



# Memorandum

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

Subject: ACTION: Report on Revenue Diversions  
at San Francisco International Airport  
SC-2004-038

Date: March 31, 2004

From: Alexis M. Stefani   
Principal Assistant Inspector General  
for Auditing and Evaluation

Reply to  
Attn. of: JA-60

To: Associate Administrator for Airports

This report summarizes the results of our review of revenue diversions at San Francisco International Airport. Airport revenue diversions result from unsupported, ineligible, and duplicate payments to airport sponsors. The objective of this review was to determine whether San Francisco International Airport (Airport) revenues were diverted to the City and County of San Francisco (City), the Airport's sponsor. We conducted this review with the Federal Aviation Administration's (FAA) San Francisco Airports District Office.

During its annual single audit of the Airport for the City's fiscal year (FY) that ended June 30, 2001, the accounting firm of KPMG LLP (KPMG) identified several City charges to the Airport that appeared to be revenue diversions. This disclosure was the catalyst for the request by the airlines that service the Airport (Airlines) that the Office of Inspector General determine whether these charges were, in fact, revenue diversions and whether the City complied with the provisions of the 1981 Lease and Use/Settlement Agreement and FAA's revenue use policies. The exhibit to this report details the scope and methodology we used in conducting the review.

## BACKGROUND

The Airport and Airway Improvement Act of 1982, as amended and codified in Title 49 United States Code Chapter 471, requires all airport sponsors receiving Federal assistance to use airport revenue for the capital and operating costs of the airport, the local airport system, or other facilities that are owned or operated by the airport and are substantially and directly related to the actual transportation of passengers and property. Any other use of airport revenue is considered a revenue diversion. However, there is a "grandfather" provision that permits use of airport

revenue for non-airport purposes if assurances, agreements, or governing laws that existed before September 3, 1982, allowed such use. Non-airport use of revenue is limited to the terms and duration specified in the grandfathered agreements.

One such grandfathered agreement exists between the City and the Airlines. On July 1, 1981, a Lease and Use/Settlement Agreement (Agreement) was made between the City and the Airlines, wherein the City would receive an annual service payment as compensation for indirect services, management, and facilities provided to the Airport. The annual service payment is the greater of \$5 million or 15 percent of Airport concession revenues.

According to the Agreement, this annual service payment constitutes full satisfaction of “any and all indirect services provided by the City to the Airport....” In other words, the City agreed to this annual service payment in lieu of charging the Airport for the cost of any indirect services. Also, under the Agreement, the Airport is obligated to pay the City for direct services only as long as the direct services are actual, verifiable, and reasonable.

Indirect services are those services that provide a common benefit to more than one activity (e.g., City department) and generate costs that cannot be readily assigned to any one activity.<sup>1</sup> Called indirect costs, any such costs generally are assigned to each activity using an allocation rate. Some common examples of the City’s indirect costs are executive salaries (e.g., the mayor), auditing, accounting, payroll, human resources, and purchasing.

An allocation rate is used when the effort to identify and assign actual cost to an activity is too burdensome or is virtually impossible; it is simply a device for determining fairly and expeditiously the proportion of indirect expenses that each activity will bear. As an example, a city’s fire department allocates indirect costs to the airport based on the percentage of city firefighters assigned to the airport (number of firefighters assigned to the airport divided by the total number of firefighters city-wide) multiplied by the total amount of training and administrative costs.

Also, FAA’s “Policy and Procedures Concerning the Use of Airport Revenue” (Final Policy), dated February 16, 1999, requires that the sponsor departments must provide evidence of actual service provided to obtain payment from the airport and prohibits the use of airport revenue for direct or indirect payments not calculated consistently for the airport and other comparable units of government.

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<sup>1</sup> The definition of indirect services used in this report is supported by a variety of Federal, state, and local guidelines on accounting concepts and standards.

## RESULTS

We concluded that the City did not comply with either the Agreement or FAA's revenue use policies. As a result, the City diverted about \$12.5 million of revenue from the Airport during FYs 1998 through 2002. Also during this period, the City received, under the Agreement, annual service payments as compensation for the City's indirect services, management, and facilities provided to the Airport. As seen in Table 1, the Airport paid a total of nearly \$107.5 million (15 percent of Airport concession revenues) to the City's General Fund for the 5-year period.

**Table 1. Annual Service Payments to the City for Fiscal Years 1998 Through 2002**

<b>Fiscal Year</b>	<b>Annual Service Payment</b>
1998	\$21,184,221
1999	21,009,065
2000	22,398,546
2001	25,064,370
2002	17,784,263
<b>Total</b>	<b>\$107,440,465</b>

In breach of the Agreement and/or in non-compliance with FAA's revenue use policies, all eight City departments we reviewed included either indirect costs, unsupported costs, or other prohibited uses of revenue in their charges to the Airport, resulting in diversions of revenue that should have been used for capital and operating costs of the Airport. Therefore, the City needs to reimburse the Airport for the \$12.5 million charged by these City departments.

For example, the Airport paid the:

- City Attorney's office \$1,149,179 for overhead costs that included secretarial and administrative costs.
- Department of Public Works \$197,074 for overhead costs based on its direct labor charges to the Airport.
- Civil Service Commission \$335,725 for the costs of a labor negotiator, but the Commission did not assign a labor negotiator exclusively to the Airport.
- Police Department \$62,456 in unsupported costs for workers' compensation.

Pursuant to the Agreement, the City should not charge the Airport for the cost of indirect services, since they are paid for by the annual service payment, or for any unsupported costs, since they are prohibited under the Agreement. Also, under FAA's

Final Policy, the City's departments must provide evidence of actual service provided to obtain payment from the Airport.

The City contends that charges by individual City departments, whether direct or indirect, do not violate the Agreement. This view is based on a FY 2000 report prepared by the City's Budget Analyst stating that the City could not charge the Airport for any of its overall indirect costs, but that individual City departments could charge administrative and indirect costs associated with direct services provided to the Airport. In our opinion, some of the improperly charged indirect costs from the City departments we identified may have occurred due to this practice. For example, we found that the City's Department of Public Works has its own indirect cost allocation plan to allocate costs to City departments using its services, including the Airport.

However, we found nothing in the Agreement to support this rationale that individual City departments can allocate indirect costs to the Airport. To the contrary, we found documentation supporting our conclusion that indirect costs are covered by the Agreement. For example, in 1992 during a previous audit, we obtained memoranda of understanding between the various City departments and the Airport that stated, "In recognition of the requirements of the Airport/Airline Lease & Use Agreement ... [City Departments] will not charge the Airport for any indirect services or for overhead."

In view of the budget constraints now facing FAA and the financial strains on the Nation's airlines and airports, the results of this report underscore the need for vigilant oversight of Airport revenue use. FAA should act expeditiously to ensure the City reimburses the Airport for those revenue diversions we have identified in this report, further identify revenue diversions from prior fiscal years that we did not review, and take steps to prevent the City practices that led to the revenue diversions.

### ***Synopsis of Revenue Diversions by City Departments***

We selected and reviewed charges from the City Attorney, Civil Service Commission, Department of Public Works, Fire Department, Human Resources, Mayor's Office, Office of Citizen Complaints, and Police Department. We selected these departments based on findings in KPMG's single audit report, the Airlines' complaint letter to the Office of Inspector General, and our review of the City's cost allocation plan.

Our analysis of these charges found that the eight City departments had charged the Airport for:

- *Indirect costs* already paid for by the Airport's annual service payment to the City's General Fund. The Airport's annual service payment—an average of nearly \$21.5 million yearly since 1998—covers any and all indirect services provided by the City to the Airport.

- *Unsupported costs* that could not be verified as actual costs to the Airport because of the lack of adequate documentation. Under the Agreement, the Airport is only obligated to pay the City for direct services that are actual, verifiable, and reasonable.
- *Prohibited costs under FAA's revenue use policies.* The Airport was charged for direct services (salaries and benefits) based on an allocation that was not consistent with comparable units of government. FAA's Final Policy requires that the sponsor departments must provide evidence of actual service provided before being paid by the airport and prohibits the use of airport revenue to pay direct or indirect charges that were not calculated consistently for the airport and other comparable units of government.

Table 2 lists revenue diversions from the various City departments that we identified for one or more of the FYs from 1998 through 2002 and are in addition to the nearly \$107.5 million in annual service payments the Airport paid to the City's General Fund during the same period.

**Table 2. Revenue Diversions by City Department**

<b>Department</b>	<b>Amount</b>
City Attorney (FY 2001)	\$2,062,324
Civil Service Commission (FYs 1998-2002)	335,725
Department of Public Works (FY 2001)	197,074
Fire Department (FY 2001)	147,846
Human Resources (FYs 1998-2002)	5,401,924
Mayor's Office (FYs 1998-2002)	3,902,975
Office of Citizen Complaints (FYs 1999-2002)	334,231
Police Department (FY 2001)	143,822
<b>Total</b>	<b>\$12,525,921</b>

### **City Attorney**

The City Attorney's office provides legal services by attorneys exclusively assigned and stationed at the Airport and attorneys who only work on Airport projects as

needed. The Airport should only be charged for direct costs of providing legal service, such as the salaries and benefits of the attorneys providing the service.

However, in FY 2001, the City Attorney's office charged the Airport \$2,867,356 for legal services, of which \$1,149,179 was for overhead costs. The Airport reimbursed the City for these services at hourly rates ranging from \$105 to \$170, which included overhead of \$47 to \$68 per hour for secretarial and administrative costs.

The City Attorney's secretarial services are indirect as these costs are based on an allocation of the average FY 2001 secretarial salary. The administrative costs are overhead that the City Attorney's office allocates to City departments that use its services and include building rent, equipment purchases, mail services, and office supplies. The secretarial and administrative costs to the Airport were for *indirect services* already paid for by the Airport's annual service payment to the City's General Fund.

We also found an additional \$913,145 in *unsupported costs* the City Attorney charged to the Airport that could not be verified as actual costs to the Airport. Under the Agreement, the Airport is only obligated to pay the City for direct services as long as the direct services were actual, verifiable, and reasonable. This adds up to \$2,062,324 (\$1,149,179 + \$913,145) in revenue diversion by the City Attorney's office in FY 2001.

### **Civil Service Commission**

From FY 1998 through FY 2002, the Civil Service Commission charged the Airport \$335,725 for the costs of a labor negotiator, but the Commission did not assign a labor negotiator exclusively to the Airport. For example, in FY 2001, the City billed the Airport \$76,484 for the costs (80 percent of salary and benefits) of the Commission's labor negotiator. Because the salary and benefits for the negotiator were not incurred for direct services provided to the Airport, the payments are a prohibited under FAA's Final Policy.

Also, the labor negotiator provides services that affect other City departments' personnel operations and those services, along with the entire Civil Service Commission services, were allocated as indirect costs through the City's cost allocation plan. As such, the City was not in compliance with FAA's revenue use policy, which prohibits the use of airport revenue for direct or indirect payments not calculated consistently for the airport and other comparable units of government. If the labor negotiator's cost to the Airport had been allocated through the City's cost allocation plan, the cost would have been for an *indirect service* paid for by the Airport's annual service payment to the City's General Fund.

## ***Department of Public Works***

The City's Department of Public Works (DPW) provides building repair, construction management, engineering, and architectural services to the Airport. However, in FY 2001, DPW charged the Airport \$197,074 for overhead costs.

DPW has its own indirect cost allocation plan to allocate costs to City departments using its services. Although DPW provided direct services to the Airport and properly charged direct costs, it also allocated overhead to the Airport based on a rate applied to the direct labor. The overhead costs are for indirect services already paid for by the Airport's annual service payment to the City's General Fund.

## ***Fire Department***

In FY 2001, the Fire Department charged the Airport \$147,846 for administrative and training costs. This amount was an allocation of City-wide Fire Department costs, based on the number of uniformed firefighters assigned to the Airport, not on the direct costs for providing these services. The administrative and training costs are for indirect services already paid for by the Airport's annual service payment to the City's General Fund.

## ***Human Resources***

In FYs 1998 through 2002, the City's Human Resources Department allocated to the Airport \$5.4 million of indirect costs. The Airport was allocated a portion of costs for a City-wide computer program system, consultation services, salary of an information systems assistant, a comprehensive City-wide administrative review, and drug testing.

The costs charged were not the actual costs of providing these services to the Airport but were based on allocation formulas (a method used to distribute the cost of indirect services) and, therefore, already paid for by the Airport's annual service payment to the City's General Fund.

## ***Mayor's Office***

The Mayor's Office falls into the category of general cost of government, which is inherently an indirect service. FAA's Final Policy states that "...a portion of general costs of government, including executive offices...may be allocated to the airport indirectly under a cost allocation plan." Although the Airport receives benefit from services provided by the Mayor's Office, it is an executive office that provides City-wide services allocated through the City's cost allocation plan. The effort to account for actual time the Mayor's Office spends on each City department would be time consuming and not beneficial to the City.

In FYs 1998 through 2002, the Mayor's Office charged the Airport \$3.9 million of indirect costs based on allocations of administrative costs and the office's role in

expanding the international and global reach of the Airport. The costs are for indirect services already paid for by the Airport's annual service payment to the City's General Fund.

### ***Office of Citizen Complaints***

The Office of Citizen Complaints (OCC) investigates complaints against police officers. The City Charter requires that one investigator be hired for every 150 sworn police officers. In FYs 1999 through 2002, OCC charged \$334,231 to the Airport for:

- The salary and benefits for one full-time investigator, but OCC did not assign an investigator exclusively to the Airport. Because the salary and benefits for one investigator were not incurred for services provided to the Airport, the payments are prohibited under FAA's Final Policy.
- A percentage of all OCC non-personnel costs (such as building rent, mail services, and office supplies). They are indirect costs and, therefore, already paid for by the Airport's annual service payment to the City's General Fund.
- Direct billings for OCC investigations at the Airport in FYs 1999 through 2002. We found that OCC investigators maintained logs to track time for Airport-related work. These logs were then used to calculate the salary and benefits to bill the Airport. The practice of maintaining logs to track OCC investigators time for Airport-related work was discontinued in FY 2003.

In our meeting with OCC, we determined that the Airport was the only department for which these logs were maintained. Although these charges are based on actual costs, they are prohibited under FAA's Final Policy because OCC does not maintain logs and directly bill other City departments for its services. FAA's Final Policy prohibits the use of airport revenue for direct or indirect payments not calculated consistently for the airport and other comparable units of government.

### ***Police Department***

All police officers assigned to the Airport are City employees, and the Airport reimburses the City for their direct services, such as the salaries and benefits of the officers providing the services. In FY 2001, the Airport was billed \$81,366 for one OCC investigator through the Airport Police Bureau, but the Police Department did not assign an investigator exclusively to the Airport.

Because the salary and benefits for the investigator were not incurred for direct services provided to the Airport, the payments are prohibited under FAA's revenue use policies. Also, the Airport was actually charged twice for an OCC investigator—once by the Police Department and once by OCC.

We also found an additional \$62,456 in unsupported costs for workers' compensation the Police Department charged to the Airport that could not be verified as actual costs to the Airport. This adds up to \$143,822 (\$81,366 + \$62,456) in revenue diversion by the Police Department in FY 2001.

## **RECOMMENDATIONS**

Actions need to be taken to collect those revenue diversions we have identified in this report, to further identify revenue diversions from prior fiscal years not reviewed here, and to prevent the City practices that led to these revenue diversions. Therefore, we recommend that FAA's Associate Administrator for Airports:

1. Determine if practices that led to the revenue diversions identified in this review have been corrected. If not, take enforcement steps under Title 14 Code of Federal Regulations Part 16, which may include a hearing, against the City for unlawful revenue diversions.
2. Determine the extent of revenue diversions for the eight City departments identified in this review and other City departments that FAA deems necessary during its follow-on review. Title 49 United States Code Section 47107(n) imposes a statute of limitations of 6 years for recovering illegal revenue diversions. Therefore, FAA's follow-on review should cover all City charges to the Airport going back to the fiscal year that ended June 30, 1998.
3. Seek full recovery of the \$12.5 million of revenue diversions identified in this report and other revenue diversions identified in FAA's ongoing review, plus interest as required by the Airport Revenue Protection Act of 1996.

## **MANAGEMENT RESPONSE**

On January 28, 2004, we met with staff from the FAA Office of the Associate Administrator for Airports to discuss the results of our audit and provide them with a draft copy of our report. FAA officials generally agreed that the City had diverted revenues from the Airport but could not make a determination on the extent of revenue diversions until the Agency received our report and collected additional information from the City. FAA officials agreed to take action to ensure the Airport recovers any amounts found to have been diverted to non-Airport use.

## **ACTION REQUIRED**

In accordance with Department of Transportation Order 8000.1C, we would appreciate receiving your written comments within 30 calendar days. If you concur with the finding and recommendations, please indicate the specific action taken or planned for each recommendation and the target date for completion. If you do not concur, please provide your rationale. You may provide alternative courses of action that you believe

would resolve the issues presented in this report. For the recommendation with dollar amounts, we request you indicate your agreement or disagreement with the amount.

We appreciate the cooperation and assistance provided by you and your staff during our review. If you have any questions or need further information, please contact me at (202) 366-1992 or Robin K. Hunt, Deputy Assistant Inspector General for Hazardous Materials, Security, and Special Programs, at (415) 744-3090.

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## **EXHIBIT. SCOPE AND METHODOLOGY**

We conducted our review in accordance with Government Auditing Standards prescribed by the Comptroller General of the United States. We designed the review steps to provide reasonable assurance of detecting abuse or illegal acts and included such tests as were considered necessary under the circumstances.

We conducted the review during the period August through December 2003. The review was performed at the San Francisco International Airport, at various San Francisco City and County offices, and at KPMG Certified Public Accountants. Our review primarily covered the City's fiscal year that ended June 30, 2001, but was expanded to earlier and later periods as necessary.

We obtained a list of all payments the Airport made to the City for the fiscal years that ended June 30, 2001, and June 30, 2002. We selected and reviewed charges from the following City departments: City Attorney, Civil Service Commission, Department of Public Works, Fire Department, Human Resources, Mayor's Office, Office of Citizen Complaints, and Police Department. We selected these departments based on findings in KPMG's single audit report, on the Airlines' complaint letter to the Office of Inspector General, and through our review of the City's cost allocation plan.

We met with staff from each of the selected City departments to determine their methodology for charging costs to the Airport and whether they were aware of the Lease and Use/Settlement Agreement between the City and the Airlines. We also met with City Controller staff to obtain information about the City's cost allocation plan. Additionally, we reviewed working papers from our 1992 audit to obtain memoranda of understanding between the various City departments and the Airport agreeing not to allocate indirect costs to the Airport.

Our review of expenditures in FYs 2001 and 2002 for these departments led us to prior fiscal year expenditures that we also found to be revenue diversions. Title 49 United States Code Section 47107(n) imposes a statute of limitations of 6 years for recovering illegal revenue diversions. Thus, to the extent possible, we determined dollar amounts for revenue diversions back to the City's fiscal year that ended June 30, 1998. Due to time constraints, we were not able to obtain this information for each City department we reviewed. Consequently, we have recommended that FAA obtain this information.