

Items 3 and 4 Files 11-0559 and 11-0560	Department(s): San Francisco International Airport
EXECUTIVE SUMMARY	
<p style="text-align: center;">Legislative Objective</p> <ul style="list-style-type: none"> • <u>File 11-0559</u>: Resolution approving and authorizing the execution of Modification No. 6 of the 1981 Airline-Airport Lease and Use Agreement with Continental Airlines, Inc. (Continental Airlines) to provide a one-month retroactive rent credit for terminal rent of Exclusive Space vacated in Terminal 1 due to the merger of United Airlines, Inc. (United Airlines) and Continental Airlines at the San Francisco International Airport (Airport). • <u>File 11-0560</u>: Resolution approving and authorizing the execution of Modification No. 1 of the 2011 Lease and Use Agreement with Continental Airlines, to eliminate all Exclusive Space in Terminal 1 due to the merger of United Airlines and Continental Airlines. <p style="text-align: center;">Key Points</p> <ul style="list-style-type: none"> • On May 2, 2010, Continental Airlines began the process of merging with United Airlines. The final stage of the merger process between Continental Airlines and United Airlines, including the issuance of a single operating certificate from the Federal Aviation Administration, is currently expected to occur in the fall of 2011. • The Airport entered into a 30-year lease with Continental Airlines, which commenced on July 1, 1981 and extended through June 30, 2011. As part of that previous lease, Continental Airlines leased approximately 44,806 square feet of space in the Airport's Terminal 1 and paid the Airport annual rent of \$5,163,842 or \$430,320 per month. • On November 5, 2010, the Airport entered into a new ten-year lease with Continental Airlines effective July 1, 2011 through June 30, 2021. Under this existing lease, Continental Airlines leases approximately 37,052 square feet and pays the Airport annual rent of \$3,938,743 or \$328,229 per month. <p style="text-align: center;">Fiscal Impacts</p> <ul style="list-style-type: none"> • Under File 11-0559, the proposed retroactive one-month rent credit to Continental Airlines would be for the month of June, 2011 at a cost of \$430,320 to the Airport. • Under File 11-0560, Continental Airlines would relinquish all 37,052 square feet of Exclusive Space which it has assigned in Terminal 1. As a result, the total ten-year reduced rent to the Airport from Continental Airlines from the existing lease would be approximately \$39,387,430. • The revenues generated by both the previous and existing leases are calculated by the Airport's residual rate setting methodology (breakeven policy), such that the proposed modifications would continue to result in the Airport's budget being fully balanced by the revenues paid by the airlines which operate at the Airport, after considering the Airport's budgeted expenditures and all non-airline revenues. <p style="text-align: center;">Recommendations</p> <ul style="list-style-type: none"> • Approve the two proposed resolutions. 	

MANDATE STATEMENT / BACKGROUND**Mandate Statement**

Section 2A.173 of the City's Administrative Code authorizes the Airport to negotiate and execute leases of Airport lands and space in Airport buildings, without undergoing a competitive bid process, as long as the original term of the lease does not exceed 50 years.

Charter Section 9.118 (a) requires that any contract or lease, which would result in revenues to the City in excess of \$1,000,000, be subject to approval of the Board of Supervisors.

Continental Airlines and United Airlines are Merging

On May 2, 2010, Continental Airlines began the process of merging with United Airlines (UAL) Corporation, the parent company of United Airlines. Currently, the operations of both airlines have been fully consolidated. The final stage of the merger process between Continental Airlines and United Airlines, including the issuance of a single operating certificate from the Federal Aviation Administration, is currently expected to occur in the fall of 2011.

Airport's Leases With Continental Airlines

Continental Airlines previously entered into a 30-year lease with the Airport, which commenced on July 1, 1981 and expired on June 30, 2011. As part of that lease, Continental Airlines leased approximately 44,806 square feet of space in the Airport's Terminal 1 and paid the Airport an annual rent of \$5,163,842 or \$430,320 per month to the Airport with an average monthly rent of approximately \$9.60 per square foot.

On November 5, 2010, the Board of Supervisors approved a resolution (Resolution No. 505-10) for the Airport to enter into a new ten-year lease with Continental Airlines, effective July 1, 2011 through June 30, 2021. Under this existing lease, Continental Airlines leases approximately 37,052 square feet of Exclusive Space¹ with an annual rent of \$3,938,743 or \$328,229 per month with an average monthly rent of approximately \$8.86 per square foot. The 7,754 square foot reduction from the previous 44,806 square foot lease to the current 37,052 square foot lease was due to Continental Airlines decision to no longer lease Preferential Gates² in Terminal 1 because the merger with UAL was already underway, such that Continental Airlines knew that it would no longer be operating and therefore would not need Preferential Gates in Terminal 1 as of July 1, 2011.

In addition, both the previous and existing leases with Continental Airlines include provisions requiring Continental Airlines to pay Landing Fees³ to the Airport on a monthly basis. Under the existing lease, Continental Airlines is also responsible for paying the Airport other miscellaneous

¹ Exclusive Space is Airport Terminal space leased or permitted to a single airline for its exclusive use.

² A Preferential Gate is a gate assigned to a specific airline, with scheduling preference over similar operations by other airlines.

³ The Landing Fee is currently \$3.79 per 1,000 pounds of aircraft landing weight.

activity-based fees, including (a) Aircraft Parking Fees⁴, (b) Custom Cargo Facility Fees⁵, (c) Electricity Fees⁶, and (d) Water/Sewer Fees⁷ for the use of additional Airport-provided facilities, equipment and services. As shown in Table 1 below, based on data provided by the Airport, Continental Airlines paid an average of \$257,001 in total monthly fees from June 1, 2010 through May 31, 2011.

Aircraft Parking Fee	\$2,207
Custom Cargo Facility Fee	383
Electricity Fees	13,086
Landing Fees	240,302
Water/Sewer Fees	1,023
Total	\$257,001

DETAILS OF PROPOSED LEGISLATION

File 11-0559: The proposed resolution would approve and authorize the execution of Modification No. 6 to the 1981 Airline-Airport Lease and Use Agreement with Continental Airlines, Inc. to provide for a retroactive rent credit for the month of June, 2011 for terminal rent of Exclusive Space vacated in Terminal 1 due to the merger with United Airlines, Inc.

File 11-0560: The proposed resolution would authorize the execution of Modification No. 1 of the 2011 Lease and Use Agreement with Continental Airlines by eliminating of all Exclusive Space in Terminal 1 due to the merger of United Airlines and Continental Airlines at the Airport.

Retroactive Rent Credit to Previous Continental Airlines Lease for Space Vacated in Terminal 1 (File 11-0559)

The proposed resolution (File 11-0559) would retroactively approve Modification No. 6 to the previous lease between Continental Airlines and the Airport, which expired on June 30, 2011. Modification No. 6 would provide Continental Airlines with a one-month retroactive rent credit for payment of rent for the space vacated in Terminal 1 due to the merger between Continental and United Airlines. According to Ms. Diane Artz, Senior Property Manager at the Airport,

⁴ The Aircraft Parking Fee is \$325 for the first eight hours if the aircraft weighs less than 250,000 pounds and \$660 for the first eight hours if the aircraft weighs 250,000 pounds or more. After the first eight hours, the Aircraft Parking Fee is \$175 if the aircraft weighs less than 250,000 pounds and \$300 if the aircraft weighs 250,000 pounds or more for each additional eight-hour period.

⁵ The Custom Cargo Facility Fee is an annual fee collected by the Airport from airlines utilizing the United States Custom Service (USCS) on Airport property for the clearance of international cargo shipments into the United States. The amount of the fee is determined annually to cover facility rent and recover the Airport's tenant improvement costs and operating and maintenance costs associated with housing this governmental function on Airport property. The fee is billed monthly to airlines based on a proportional share of the quarterly transactions reported by the USCS to the Airport.

⁶ The Electricity Fees are metered and based on actual usage.

⁷ Water/Sewer fees are metered and based on actual usage.

Continental Airlines removed all fixtures, furnishings and specialty equipment between May 9, 2011 and May 30, 2011, and vacated all Exclusive Space in Terminal 1 to relocate to Terminal 3 to integrate its operations with United Airlines on May 30th, 2011. Therefore, the retroactive rent credit would apply to the month of June, 2011. The retroactive rent credit to Continental Airlines from June 1, through June 30, 2011 is equivalent to one month's rent of \$430,320.

Modifications to Existing Continental Airlines Lease (File 11-0560)

The second proposed resolution (File 11-0560) would approve a modification to the existing ten-year lease between the Airport and Continental Airlines, which commenced on July 1, 2011 and will extend until June 30, 2021, to eliminate all 37,052 square feet of Exclusive Space in Terminal 1 for the entire term of the lease due to the merger of United and Continental Airlines. According to Ms. Artz, Continental Airlines is requesting the subject modification of the existing lease, rather than a termination, because the existing lease, in addition to providing Exclusive Space in Terminal 1, which would be eliminated under the proposed lease modification, also grants the right to land aircraft at the Airport. That right would be retained until the Federal Aviation Administration (FAA) issues a single operating certificate for both Continental and United Airlines. Therefore, if the proposed resolution is approved to eliminate all 37,052 square feet of Exclusive Space, Continental Airlines will continue to pay for Landing Fees and other miscellaneous fees to the Airport under the existing lease until the FAA operating certificate is issued.

The proposed resolution would result in Continental Airlines vacating approximately 37,052 square feet of Exclusive Space at Terminal 1, with a monthly rent of \$328,229 and an annual rent of \$3,938,743 (\$328,229 times 12). The total reduced rent to the Airport from Continental Airlines for the ten-year term of the existing lease would be approximately \$39,387,430. (\$3,938,743 times 10).

FISCAL IMPACTS

Residual Rate Setting Methodology

The Airport uses a "breakeven policy" known as the residual rate setting methodology to determine the rental rates, landing fees, and related fees to calculate the total rent to be paid by each airline for use of Airport terminal space. The rental rates, landing fees, and related fees include (a) the cost per square foot charged to an airline for that airline's exclusive use of Airport space, (b) fees for use of space which is shared by multiple airlines, and (c) various non-space-related fees, such as landing fees and aircraft parking fees. Those rental rates, landing fees, and related fees are then used to calculate the total rent payable by each airline to the Airport, such that while the total rent payable by each airline may differ due to (a) the amount of space leased, (b) the type of space leased, and (c) passenger and aircraft traffic, no airline has preferable lease terms over another airline.

The residual rate setting methodology is a formula which sets the schedule of all rental rates, landing fees, and related fees to a level which ensures that Airport revenues received from the

airlines, plus the non-airline revenues (such as concession revenues) received by the Airport, are equal to the Airport's total costs, including debt service and operating expenditures. According to this methodology, the amount needed to balance the Airport's budget then becomes the basis for calculating, by a formula specified in the leases with the airlines, the rental rates, landing fees, and related fees charged to airlines operating at the Airport in the upcoming year, such that the total revenues paid to the Airport by all airlines in the upcoming year is sufficient to balance the Airport's budget. At the end of the fiscal year, any budget shortfall or surplus is carried forward into the following fiscal year and is used in the calculation of the new rental rates, landing fees, and related fees charged to the airlines.

The revenues generated by both the previous and existing leases are calculated by the Airport's residual rate setting methodology (breakeven policy), such that the modifications would continue to result in the Airport's budget being fully balanced by the revenues paid by the airlines to the Airport, after considering the Airport's budgeted expenditures and all non-airline revenues.

The Proposed Resolutions Will Not Result in Reduced Overall Revenues to the Airport

As shown in Table 2 below, the two proposed resolutions would result in \$39,817,750 in total potential lost revenue to the Airport due to the proposed retroactive rent credit for the month of June, 2011 and the relinquishment of Exclusive Space within Terminal 1 for the entire ten-year term of the existing lease.

Table 2: Estimate of Approximate Loss in Revenue to the Airport Due if Proposed Resolutions are Approved	
Resolution 11-0559 (Retroactive Rent Credit for the month of June, 2011)	\$430,320
Resolution 11-0560 (Relinquishment of Terminal 3 Exclusive Space - \$3,938,743 times 10 years)	39,387,430
Total Estimated Lost Rent	\$39,817,750

However, as discussed above, the estimated (a) \$430,320 retroactive rent credit under File 11-0559 for the month of June, 2011, and (b) \$39,387,432 reduced rental revenues under File 11-0560, due to Continental Airlines vacating all Exclusive Space in Terminal 1 will not result in reduced overall revenues to the Airport because the rental rates and fees paid by all airlines will be adjusted automatically under the Airport's residual rate setting methodology, the breakeven policy, to fully offset the reduced rental revenues from Continental Airlines. Ms. Artz advises that the Airport plans to rent the vacated space to other airlines, aviation support companies involved with passenger support services, or other tenants such as concessionaires, as demand arises.

If Resolution 11-0560 is approved, Continental Airlines will continue to pay Landing Fees and other miscellaneous activity-based fees as specified in the terms of the existing lease. As shown in Table 1 above, the total average monthly fees paid by Continental Airlines to the Airport is \$257,701. However, Ms. Artz advises that Continental Airlines will not be responsible for

Electricity Fees and Water/Sewer Fees under the existing lease, which represents \$14,109 or 5.49 percent of the \$257,001 in total average monthly fees because those costs are directly associated with the renting of the Exclusive Space which Continental Airlines will be relinquishing.

POLICY CONSIDERATIONS

Ms. Artz advises that authorizing a retroactive Airport rent credit for Continental Airlines is a unique occurrence and she cannot identify a prior instance in which the Airport authorized rent credits for other airlines. However, according to Ms. Artz, given the fact that United Airlines, the Airport's largest airline, and Continental Airlines, the Airport's seventh largest airline, have been Signatory Airlines⁸ at the Airport and tenants in good standing for over 30 years, the Airport believes that approval of both resolutions is in its and the traveling public's best interests to support the merger of United and Continental Airlines to ensure stable operations by the newly merged entity at the Airport.

RECOMMENDATIONS

Approve the two proposed resolutions.

⁸ A Signatory Airline is an airline that signs a Lease and Use Agreement with the Airport.