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BEFORE THE SECRETARY
OF THE
DEPARTMENT OF TRANSPORTATION

LOS ANGELES INTERNATIONAL RATE PROCEEDING AND SECOND LOS ANGELES INTERNATIONAL RATE PROCEEDING	Docket OST-97-2329 (50176) -3 Docket OST-95-474 -111

On Remand From the United States Court of Appeals for the District of Columbia Circuit

BRIEF FOR THE ORIGINAL COMPLAINANT AIRLINES

The Air Transport Association of America, the 16 airlines that were the original complainants in the first *Los Angeles International Airport Rates Proceeding,* and the 59 airlines that were the complainants in the *Second Los Angeles International Airport Rates Proceeding* (collectively, the "Airlines") hereby submit this brief in response to the Order on Remand issued on April 9, 1997. As explained below, the airlines urge the Secretary to hold—under the policies embodied in the governing statutes and the circumstances of this case—that respondents' "land rental" charges are unreasonable and therefore invalid.

INTRODUCTION

In its decision in *LAX I*, the D.C. Circuit expressly recognized that by switching to a compensatory methodology for assessing landing fees at LAX, the City became obliged to set those fees based upon "the actual costs to the City of maintaining and operating the airfield and the apron." *City of Los Angeles Department of Airports* v. *United States Department of Transportation*, 103 F.3d

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1027, 1029 (1997). The Court also expressly recognized that "[h]istoric cost is, to be sure, one permissible measure" of those actual costs. *Id.* at 1032. At the same time, however, the Court concluded that at least in some circumstances "opportunity costs" might also be a reasonable measure of "actual costs." *Id.* at 1032-34. It further stated that the Secretary had not fairly considered whether the particular kind of "opportunity costs" sought by the City here should be thought "reasonable" under the governing statutes. Instead, the Court held, the Secretary wrongly rejected the City's claim without weighing the respective merits of "historic costs" and "opportunity costs" and without exercising his discretion concerning whether the latter should be thought "reasonable" in the circumstances of this case. *Id.*

The Court therefore remanded the case to the Secretary, with directions that he give "express consideration" to the City's argument that one of its "actual costs" is the "opportunity cost" it experiences by foregoing the value the City could have obtained from the airfield land in the best alternative use. *Id.* at 1033-34. In particular, the Court said, the Secretary should address the City's contention that the fair rental value of the land in its best alternative use "would . . . ensure that the actual costs of the airfield are borne by those receiving the benefits of the airfield and would create the proper incentive for the City to allocate land to airport use." *Id.* At the Secretary's invitation, the Airlines now submit this brief addressing the question the Court has remanded to the Secretary.

In addressing the remanded question, this brief takes into account the related issues noted in the Secretary's April 9, 1997 Order. *See* Remand Order at 8-9. In addition, at the Secretary's direction, the brief is limited to the current record and considers the evidence both in *LAX I* and *LAX II*. 1/ Based on that evidence

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1/ At the Secretary's direction, we have not attempted to supplement the record with new evidence. *See* Remand Order at 6-7. Instead, as the Secretary indicated,

[Footnote continued]

and the issues identified by the Secretary, the Airlines submit that the Secretary should adhere to his previous decision in this matter for two central reasons: (1) in light of the policies and purposes of the governing statutes, recovery of the kind of opportunity costs sought here would not be reasonable; and (2) even if recovery of such "costs" would in some cases be reasonable, their recovery would not be reasonable in the particular circumstances of this case.

ARGUMENT

I. Recovery of the Type of Opportunity Costs Sought Here Would Not Be Reasonable In Light of the Purposes of the Pertinent Statutes

Economists and regulators have long considered more than one kind of "opportunity cost." The kind sought here, as made clear by the City's own witnesses and appraisers, is the total return (including profits) the City says it would receive if the airport land were commercially developed for non-airport use. Accordingly, the ultimate question now before the Secretary is whether it is "reasonable" under the governing statutes for airports to charge airport users for such alleged, "lost" profits. To address that question, we believe the Secretary should consider the policies underlying four key statutes and congressional actions: (1) the portion of the statute that governs this proceeding and that authorizes the compensatory methodology applied here (49 U.S.C. § 47129); (2) the AHTA (now codified in 49 U.S.C. § 40116); (3) the subsidies provided by the federal government and the related AAIA grant provisions (now codified in 49 U.S.C. § 47107); and (4) the

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[Footnote continued]

we believe the remanded question and related issues can and should be decided on the current record. *See id.* If the Secretary should decide to accept new evidence from respondents, the Airlines respectfully request an opportunity to respond to that new evidence within 30 days of the Secretary's decision to accept the evidence.

recent provisions prohibiting creation of airport surpluses (49 U.S.C. § 47101(a)(13)). Taken together, these provisions demonstrate why the Secretary should find the opportunity costs sought here to be unreasonable.

A. In 49 U.S.C. § 47129(b)(2), Congress directed the Secretary to develop "standards or guidelines that shall be used . . . in determining . . . whether an airport fee is reasonable." In the same section Congress provided that airport fees "may be calculated pursuant to either a compensatory or residual fee methodology or any combination thereof." 49 U.S.C. § 47129(a)(2). It is the "compensatory" methodology that the City has applied here. And it was the "reasonable" application of that methodology that was at issue in the Supreme Court decision that immediately preceded the adoption of § 47129—*Northwest Airlines, Inc.* v. *County of Kent, Michigan*, 510 U.S. 355 (1994).

In that case, the Sixth Circuit defined the compensatory methodology as being "widely used by airports" and being "designed so that the Airlines are only charged for the land costs, physical facilities and other expenses which can be directly allocated to them." 955 F.2d 1054, 1057 (1992). Likewise, the Supreme Court defined the methodology as a " 'cost of service' accounting system" that is "designed to charge the Airlines only for the cost of providing the particular facilities and services they use." 510 U.S. at 359 (footnote omitted).

Significantly, in defining the "reasonable" application of such a cost-of-service methodology, the Supreme Court in *Kent County* expressly relied on a series of prior precedents, *id.* at 367-68, including *Evansville-Vanderburgh Airport Authority Dist.* v. *Delta Air Lines, Inc.*, 405 U.S. 707 (1972), *American Trucking Associations, Inc.* v. *Scheiner*, 483 U.S. 266 (1987), and *Massachusetts* v. *United States*, 435 U.S. 444 (1978). Even more significantly, not one of these cases contemplates that a compensatory methodology would be based on assessed fair market value of assets, or would capture claims for lost profits based on claimed alternative use of assets. To the contrary, as the Supreme Court said in the *Massachusetts* case, reasonable fees are designed to ensure that "total revenues not exceed expenditures"; or, stated another way, the "validity" of such fees is determined by "by comparing total revenue with total outlays." *Massachusetts*, 435 U.S. at 467, 470 n. 25 (citing *Evansville*, 405 U.S. at 719-20). *See American Airlines, Inc.*, 560 F.2d 1036, 1038-39 (1st Cir. 1977) (landing fees should be based on "expenditures . . . actually incurred," not on asserted fair market value of benefits received); *Northwest Airlines, Inc.* v. *County of Kent, Michigan*, 738 F. Supp. 1112, 1119 (W.D. Mich. 1990) (airport "should be reimbursed for costs of providing [service]," but "should not be allowed to make a profit on this charge"), *aff'd on other grounds*, 955 F.2d 1054 (6th Cir. 1992), *aff'd*, 510 U.S. 355 (1994).

It is reasonable for the Secretary to conclude that in § 47129 Congress intended to further the policies embodied in these prior judicial constructions of "compensatory" and "reasonable" and "cost." *See, e.g., Farmers Union Central Exchange, Inc. v. Federal Energy Regulatory Commission*, 734 F.2d 1486, 1504 (D.C. Cir.) ("an agency may not supersede well established judicial interpretation that structures administrative discretion under the statute"), *cert. denied*, 469 U.S. 1034 (1984). It is also reasonable for the Secretary to conclude that a "compensatory" methodology should not be implemented via "opportunity costs" when to do so would essentially turn the "compensatory" methodology authorized by the statute into something quite different—a "fair-market-value" methodology. Indeed, as next discussed, *all* the other pertinent statutory provisions confirm that important federal policies would be hindered if airports were allowed to profit from airlines and their passengers through the guise of opportunity costs rather than recovering only their actual out-of-pocket expenditures and outlays. Stated another way, while the governing statutes may not expressly prohibit the recovery of opportunity costs, such recovery would be contrary to the policies underlying those statutes, which the Secretary has been asked to construe and implement here.

B. The earliest statutory provision confirming this proposition is the Anti-Head Tax Act of 1973 ("AHTA"), which was passed in response to the Supreme Court's decision in *Evansville.* That decision had said, among other things, that airports could impose head taxes on airport passengers, provided that the amounts charged were not "excessive in relation to costs incurred by the taxing authorities" for benefits conferred on users. 405 U.S. at 719. In response, Congress enacted the AHTA, which prohibited head taxes altogether but allowed imposition of "reasonable" fees on aircraft operators. In allowing such "reasonable" fees, Congress made clear in the AHTA's legislative history that it did not intend that such fees should be imposed "to gain financial windfalls" but, rather, that "reasonable" fees should be imposed only where needed "for airport development." S. Rep. No. 12, 93d Cong., 1st Sess., *reprinted in* 1973 U.S.C.C.A.N. 1434, 1446. Congress furthermore made clear that it recognized that unreasonable fees, whether imposed on passengers or airlines, could produce the same unacceptable result: "[i]n the end, a fare increase would have to be implemented." *Id.* at 1451.

C. At the same time it enacted the AHTA, Congress also increased federal subsidies to airports. Significantly, Congress intended these increased subsidies to *minimize* the need for additional fees on airlines and their passengers. *See id.* at 1455 ("the two actions [limitations on fees and increased subsidies] must be viewed together . . . ."). Moreover, in the Airports and Airways Improvement Act of 1982, Congress made clear that by accepting federal subsidies (largely funded by airline passenger taxes), airports must expressly agree not only that fees on all airport users would be "reasonable," 49 U.S.C. § 47101(12), but that all "revenues generated by [the] public airport . . . will be expended for the capital or operating costs of the—airport . . . ." 49 U.S.C. 47107(b)(1)(A). And this is so even though, as *Kent County* made clear, Congress had placed *no limits* on the revenues the airports could extract from airports' non-aeronautical (concessions) operations. 510 U.S. at 371.

D. Finally, Congress recently amended the statutory provision which previously said only that airports "should be as self-sustaining as possible." The statute now also says that "[i]t is the policy of the United States" that "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 systems purposes and for other purposes for which airport funds may be spent under section 47107(b)(1) . . ., including reasonable reserves and other funds to facilitate financings and cover contingencies." 49 U.S.C. § 47101(a)(13). As noted, § 47107(b)(1) requires each airport receiving federal grants (which includes virtually every commercial service airport in the U.S.) to agree that all its revenue will be expended for its "capital or operating costs."

Thus, when read together, these pertinent statutes evidence a federal policy that (1) fees on airlines and their passengers are to be kept to a minimum, taking into account the considerable federal subsidies, and (2) that such fees should not be designed to create "surpluses," but rather should meet all of a given airport's specific operational expenses, capital costs, reserves, and contingency funds. There is no indication in any of these statutes that federal policy contemplates fees designed to produce profits or to meet an airport's estimate of so-called opportunity costs (which themselves include profits). To the contrary, when Congress listed the items to be covered by fees and subsidies, it included only items constituting *actual cash outlays* for *actual expenditures* made by airports—"capital and operating costs," "reserves," "contingenc[y]" funds, and funds for "airport development." *See* 49 U.S.C. §§ 47107(b)(1), 47101(a)(13). It is these listed items that Congress thought necessary to make an airport "self sufficient." 2/ And it is the listed items that are consistent with the Supreme Court's own description of the purpose of "reasonable" fees; *i.e.*, they are to cover "expenditures" and "outlays." *Massachusetts*, 435 U.S. at 467, 470 n. 25.

It is clear that the opportunity costs sought here are not an "expenditure," or an "outlay," or an expense of the kind listed in the statutes. 3/ It is also clear that the "costs" sought here include profits the City claims it could make through non-airport uses of the land. Indeed, the City does not contest these points. Nor does the City contest that all of the costs expressly contemplated by the statutes—its out-of-pocket expenses, all capital costs, and all funds needed for reasonable reserves and contingencies—are fully compensated by its fees and are fully authorized by the Secretary's prior decision. Indeed, the City does not—and cannot—dispute that the fees it is earning are more than adequate to render it "self sufficient" within the meaning of the statute. Nevertheless, the City claims that under its compensatory methodology it is entitled to ask for still more. We submit

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2/ The proposition that the listed items are in practice sufficient to make airports "self-sufficient" is confirmed by the fact that, as the Secretary has noted, LAX is the *only* airport ever to claim it needed to impose fees to gain the opportunity costs sought here. Final Decision at 21 (*LAX I*).

3/ The Court of Appeals assumed that a central question in this case is whether the term "actual costs" includes "opportunity costs." But it made that assumption because it thought the phrase "actual costs" appeared in the statute. 103 F.3d at 1034. In fact, that phrase does not appear in the statute at all. Instead, the statute's only reference to costs is its listing of the kind of costs which should be covered by airport fees. And, as noted, all of the listed costs are out-of-pocket expenditures and none of them includes profits.

that its claim is not "reasonable" under the governing federal policies and therefore should be rejected. Moreover, as next discussed, neither the considerations suggested by the D.C. Circuit nor any of the special circumstances of this case show that the claimed opportunity costs are reasonable.

II. Nothing in the Circumstances of this Case Shows that the Claimed Opportunity Costs Are Reasonable Here

In directing the Secretary to consider when, if ever, opportunity costs might reasonably be recovered here, the D.C. Circuit cited four authorities: (1) FERC's decision in *Pennsylvania Electric Co.*, 60 F.E.R.C. ¶ 61,034 (1992), *aff'd sub nom. Pennsylvania Electric Co.* v. *FERC,* 11 F.3d 207 (D.C. Cir. 1983); (2) a treatise by William Baumol and J. Gregory Sidak (*Transmission Pricing and Stranded Costs in the Electric Power Industry*); (3) a treatise by Alfred Kahn (*The Economics of Regulation*); and (4) the declaration of Kenneth Arrow. In addition, the Court asked the Secretary to reconsider whether the administrative difficulties of fair-market-value appraisals constitute a valid ground for adhering to historical costs. In fact, none of these five considerations, either alone or collectively, indicates that it would be reasonable to allow the opportunity costs sought here. 4/

A. Citing the *Pennsylvania Electric* decision, the D.C. Circuit said that "agencies that regulate utility rates have recognized 'opportunity cost' as a factor to be considered when setting rates designed to cover the actual costs incurred to provide a particular service." 103 F.3d at 1032. Of course, the most

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4/ The Airlines believe that the Secretary should find that land rental charges such as those imposed here are necessarily unreasonable as a matter of federal policy, as the Secretary has concluded in the Policy Statement, and that respondents have presented no special circumstances justifying an exception to that policy in this case. *See* 61 Fed. Reg. 31994, 31995, 32011-32012 (1996) (permitting exception to rule based on showing of "unusual circumstances").

important guide to whether opportunity costs are recoverable should be the policies underlying the particular statutes at issue, not how other regulatory agencies have set rates for other public utilities in other contexts under other statutes. But even if *Pennsylvania Electric* had construed the statutes that control this case, for two reasons that case would not support the particular opportunity costs claimed here.

First, as FERC was at pains to make clear in the cited decision and as the D.C. Circuit noted in affirming FERC's decision, the *only* kind of "opportunity costs" permitted there were those "incurred by a utility when the utility accommodates [one user's] request for . . . service . . . and thereby foregoes an opportunity to reduce its . . . costs [of serving other users]. . . ." *Pennsylvania Elec. Co.* v. *FERC*, 11 F.3d at 209, *aff'g Pennsylvania Elec. Co.*, 58 F.E.R.C. at 61,278. Such a situation was presented in the *Pennsylvania Electric* case because there, in order to provide special service to one user, the utility had to forego an opportunity to economize in its provision of services to a second large category of users; in such circumstances, FERC said (and the D.C. Circuit agreed) that the first user could be asked to pay the effective increase in expenses the utility incurred by being unable to reduce its cost-of-service to the second category of users. This was so, FERC said, because the permitted "opportunity costs" were the "actual (additional) costs [the utility] will incur by providing the [service] to the [first user]." 60 F.E.R.C. at 61,126.

Obviously, that situation is a far cry from the one presented here. For here, the airport does not ask to recover actual lost *expenses* incurred in having to serve a particular airport user. Quite the contrary, it is already recovering all its actual expenses. What it is seeking here is to recover alleged *profits* it says it loses by serving any airport users at all. Nothing in FERC's decision approves the recovery of such profits.

Indeed, the *Pennsylvania Electric* decision directly refutes the appropriateness of the "opportunity costs" claimed here. The City has asked the Secretary for the right to continue to assess other aeronautical fees, recover concession revenues, and benefit the City of Los Angeles by using the land in question as an airport, but at the same time also charge alleged opportunity costs based on the supposition that it is *not* using the land as an airport. In *Pennsylvania Electric,* however, FERC said a public utility cannot have it both ways. It cannot *both* assess fees and reap benefits for using its assets in a particular way, and also assess opportunity costs based on the proposition that it had not used the asset that way. As FERC explained: a utility "cannot simultaneously sell and retain the same capacity, and thus should not be allowed to charge a rate which reflects that impossibility." 60 FERC at 61,128.

Yet that is precisely what the City asks to do here: reap benefits and charge fees by using the land as an airport, but also recover the profits it says it would earn if it used the land as other than an airport. This is no more "reasonable" under the statutes here at issue than it would have been "just and reasonable" under the statute construed by FERC in *Pennsylvania Electric.* 5/

B. The D.C. Circuit also cited Baumol and Sidak's treatise and stated that "[e]conomists . . . have argued that opportunity costs should be considered in ratemaking." 103 F.3d at 1032. It is true that these economists have made such an argument, but the argument would certainly not support the opportunity costs claimed here.

5/ The governing statute in *Pennsylvania Electric* was Section 205 of the Federal Power Act, which provides that all fees shall be "just and reasonable." 16 U.S.C. § 824d.

First, even if there were some public utility settings in which opportunity costs of the kind sought here should be allowed, they are not allowable under the statutes here for the very reason Baumol and Sidak point out: under their definition of opportunity costs, a regulated utility may include in its fees "profits of foregone sales." Baumol & Sidak, *supra*, at 158. Indeed, these authors criticized the *Pennsylvania Electric* decision for defining opportunity costs too narrowly, in that it "ignores the profits foregone because of revenues that might have been earned." *Id.* at 142. As we have shown, however, such a "profit" component would be inconsistent with the federal policies governing the regulation of aeronautical user fees. Because Congress has otherwise allowed considerable subsidies to airports, and has permitted considerable monopoly profits to be earned in non-aeronautical operations, there is no need for airports to earn aeronautical revenues in excess of amounts needed to meet all actual operational, capital, developmental, and reserve costs. Accordingly, Baumol and Sidak's approach, even if valid in other regulatory settings, is not helpful here.

There is a second reason why these authors' approach does not help the City. As their treatise repeats over and over, opportunity costs should be allowed in regulatory settings *only* when the regulatory agency otherwise has assurances that the inclusion of such costs will produce only "competitive" profits for the utility, and not "monopoly profits." *Id.* at 117 ("we must reemphasize from the very beginning of this chapter what has been said in this book before and will be reemphasized later. The opportunity costs whose recovery is required for economic efficiency *must exclude any monopoly profits or excessive costs attributable to inefficiency*") (emphasis in original). As a result, under Baumol and Sidak's approach, a regulator may not allow opportunity costs to be earned on an asset without first determining that the asset is not being allowed to earn monopoly profits, but instead, is being allowed only the earnings it would have received in an "effectively competitive arena." *Id.* at 81.

Here, no such determination has been (or likely could be) made. To the contrary, the record shows that LAX possesses significant market power as a result of its unique locational advantages and the existence of substantial barriers to entry. Kasper Declaration, Ex. ATA-E1 at ¶ 8 (*LAX I*); Kasper Supplemental Declaration, Ex. ATA-E2 at ¶¶ 10-12 (*LAX I*). Indeed, the airport's own witness Michael Brown recognized this to be so. Ex. ATA-76 at 3 (*LAX I*). In addition, as the Secretary determined in his initial decision, the surpluses the City earned by using this land as an airport rather than for something else were $71 million in the 1993-94 fiscal year—forty percent higher than its operating expenses. Final Decision at 22 (*LAX I*). This resulted in total retained earnings of more than $825 million as of June 30, 1994. *See* Ex. ATA-11 at 3 (*LAX I*). Moreover, due to the "circular" nature of any appraisal method used to value the land, that appraisal would necessarily reflect and capture the City's ability to earn monopoly profits. 6/

In these circumstances, not only is Baumol and Sidak's argument that fees should be set at levels to earn "competitive profits" inapplicable, but charging opportunity costs would not be appropriate here because they would not exclude monopoly profits. In sum, the Court may be right that "[e]conomists . . . have argued that opportunity costs should be considered in ratemaking." But the

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6/ Experts for both sides recognize this "circularity." Kasper Declaration, Ex. ATA-E1 at ¶ 14 (*LAX I*); Levy Declaration, Ex. LAX-F1 at ¶ 12 (*LAX I*). The circularity lies in the fact that valuations of the land must be based either on the income the land is able to generate, including any monopoly profits it is able to generate (*i.e.*, by charging monopoly prices for any uses of the land); or it must be based at least in part on land values near the airport, which necessarily derive much of their own present value from the airport's existence (*i.e.*, from the market power of the airfield's operation).

particular opportunity costs being sought here are not appropriate under the facts of this case and the policies of the governing statutes.

C. The treatise by Alfred Kahn cited by the Court confirms this last point. As Professor Kahn says, no "simple set of rules can answer all problems of regulatory policy. On the contrary, each regulated industry . . . is in essential respects unique *and must be so treated.*" 1 Alfred Kahn, *The Economics of Regulation* 12, 13 (1970) (emphasis supplied). In fact, even though the Court relied on Professor Kahn in remanding this case to the Secretary, on the key point now before the Secretary, Kahn supports the result the Secretary originally reached in this case.

Thus, as the Court noted, Kahn himself makes a strong case for the use of historic cost over the so-called fair market value approach advanced by the City. This is because, as the Court points out, Kahn believes that reliance on "actual money outlays" represented by historic costs, rather than on "hypothetical or imaginary" fair-market values, introduces "a strong element of stability and predictability into the regulatory process." *Id.* at 41 (cited in *LAX I*, 103 F.3d at 1032). But what the Court did not point out is that Kahn believes that without the assurance of hard accounting data to show actual costs, the risk is great that routine reliance on hypothetical market values will lead to overstated fees.

As Kahn explains, this risk is due to "the simple danger of concealment of profits by exaggeration of costs. Whatever his *actual* level of costs, it obviously pays a regulated monopolist to exaggerate his estimated cost of service." *Id.* at 27 (emphasis in original). And if there are no hard "accounting records" to show what those costs actually are, but instead the regulated entity is free to claim opportunity costs based on hypothetical market values, the entity "can more completely exploit his monopoly power by fooling the commission into permitting him higher rates than his actual costs justify." *Id.* Thus, wholly apart from the question whether opportunity costs of the kind sought here are reasonable under the policies of the statute—which they are not—Kahn confirms that for reasons of stability, reliability, and predictability, those costs should not be considered.

D. Next, there is the Court's citation to ¶¶ 6-10 of Professor Arrow's declaration. 103 F.3d at 1034. At the outset, the Airlines note that the declaration is not part of the record before the Secretary in this case. Before Chief Judge Mathias, the Airlines objected to the Arrow declaration as being irrelevant and duplicitous and, in response to this objection, respondents expressly *withdrew* it from consideration. *See* April 24, 1995 Transcript at 25. As Chief Judge Mathias noted at the hearing, "[a]s to the Arrow declaration, *that declaration has been withdrawn* so the objections are moot." *Id.* (emphasis supplied). The declaration is therefore not part of the record before the Secretary and the Airlines were never given an opportunity to confront it. 7/

Even if the Secretary were to consider the declaration—which he should not—Professor Arrow's views do not validate the City's land rental charges. In the relevant paragraphs, Arrow makes the following points: (a) the airport land is "highly valued" and, if it were available on the market, "the product of goods and services in Los Angeles would be increased over its present level"; (b) the amount of the increase is equal to the income that could be earned by the land in its "best alternative use" and that lost income is a "true cost" to the City; and (c) allowing the

7/ The Court of Appeals, although it mistakenly believed the declaration was in the record, did not rule on its admissibility. Rather, as noted, the Court held that the Secretary had not considered any of respondents' evidence on this point and remanded for the Secretary to do so. As the Secretary noted in the remand order, the Court's ruling does not permit respondents to rely on evidence—such as the Arrow declaration—that was not presented in the initial proceedings.

recovery of this cost is "not only a matter of justice," but it serves as "a tool for achieving an efficient use of the resources available, in this case the land used for the airport." There are several complete answers to these contentions.

First, Arrow's entire declaration is premised on the indispensable—and erroneous—assumption that the City is actually foregoing an "opportunity" for alternative use of the land. In fact, however, as Daniel Kasper explained in his Supplemental Declaration, Ex. ATA-E2 at ¶ 9 (*LAX I*), LAX is bound for years to come by the conditions of its federal grants to use the land for airport purposes. *See* 49 U.S.C. §§ 47107(a)(1), (a)(7), (a)(16), (d); FAA, *Airport Compliance Requirements*, Order No. 5190.6A ¶¶ 2-2, 4-5 at 3, 14 (Oct. 2, 1989); Ex. ATA-71 at 25-26 (*LAX I*) (LAX grant assurances). Accordingly, LAX can have no "opportunity" cost if it has no actual opportunity. Stated another way, opportunity costs are not required to ensure efficient allocation of the land where, as here, no other allocation is currently possible.

Moreover, there is a second reason why Professor Arrow is wrong to assume that permitting the City to base its charges on opportunity costs is necessary to ensure efficient allocation of resources here. That is because, as the City's own appraisers concluded, the land in question is in fact already at its highest and best use as an airport. 8/ As a result, while it is right to say that opportunity costs are often taken into account to ensure efficient allocation of resources, it is wrong to say so here because (1) under the governing law, no other use of the airport land is possible; and (2) under the actual facts, no other use of the land would produce a better allocation of resources.

8/ In their report the appraisers concluded that "[i]n sum, based upon our research and analysis of the subject property, . . . the highest and best use of the subject property is the current airport use." Ex. LAX-14 at 13 (*LAX I*).

Third, Arrow nevertheless opines that renting the land for non-airport use would increase "the product of goods and services in Los Angeles." But, again, either he is assuming that non-airport use of the land is more profitable to Los Angeles than airport use, an assumption that is directly refuted by the finding of the City's own appraisers that the land in question is already at its highest and best use as an airport; or he is assuming that the City should be able to reap the benefits of airport use and at the same time earn the assumed rental profits from the imaginary non-airport use, a result that is contrary to *Pennsylvania Electric.* Moreover, Professor Arrow's assumption that total goods and services to the City would be increased by non-airport use is completely without basis in the record. Indeed, his unexplained assumption takes no account of the substantial value to the City and its citizens from the use of the land for airport purposes. And, obviously, although that value is nowhere specifically quantified in this record, it is immense. Indeed, as Michael Brown conceded during cross-examination in *LAX II*, the airport is "an important economic asset of the City. There's no doubt about it." October 19, 1995 Tr. at 379 (Brown) (*LAX II*). And as Judge Kolko determined: "Arriving at LAX are . . . goods and millions of people destined to spend their money in Los Angeles . . . and enrich the City's tax coffers, directly and indirectly." Recommended Decision of the Administrative Law Judge at 16-17 (*LAX II*).

Fourth, Arrow's declaration is not only made without regard to the facts of this case, it is also made without regard to the governing federal policies. He assumes that "profits" from the best alternative use of the land should be built into airport fees; however, as shown, that would not be reasonable under the federal policies applicable here.

Fifth, Arrow ignores what Baumol and Sidak make clear: that while in the abstract opportunity costs might in some cases be includable, that is not so where, as here, those opportunity costs may include monopoly profits.

Finally, in any event, as the D.C. Circuit's own cases have made clear, regulated public entities are not entitled to earn a profit. *Jersey Central Power & Light Co.* v. *FERC*, 810 F.2d 1168, 1180-81 (D.C. Cir. 1987) (*en banc*). 9/ Rather, under a statutory "just and reasonable" standard, they are entitled only to the fair "end result" promised them under *FPC* v. *Hope Natural Gas Co.*, 320 U.S. 591 (1944), *i.e.*, "that there be enough revenue not only for operating expenses but also for the capital costs of the business." *Id.* at 603. Arrow and respondents' other witnesses all ignore the undisputed fact that LAX revenues are already substantially in excess of this amount. The City nevertheless asks for more. The Secretary should deny that request as unreasonable.

E. In its remand decision, the D.C. Circuit noted that while the Supreme Court abandoned fair-market-value ratemaking in part due to valuation difficulties, such difficulties "are not necessarily present in this or any particular airport case." 103 F.3d at 1033 (citing *Duquesne Power & Light* v. *Barusch*, 488 U.S. 299, 308-09 (1989)). It supported that view by noting that (1) the airlines did not contest the accuracy of the appraisal in this case, (2) there will often be a ready market from which a professional appraiser can extrapolate airport values "with some confidence"; and (3) there was nothing to indicate that the airport would calculate market value of the land more than once, thereby easing administrative difficulties. *Id.* For several reasons, we think the Court has understated both the

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9/ Nor is the City entitled to a "rate of return" in addition to all its capital costs. Again, the City wants to double count. The whole purposes of a rate of return is to cover a regulated entity's capital costs—both debt and equity. *NEPCO Municipal Rate Comm.* v. *FERC*, 668 F.2d 1327, 1335 (D.C. Cir. 1981). The City's debt costs are already fully covered in its fees and it has no equity costs. It is therefore not entitled to a "rate of return" on top of that.

nature and the severity of the administrative difficulties that would accompany routine airport estimates of opportunity costs.

First, the Court seems to assume that the Supreme Court abandoned fair-market value solely because of valuation difficulties. But that is not so. As the D.C. Circuit itself pointed out in *Farmers Union Central Exchange, Inc.* v. *FERC,* 584 F.2d 408, 417 n. 27 (1978), the Supreme Court also abandoned fair-market-value ratemaking because of its circularity in a regulatory setting such as this 10/ and because it was "likely to impair capital or produce windfall profits in, respectively, deflationary or inflationary times." *Id.* Even at current levels of inflation, what the methodology would produce here is "windfall profits"—the precise thing Congress intended to avoid when it passed the AHTA. *See supra* at 6. Moreover, as the D.C. Circuit has repeatedly held, when a regulated entity reaps profits from an increase in land values, those profits belong to the ratepayers, not to the utility or its investors. *Southwestern Bell Corp.* v. *FCC,* 896 F.2d 1378, 1381 (D.C. Cir. 1990); *Democratic Central Comm.* v. *Washington Metropolitan Area Transit Comm'n,* 485 F.2d 786, 821-822 (D.C. Cir. 1973), *cert. denied,* 415 U.S. 435 (1974.) Yet here, perversely, the airport seeks to *charge* the rate payers for the increased value of the land.

Furthermore, wholly apart from the stability, predictability, and reliability factors mentioned by Alfred Kahn, airport land valuations will at the very least be far more difficult to assess and administer than the mere reporting of historic costs. Indeed, the appraisers' report in this very case demonstrates the difficulties inherent in such valuations. While the Court assumed "a ready market" in comparable properties, 103 F.3d at 1033, the appraisers' report here says,

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10/ *See supra* at 13 & n. 6.

instead, that while the appraisers "attempted to find comparable sales" of similar properties, "meaningful analysis on a direct comparison is really not possible given the numerous differences in the development of such a large property and the current environmental and political considerations." Ex. LAX-14 at 14 (*LAX I*). Moreover, the appraisers found that "[c]omparable data within the immediate area is limited since the region has been almost fully developed for some time . . . ." *Id.* at 15. The appraisers therefore searched far beyond the airport area for data upon which to base their estimations. *Id.*

Even more significantly, the appraisers' estimates were not based on comparable sales of land *at all*. They were based instead on the assumption that the land would be *developed* and earn huge returns to the City of $25.00 per square foot, less development costs; the appraisers furthermore assumed that the market could absorb the costly development of an enormous amount of land (over 1500 acres); and they then assumed that the present value of this unprecedented developmental undertaking could all be rented out at a return of 10% of that value. Ex. LAX-14 at 29-38 (*LAX I*).

It is unrealistic to suppose that appraisals with this many uncertainties and variables can with "confidence" produce reliable fair market value estimates. It is even more unrealistic to suppose that such appraisals will go unchallenged either at LAX or elsewhere. 11/ Instead, they will surely lead to

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11/ It is furthermore unfair to say that the appraisals are unchallenged here. In the first place, the Airlines' expert witness, Dan Kasper, did in fact criticize the fair market value approach used here as logically flawed as well as administratively complex and costly, Ex. ATA-E1 at ¶ 13 (*LAX I*). Moreover, the obvious reason the Airlines did not further complicate these expedited proceedings by addressing the particular numbers in the appraisers' report was because the Secretary had already announced in his policy statement that only historical cost was acceptable. The Secretary should therefore not assume that the Airlines treat the City's appraisal as reliable. To the contrary, if the Secretary were now to accept a fair market value

[Footnote continued]

numerous fee complaints—both when the fees are set initially and when they are reconciled to reflect actual experience—occupying considerable DOT resources in the expedited proceedings mandated by Congress. Accordingly, given that LAX is the only airport even to claim it needed to recover fair market value of its land in order to be "self-sufficient," it is not reasonable to invite the administrative difficulties entailed in such valuations.

In addition, it is difficult to understand how, as a matter of logic or fairness, there could be only one permanent valuation per airport, regardless of future changes in fair market value. Rather, the fair market value and hence, the opportunity cost, would obviously change significantly over time, as evidenced by the methodology and variables relied on by the appraisers in this case. As a result, and not surprisingly, the only information in the record directly contradicts the Court's suggestion that the City would appraise the land but once. Specifically, an October 12, 1992 letter from airport witness Michael Brown to airport witness Professor Levy explains the valuation methodology to be used by the airport and states that "[b]y policy, land is to be appraised . . . at least once every five years. Based upon the appraisal and other factors, the Board is to set the value of airport land, the rental rates, and the periods of time for which the rates are effective." Ex. ATA-74 at 1 (*LAX I*). And even if the City nevertheless planned to claim only one

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[Footnote continued]

approach in this case, he should address the reliability of the appraisers' report and allow the parties the opportunity to submit evidence on that issue. In any case, even if no new evidence were received on the issue, it is submitted that the report is questionable on its face for the reasons earlier noted.

increase in value, *airport users* would certainly seek adjustments if current values fell. 12/

Finally, we would suggest that if the Secretary were to assess the reliability of the kind of opportunity costs sought here, the administrative proceedings needed to estimate those costs would be far more complicated than the City and the Court assume. For example, to accurately measure the City's *net* opportunity costs from foregoing alternative uses of airport land, the Secretary would need to consider at least two things that were never addressed here at all: (1) the loss to the City's economy if the airport were no longer operating on the land; and (2) the loss of the enormous concession revenues now produced by using the land as an airport. In other words, an airport cannot do a comprehensive assessment of its net opportunity costs (or losses) from using the land as an airport as compared with potential non-airport use, unless it first takes into account all the benefits it would lose if it ceased that airport use. For otherwise, it would be doing what *Pennsylvania Electric* says it cannot do: have it both ways.

12/ The appraisers' report strongly suggests this might happen. *See* Ex. LAX-14 at 29 (*LAX I*) (noting that part of the five-year data relied on for square footage prices "show a recent decline in unit prices after having held steady for most of the five years").

CONCLUSION

For all these reasons, the Secretary should adhere to his original decision in this case and limit the City to recovery of its historical costs of airport land.

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