Items 1 and 2 **Files 10-1213 and 10-1214**	**Department(s):** San Francisco International Airport

EXECUTIVE SUMMARY

Legislative Objective

- File 10-1213: Resolution approving six new leases for a ten-year period from July 1, 2011 to June 30, 2021, between the San Francisco International Airport (Airport) and six airlines, including: (1) Alaska Airlines, Inc., (2) Continental Airlines, Inc., (3) US Airways, Inc., (4) Kalitta Air, LLC, (5) Nippon Cargo Airlines Company, Inc., and (6) Southern Air, Inc.

- File 10-1214: Resolution approving modifications to two existing leases which will expire on June 30, 2011, between the Airport and Alaska Airlines, Inc. and Continental Airlines, Inc.

Key Points

- The rate and fee schedule, which is used to calculate the total rent paid by each airline, is determined by the Airport's "breakeven policy," or the residual rate setting methodology, which places the financial risk of balancing the Airport's budget on the airlines instead of the Airport, by allowing for automatic rent increases to the airlines to eliminate any Airport budgetary shortfalls.

- The proposed resolution (File No. 1213) would approve the following six significant changes: (1) require airlines to submit all required landing fee payments 30 days earlier than they are due under the existing leases, (2) reduce security deposits required for four of the six airlines, (3) allow the airlines to request a one-time space reduction, on July 1, 2016, (4) consider the new leases for terminal space in default if an airline defaults on any other lease for non-terminal Airport space, (5) increase the insurance requirements, and (6) increase environmental protections.

- The proposed resolution approving six new airline leases (File 10-1213) contain the same terms as leases for 25 airlines at the Airport, which were previously approved by the Board of Supervisors in May 2010 (File 10-351).

Fiscal Impacts

- Under the terms of the proposed six new leases (File 10-1213), the Airport anticipates receiving $355,390,000 of lease revenues from the six airlines over the ten-year term. The proposed modifications to two existing leases (File 10-1214) would reduce the overall space leased to these two airlines by 37,391 square feet, or 5.1 percent. Together, these two resolutions would result in $907,365 of reduced rent payable (see pages 7 and 8) to the Airport, which would be fully offset by increased rates to all airlines through the Airport's breakeven policy.

Recommendations

- Approve the 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.

City Charter Section 9.118 (a) requires the Board of Supervisors approve any contract which would result in revenues to the City in excess of $1,000,000.

Residual Rate Setting Methodology

Under the proposed leases, the Airport uses a "breakeven policy" known as the residual rate setting methodology to determine the rental rates, landing fees, and related fees used 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 received by the Airport, are equal to the Airport's total costs, including debt service and operating expenditures. According to this methodology, prior to the beginning of each fiscal year, the Airport first determines the total airline rent revenues needed to balance the Airport's budget in the upcoming year, after considering all other non-airline revenue sources (such as concession revenues and parking revenues) and carrying forward any projected budget shortfall or surplus from the current fiscal year. The amount needed to balance the Airport's budget then becomes the basis for calculating, by a formula specified in the lease, the rental rates, landing fees, and related fees charged to airlines 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.

Existing Leases

According to Mr. Gary Franzella, Associate Deputy Airport Director, there are currently 60 airlines that have active operating leases or permits with the Airport, which allow each airline to conduct domestic and international flight operations at the Airport. Airlines without leases, but have permits, are non-signatory airlines, which according to Mr. Franzella, operate at the Airport under Airline Operating Permits and Terminal Space and Use Permits on a month-to-

month basis and, currently pay the same rental rates, landing fees, and related fees as airlines with leases (signatory airlines), as calculated by the residual rate setting methodology. Mr. Franzella notes that the main difference is that signatory airlines are included in the Airport's capital project approval process while non-signatory airlines are not. Mr. Franzella noted that these non-signatory airlines are not required to enter into leases with the Airport because, pursuant to Federal law, the Airport cannot prohibit airlines from operating at the Airport. Mr. Franzella stated that non-signatory airlines generally have not entered into leases with the Airport because, despite being offered leases by the Airport, there is currently no financial incentive to enter into a lease.

There are currently 24 airlines which have existing leases with the Airport. All current leases will expire on June 30, 2011. These leases were entered into either in 1981 or 1999, depending on when the airline decided to obtain a lease at the Airport. The airline leases entered into in 1999 are essentially an update to the leases entered into in 1981, with several provisions added to comply with the City's regulations that were approved between 1981 and 1999. The leases entered into in 1999 were only offered to international airlines because the International Terminal at the Airport became operational in 2000. The 24 airlines with existing leases each pay rent based on the same rental rates, landing fees, and related fees, all of which are established by the Airport each fiscal year. The total amount paid by each airline differs only due to the (a) square footage of the area occupied, (b) type of space occupied, (c) maximum landing weight of each aircraft landed, and (d) number of passengers. As such, no airline has preferable lease terms to any other airline.

Because all current leases will expire on June 30, 2011, the Airport has undertaken efforts to have as many airlines maintain or obtain signatory status by signing a 2011 Lease and Use Agreement, which would be effective from July 1, 2011 to June 30, 2021. As an incentive to becoming a signatory airline or maintaining signatory status, the Airport also offered participating airlines the opportunity to right-size their leased space in their current leases which expire June 30, 2011. In May 2010, the Board of Supervisors approved new leases with 25 airlines and 19 airlines took advantage of the right-sizing opportunity and reduced their leased space (File 10-351).

The proposed resolution (File 10-1213) would approve six new airline leases with (1) Alaska Airlines, Inc., (2) Continental Airlines, Inc., (3) US Airways, Inc., (4) Kalitta Air, LLC, (5) Nippon Cargo Airlines Company, Inc., and (6) Southern Air, Inc. Currently, Alaska Airlines and Continental Airlines have existing leases with the Airport which were entered into in 1981, Kalitta Air, Nippon Cargo Airlines, Southern Air, and US Airways have Airline Operating Permits and are non-signatory airlines. US Airways currently has a month-to-month permit and was given the opportunity to right-size its permitted spaces if it agreed to the 2011 Lease and Use Agreement in February 2010 and became a signatory airline.

DETAILS OF PROPOSED LEGISLATION

The proposed resolution (File 10-1213) would approve six new leases for a ten-year period between July 1, 2011 and June 30, 2021, between the San Francisco International Airport

(Airport) and six airlines to conduct domestic and international flight operations at the Airport. The six new leases are with the following airlines: (1) Alaska Airlines, Inc., (2) Continental Airlines, Inc., (3) US Airways, Inc., (4) Kalitta Air, LLC, (5) Nippon Cargo Airlines Company, Inc., and (6) Southern Air, Inc. Three of the proposed new leases (Alaska Airlines, Continental Airlines, and US Airways) would provide both landing rights and terminal space. The remaining three proposed new leases (Kalitta Air, Nippon Cargo Airlines, and Southern Air) are cargo-only airlines, which would only provide landing rights.[1]

The proposed resolution (File 10-1214) would approve modifications to two existing leases between the Airport and Continental Airlines and Alaska Airlines, which will expire on June 30, 2011. These two airlines will have new leases under File 10-1213.

Six New Airport Leases (File 10-1213)

The proposed resolution (File 10-1213) would approve six new leases to provide terms under which these six airlines would use terminal space and/or have landing rights at the Airport. Each of the proposed six new leases is for a ten-year term, from July 1, 2011 through June 30, 2021. Under these new leases, each airline would pay the Airport revenues based on the rental rates, landing fees, and related fees calculated under the same residual rate setting methodology included in the existing leases. The only differences between the individual new leases would be (a) the name of each airline, and (b) the amount of space allocated to each airline. Because these leases function identically, they are discussed in combination as the "new leases," rather than in six separate descriptions.

In addition to continuing the residual rate setting methodology (breakeven policy), the proposed new leases would also continue to require that the rental rates, landing fees, and related fees be sufficient to guarantee that the Airport's Annual Service Payment to the City's General Fund will not be less than $5,000,000. The Annual Service Payment made by the Airport to the City is equal to the greater of (a) 15 percent of concession revenues[2], or (b) $5,000,000. In the event that 15 percent of concession revenues is less than $5,000,000, the Airport pays the City's General Fund $5,000,000, and the Airport recaptures the difference between the $5,000,000 and 15 percent of concession revenues the following fiscal year through increased rental rates, landing fees, and related fees charged to the airlines as calculated by the residual rate setting methodology. Notably, the Airport's 15 percent of concession revenue has exceeded $5,000,000 every year since 1982. In FY 2010-2011, the Annual Service Payment to the City's General Fund was budgeted at $27,371,000.

There are six material differences between the existing leases and the proposed new leases that would impact Airline lessees as follows:

1. <u>Landing Fees To Be Paid 30 Days Earlier</u>

[1] The leases for the cargo-only airlines involve only landing rights and not terminal space. Cargo-only airlines have a separate type of lease that allows them to lease warehouses, office space, ground service equipment maintenance building, etc. The subject leases allow the cargo-only airlines to operate (land and take-off) at the Airport.
[2] Concession revenues are defined in the lease as those revenues paid to the Airport by non-airline entities such as newsstands, restaurants, bars, advertisers, and ground transportation operators.

Under the terms of the proposed leases, all six airlines would be required to submit all required landing fees to the Airport 30 days earlier than they are due under the terms of the existing leases. Currently, each airline must submit the number of monthly landings to the Airport by the 10th of the following month. Invoices for the landing fees are then processed and sent to each airline with a 30 day payment deadline. The new provision would require immediate payment of the invoices sent to the airlines. According to Mr. Franzella, this new provision benefits the Airport by reducing the amount of outstanding landing fees at any given time, thus reducing the Airport's risk of financial loss in the event that an airline files for bankruptcy.

2. Security Deposit Requirement to Be Decreased

The proposed new leases would require all six airlines to submit security deposits equal to two months of rent. Previously, leases that were executed in 1981 (Alaska Airlines and Continental Airlines) required airlines to provide the Airport with security deposits equal to two months of rent, and airlines with operating permits (Kalitta Air, Nippon Cargo Airlines, Southern Air, and US Airways) required airlines to provide the Airport with security deposits equal to six months of rent. The proposed new requirement is comparable to the 1981 executed leases but represents a reduction of four months in the required security deposit when compared to the operating permit requirements.

According to Mr. Franzella, the security deposits are intended to reimburse the Airport for losses which might occur in the event an airline is unable to pay rent or otherwise cause financial harm to the Airport. Mr. Franzella noted that a reduction in the security deposits does not increase the overall risk of financial loss to the Airport because, under the residual rate setting methodology, any budgetary shortfalls resulting from an airline's inability to pay rent would result in increases to the rental rates, landing fees, and related fees sufficient to offset such shortfalls.

3. Airlines to Have a One-Time Option to Reduce Exclusive-Use Space

Under the existing leases, airlines cannot reduce the amount of exclusive-use[3] space in their lease. According to Mr. Franzella, this has resulted in underutilized space which was leased by airlines which have since reduced their flight operations and therefore their need for space at the Airport. The proposed leases would allow airlines to reduce the amount of leased exclusive-use space only one time, by up to 20 percent, on July 1, 2016. In the proposed resolution (File 10-1213), the three cargo-only airlines (Kalitta Air, Nippon Cargo Airlines, and Southern Air) would not be eligible for this one-time option because these cargo-only airlines would not be leasing any terminal space.

4. Airport to Have Additional Protections In The Event Of an Airline Lease Default

In addition to leases for airlines' use of terminal space, most airlines have separate leases for space on Airport land that is outside the terminal, such as hangar space, flight kitchens, and cargo buildings. For leases which were executed in 1981 for terminal space (Alaska Airlines and Continental Airlines), any default by an airline on its lease for non-terminal space has no effect

[3] Exclusive-use space is space that is leased to a single airline and charged on a per square foot basis. Offices, clubs, lounges, ticket counters, and baggage handling space in domestic terminals comprise exclusive-use space.

on the lease for terminal space. Under the proposed leases for terminal space, if an airline defaults under any of its other leases for non-terminal space with the Airport, it would trigger default of the proposed lease for terminal space between that airline and the Airport. According to Mr. Franzella, this provides additional leverage to the Airport over airlines to enforce the terms of their other leases, and prevents an airline in bankruptcy from selectively keeping only those leases that the airline wishes to maintain.

5. Airline Insurance Requirements to Increase

Under the terms of the existing leases, all airlines are required to have $25,000,000 in general liability insurance. Under the terms of the proposed leases, the six airlines would be required to maintain higher amounts and more specific types of insurance, including the following:

(a) $500,000,000 in aircraft liability insurance which provides coverage to both the airline and the Airport in the event of injury or property damage which results from airline activity, excluding injury or damage which occurs during acts of war,

(b) $100,000,000 in war and named perils insurance, which provides coverage for injury or property damage from airline activity which occur during war and other related events (or "named perils") and excluded from aircraft liability insurance discussed above,

(c) $2,000,000 in worker's compensation and employer's liability insurance, which is required by the State of California, with such insurance providing coverage to the airline for injuries sustained by employees,

(d) $2,000,000 in commercial auto insurance, which is also required by the State of California, with such insurance providing liability coverage for injuries and damage which occur resulting from the operation of vehicles at the Airport, and

(e) property insurance in the amount of any improvements constructed by the airlines, which insures the airline against property damage which occurs from fire, flood, or other similar causes, except earthquakes.

According to Mr. Franzella, although these new insurance requirements are not directly comparable to the insurance requirements under the existing leases, the new requirements (a) better address the specific risks of concern to the Airport, and (b) reflect changes in the insurance industry which have occurred since the existing leases were written in 1981 and 1999. Mr. Franzella added that any damages which might occur which are not covered by the required insurance provisions would result in higher rental rates, landing fees, and related fees charged to the airlines under the Airport's residual rate setting methodology.

6. Environmental Protections to Increase

Leases which were executed in 1981 do not address the handling of hazardous materials, and leases executed in 1999 had limited restrictions on airline's handling of hazardous materials. The proposed six new leases would provide for a number of increased environmental protections, including (a) expanding the definition of "environmental law" to include decisional law, also referred to as case law, (b) requiring airlines to investigate and remediate any release of

hazardous materials, (c) providing the Airport access to any premises for environmental inspections, and (d) clarifying that the airlines are fully responsible and liable for all costs attributable to hazardous materials resulting from airline activities.

In addition to the six differences discussed above which would impact the airlines with leases with the Airport, the proposed six new leases would require non-signatory airlines to pay a 25 percent premium on landing fees above the landing fees paid by the 25 airlines who will be under lease with the Airport, such that there would be a financial incentive for "non-signatory" airlines to enter into a lease with the Airport.

Modifications to Two Existing Leases (File 10-1214)

The other proposed resolution (File 10-1214) would approve modifications to two existing leases between the Airport and Alaska Airlines and Continental Airlines, which will expire on June 30, 2011. According to Mr. Franzella, as part of an incentive to airlines for agreeing to the new 2011 Lease and Use Agreements by February 2010, which would be effective from July 1, 2011 to June 30, 2021, the Airport offered all airlines the opportunity to reduce each airline's current rental space in a "right-sizing" effort from their leased space. Two airlines, Alaska Airlines and Continental Airlines, agreed to new 2011 Lease and Use Agreements with the Airport in February 2010 and are now requesting lease modifications to right-size their current rental space.

According to data provided by the Airport, the proposed resolution would result in a reduction of 37,391 square feet or 5.1 percent of leased space, as shown in Table 1 below.

Table 1: Amount of Total Space in the Proposed Lease Modifications

	Total Sq. Ft. Under Existing Leases	Total Sq. Ft. Under Proposed Lease Modifications	Increase or (Decrease)	Percent Change
Exclusive-Use Space	73,857	48,907	(24,950)	-33.8%
Shared-Use Space	657,461	645,020	(12,441)	-1.9%
Total Leased Space	731,318	693,927	(37,391)	-5.1%

According to Mr. Franzella, both Alaska Airlines and Continental Airlines have requested to reduce exclusive-use space and shared-use space. Based on a total reduction of 37,391 square feet of exclusive-use and shared-use space, and assuming an effective date of November 1, 2010, the Airport will receive an estimated reduced rent of $767,027 in FY 2010-2011 from the two airlines, including (a) $79,251 in reduced rent from Alaska Airlines and (b) $687,776 in reduced rent from Continental Airlines, as shown in Table 2 below.

In addition, although not part of the proposed resolution (File 10-1214), US Airways has also requested to reduce its permitted space at the Airport. As mentioned above, US Airways is currently a non-signatory airline and operates on a month-to-month permit basis. Because US Airways will become a signatory airline with the 2011 Lease and Use Agreement, the Airport allowed US Airways the opportunity to reduce its permitted space at the Airport. US Airways

will reduce its current permitted space by 4,781 square feet resulting in reduced rent payable to the Airport of $140,338, as shown in Table 2 below.

Table 2: Comparison of Rent Revenues

Airline	FY 2010-2011 Current Rental Revenue Paid to the Airport	FY 2010-2011 Modified Rental Revenue Paid to the Airport***	Reduced Rental Revenue Payable to the Airlines
Alaska Airlines*	$ 6,009,450	$ 5,930,199	$ 79,251
Continental Airlines*	8,269,248	7,581,472	687,776
US Airways**	7,574,580	7,434,242	140,338
Total	**$ 21,853,278**	**$ 20,945,913**	**$ 907,365**

* Alaska Airlines and Continental Airlines are currently signatory airlines and because they have leases with the Airport, lease modifications require resolutions subject to Board of Supervisors' approval.
** US Airways currently operates on a month-to-month permit basis and not on a lease. US Airways will become a signatory airline with the 2011 Lease (File 10-1213). Because US Airways agreed to a lease with the Airport, US Airways was allowed to reduce its current permitted space by 4,781 square feet.
*** Assumes an effective date of November 1, 2010 for the proposed lease modifications.

The total reduced rent to the Airport from Alaska Airlines ($79,251), Continental Airlines ($687,776), and US Airways ($140,338), is $907,365. However, as discussed above, such reductions in space will not result in reduced overall revenues to the Airport because the rental rates and fees paid by all airlines will be increased automatically under the Airport's residual rate setting methodology to fully offset the anticipated $907,365 in reduced rental revenues, if the Airport is unable to find tenants for such vacated space.

The proposed resolution would also add several non-material modifications to bring each of these two leases into compliance with all applicable laws, including the Pesticide Prohibition, Tobacco Advertising Prohibition, and the First Source Hiring Ordinance.

FISCAL IMPACT

As shown in Table 3 below, the proposed six new lease agreements are estimated by the Airport to provide $355,390,000 in total revenues to the Airport, over the ten-year lease term from July 1, 2011 through June 30, 2021.

Table 3: Estimated Total Annual Rental Revenues

Fiscal Year	Estimated Total Rent Paid Under the Six Proposed Leases
2011-2012	$ 24,627,000
2012-2013	28,080,000
2013-2014	31,444,000
2014-2015	33,912,000
2015-2016	36,354,000
2016-2017	37,597,000
2017-2018	38,814,000
2018-2019	40,181,000
2019-2020	41,576,000
2020-2021	42,805,000
Total	**$ 355,390,000**

As discussed above, the revenues generated by both the current and proposed leases are calculated by the Airport's residual rate setting methodology (breakeven policy), such that the proposed new leases and 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.

RECOMMENDATIONS

Approve the proposed resolutions.