COUNCIL AGENDA: 05-15-12
ITEM: 4.2

CITY OF
SAN JOSE
CAPITAL OF SILICON VALLEY

Memorandum

TO: HONORABLE MAYOR AND CITY COUNCIL

FROM: Joseph Horwedel
Kim Walesh

SUBJECT: **DOWNTOWN HIGH RISE INCENTIVES**

DATE: April 23, 2012

Approved

Date 5/3/12

RECOMMENDATION

Accept staff's recommended set of incentives to encourage high rise office and residential tower construction in the next two years including:

a) Direct the City Attorney to draft an ordinance to delete from the Municipal Code the requirements for breathing air tank replenishment systems.

b) Approve staff's proposed schedule of expedited processing of high rise development citywide.

OUTCOME

Approval of the proposed set of incentives will help accelerate investment in new high rise development citywide and particularly downtown.

BACKGROUND

In March 2011, the Mayor's Budget message directed staff to review costs assigned to private development, and develop a structure that makes San José more competitive with surrounding communities. Staff returned with a number of measures focused on office leasing and new development in North San José, which was approved by the Council on January 31, 2012. At that meeting the Council directed staff to return with incentives for high rise development downtown, modifying a proposal by staff to encourage high rise residential development citywide.

While we are seeing increasing activity in different parts of the local economy, one key area has not rebounded: high rise construction. This is due to many factors, such as increased construction costs for this type of construction vs. wood and tilt up construction, the greater market risks caused by the difficulty to phase high rise buildings, and market acceptance. The

City can help reduce some of these obstacles by processing projects to shorten timelines and through controlling requirements that add costs to projects.
What is an incentive for one project or development type might have little to no benefit for other projects. Staff has assembled a set of items that we believe collectively can help move high rise projects forward. Many of these overlap with ideas that came from developers with whom staff have met over the past three months as well as ideas from Councilmember Liccardo. Not all ideas proposed through the consultation process have been incorporated into the staff recommendation due to their cost, although several are included in the Policy Alternatives section for consideration by the Council and community.

ANALYSIS

The incentive package proposed by staff includes three elements where, with minimal cost, the City could provide incentives to the desirable high rise office and residential development types. The memo addresses a third incentive that could be provided, but with substantial costs to the City from fee reductions or deferrals.

Clearly the City has fewer resources and tools available today with the elimination of the Redevelopment Agency. The ability to subsidize projects with tax increment funds no longer exists, so financial incentives have General Fund implications. This is compounded in areas of the City like Downtown, where property revenues are collected as tax increment and are not available for potential rebates to project developers. Since any financial incentive has General Fund linkages, one consideration should be return on the incentive to the General Fund. Another consideration is whether an incentive should be granted to a project that negates previous Redevelopment Agency investment in buildings, such as those that house long-time anchor cultural venues in the SoFA Creative District.

For the purposes of incentives, staff is using a local definition of high rise building: 150 feet in height or taller vs. the Building Code definition of 75 feet. The 150 foot number has been used by the City for years to designate buildings appropriate for incentives and achieving our development goals.

Expedited Review: Staff, during the meetings on North San José and Downtown with property owner and developers, put forward an expedited service delivery for high rise development projects. Staff would guarantee all high rise development an expedited processing schedule through the Planning entitlement stage, and also set a schedule for staff review for the plan check process at the Building Permit stage. This review would utilize the new staff capacity approved in January (currently being filled) in order to minimize delays to other projects moving through the process. This would be a citywide incentive for all types of high rise buildings.

Elimination of Requirement: Staff has been reviewing city-specific requirements that add costs beyond state requirements. The Council has already endorsed this review of rules that apply only to San José and reduce our economic competitiveness where the rationale for the rule no longer is relevant. One such example is a local amendment to the State Fire Code that requires the inclusion of a breathing air replenishment system in high rise buildings. Staff proposes to eliminate the requirement because they have determined that it is not cost effective based on the level of expense versus the limited benefit of its use by the Fire Department during a major fire in a high rise. The current enhanced elevator design requirements would remain following this change. This would be a citywide change.

The current Inclusionary Housing Policy that applies to redevelopment project areas provides incentives for downtown projects and high rise projects. The Policy exempts projects in three downtown project areas – Park Center Plaza, San Antonio Plaza, and Pueblo Uno – from any affordability requirements. Additionally, there is an Inclusionary in-lieu fee discount of 50% ($8.50 per net square foot of market-rate residential with a maximum of $65,000 per unit) for high rise for-sale projects of at least 10 stories within an expanded downtown core area. Both the City's Inclusionary Housing Policy and the upcoming Citywide Inclusionary Housing Ordinance exempt rental projects from inclusionary requirements following the California's appellate court's *Palmer* decision. The Council can, however, negotiate an affordability component if developers seek concessions from the City.

Fee Reduction: Staff has completed the yearly land value review for the Parkland Dedication and Parkland In-lieu Ordinances (PDO/PIO) and has identified the ability to lower the parkland fee in Downtown San José for new residential projects. The City has already set the incentive fee for Downtown high rises at 50% of the normal rate and has allowed for projects to pay the fees at certificate of occupancy rather than at the building permit stage. As of the drafting of this memo, staff has agendized an update of the parkland in-lieu fees citywide for the May 8, 2012 City Council meeting. This update, if approved, would lower the fee from $8,950 to $7,650 per unit. This would be a downtown area incentive, resulting in a cost savings of $130,000 for every 100 units in a high rise development. It is important to note, however, since the Downtown High Rise fees will now be tracking at 50% of the normal rate as opposed to a flat $8,950 fee, that the fees could increase in future years as the land value in the Downtown increases from its current rate.

Tax Reduction: Staff considered suspending or reducing the various construction related taxes that are collected at the Building Permit stage as a means to lower costs. Based on several past projects downtown, staff estimated that the average tax for a high rise residential tower has been approximately $4,000 per unit. Assuming a goal of three residential towers, each containing from 200 to 350 units, elimination of the taxes would cost the City and benefit the development approximately $3,000,000 for 750 units. One idea suggested was a 50% reduction in the amount of the construction related taxes. Based on these previous projects, this incentive would be worth approximately $1,500,000.

The construction related taxes which were considered (Building and Structure Construction Tax and Construction Excise Tax) are the City's primary source of funding to address the operations, maintenance and improvement of San José's transportation system. A significant use of the City's revenues are to provide local matching funds to leverage grants from regional, state, and federal sources.

As reported to the City Council on April 24, 2012, the City has a significant backlog of transportation infrastructure maintenance needs totaling $444 million, including $293 million for deferred pavement maintenance and $63 million for ADA curb ramps. Other additional needs include enhancements to the transportation system to improve safety and facilitate sustainability goals such as low energy streetlighting, attractive streetscapes, and increased travel by walking and bicycling.

With the loss of redevelopment revenues, the City's transportation development taxes are also now being used to help address environmental mitigation requirements and other legal commitments for transportation improvements included in adopted development plans for the North San José, Downtown and Edenvale areas. The estimated local funding responsibility for these improvements exceeds $100 million.

Due to the challenges with funding transportation-related improvements in Downtown especially in light of the elimination of the Redevelopment Agency, which has in the past funded some of the CEQA-related improvements, staff did not include the tax suspension in this incentive package. As mentioned previously, the impact to the Traffic Capital Program from a 50% reduction to the construction related taxes would be approximately $1.5 million ($900,000 in the Construction Excise Tax Fund, $600,000 in the Building and Structure Construction Tax Fund).

One critical Downtown transportation project in the Traffic Capital Program is the Autumn Street extension that has a total cost of $22 million, with only $9.5 million funded in the 2013-2017 Proposed CIP. The funding shortfall results in a potential fiscal liability for the City or future Downtown development projects. Another example is the $11 million payment requirement to the County of Santa Clara as part of the North San José litigation settlement. It was originally anticipated that this payment would be made by the San Jose Redevelopment Agency, however due to the dissolution of the Agency, this requirement has fallen to the City. The 2013-2017 Proposed CIP includes $6 million for this payment, however the remaining $5 million is unfunded at this time.

Another example of the challenges facing the Traffic Capital Program is the pavement maintenance program. This program has an annual need of $100 million to achieve an overall "good" street rating (70 PCI rating). The 2013-2017 Proposed CIP includes an average allocation of $20.3 million for this purpose, which lead to a recommended deferral of pavement maintenance on local/neighborhood roads and major roads not within the "Priority Street Network." Until alternative means of funding can be identified, the overall condition of the City's roads will continue to deteriorate. It should be noted that City Council recently gave approval for staff to move forward on measuring community support for a general obligation bond measure to assist with the funding shortfall. The construction related taxes also support the General Fund. For example, in 2011-2012 $3.5 million ($2.0 million ongoing) was transferred from the Construction Excise Tax Fund to the General Fund as part of a budget balancing strategy.

A 50% suspension for two years is presented below as a Policy Alternative so that the City Council can discuss the policy choice and financial consequences to the Traffic Capital Program and General Fund.

The City already offers a full exemption from the Building and Structures and the Commercial – Residential – Mobilehome Park Building Taxes for all new construction in three redevelopment project areas: Park Center, San Antonio and Pueblo Uno. This exemption will benefit several of the housing towers being discussed with staff. The City has previously approved suspensions for high rise residential development in the downtown.

EVALUATION AND FOLLOW-UP

Staff will track the progress of projects utilizing the incentives and return to the City Council in six months to assess whether the high rise incentives should be broadened citywide. Staff will track the on-going use of the time-based incentives and report as appropriate to the Community and Economic Development Committee.

POLICY ALTERNATIVES

Alternative #1: Approval of a 50% reduction in construction related taxes for up to 500 units of high rise projects Downtown that break ground by the end of 2014.

Pros: A reduction of taxes of 50% could reduce costs for an individual high rise project approximately $2,000 per unit and reduce the upfront costs that developers are required to fund. This helps reduce the costs of projects and for projects on the verge of economic feasibility, the City could see high rise construction occur in this economic cycle, add to residents and workers downtown supporting Downtown businesses. The limitation on number of units and time frame would put a time incentive for developers to act quick or risk losing the incentive to another developer.

Cons: A reduction in construction related taxes would reduce revenues to the City to fund Downtown needed transportation improvements as well as the Traffic Capital Program as described in detail above (loss of approximately $1.5 million annually). The Downtown improvements, while overridden in the Downtown Strategy Plan EIR for individual projects, will at some point become a potential issue for next phases and may require a future impact fee for Downtown developers to pay for their fair share of improvements. Staff is beginning a review of the specific transportation improvements from the EIR and the number of improvements already built or funded to better understand longer term consequences.

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

While this action does not meet any of the above Criteria, staff has met on several occasions with the major developers and property owners active in Downtown as a group and individually to solicit ideas on what would encourage high rise development in the near term.

COORDINATION

This Memorandum has been coordinated with the City Attorney's Office, Department of Transportation, Department of Parks, Recreation and Neighborhood Services, Public Works Department, Housing Department, the City Manager's Budget Office and the Successor Agency to the Redevelopment Agency.

FISCAL IMPACT

The staff proposal includes continued deferral of PDO/PIO funds which would delay improvements that would use those funds. The Building and Structures Tax (SJMC 4.46) and the Construction Excise Tax found at SJMC 4.47 (also known as the CRMP Tax) fund the majority of the Traffic Capital Improvement Program as noted above.

CEQA

Not a Project, File No.PP10-067 (Statutory Exemption, Sec. No. 15273), Rates, Tolls, Fares, and Charges.

/s/
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