

Item 2
File 10-0983

Department:
San Francisco International Airport

EXECUTIVE SUMMARY

Legislative Objective

- The proposed resolution would authorize a modification to the existing Lease No. L01-0297 between the San Francisco International Airport (Airport) and Japan Airlines Company Limited (Japan Airlines), for space to provide handling of cargo on freighter and passenger aircraft and other ground support operations, by reducing the annual rent payable by Japan Airlines to the Airport by \$328,253, from \$1,899,990 to \$1,571,737.

Key Points

- Japan Airlines is entering the final year of an existing ten-year lease with the Airport for space for the handling of cargo on freighter and passenger aircraft, which includes (a) warehouse space, (b) office space, (c) covered truck docking space, (d) area to store and maintain ground service equipment, and (e) space for employee and aircraft parking. Under the current lease, Japan Airlines pays the Airport annual rent of \$1,899,990. Japan Airlines will not be renewing this lease when it expires on October 25, 2011.
- Japan Airlines declared bankruptcy on January 19, 2010 and has not had freight operations at the Airport since January 1, 2008. According to Ms. Diane Artz, Senior Property Manager at the Airport Aviation Management Department, pursuant to bankruptcy protection laws, such a declaration of bankruptcy allows airlines in bankruptcy to (a) continue operating while restructuring in order to reduce debt, and (b) terminate the subject lease. However, in lieu of terminating the lease, Japan Airlines is seeking the proposed lease modification that would (a) reduce the amount of leased space by 3,249 square feet, from 81,370 to 78,121 square feet and (b) relinquish 3.855 acres used for employee and aircraft parking, resulting in a reduction in the annual rental rate by \$3.23 per square foot per year, from \$23.35 to \$20.12 per square foot per year.
- In May 2010, the Board of Supervisors approved a new separate passenger terminal operations lease, authorizing Japan Airlines to continue its passenger terminal operations at the Airport for another ten years, beginning July 1, 2011 (File No. 10-0351). The new separate passenger terminal operations lease will not be impacted by the proposed lease modification.

Fiscal Impacts

- The proposed lease modification would reduce the rent payable to the Airport by Japan Airlines by \$328,253, from \$1,899,990 to \$1,571,737. However, because any budgetary shortfall resulting from the proposed lease modification would be eliminated through increased rental rates and related fees charged to other airlines under the Airport's residual rate setting methodology, the proposed lease modification does not have a direct fiscal impact on the Airport.

Recommendation

- Approve the proposed resolution.

MANDATE STATEMENT / BACKGROUND

Mandate Statement

City Charter Section 9.118(c) states that the modification of any lease of real property which, when entered into, was for a period of ten or more years or had anticipated revenue to the City and County of \$1,000,000 or more, requires approval by resolution of the Board of Supervisors.

Background

On September 4, 2001, the Board of Supervisors approved Resolution No. 875-01, authorizing the current lease¹ between Japan Airlines Company Limited (Japan Airlines) and the San Francisco International Airport (Airport). The current lease began on October 26, 2001 and terminates October 25, 2011, for a term of ten years. The lease includes 81,370 square feet of ground support space for both freighter and passenger operations equipment at the Airport comprising (1) 59,438 square feet of cargo warehouse space, (2) 13,500 square feet of office space, (3) 5,183 square feet of covered truck dock space, and (4) 3,249 square feet of space for ground services equipment repair (baggage carts, potable water trucks, etc.). The current lease also includes 3.855 acres used for parking for employees and freight aircraft. However, the cost of such parking is included in the rental rates for the four types of ground support space listed above. The annual rent payable by Japan Airlines to the Airport is currently \$1,899,990, or an average of \$23.35 per square foot, based on 81,370 square feet of ground support space, which is adjusted annually to correspond to increases in the U.S. Consumer Price Index.

On January 1, 2008, Japan Airlines ceased freighter operations at the Airport. On January 19, 2010, Japan Airlines filed for bankruptcy protection in the U.S. Bankruptcy Court. According to Ms. Diane Artz, Senior Property Manager at the Airport Aviation Management Department, pursuant to bankruptcy protection laws, filing bankruptcy allows Japan Airlines to (a) continue operating while restructuring in order to reduce its debt, and (b) terminate the subject lease. However, instead of terminating the subject lease, Japan Airlines has requested the proposed lease modification to its existing lease in order to eliminate the space Japan Airlines had previously used for ground support for freighter operations, while at the same time maintaining the space currently used to provide ground support for continued passenger operations. Ms. Artz advises that Japan Airlines does not intend to renew the subject ground support lease when it expires on October 25, 2011. According to Ms. Artz, Japan Airlines may contract with another airline or business to provide ground support for its passenger operations after the expiration of the subject lease on October 25, 2011.

¹Pursuant to Section 2A.173 of the City's Administrative Code, which grants the Airport the power to negotiate and execute leases of Airport lands and space in Airport buildings without undergoing a competitive bidding process, the subject lease was not awarded through a competitive bidding process.

DETAILS OF PROPOSED LEGISLATION

As discussed above, the proposed resolution would authorize Japan Airlines to relinquish the space it previously used for ground support for freighter operations while maintaining the space currently used to provide ground support for cargo transported on passenger aircraft operations. Specifically, the proposed lease modification would authorize Japan Airlines to (a) reduce its leased ground support space by 3,249 square feet, from 81,370 to 78,121 square feet and (b) relinquish 3.855 acres used for employee and aircraft parking, resulting in a reduction in the annual rental rate by \$3.23 per square foot, from \$23.35 to \$20.12 per square foot. As shown in Table 1 below, the proposed modification results in a rent reduction of \$328,253 to Japan Airlines, from \$1,899,990 now being paid to the Airport to \$1,571,737, based on a reduction of 3,249 square feet from 81,370 to 78,121 square feet.

Table 1: Proposed Reduction In Leased Space

Type of Space	Square Feet Under Current Lease Terms	Square Feet Under Proposed Modified Lease Terms
Warehouse Space	59,438	59,438
Office Space	13,500	13,500
Covered Truck Dock	5,183	5,183
Ground Services Equipment Space	3,249	--
Total Space (Square Feet)	81,370	78,121
x Blended Annual Rental Rate	\$23.35	\$20.12
Annual Rent	\$1,899,990*	\$1,571,795**

* $\$23.35 \times 81,370 = \$1,899,990$

** $\$20.12 \times 78,121 = \$1,571,795$

The proposed resolution would also approve updates to the lease to reflect laws that have been enacted since the inception of the subject lease in 2001. These updates include (a) compliance with the City's Campaign and Governmental Conduct Code which prohibits a person wishing to enter into a contract or lease from contributing to an elected officials who will approve such a contract or lease, and (b) compliance with the City's Food Service Waste Reduction Ordinance, which requires food vendors within City facilities to use disposable foodware that is biodegradable, compostable, or recyclable. These updates do not impact the rental rates and terms.

FISCAL IMPACT

As noted above, Japan Airlines currently pays the Airport \$1,899,990 of annual lease revenues to the Airport. Under the proposed resolution, Japan Airlines would reduce their ground support space by 3,249 square feet, resulting in a revised annual rent payable by Japan Airlines to the Airport of \$1,571,737, or \$328,253 less than the current rent of \$1,899,990. According to Ms. Artz, the Airport intends to lease the relinquished 3,249 square feet of ground support space, as well as 3.855 acres currently used for parking for employees and aircraft, which would be

vacated by Japan Airlines, to other airlines or tenants as soon as possible, but has not yet identified a replacement tenant.

As a result of the Airport's "residual rate setting methodology" (the breakeven policy) used by the Airport to determine rental rates, landing fees, and related fees for all Airlines, even if a replacement tenant is not found, the proposed rent reduction for Japan Airlines will not result in any budgetary shortfall for the Airport. 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 all of the airlines at the Airport, plus the non-airline revenues received by the Airport, is equal to the Airport's total costs, including debt service and operating expenditures. According to the Airport's breakeven rate setting methodology, prior to the beginning of each fiscal year, the Airport 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 with the airlines, the rental rates, landing fees, and related fees charged to the airlines each fiscal year, such that the total revenues paid to the Airport by all airlines and other tenants in the upcoming fiscal year is sufficient to balance the Airport's budget. At the end of the fiscal year, any budgetary 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 and other tenants. Because any budgetary shortfall resulting from the proposed lease modification would be eliminated through increased rental rates and related fees, the proposed lease modification does not have a direct fiscal impact on the Airport.

POLICY CONSIDERATION

As distinct from the subject lease, Japan Airlines maintains a separate passenger terminal operations lease at the International Terminal at the Airport for passenger terminal space, including gates, kiosks, and check-in areas. That lease would not be affected by the proposed resolution. In May 2010, the Board of Supervisors approved a new passenger terminal operations lease for Japan Airlines for passenger terminal space (File No. 10-0351). The new Japan Airlines passenger terminal operations lease in the International Terminal commences on July 1, 2011 with a term of ten years, or through June 30, 2021.

Currently, Japan Airlines leases 9,926 square feet of passenger terminal operations space at the Airport's International Terminal. Under the recently approved new passenger terminal operations lease (which is not the subject of the proposed resolution), the Japan Airlines space will be reduced to 7,194 square feet, a reduction of 2,732 square feet. Over the past three years, under the existing lease for passenger terminal operations, Japan Airlines has paid an average rent and landing fees of \$3,744,230 per year to the Airport. The proposed resolution to modify Japan Airlines lease for cargo operations would not affect the Japan Airlines lease for passenger terminal operations.

RECOMMENDATION

Approve the proposed resolution.