COUNCIL AGENDA: 11/05/19
ITEM: 4.6

CITY OF
SAN JOSE
CAPITAL OF SILICON VALLEY

Memorandum

TO: HONORABLE MAYOR AND CITY COUNCIL

FROM: Councilmember Raul Peralez

SUBJECT: Downtown High Rise Inclusionary Housing Ordinance

DATE: November 4, 2019

Approved by:

Date: 11/4/19

RECOMMENDATION

1. Accept staff recommendation and direct the City Manager to do one of the following:

   a. Eliminate the exemption for Downtown High Rise developments from the Inclusionary Housing Ordinance and allow the creation of a "soft second" deferral program that permits developers to create a deed of trust for the amount of the fees, which must be paid in full in the event that the project is refinanced or sold to a third party, ***or***,

   b. Modify the Inclusionary Housing Ordinance (IHO) fee structure for Downtown High Rises from $0 to a 50% reduction *and* allow a 50% reduction on park fees without allowing a 50% maximum credit, and maintain a 50% reduction on Construction Excise Taxes, ***or***,

   c. Return back to City Council with an alternative fee structure for Downtown High Rises that will produce some form of affordable housing revenue and if needed, adjust other existing fees for project feasibility.

2. Require that another feasibility study per SJMC 14.10 (Private Development Workforce Standards) be conducted no later than June 30, 2022.

BACKGROUND

In an ideal world, new high rise development would be building affordable units directly into their projects as envisioned by our IHO. However, we have set a precedent to allow developers to opt out of building these much-needed units for the sake of project feasibility. While I am optimistic that some of the recommended changes to the IHO program will help incentivize on site construction, I am cognizant of the same reality that staff stated in their IHO Proposed Revisions (Item 4.4) memo: "all but one recent project has selected the in-lieu fee option and this is likely to be the case for nearly all upcoming projects as well."

This ongoing discussion surrounding the cost of development and the feasibility of projects has shed light on the dynamics of building Downtown High Rise projects and whether to build in affordable units, pay the in-lieu fee, or be exempted. For quite some time, we as a City have opted for the latter, carving out Downtown high rises from the equation and while I do not want to halt the momentum of development - the demand for affordable housing needs to remain highly prioritized.

We are seeing more affordable housing projects opening up, largely thanks to the voter-approved $950 million Measure A bond. However, we cannot simply rely on bond measures as the only means to generate these dollars as we have seen recently with Measure V, a $450 million bond that failed to pass. Funding sources for affordable housing must be diverse. We are venturing into exploring a Commercial Linkage Fee for developers that would generate the dollars to balance the potential job growth. Fortunately, this work for market-rate housing development has been long approved: first by implementing the AHIF, then followed by the Inclusionary Housing Ordinance (IHO), deemed lawful by the California Supreme Court. The question then revolves around whether implementation of a partial IHO fee would impact project feasibility. This memorandum is recommending an alternative model to what we have historically done.

ANALYSIS

I recognize the complex nature of developing high rises in Downtown and staff's October 25th report on the Cost of Development reaffirms those complexities. On September 24, our City Council had a spirited debate around incentivizing Downtown High Rise construction through extending the current program of reduced fees. The feasibility study that Strategic Economics conducted for that specific council discussion provided a glimpse in the current economic climate for development and its relation to our city's fees. While the report claims that projects will struggle to pencil without "incentives", the analysis that my office did infers potential flexibility within the fee structure itself that would not substantially impact predicted yield-to-cost ratios.

I understand that full payment of all our city fees could be viewed as quite substantial under unfriendly market conditions. Using the Conceptual High Rise Prototype (the prototype), projects subjected to paying full fees with no incentives would pay a total of $21 million in municipal fees. However, while the majority of this Council may desire to extend the current fee incentives: the fee structure itself is not balanced. Downtown high rises have been long exempted from paying AHIF fees and if using the prototype as an example, that would equate to $8 million of loss affordable housing fees from a project (**Figure 1**). For perspective, since 2016, two high rise projects have commenced construction and while they were rightfully exempted from AHIF, both projects would have generated roughly $13 million for affordable housing (*assuming $18.26 per sq. ft. at an average 800 SF/Unit*).

If we are to work in the best interest of the community, then we should explore restructuring our fees where there would be an equitable share across all the revenue sources. For example, using the assumed fee structure for a conceptual high rise prototype, I modified the requirement for AHIF/IHO to a reduced fee rather than an exemption, a 50% reduction in park fees sans the max credit allowed by building onsite amenities and the existing 50% reduction on construction taxes. Based on the data model that Strategic Economics generated and using the profile of the prototype, there is a **0.03%** difference in the project yield-to-cost ratio compared against the recently council-approved incentives. (**Figure 2**) While the yield is not any closer to a desirable threshold of 5.25%, this is a nominal delta resulting with better benefits for the community through a more equal distribution of fees.

DISCUSSION

I do not discount the economic benefits from many of the market-rate high rise projects that have increased vibrancy in Downtown. But I am conscientious of the housing crisis we are in and it is my responsibility as an elected official to consider all potential revenue that could help alleviate this crisis while continuing to fund our other needs.

"Soft Second" Deferral Program

The concept of a "Soft Second" deferral program is not foreign. In the past, the San José Redevelopment Agency had structured similar arrangements to defer fees in order to spur development such as The 88 and 360 Residences. A soft second program would allow the developer to defer their full fees via a deed of trust for a period of time, accounted within the City of San José, and upon selling or refinancing the completed projected, would be required to fully pay those fees. In the event that the economy takes a downturn and the projects are forced to sell with no return, then the fees could then be waived or reduced out of consideration of the financial harm to the investing partners who took a chance developing a high rise in Downtown San José.

This is another creative solution that Council could consider, especially with feedback from developers regarding the burden of upfront costs to break ground and to ultimately make a project pencil out. The City would ultimately get the full fees but at a different point in time. Considering there are high rise projects in Downtown that have quickly changed hands post-construction, there is a strong likelihood the City may receive those fees sooner than expected, especially if it stimulates immediate construction activity.

Parks
As a park advocate, I truly believe that we need to ensure we continue to receive park funds to create and maintain our parks. We are fortunate that three new parks will be coming online in the next several years in the North San Pedro area where it has been long planned: Pellier Park, North San Pedro Park and Bassett Park. While the prospect of three new Downtown parks is exciting, the reality is that with limited site availability, there is low-probability that any further new *traditional* parks will be planned in the Downtown core in the near future.

We need to creatively recalibrate our approach to open spaces, especially within an urban environment. My office has long been working to convert some of our high pedestrian corridors such as San Pedro Square to "urban parks". We recently conducted a pilot this past summer and look forward to exploring more similar opportunities. With this shift in approach, should also come a shift in the way we use our park funding and I am committed to exploring ways to effectively use those funds to facilitate vibrant public life. We can continue to bring in adequate park funding with a balanced fee structure that also allows for affordable housing revenue.

Feasibility Study
The proposed tiered program for high rises IHO would be at a reduced rate until June 30, 2025. Yet, there is no clarity on when another feasibility study under the Private Development Workforce Standards would need to be conducted, especially when market conditions are always in flux. Originally, the AHIF deadline was June 30, 2021 but the majority of the Council chose to extend the date to June 30, 2023. I feel then it is appropriate that by 2022, a thorough and transparent study should be completed to assess whether projects are feasible under current market conditions with incentives while complying with the Private Development Workforce Standards.

CONCLUSION

Thank you staff for all of your hard work on this proposal. Since taking office, the persistent narrative that I continue to hear is that our City fees are a barrier to developers achieving feasibility and breaking ground. However, my responsibility is not only to the developer but as an elected representative, to my community as a whole. Ideally, I hope that the development community will find creative means to building affordable housing on site. However, if that is not the case, then we should at the very least be courageous enough to ask for them to contribute a share into solving our housing crisis.

FIGURE 1: MUNICIPAL FEE ASSUMPTIONS *(PER UNIT)*

Fee Category	Description	Before Incentives	After Incentives	After Modified Incentives
Affordable Housing Impact Fee	AHIF is $18.26 per net residential square foot.	$14,608	Waived	*N/A*
Inclusionary Housing Ordinance	$125,000 per unit or $28 per sq. foot. Following staff's proposed revised IHO rate of $18.26 per square foot, then a 50% would be $9.13 per sq. foot.	N/A	N/A	*$7,304*
Park Fee (net of credits)	Parks fee is $14,600 less an assumed credit of 30%. **This includes not requiring the 50% max park credit.	$10,220	$10,220	*$7,300***
Development Permits	Building Permit Fee and other development permits.	$6,500	$6,500	*$6,500*
Construction Taxes	CRMP and B&S Construction taxes assumed to be $6500 per unit or $3250 with the incentive. Other construction taxes are assumed to be $200 per unit.	$6,700	$3,450	*$3,450*
TOTAL		**$38,028**	**$20,170**	***$24,554***

SOURCE: Strategic Economics (2019) *Financial Feasibility of Downtown High-Rise Projects*

FIGURE 2: CONCEPTUAL HIGH RISE PROTOTYPE

	No Incentives	Current Incentives	D3 Recommendation
REVENUE			
Annual Gross Scheduled Income	$22,770,000	$22,770,000	$22,770,000
Less Vacancy	-$1,138,500	-$1,138,500	-$1,138,500
Less Expenses	-$6,831,000	-$6,831,000	-$6,831,000
Net Operating Income	$14,800,500	$14,800,500	$14,800,500
Capitalized Value	$348,247,059	$348,247,059	$348,247,059
DEVELOPMENT COSTS			
Land and Site Costs	$33,000,000	$33,000,000	$33,000,000
Memo: Land Costs in $ per sf land	$505	$505	$505
Direct Costs			
Building Area	$208,718,110	$208,718,110	$208,718,110
Parking	$33,000,000	$33,000,000	$33,000,000
Subtotal Direct Costs	$241,718,110	$241,718,110	$241,718,110
Indirect Costs			
Soft Costs	$29,006,173	$29,006,173	$29,006,173
Municipal Fees	$20,915,400	$11,093,500	$13,504,700
Financing	$21,259,841	$20,616,630	$20,774,533
Subtotal Indirect Costs	$71,181,414	$60,716,303	$63,285,406
Contingency	$12,085,906	$12,085,906	$12,085,906
Total Development Costs	$357,985,430	$347,520,318	$350,089,422
% Changes from Scenario (1)		**-3%**	**-2%**
FEASIBILITY			
Net Operating Income	$14,800,500	$14,800,500	$14,800,500
Total Development Costs	$357,985,430	$347,520,318	$350,089,422
PROJECT YIELD ON COST *(5.25% for feasibility)*	**4.13%**	**4.26%**	**4.23%**

SOURCE: Strategic Economics (2019) *Financial Feasibility of Downtown High-Rise Projects*