OFFICE OF THE CITY AUDITOR

AUDIT OF AVIATION CONCESSION OPERATIONS

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Memorandum

CITY OF DALLAS

January 9, 2004

Honorable Mayor and Members of the City Council
City of Dallas

We have conducted an audit of Aviation (AVI) Concession Operations at Love Field Airport for the period ending September 30, 2002. 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.

Concession operations and administration appear adequate and generally meet the requirements set by applicable guidelines and policies. However, there are areas in contract management and administration that can be improved. Related opportunities for improvement and recommendations are presented in this report.

We appreciate the cooperation shown by staff during our audit.

Thomas M. Taylor

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City Auditor

c: Teodoro J. Benavides, City Manager

AUDIT OF CONCESSION OPERATIONS AT DALLAS LOVE FIELD

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EXECUTIVE SUMMARY

We have conducted an audit of Concession Operations at the Dallas Love Field Airport for the period October 1, 2000 through September 30, 2002. Our audit objectives were to:

- Identify strengths and weaknesses in Aviation's control environment;
- Determine if concession revenues paid to Aviation were reported accurately and proceeds were paid in a timely manner;
- Determine if concessionaires met contractual requirements;

Aviation's concession operations generally met the requirements set by applicable guidelines and policies. However, there are some areas that can be enhanced.

We have summarized our opportunities for improvement below:

- Aviation's management of contracts should be improved to ensure that the City's best interest is protected. We noted instances where renewal options for contracts were exercised at the request of concessionaires and prematurely committed the City to do business with those concessionaires for periods in excess of 15 years.

- Our audit revealed that Aviation does not record late fees, penalties, and certain revenue in the RESOURCE accounting system in a consistent manner or in accordance with generally accepted accounting principles. One concessionaire failed to meet their contractually required minimum guarantee and underpaid the City $1,672,535. The department has not recorded this debt as an account receivable in the City's accounting system.

- Aviation does not have written policies or procedures requiring the monitoring of contractually required initial capital improvements. According to the department, Aviation pre-authorizes concessionaire's construction plans and then conducts a post-improvement inspection. These inspections are conducted to ensure that a capital improvement was completed on the approved premises and that the price for completing the improvement was reasonable. However, these inspections have not been documented. Therefore, the extent of the improvements and the amount expended on those improvements has not been tracked, documented, or verified.

- The audit also noted that some concession contract language did not adequately protect the City's financial interests. A concessionaire's monthly payments (to the City) during 2002 were below the required minimum annual guarantee, but the City had to continue its monthly compensation to this concessionaire.

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Authorization

We have conducted an audit of Concession Operations at the Dallas Love Field Airport for the period October 1, 2000 through September 30, 2002. 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.

We conducted a limited review of Aviation's operations and procedures in order to accomplish the audit objectives. Our audit objectives were to:

- Identify strengths and weaknesses in Aviation's control environment;
- Determine if concession revenues paid to Aviation were reported accurately and proceeds were paid in a timely manner; and
- Determine if concessionaires met contractual requirements.

We noted that a clear distinction exists between the top four, non-rental car agency, revenue producers and the remaining concessionaires. Audit staff judgmentally selected the four highest non-auto rental revenue-producing concession contracts. Total revenue for these four concessionaires for the period of October 2000 through March 2002 was $22,254,038. The four highest revenue-producing concession contracts at Dallas Love Field are with Ampco System Parking, Dallas Love Field Joint Venture, Hudson Retail-Dallas Joint Venture, and Sky Sites, Inc. Total concession revenue for the selected sample for the period of October 2000 through March 2002 was $17,930,181 (78% of total concession revenue).

Aviation's accounts receivable process was evaluated to determine if the department maintains an accurate receivables aging report, if invoices were mailed in a timely manner, and if established City of Dallas delinquent accounts collection procedures were being followed.

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The revenue reporting and collection environment was tested to determine if revenues were accurately reported and proceeds were paid to the City in a timely manner. Individual monthly revenue reports and payments from concessionaires were reconciled with the RESOURCE accounting system and payments were evaluated to ensure that they were made in accordance with contract requirements.

Aviation's contract monitoring and oversight environment was evaluated in order to determine if concessionaires are meeting contractual requirements. The three requirements evaluated were initial capital investment improvements, annual refurbishments of not less than one-half of one percent (0.005) of annual gross revenues, and the existence of insurance coverage at the specified amounts.

To develop an understanding of the policies and procedures relating to Concession Operations, we:

- Reviewed Administrative Directive (AD) 4-5, Contracting Goods and Services, dated May 10, 1999; AD 4-10, Delinquent and Uncollectible Accounts Receivable, dated August 1, 1997
- Interviewed City and departmental management and staff.
- Examined records, supporting documents, and related transactions.
- Considered the relevant findings and recommendations of prior audit reports.

Overall Conclusion

Aviation's concession operations generally met the requirements set by applicable guidelines and policies. However, there are some areas regarding concession revenue and contractual requirements that can be enhanced. Opportunities for improvement are presented in this report.

Background

The Aviation Department is an enterprise fund with operations at Dallas Love Field Airport, Southwest Executive Airport (formerly Redbird Airport), and the downtown heliport. The Department's mission is to provide a safe and efficient airport system by addressing customer concerns and continuously improving City services to commercial and general aviation users. The Department leases property to approximately 40 long-term vendors, has 25 month-to-month leases, and has

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concessionaire agreements with 14 vendors at Dallas Love Field Airport.

Concession contracts obligate concessionaires to pay the City of Dallas the greater of a percentage of their monthly gross revenues or a minimum annual guaranteed (MAG) payment. Concession agreements are established for services such as car rentals, retail stores, food and beverage sales, airport advertising, parking, shoe shining, and bag cart rentals.

- AMPCO System Parking (AMPCO) has a five-year parking concessions contract with five one-year renewal options. The five-year term of the contract is January 1, 1998 through December 31, 2002. On June 28, 2002, the City exercised a one-year renewal option for the period of January 1 to December 31, 2003. AMPCO provides exclusive management and operational control of the four-story parking garage and surface lot adjacent to the garage. AMPCO collects and makes daily deposits into a City controlled bank account. The City pays AMPCO 9.725%[1] of adjusted gross revenues collected for parking at Love Field. The contract guarantees that the City will annually receive a minimum of $7,366,301 in revenues from the concessionaire.

- On August 24, 1994, the City Council approved Resolution 94-3120, authorizing a 10-year contract with a one five-year renewal option for food and beverage concessions at Dallas Love Field with the Dallas Love Field Joint Venture (Joint Venture). The contract allowed for an interim term for build-out and the completion of initial capital investment improvements. The 10-year contract commenced after the completion of the interim term. Therefore, the primary term of the contract began on July 1, 1996, and will expire on June 30, 2006. The option to renew for five years was granted on March 18, 2002 by AVI and extends the term of the contract until 2011.

[1] 5.985% per initial contract and an additional 3.740% per Council Resolution No. 99-3292, dated October 13, 1999

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- On August 24, 1994, the City Council approved Resolution 94-3119, authorizing a 10-year contract with a one five-year renewal option to Hudson Retail-Dallas Love Field Joint Venture (Hudson News). This contract was for retail merchandise concessions at Dallas Love Field. The contract allowed for an interim term for build-out and the completion of initial capital investment improvements. The 10-year contract commenced after the completion of the interim term. Therefore, the primary term of the contract actually began on July 1, 1996, and will expire on June 30, 2006. The five-year renewal option was granted by AVI on July 20, 2000 and extends the term of the contract until 2011.

- Council Resolution 00-3009 authorized a five-year advertising concession service contract with Sky Sites[2]. The term of the contract is June 1, 2001 through May 31, 2006. Sky Sites pays the City fees of 67.6 percent of annual gross receipts or a minimum annual fee of $1,500,000. Gross receipts are defined as all monies received by the concessionaire for advertising services less taxes paid and commissions paid to advertising agencies. Due to the impact of the September 11, 2001 terrorist attacks, the travel industry has experienced a large decrease in passenger traffic. Similarly, advertising concessions at airports have also seen a considerable decrease in revenue generating opportunities. In an attempt to alleviate some short-term pressure on Sky Sites, the City Council authorized a reduction in the minimum annual fee to $1,125,000 for the second and third contract years.

[2] Sky Sites was subsequently acquired by JC Decaux Airport Inc.

OPPORTUNITIES FOR IMPROVEMENT

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

1. Two concession contracts were renewed prematurely.

The Love Field Retail Merchandise Concessions (LFRMC) contract, primary term of July 1, 1996 to June 30, 2006, was given a renewal option on July 20, 2000, extending the contract period to June 30, 2011. The renewal option was exercised just after the four-year anniversary of the contract, and committed the City to a 15-year contract.

The Love Field Food and Beverage Concessions contract, primary term of July 1, 1996 to June 30, 2006, was given a renewal option on March 18, 2002, extending the contract period to June 30, 2011. The renewal option was exercised prior to the six-year anniversary of the contract, and committed the City to a 15-year contract.

We determined that these renewals occurred due to the following:

- Neither City policy nor AVI's procedures address when and how renewal options may be exercised.
- Concessionaires requested that renewal options be exercised to assist them with their long term planning and financing.

Article III, Section 3.2 of the concessions contracts states in part: "…In order to exercise such renewal option, City shall advise Concessionaire in writing of its intent to renew no later than six (6) months prior to the end of the Primary Term of this Agreement."

Article XVI, Section 16.17 of the contract states: "The Director shall be designated as the official representative of the City in all matters pertaining to this Agreement and shall have the right and authority to act on behalf of the City with respect to all action required of the City in this Agreement."

The LFRMC contract was awarded a five-year extension contrary to the following AVI staff concerns:

- Verification had not been completed to ensure that LFRMC had expensed the requisite 0.005 of Gross Revenue (beginning in year three) on refurbishments, replacements, etc.
- LFRMC has not provided any documentation of the amounts spent on Gate 11 capitalization costs.
- As of June 23, 2000, LFRMC has not paid any percentage rental to the City.

The renewal options exercised by the Director (for years 11 through 15) specified the same MAG as in years 6 through 10. The MAG rate for the option years could have been renegotiated and may have been at higher rates if the renewal options were exercised later into the contracts. The renewal options were for the benefit of the concessionaires and not primarily for the best interest of the City. By extending long-term concession contracts prematurely, AVI forfeits their ability to react in a timely manner to market changes. Future revenue may be jeopardized when market conditions increase at levels not commensurate with terms negotiated in the original contract.

A lack of established procedures for evaluating and exercising renewal options for contracts can result in inequitable treatment of City contractors and a possible loss of revenue. AVI has several other contracts that include options for renewal. By renewing these two contracts at-will, (without a documented evaluation) AVI may be forced to exercise less desirable options with other contractors to ensure equitable treatment.

We recommend that the Director of AVI consult with the City Manager to ensure that written procedures are developed to specifically address how requests for contract renewal options will be evaluated, the criteria used to determine a contractor's performance, and an acceptable time frame (prior to the end of a contract term) when a renewal option may be exercised. These procedures should also specify when City Council approval is required. Additionally, management could include criteria in the contract specifying under what conditions renewal options may be exercised.

Management's Response:

The circumstances regarding the exercising of the renewal were discussed at length with Audit Staff. There were two contracts that were the subject of this finding – Hudson News Retail and the Dallas Love Field Joint Venture. The Aviation staff welcomes discussions to formalize a City policy that addresses when a renewal may be exercised. To guarantee, however, that such policy would be in the best interest of the City would be difficult given the inability to predict with certainty what the financial conditions will be in the future.

Auditor's Comments:

Renewal options should be exercised close to the contract ending date to allow for an assessment of current market conditions. Exercising renewal options six years and four years prior to the contract ending dates inhibits such assessments

2. AVI needs to enforce accounts receivable procedures.

We noted that the parking operator's underpayment of $1,672,535 representing 22% of the MAG ($7,366,301) for contract year ending December 31, 2002 has not been recorded as an accounts receivable. (This is currently under litigation. See Opportunity for Improvement #4 for more information.)

OPPORTUNITIES FOR IMPROVEMENT

AVI staff emphasized that the underpayment of MAG has been briefed and brought to the attention of City Council and the City Attorney's Office. AVI staff stated that these briefings have provided the proper visibility and that AVI and City staff are well aware of this issue and that this receivable will not be forgotten or lost. Additionally, AVI staff stated that since the receivable amount is under question, the receivable should be recorded after the final amount is known.

AVI is an enterprise fund subject to generally accepted accounting principles (GAAP) and the accrual system of accounting. Therefore, revenue earned must be recognized and recorded in the City's accounting system (RESOURCE).

Chapter 2 of the City's RESOURCE Guide requires the department to ensure that accounts receivable are computed accurately and promptly recorded in the RESOURCE accounting system. Management oversight should be adequate to ensure that:

- Established City polices and procedures are followed.
- City assets are adequately safeguarded and maintained in accordance with applicable laws and regulations.
- Accounts receivable should be computed accurately and promptly recorded in the RESOURCE accounting system.
- Revenue should be recognized in accordance with established policies, procedures, and generally accepted accounting principals.
- Adjustments to accounts receivable should be authorized in accordance with laws, regulations, and management's policy.

MAG is revenue earned and is due to the City. Failure to properly record accounts receivable could result in inaccurate reporting and failure to recognize an asset.

We recommend that the Director of AVI ensure:

- The MAG underpayment is properly accounted for as an accounts receivable.
- City policy and procedures are enforced.

Management's Response:

The problem area cited in the report is the failure to note the parking operators underpayment of the minimum annual guarantee (MAG) to accounts receivable. While efforts will continue to collect this debt, we will add this to the resource system.

OPPORTUNITIES FOR IMPROVEMENT

3. Contract oversight needs to be improved.

Concessionaires' requirements to perform initial capital investment were not enforced by AVI. We also noted that concessionaires' annual financial reports did not meet contract requirements.

- Initial Capital Investment Improvements
  The retail merchandise concessions contract required an expenditure of $1,182,366 for initial capital investment improvements. Our review of records indicated that the concessionaire spent $1,039, 557.

  The food and beverage concessions contract required an expenditure of $3,117,750 for initial capital investment improvements. The schedule submitted with the Chief Financial Officer's letter showed capital investment improvements $3,298,209. However, the dollar amount reported in the concessionaire's full or conditional release of liens did not agree to the schedule. Additionally, the concessionaire did not provide full waiver and release of lien for projects #95122E and #95123E.

  Retail merchandise concessions contract, Article VII, § 7.1 states "… Concessionaire agrees to expend $1,182,366 for Initial Capital Investment improvements to the Assigned Premises."

  Food and beverage concessions contracts, Article VII, § 7.1 "… Concessionaire agrees to expend $3,117,750 for Initial Capital Investment improvements to the Assigned Premises."

  Article VII in both concession contracts state:

  Section 7.6 "Upon completion of the Initial Capital Investment obligations required hereunder, Concessionaire must provide the City with the following:

  A. Within 30 days following the completion of the improvement obligations, one reproducible copy of as-built drawings for each site.
  B. Within 60 days following the completion of the improvement obligations: 1) a statement certified by the Chief Financial Officer of the Concessionaire specifying the final total cost of all improvement obligations required hereunder, in a format similar to the format contained in the bid document; 2) a certification that all improvements have been constructed in accordance with the approved plans and specifications, and in strict compliance with all applicable building codes, laws, rules, ordinances and regulations; and 3) certified proof demonstrating that no liens exist on any or all of the construction."

OPPORTUNITIES FOR IMPROVEMENT

- Annual Financial Reports
  The parking concessionaire's annual financial report for 2002 was due to the City by January 31, 2003. The report was still not available as of May 31, 2003.

  The food and beverage concessionaire's annual financial report was based on net sales rather than on the contractually required gross revenues.

  Section 6.8 of both concession contracts state:
  "Within ninety (90) days after the end of each Year, Concessionaire shall submit to the City an annual report of Gross Revenue for the preceding Year covering all business transacted by Concessionaire under this Agreement. Such annual report shall be certified by an independent certified public accountant. The independent CPA shall certify the Concessionaire's schedule of Gross Revenue and such other activity related to Percentage Payments, all as defined in this Agreement, is free from material misstatements and that the statements and payments to the City resulting therefrom are in accordance with this Agreement."

We determined that these conditions existed due to:

- AVI did not document their inspections of concessionaires' capital improvements.
- AVI did not have a vested interest since ownership of the assets would not revert to the City until termination of the contracts (which were extended to 6/30/2011).
- AVI did not aggressively enforce contract requirements related to concessionaires' responsibilities for financial reporting and initial capital investment improvements.

Administrative Directive 4-5, paragraph 5.1.12 states in part: "It shall be the responsibility of department directors to: …Monitor the contract to ensure contractors comply with the specifications or proposals and items and conditions of the contract."

The effects of these conditions are:

- There is limited assurance that concessionaires' are enforced to comply with contract requirements.
- The retail merchandise concessionaire was below by $142,809 in meeting its initial capital investment improvements.
- It could not be confirmed that the food and beverage concessionaire met its requirements of $3,117,750 for initial capital investment improvements.

We recommend that the Director of AVI:

Develops written procedures that, as a minimum, address:

- Inspecting, monitoring, and evaluating the required capital improvements;
- Identifying a specific person or position responsible for monitoring contract performance; and

OPPORTUNITIES FOR IMPROVEMENT

- Reconciling monthly revenue reported by concessionaires to their annual reports.

Confirms that concessionaires meet their initial capital investment improvements obligations. If concessionaires do not fulfill this obligation, then the Director should seek payment from the concessionaires in accordance with the provision of the concessions contract.

Management's Response:

At issue were the capital improvement requirements of both the food and beverage and the retail concession contracts. As you stated in the report, both contracts required a statement certified by the Chief Financial Officer of the company that the required improvements have been constructed and the financial obligation had been met. The concessionaire in both cases provided the documentation required by the contract. Staff long recognized that this degree of documentation is not sufficient. The contracts were written in the mid-1990's. New contracts will require a greater degree of documentation to support the capital expenditure requirements of the contract. Absent of the contractual language to require more detail documentation, the concessionaire provided what was required under the then existing contract.

I do take issue with the implication that no inspecting, enforcement, monitoring or oversight exists on these contracts. As a result, the audit recommends that procedures need to be put in place and that a person be given responsibility to monitor contracts. It is also important to note that the Assistant Director for Finance and Administration has compliance responsibility on all concession contracts. She is assisted in this effort by a Contract Compliance Manager and a Property Manager specifically in charge of the terminal building.

Auditor's Comments:

Submission of a statement certified by the Chief Financial Officer is but a component of the contract requirements. Additionally, the amounts reported in documents supporting the certified statement must agree with the amounts specified in the contract. The certified statements and documents did not agree with the contract amounts. AVI staff accepted the certified statements at face value and did not ensure contract compliance.

4. Contract provisions did not adequately protect the City's financial interests.

The parking concessionaire agreed to meet minimum annual guarantee (MAG) payments to the City in the amount of $7,366,301. The parking concessionaire's payments to the City were $1,672,535 less than the required MAG for the year ending December 31, 2002.

OPPORTUNITIES FOR IMPROVEMENT

We determined that the contributing causes were:

- The concessionaire's monthly-adjusted revenue collections that were remitted to the City were below the required MAG.
- The City (per legal counsel) cannot withhold compensation to the concessionaire to make up the difference between the collections made (by the concessionaire) on behalf of the City and the MAG.
- AVI staff was not aware of all contract options.

The Parking Concessions Agreement, Section 5.1 states:

"City will compensate Operator for management and operation of DPA (Designated Parking Area) in accordance with the bid and as approved by the Dallas City Council, which is a percentage of adjusted gross revenue (5.985%) paid to the Parking Operator. Within thirty (30) days after the end of the year, Contractor shall furnish the City with a statement showing gross revenue collected from the DPA and adjusted gross revenue for the preceding year. This statement will compare the percentage payments made during the year to the minimum annual guarantee ($7,366,301) for reconciliation purposes. Any adjustments required will be made within thirty (30) days after the end of the year. "

Council Resolution # 993292, dated October 13, 1999, Section 3 states:

"That the City Controller is hereby authorized to reimburse AMPCO System Parking an increase of 3.740% of adjusted gross revenue collected for parking at Dallas Love Field, provided the minimum annual guarantee to the City of $7,366,301 is met or surpassed, from the opening of the new temporary parking facility until this amendment is effectively terminated after the City provides a 30-day written notice of termination…"

Due to the contract language, the City could not withhold compensation to the parking operator to ensure it received the MAG. However, it appears that AVI could have reduced the rate of compensation, but failed to do so. For the contract year ending 12/31/02, the parking operator owes the City $1,672,535 as shown below.

Summary of Parking Concession Payments in 2002						
	Adjusted Gross Revenue (1)	Compensation Rate to Operator (2)	Compensation To the Operator (3) = (1) * (2)	Payments to The City (4) = (1) - (3)	MAG (5)	Difference (5) - (4)
Jan. to Dec.2002	$6,307,134	9.725%	$613,368	$5,693,766	$7,366,301	$1,672,535

AVI indicated that this matter has been referred to the City Attorney's Office and that the parking concessions contract is out for bid (reference bid number BGZ0401; a request for proposal for a five year concession contract).

OPPORTUNITIES FOR IMPROVEMENT

We recommend that the Director of AVI:

- Continues collection efforts on amounts due from parking operator from contract year ending 12/31/02.

- Promptly determines whether the parking concessionaire will meet MAG requirements for contract year ending 12/31/03, and refer to the City Attorney as may be necessary.

- Ensures that all concession contracts provide options to protect and enforce the City's interest, such as:
  - Allowing the City to collect monthly payments no less than 1/12th of the MAG;
  - Allowing the City to withhold or reduce compensation/payments until contract requirements are met; and
  - Consult with the City Attorney to seek modification of existing contracts to allow the above options.

Management's Response:

We agree that the provisions in the parking concession contract that provide for a reconciliation and payment of the MAG at the end of the contract year are not in the best interest of the City. Future contracts will require payment of the MAG in monthly installations. This is the standard for all new contracts and leases where MAG's are applicable. We will also seek additional ways to ensure that future contracts protect the city's ability to collect the MAG in a timely manner.