

<b>Item 4</b> <b>File 11-1290</b>	<b>Department:</b> San Francisco International Airport (Airport)
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**EXECUTIVE SUMMARY****Legislative Objective**

- The proposed resolution would authorize the First Amendment to the existing lease between the San Francisco International Airport (Airport) and United Airlines, Inc. (United Airlines) for the premises known as Plot 6, to (a) extend the lease term by ten years, retroactively from July 1, 2011 to June 30, 2021, (b) reduce the square footage of the leased space from 16.04 acres to approximately 12.5 acres, (c) reduce the annual rent to correspond with a reduction in acreage based on 12.514 acres, and (d) provide for United Airlines to pay the Airport \$696,000 in deferred payments for hazardous materials remediation for Building 575 on Plot 6.

**Key Points**

- On June 1, 2001, the Board of Supervisors approved a resolution (File 01-0052) to lease to United Airlines land known as Plot 6. The original lease was for a period of 12 years and one month, retroactive from June 1, 1999 through June 30, 2011 and included approximately 16.04 acres of land, including Buildings 575 and 585.
- On October 30, 2008, United Airlines separately subleased back to the Airport 39,425 square feet of space in Building 575 and ancillary parking for Airport staff at a rental rate of \$82,135 per month. In July, 2010, the Airport increased their subleased space by 1,329 square feet, from 39,425 square feet to 40,754 square feet, increasing the Airport's obligation to United Airlines under the sublease by \$2,769, from \$82,135 per month to \$84,904 per month, or a total of \$1,018,850 per year.
- Under this separate sublease between United Airlines and the Airport, United Airlines was required to pay the Airport \$2,436,000 for hazardous materials remediation in Building 575 in monthly payments of \$73,840. When the existing sublease terminated on June 30, 2011, United Airlines had paid \$1,740,000 and had a remaining unpaid balance to the Airport of \$696,000.

**Fiscal Impacts**

- The proposed 12.5 acres of leased space includes an electrical substation shared by United Airlines and the Airport, comprising approximately 0.026 acres, which is not included in the rent, for a net of 12.514 acres.
- Currently, United Airlines pays the Airport annual rent of \$2,081,080 for 16.04 acres of leased property, or an average of \$129,743 per acre per year. Under the proposed lease amendments, United Airlines would pay the Airport an average of \$130,910 per acre per year for 12.514 acres, or annual rent of \$1,638,208 in the first year. Therefore, approval of the proposed lease amendment will result in a reduction of \$442,872 in annual revenues to the Airport.
- However, assuming termination of the existing sublease between United Airlines and the Airport for 40,754 square feet of Building 575 and the adjacent parking lot, and commencement of a separate new month-to-month permit for United Airlines to lease approximately 26,872 square feet of space in Building 575, will actually result in net annual additional revenues of \$1,125,617 for the Airport.
- United Airlines will also pay the balance of \$696,000 owed to the Airport for hazardous materials remediation, expected in 60 monthly payments of \$11,600 per month.

**Recommendation**

- Approve the proposed resolution.

**MANDATE STATEMENT / BACKGROUND****Mandate Statement**

Section 2A.173 of the City's Administrative Code authorizes the Airport to negotiate and execute leases of Airport land 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 states that leases, which would result in revenues to the City in excess of \$1,000,000, are subject to Board of Supervisors approval.

**Background**

On June 1, 2001, the Airport entered into a lease agreement with United Airlines, Inc. (United Airlines) for land known as Plot 6, including Buildings 575 and 585, located on the west side of the Airport near McDonnell Road, which was approved by the Board of Supervisors (File 01-0052).

This June 1, 2001 lease between the Airport and United Airlines extended for a period of 12 years and one month, retroactive from June 1, 1999 through June 30, 2011, and included approximately 16.04 acres of land, including Building 575, containing 63,822 square feet of space, and Building 585 containing 149,270 square feet of space. United Airlines used the space for aviation functions including cargo operations, emergency procedures training, administrative offices, plant and aircraft maintenance, and United Airlines employee parking.

According to Ms. Diane Artz, Senior Property Manager at the Airport, United Airlines constructed these two buildings in 1969, which reverted to the Airport in 1999, under the terms of the original lease with United Airlines.

The first year rent payable by United Airlines to the Airport was \$1,584,656 from June 1, 1999 through May 31, 2000, or \$132,055 per month. The lease provided for annual Consumer Price Index (CPI) increases, resulting in annual rent paid by United Airlines to the Airport from July 1, 2010 through June 30, 2011 of \$2,081,080, or \$173,423 per month. Based on the existing 16.04 acres leased, the current rental rate is approximately \$129,743 per acre.

On October 30, 2008, the Airport entered into a separate sublease agreement with United Airlines to lease back 39,425 square feet of space of the total 63,822 square feet in Building 575, including the adjacent parking lot, to be used by the Airport as office space and parking for Airport employees, for the two years from July 1, 2009 through June 30, 2011 at a cost of \$82,135 per month, or \$985,620 per year. According to Ms. Artz, the rent to be paid by the Airport to United Airlines under this sublease was based on the fair market value of approximately \$25 per square foot per year. This sublease did not require approval by the Board of Supervisors because the term was less than ten years and the cost to the Airport was less than \$10,000,000.

In addition, under this separate sublease with United Airlines, the Airport required United Airlines to reimburse the Airport \$2,436,000 for the Airport's cost of remediation of hazardous materials in Building 575<sup>1</sup>, which was completed before the Airport occupied the subleased

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<sup>1</sup> United had originally constructed the buildings in 1969 and upon inspection prior to finalizing the sublease, the Airport found hazardous materials that needed to be remediated.

space on July 1, 2009. To facilitate United Airlines reimbursement to the Airport, the Airport reduced the monthly sublease payments to United Airlines by \$73,840 per month, such that the Airport paid a net amount to United Airlines of \$8,295 per month (\$82,135 sublease monthly cost less \$73,840 monthly reimbursement payments) to sublease the 39,425 square feet in Building 575.

In July, 2010, the Airport increased their subleased space in Building 575 by 1,329 square feet, from 39,425 square feet to 40,754 square feet, increasing the Airport's sublease costs to United Airlines by \$2,769, from \$82,135 per month to \$84,904 per month, or a total of \$1,018,850 per year. The Airport continued to deduct \$73,840 per month for the hazardous materials remediation from the sublease rent payments to United Airlines, resulting in monthly net rent payments of \$11,064 (\$84,904 less \$73,840). According to Ms. Artz, as of June 30, 2011, the end of the lease term, United had reimbursed the Airport a total of \$1,740,000 for the hazardous materials remediation costs totaling \$2,436,000, such that United Airlines still owes the Airport a balance of \$696,000.

According to Ms. Artz, although the Airport began negotiations with United Airlines in 2010 to modify the lease, there were delays in completing the negotiations caused by resurveying the site and due to repositioning of nearby runways. Given these delays, the lease and the sublease expired on June 30, 2011. However, United Airlines and the Airport agreed that the lease and sublease would continue on the same terms and conditions on a month-to-month basis, until the negotiations could be completed, and the lease amendment approved by the Airport Commission and the Board of Supervisors.

In addition, Ms. Artz advises that if the proposed resolution is approved, United Airlines will separately enter into a month-to-month permit with the Airport, to continue to occupy approximately 26,872 square feet of space on the first and mezzanine levels of Building 575, at a monthly rental rate of \$45,803, or \$549,639 per year, to be paid by United Airlines to the Airport, retroactive to July 1, 2011. This month-to-month permit would not be subject to Board of Supervisors approval.

Ms. Artz advises that since July 1, 2011, United Airlines has continued paying the Airport the full \$173,423 per month in rent pursuant to the terms of the prior lease. Although the Airport has continued to occupy 40,754 square feet of Building 575 and the adjacent parking lot space, and United Airlines has continued to occupy the balance of approximately 26,872 square feet of space on the first and mezzanine levels in Building 575, during this month-to-month holdover period, Ms. Artz advises that the Airport and United Airlines agreed not to make payments for these spaces in Building 575 during this holdover period. According to Ms. Artz, if the proposed resolution is approved, United Airlines will enter into a month-to-month permit for their space in Building 575 as described above, and the Airport will reimburse United Airlines for the required lease payments, less the subleased space by the Airport in Building 575, retroactive to July 1, 2011.

## **DETAILS OF PROPOSED LEGISLATION**

The proposed resolution would retroactively authorize the First Amendment to the existing lease between the Airport and United Airlines for Plot 6, including Buildings 575 and 585, to:

- Extend the lease term for ten years, retroactively from July 1, 2011 through June 30, 2021.
- Reduce the leased space from approximately 16.04 acres to approximately 12.54 acres, a reduction of 3.5 acres<sup>2</sup> because the Airport will take back Building 575 and the adjacent parking lot. Reduce the annual rent payable by United Airlines to the Airport by \$442,872 from \$2,081,080 to \$1,638,208 to correspond with the reduction in space.
- Provide for United Airlines' payment to the Airport of the remaining balance of \$696,000 for the Airport's costs of hazardous materials remediation, either through one lump-sum payment, or 60 monthly payments of \$11,600.

All other terms, including the annual CPI adjustment, would remain the same under the proposed First Amendment, with the exception of Year 6 of the proposed amended lease, when the rent would be adjusted to the greater of (a) rent in Year 5 as increased by the CPI, or (b) fair market value for the land, which would be determined by the Department of Real Estate.

## FISCAL IMPACT

Under the proposed First Amendment to the lease, the land leased by United Airlines will be reduced from approximately 16.04 acres to approximately 12.54 acres, a reduction of 3.5 acres or 21.8 percent, because of the removal of Building 575 and the adjacent parking area from the lease. However, as noted above, United Airlines will actually pay the Airport based on 12.514 acres of leased land, not including the 0.026 acres that is occupied by the Airport's and United Airlines' electric substation. Currently, United Airlines pays the Airport annual rent of \$2,081,080 for 16.04 acres of leased property, or an average of \$129,743 per acre. Under the proposed lease amendment, United Airlines would lease a net total of 12.54 acres and pay the Airport annual rent of \$1,638,208 in the first year, or an average of \$130,910 per acre for 12.514 acres of land. Under the proposed lease amendment, the rent would be adjusted annually by the CPI, except year 6 when the rent would be adjusted to the greater of (a) rent in Year 5 as increased by the CPI, or (b) fair market value for the land.

Although not part of the subject lease amendments, the separate sublease between United Airlines and the Airport will also terminate, such that the Airport will no longer be required to pay \$1,018,850 annual sublease payments to United Airlines for use of 40,754 square feet of Building 575 and the adjacent parking lot space. In addition, as described above, although not part of the subject lease amendments, United Airlines will enter into a separate month-to-month permit to rent approximately 26,872 square feet of space on the first and mezzanine levels of Building 575, at a rental rate of \$549,639 per year.

The Table below compares the acreage and cost of the existing lease and the proposed First Amendment to the lease between United Airlines and the Airport. In addition, the Table below provides comparative cost data for the current sublease and proposed permit for the use of Building 575 between United Airlines and the Airport.

<sup>2</sup> In addition, the proposed lease does not include rent for approximately 0.026 acres for the Airport's and United Airlines' electric substation located in the parking lot adjacent to Building 575. Therefore, the rent is actually based upon 12.514 acres (12.54 acres of leased space less 0.026 acres for the electric substation).

**Table: Comparison of the Existing Lease and the Proposed First Amendment to the Lease and the Sublease and Permit between United Airlines and the Airport**

	<b>Lease that Expired as of June 30, 2011</b>	<b>Proposed Amendment to the Lease Retroactive to July 1, 2011</b>	<b>Differences</b>
Net Acres of Leased Space	16.04	12.514	3.526
Annual Rent Payments by United Airlines to the Airport	\$2,081,080	\$1,638,208	(\$442,872)
Annual Sublease Payments by the Airport to United Airlines to be terminated	(\$1,018,850)	\$0	\$1,018,850
United Airlines Permit for Building 575 to commence	\$0	\$549,639	549,639
<b>Net Revenue to the Airport</b>	<b>\$1,062,230</b>	<b>\$2,187,847</b>	<b>\$1,125,617</b>

As shown in the Table above, approval of the proposed lease amendment will result in a reduction of \$442,872 in annual revenues to the Airport.

However, as also shown in the Table above, assuming termination of the existing sublease between United Airlines and the Airport for 40,754 square feet of Building 575 and the adjacent parking lot, and commencement of a separate month-to-month permit for United Airlines to lease approximately 26,872 square feet of space in Building 575, will actually result in net annual additional revenues of \$1,125,617 for the Airport.

In addition, based on total hazardous materials remediation costs of \$2,436,000, as of June 30, 2011, United Airlines had reimbursed the Airport a total of \$1,740,000, leaving a remaining unpaid balance of \$696,000. The proposed amendment requires United Airlines to pay off the balance in one lump sum or pay \$11,600 per month for 60 months until the balance is paid off. Ms. Artz advises that United Airlines will likely pay the balance over the 60 month period.

The revenues generated by both the previous and proposed lease are based on fair market value and are revenues that are considered in the Airport's residual rate setting methodology (breakeven policy), 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 annual costs, including debt service and operating expenditures.

## RECOMMENDATION

Approve the proposed resolution.