



Memorandum

TO: HONORABLE MAYOR AND
CITY COUNCIL

FROM: William F. Sherry, A.A.E.

SUBJECT: SEE BELOW

DATE: February 21, 2007

Approved

Date

2/26/07

Council District: City-Wide

SUBJECT: APPROVAL OF THE SIGNATORY AND NON-SIGNATORY AIRLINE-AIRPORT LEASE AND OPERATING AGREEMENTS BETWEEN THE CITY AND ALL AIRLINES OPERATING AT THE AIRPORT

RECOMMENDATION

- (a) Adoption of a resolution authorizing the City Manager to:
- (1) Negotiate and execute Signatory Airline-Airport Lease and Operating Agreements with all passenger and cargo airlines currently operating at the Norman Y. Mineta San José International Airport that meet the minimum requirements to be a signatory airline, for the term July 1, 2007 to June 30, 2012.
 - (2) Negotiate and execute Non-Signatory Airline-Airport Lease and Operating Agreements with any passenger or cargo airlines currently operating at the Norman Y. Mineta San José International Airport that do not meet the minimum requirements to be a signatory airline or choose not to enter into a signatory lease, for the term July 1, 2007 to June 30, 2012.
 - (3) Negotiate and execute Signatory and Non-Signatory Airline-Airport Lease and Operating Agreements with any passenger or cargo airlines that commence operations at the Norman Y. Mineta San José International Airport after July 1, 2007, for the term from commencement of operations to June 30, 2012.
- (b) Approval of an ordinance amending Title 25 to add a new Chapter establishing minimum requirements for the operation at and use of the Norman Y. Mineta San José International Airport by any passenger or cargo airlines that have not signed either a Signatory or Non-Signatory Airline-Airport Lease and Operating Agreement on or after July 1, 2007.

CEQA: Resolutions No. 67380 and 71451, PP 07.

OUTCOME

Adoption of the resolution will authorize the City to finalize and execute the new Signatory and Non-Signatory Airline-Airport Lease and Operating Agreements (“Agreements”) for implementation effective July 1, 2007. The Agreements will terminate and supersede the existing airline agreements, which is due to expire on November 30, 2007. The July 1, 2007 effective date for the Agreements will enable the City to implement new rates and charges, and an operating structure that will permit a majority of the terminal facilities to be leased and operated on a shared use, or preferential use, basis. Approval of an ordinance amending Title 25 will set the rates and charges, and minimal operating requirements for any passenger or cargo airline that has not executed either a Signatory or Non-Signatory Airline-Airport Lease and Operating Agreement on or after July 1, 2007.

EXECUTIVE SUMMARY

Current rates and charges, and the operational structure for the Airport are set forth in the Scheduled Airline Operating Agreement and Terminal Building Lease (“Scheduled Airline Agreement”). There are presently three airlines remaining at the Airport that operate under the Scheduled Airline Agreement – American Airlines, Delta Air Lines and United Airlines. The Scheduled Airline Agreement has a 30-year term and it expires on November 30, 2007. All other airlines operate from month-to-month and can be terminated by either party on 30 days written notice.

In early 2006, the Airline-Airport Affairs Committee (“AAAC”) selected representatives from the airlines to form a negotiating subcommittee to work with the City on the development of a new operating agreement and lease. For the past year, this subcommittee has met with City staff on a monthly basis to negotiate the terms of the Agreements. These Agreements significantly change the business and operating environment at the Airport.

The Agreements will be effective July 1, 2007 and the current Scheduled Airline Agreements will terminate on that date. The Agreements will be effective for 5 years, with one 5-year renewal period, subject to the mutual agreement of the City and the airlines. The City Manager will also have the authority to execute the Agreements with any new passenger or cargo airlines that commence operations at the Airport after July 1, 2007, through the five-year term.

Under the Agreements, most terminal facilities will be leased on a shared use or preferential use basis. Rules for the use of these facilities will be detailed in the Airport rules and regulations to be established by the Director of Aviation. Airline operational offices and VIP lounges may be leased to the airlines on an exclusive basis.

The Agreements establish the methodology for calculating rates and charges. Landing fees will be calculated using a residual airfield cost center method, while terminal rents will be calculated using a compensatory methodology. In order to maintain rates at the projected cost per enplaned

passenger ("CPE"), a rate stabilization fund will be maintained. The Agreements also provide for sharing of revenues, after certain requirements are met, between the Airport and the signatory airlines.

Airline approval of all projects in Phase I of the Terminal Area Improvement Program ("TAIP") is incorporated in the Agreements. Phase II TAIP projects are also approved, so long as specific activity triggers are met before the City initiates design or construction of these projects. With respect to new capital projects not pre-approved as either Phase I or Phase II projects in the Agreements, majority-in-interest consideration will apply to projects that will affect airline rates and charges, and have gross project costs in excess of \$5 million. Such capital projects will be presented to all signatory airlines. If a majority-in-interest of the signatory airlines disapproves the proposed project, the City shall defer such project for up to one year to allow for further consultation with the signatory airlines. At the end of the one-year period, the City may proceed with the project despite any remaining airline objections.

The Agreements incorporate the specific terms of the City's Curfew Ordinance as adopted by Council on October 21, 2003. In addition, the Agreements include the voluntary agreement of each airline to continue to ensure that airline corporate and flight scheduling personnel are aware of the Curfew Ordinance. Local airline personnel will continue ongoing efforts to coordinate flight schedule changes and curfew reports documents with Airport staff, as well as familiarize new personnel with the Curfew Ordinance and the airline's commitment to curfew compliance. The Agreements also include the airlines' voluntary commitment to schedule and conduct all takeoffs and landings at the Airport between the hours of 6:30 a.m. and 11:30 p.m. However, an airline's failure to comply with the voluntary commitments regarding the City's Airport curfew that are above and beyond the mandatory provisions of the Curfew Ordinance will not constitute either an event of default under this Agreements or a violation of the Curfew Ordinance. In addition, violations of the Curfew Ordinance will not constitute events of default under the Agreements, but will continue to be subject to fines and other enforcement under the Curfew Ordinance.

On February 14, 2007, the full AAAC met to discuss the final draft of the Agreement. The meeting ended with the City and the airlines in agreement on nearly all of the essential terms of the Agreements. In the unlikely event that any one or more of the 3 airlines (American Airlines, Delta Air Lines and United Airlines) that is a party to the current Scheduled Airline Agreement should fail to execute the new Agreement, the current Scheduled Airline Agreements would remain in effect until November 30, 2007.

BACKGROUND

The current Scheduled Airline Operating Agreement and Terminal Building Lease ("Scheduled Airline Agreements") establish the methodology for setting rates and charges, and set forth operational procedures under which the Airport functions today. The Scheduled Airline Agreement was effective April 1, 1978 and has an expiration date of November 30, 2007. At the

present time, 3 airlines currently operate at the Airport pursuant to the Scheduled Airline Agreement – American Airlines, Delta Air Lines and United Airlines, and the City cannot terminate these three agreements prior to November 30, 2007, without the concurrence of the three airlines.

The remaining 13 passenger airlines operate at the Airport pursuant to either the standard Operating Agreement and Terminal Building Lease, or the Secondary Airline Operating Agreement and License. At this time, several of these agreements have expired or airlines are operating pursuant to a letter of understanding; and new or extended agreements have not been pursued in anticipation of completion and approval of the new Agreement. There are 4 cargo airlines presently operating at the Airport pursuant to the Air Cargo Operating Agreement and License. All of these airlines, both passenger and cargo, operate on a month-to-month basis at the Airport and therefore can be terminated by either party on 30 days written notice.

In anticipation of the impending expiration date of the Scheduled Airline Agreement, the City initiated discussions with the airlines for development of a new agreement during the Airport Master Plan Workshop, held September 14 – 16, 2005. For the past year or so, detailed negotiations on the new Agreement were held on a monthly basis with the representatives of the AAAC, who were selected by the airlines to serve on the negotiating subcommittee. The full AAAC met with City staff on February 14, 2007 and ended the meeting with agreement on nearly all of the essential terms of the Agreements.

ANALYSIS

A. Signatory and Non-Signatory Airline-Airport Lease and Operating Agreements

The new Agreements represents a significant change from the existing business and operating environment now in place at SJC. A change in the methodology for calculating rates and charges is incorporated in the Agreements, and a majority of the terminal facilities will be occupied on a shared use or preferential use basis. The major provisions of the new Agreements are discussed below.

Term

The new Agreements will take effect on July 1, 2007 and will have a five-year term, expiring on June 30, 2012. The Agreements will terminate and supersede the existing Scheduled Airline Agreements, which expire on November 30, 2007. The Agreements will provide for one 5-year renewal period (July 1, 2012 – June 30, 2017) subject to the agreement of the City and the airlines. The City Manager will also have the authority to execute the Agreements with any new passenger or cargo airlines that commence operations at the Airport after July 1, 2007, through the five-year term.

Use of Terminal Facilities

A majority of the terminal facilities will be leased on a shared use or preferential use basis. These will include such facilities as gates, ticket counters, baggage make-up ("Baggage Make-Up" is the area post-check in where airlines sort and process checked baggage") and baggage claim facilities. Rules governing the use of shared use and preferential use facilities will be prescribed by Airport Rules and Regulations to be established by the Director of Aviation. Airline Ticket Offices ("ATOs"), VIP lounges and other such space may be leased to the airlines on an exclusive, short-term basis as conditions warrant.

Rates and Charges

The Agreement will set the formulas to be used to calculate rates and charges for Fiscal Year (FY) 2008 through FY 2012. Landing Fees will be calculated using a residual Airfield Cost Center method and will be based upon the landed weight of each aircraft. Under the residual methodology, the airlines assume the financial risk associated with airfield costs and revenues. There will be no crediting of revenues generated from other cost centers (i.e. parking, concessions). Terminal Rents will be calculated using a commercial compensatory method and will be based upon the square footage of the terminal space. Under the compensatory methodology, the airlines will pay only for the facilities they use. The structure of charges for the shared use space will be based in accordance with the activity of that particular space (i.e. shared use charge of the gate/holdroom will be based on aircraft turns; shared use charge of the ticket counter will be based on hours used). The rates and charges model was based on encouraging the use of larger aircraft (i.e., number of passenger seats) by providing incentives to airlines that utilize larger aircraft. This would result in fewer aircraft operations on the neighborhoods. However, while it will help to reduce aircraft operations over the neighborhoods, the use of larger aircraft could result in reduced frequency of air services to and from certain cities.

Revenue Sharing

In any year in which there are net remaining revenues generated at the Airport, and all requirements of the Bond Trust Agreement have been satisfied, including the minimum rate covenant requirement, the net remaining revenues shall be divided 50/50 between the Airport and the airlines executing the Agreement (Signatory Airlines). The Signatory Airlines' share of the net remaining revenues shall be applied as a credit to the terminal cost center, thus reducing the Signatory Airlines' terminal rents for the following year. The first \$1 million of the City's share shall be retained by the Airport in a discretionary fund to be used for any lawful Airport purpose. The remaining balance of the City's share (at least during the initial term of the agreement) shall be applied to the capital costs of the projects in the approved Airport Master Plan Program to reduce the costs of those projects borne by the Signatory Airlines.

Airline Approval of Master Plan Program

Phase I: All of the projects in Phase I of the Airport Master Plan Program (to be enumerated in the Agreement) are pre-approved and may be designed and built by the City without further Signatory Airline approval. Phase I projects include improvements to Terminal A, construction of Terminal B, demolition of portions of Terminal C, roadway improvements, and a consolidated rental car parking facility.

Phase II: The projects in Phase II of the Airport Master Plan Program (to be enumerated in the Agreement) are pre-approved, but the City will not initiate design or construction of these projects until a specified activity trigger is met: 217 flights/peak day or 12.2 million total passengers in any given year. If either trigger is met, the City may, in its sole discretion, proceed with any or all of the pre-approved Phase II projects without first consulting with the Signatory Airlines. Subsequent to the activity trigger being met, and in the event that passenger levels fall 25% or more below the 12.2 million passenger level, any Phase II project, or portion thereof, for which the City has not issued bonds, issued commercial paper or awarded a construction contract shall not proceed without first consulting with the Signatory Airlines. Phase II projects will include expansion of the terminal from 30 to 40 gates.

If at any time during the term of the new Agreement the cost per enplaned passenger ("CPE") is projected to exceed \$9 (in 2005 dollars) after application of available funds from the rate stabilization fund, the City will not proceed with design or construction of any Phase II projects without first consulting with the Signatory Airlines.

Capital Projects

The Airport will undertake an annual assessment with the development of a Renewal and Replacement ("R&R") Capital Improvement Program ("CIP") each year during the term of the Agreement to determine the appropriate allowance for R&R expenditures to be included in the budget for the next fiscal year. The necessity for these expenses is for the replacement and renewal of existing facilities as contemplated by the Airport's Bond Trust Agreement. This budget amount, with an accompanying description of the associated projects, will be included in the Airport's annual budget and will be subject to review and consultation, but not to approval, by the Signatory Airlines.

Majority-in-Interest ("MII") consideration will only apply to new capital projects not already pre-approved as Phase I or Phase II projects that: (a) will affect airline rates and charges during the Term of the Agreement; and (b) have gross project costs expected to exceed \$5 million. MII consideration will not apply to projects: (a) that are required by the federal government; (b) that must be rebuilt or replaced to meet the Airport's obligations under the Agreement or applicable law; (c) that are required to respond to emergencies in order to keep the Airport open for public use; (d) that are undertaken in cost centers other than the Airfield and Terminal cost centers; (e) for the increased requirements of any Signatory Airline(s) if such Signatory Airline(s) agree to

increased rentals, fees, and charges sufficient to cover the annual debt service associated with the project; or (f) that are for special purpose facilities for which the user will pay or reimburse the Airport.

The Airport will not proceed to design or build projects that are subject to MII consideration without first giving the Signatory Airlines a detailed description of the purpose and expected costs of each such project and an opportunity to voice any objections to the project. If an MII of the Signatory Airlines does not disapprove the project, the Airport may proceed with design and construction. If, within 60 days of the Airport's notice, an MII of the Signatory Airlines disapproves the proposed project, the Airport shall defer the project for a period of up to one year to allow for further consultation with the Signatory Airlines. At the end of the one-year deferral period, the Airport may proceed with the project notwithstanding any remaining airline objections.

All Signatory Airlines will have MII participation rights with respect to Airfield projects; only passenger Signatory Airlines will have MII participation rights with respect to Terminal projects.

MII for Airfield projects shall be Signatory Airlines with at least 50% of the total landing fees paid by Signatory airlines during the preceding fiscal year. MII for Terminal projects shall be at least 50% of the Signatory Airlines who together have (a) paid at least 50% of the total Terminal rents paid by Signatory Airlines during the preceding fiscal year; and (b) carried at least 50% of the enplaned passengers in the preceding fiscal year.

Signatory Airline

Both passenger and cargo airlines will be given an opportunity to become a Signatory Airline by executing an agreement in standard form provided, in the case of a passenger airline, that: (a) it leases an amount of space in the Terminal for the Term of the Agreement that is deemed sufficient by the Airport to support the airline's operations; and (b) it operates at least one (1) flight, scheduled year round, at least three (3) days per week; and in the case of a cargo airline, that it leases cargo-handling facilities on the Airport from the Airport for no less than the term of the Agreement and guarantees a minimum of 142,000 pounds of Maximum Gross Landed Weight per Operations and operates at least three (3) scheduled operations per week. .

Non-Signatory Airline

Any passenger or cargo airline that does not meet the minimum requirements to be a Signatory Airline will be given the opportunity to become a Non-Signatory Airline by executing an agreement in similar form. Rates and charges for a Non-Signatory Airline will be charged at a 25% premium over the rates and charges for a Signatory Airline. In addition, Non-Signatory Airlines will not participate in any MII consideration of proposed capital projects.

Contract Security

Signatory and Non-Signatory Airlines will provide contract security in an amount equal to two months' landing fees, terminal rents and other charges to guarantee the faithful performance by the Airline of its obligations under the Agreement.

Rate Stabilization Fund

A Rate Stabilization Fund will be maintained at the level of \$9 million. Deposits and withdrawals will be made to the Rate Stabilization Fund based on the City's ability to achieve the forecasted CPE. Once the Rate Stabilization Fund has a balance of \$9 million, there will be no further deposits made until the balance falls below \$9 million.

Operation and Maintenance Expenses

The Agreements provide that the City will use reasonable efforts to manage and control the growth of operation and maintenance (O&M) expenses at the Airport and will set as its goal that "controllable" expenses will not rise by more than 5% per year. However, the Agreements further provide that the City will have no obligation to keep "controllable" expenses below this goal if, in Director's sole discretion, this is impractical at any time during the term of the Agreements.

Curfew

The Agreements provide that the Signatory and Non-Signatory Airlines will agree: (a) to abide by the City's Curfew Ordinance and all other noise control restrictions that may be adopted by the City in accordance with applicable law; (b) not to schedule or conduct takeoffs or landings between the Curfew Hours of 11:30 p.m. and 6:30 a.m. (local time), unless such takeoff or landing is allowed under the terms of the Curfew Ordinance; (c) to restrict static jet engine testing between the hours of 11:30 p.m. and 6:30 a.m. (local time); and (d) to inform its staff of the Curfew Ordinance requirements and to work cooperatively with Airport staff for timely submission of flight schedule changes and Curfew reporting documents. Violations of the Curfew Ordinance will continue to be subject to fines under the terms of the Curfew Ordinance, but will not constitute a default of the Agreement.

In addition, the Signatory Airlines will voluntarily agree to schedule and conduct all takeoffs and landings at the Airport between 6:30 a.m. and 11:30 p.m. (local time), regardless of whether the takeoff or landing would otherwise be permitted under the provisions of the Curfew Ordinance. In recognition that this last provision is a voluntary commitment by the Signatory Airlines above and beyond the mandatory provisions of the Curfew Ordinance, a Signatory Airline's failure to schedule its otherwise permitted operations outside the Curfew Hours shall not constitute either an event of default or a violation of the Curfew Ordinance.

Municipally-Funded Air Service Incentive Program

After any year during the Term of the Agreement in which the percentage growth in annual enplanements at the Airport exceeds the growth in annual enplanements nationwide, the City will credit back to the Signatory Airlines a corresponding percentage decrease in the amount of City indirect overhead expenses allocated to the Airport's operating budget for the next succeeding year. For example, if in a given year the rate of growth in annual enplanements at the Airport (say, 6%) exceeds the national growth rate (4%) by two percentage points, the City will reduce the percentage share of total City indirect overhead expenses allocated to the Airport (say, 22%) for the next year by two percentage points (to 20%). Each percentage point in overhead expense reduction is estimated at \$250,000. The Agreement will cap the City indirect operating overhead rate at 25% and will set a corresponding floor at 15%. In addition, the Agreement will provide an appropriate period of time for the City to credit any funds due to the Airlines. The Agreement also provides for a reassessment of this incentive calculation following the increase in the number of gates at the Airport (i.e., Phase II of the Airport Master Plan Program).

Other Selected Provisions

Annual operating budget review process: No later than 60 days before the end of each fiscal year, the City shall notify the Signatory Airlines of the proposed rates and charges for the next fiscal year. No later than 30 days after the forwarding of the budget information, the City agrees to meet with the Signatory Airlines to discuss the proposed rates and charges.

Annual settlement provision: The City shall use reasonable efforts to complete within 120 days after the end of a fiscal year the audit of its financial data, so that the City can recalculate rates and charges for the Signatory Airlines based on the City's actual expenses.

Other rate adjustments: Landing fees, terminal rents and other charges may be changed at any other time when, based upon the City's actual expenses and the actual levels of activity at the Airport, the City reasonably estimates that the rates will deviate by more than 10% from the landing fees, terminal rents or other charges projected for the fiscal year. Landing fees, terminal rents and other charges may also be adjusted whenever required by the terms and provisions of the Bond Trust Agreement.

Terminal A+

Pursuant to a Ground Lease effective October 1, 1990, American Airlines constructed the terminal facility at the north end of Terminal A, commonly known as Terminal A+. The Ground Lease expires on November 30, 2007. The expiration date of this Lease will remain unchanged by the execution of the Agreement and the early termination of the Scheduled Airline Agreement. As of December 1, 2007, ownership of Terminal A+ will revert to the City. At that time, all airlines operating in Terminal A+ will be responsible for paying rates and charges in accordance with the Agreement.

B. Ordinance Establishing Minimum Requirements for Airport Operation and Use

In the event that a passenger or cargo airline operates at the Airport without signing either a Signatory or Non-Signatory Agreement, the proposed ordinance would establish minimum requirements for the operation at and use of the Airport by any such airline on or after July 1, 2007. The proposed ordinance establishes airfield and terminal rates and charges for such airlines at a 30% premium over the rates and charges for a Signatory Airline. In addition, the proposed ordinance requires any such airline to comply with all applicable rules and regulations as established by the Director of Aviation.

C. Living Wage Policy

On November 17, 1998, by Resolution No. 68554, and amended on June 8, 1999 by Resolution No. 68900, City Council adopted its Living Wage Policy to meet the employment and economic development needs of low wage workers by mandating:

1. A minimum level of compensation for workers employed by contractors and subcontractors who are awarded certain City of San José service and labor contracts with an expenditure in excess of \$20,000, and recipients of direct monetary financial assistance from the City in the amount of \$100,000 or more in any twelve month period, excluding any non profit corporation;
2. The provision of basic health insurance benefits or the ability to afford basic health insurance;
3. Retention of employees when certain new contractors take over a continuing City service;
4. An environment of labor peace on certain new contractors; and
5. Employee Work Environment Evaluation (Third Tier Review) on all proposals.

In general, the Living Wage Policy applies to any service or labor contract that provides for the furnishing of services or labor to the City and to any amendment or extension of a service or labor contract that modifies the provisions of the contract. Accordingly, the Living Wage Policy has been applied at the Airport to food and beverage concession agreements, retail concession agreements and shuttle bus management and operations agreements.

The Living Wage Policy provides exemptions for certain City contracts. The City has not applied the Living Wage Policy to the passenger and cargo airlines operating at the Airport, pursuant to the exception in the Policy for contracts that involve programs that do not provide direct services to the City but have a contract to provide services to the residents of the City.

POLICY ALTERNATIVES

Alternative #: Establish Airport rates and charges by ordinance.

Pros: This alternative eliminates need for an airline-airport lease and operating agreement.

Cons: An airline lease would still be required to document exclusive use space. In addition, it does not address the airlines' interest in having a voice in Airport planning and operations.

Reason for not recommending: In the interest of establishing and maintaining a partnership between the City and the airlines operating at the Airport, approval of the Agreement is recommended.

PUBLIC OUTREACH/INTEREST

- Criteria 1:** Requires Council action on the use of public funds equal to \$1 million or greater. **(Required: Website Posting)**
- Criteria 2:** Adoption of a new or revised policy that may have implications for public health, safety, quality of life, or financial/economic vitality of the City. **(Required: E-mail and Website Posting)**
- Criteria 3:** Consideration of proposed changes to service delivery, programs, staffing that may have impacts to community services and have been identified by staff, Council or a Community group that requires special outreach). **(Required: E-mail, Website Posting, Community Meetings, Notice in appropriate newspapers)**

This item does not meet the above criteria requiring additional notification; however, staff has coordinated preparation of the Agreement with an airline negotiation subcommittee that was selected by the AAAC. The final draft of the Agreement was provided to the full committee on February 6, 2007 and discussed at the AAAC meeting held on February 14, 2007.

COORDINATION

This agreement has been coordinated with the Finance Department/Risk Management and the City Attorney's Office.

FISCAL/POLICY ALIGNMENT

The Agreement is consistent with the Economic Development Strategy adopted by Council in November 2003 and aligns most significantly with Strategic Initiative #1: Build a World-Class Airport and Air Services.

HONORABLE MAYOR AND CITY COUNCIL

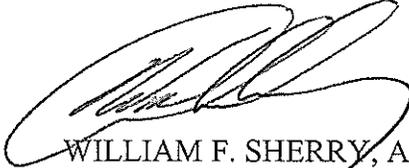
02-21-07

Subject: Approval of the Signatory Airline-Airport Lease and Operating Agreement between the City and All Airlines Operating at the Airport

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CEQA

CEQA: Resolutions No. 67380 and 71451, PP 07.

A handwritten signature in black ink, appearing to read 'W. Sherry', is written over the printed name and title.

WILLIAM F. SHERRY, A.A.E.
Director of Aviation

For questions, please contact William Sherry, Director of Aviation, at (408) 501-7669.