

OFFICE OF THE CITY AUDITOR

AVIATION LEASE AND RENTAL AGREEMENTS



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January 14, 2005

Memorandum



CITY OF DALLAS

January 14, 2005

Honorable Mayor and Members of the City Council
City of Dallas

We have conducted an audit of the lease and rental agreements at the Dallas Love Field and Dallas Executive (formerly Redbird) Airports for the period October 1, 2002, through March 31, 2004. This audit was conducted under the authority of Chapter IX, Section 2 of the Dallas Charter and in accordance with the Annual Audit Plan approved by the City Council.

We concluded that the Aviation Department's accounting and real estate management staffs adequately ensured that the lease/rental payments were in accordance with the contract provisions, that the rentals payments are paid on a timely basis, and that the rental revenues are properly accounted for and recorded. However, we identified issues related to the month-to-month agreements, the tracking and accounting of leasehold improvements, and the reasonableness of rental rates.

These issues are addressed in the Opportunities for Improvement section of this report.

We appreciate the cooperation of City staff during our audit.

Paul Garner

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Assistant City Auditor

c: Mary K. Suhm, Interim City Manager

AVIATION LEASE AND RENTAL AGREEMENTS

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INTRODUCTION

AUTHORIZATION

We have conducted an audit of the lease and rental agreements at the Dallas Love Field and Dallas Executive (formerly Redbird) Airports for the period October 1, 2002, through March 31, 2004. This audit was conducted under the authority of Chapter IX, Section 2 of the Dallas Charter and in accordance with the Annual Audit Plan approved by the City Council.

SCOPE AND METHODOLOGY

Our audit was conducted in accordance with generally accepted government auditing standards and, accordingly, included inquiries, tests of the accounting and related records, and other procedures that we considered necessary. Our audit scope was all leases/rental agreements (on and off-premises) in effect during the period October 1, 2002, through March 31, 2004.

Our audit objectives were to determine whether:

- Rental/lease payments were in accordance with the contract provisions
- Rental/lease agreements are properly accounted for.
- Contract rates are reasonable.

To develop an understanding of the Aviation Department's leasing practices and procedures, we:

- Reviewed City Code, Chapter 5 – Aircraft and Airports.
- Reviewed Federal Aviation Administration (FAA) *Policy Regarding Airport Rates and Charges* and FAA grant assurances applicable to recipients of federal funds.
- Interviewed Aviation Department staff and reviewed department's policies and procedures for the management of public property.
- Examined records, supporting documents, and related transactions.
- Toured the facilities to identify and locate leased property.

Aviation Department records showed that the department leases property at Love Field and Executive airports to 80 vendors¹. The preponderance of rental revenues is comprised of long-term leases and airline leases at Dallas Love Field. A small number of leases (four) were for off-premises property². We judgmentally selected a 20% sample (i.e., 16 vendors), which would be representative of each lease category. Each sample item was judgmentally selected by considering the following factors: (a) annual rental revenue, (b) lease expiration date, (c) vendor, (d) whether lease was located on or off the airport premises, and (e) whether the lease was long-term or month-to-month.

¹ Some vendors have multiple leases.

² Off-premises property is property owned by the City, but located outside the airport perimeter fence or at a geographically separate location.

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Our initial sample of six month-to-month agreements revealed that these were not temporary or short-term agreements because they had been on a month-to-month basis for an extended period. Since these agreements were allowed to be indefinite, did not have Council approval, and disclosure was not required, we expanded our sample and made a 100% examination of all month-to-month agreements at Love Field and Executive airports (31 and seven agreements respectively). We also sent confirmations to our initial sample of six month-to-month tenants to verify monthly payments and to verify the number of years that they had been on a month-to-month basis.

OVERALL CONCLUSION

Aviation Department's accounting and real estate management staff adequately ensured that lease/rental payments were in accordance with contract provisions, that rentals payments were paid on a timely basis, and rental revenues were properly accounted for and recorded. We noted that long-term leases, unlike month-to-month leases, have a high visibility since they are approved by the City Council.

We have identified issues related to the month-to-month agreements, the tracking and accounting of leasehold improvements, and the reasonableness of the rental rates. These issues are addressed in the Opportunities for Improvement section of this report.

Management's Response:

The Department of Aviation has reviewed the "*Audit of Aviation Lease and Rental Agreement*" and welcomes this opportunity to offer the Department's Response. The staff believes that the most significant finding is discussed in the "**Overall Conclusion**" of the audit that addresses long term leases. Clearly, the majority of the leasing activities of the department, both in volume and revenue, involve these type leases. As noted in the audit, they also have a high degree of visibility. Yet, your review of the lease practices concluded that:

"... staff adequately ensured that lease/rental payments were in accordance with contract provisions, that rental payments were paid on a timely basis, and rental revenues were properly accounted for and recorded."

The audit did identify three areas for improving lease practices and makes recommendations. The Aviation Department agrees with the recommendations and will fully implement each of them. As you are aware, a task force made-up of real estate professionals in the private sector has also conducted a review of the lease practices of the Department of Aviation. A preliminary review of Real Estate Task Force report indicates a similarity in the recommendations of this audit. While staff fully supports the recommendations, we disagree with the conclusions reached that formed the basis for your recommendations. The following is the response to the conclusions drawn in the audit.

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BACKGROUND

The City of Dallas owns and operates the Dallas Love Field Airport, Dallas Executive Airport (formerly Redbird Airport), and a heliport. These facilities are operated and managed by the City's Aviation Department, which is designated as an enterprise fund. An enterprise fund has operations that are financed and operated in a manner similar to private business enterprises – where the intent is that the costs of providing goods or services to the public on a continuing basis are financed or recovered primarily through user charges.

Dallas Love Field generates virtually all of the Aviation Department's revenues and is classified as a "compensatory" airport. This is one of the rate setting methodologies approved by the FAA. Under this methodology, an airport proprietor assumes all liability for airports costs and retains all airport revenues for its own use in accordance with federal requirements. *FAA Policy Regarding Airport Rates and Charges* states that airport proprietors must maintain a fee and rental structure that, in the circumstances of the airport, makes the airport as financially self-sustaining as possible. This is also reiterated in the FAA grant assurances for federal fund recipients.

The City's Financial Management Performance Criteria, which is included in the appendices of the adopted budgets, states that each enterprise fund of the City will maintain revenues that support the full (direct and indirect) cost of the utility. Additionally, Aviation's bond ordinance³ requires that total rentals, rates, fees, and charges produce sufficient annual gross revenues that will:

- Pay the operating and maintenance expenses of the airport system and,
- Be able to pay 1.25 times the sum of both the principal and interest on outstanding parity obligations.

Leasing activity consists of ground leases (which are long-term and normally aviation related) and month-to-month leases. Rental revenues comprise approximately \$9.2 million or 31.6% of total revenues and are derived from long-term leases and month-to-month leases. City Council establishes and approves rental rates for ground leases, landing fees, and fuel flow fees. The current annual ground lease rates for Love Field are (a) \$0.32/sq ft for unimproved land, and (b) \$0.46/sq ft for improved land. The annual rates for Dallas Executive are (a) \$0.13/sq ft for unimproved land, and (b) \$0.17/sq ft for improved land. Council has recently been emphasizing that leases provide for rental increases. The Aviation Department has subsequently responded to Council and ensured that leases initiated since 2003 do provide for rental increases based on a consumer price index (CPI) average. The timing for such rental increases varies per contract.

Dallas City Code, Section 5-3(c) allows the Director of Aviation to manage and execute short term, month-to-month leases for all properties and facilities situated on or having a

³ \$59,385,000 Airport System Revenue Bonds, Series 2001 (construction of 4,000 space parking garage).

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relationship to any municipally owned airport. These properties and facilities do not have to be directly related to aviation activities. Therefore, rental rates and fees, not addressed by Council ordinance, such as office space and corporate hangers, are determined by the Aviation Department.

We noted that there were 31 month-to-month leases at Love Field and seven month-to-month leases at Dallas Executive.

- Love Field's 31 month-to-month leases are categorized as follows:
 - Thirteen were aviation related.
 - Eighteen were non-aviation related; nine of the 18 were concessions related; and the other nine were for rental of office space or floor space.
- Dallas Executive's seven month-to-month leases are categorized as follows:
 - Two were aviation related.
 - Five were non-aviation related; two of the five were concessions related, and the other three were for rental of office space or floor space.

A real estate task force, appointed by the Mayor and Council, has studied and assessed the Aviation Department's real estate practices and issued their report, dated October 18, 2004. The task force stated that a significant item missing from current procedures was a mechanism for formal review of month-to-month leases that have been in place for an extended period.

OPPORTUNITIES FOR IMPROVEMENT

We identified certain policies, procedures, and practices that could be improved. Our audit was not designed or intended to be a detailed study of every relevant system, procedure, and transaction. Accordingly, the opportunities for improvement present in this report may not include all areas where improvements may be needed.

1. Month-to month leases are allowed to be indefinite in length of term and are not standardized.

We made a 100% review of all month-to-month leases in effect during our audit period. There were 31 month-to-month leases at Love Field airport and seven month-to-month leases at Dallas Executive airport.

- A. Month-to-month leases are not short term; they are allowed to be indefinite in length of term.
- The average length of time (since inception of the lease) for the 31 month-to-month leases at Love Field was 44 months. However, one tenant confirmed that he has had a month-to-month lease for 21 years.
 - The average length of time (since inception of the lease) for the seven month-to-month leases at Dallas Executive was 87 months. The longest noted was 20 years and 9 months.
 - Some month-to-month leases are carry-overs from the previous Aviation Director's administration.

Aviation Department contended that these month-to-month leases are short term since they are automatically renewable every 30 days.

Dallas City Code, Section 5-3(c) states, "The director of aviation shall exclusively manage, and may execute **short term** (*emphasis added*), month-to-month leases on, all properties and facilities situated on or having a relationship to any municipally owned airport, whether such properties and facilities are directly related to aviation activities or not,..." The city code does not require disclosure and does not define "short term" or specify what authority is conveyed by the term "may execute."

Consultation with the City Attorney's Office (CA) yielded a determination that although state statutes do not specify *short-term* as 12 months, general practice is not longer than 12 months. The CA also stated that month-to-month leases are not renewable every 30 days; these leases remain in effect until canceled by one of the parties.

Webster's Dictionary defines *short-term* as "payable or reaching maturity within a relative short time, as a year." The concept of one year or less is also supported by the Governmental Accounting, Auditing and Financial Reporting book, published by the Government Finance Officers Association.

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Lack of required disclosure allowed these leases to continue for an indefinite period. Month-to-month leases allowed to be continued on an indefinite basis are not in the City's best interest. These types of leases:

- Do not require the tenant to make any investments or improvements on the property.
- Are not written in a manner to properly protect or benefit the City.
- Do not address increases in rent. Some tenants have paid the same rents since the inception of their leases.

B. Month-to-month leases are not standardized and do not specify requirements to adequately protect or benefit the City.

Our examination of month-to-month leases revealed the following:

- Deposit requirements vary:
 - Seventeen of 31 leases at Love Field did not require a security deposit.
 - Four of seven leases at Dallas Executive did not require a security deposit.
- Assessment of penalty/delinquent fees vary:
 - Love Field leases (31) varied as follows:
 - 1 each - \$2.50/day
 - 1 each - \$2.50/day not to exceed \$20
 - 2 each - \$1.00/day not to exceed \$20
 - 10 each - \$1.00/day
 - 5 each – no penalty fees assessed
 - 10 each – 10% of rent due
 - 2 each – one time charge; 10% of monthly rent
 - Dallas Executive leases (7) varied as follows:
 - 5 each – 10% of rent due
 - 1 each - \$1.00/per day
 - 1 each – no penalty fees assessed
- Right-to-audit clause - Four of the Love Field leases and one of the Dallas Executive leases specified that monthly rent would be the greater of a fixed rent or a percentage of sales, but these leases did not have a right-to-audit clause. Tenants paid only the fixed rent amount.
- Leases did not address rent increases:
 - Twenty-seven of 31 agreements at Love Field did not address increases in rent. Tenants have basically paid the same rents since the inception of their leases. The remaining four monthly leases (executed since 2003) do specify that rent will increase based on the average consumer price index (CPI) for the preceding 12 months.

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- Six of seven agreements at Dallas Executive did not address increases in rent.

The Aviation Department contended that these leases were standardized because they were all on a month-to-month basis. Aviation Department stated that the leases did not all contain the same contract clauses because they wrote the lease(s) to meet the circumstances applicable at the time to accommodate the tenant. It was noted that Aviation Department has developed a standardized contract for long-term leases, but has not developed a standard contract for month-to-month leases. Aviation Department further stated that although the leases did not contain right-to-audit or rent increase clauses, the leases were considered renewable every 30 days. Therefore, the leases could be modified at any time by giving the tenant a 30 day notice. Aviation further asserted that the City's exposure to liability was minimal since these leases could be terminated with a 30 day notice however; this approach is reactive instead of proactive.

Consultation with the CA confirmed that any changes to a lease must be agreed upon by the tenant. The alternative, if not agreed to by the tenant, is that the month-to-month lease could be terminated by the landlord. Additionally, there was no documented evidence that month-to-month leases were reviewed and approved by the City Attorney's Office as to form; thereby assuring that the leases adequately protected the City.

Dallas City Charter, Chapter XXII – Public Contracts, Section 1, states: “No contract, other than purchase orders for supplies and equipment and change orders authorized in accordance with Section 6, Chapter XXII of this Charter, shall be binding upon the city unless it has first been signed by the city manager and approved by the city attorney.”

Lack of a standardized lease agreement gives the appearance that all tenants are not consistently treated the same.

We recommend that the Aviation Department Director:

- A. Limit month-to-month leases to no more than 12 months. Current month-to-month leases should be converted to longer term leases (e.g., two to five years). If a business case can be made to support an extended month-to-month agreement, it should be presented to the City Council (at least to the Business and Commerce committee). Additionally the Director should seek clarification from the CA as to what authority the department has to approve and modify a lease without City Manager, City Council, or CA approval.
- B. Coordinate with the CA and develop a standardized month-to-month lease and also consult with the CA to standardize the assessment of penalties and delinquent fees.

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Management's Response:

Month-to-Month Lease make-up a small percentage of the lease activities conducted by the department. As of December 1, 2004, 32 of the 106 Aviation Department leases are on a month-to-month basis. These leases represent 6.07% of the total rental revenue of the Department and 2.28% of all of the leased land. Clearly, the majority of the leasing activities involve long-term agreements which provide the greatest share of lease revenue to the Department.

The audit reviewed multiple month-to-month lease agreements and concluded that the agreements "...were not temporary or short-term agreements..." The audit postulated that because the leases were in effect for, in some instances, several years; they were not month-to-month lease agreements. **The fact the lease agreements were in effect for longer than one month does not change or alter the provisions of the lease agreements that clearly state the lease-term is for one month.** The leases contain provisions (common in public/private sector month-to-month leases) that permit the lease to continue provided certain conditions are met, including, but not limited to, payment and acceptance of rent, maintaining insurance/indemnification requirements, etc. In the event that both parties to the lease are in agreement to continue the lease on a month-to-month basis (pursuant to the lease), the lease shall continue.

The audit goes further to state that, 'month-to-month leases allowed to be continued on an indefinite basis are not in the City's best interest' and cites several reasons why these types of leases are not in the City's best interest.

The following are reasons why month-to-month leases that are renewed or allowed to continue for another thirty-day period. These include:

- Generate immediate revenue to the City when there may be no other viable market to lease the property due to its configuration, proximity to adjacent property, lack of access, lack of utilities or remote location;
- Provide the needed flexibility to immediately make adjustments to the lease to immediately make adjustments to the lease to benefit the City;
- Benefit the City when the City wants to reserve the right to recall the space for a higher and better use and;
- Temporarily accommodate, if possible, airport contractors or other tenants who request an office at the airport during their construction/design contract period.

The audit also states that the month-to-month leases are not written in a manner to properly protect the City. **All of the Aviation Department's month-to-month leases contain the same or similar type provisions as the department's long-term leases**

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that properly protect the City against liability. However, if there is a need to modify a lease agreement to insure further protection for the City the Department would provide a 30 notice to the tenant and if the tenant did not agree, the lease would terminate. This approach to protecting the City is considered proactive instead of reactive. It gives maximum control and flexibility to the City with respect to modifying, adjusting, terminating or extending the lease.

The recommendations of reviewing month-to-month leases with the Dallas City Council or the Council Committee on a yearly basis and having the City Attorney to review the standard lease used by the Department are supported by the Department.

Auditor's Comment:

Although month-to-month leases only account for a small percentage of total rental revenue and leased land, they are City property and should be managed and safeguarded in a manner commensurate to the long term leases. Month-to-month leases provide a degree of flexibility, but they should be short term. However, the use of month-to-month leases for 5-20 years with the same tenants, at the same locations, and for the same amount of rent does not appear to be in the best interest of the City.

2. The Aviation Department's property records do not account for all leasehold improvements.

Land lease agreements require a minimum investment in capital improvements as a condition of the lease. These leases state that title to the capital improvements will vest with the City upon completion of construction and will become assets of the City upon termination of the lease. The Aviation Department does monitor to ensure that the minimum required capital improvements are accomplished; however, it does not track and account for leasehold improvements beyond the minimum requirements.

Aviation staff stated that the Department is aware of leasehold improvements because tenants must submit plans to the Aviation Director for approval; however, Aviation staff believes that the tenant is under no obligation to report improvements made in excess of the required minimum amount.

A review of three long-term leases (in our sample) for land and facilities at Love Field revealed that the clause entitled "Improvements" or "Use of Premises" states, "The additions and improvements to the Leased Premises constructed or erected by Lessee, or which lessee causes to be constructed or installed, hereunder shall be deemed fixtures, excluding trade fixtures, and constitute a part of Leased Premises and title to such additions and improvements shall vest in the Lessor and shall become the property of Lessor upon completion." Similar wording is used in the recent template developed by the Aviation Department for long-term contracts.

Aviation Department's Management Policies and Procedures for Public Property, Section III, GROUND LEASE – LESS THAN 40 YEARS, paragraph 6.1 states, "Title to

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improvements constructed by lessee will vest in the City upon completion of construction.” Per Aviation staff, these leasehold improvements pertain to aviation related leases. For ground leases greater than 40 years, Aviation staff stated that title to improvements constructed by the lessee will vest with the City upon expiration of the leases’ primary term.

RESOURCE Information Guide (i.e., guide to the City’s financial management information system) Chapter 4.4, paragraph 6 states in part, “Each Department Director, or their designee, is responsible for the appropriate accountability of fixed assets owned by that department, leased from another City department, or obtained from external sources through capital leases...”

We recommend that the Aviation Department Director track and account for all leasehold improvements.

Management’s Response:

The audit concludes that the Department fails to “track and account for all leasehold improvements” At issue in the audit are capital improvements made by a tenant that are “over and above” what is required in the lease. All of the current leases require the tenant to report, document and verify capital improvements that are required in the lease. There is no such requirement in many of the existing leases that such documentation be provided outside of the required capital expenditure. The Department is aware of type and extent of any construction on leasehold premises due to the requirement for the Director of Aviation review of building plans and the approval that must be obtained as part of the permitting process. Absent the lease language, staff welcomes suggestions for requiring such disclosure from a tenant who are under existing leases. Staff will make reporting all capital improvements in excess of what is required in the lease a standard provision of future leases and such information will be properly accounted in the City’s financial management system.

3. Rental rates should be set to sustain airport operations.

All rental rates and fees, not established by the Council, are determined by the Aviation Department. Therefore, the Aviation Department sets rates for (a) terminal space, (b) office space, (c) floor space, (d) canopy space (for rental car agencies), and (e) hangar space. These rates have historically not required Council approval. Rates for office space and corporate hangars have remained unchanged since 1998.

The reasonableness of these rates, as established by the Aviation Department, is questionable based on the following:

- Interviews with Aviation staff and review of lease files revealed that rental rates are not based on a market appraisal.
- As previously reported, rental rates for month-to-month leases remain the same since the inception of the lease.

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- Aviation Department has not enforced rents that are based on a percentage of sales.
- Rates were not based on revenue potential. Prior to the current ATM concession contract, (effective 4/1/04) all six month-to-month leases (one of these leases dates back to 1997) for ATMs were for a fixed monthly rent of \$500. Rent was not based on transactions or dollar volume. The aggregate rent of the month-to-month leases was \$36,000 per year. The current ATM concessions contract has a minimum annual guarantee of \$115,000.

It was also noted that tenants do not pay ad valorem taxes. The City, as the property owner, is exempt from such taxes, and the tenants benefit from this tax-exempt status.

Aviation Department personnel stated that it has not raised rents for fear that tenants will terminate their leases and thus cause the loss of rental revenues and jobs. Aviation personnel further stated that there is not a high demand for office space at Love Field and that Love Field's main terminal has a 98% occupancy (excluding the east wing that was formerly occupied by American Airlines).

FAA, *Policy Regarding Airport Rates and Charges*, effective June 19, 1996, paragraph 4 states in part, "*Airport proprietors must maintain a fee and rental structure that in the circumstances of the airport makes the airport self-sustaining as possible.*"

FAA grant assurances (applicable since Aviation receives federal grant funds), paragraph C.24. *Fee and Rental Structure*, states, "*It will maintain a fee and rental structure for the facilities and services at the airport which will make the airport as self-sustaining as possible under the circumstances existing at the particular airport,...*"

Aviation management's reluctance to adjust rental rates demonstrates that it has not fully assessed the circumstances that could make the airports self-sustaining. Rates have remained the same despite rising costs for utilities and the significant increase in security costs resulting from the September 11, 2001, tragedy. Review of the City's Comprehensive Annual Financial Report shows that Aviation had operating losses in FY 02 and FY 03. Aviation's FY 04 budget and proposed budget for FY 05 reflect a deficit.

We recommend that the Aviation Department Director:

- Should strive to make the airport self-sustaining by developing rates and fees based on market conditions and based on its financial position and obligations.
- Disclose its rates and fees to the City Council, at least annually.

Management's Response:

The Department of Aviation is an Enterprise Fund. As such, the funds that it takes to operate and maintain the airport derive from the fees charged to airport users and the customers. Each year, the Departments Operating and Capital budgets are developed and approved by the City Council. It is during this process where costs are determined

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and revenues are identified to meet those costs. There has not been a time in recent memory where the Department has failed to meet this obligation. The Department has in excess of \$50 million in cash earmarked for capital projects and to meet certain cash reserve obligations.

As you know, Federal Regulations require that airports not seek to create revenue surpluses. The airport cannot be considered as a profit center with normal profit motives. The main goal in establishing rates and charges should be to have the cash flow to operate the airport and to service the long-term capital requirements of the airport. The Aviation Department rates and charges currently provide sufficient revenue to offset expenses. Revenue is adequate to meet financial obligations.

Finally, it is also important to note that the airport has made several significant changes in the rates and charges since 2000. These include rates and charges for parking, fuel flowage, terminal rent, and ground rent and ATM concessions.

The staff does support presenting to Council the rates and fees to the City Council on an annual basis.

Auditor's Comment:

The Aviation Department has reported an operating loss since FY 02 and its current FY 05 budget reflects expenditures exceeding revenues by approximately \$3.7 million. Cash earmarked for capital projects is a restricted asset and is not available for airport operations and maintenance. Therefore, we reiterate that the Aviation Director should strive to make the airport self-sustaining.