

Memorandum

TO: HONORABLE MAYOR
AND CITY COUNCIL

FROM: Joseph Horwedel, Paul Krutko

SUBJECT: SEE BELOW

DATE: June 3, 2008

Approved

Date

6/3/08

COUNCIL DISTRICT: City-Wide

**SUBJECT: SPECIAL TENANT IMPROVEMENT & INDUSTRIAL TOOL
INSTALLATION PROGRAMS**

REASON FOR REPLACEMENT

The purpose of this replacement memo is to provide more detail and clarity regarding the recommended changes in the Special Tenant Improvement Program and Industrial Tool Installation Program. This item was originally scheduled to be presented at the June 10, 2008 Council meeting. The original memorandum was distributed in the June 10, 2008 Early Distribution Packet on May 27, 2008.

RECOMMENDATION

Acceptance of Report on making the Special Tenant Improvement (STI) Industrial Tool Installation (ITI) programs permanent with certain modifications.

OUTCOME

The STI and ITI Programs are highly regarded by businesses and the brokerage community. Institutionalizing the programs align to key initiatives of the Economic Development Strategy by supporting City's business retention and attraction efforts to enhance the revenue base and job creation.

BACKGROUND

Special Tenant Improvement

The City Council initially approved the Special Tenant Improvement (STI) Program for an 18-month period beginning on April 30, 2002. Following this period, the City Council approved three 18-month extensions of the program, first, on October 28, 2003 (amending the program to

HONORABLE MAYOR AND CITY COUNCIL

June 3, 2008

Subject: Special Tenant Improvement & Industrial Tool Installation Program

Page 2 of 6

include vacant office buildings in the Downtown Core) second, on May 17, 2005 and third, October 24, 2006. Council's last approval of the program also included approval of an ordinance extending the suspension on the collection of Building and Structure Construction Taxes through April 30, 2008. Under the sunset provisions of the ordinance the suspension has now expired.

From its inception the STI Program included the suspension of the Building and Structures Tax, utilizing a Coordinated Plan Check Review process, and the deferral of plan check fees until permit issuance. The STI Program was designed to expedite tenant improvements on vacant buildings to make the space ready earlier for more cost effective occupancy. The STI Program provides San Jose with a competitive edge in a real estate market characterized by historic levels of vacancy. As of December 2007, San Jose confronts nearly 14.4 million square feet of vacant space. This total vacant square footage is spread across four primary sectors: R&D at 9.2 million, Office at 3.2 million, Industrial at 1.3 million, and Warehouse at 500 thousand. Vacancy rates for R&D range from 20.0% in South San Jose to 20.5% in North San Jose, west of I-880. Vacancy rates peak at 15.9% for Downtown Office space, 9.3% for Industrial space in North San Jose, and 2.5% for Warehouse space in North San Jose (Exhibit A).

Since its initiation approximately six years ago, the STI Program has been highly successful and visible. The STI program has been an effective tool to provide services to the business and development community. A total of 9.1 million square feet of space has been permitted since the inception of the STI Program. An estimated 14,700 jobs have been added or retained in the local economy since the STI Program's inception. The net cost of the program in terms of jobs has been estimated at \$81 per job (Exhibit B).

Industrial Tool Installation Program

City Council initially approved the Industrial Tool program through the adoption Manager Budget Addendum #22 for fiscal year 2006-2007. The Program was in part a response to concerns from San Jose's corporate clients like Novellus Systems and KLA Tencor regarding the slowness and lack of coordination in the permitting process for complex industrial tool installation projects. City staff responded by researching practices in peer cities and responded with a proposal and subsequent approval of the ITI program. The Industrial Tool program is intended to shorten the tool installation to production cycle through an expedited plan review and inspection process. This is done by a team that includes staff from Building, Fire, and Planning. When a participating company wants to initiate a project, the team meets with the facility's staff to review plans, issue permits and establish an inspection schedule.

Since September 2006, the ITI program has supported projects and systems such as large industrial photovoltaic systems, cell sites and mechanical conditioning systems. In addition to meeting with over a hundred companies, the ITI program issued 132 permits valued at over 21 million dollars of tool and system installations. Many of the participants in the ITI program also participated in the Special Tenant Improvement Program.

The success of the programs indicates that businesses are responding to the incentive program and that it makes a difference in choosing San Jose as a place to do business. The elimination of the STI and ITI program would be counter productive to the City's retention and attraction efforts. Staff strongly recommends making a modified STI program and the ITI program permanent at the end of their last extensions, April 30, 2008 and June 30, 2008, respectively.

June 3, 2008

Subject: Special Tenant Improvement & Industrial Tool Installation Program

Page 3 of 6

While the tax suspension incentive is sunsetted for the STI program, the Coordinated Review process remains available.

ANALYSIS

STI Performance to Date

The historical record of the Special Tenant Improvement (STI) Program is compelling. During the first period the STI Program accrued revenue for the City in excess of the cost of the construction tax suspension. The cost of implementing the initial phase of the STI Program was \$330,000, equivalent to the 1% of valuation charged through the Buildings and Structures Tax. OED reviewed property tax, utility tax and sales tax generated by the companies that used the STI Program in its initial period, and approximately \$389,000 in net new revenue was generated from these companies. The first period demonstrated STI's ability to provide the City with a 18% net revenue gain over the foregone revenue. It is important to note that the net new revenue figures reflect two points in time. STI projects produce revenue on an ongoing basis.

The second period of the STI Program included an extension of incentives for Downtown Core office space. This programmatic change reflected STI's ability to address significant challenges in 2004 when several large tenants relocated out of Downtown for lower lease rates and free parking elsewhere. The results of the second period were strong, 70,600 square feet of permitted space and generated approximately 211 jobs Downtown. Again, the STI Program proved to be a net gain for City revenues. Overall the second period cost \$440,000 for implementation, or 1% of valuation charged through the Buildings and Structures Tax. However the STI Program generated a substantial \$511,000 in additional net new revenues, a 16% net increase over the foregone revenue for the same period.

The third period of the STI Program resulted in roughly 2 million square feet of permitted space and generated approximately 3,000 jobs. In this period, the STI Program resulted in a net loss of \$370,000 in revenue. It is important to note that many of the projects that occurred in the third period have only realized one years worth of tax data. Over time we expect some of the participating firms like Hitachi and Qualcomm to generate significantly more revenue on an ongoing basis for the City.

San Jose's vacancy rates for R&D space remained at high levels as the STI program was renewed for a third time. The fourth period of the STI program generated significant highlights. Forty-One (41) companies, several with multiple phases and projects, utilized the STI Program. Approximately 5,000 jobs were created and/or retained, with a sector breakout as follows: 74% R&D/manufacturing/labs, 2% Warehouse and 24% Downtown offices. Finally, the construction valuation of the tenant improvements permitted in the fourth period rose to \$97.3 million from \$59 million during the previous timeframe: the \$38.3 million increase includes \$29 million for downtown projects. The cost of implementing the fourth phase of the STI Program was \$973,000, equivalent to the 1% of valuation charged through the Buildings and Structures Tax.

ITI Performance to date

The ITI program expanded to include industrial support projects and systems such as large industrial photovoltaic systems, cell sites and mechanical conditioning systems. The ITI program issued 132 permits for over 21 million dollars of tool and system installations. The ITI program

facilitated tool installation with several companies including Hitachi, NanoSolar, Solo Power, eBay and others.

The administration is recommending the removal of the \$1,500 administrative fee associated with the ITI Program to be approved through Council's annual adoption of the Building and Structure Fee Permits Schedule. The expedited review process associated with the ITI program charges 1.5 times the current hourly plan review rate. The expedited fee negates the necessity of charging the annual administrative fee.

Impacts to City Transportation Programs

The reduction in revenue that has resulted from the B&S tax suspension element of the STI program has had a direct impact to the funding capacity of the City's Traffic Capital Improvement Program. B&S taxes are dedicated for the improvement and rehabilitation of the City's arterial street system. Typical expenditures include traffic signal improvements, arterial street enhancements, bridge rehabilitation and City local matching funds for regional highway project grants. The Administration is now recommending that the permanent program no longer include a construction tax suspension. This modification should result in a revenue increase for the City's Traffic Capital Improvement Program. No Council action is necessary because the suspension has already expired as of April 30, 2008.

City Economic Development Benefits

The STI and ITI programs continue to help the City remain aggressive in its bid to keep companies in San Jose. The programs enable San Jose to capture a significant amount of new leased space and is a critical component of the City's business retention strategy. In summary,

- STI users continue to praise the Program
- Developers such as Equity Office Partners, Legacy, Orchard and Mission West cite its value when deciding whether to do business in San Jose or another City
- The number of projects continues to rise during each period. Customer satisfaction is high
- The actual number of jobs created or retained is approaching 15,000. This number has a multiplier effect, contributing to the economic success of other San Jose businesses, retail, education and cultural venues as well as strengthening the San Jose quality of life

Summary of changes

The following is a summary of the changes to the programs:

Summary of Program Changes

	Existing	Proposed
STI Program		
- Suspension of Building & Structures Construction Tax	Yes	No
- Coordinated Plan Check Review	Yes	Yes
- Plan Check Fee Deferral until permit issuance	Yes	Yes
ITI Program		
- Plan Check Fee Deferral until permit issuance	Yes	Yes
- Industrial Tool Installation Program Annual Registration Fee	Yes	No

June 3, 2008

Subject: Special Tenant Improvement & Industrial Tool Installation Program

Page 5 of 6

EVALUATION AND FOLLOW-UP

Staff recommends returning to council with an information memorandum in one year with an update on activity from the last year.

POLICY ALTERNATIVES

The Special Tenant Improvement Program has been in effect since 2002 and has had a demonstrated effect on reducing Industrial and Downtown Office vacant space in San Jose. The success of the STI program as commented by many participating companies has focused on the expedited review process.

Alternative #1: The STI Program could continue to offer the 1% Building & Structures Construction Tax suspension.

Pros: The positive aspect of keeping the tax incentive is that it does offer San Jose a competitive advantage over other jurisdictions.

Cons: Continuing the 1% Building & Structures Construction tax incentive continues to divert tax revenue used by the Transportation Department for traffic signal improvements, arterial street enhancements and bridge rehabilitation.

Reason for not recommending: Continuing the incentive would not be in line with City Council direction to address maintenance and rehabilitation of the City's transportation infrastructure.

Alternative #2: The STI Program could continue to provide a 1% tax incentive through the General Fund instead of the Building & Structures Construction Tax.

Pros: The positive aspect of keeping a tax incentive is that it does offer San Jose a competitive advantage over other jurisdictions.

Cons: The impact on the general fund revenues is immediate whereas as general fund revenues resulting from the project will come in over time.

Reason for not recommending: Funding the incentive through the General Fund could ultimately result in a loss of General Fund revenue. Because of the time value of money, the incentive would be given first, and over time, on going revenues will be generated by the project, however when future revenues are adjusted for inflation they could be lower than the original incentive provided.

PUBLIC OUTREACH/INTEREST

Criterion 1: Requires Council action on the use of public funds equal to \$1 million or greater.

(Required: Website Posting)

✓ **Criterion 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)**

Criterion 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

June 3, 2008

Subject: Special Tenant Improvement & Industrial Tool Installation Program

Page 6 of 6

a Community group that requires special outreach. **(Required: E-mail, Website Posting, Community Meetings, Notice in appropriate newspapers)**

COORDINATION

This memorandum has been coordinated with the City Attorney's Office, the City Manager's Budget Office, Department of Transportation, Planning, Building & Code Enforcement and the Redevelopment Agency.

FISCAL/POLICY ALIGNMENT

The activities of the STI and ITI program align with Strategic Initiative #5 "Support the Start-Up and Growth of Local Businesses, in Tech as well as Non-Tech Fields" and Initiative #6 "Improve Speed and Predictability of Development Review Process, and Reduce Costs of Operating in San Jose" to support the vision of an Entrepreneurial Environment.

COST SUMMARY/IMPLICATIONS

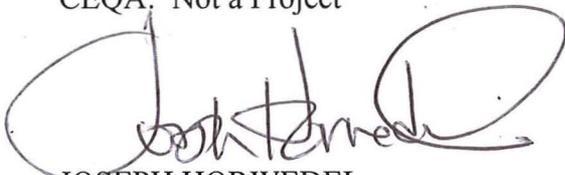
Exhibit B provides a breakdown of the costs and performance of the STI Program beginning April 2002. The foregone revenue in the fourth period is estimated in the amount of \$973,000 are funds dedicated to the City's Traffic Capital Improvement Program and used for transportation system improvements and rehabilitation. The net gain of additional revenues stimulated by the STI Program constitute monies that go directly to the City's General Fund.

The Business & Structures Construction tax suspension expired as of April 30, 2008.

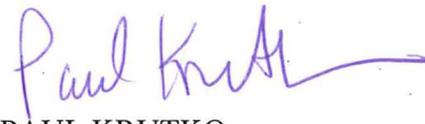
Both the STI and ITI Program will continue to allow plan check fees to be deferred until the time of building permit issuance for projects that meet the eligibility requirements. If a permit is not taken out by a customer benefiting from this program, plan check fees will be due no later than twelve (12) months from the application for the plan check service.

CEQA

CEQA: Not a Project



JOSEPH HORWEDEL
Director, Planning Building & Code Enforcement

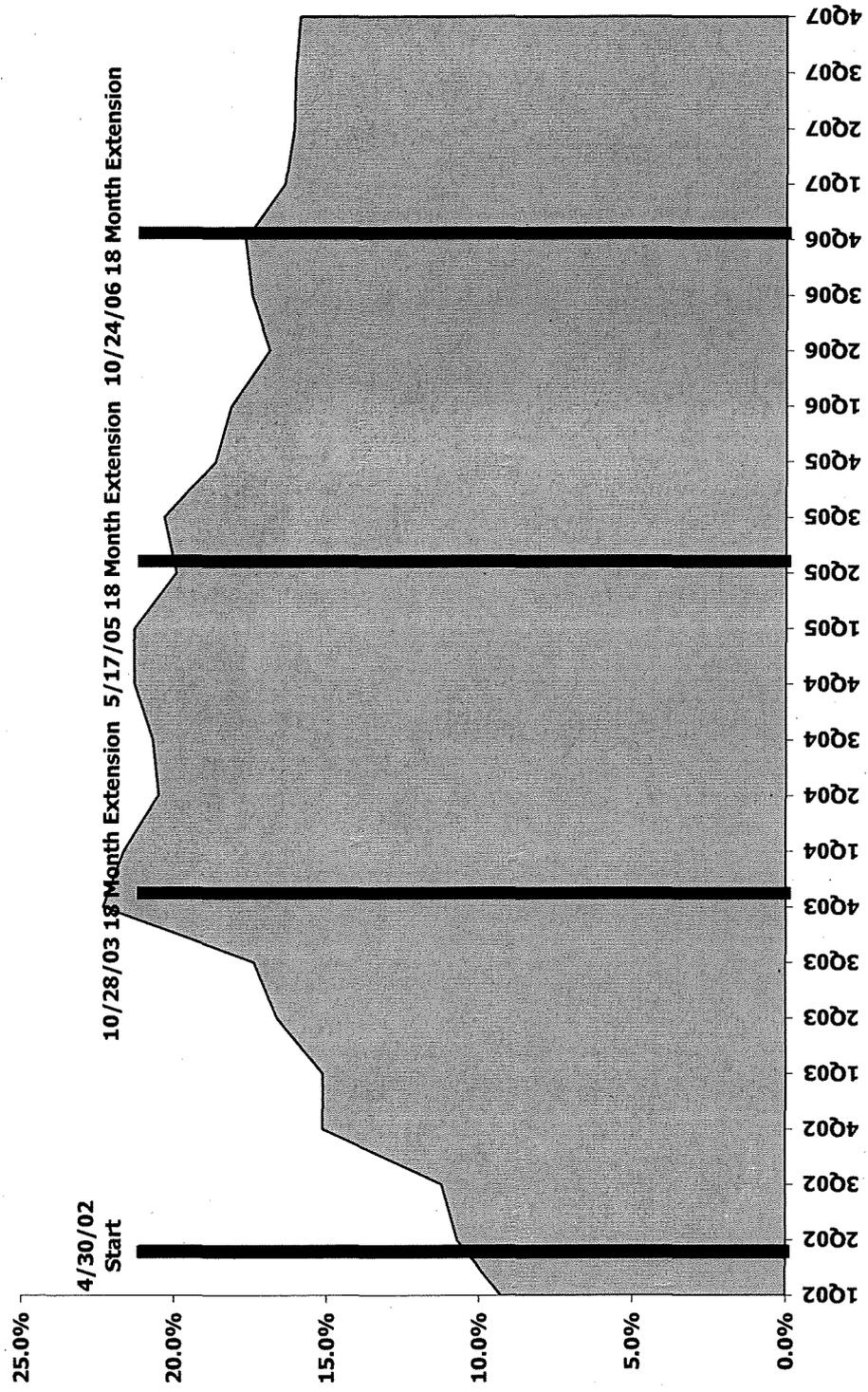


PAUL KRUTKO
Chief Development Officer

For questions please contact John Lang, Economic Development, at 408-535-8178.

Exhibit A
Vacancy Rates

San Jose Vacancy Rates for R&D Space



Absorption Rates

1/4 of Silicon Valley's Gross Absorption has been in San Jose

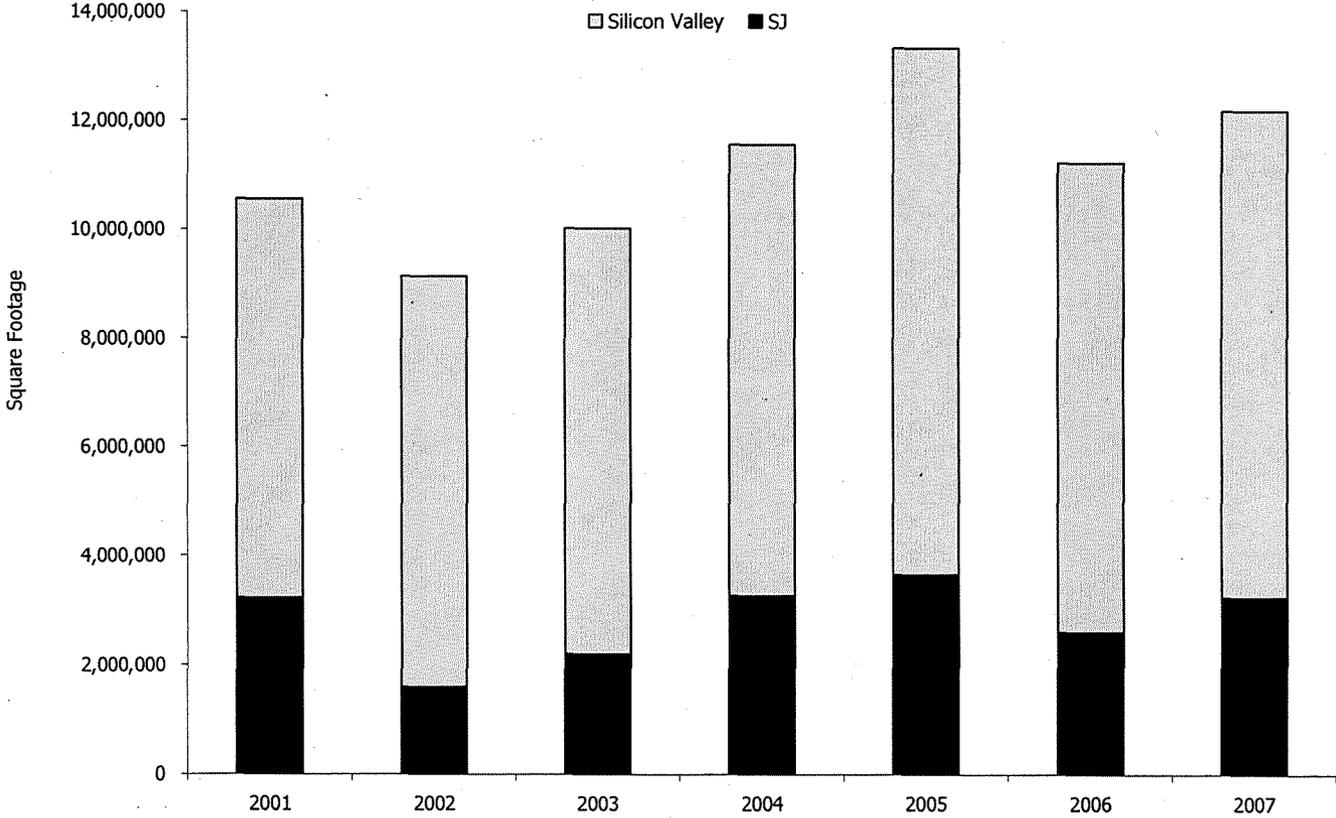


Exhibit B

Phase	Area	Timeframe	Projects	Sqft Generated	Jobs	Construction Value	Net New Tax Revenue ¹	Tax Suspension
1	Industrial	4/02-10/03	30	1,500,000	2,800	\$33,000,000	\$388,903	\$330,000
2	Industrial	10/03-4/05	44	2,529,400	3,689	\$42,700,000	\$499,096	\$427,000
2	Downtown	10/03-4/05	3	70,600	211	\$1,300,000	\$11,951	\$13,000
<i>Phase #2 Subtotal</i>			47	2,600,000	3,900	\$44,000,000	\$511,047	\$440,000
3	Industrial	5/05-10/06	51	1,960,000	2,975	\$58,300,000	\$221,844	\$583,000
3	Downtown	5/05-10/06	2	20,000	70	\$1,000,000	\$0	\$10,000
<i>Phase #3 Subtotal</i>			53	1,980,000	3,045	\$59,300,000	\$221,844	\$593,000
4	Industrial	11/06-12/07	47	2,730,000	3,800	\$75,400,000	\$10,000*	\$754,000
4	Downtown	11/06-12/07	6	361,000	1,200	\$21,900,000	\$*	\$219,000
<i>Phase #4 Subtotal</i>			53	3,091,000	5,024	\$97,300,000		\$973,000
Program Total			183	9,171,000	14,749	233,600,000	\$1,131,794*	\$2,336,000

Only four projects in phase four have recorded tax revenue, there are over 49 projects not accounted for.

¹ Revenue does not align with historical reports because revenue figures were updated to current year 2007.

Average cost to the City of each additional job is \$81

Over \$90,000 in revenue is related to RDA tax increment