDt
DATE
11/9/9

U.S. Department of Transportation
Office of the Secretary of Transportation
General Counsel

Subject: Resolution of Office of Inspector General Audit R3-FA-5-003

Date:

From: Rosalind A. Knapp, Acting General Counsel

Reply to Attn. of: NKessler x.69154

To: Melissa J. Spillenkothen, Assistant Secretary for Administration

INTRODUCTION

You have requested a legal opinion regarding the November 25, 1994 Office of Inspector General (OIG) report, "Accountability and Use of Airport Revenues at Philadelphia International and Northeast Philadelphia Airports."

As explained below, the OIG found that the city of Philadelphia, as the airport sponsor, did not comply fully with its grant obligation to maintain a fee and rental structure to make the airport as self-sustaining as possible. The OIG recommended that the airport sponsor obtain an appraisal to establish the fair market rental value for airport property before the renegotiation of any lease and adjust future lease rental amounts accordingly. The Federal Aviation Administration (FAA) disputed the OIG's interpretation of the self-sustaining obligation and did not concur in the need for appraisals. The FAA would rely on the airport sponsor to establish a reasonable rental charge, on the basis of the economic circumstances existing at each specific airport.

We disagree with the OIG's conclusion that the obligation to make the airport as self-sustaining as possible *requires* the proprietor to charge fair market value for leases of airport assets for aeronautical use. The statutory language implies discretion on behalf of the proprietor to weigh the volume of traffic, economy of collection, and other circumstances at the airport, with the use made of the airport's facilities and services, to arrive at a schedule of charges that will make the airport as self-sustaining as possible. It does not place an affirmative obligation on the sponsor to use fair market value to establish fees.

This conclusion is based on an analysis of the federal statutory conditions directing airport sponsors to charge reasonable fees, avoid creating excessive airport surpluses, use airport revenue for lawful statutory purposes, as well as to make the airport as self-sustaining as possible. It is also based on the interim and proposed airport rates and charges policy guidelines, both published jointly this year by the Department and the FAA. [1] We anticipate that the conclusions reached here will also be supported by the final rates and charges policy; if not, we will provide another opinion at that time.

Office of Inspector General Findings

With regard to the properties in dispute, the OIG found that Philadelphia did not maintain adequate fee and rental structures, because it leased 11 properties, at Philadelphia International Airport, at below fair-market rental value. The OIG claimed that the lease schedules resulted in total lost rental revenues for the period July 1, 1991 through June 30, 1993 of $3,521,475 and annual future losses of $1,710,040. Ten of the properties subject to OIG audit were for aeronautical use, including cargo, hangar, airmail loading and sorting, and fixed base operation facilities. One property was used for non-aeronautical activities, namely, an in-flight kitchen. [2] (With regard

---

[1] On February 3, 1995, the DOT/FAA published an interim "Policy Regarding Airport Rates and Charges" (Interim Policy), 60 Fed. Reg. 6906, *et seq.*, and requested comments because of substantial industry interest in the original proposed policy (which had been published June 9, 1994). The Interim Policy was effective immediately upon publication. As relevant here, the Interim Policy provides that, unless otherwise agreed to by the airport proprietor and air carrier user, the proprietor's total charges for aeronautical use of airport facilities must not exceed the proprietor's total historic (that is, actual) costs. (section 2.4, Interim Policy). The self-sustaining obligation does not require a sponsor to charge more than its historic costs, and in certain circumstances, the proprietor is permitted to charge less than those costs. (section 4, Interim Policy). Due to concerns by airport operators that the Interim Policy's historic cost requirement significantly deviated from current industry practices in leasing nonairfield facilities and could have profound effects on capital replacement funding by smaller airports, the Department issued a supplemental notice of proposed policy (Proposed Policy), and reopened the comment period. 60 Fed. Reg. 47012, *et seq.*,(September 8, 1995) The Proposed Policy drops the historic cost requirement for airport facilities such as terminals and hangars (that is, nonairfield facilities). It would allow airport proprietors to use any reasonable methodology to determine fees. (Section 2.6, Proposed Policy). It does not require use of a particular fee methodology. Public hearings on the Proposed Policy have been held (on September 20 in Fort Worth, Texas and on October 17 in Washington, D.C.) and written comments on the Proposed Policy were filed November 7. A final policy will be adopted after full consideration of the oral and written comments by the FAA/DOT.

[2] The OIG did not distinguish between the leases for aeronautical use, on the one hand, and those for non-aeronautical use, on the other hand. The distinction is important, however, for purposes of FAA's obligation to assure compliance with the grant assurances. The FAA must assure compliance with rates and charges assessed for aeronautical use. Both the Interim Policy and Proposed Policy provide guidance on standards applicable to airport fees imposed for *aeronautical use* of the airport. (60 Fed. Reg. 6914; 60 Fed. Reg. 47015)
"Aeronautical use" is defined as "any activity that involves, makes possible, is required for the safety of the operations of, or is otherwise directly related to, the operation of aircraft." (60 Fed. Reg. 6915; 60 Fed. Reg. 47015) This would cover the cargo, hangar, and fixed base operation properties audited by the OIG at the Philadelphia airport. It would also cover the sorting and loading of air mail at the airport ramp area, including the space leased by the U.S. Postal Service.

to the remaining leased property audited--an athletic facility leased for a nominal value by the city of Philadelphia--the FAA has concurred in the OIG's recommendation to have the airport sponsor charge the city of Philadelphia market rate for this lease).[3]

The OIG recommended that the Federal Aviation Administration (FAA) require the sponsor, prior to renegotiation of any lease, to establish by appraisal the fair-market value and fair-rental value for airport property and adjust future lease rental amounts accordingly. [4]

"Non-aeronautical use" of airport facilities by air carriers is defined as "the operation by air carriers or foreign air carriers of facilities such as a reservations center, headquarters office or flight kitchen on an airport. . . . Such facilities need not be located on an airport. A carrier's decision to locate such facilities is based on the negotiation of a lease or sale of property. Accordingly, the Department relies on the normal forces of competition for commercial or industrial property to assure that fees for such property are not excessive." (*Id.*)
The non-aeronautical use property leased by an air carrier and covered by the OIG audit would include the in-flight kitchen. Rates charged for non-aeronautical use are not within the purview of DOT/FAA oversight. Interim Policy 60 Fed. Reg. 6915, 6918, section 4.2., Proposed Policy 60 Fed. Reg. 47019, section 4.2. See also Denver v. Continental Air Lines, 712 F. Supp. 834, 836-837 (D. Colo. 1989).

[3] When airport property is leased by a sponsor at less than commercial market lease rates, issues of unlawful diversion of airport-generated revenues are raised under 49 U.S.C. 47107(b). Such a difference in lease rates may be construed as an imputed diversion of revenues to the sponsor for non-airport related purposes. The FAA's actions with regard to the rates for the city's lease of the athletic facility at the Philadelphia airport appears to be a proper attempt to place the airport sponsor in compliance with the statutory revenue retention requirement by ensuring that the city pays the airport department a commercially fair lease rate for this property.

[4] The OIG relied on section 511(a)(9) of the Airport and Airway Improvement Act of 1982, as amended. This has since been recodified as 49 U.S.C. 47107 (a)(13) and requires the sponsor to assure the Secretary that:

> the airport owner or operator will maintain a schedule of charges for the use of facilities and services at the airport--
>
> > (A) that will make the airport as self-sustaining as possible under the circumstances existing at the airport, including volume of traffic and economy of collection; and
> > (B) without including in the rate base used for the charges the Government's share of costs for any project for which a grant is made under this subchapter or was made under the Federal Airport Act or the Airport and Airway Development Act of 1970.

The OIG also relied on FAA Order 5190.6A, Airport Compliance Requirements (October 2, 1989), ¶4-14(d)(1)(e), requiring FAA to ensure, with respect to terms and conditions applied to tenants offering aeronautical services at air carrier airports, that:

> All leases of 5 years or more should contain an escalation provision for periodic adjustments based on a recognized economic index. Future lessees may expect like treatment in that their leases will have a built-in escalation provision. This is in accordance with the sponsor assurance "...to make the airport as self-sustaining as possible under the circumstances...".

Federal Aviation Administration Response

The FAA did not concur with the OIG recommendation to require sponsors to establish by appraisal the fair market value of airport properties for purposes of airport leases. The FAA claimed that there is no statutory or regulatory requirement mandating that aeronautical leases be at fair market value. It explained that these leases generally result from negotiations between the airport and pertinent aeronautical interests and are based on a variety of business decisions such as location, demand, maintenance, and other factors.

The FAA further argued that its policy is to require sponsors to charge fair, reasonable, and not unjustly discriminatory rates and charges for aeronautical use. It asserted that a fair and reasonable charge includes consideration of a sponsor's costs, which may not equate with fair market value. Further, it maintained that what is fair and reasonable must be judged on the basis of the unique economic circumstances existing at each specific airport.

Inspector General Comments

The OIG continued to maintain its position that leasing property at below fair market rental value reduces funds potentially attainable by the airport and therefore is contrary to the grant assurance requiring the airport to be as financially self-sustaining as possible. It argued for reliance on independent appraisals because they consider economic circumstances at specific airports and adjust for various factors at each property such as location, condition and size of the parcel to be leased, comparable rental rates within the area, and any proposed future actions which could affect the rental of the property.

LEGAL OPINION

As explained more fully below, we do not interpret Federal law to require the city of Philadelphia and other airport sponsors to lease airport facilities pursuant to a specific valuation methodology, such as fair market value, nor to obtain appraisals for such properties. The requirement that an airport be self-sustaining is a grant obligation that is expressly dependent upon the circumstances existing at the airport, including the volume of traffic and economy of collection. It does not stand alone and must be interpreted consistently with the statutory requirement that airport fees be "reasonable." [5] Moreover, the Department is expressly prohibited by statute from

[5] The reasonableness standard is derived from four statutory provisions. First, the Anti-Head Tax Act, recodified at 49 U.S.C. 40116, permits a State or political subdivision of a State to levy or collect only "reasonable" rental charges, landing fees, and other service charges from aircraft operators for using airport facilities of an airport owned or operated by that State or subdivision. See also Northwest Airlines, Inc. v. County of Kent, 114 S. Ct. 855, 863 (1994). Second, the grant assurances required by the Airport and Airway Improvement Act of 1982, as amended, recodified at 49 U.S.C. 47107, obligate the airport owner or operator to make the airport available for "public use on reasonable conditions." 49 U.S.C. 47107(a). Third, 49 U.S.C. 47101(a)(13), as added by Section 110 of the 1994 Federal Aviation

setting the level of a fee. [6] Finally, there are statutory limitations on the purposes for which airport revenue, including surplus funds, might be used. [7] Airport operators are constrained in the amounts of surplus revenue they may attempt to create: statutory policy directs them not to seek to create revenue surpluses that exceed amounts necessary for use for airport system purposes and other lawful purposes, including reasonable reserves and other funds to facilitate financing and to cover contingencies. [8]

The Department of Transportation has the administrative discretion to interpret the statutory requirement that airport fees be "reasonable" and that they be maintained to make the airport as self-sustaining as possible under the circumstances existing at that airport. The Supreme Court, ruling on fees charged at Grand Rapids, Michigan Kent County International Airport stated the DOT "is equipped...to survey the [airport] field nationwide, and to regulate based on a full view of the relevant facts and circumstances." Northwest Airlines v. County of Kent, 114 S. Ct. 855, 863 (1994). Noting that the Department had not done so, it exhorted us to "comprehend the details of airport operations across the country, and the economics of the air transportation industry" to apply a formula for determining whether fees are "reasonable." It stated that this exposition will be accorded substantial deference, so long as it is a permissible construction of the statute. County of Kent, *op cit.* 114 S. Ct. 863 and 864, n. 14.

Since the issuance of the Kent County decision and with the enactment of the 1994 Authorization Act, the Department has analyzed the economics of airport operations and has developed guidance on airport rates and charges. Based on the extensive study of airport practices, and viewed in connection with the statutory requirements

---

Administration Authorization Act of 1994 (1994 Authorization Act), expressly states that "airport fees, rates, and charges must be reasonable and may only be used for purposes not prohibited by this Act." Finally, 49 U.S.C. 47129, a new provision added by Section 113 of the 1994 Authorization Act, directs the Secretary to establish guidelines to determine whether an airport-air carrier fee is "reasonable."

[6] 49 U.S.C. 47129(a)(3). "In determining whether a fee is reasonable under this section [*i.e.*, resolution of airport-air carrier disputes concerning airport fees], the Secretary may only determine whether the fee is reasonable or unreasonable and shall not set the level of the fee."

[7] Airport sponsors are required to use revenues generated by a public airport for the capital or operating costs of the airport; the local airport system; or other local facilities owned or operated by the airport owner or operator and directly and substantially related to the air transportation of passengers or property, unless excepted from this requirement by pre-September 3, 1982 debt covenants or legislation controlling financing. 49 U.S.C. 47107(b).

[8] 49 U.S.C. 47101(a)(13) reads, in pertinent part:

> "[I]n establishing new fees, rates, and charges, and generating revenues from all sources, airport owners and operators should not seek to create revenue surpluses that exceed the amounts that may be lawfully used by the airport sponsor, including reasonable reserves and other funds to facilitate financing and cover contingencies."

of airport fees, the Department has concluded that an airport proprietor is not required to charge a user a particular rate. [9]

Reasonableness Standards

First, judicial decisions on airport rates and charges have recognized a number of different practices for establishing rates for terminal space rental. For example, in examining rates charged at the Raleigh-Durham Airport, the court noted that terminal tenants and fixed base tenants pay either fixed rentals, percentage rentals, or a combination of fixed and percentage. [10] A Congressional Budget Office study similarly found that airports leased space to airlines on the basis of either average actual costs; outside appraisals of the property value; negotiation with the airlines; or a reflection of the market rate, in the context of market constraints and the airport's own policy objectives.[11] Additionally, in analyzing the rates charged by Dade County at the Miami International Airport, the court understood that property rentals for airport property were only 75 to 80 percent of the market-level rents for similar property in the areas surrounding the airport. [12]

Thus, the courts have not interpreted the Airport and Airway Improvement Program provisions to require the use of fair market value for airport leases. Indeed, the Supreme Court in the Kent County decision indicated its expectation that the Department would adopt standards for reasonable airport fees based in large measure on the relevant facts and circumstances of the air transportation industry. [13]

The policy guidelines currently being developed by DOT/FAA provide standards for establishing airport-air carrier fees, based on judicial precedent and administrative interpretation of the statutory requirements. Neither the Interim Policy nor the Proposed Policy requires a proprietor to use a particular methodology for asset valuation. The Interim Policy does prohibit a proprietor from realizing total aeronautical revenue in excess of its costs of providing airport services and facilities currently in aeronautical use, unless otherwise agreed. [14] However, within the constraints of this historic cost cap, it permits an airport proprietor to use its business judgment to fix fees for aeronautical use of facilities such as terminals, hangars, and

[9] Interim Policy, 60 Fed. Reg. 6906, 6917, par. 2.4.1; Proposed Policy, 60 Fed. Reg 47012, 47108, par. 2.6.

[10] Raleigh-Durham Airport Authority v. Delta Air Lines, Inc., 429 F. Supp. 1069 (D.N.C. 1976)

[11] Financing U.S. Airports in the 1980s, Congress of the United States, Congressional Budget Office (April 1984) at 32-33.

[12] Arrow Airways, Inc. v. Dade County, 749 F.2d 1489 (11th Cir. 1985).

[13] Northwest Airlines v. County of Kent, 114 S. Ct. 855, 863-864 (1994).

[14] Section 2, Interim Policy, 60 Fed. Reg. 6916.

other landside facilities. Fees may be set by "valuation methodologies other than historic cost valuation," including, for example, current cost, fair market value, use of an inflation index, or by a percentage of the tenant's gross revenues. [15]

The Proposed Policy would lift the historic cost cap for nonairfield facilities, such as terminals, hangars, etc. [16] It would regard as reasonable any methodology to determine fees, so long as justified and applied on a consistent basis to comparable facilities. Such methodologies could include, in addition to historic cost valuation, direct negotiation with prospective aeronautical users, or objective determinations of fair market value. The Proposed Policy would rely on the discipline of competition to assure that fees for nonairfield facilities meet the requirements of reasonableness contained in statutes, grant agreements and applicable international aviation agreements. (60 Fed. Reg. 47013).

It is clear, then, that the Department does not interpret the "reasonableness" requirement to obligate an airport proprietor to obtain an appraisal report and to use fair market rental rates for leases of aeronautical facilities. Rather, both the Interim Policy and the Proposed Policy recognize the proprietor's discretion to establish nonairfield property lease rates based on justifiable valuation methodologies. Furthermore, both policies emphasize the importance of local negotiation and resolution of airport fees, and encourage agreement upon fees between the proprietor and the air carrier user, without the need for Federal intervention. [17]

<u>Financially Self-Sustaining</u>

The OIG report found the city of Philadelphia violated the grant requirement that airport fees should be structured so as to make airports as financially self-sustaining as possible under the circumstances existing at each particular airport, since it did not lease airport property at fair market rental value, as established by an appraisal.

---

[15] Section 2.4.1, Interim Policy, 60 Fed. Reg. 6917. Such valuation methodologies must be justified and applied on a consistent basis to comparable facilities.

[16] Section 2.6, Proposed Policy, 60 Fed. Reg. 47108. The "airfield assets" would be defined as consisting of "runways, taxiways, ramps or aprons not leased on an exclusive use basis and land associated with these facilities." 60 Fed. Reg. 47106. The historic cost cap would apply to airfield revenues, unless otherwise agreed to. Section 2.2, Proposed Policy.

[17] Section 1 of the Interim Policy and of the Proposed Policy states the Department's general reliance on local negotiation and resolution to ensure compliance: "In general, the Department relies upon airport proprietors, aeronautical users, and the market and institutional arrangements within which they operate, to ensure compliance with applicable legal requirements." 60 Fed. Reg. 6915; 60 Fed. Reg. 47106. In addition, Section 1.3 of both the Interim Policy and Proposed Policy recognizes the impact of market conditions upon proprietor's fees. "Airport proprietors must retain the ability to respond to local conditions with flexibility and innovation." 60 Fed. Reg. 6916; 60 Fed. Reg. 47017.

We do not agree with the OIG's interpretation of this provision. First, the statutory provision is more complex than the OIG evidently assumes. Nowhere in this statutory provision is the term "self-sustaining" linked to a specific fee methodology, such as appraised fair market value. Further, the term "self-sustaining" does not stand alone, but is modified by the phrase "as possible under the circumstances existing at the airport, including volume of traffic and economy of collection." [49 U.S.C. 47107(a)(13)]. The so-called self-sustaining requirement thus lends itself more to a goal of self-maintenance or existence than to a specific annual requirement of fee levels.

Second, as noted above, the 1994 Authorization Act added a new provision to the airport fees policy:

> that airports should be as self-sustaining as possible under the circumstances existing at each particular airport and in establishing new fees, rates, and charges, and generating revenues from all sources, airport owners and operators should not seek to create revenue surpluses that exceed the amounts to be used for airport system purposes and for other purposes for which airport revenues may be spent under section 47107(b)(1) of this title, including reasonable reserves and other funds to facilitate financing and cover contingencies. 49 U.S.C. 47101(a)(13).

This section indicates Congressional concern that airport fees should not be established at such a level that the airport is generating surplus that is, over time, excess to the airport proprietor's lawful needs. To require that proprietors necessarily charge for terminal leases based on fair market value could well be inconsistent with this policy against the creation of excessive surplus.

The Department's Interim and Proposed policies recognize the room for discretion on the part of the proprietor in attempting to maintain a level of self-sustainability, on the one hand, while also considering the economic circumstances at the particular airport and the policy against significant accumulation of excess surplus, on the other hand. The policies, then, encourage airport proprietors, when entering into new or revised agreements or otherwise establishing rates, charges, and fees, "to undertake reasonable efforts to make their particular airports as self-sustaining as possible in the circumstances existing at such airports." [18]

The policies make clear, however, that the obligation to make the airport as self-sustaining as possible does not permit the airport proprietor to establish aeronautical fees that exceed its aeronautical costs, absent agreement with aeronautical users. [19]

---

[18] Section 4.1.1 of the Interim Policy, 60 Fed. Reg. 6918, and of the Proposed Policy, 60 Fed. Reg. 47109.

[19] Section 4.1.1(a) of the Interim Policy and of the Proposed Policy, *op cit.*

Moreover, the Proposed Policy expressly states, for those facilities for which this policy permits the use of fair market value, "the Department does not construe the obligation of self-sustainability to compel the use of fair market value to establish fees." [Section 4.1.1(b), Proposed Policy] Finally, the Proposed Policy links the statutory policy against progressive accumulation of excessive revenues with the requirement for reasonable aeronautical fees by proposing to provide that accumulation of surpluses attributable to aeronautical revenue may warrant an inquiry into the reasonableness of the aeronautical fees. [Section 4.2.1, Proposed Policy; 60 Fed. Reg. 47015 and 47109].

Both the Interim and Proposed policies recognize that at some airports, market conditions may not permit an airport proprietor to establish fees that are sufficiently high to recover aeronautical costs and sufficiently low to allow commercial aeronautical services to operate at a profit. In such circumstances, an airport proprietor's decision to charge rates that are below those needed to achieve self-sustainability in order to assure that services are provided to the public is not inherently inconsistent with the obligation to make the airport as self-sustaining as possible in the circumstances. [20]

Based on this discussion of self-sustainability, we conclude that this requirement does not obligate airports to charge airport tenants at fair market rental value, based upon property appraisals.

Additionally, the statutory grant assurances do not compel the city of Philadelphia to renegotiate the rental rates of unexpired long-term airport leases in order to bring them up to fair market rental value. Section 113 of the 1994 Authorization Act [49 U.S.C. 47129(f)(1)] instructs the Department not to adversely affect the rights of any party under any existing written agreement between an air carrier and the owner or operator of an airport. Any renegotiation of existing cargo area leases with American Airlines or with USAir (which was assigned Eastern Airlines' lease), for example, would adversely affect the rights of those air carriers, within the meaning of the statute.

Furthermore, the OIG's suggestion that the FAA require the airport to charge specific rental rates for the property audited at the Philadelphia airport is inconsistent with the directive in the 1994 Authorization Act that the Secretary is not to set the level of a fee that is in dispute between an air carrier and an airport. The Secretary may only determine whether a fee is reasonable or unreasonable and may not set the level of the fee (49 U.S.C. 47129(a)(3), as added by Section 113 of the 1994 Authorization Act).

Fees for Non-aeronautical Uses

---

[20] Section 4.1.2 of the Interim Policy and of the Proposed Policy, *op cit.*.

As discussed above, the OIG report criticized the FAA for allowing the city of Philadelphia to charge below-market rental value for an in-flight kitchen. An in-flight kitchen facility is considered not to be an aeronautical activity within the purview of the FAA/DOT, because it is not required for, does not involve or make possible the safety of the operations of, and is otherwise not directly related to, the operation of aircraft.[21] A flight kitchen need not be located on airport property, and a carrier's decision regarding location of this type of activity is generally based on the negotiation of a lease or sale of the property. Accordingly, the normal market forces of competition are relied upon to regulate the fees for such property.[22] Judicial decisions have also recognized that airport fees charged for non-aeronautical use are not subject to the DOT/FAA's jurisdiction over "reasonableness."[23]

The DOT/FAA is interested in the use of airport revenues, including the use of surplus revenues, to ensure that they are used for airport system purposes and for other purposes for which airport revenues may be spent under the revenue retention provision, including reasonable reserves and other funds to facilitate financing and to cover contingencies. While fees assessed for nonaeronautical uses may exceed the cost of service to those users, the surplus funds accumulated from those fees must be used in accordance with the statutory revenue retention provisions.[24]

Accordingly, the lease rates charged to United for the in-flight kitchen activities are not within the jurisdiction of the DOT/FAA.

---

[21] Interim Policy, 60 Fed. Reg. 6915; Proposed Policy, 60 Fed. Reg. 47015-016. See also, A Review of the Imposition of Gross Receipts Fees on Off-airport Car Rental Companies, DOT Report to Congress, P-37-89-1 (1989), at Appendix.

[22] Interim and Proposed policies, *op cit.*

[23] City and County of Denver, 712 F. Supp. 836-837, cited for the proposition that the Anti-Head Tax Act does not regulate rates charged to non-aircraft operators for non-aeronautical uses because concessionaire revenue was intended to generate surplus airport revenues to fund airport expansion and development. Northwest Airlines v. County of Kent, 114 S. Ct. at 865.

[24] Section 4.2 of both Interim and Proposed policies, 60 Fed. Reg. 6918; 60 Fed. Reg. 47109.