



GAO

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United States General Accounting Office  
Washington, DC 20548

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June 4, 2004

The Honorable John McCain  
Chairman  
The Honorable Ernest Hollings  
Ranking Minority Member  
Committee on Commerce, Science, and Transportation  
United States Senate

The Honorable Don Young  
Chairman  
The Honorable James L. Oberstar  
Ranking Democratic Member  
Committee on Transportation and Infrastructure  
House of Representatives

Subject: *Aviation Assistance: Compensation Criteria and Payment Equity under the Air Transportation Safety and System Stabilization Act*

In response to the September 11, 2001, terrorist attacks on the United States, the Congress enacted the Air Transportation Safety and System Stabilization Act (Stabilization Act)<sup>1</sup> that provided, among other things, \$5 billion in emergency assistance to compensate the nation's air carriers for losses incurred as a result of the attacks. Pursuant to a previous congressional request, we monitored the Department of Transportation's<sup>2</sup> (DOT) progress in administering the emergency assistance program. As a result of our work, we reported<sup>3</sup> on the payment process DOT employed to administer the program, details on the losses claimed by the air carriers, and the payments disbursed under the program.

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<sup>1</sup> Air Transportation Safety and System Stabilization Act, Pub. L. No. 107-42, 115 Stat. 230 (Sept. 22, 2001). This act was later amended by the Aviation and Transportation Security Act, Pub. L. No. 107-71, § 124, 115 Stat. 597, 631 (Nov. 19, 2001).

<sup>2</sup> The Stabilization Act directed the President to take actions to compensate air carriers. The President subsequently delegated his authority to do so to the Secretary of Transportation, 66 Fed. Reg. 49,507 (Sept. 27, 2001).

<sup>3</sup> U.S. General Accounting Office, *Aviation Assistance: Information on Payments Made Under the Disaster Relief and Insurance Reimbursement Programs*, GAO-03-1156R (Washington, D.C.: Sept. 17, 2003).

Now, Section 824 of the Vision 100 – Century of Aviation Reauthorization Act<sup>4</sup> requires that we report on the criteria and procedures used by DOT to compensate air carriers under the Stabilization Act emergency assistance program with a particular focus on whether it is appropriate to compensate air carriers for the decrease in value (asset impairment) of their aircraft after September 11, 2001, and to ensure that comparable air carriers receive comparable percentages of the maximum compensation payable. DOT published its criteria and procedures in a series of guidelines and regulations promulgated between September 2001 and August 2002.

The DOT regulations relevant to asset impairment and comparable compensation, among others, are the subject of a suit pending in the U.S. Court of Appeals for the District of Columbia Circuit. Since DOT's regulations are subject to the court's review, we will not specifically address the appropriateness of DOT's criteria and procedures as they relate to these matters. The litigation is discussed in more detail later in this report. In light of the ongoing litigation, we met with your staff and agreed that we would (1) describe the measure(s) by which the air carriers were compensated under the Stabilization Act as well as DOT's criteria and procedures, such as policies on impairment, established to administer the program and (2) determine if there are possible scenarios under which air carriers, comparable in size and type (cargo or passenger), conceivably could receive different levels of compensation.

In order to address the first objective, we reviewed the Stabilization Act, analyzed DOT's regulations and implementation guidance, and interviewed the DOT staff who administered the program. Additionally, we reviewed and analyzed the arguments contained in the legal briefs filed by the air carriers and DOT in the U.S. Court of Appeals for the District of Columbia Circuit. For the second objective, we determined if there were possible scenarios under which comparable air carriers could potentially receive different amounts of compensation. On the basis of our previous work,<sup>5</sup> we identified various factors that influenced the amount of compensation a carrier could receive and illustrated the impact of these factors in several different scenarios. We discussed these scenarios with the DOT officials who administered the program to obtain assurances that our scenarios were representative of situations that they observed in administering the program. We were unable to base our scenarios on details from actual claim files because of the confidential and proprietary nature of much of those data. We requested comments on a draft of this report from the Secretary of Transportation or his designee. Written comments from the Assistant Secretary of Administration are reprinted in the enclosure. Our work was performed from February 2004 through May 2004 in accordance with U.S. generally accepted government auditing standards.

## RESULTS IN BRIEF

Sections 101 and 103 of the Stabilization Act established three criteria on which to base air carriers' compensation amounts: (1) direct losses incurred as a result of the

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<sup>4</sup> Vision 100 – Century of Aviation Reauthorization Act, Pub. L. No. 108-176, § 824, 117 Stat. 2490, 2595 (Dec. 12, 2003).

<sup>5</sup> Work performed for GAO-03-1156R was conducted from September 2001 through August 2003 and was performed in accordance with U.S. generally accepted government auditing standards.

federal ground stop order and incremental losses incurred from September 11 through December 31, 2001, as a result of the terrorist attacks; (2) carrier type (e.g., passenger or cargo); and (3) a calculated formula amount based upon each carrier's percentage of industry capacity and the total amount of compensation available under the legislation. Because the statute required that the maximum air carrier compensation amounts be equal to the lesser of direct and incremental losses as determined by DOT or this formula amount, the formula effectively "capped" the amount of compensation an air carrier could receive for its September 11-related losses. DOT published a series of procedural rules describing the compensation process and provided additional guidance for how it would determine, among other things, direct and incremental losses, including policies relating to the exclusion of asset impairment losses. Generally, DOT excluded impairment losses for a number of reasons, including DOT's view that these losses were presumed to be typically experienced over a period much longer than the September 11 through December 31, 2001, compensation period and that it would be difficult, if not impossible, to separate impairment losses due to the terrorist attacks from impairment losses associated with the general economic slowdown generally acknowledged to be under way at the time of the attacks.

A number of factors influenced the amount of compensation air carriers ultimately received under the Stabilization Act. Conceivably, these factors could result in scenarios in which comparable air carriers could have received different levels of compensation. For example, two air carriers could have comparable losses related to September 11, but be subject to different formula caps because they had different capacity levels. If one or both carriers had losses that exceeded the formula amount, the formula would cap the compensation amount at different levels. Other factors unique to individual air carriers, such as geographic location and carrier forecasts, influenced the amount of direct and incremental losses an air carrier reported and affected the compensation levels air carriers could potentially receive. For example, air carriers located on the East Coast where the market showed a greater sensitivity to the terrorist attacks may have incurred more revenue decline and more direct and incremental losses than carriers on the West Coast. Also, because forecasts formed the basis of a carrier's direct and incremental losses, an optimistic forecast could have resulted in more direct and incremental losses than a pessimistic forecast. These and other factors or combinations of factors influenced the levels of compensation in different ways for different carriers.

Three air carriers are seeking from the U.S. Court of Appeals for the District of Columbia Circuit a judicial determination that DOT's regulations implementing provisions of the Stabilization Act relating to direct and incremental losses are inconsistent with that act and reflect "arbitrary and capricious" administrative actions by DOT. As of June 4, 2004, the court had not issued its decision, nor had the carriers participating in this lawsuit settled their compensation claims with DOT. DOT officials also told us the claims of a small number of other carriers also remain pending. Therefore, the emergency assistance program, although substantially completed, is still ongoing.

In commenting on a draft of this report, DOT said it found our report to be accurate and well reasoned. DOT offered additional support for and amplification of what it felt were key issues. DOT's comments are reprinted in the enclosure.

## CRITERIA AND PROCEDURES USED BY DOT UNDER THE STABILIZATION ACT

The Stabilization Act established that air carriers could be compensated for direct and incremental losses caused by the terrorist attacks and related ground stop order, subject to a cap based on a formula allocation of the total compensation amount. DOT published a series of procedural rules describing the compensation process and provided additional guidance for how it would determine, among other things, direct and incremental losses, including policies relating to the exclusion of asset impairment losses.

### Statutory Criteria

Sections 101 and 103 of the Stabilization Act<sup>6</sup> established three criteria on which to base air carriers' compensation amounts: (1) direct losses incurred as a result of the federal ground stop order<sup>7</sup> and incremental losses incurred from September 11 through December 31, 2001, as a result of the terrorist attacks; (2) carrier type (e.g., passenger or cargo);<sup>8</sup> and (3) a calculated formula amount based upon each carrier's percentage of industry capacity and the total amount of compensation available. Each carrier was to receive maximum compensation equal to the lesser of these demonstrated direct and incremental losses or the formula amount.

The Stabilization Act distinguished between passenger and cargo carriers. It allocated \$4.5 billion<sup>9</sup> to be used to compensate passenger-only carriers and combined passenger and cargo carriers; the remaining \$500 million was to be used to compensate cargo-only carriers. The Stabilization Act, as illustrated in step 1 of figure 1, specified how to calculate the air carriers' formula amounts. For passenger carriers, the available amount of compensation (\$4.5 billion) was to be multiplied by the ratio of the individual carrier's August 2001 available seat miles (ASM), a measure of available capacity, to total available seat miles of all applying carriers. Similarly, for cargo carriers, the available amount of compensation (\$500 million) was to be multiplied by the ratio of the latest quarterly data available for revenue ton miles (RTM), a measure of utilized capacity, to total revenue ton miles of all applying carriers. This formula effectively capped the amount of compensation an air carrier could receive for its September 11-related losses. Direct and incremental losses exceeding the formula amount were not compensated.

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<sup>6</sup> Pub. L. No. 107-42, § 101(a)(2)(A) and (B) and § 103(b).

<sup>7</sup> The Federal Aviation Administration ordered a federal ground stop order (a shutdown of the nation's airspace) from September 11 through the morning of September 13, 2001, although some planes were allowed to reposition and return to their starting locations during that time. Certain airspace and airports were not returned to pre-September 11, 2001, status until later. For example, Ronald Reagan Washington National Airport, which services Washington, D.C., was phased back into operation beginning October 4, 2001.

<sup>8</sup> In addition to passenger and cargo carrier types, an amendment to the Stabilization Act later authorized the President to set aside a portion of the \$5 billion for certain classes of air carriers, such as air tour operators and air ambulances. Pub. L. No. 107-71, § 124.

<sup>9</sup> Under the amendment to the Stabilization Act, \$35 million of this amount was set aside for smaller air carriers and distributed using a modified formula calculation.

**Figure 1: Calculation of an Air Carrier's Maximum Compensation Amount**

<b>Step 1:</b>	Total available compensation	X	$\frac{\text{Individual ASMs/RTMs}}{\text{Total ASMs/RTMs}}$	=	Formula amount
<b>Step 2:</b>	The lesser of:		Direct and incremental losses as determined by DOT	or	Formula amount (from step 1)
				=	Payment amount

Source: GAO analysis of Pub. L. 107-42, § § 101(a)(2), 103(b).

### Structured Payment Process

As we reported in September 2003, DOT developed a structured payment process to implement the statutory provisions set forth in the Stabilization Act and expedite the distribution of funds. Generally, DOT's compensation process consisted of a series of payment rounds. In each payment round, as initial estimates of losses were replaced with actual accounting data for the compensation period, air carriers were allowed to receive an increased percentage of their total compensation. Maximum compensation equaled the lesser of the carrier's direct and incremental losses as determined by DOT or the carrier's formula amount, as shown in step 2 of figure 1.

The department published program guidance in a series of *Federal Register* notices of final regulations<sup>10</sup> that took effect immediately without a formal comment period. However, in publishing each set of notices, DOT solicited comments from air carriers and others, and responded to them in subsequent notices. Table 1 summarizes the chronology of the procedural rules and the amount of maximum compensation allowed under each payment round.

**Table 1: DOT Procedural Rules**

Publication	Date	Significant issues addressed in guidance	Maximum percentage of compensation allowed
Program Guidance Letter	October 1, 2001 <sup>a</sup>	Structure of the payment process and policies for initial disbursement of funds	50%
Rule #1	October 29, 2001	Round 2 application and submission deadlines	85%
Rule #2	January 2, 2002	Various air carrier comments	
Rule #3	April 16, 2002	Round 3 application, audit requirements, clarification of emerging issues, and air carrier comments	100%
Rule #4	August 20, 2002	Various air carrier comments	

Source: GAO analysis.

Note: Based on Program Guidance Letter (Oct. 1, 2001); 66 Fed. Reg. 54, 616 (Oct. 29, 2001); 67 Fed. Reg. 250 (Jan. 2, 2002); 67 Fed. Reg. 18, 468 (Apr. 16, 2002); 67 Fed. Reg. 54, 058 (Aug. 20, 2002).

<sup>a</sup>Draft versions of the Program Guidance Letter were distributed to air carriers immediately after the Stabilization Act was signed into law.

<sup>10</sup> These regulations are codified at Title 14, Code of Federal Regulations Part 330 (2004).

## Principle for Determining Direct and Incremental Losses

An integral part of the payment process was the determination of direct and incremental losses. DOT generally calculated an air carrier's direct and incremental losses as the adjusted difference between forecasted and actual financial results for the period September 11 through December 31, 2001. Specifically, DOT presumed that the difference between an air carrier's pre-September 11 forecasted financial results and actual financial results for the compensable period would approximate the carrier's direct and incremental losses related to the terrorist attacks. DOT expected the carrier to make adjustments to this difference for items the carrier could demonstrate to the department's satisfaction were unrelated to the terrorist attacks. For example, an air carrier could exclude unrelated income, such as an unforecasted tax settlement from a prior year that was received during the compensable period, if it was substantiated with appropriate tax and accounting records.

Under DOT's basic principle of calculating losses, revenue decline was the primary driver of losses. DOT offset these losses with any cost savings as well as any incremental gains or profits incurred after the federal ground stop order through the end of the compensable period that were deemed to have resulted from the terrorist attacks.

## Issues Addressed in the Procedural Rules

Although the basic principal for determining direct and incremental losses appears straightforward, several issues arose during the administration of the program. As a result, DOT published specific guidance on how impairment and certain cost savings, among other issues, should be considered in the calculation of direct and incremental losses.

### Impairment Losses

In its April 16, 2002, rule, DOT defined the criteria that certain items, such as impairment losses, were required to meet in order to be included in the calculation of losses and be compensated. The procedural rule said such items must be presented to DOT for review on a case-by-case basis and be (1) a direct result of the terrorist attacks of September 11; (2) fully borne (incurred) within the September 11 to December 31, 2001, period; (3) permanent; (4) nonduplicative; and (5) reported in accordance with U.S. generally accepted accounting principles, except if these principles would require or allow treatment inconsistent with the Stabilization Act. If items claimed by air carriers did not meet these standards, DOT generally excluded them from the calculation of direct and incremental losses.

Applying these criteria, DOT determined that impairment losses, representing the permanent devaluation of an asset (such as aircraft) as a result of a decline in the market value of the asset or revenue-generating capabilities, ordinarily did not meet all of the above-stated criteria of a compensable loss and were generally excluded. DOT believed that impairment losses were typically experienced over a period of time much longer than the September 11 through December 31, 2001, compensation period and, therefore, generally would not qualify as "incurred" compensable losses

under the Stabilization Act. DOT also explained that it lacked the “practical ability to monitor accounting for those assets in the future to ensure that they recapture excess compensation” if the assets were returned to service. Additionally, impairment losses were considered duplicative. DOT’s April 2002 procedural rule stated “the theoretical basis for an impairment charge is an expected decline in asset value that reflects an expected permanently reduced demand and reduced ability to generate revenue. However, since we are already compensating carriers for the actual decline in revenue they are experiencing through the end of the year, there is an inherent duplication in also compensating them for the associated asset devaluation costs.” Further, DOT claimed that its position was consistent with a Financial Accounting Standards Board Emerging Issues Task Force statement that “impairment of long-lived assets as a result of the September 11 events would in many cases be impossible to measure separately from impairment due to the general economic slowdown that was generally acknowledged to be under way.”<sup>11</sup>

A number of carriers objected to the exclusion of impairment losses on the basis that these losses had “real world” impacts on air carrier finances, such as a carrier’s ability to obtain credit, and that asset write-downs are recognized as losses under U.S. generally accepted accounting principles. Additionally, for some carriers, excluding impairment losses reduced their direct and incremental losses to less than the maximum possible compensation as calculated by the formula amount and therefore decreased the amount of compensation they received.

#### Cost Savings

Generally, DOT presumed that management actions taken after September 11 to achieve cost savings were prompted by the terrorist attacks, implicitly if not explicitly, and should, therefore, offset revenue decline, and in turn reduce compensable losses.<sup>12</sup> In the April 16, 2002, procedural rule, DOT gave the following reasons for its decision to offset revenue decline with cost savings: (1) cost reduction plans developed prior to September 11 would have been accounted for in the pre-September 11 forecasts, (2) post-September 11 cost reduction plans were attributable to changed expectations after the attacks, (3) excluding post-September 11 cost reductions would result in compensating carriers for losses not actually incurred, and (4) DOT interpreted the Congress’s statutory language as “indicating an intent that carriers not receive increased compensation for achieving savings in costs, which they have an independent obligation to their managements and shareholders to achieve, and which it is reasonable to expect them to undertake to mitigate the need for compensation.”

Some air carriers objected to DOT’s presumption of considering all cost savings as related to the terrorist attacks and requested a case-by-case review approach. For example, one air carrier, which took significant actions to reduce food service

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<sup>11</sup> The Emerging Issues Task Force (EITF) No. 01-10, “Accounting for the Impact of the Terrorist Attacks of September 11, 2001,” November 14-15, 2001. EITF assists the Financial Accounting Standards Board by promptly identifying, discussing, and resolving financial accounting issues within the framework of existing authoritative literature.

<sup>12</sup> Offsets, in some cases, may not necessarily reduce an air carrier’s resulting compensation amount if the resulting direct and incremental losses exceeded, and therefore were capped by, the formula amount.

expenses, argued that its actions to cut costs exceeded the industry's average expense decrease in food service. Therefore, the carrier concluded, its actions went beyond what was reasonably expected of an air carrier to accomplish after the terrorist attacks and the excess amount should be excluded from the calculation. DOT did not agree with the air carrier's argument.

## SCENARIOS RESULTING IN DIFFERENT LEVELS OF COMPENSATION

On the basis of our previous work and interviews with DOT officials, we determined that a number of factors influenced the amount of compensation air carriers ultimately received under the Stabilization Act. Conceivably, these factors could result in scenarios in which comparable air carriers could have received different levels of compensation. For example, as described in scenario 1 below, two comparable air carriers could have had comparable losses related to September 11, but be subject to different formula caps because they had different capacity levels. If one or both carriers had losses that exceeded the formula amount, the formula would cap the compensation amount at different levels. Additionally, as illustrated in scenarios 2 through 5, other factors unique to individual air carriers influenced the amount of direct and incremental losses air carriers reported as well as the affected compensation levels they could potentially receive. Scenarios 2 through 5 assume that the two carriers were comparable in terms of size (in this case, capacity as defined by the Stabilization Act) and incurred losses less than their formula caps, thus making them eligible for compensation not to exceed their direct and incremental losses. DOT officials who administered the compensation program agreed that these illustrations are representative of situations observed during their review.

### Scenario 1: Formula Impact

As discussed previously, each carrier's formula amount was calculated based upon the air carrier's measure of capacity. It is possible that two carriers could be comparable in organizational structure or even annual revenues, but yet report different amounts of capacity. As a result, two comparable air carriers could potentially have comparable losses related to September 11, yet be eligible to receive different formula amounts. If both of these carriers had losses that exceeded the formula amount, the formula would cap the carriers' compensation amounts at different levels.

For example, carrier A and carrier B are comparable carriers in that they both reported \$50 million in annual revenue and incurred \$10 million in direct and incremental losses related to the attacks during the compensable period. However, carrier A reported more available seat miles for the required August 2001 period than did carrier B. As a result, and as shown in table 2, carrier A received \$10 million while carrier B's compensation was capped by the formula amount.



**Table 2: Impact of the Statutory Formula (Dollars in Millions)**

	<b>Gross revenues</b>	<b>Direct and incremental losses</b>	<b>Formula cap</b>	<b>Compensation received</b>
Carrier A	\$50	\$10	\$11	<b>\$10</b>
Carrier B	\$50	\$10	\$8	<b>\$8</b>

Source: GAO analysis of hypothetical data.

In another example of the formula impact, two cargo carriers similar in all aspects except that they transport different types of cargo could also receive different levels of compensation as a result of the formula cap. For cargo carriers, the statutory measure of capacity used in the formula calculation is actual revenue ton miles flown (not available capacity, as was the case with passenger carriers.) This could result in a carrier that transports generally heavier cargo reporting more revenue ton miles than a carrier hauling lighter cargo. For example, assume that carriers C and D are similar in all aspects except for the nature of their cargo. Although both carriers fly identical planes that generate the same revenue, carrier D, as a result of its lighter cargo, transported less tonnage than carrier C and, therefore, if compensated pursuant to the formula, would receive less compensation than carrier C.

### Scenario 2: Geographic Location

The primary location of an air carrier's operations may have influenced the amount of losses an air carrier incurred after September 11. As stated previously, revenue decline was the primary driver of an air carrier's direct and incremental losses. If a carrier, due to its geographic location or affiliation with a particular airport, suffered more revenue decline (i.e., flew fewer passengers due to the terrorist attacks or had planes grounded for an extended period due to security concerns)<sup>13</sup> than a carrier comparable in size and type, it is likely that this carrier could have incurred more losses and received more compensation than the comparable carrier.

After the terrorist attacks, passenger traffic declined across the nation; however, traffic through the northeast corridor (where the terrorist attacks occurred) declined more sharply than in other areas. To illustrate how this situation affected comparable carriers, assume a majority of carrier E's operations are centered in the northeast, while a majority of carrier F's operations are centered in the Northwest. In this case, carrier E in the Northeast carried fewer passengers during the compensation period and reported a larger revenue decline than carrier F. Although carriers E and F are comparable in size, carrier E received more compensation as a result of larger direct and incremental losses.

<sup>13</sup> For example, Ronald Reagan Washington National Airport was closed due to security concerns after the September 11, 2001, terrorist attacks until October 4 when flights gradually resumed.

Scenario 3: Impact of the Inherent Imprecision of Forecasts

Forecasts of financial results for the September 11 through December 31, 2001, period formed the basis of DOT’s calculation of direct and incremental losses.<sup>14</sup> The precision of the forecasts influenced the amount of direct and incremental losses an air carrier could report on its application. Recognizing the importance of the quality of the forecasts, DOT required the air carriers to provide the two most recent forecasts (e.g., August and July forecasts) and their corresponding actual performance. DOT officials said they extensively reviewed this information and generally requested additional data to determine the reasonableness of each carrier’s forecast. DOT reviewed year-over-year trends of historical data, comparisons to similar carriers’ forecasts, related documentation maintained by other DOT offices, and rates of return. As a result of these procedures, DOT said it revised, amended, or recreated many air carrier forecasts in order to normalize or control for forecasts that could significantly affect the calculation of a carrier’s losses.<sup>15</sup> Even with these procedures, the inherent imprecision of forecasting could still have influenced many carriers’ ultimate compensation determination.

Assume carriers G and H are comparable passenger carriers that reported the same financial results for the compensable period. However, carrier G had forecasted \$100 million in revenues for the compensable period, whereas carrier H had produced a slightly more optimistic forecast of \$105 million. Although the revenue forecasts for both carriers G and H might have been considered reasonable, carrier H received more compensation as a result of its more optimistic forecast, as shown in table 3.

**Table 3: Impact of Optimistic Forecast (Dollars in Millions)**

	<b>Pre-9/11 forecast</b>	<b>Actual financial results</b>	<b>Direct and incremental losses</b>
<b>Carrier G</b>			
Revenues	\$100	\$80	(\$20)
Expenses	\$110	\$110	\$0
Gain/Loss	(\$10)	(\$30)	<b>(\$20)</b>
<b>Carrier H</b>			
Revenues	\$105	\$80	(\$25)
Expenses	\$110	\$110	\$0
Gain/Loss	(\$5)	(\$30)	<b>(\$25)</b>

Source: GAO analysis of hypothetical data.

Scenario 4: Quality of an Air Carrier’s Application

To receive compensation, the Stabilization Act required that air carriers demonstrate losses related to terrorist attacks to the “satisfaction of the President using sworn financial statements or other appropriate data.” DOT’s procedural rules specified the nature and content of the data to be included in applications as well as additional criteria and requirements. For example, in the third payment round, DOT required

<sup>14</sup> As previously discussed, baseline losses used to determine compensation for individual air carriers were calculated as the difference between forecasted and actual financial results for the September 11 through December 31, 2001, period.

<sup>15</sup> DOT said several small air carriers did not produce forecasts. In that event, DOT created forecasts for them based upon historical financial and operational data.

agreed-upon procedures to be performed by independent public accountants on the information submitted by the air carriers.<sup>16</sup> The purpose was to verify that the amounts submitted either agreed with or reconciled to the carriers' financial systems and other supporting documentation. Despite these guidelines, the review team stated that the quality and amount of supporting documentation accompanying the air carrier applications varied widely. Some applications contained extensive supporting documentation; in other cases DOT staff had to request that additional information be submitted to support the carrier's claims. DOT told us that if losses or adjustments to losses submitted by the air carriers were ultimately not supported to DOT's satisfaction, the losses were excluded from amounts eligible for compensation.

**Scenario 5: Management Response to the Terrorist Attacks**

After the terrorist attacks occurred, the federal government shut down the nation's airspace. When air travel resumed, passenger traffic had significantly declined, reducing operating revenues for most carriers. To mitigate the reduction in revenue, some carriers took aggressive measures to reduce costs, conserve cash, and preserve liquidity. Alternatively, some carriers did not take as immediate or aggressive actions to reduce costs, while others that already had low-cost structures had fewer opportunities in their business models to cut costs. As previously discussed, DOT offset cost savings, whether achieved through management action or as a by-product of volume decline, against revenue decline in the calculation of direct and incremental losses. Said in another way, the amount of cost savings achieved reduced the levels of compensation air carriers could potentially receive.

To illustrate, suppose carriers I and J were comparable in size and forecasted identical financial performance for the compensable period. After the attacks, carrier I aggressively cut costs and reduced expenses 10 percent during the period September 11 through December 31, 2001. Carrier J took fewer, less aggressive measures to reduce costs, and at the end of the period, expenses were reduced by only 5 percent. As shown in table 4, carrier I's cost savings reduced its direct and incremental losses by more than carrier J's, and therefore carrier I received less in compensation than carrier J.

**Table 4: Impact of Aggressive Cost Reduction (Dollars in Millions)**

	<b>Pre-9/11 forecast</b>	<b>Percentage of cost savings achieved</b>	<b>Actual financial results (after cost reductions)</b>	<b>Direct and incremental losses</b>
<b>Carrier I</b>				
Revenues	\$400		\$320	(\$80)
Expenses	\$450	10%	\$405	(\$45)
Gain/Loss	(\$50)		(\$85)	<b>(\$35)</b>
<b>Carrier J</b>				
Revenues	\$400		\$320	(\$80)
Expenses	\$450	5%	\$428	(\$22)
Gain/Loss	(\$50)		(\$108)	<b>(\$58)</b>

Source: GAO analysis of hypothetical data.

<sup>16</sup> Small air carriers were required to submit simplified agreed-upon procedures.

## PENDING LITIGATION

DOT's regulations as partly described in this report are the subject of pending litigation. Three air carriers are seeking from the U.S. Court of Appeals for the District of Columbia Circuit a judicial determination that DOT's regulations implementing provisions of the Stabilization Act relating to direct and incremental losses are inconsistent with that act and reflect "arbitrary and capricious" administrative actions by DOT.<sup>17</sup> In particular, the air carriers contended that DOT's payment rules and assumptions improperly combined two categories of losses under Section 101(a)(2) of the act into one by offsetting losses that were incurred during the federal ground stop order with any incremental gains after the federal ground stop order. Also, the air carriers contended that DOT improperly excluded aircraft impairment costs, among others, as compensable losses under the act. They argued that these rules establish "overly simplistic" criteria and "irrebuttable presumptions," and, further, that they result in "impermissibly" different percentages of allowable maximum compensation among comparable air carriers.

DOT, in defending its regulations argued that, among other reasons, it permissibly interpreted the Stabilization Act as providing for one "loss period," September 11 through December 31, 2001, with two types of compensable losses, direct and incremental. It also argued that its regulations provide a rational basis for determining how certain items, such as aircraft impairment or cost savings, should be recognized in calculating carriers' compensation.

The court held oral arguments on these issues in October 2003 after receiving the parties' legal briefs from April through June 2003. As of June 4, 2004, the court had not issued its decision, nor had the carriers participating in this lawsuit settled their compensation claims with DOT. DOT officials told us the claims of a small number of other carriers also remain pending. Therefore, the emergency assistance program, although substantially completed, is still ongoing.

## AGENCY COMMENTS

We requested comments on a draft of this report from the Secretary of Transportation or his designee. The Assistant Secretary for Administration provided the department's written comments, stating that the report correctly described DOT's administration of the program and concurring with our finding that various factors can cause differences in compensation amounts. The department characterized our report as accurate and well reasoned and provided additional support and amplification of what DOT considered to be key issues. Its comments are reprinted in the enclosure. DOT also provided separate specific technical comments that we considered and incorporated into this report as appropriate.

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<sup>17</sup> The carriers also allege that in promulgating the April 16, 2002, and August 20, 2002, rules, DOT failed to follow proper rule-making procedures required by the Administrative Procedure Act, 5 U.S.C. § 553.

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We are sending copies of this report to the Secretary of Transportation and interested congressional committees. This report will also be available at no charge on GAO's Web site at <http://www.gao.gov>. If you have any questions about this report, please contact me at (202) 512-9508, or Phillip McIntyre, Assistant Director, at (202) 512-4373. You may also reach us by e-mail at [calboml@gao.gov](mailto:calboml@gao.gov) or [mcintyre@gao.gov](mailto:mcintyre@gao.gov). Other key contributors to this report were Abe Dymond and Ruth Walk.



Linda M. Calbom  
Director, Financial Management and Assurance

Enclosure

Comments from the Department of Transportation



U.S. Department of  
Transportation

Assistant Secretary  
for Administration

400 Seventh St., S.W.  
Washington, D.C. 20590

MAY 25 2004

Ms. Linda Calbom  
Director, Financial Management and Assurance  
U.S. General Accounting Office  
441 G Street, N.W.  
Washington, D.C. 20548

Dear Ms. Calbom:

We reviewed the General Accounting Office (GAO) draft report, "Aviation Assistance: Compensation Criteria and Payment Equity Under the Air Transportation Safety and System Stabilization Act," and find it to be accurate and well-reasoned.

The draft report correctly noted that the Department of Transportation's (DOT) general exclusion for compensation of impairment losses was explained and adopted through the rulemaking process. Also, we concur with GAO's finding that under the Stabilization Act, differences in compensation amounts between similar carriers can appropriately exist due to application of the statutory formula cap, carriers' geographic locations, differing qualities of carrier forecasts and applications, and varying carrier management responses to the terrorist attacks. We offer these additional comments to support and amplify these GAO observations, as well as other key aspects of the Department's process covered by the GAO draft report.

First, GAO correctly identified DOT's handling of compensable losses incurred. It is important to note that Congress identified two different types of losses that may be compensated under the time period covered by this program--direct losses incurred from the federal shutdown of the aviation system, and incremental losses incurred, stemming from the terrorist attacks, through December 31, 2001. DOT applied the Stabilization Act to provide compensation based on the accumulation of those losses actually incurred. This provided compensation for actual losses while avoiding the potential for a windfall if a carrier were to receive compensation for one type of loss without regard to its offsetting gains in the time period through December 31, 2001.

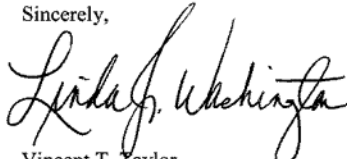
Second, DOT concurs with GAO's finding that a number of criteria were examined for air carriers claiming September 11 losses due to write-downs (impairments) of flight equipment purportedly stemming from the terrorist attacks. In this regard, GAO specifically noted the Financial Accounting Standards Board finding that it would be "impossible" in many cases to measure impairments due to the September 11 events

separately from those due to the general economic slowdown then generally acknowledged to be under way. However, another factor noted by GAO deserves additional emphasis. One of the most important elements in assessing losses properly attributable to the eligible period from September 11 through December 31, 2001, was the fact that DOT was already compensating air carriers for all aviation-related revenue losses for that eligible period. DOT determined that to further compensate air carriers for impairment losses stemming, in large part, from reduced revenue-generating capacity of that same equipment over the eligible period would have essentially paid them twice for the same loss.

Third, the scenarios developed by GAO are accurate in helping to describe circumstances under which air carriers arguably comparable in terms of business plan or size might have been compensated at different levels, and under which carriers might be compensated at levels not in proportion to their relative available seat-miles or revenue ton-miles. Since pre-September 11 forecast information provided the baseline for the compensation paid to carriers for their losses incurred, DOT attached great significance to the assumptions inherent in the carrier's own forecasts, the logical bases for those forecasts, and the consistency of carrier forecasts with historical trends. Moreover, DOT notes the importance of GAO's finding that different management responses to the terrorist attacks (Scenario 5) could explain why seemingly "comparable" carriers might have received different levels of compensation. As GAO pointed out, such carriers may have achieved quite different actual financial results for the compensation period, depending upon how management was positioned to recover from the attacks. The organizational structures of air carriers sometimes had an effect on their compensation as well. In addition, air carriers might also be differentiated due to business relationships, both with government and private industry, entered into or expanded after the Federal shutdown. Increased military shipments, diversion of mail due to the anthrax scare, and diversion of belly-cargo from passenger to cargo aircraft for security reasons are examples of situations that created business opportunities for some carriers after the terrorist attacks. Not all carriers could take equal advantage of those opportunities, but those that could earned revenues that often substantially reduced the size of their compensable losses.

We appreciate the opportunity to review the draft report and offer comments. If you have any questions, please contact Martin Gertel of my staff on (202) 366-5145.

Sincerely,



Vincent T. Taylor

(190119)

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