COUNCIL AGENDA: **1/24/23**
FILE: **23-058**
ITEM: **2.7**

CITY OF SAN JOSE
CAPITAL OF SILICON VALLEY

Memorandum

TO: HONORABLE MAYOR AND CITY COUNCIL

FROM: John Aitken
Jim Shannon

SUBJECT: **HEWLETT PACKARD GROUND LEASE TERMINATION**

DATE: January 3, 2022

Approved

Date 1/12/23

RECOMMENDATION

1) Adopt a resolution authorizing the City Manager or designee to negotiate and execute a Third Amendment to the Ground Lease of Parcel W-9 Agreement with Hewlett Packard Enterprise Company to terminate the agreement early, effective upon execution by the City with a payment to Hewlett Packard Enterprise Company of $2,200,000;

2) Adopt the following 2022-2023 Appropriation Ordinance amendments in the Airport Renewal and Replacement Fund:
    a. Increase the Hewlett Packard Incorporated Lease Buyout appropriation to the Airport Department by $700,000; and
    b. Decrease the Ending Fund Balance by $700,000.

OUTCOME

Should City Council approve the recommended actions, the City Manager or designee will finalize an amendment to terminate the Ground Lease of Parcel W-9 Agreement (Agreement) and the City will pay Hewlett Packard Enterprise Company (H.P.E.) $2,200,000 for the leasehold improvements and buy-out the remaining approximate six years of the lease. This action allows the City to issue a Request for Proposals (RFP) for new corporate aviation or Specialized Aviation Service Operation service tenants with a more advantageous rent structure than the existing Agreement provides. The City will negotiate a contract with a current subtenant, Hewlett Packard Company (H.P.I.), for the term of the sublease, which expires in October 2023.

BACKGROUND

Hewlett Packard has operated a corporate aviation operation at the airport since 1973. On May 29, 1986, the City and H.P.E. entered into a ground lease agreement for 7.08 acres on the airport property to build and operate a corporate aviation operation on the west side of the airport.

H.P.E. and its subtenant H.P.I. occupy a facility that is comprised of 56,804 square feet of hangar and office space, associated ramp for aircraft operations, and 112 automobile parking spaces which H.P.E. built in 1986. The current use of the facility is limited to corporate aviation operation. H.P.E. spent just over $9.6 million in capital improvements on the site since 1986 and the current lease has approximately six years left before it terminates. Based on the terms of the Agreement, the leasehold improvements revert to the City at the end of the lease term, which is November 2028.

In December 2020, H.P.E. announced plans to relocate its corporate headquarters from San José, California to Houston, Texas. H.P.E. then contacted the City to discuss the possibility of the City buying out H.P.E. from the remainder of the lease or marketing the lease to another party. City staff recommends buying out the remainder of the lease now, as current corporate aviation lease market trends indicate a favorable return on investment during the remaining term of the lease. Airport staff would conduct an RFP to find a new corporate lease tenant or Specialized Aviation Service Operation to lease the site with a rent structure that includes the ground rent as well as rent for the hangar and office space.

At its meeting on April 26, 2022, the City Council approved an appropriation in the amount of $1.5 million in the Airport Renewal and Replacement Fund for the buyout of the remaining term of the H.P.E. lease. Since that time, through market research, it has been determined that the market value of the premises is estimated to be considerably higher than originally valued. Additionally, the Airport secured more favorable surrender terms in that it is no longer required to keep the current H.P.E. subtenant. These conditions have a considerable positive impact on the marketability and value of the premises. For those reasons, H.P.E and the City re-entered negotiations to make the purchase more equitable to both parties and settled on a final leasehold purchase value of $2.2 million, or $700,000 more than the originally requested amount of $1.5 million.

ANALYSIS

Under the current lease, H.P.E. is allowed to assign or sell its ground lease to another party and the new entity would continue making payments to the City in accordance with the lease terms. In the proposed deal, H.P.E would turn over the hangar to the City and H.P.E. would not have any input on the selection of the new tenant. The relocation of its corporate headquarters prompted H.P.E. to inform City staff that H.P.E. intended to market the lease opportunity to other potential corporate tenants, but it also provided an opportunity for the City to negotiate a buy-out of the remaining leasehold including improvements.

Staff believes the buyout of the leasehold improvements would be beneficial to the City as the Airport could market the ground lease and improvements for greater revenue than the current ground rent. The current annual ground rent to the City is approximately $900,000 and staff estimates that marketing the lease opportunity through an RFP could result in an overall annual rent of approximately $1.7 million.

H.P.E. requested that the City allow its current subtenant, H.P.I., to stay for the term of the current sublease, which expires in October 2023 and generates revenue of $546,949 annually. Upon termination of the H.P.E. agreement, the City will enter into a new lease with H.P.I. with an expiration date of October 2023. The Airport will provide some maintenance of the facility until a new master tenant lease is executed.

CONCLUSION

By the City buying out the remaining leasehold interest including improvements, alterations, betterments, structures, construction additions, and fixtures and allowing H.P.E. to terminate the Agreement, it permits the Airport to provide opportunities for new aviation operations, with the potential to generate added revenue for the Airport.

EVALUATION AND FOLLOW-UP

The Director of Aviation shall be responsible for coordination of the Third Amendment to the Agreement and shall render overall supervision for development of an RFP for a new aviation tenant. The Director will keep City Council apprised of progress and performance and will return to City Council with a recommendation for award of the new tenant.

CLIMATE SMART SAN JOSE

The recommendation in this memorandum has no effect on Climate Smart San José energy, water, or mobility goals.

POLICY ALTERNATIVES

Alternative #1: The City Council may choose to reject the Third Amendment to the Agreement to terminate the H.P.E. lease and buy-out of the leasehold interest for $2.2 million.

Pros: The tenant, or an assigned tenant, will continue to be financially responsible for the maintenance, upkeep, and lease of premises until the end of the term resulting in approximately $900,000 in revenue per year, $5.4 million over the remaining term.

Cons: The Airport would forgo potential additional annual revenue of $800,000 and would not be able to select the new tenant who takes over the ground lease for the next five years.

Reason for not recommending: By having the Airport manage the property, the Airport can leverage additional revenue from the developed site and ensure the property use complies with Federal Aviation Administration guidelines as well as current goals for general aviation at the

Airport. The City would also be in a position to choose the new tenant using a competitive process. Increased revenue from a new lease of the property is expected to recover of the $2.2 million buy-out cost in under three years.

PUBLIC OUTREACH

This memorandum will be posted on the City Council's Agenda website for the January 24, 2023 City Council meeting.

COORDINATION

This memorandum was coordinated with the City Attorney's Office.

COMMISSION RECOMMENDATION

This item does not have explicit input from the Airport Commission, although commission members are provided with regular updates of airline services and proposed program changes.

FISCAL/POLICY ALIGNMENT

This action aligns with the City's Economic Development Strategy #9 "Keep Developing a Competitive, World Class Airport, and Attract New Air Service."

COST SUMMARY/IMPLICATIONS

This memorandum includes budgetary actions to reallocate $700,000 within the Airport Renewal and Replacement Fund to increase the appropriated amount for the least buyout from $1.5 million to $2.0 million. Buying out the remaining term of the lease initially reduces Airport annual revenue by approximately $353,000 due to H.P.I.'s continued use of the site under a new agreement with annual revenue of approximately $547,000 through October 2023 or until the City awards a new lease to a new master tenant. However, buying out the H.P.E. lease enables the City to conduct an RFP and select other tenants at rates the City identifies, which is expected to increase annual revenue to approximately $1.7 million or an annual increase of approximately $800,000 over the existing agreement terms.

BUDGET REFERENCE

The table below identifies the fund and appropriations to fund the payment recommended as part of this memorandum.

Fund #	Appn #	Appn Name	Total Appn	Rec. Budget Action	Amount For Payment	2022-2023 Adopted Capital Budget Page	Last Budget Action (Date, Ord. No.)
527	8999	Unrestricted Ending Fund Balance	$2,720,169	($700,000)		835	10/18/2022, Ord. No. 30833
527	428B	Hewlett Packard Incorporated Lease Buyout	$1,500,000	$700,000	$2,200,000	N/A	10/18/2022, Ord. No. 30833

CEQA

File No. PP17-003 Not a Project, Agreements/Contracts resulting in no physical changes to the environment.

/s/
JOHN AITKEN, A.A.E.
Director of Aviation

JIM SHANNON
Budget Director

For questions, please contact John Aitken, Director of Aviation, at (408) 392-3610.