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CITY OF
SAN JOSE
CAPITAL OF SILICON VALLEY

Memorandum

TO: HONORABLE MAYOR AND CITY COUNCIL

FROM: Kim Walesh
Rosalynn Hughey

SUBJECT: SEE BELOW

DATE: April 20, 2018

Approved D. DSyC   Date 4/20/18

SUBJECT: REPORT ON THE COST OF DEVELOPMENT IN SAN JOSE

RECOMMENDATION

Accept staff's report on the Cost of Development in San José.

OUTCOME

The purpose of this memo is to provide background information in advance of the April 23, 2018 City Council Study Session on the Cost of Development in San José. The May 1, 2018 City Council meeting will include a follow-up item from the Study Session to allow Council to hear further from consultants and staff about development feasibility for multi-family residential development. Together, these items are intended to provide City Council with a high level overview of the local real estate market, and the impact of direct City costs on housing development.

Staff will be joined by members of the Urban Land Institute (ULI) for the April 26 Study Session, who will provide a presentation by their staff and members on *Residential and Mixed-Use Real Estate Development Economics in San José*. The presentation will include an overview of how the development community approaches development financing and the impact of different costs, including fees and taxes, on the viability of projects. ULI's presentation will include a prototypical pro forma based on information gathered by their staff and from their membership, including information drawn from actual San José housing developers, lenders, and contractors. Staff will follow this with a presentation on the City of San José's fees and taxes applicable to residential development.

Representatives from Keyser Marston and Associates (KMA) will join City staff for the May 1 City Council meeting to complete the discussion on the Cost of Development in San José and discuss their Conceptual Pro Forma Analysis. KMAs full report on development feasibility is attached to this report.

These presentations are intended to provide the background and context to inform Council discussion and decision-making regarding City policies, fees, and taxes that impact development.

EXECUTIVE SUMMARY

While San José and its surrounding metro area continue to be one of the most robust real estate markets in the nation, the increases in cost associated with new construction and the relative slowing of rents mean that development in most areas of San José is currently unlikely without some extenuating project circumstances (such as long-term land ownership, or self-financed development with expectations of a return over a longer timeframe). Rents in some nearby communities close to major regional employers or key transit facilities are higher and, while their land values are generally also higher, construction costs (which remain the largest share of the total cost of development) are the same regardless of where a project is located. These economic conditions favor development in neighboring cities because projects there will bring higher returns.

While speculative development remains unlikely in many parts of San José at this time, the economy is continuing to expand and create demand for housing. In the current economic climate, it's unlikely that development and land costs will undergo a major reset sufficient enough to begin moving the ratio between cost and return back towards feasible development. As such, for development to become more likely in this economic cycle, returns (revenues from rents or sales) would need to increase to offset rising costs.

City fees and taxes have a real but marginal impact on development feasibility. The per unit breakdown of City fees and taxes in San José for higher-density mixed use residential product has risen significantly over the past five years, and is currently between $39,853 and $63,373 per market-rate unit depending on where a project is located. In some cases, this is comparable to the cost of land on a per unit basis. However, the major drivers of development feasibility remain the broader construction cost and the available return. In almost all cases, the City fee stack is less than 10% of the value of a unit to the developer. Based on consultant analysis of prototypical pro forma, development in some areas of San José would yield a negative return. In these cases, even the elimination of all City fees and taxes would not likely tip the development into profitability and trigger the developer to move forward with construction. This is especially the case when nearby communities, other major national markets, or other investment opportunities offer a lower risk or higher return.

The most likely area for new residential development to occur within the current economic climate is in West San José where rents per square foot are on par with surrounding communities, and as such would yield sufficient return to make speculative residential development feasible. While only providing marginal if any return, development in Downtown and North San José potentially represent the best opportunities for new residential units outside of West San José, due to their proximity and transit accessibility to major regional employers (both in and outside of San José).

BACKGROUND

On December 19, 2017, Council directed staff to convene a Council Study Session prior to June 30, 2018 to discuss the aggregate impact of all the fees that the City imposes on housing development and construction. This information is intended to provide context for a number of development-related items which are scheduled to be considered by the City Council in May/June, including the proposed approach to the implementation and financing of amenities in Urban Villages, a discussion on the transition between the administration of Affordable Housing Impact Fees versus the City's Inclusionary Housing Ordinance, and an update on staff's work to respond to City Council prioritization of items included in the Mayor's *Response to the Housing Crisis* memorandum.

San José's Historical Context

Since the passage of Proposition 13 in 1978, California cities have used development and permit fees (cost for service), in lieu fees (mitigations) and taxes (unrestricted and special funds) to pay for the development, expansion, and maintenance of City infrastructure. This includes traditional infrastructure, such as roads, sewers, and parks, as well as public realm improvements, and social and environmental mitigations (Inclusionary Housing, Habitat Conservation Plan). During this time San José has continued to expand its population and residential housing base, for the most part through lower density sprawling development.

The past 10-15 years have seen a significant shift in the way the City has approached the location and form of housing development. Concurrently, the City has implemented one-off policies, the introduction of new fees, and temporary reductions on other existing fees in order to respond to changes in the economy and as legislation from the State has impacted the tools available to the City. The results of these actions have not always been considered in their entirety and developers have often provided feedback that the layering of these actions has a negative impact on the cost of development.

Prior to the Recession

Beginning in 2005, the environment for residential development in San José underwent a paradigm shift that is still underway. Prior to this time, the City experienced a housing boom which was in part fueled by the conversion of employment (largely industrial) lands to support new residential units. This provided significant opportunity to generate a return on investment for residential development since industrial land is generally valued lower than residential-zoned properties. In 2005, the City adopted the Industrial Preservation Framework, which called for a stop to industrial conversions, limiting the supply of less expensive land for residential development and reducing the return available to developers. This was done to halt further decline of San José's jobs deficit and fiscal health.

Around the same time, the City adopted the North San José Area Development Policy (NSJADP), which called for a different type of development at higher densities (55 DU/A), proximate to a major employment center and transit. The Horizon 2020 General Plan in place at the time considered High Density Residential development to be 25-50 dwelling units per acre. This was envisioned to be three-to four-story apartments or condominiums over parking, primarily near the Downtown Core Area, near commercial centers with ready access to freeways and/or expressways, and in the vicinity of the rail stations within the Transit-Oriented Development Corridors Special Strategy Area. Following the settlement of litigation against the NSJADP, new housing development entitlements started getting approved by the City Council in 2007, quickly accounting for almost all of the 8,000 units considered in Phase 1 of the NSJADP. It should be noted that while the NSJADP had a goal of creating 20% of the total units affordable, only a limited number of affordable units were developed. Also around this time, the Downtown Highrise Incentive, originally approved in 2004 and then renewed in 2007, played a role in the construction of a first wave of highrise residential development in the Downtown with the construction of the Axis, 360 Residences, City Heights and The 88.

The Great Recession

While several Downtown towers were already under construction or nearing completion, when the Great Recession started in December of 2007 the majority of the North San José projects stalled before starting construction. This significantly slowed residential development in San José until 2010 when interest returned and picked up where it had left off.

The City's Inclusionary Housing Policy, first put in place by the City and the former Redevelopment Agency in 1988, required affordability for new residential developments located in San José's redevelopment project areas. In 2010, the City Council deactivated the rental provisions of its Inclusionary Housing Policy and crafted its citywide Inclusionary Housing Ordinance to respond to a Southern California lawsuit, *Palmer v. City of Los Angeles (2009)*. The Inclusionary Housing Ordinance, Chapter 5.08 of the San José Municipal Code, was adopted on January 12, 2010. The Inclusionary Housing Ordinance requires that, in market-rate developments of 20 or more units, 15% of the units be made affordable to income eligible buyers or renters. If affordable homes are not built on-site, in-lieu fees can be paid or other alternatives pursued based on a 20% obligation.

In 2011, in order to spur development during the downturn, the City entered into Satisfaction Agreements for five large development sites in North San José. The Agreements ensured that Inclusionary Housing requirements would not be imposed on rental developments even if the rental provisions were reactivated, so long as development milestones were met. As site development entitlements for these and most other developments in North San José were still valid development, activity began here and within three years, almost all of the 8,000 units contained in Phase I of the NSJADP were under construction.

Changes in Policy and City Structure

In 2011, the City adopted the Envision 2040 General Plan that redefined how the City would continue to grow. Envision 2040 significantly increased the expectation of density in core growth areas, introduced the concept of redeveloping underdeveloped commercial corridors and centers to create mixed-use environments, and focused development in transit accessible areas.

In 2012 Redevelopment Agencies were eliminated as a tool for investing in growth areas and attracting development. The elimination of the City's main source of affordable housing funding (approximately $40 million annually) highlighted the importance of the City's Inclusionary Housing programs, of development agreements, and of area plans such as the NSJADP, as they provided a mechanism for the creation of affordable homes by market-rate development.

In 2012, the renewal of the Downtown Highrise Incentive played a role in the development of One South Market, Centerra, 27 North student housing and The Pierce. The extension in 2014 resulted in the breaking ground of Silvery Towers and Miro. That year also saw the adoption of the Affordable Housing Impact Fee on rental residential developments as the City was still unable to implement the rental portion of the IHO.

Since the adoption of the General Plan, the local residential real estate market has continued to mature, and outside of Downtown housing production has continued largely within specific plans or through entitlements approved prior to the adoption of Envision 2040.

In 2017, the State legislature approved AB 1505, resulting in reactivation of the City IHO's rental housing provisions effective January 1, 2018. The IHO is flexible and provides alternatives for how developers may meet the affordable unit requirement, including payment of an In-Lieu Fee and construction of affordable units off-site. When a developer selects an alternative to providing the units on the same site as the market-rate units, the requirement is increased to 20%. The In-Lieu Fee is calculated based on the 20% requirement. The newly-defined IHO in-lieu fees for rental developments will replace Affordable Housing Impact Fees on market-rate rental developments, which are being phased out given the return of a fully-implementable IHO.

Given San José's very sound market fundamentals, developers' anticipation of rental revenue would seem to be quite healthy in our market, and contribute to economic feasibility. The average rent in San José rose approximately 3% over the past year. This is the latest increase in the steady recovery from rents a decade ago, which surpassed highs prior to the Great Recession and rose a total of 48% in the past 10 years[1]. Rents for market-rate apartments in San José are among the highest in the nation, as shown by a February 2018 national survey of one-bedroom rents that found San José was third highest in the U.S., behind San Francisco and New York[2]. However, as rental developers build Class A apartments, and some rent concessions do exist currently in that type of property, their underwritten rent projections are less positive than our market would seem to indicate.

Looking forward, the recent changes in State law facilitating CEQA analysis on the basis of vehicle miles travelled (VMT) rather than level of service (LOS) will have a positive impact on the ability for development to proceed in growth areas outlined in the General Plan. In addition,

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[1] CoStar market data as of 4thQ 2017 and 1stQ 2018.
[2] Zumper National Rent Report, Jan. 2018 (https://www.zumper.com/blog/2018/01/zumper-national-rent-report-january-2018/).

Council's upcoming consideration of staff's proposed approach to Urban Village Implementation will enable more housing development to proceed.

Through these and other development related initiatives, the City is providing the groundwork for a predictable and transparent interaction for developers looking to invest in San José. This, coupled with the residential development capacity contained in the General Plan and strong market demand, should ideally facilitate the production of more housing units in growth areas; however, the current trajectory of unit production is slowing as a result of the full cost of development, and weakened opportunity for return on investment, in San José.

ANALYSIS

The focus of the analysis for this report has been on mid- to high-density (60-90 DU/A), mixed-use, multi-family residential development. More than 90% of the residential capacity created in the Envision 2040 General Plan is intended to be of this type within major growth areas and urban villages. Because this development type will be so prevalent in the build out of the General Plan, staff has used this development type to analyze the impact of City fees and taxes on development, to compare San José's development costs to surrounding communities, and to understand the feasibility and current market dynamics of residential development.

In addition to providing an assessment of the City's cost of development, staff has worked to develop a deeper understanding of the economics of residential development in an attempt to set a baseline understanding that can be used when considering future policy or fee changes. Working with a consultant, staff approached this assignment from the standpoint of a speculative developer who expects a return based on existing investment once leasing and rents have stabilized. The assumption is that the developer will sell the asset once it is stabilized and performing. As such, the models developed by staff represent an average of sorts, using assumptions gathered from market data to build a series of financial pro formas. This is intended to provide City Council with a high level overview of the local real estate market, the impact of direct City costs on development, and the opportunity to make policy adjustments to support it. Within San José, there will always be sites that proceed with development projects. Examples of development that may appear to differentiate from the models presented here include self-financed developers who are willing to accept a lower (or break-even) rate of return because they intend to hold the property over a longer time to generate a return, a property owner who has held the land for a longer time and as such has a lower cost basis, or a developer with an option on a property who is attempting to entitle it prior to changing conditions in the market that might enable development.

In completing the analysis, staff also considered for-sale housing. While there may be some variations in process and permit requirements, the cost of permitting for-sale and rental apartments is relatively similar. The reason to focus the analysis on market rate rental development is that for-sale projects involve additional non-City costs, including protection from construction defect liability. While staff and consultants believe that some developers are considering for-sale projects, one of the challenges to financing a condominium project is projecting an expected per unit sale price. To generate a sufficient return on investment, condominiums need to sell for prices comparable to single family homes. In the current market it is unclear that buyers are willing to pay a comparable price to live in a condo in San José. To provide flexibility to adapt to a potentially changing market, some developers have constructed projects that are "condo mapped" and could be converted from rental to for-sale. Because of these complications, the basis for this analysis has been rental apartments.

Current Regional Market Conditions

San José, and its surrounding metro area, continues to be one of the most robust real estate markets in the Country. The region's highly skilled workforce continues to drive growth in tech and related sectors. The region's economy has essentially reached full employment, with the unemployment rate for San José at 2.7%, compared to 2.5% in Santa Clara County. Net job growth has slowed as the availability of skilled workers declines; however, the appetite for growth by the region's largest companies drives continued demand for more housing as workers relocate from other parts of the country and the world. Publicly disclosed plans of some of Silicon Valley's largest employers alone could foretell an additional 30,000-40,000 jobs or more, which continues to place pressure on the local housing market. Representing roughly 25% of the region's employment, the tech sector has created a wealthy buyer pool with the available income to keep pace with the increased cost of housing. This in turn has driven up prices for local goods and services, resulting in the San José metro having some of the highest business and living costs in U.S.

This is most apparent in the cost and availability of housing. Across the region, vacancy rates for rental multi-family housing have remained at approximately 5% even through the Great Recession. Between 2010 and 2015, asking rents across the Silicon Valley region increased by roughly 6% annually, resulting in a cumulative increase of more than $700 per unit in six years[3]. Low vacancy and strong rents attracted apartment builders to the area and since 2015, the San José metro saw more than 10,000 units completed, with another 9,700 units currently under development. This surge in supply resulted in rents flattening (and in some cases dropping slightly) in 2016. While rents began to increase again in 2017 and 2018, it appears to be at a slower rate and many market reports point to a continued flattening of rents over the next several years.

While rent increases have slowed somewhat, costs related to construction have continued to rise. A primary cause of rising construction costs is the current shortage of labor. This labor shortage is due in part to the growing Bay Area economy, and the accompanying boom in residential, office/industrial and infrastructure projects. This construction boom has resulted in fierce competition for labor amongst developers. Compounding this problem is the fact that, both nationally and locally, the construction industry has experienced a significant loss of labor, with the retirement of workers from the baby boom generation and many permanently leaving the trades during the Great Recession. In the years immediately following the Great Recession, the labor shortage was not immediately felt in the Bay Area. Because the Bay Area economy (led by

[3] CoStar San José Market Report

growth in tech industries) recovered at a faster pace than many other regions across the state or nation, workers came from the Central Valley and beyond to build projects here. With the recovery spreading to other parts of the state and nation, construction workers can now find work closer to home and are less likely to relocate or commute to build projects in the Bay Area. Adding to current construction challenges are fluctuations and increases in the cost of construction materials. Uncertainty surrounding the future of the North American Free Trade Agreement and resulting implications, coupled with continued demand for building materials, resulted in lumber costs increasing 11.4% year over year in Q4 2017[4]. Parallel uncertainties related to trade relations with China are having a similar effect on the price of steel, as both higher prices and a future 17% price drop have been forecast in recent weeks.[5] Concrete prices have dipped almost 30% since the start of 2018, but the price of concrete still has almost tripled since 2015[6]. These uncertainties and volatilities are resulting in increased costs but also concern about the ability to deliver on projects within a stated timeline or price. This lack of predictability results in increased risk for the development community, and has impacted some projects moving forward.

Land Costs, Construction Costs, Rent Affect New Development

Many factors influence the viability of new development, but in general, the ratio between cost and return is the major consideration for development timing within a market cycle. Of the different elements that affect this ratio, construction costs, land costs, and anticipated return (in the form of rental income or sale price) play the biggest role. Entitlement and permitting timing, commercial-space replacement requirements, and required parking ratios can also have impacts on development feasibility. But rather than contributing to major changes in market cycles, these factors influence at the margin how quickly development might respond when the ratio between cost and return begins to favor of new development, as the cost basis in their pro forma would be more favorable. Similarly, while they are a relatively small portion of a development budget, development fees and taxes play an important role in development feasibility. More information on the basis for development fees, and in particular impact fees and exactions, is contained in the City Fees and Taxes section below. The influence that these fees have on development feasibility, and their relation to total cost of development, is discussed further below.

Due to the increases in cost associated with new construction, and the relative slowing of rents, the ratio between cost and return is such that development in most areas of San José is currently unlikely without some extenuating project circumstances (these might include entitlements that predate requirements, or long term ownership). Rents in surrounding communities close to major regional employers or key transit facilities are significantly higher, and while land values are generally also higher, construction costs (which remain the largest share of the total cost of development) are the same regardless of where a project is located; these economic conditions favor development in neighboring cities because projects there will bring higher returns.

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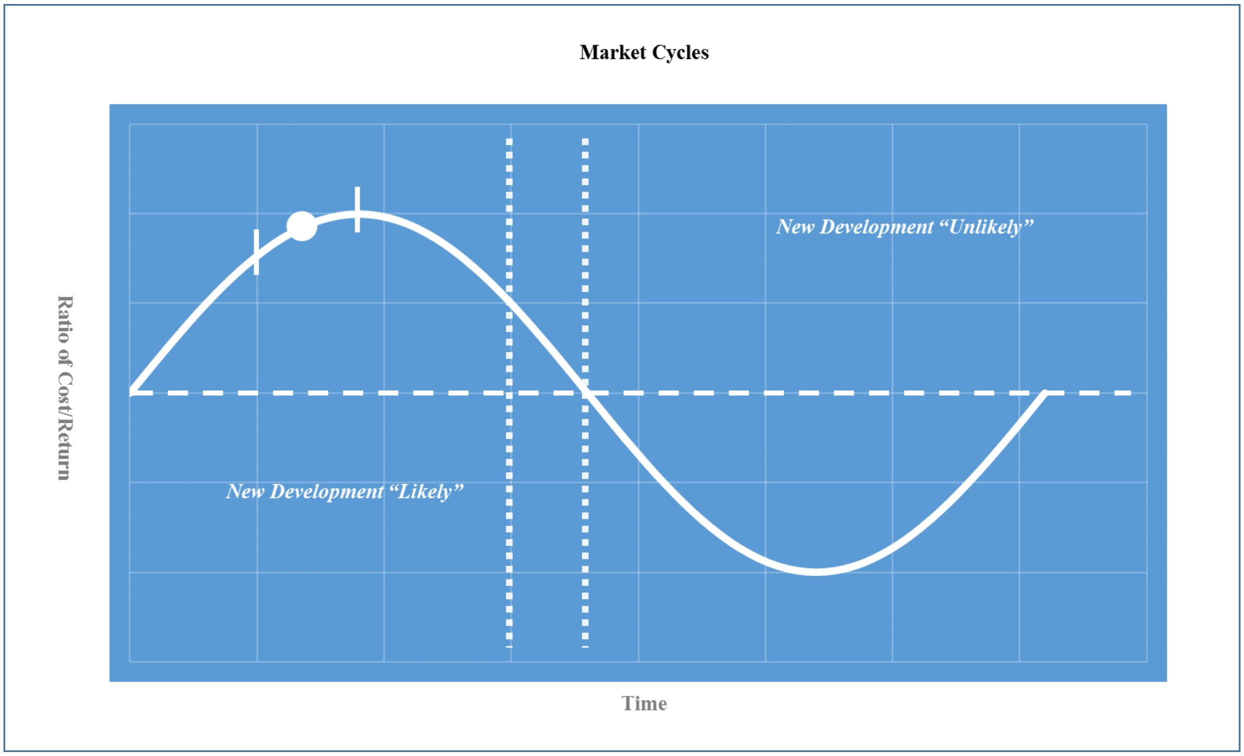
[4] JLL Construction Update (http://www.us.jll.com/united-states/en-us/Research/United-States-Construction-Update-Year-End-2017-JLL.pdf?a7e899fa-7ba7-45d8-8e52-31d09324a065)
[5] SeekingAlpha.com (https://seekingalpha.com/news/3342539-u-s-steel-benefit-higher-prices-supply-shortage-analyst-says; https://seekingalpha.com/news/3346488-sell-u-s-steel-ak-steel-prices-drop-17-percent-2019-ubs-says.)
[6] YCharts, U.S. Concrete Prices as of April 20, 2018 (https://ycharts.com/companies/USCR/price).



While speculative residential development remains unlikely in many parts of San José at this time, the economy is continuing to expand and to create demand for housing. In the current economic climate, it's unlikely that development and land costs will undergo a major reset sufficient enough to begin moving the ratio back towards likely development. As such, for development to become more likely in this economic cycle, return (revenues from rents or sales) would need to increase to offset rising costs.

City Fees and Taxes

Development fees and taxes in San José are complex. A number of factors determine which fees are applied to a particular development, when fees are due, and which department within the City is best to work with on developing an accurate cost estimate. The development process includes fees leveraged by Planning, Building, Public Works, Fire, Housing, PRNS, and DOT, and calculated using a variety of baselines: square feet, units, dollar value, service hours, construction type, and traffic trips (to name a few). In addition to complexity related to what fees and how much will be applied to a particular project, development is also impacted by the timing of when fees are charged. The City's development process can range in time from 18 months to several years. Add to that the time to obtain control of a property, assemble an appropriate development team, and ultimately construct the project, and the ability of developers to accurately anticipate fees is greatly diminished. Many of the City's fees adjust on an annual or biannual basis meaning that estimates developed at the beginning of the entitlement process may be out of date when it comes time to obtain building permits. Construction costs continue to fluctuate during this time and, given the potential disruption of market cycles, the timeline for a development from inception to certificate of occupancy could take 10 years, with City costs changing significantly during this timeframe.

Overview of Existing Fees and Taxes
The City doesn't have a single development related fee structure. Currently development projects across their life cycle will encounter service and mitigation fees from the departments of Planning, Building and Code Enforcement, Fire, and Public Works, as well as impact fees related to transportation, the provision of parks, and the provision of affordable housing, and taxes paid through the issuance of building permits that support the construction of transportation infrastructure. The fee prototypes used to complete staff's analysis contained over 60 individual line items or fees that are assessed on a wide range of variables including project type and size factors, including location within the city, square footage, occupancy type, and number of floors. To be able to provide a baseline comparison, staff has broken the fees across projects and agencies into five broader categories described in the table below. In completing aggregate analysis and to allow Council to understand how these variables are impacting the cost of development, staff analyzed fees based on a per unit basis.

Category	**Description**
Entitlement and Permitting Fees	Service fees for Planning, Building, Public Works, Fire development review.
Public Improvement Costs	Fees and costs associated with public and offsite improvements including storm and sanitary sewer requirements, undergrounding and street frontage requirements, and transportation related items such as protected intersection fees.
Taxes	Any development or construction related taxes.
Mitigation Fees	Any CEQA related costs or fees, or any other fees (not covered elsewhere) that are subject to the Mitigation Fee Act.
Parks and Housing Fees	Impact fees or requirements such as Inclusionary Housing and Park Impact requirements.

Of the five categories described above, the *Entitlement and Permitting Fees*, *Public Improvement Costs*, and *Mitigation Fees* categories are generally proportional to either the service requirement to process them or the direct impact created by development. The remaining two categories, *Taxes* and *Parks and Housing Fees,* are leveraged against development to support broader City goals, and generally constitute a greater proportion of the City cost of development than the remaining fees. As such, a brief description of how these costs to development are assessed is included below.

Construction Taxes:
San José has four residential construction-related taxes, with the Building and Structures Construction Tax (SJMC 4.46) and the Commercial-Residential-Mobilehome Park Building Tax (SJMC 4.47), representing most of the cost on development projects. These two taxes have been the primary focus of previous analysis because when a developer comes to pull a building permit to begin construction, these taxes can account for up to approximately two-thirds of the cost of that permit.

San José's Building and Structure Construction Tax and Commercial-Residential-Mobilehome Park Building Tax are applicable to all building permits including both new construction and tenant improvements. The Building and Structures Tax is a special tax, the revenues from which must be used for the construction of major collectors and arterial streets in the City. The Commercial-Residential-Mobilehome Park Building Tax is a general tax with no restrictions on expenditure, but has historically been used for programs in support of the City's General Plan and Green Vision goals to develop a pedestrian, bicycle, and transit environment.

Rates for these taxes vary based on the intended use of the building or structure being permitted. Construction taxes are collected against the valuation of the project derived from the higher of either the International Code Council's building valuation data table or the submitted valuation estimate by the project proponent.

Building & Structure Construction Tax (B&S) Chapter 4.46	Tax Rate of Building Valuation: 1.54%
Commercial-Residential-Mobilehome Park Building Tax (CRMP) Chapter 4.47	Tax Rate of Building Valuation: 2.42%
Construction Tax Chapter 4.54	$75 - $150 Per Unit
Residential Construction Tax Chapter 4.64	$90 - $180 Per Unit

The City heavily relies on construction taxes to maintain and evolve our complex transportation network. These monies fund a significant portion of our pavement maintenance work, necessary repair and maintenance to keep traffic signals and streetlights operating and our signs and roadway markings in good condition, safety measures such as enhanced crosswalks and traffic radar signs, complete street projects that modernize the travel experience for vehicles, pedestrians, bicyclists and vehicles, and signal timing projects and maintenance. In addition, staff leverages these monies as matching funds in grant applications.

Parkland Obligation:
Residential development's "parkland obligation" is based on the requirements of Municipal Code Chapters SJMC 14.25 Park Impact Ordinance (PIO) and SJMC 19.38 Parkland Dedication Ordinance (PDO). Both Chapters outline a residential project's responsibility to provide new

parks, trails, and community centers or to rehabilitate existing recreational amenities to serve the new residents who will be living in the community. The City first adopted the PDO for for-sale units under the authority of a subsection of the State Subdivision Map Act known as the Quimby Act. The City adopted the PIO for rental units under the authority of the State Mitigation Fee Act using the Quimby Act as the nexus for adoption. Essentially both ordinances are implemented identically and require a project to meet the objectives of the Quimby Act.

The City's park impact (PDO/PIO) requirement is based on a Quimby Act provision that new residential development provide three acres of land for every 1,000 people added to the community by a project. The Quimby Act requires that new population growth be calculated by using U.S. Census data to estimate population based on housing types (i.e. single family, multi-family, etc.). A project's parkland obligation can be met through the dedication of land, the payment of park impact fees, through the construction of new recreational facilities, renovating existing facilities, or a negotiation to provide a combination of these solutions. It is the City's priority to receive land dedication to meet the obligation, especially in areas that are under served with park facilities.

For the purposes of creating baseline land values to establish parks fees, the City is divided into 16 Multiple Listing Services (MLS) Zones. The land value for each MLS Zone and resulting parkland fee per residential unit type can vary significantly dependent on which MLS district a project is located in. Land values are reassessed annually and the park impact fees are adjusted accordingly to be consistent with market rates. The fees can go up or down based on current assessed land value rates. In concept, this annual adjustment allows the City or the developer to be able to purchase land at current assessed rates. The annual adjustment reflects assessed value, not what the market demands in real time. In other words, even though the fee is adjusted once a year to reflect assessed value, it's difficult for the City to be able to compete to purchase land for recreational use when the market demands higher than assessed costs. The park impact in-lieu fee for multi-family residential units (in developments of 5 or more units) ranges from $8,000 per unit in Alviso to $41,600 per unit in the area of North San José south of Highway 237.

Developers can receive up to 50% of credit toward the parkland obligation for providing qualifying on-site recreation amenities (Private Recreation Credits) as part of the project. Additionally, any onsite affordable housing units qualify for a 50% credit toward the parkland obligation. For purposes of the analysis below, it was determined (based on historical averages) that on average projects receive approximately 30% of Private Recreation Credits and paid approximately 70% of the park impact in-lieu fees.

Monies gained from the PDO/PIO are placed in the Park Trust Fund (PTF) which provides approximately 50% of all funding for PRNS Capital projects. In recent years, the City has developed or received land dedication for 45 new/future parks and has developed almost half of the existing 60 miles of trails leveraging monies from the PDO/PIO program. This is in addition to the rehabilitation of numerous parks, trails, and community centers. Additionally, the PTF supports the Parks Rehabilitation Strike Team which is helping to address the approximate $177 million dollars in deferred maintenance and infrastructure backlog costs related to parks and trails (through rehabilitation)

Despite the success to date of the PDO/PIO program, the City still has 51 underserved neighborhoods that are beyond 1/3 of a mile from a park, trail, or other recreational open space. Additionally, the parks, trails and community centers have a large backlog of infrastructure repairs needs ($293 million). The PDO/PIO program provides a vital ongoing funding stream to assist with ensuring that park facilities are provided in these underserved areas and existing facilities are rehabilitated to the extent possible.

Affordable Housing Obligation:
The Inclusionary Housing Ordinance, Chapter 5.08 of the San José Municipal Code, was adopted on January 12, 2010. The Inclusionary Housing Ordinance generally requires that, in market-rate developments of 20 or more units, 15% of the units be made affordable to income eligible buyers or renters. The provisions of the Inclusionary Housing Ordinance that apply to rental developments were suspended until the court decision in *Palmer* v. *City of Los Angeles* was superseded. Recent legislation at the State level (AB 1505) now supersedes this decision effective January 1, 2018. The Inclusionary Housing Ordinance provides alternative ways that a developer may meet the affordable unit requirement, including payment of an In-Lieu Fee and construction of affordable units off-site. When a developer selects an alternative to providing the units on the same site as the market rate units the requirement is increased to 20%. The In-Lieu Fee is calculated based on the 20% requirement.

Because of the *Palmer* decision, in November 2014, the City Council approved creation of the Housing Impact Fee (AHIF) Program. Under AHIF, new market-rate rental housing developments are charged $17.00 per square foot of net rentable space to address the impact of that type of development on the need for affordable housing. This fee was set to exactly match the previous Inclusionary Housing Policy fee for rental, so that developers would not experience a change in financial predictability. The AHIF program also provided a grandfathering provision that exempted payment of the fee for those developments already in an advanced stage of planning. Grandfathering requirements were that a project would have received site-specific entitlements prior to July 1, 2016, and would receive a Certificate of Occupancy for buildings containing at least 50% of the declared units prior to January 31, 2020. Twenty-nine projects with approximately 6,500 residential units were deemed eligible for grandfathering. The AHIF Program also included a similar limited-time exemption for Downtown High-Rise rental projects that would receive a Certificate of Occupancy on or before June 30, 2021. To date, four developments with 1,200 apartments have qualified for the Downtown High-Rise Exemption.

On September 29, 2017, the Governor signed AB 1505, thus clarifying the Legislature’s intent to supersede the court decision in *Palmer* v. *City of Los Angeles* and allowing the City’s Inclusionary Housing Ordinance’s requirements to apply to rental developments effective January 1, 2018. San José’s Inclusionary Housing Ordinance requires market-rate developments to provide 15% of new units as restricted affordable, with levels of affordability differing on whether the development is for-sale or rental. Alternatively, market-rate developments can opt to pay the Inclusionary Housing Ordinance in-lieu fee for 20% of the new units being built on-site. The current in-lieu fee for rental is set at $125,000 per affordable unit, which equates to $25,000 per market-rate unit when spread across the cost of all units in a new development.

The Inclusionary Housing Ordinance contains a provision which specifically allows that the in-lieu fee may be reduced for High-Rise Residential Development in any specified area of the City via City Council resolution or policy. This incentive was created to enhance financial feasibility for the construction of high-density residential development, the feasibility for which is made more challenging given the height restriction over Downtown, high costs of steel construction, high land prices, rising labor costs, and flattening rents. To qualify, development must be located in the Downtown Core, and be at least ten (10) stories in height. Based on an assessment of the potential costs associated with delivering affordable units, it is more likely that developers will opt to pay the in-lieu fee; therefore, this is the assumption that staff has included in its analysis.

Inclusionary Housing in-lieu fees are committed to new restricted affordable housing developments providing apartments that range from affordability for extremely low-income to moderate-income residents. As the need for housing to serve the lowest income levels, including the homeless, has been the City's recent priority, in-lieu fees have been used for new such developments. However, the payment of in-lieu fees as an alternative to building affordable homes is somewhat problematic, as new affordable homes do not get integrated into large new developments and neighborhoods, which is the primary goal of Inclusionary Housing programs. In addition, it takes time for staff to commit new development awards and for new restricted affordable developments to assemble sources and be constructed. The inclusion of affordable units into market-rate developments, therefore, is staff's preferred policy objective.

City Development Costs through this Cycle

In the past, the City had led efforts to create a Bay Area Cost of Development Survey to provide insight into the cost of development in San José compared to surrounding communities. Staff worked with other agencies in the region to bring together a comparison of data based on a range of prototype development projects. The first six surveys, starting in FY03-04, covered five prototype projects plus an optional sixth residential high rise project. The FY12-13 survey featured twelve prototype projects ranging from replacing a residential water heater to a residential high rise project. Copies of these prior surveys are available on the Planning Department website (*http://www.sanjoseca.gov/index.aspx?NID=4100*). While comprehensive in its approach, the Survey received inconsistent participation from other cities and took a considerable amount of time and resources to coordinate.

In addition to re-creating and testing some hypothetical prototypes for this report, staff analyzed historical data for multi-family residential projects completed within this development cycle (since 2009). This analysis consists of a review of how much each development actually paid through the entitlement and construction process. The following table shows five examples of projects that completed construction, including total and per unit costs broken down by the categories detailed above.

Table: Fee and Tax Breakdown of Sample Projects from Between 2009 and 2016

		Example 1	Example 2	Example 3	Example 4	Example 5
Project Information	Site Area	3.28	3.59	4.97	2.01	3.16
	Number of Units	166	218	242	103	183
	Sq. Ft.	168,645	240,547	333,249	123,464	215,586
	Year Built	2016	2015	2009	2015	2014
	Number of Stories	3	5	4	4	4
Total Paid	Entitlement and Permitting Fees	$581,188	$572,137	$645,900	$347,979	$680,689
	Offsite and Improvement Fees	$421,555	$225,407	$164,441	$240,535	$188,345
	Taxes	$934,936	$1,358,408	$1,126,197	$621,140	$1,118,287
	Mitigation Fees	$274,434	$0	$0	$0	$734,084
	Parks and Housing Fees	$1,169,168	$2,600,979	$2,523,431	$1,460,558	$2,321,333
	Total Fees and Taxes	**$3,381,281**	**$4,756,930**	**$4,459,969**	**$2,670,213**	**$5,042,738**
Per Unit	Entitlement and Permitting Fees	$3,501	$2,624	$2,669	$3,378	$3,720
	Offsite and Improvement Fees	$2,539	$1,034	$680	$2,335	$1,029
	Taxes	$5,632	$6,231	$4,654	$6,030	$6,111
	Mitigation Fees	$1,653	$0	$0	$0	$4,011
	Parks and Housing Fees	$7,043	$11,931	$10,427	$14,180	$12,685
	Total Fees and Taxes	**$20,369**	**$21,821**	**$18,430**	**$25,924**	**$27,556**

Average City Cost of Development Between 2009 and 2016: $22,819

Based on the data above, the average cost of permitting higher-density mixed use residential product in San José between 2009 and 2016 was $22,819 per market-rate unit. While some variation occurs across these examples as a result of the *Mitigation Fees*[7] and *Offsite and Improvement Fees*, the most significant impact and variation arose from the *Parks and Housing Fees* category, which in these examples only represents the PDO/PIO in-lieu fee as each of these projects was built prior to the adoption of the Affordable Housing Impact Fee or the reintroduction of the Inclusionary Housing Ordinance for rental development. The variation occurs due to these projects being located across numerous MLS Zones in North, Central, and South San José and variations in the amount of credit received based on the provision of private recreation facilities.

[7] Examples 1 and 5 were constructed within Area Development Policies and were subject to traffic impact fees. Examples 2, 3 and 4 may have had other costs associated with providing CEQA mitigation but this did not consist of the collection of a fee.

FY17-18 City Development Costs

In addition to the historical analysis above, staff has re-created cost estimates from the FY12-13 Bay Area Cost of Development Survey based on a Downtown Highrise (Prototype 6) and a Multi-Family, Mixed-Use Apartment (Prototype 12). These two prototypes were chosen because they are consistent with the type of development analyzed by the consultants and staff for this memo and in the previous Cost of Development Survey. In addition, staff created a new Prototype 13 to reflect development with five stories of residential over two levels of parking. This protoype is consistent with the type and anticipated denisties of development in many of the General Plans growth areas, and similarly used in KMAs assessment of development feasibility referenced below.

The table below contains the development cost breakdown by category, total, and per unit for the above mentioned prototypes for both FY12-13 (based on the prior Survey) and FY 17-18 (based on staff's cost estimates).

This information has been compiled with the assistance of all of the Development Services partner Departments. One City-related cost that isn't represented clearly in this information is costs arising from mitigations arising from the environmental clearance of each individual project. Of the potential costs arisning from CEQA clearance, transportation improvements are often the most expensive. Currently, transportation improvement requirements placed on new development do not manifest themselves as a fee or similar mechanism unless a project is located in an Area or Transportation Development Policy (ADP or TDP) or, for projects still subject to City Council Policy 5-3, near a protected intersection. Under Policy 5-1 (where CEQA transportation impacts are studied in terms of VMT), most projects are expected to see a decrease in the cost of transportation mitigations under CEQA, with other transportation-related effects addressed through Local Transportation Analysis. In the future, the region – likely through the VTA – and/or City may decide to implement a comprehensive transportation impact fee to address regional and/or local transportation needs. This type of fee is expected to supplant – rather than add to – existing mechanisms (e.g. ADPs and TDPs), with the goal of maintaining adequate and fair investment in transportation from the development community, while streamlining the development process.

Table: FY12-13 and FY17-18 Cost of Development Survey Fee and Tax Breakdown

		Multi-family Mixed Use (4 over 1) *Prototype 12*		**Downtown Highrise *Prototype 6***			**Multi-family Mixed Use (5 over 2) *Prototype 13***
Project Information	Number of Units	218		330			230
	Sq. Ft.	240,547		584,837			168,883
	Construction Type	Type III		Type I			Type V
	Number of Stories	5		22			7
		FY 12-13	**FY 17-18**	**FY 12-13 (with incentive)**	**FY 17-18 (with incentive)**	**FY 17-18 (without incentive)**	**FY 17-18**
Total Paid	Entitlement and Permitting Fees	$613,154	$674,637	$955,001	$1,137,583	$1,137,583	$589,530
	Offsite and Improvement Fees	$263,223	$297,439	$511,255	$428,538	$428,538	$185,058
	Taxes	$1,029,097	$1,457.564	$1,295,023	$1,478874	$2,892,491	$1,156,925
	Mitigation Fees	$0	$10,602	$0	$19,614	$19,614	$7,620
	Parks and Housing Fees	$1,656,800	$7,037,040	$1,262,250	$3,372,600	$11,622,600	$7,004,360
	Total Fees and Taxes	**$3,562,273**	**$9,477,282**	**$4,023,529**	**$6,437,209**	**$16,100,826**	**$8,943,492**
Per Unit	Entitlement and Permitting Fees	$2,813	$3,095	$2,894	$3,447	$3,447	$2,530
	Offsite and Improvement Fees	$1,207	$1,364	$1,549	$1,299	$1,299	$794
	Taxes	$4,721	$6,686	$3,924	$4,481	$8,765	$4,965
	Mitigation Fees	$0	$49	$0	$59	$59	$33
	Parks and Housing Fees	$7,600	$32,280	$3,825	$10,220	$35,220	$32,130
	Total Fees and Taxes	**$16,340**	**$43,474**	**$12,193**	**$19,507**	**$48,790**	**$41,025**

Fees and Taxes Increased Between FY12/13 and FY17/18 Surveys

Prototype 12 – Multi-family mixed-use “4 over 1”:

Based on this analysis, development costs for multi-family residential development (Prototype 12) have increased 166% over the past five years from $3,562,273 to $9,477,282. About 58% of the current cost of development can be attributed to the current Inclusionary Housing Ordinance (IHO) in-lieu fee. Excluding the introduction of the IHO in-lieu fee, fees have undergone a 13% increase over the past five years. The majority of this increase can be attributed to a 42%

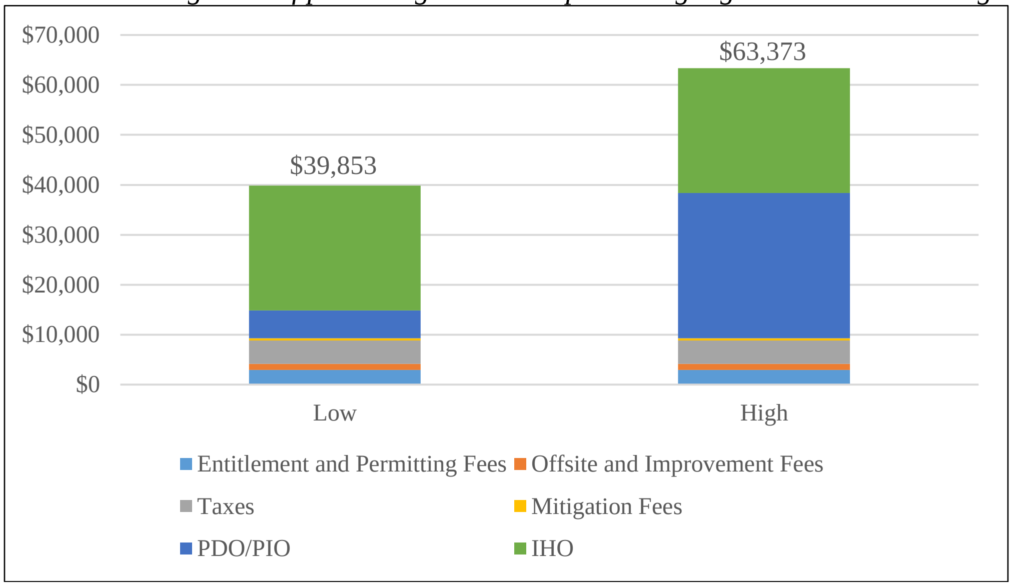
increase in construction taxes. Because these taxes are based on a determined construction value, the taxes have increased commensurate with the increased cost of construction over the five year period.

Prototype 6 – Downtown Highrise:
City fees and taxes for developing Downtown highrise residential projects have similarly increased over the same period. The major driver of this change has been increases to the PDO/PIO in-lieu fee. In Downtown (Prototype 6), the continuation of the Downtown Highrise Residential Incentive until July 2018 lessened the impact of these costs resulting in only a 60% increase over the past five years. While still subject to the incentive -- which reduces the in-lieu fee by 50% for qualifying projects -- the base fee has increased from $7,650/unit in the FY12-13 study, to $14,600 per unit today. In November 2017, City Council adopted a resolution (effective February 1, 2018) to update the in-lieu fee and establish a new park impact fee rate for high-rise units, based upon observed occupancy of existing high-rises in Downtown San José. This action provides a more permanent approach to the assessment of park fees recognizing the different occupancy patterns in dense high rises downtown.

Projects have until July 31, 2018, to obtain a building permit in order to qualify for the Downtown Highrise Incentive Program. Because of this and the transition to the IHO, new development in Downtown starting the entitlement process today is likely to experience much higher fees. As such, staff has included an example of the cost of development without the existing incentives. Based on this analysis, costs for Downtown highrise development will increase roughly 300%. As with Prototype 12, the major contributor to this increase is the introduction of the IHO in-lieu fee at $25,000 per market rate unit. Without the introduction of this fee, the increase over the five-year period would be approximately 95% due to elimination of the Construction Tax portion of the Downtown Highrise Incentive.

Estimated Average Cost of Permitting in FY17/18 Between $39,853 and $63,373
Based on a blended average of current fee estimates and historical permit data, and representing the range in parks fees, the average cost of permitting higher-density mixed use residential product in San José is currently between $39,853 and $63,373 per market-rate unit. As shown in the chart below, this represents the variation in the PDO/PIO in-lieu fee which can be significant based on the cost and availability in land across the city. The estimated average cost below is based on the PDO/PIO in-lieu fee at its lowest in Alviso where it represents a cost to development of $8,000 per unit, and at its highest across Highway 237 in North San José where it represents a cost to development of $41,600 per unit. The average cost across all of the MLS zones in the City is $15,200 per unit.

Chart: Estimated average cost of permitting in 17/18 representing highest and lowest cost geography

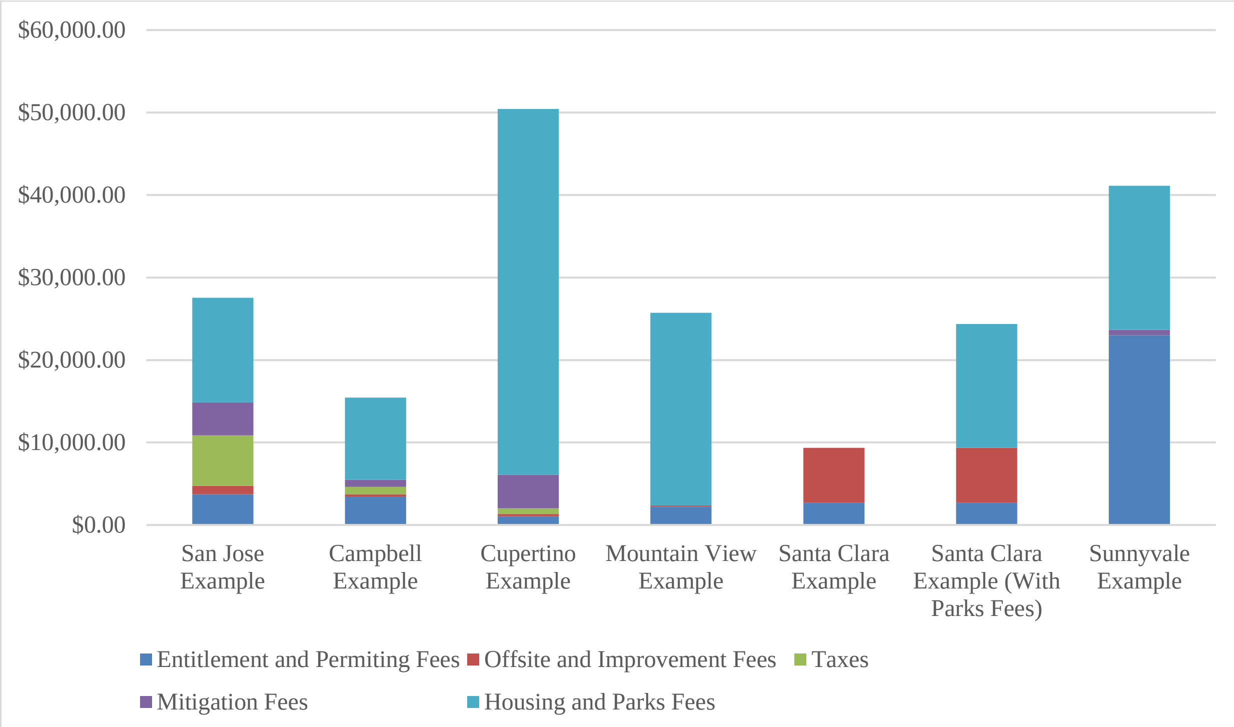


Comparison with Surrounding Cities

To provide Council with an understanding of how San José's fees compare with surrounding cities, staff reached out to other local agencies in an attempt to get a better understanding of applicable fees and taxes on development. Rather than providing a series of development prototypes as with previous surveys, staff requested that other agency staff provide a fee breakdown of projects that fell within size and timing parameters, similar to the historical permit analysis referenced above. The chart below shows the relative cost per unit across the cities that responded, compared with a San José project that was provided as a sample project. The San José sample was a North San José project completed in 2014; as such the per unit cost does not include the IHO in-lieu fee.

Based on this analysis, San José's development costs were in line with surrounding cities. However, with the addition of the IHO in-lieu fee, San José would rank at the higher end of those cities that responded to the request. It's worth noting that the nature of fees is evolving in surrounding cities. Santa Clara's response to the request was the lowest by far; however, since the sample project has been built, Santa Clara has enacted new parks-related fees which bring its cost of residential development in line with San José and other surrounding cities. In addition, a number of cities are considering what approach they should take to inclusionary housing since the changes in State law. Many cities also charge commercial developments impact fees that are used for affordable housing, which potentially gives greater latitude on how they assess residential impact fees. It is important to note that this analysis is only for residential developments and only represents a snapshot in time. It therefore should be repeated on a semi-regular basis to understand how the cost between cities is shifting over time.

Chart: City cost of development based on recently constructed multi-family residential projects



The other notable consideration that should be taken into account when reviewing this data is the viability of development projects based on location. Rents in San José for comparable product types are lower than some surrounding communities. In Cupertino and Sunnyvale rents can be 30-35% higher than some areas of San José. As such, development in other cities can sustain higher fees and still remain feasible.

<u>Current Development Feasibility in San José</u>

Based on Council's direction, staff has been preparing an Urban Village Implementation Framework that will provide community enhancements within Urban Villages as they experience intensification. Staff's recommended approach to this program has been through assessing the increased value of residential development, which in turn requires an understanding of development feasibility. Through this work staff had already engaged Keyser Marston Associates, Inc. (KMA) to provide economic context and feasibility analysis of the proposed approach. Following Council's direction to come back with a study session on the cost of development in San José, staff adjusted the scope of this work to serve both projects. KMAs full report on development feasibility is attached and summarized here.

For context, the conceptual pro forma contained in the KMA analysis are based on the relationship between the revenue potential, the estimated development costs, and the estimated value at completion for the prototypes analyzed. Profit is determined as the difference between value and cost and the estimated minimum profit target for all prototypes is 10% to 15% of costs.

Staff provided KMA with ten case study sites representing Urban Villages with proposed or adopted plans, plus North San José and Downtown. Since some sites exhibited similar market characteristics, they were grouped into five submarkets for purposes of providing a higher-level comparison of development economics in different areas of San José. These are represented by:

- Central: West San Carlos and North First Street
- West: Stevens Creek Boulevard
- South and East: Southwest Expressway, Curtner Light Rail, Blossom Hill/ Snell, Alum Rock, and Capitol Light Rail
- Downtown Core
- North San José

KMA's analysis then assigned an appropriate rental apartment prototype based on the predominant building type within the submarket. They also analyzed market rents, one of the key drivers in development profitability, based on each submarket. These rents range from $2,750 to $3,450 per month depending on the submarket. As noted above, apartment rents in the region grew significantly between 2011 and 2015, but subsequently flattened (and in some cases declined) in 2016/17. Average rents of major properties in San José and the Bay Area grew by approximately 1% in 2017—less than the rate of inflation—compared to an average growth rate of over 9% from 2011 to 2015. Consistent with recent trends, KMA's conceptual pro forma assumes that current market rents remain stable over the near-term horizon of the analysis.

The conceptual pro forma is based on the relationship between the revenue potential, the estimated development costs, and the estimated value at completion for the prototypes analyzed. A summary of the conceptual pro forma estimates is presented in the table below; detail on each component is provided in the charts and tables included in the Appendix of the attached report.

Potential Slowdown in the Development of Multi-Family Housing in San José

The KMA analysis points to a potential slowdown in the development of multi-family housing in San José. Per the summary table below, residential development currently faces challenges due to high development costs and the inability to project future rent growth to offset rising costs. The only prototype to demonstrate an estimated profit that exceeds the targeted profit threshold is in the West Valley (Stevens Creek) area. For all other prototypes, the analysis suggests that estimated profit margins under current market conditions are insufficient to support speculative residential development without some form of extenuating project circumstances. There will always be sites that proceed with development proposals. Examples of cases where this could occur include self-financed developers who are willing to accept a lower (or break-even) rate of return as they intend to hold the property over a longer time to generate a return, a property owner who has held the land for a longer time and as such has a lower cost basis, or a developer with an option on a property who is attempting to entitle it prior to changing conditions in the market that might enable development.

Summary of conceptual pro formas by sub-market

	North and West Central SJ	**West SJ**	**South and East SJ**	**DT Tower w/ Incentive**	**DT Tower w/o Incentive**	**NSJ**
Average Rent	$3.44/SF	$3.83/SF	$3.06/SF	$3.56/SF	$3.56/SF	$3.33/SF
Density	90 DU/A	90 DU/A	60 DU/A	320 DU/A	320 DU/A	90 DU/A
Per Unit City Fees	$55,000	$51,000	$49,000	$21,000	$49,000	$72,000
Per Unit Construction Costs	$450,000	$447,000	$398,000	$622,000	$622,000	$448,000
Per Unit Land Costs	$53,000	$58,000	$63,000	$40,000	$40,000	$48,000
Total Cost Per Unit	$558,000	$557,000	$505,000	$669,000	$697,000	$568,000
Total Value Per Unit	$575,000	$665,000	$455,000	$640,000	$640,000	$560,000
Estimated Profit Per Unit	$17,000 (3%)	$108,000 (19%)	n/a	n/a	n/a	n/a
Development Likelihood	**Possible**	**Likely**	**Highly Unlikely**	**Unlikely**	**Unlikely**	**Unlikely**

Impact of City Fees and Taxes - relatively small portion of total development cost
City fees and taxes have a real but marginal impact on current development feasibility. Based on KMA's modelling, City fees in certain parts of the city are comparable to the cost of land on a per unit basis. The replacement of the Affordable Housing Impact Fee by the higher IHO in-lieu fee for rental developments has significantly increased this cost since the start of 2018. Fees continue to be a relatively small portion of total development cost, with the major drivers of development feasibility remaining the broader construction cost and the available return. In almost all cases, the City fee stack is less than 10% of the value of a unit. For the development prototypes above that demonstrate a negative return, eliminating all City fees and taxes would not likely tip the development into profitability and trigger the developer to move forward with construction. This is especially the case when surrounding communities, other major national markets, or other investment opportunities offer a lower risk or higher return.

Other Factors Significantly Impact Development Feasibility

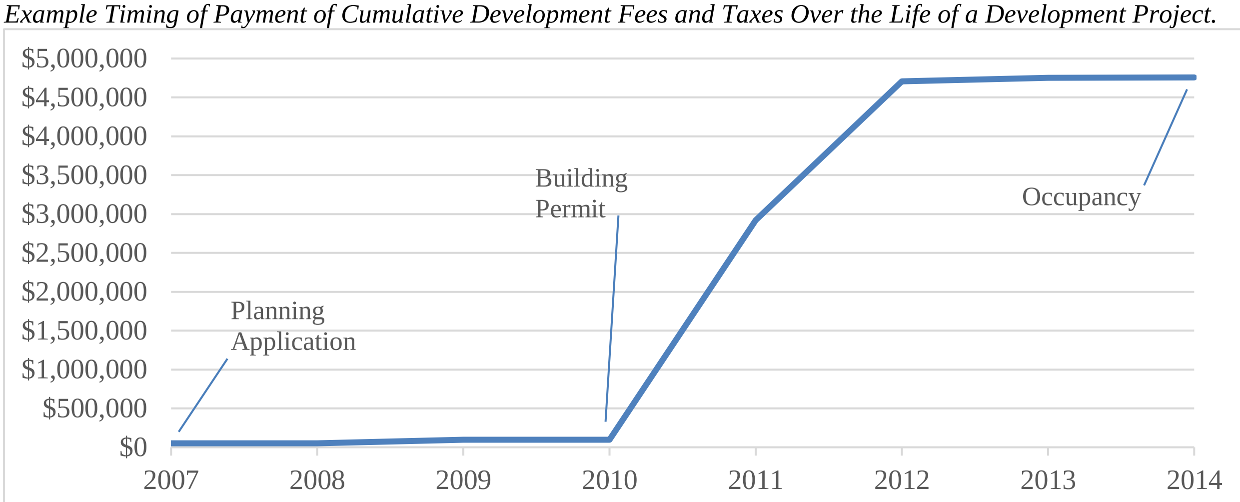
1. Cost of Land
Land cost plays an important part in the overall picture. While in some cases City costs and land cost are comparable, the availability of appropriate land for development, and the willingness and motivation of an owner to sell, may result in considerably different land prices. In addition, speculative developers are often looking for "upzoning" opportunities, where they can buy land based on its current use and create value by entitling a higher-return project. Due in part to past land use decisions, developers regularly report that land owners often have an expectation of high density residential land values, even on property that isn't designated as such. With Prop. 13 lessening the burden of holding land over a long period, opportunity site sellers aren't

motivated to sell to developers until their price expectation is met. This creates an additional burden on development feasibility.

2. City Fees and Taxes Payment Timeline

In analyzing the City cost of development, staff assessed the timing of payments to the City. The chart below shows a timeline of the fees and taxes paid to the City associated with a sample development project constructed within the last development cycle. Due to the Great Recession, many constructed projects have a protracted timeline due to sufficient time needing to pass after the market reset for rents to rise and justify a construction start. Entitlements can sit for even longer periods between cycles. Many of the projects that have been constructed during this development cycle were done using entitlements that predate the current General Plan.

Example Timing of Payment of Cumulative Development Fees and Taxes Over the Life of a Development Project.



In the example above, the time between this sample project beginning its entitlement process to the point at which the building was occupied is seven years. This represents a challenge for developers in not only monitoring the market cycle for that moment when the ratio between cost and return is right for their project to move forward, but also understanding the form and impact of new or updated fees over time, which may have significant impacts on the City cost to the project.

While developers do incur costs associated with securing a site for future development (either through purchase or option), performing due diligence on the site, and hiring consultants and architects to prepare plans and CEQA documentation to support an application, the cost associated with entitling a project and then waiting for market conditions to support the construction of a particular development is a relatively minor portion of the total cost of development. While payment of IHO in-lieu fees can be deferred until shortly before issuance of a Certificate of Occupancy, payment of most City impact fees, other in-lieu fees, and all development taxes are required to be paid at the issuance of building permits. This is intended to ensure that all obligations have been met prior to any occupancy of the building and provides an opportunity for the City to ensure that fees are paid prior to the commencement of construction.

In the example above, the time between the pulling of building permits and occupancy of the building is four years. During this time, the developer must pay interest on borrowed capital. Borrowed capital at this point in the life of a project is usually developer funding or from equity investors. Debt capital (construction loans) from traditional lending institutions are usually not available until after a project has received its building permit, which as currently is the case, means that all fees have been paid. This cost of money ultimately has to be included a project's pro forma and affect a developer's decision whether to move a project forward.

3. Commercial Space Requirement

The Envision 2040 General Plan requires that development in Urban Villages replace, and at times increase, the amount of commercial space it is displacing. The relationship between residential and commercial uses in mixed-use projects varies greatly from project to project with regard to the size of the commercial requirement, project location, tenant mix, and other factors. In other words, there is no "typical" commercial requirement that can be assumed for the residential prototypes.

For purposes of simplicity, this analysis focuses on the fundamental development economics of apartments and presumes that commercial component will pay for itself. It is recognized that each specific project will have its own unique set of conditions and that the development economics of the commercial component may be better or worse depending on many factors. Developers have raised the issue of the on-site commercial replacement requirement, and in particular the requirement of ground floor retail uses.

Part of the challenge associated with retail replacement is that a retail tenant being displaced often doesn't meet the tenant profile expected to fill the space after construction. This relates to the credit-worthiness of particular tenants and how commercial development is financed. In addition, small independent businesses often cannot afford to make the tenant improvements needed to make the commercial space useable for their business. The complexity of this issue is why staff has not included it as a primary focus of this analysis. In addition, many of the General Plan's underlying policies revolve around the preservation and creation of jobs in the commercial areas, and the importance of placemaking. As such, a conversation about the impact of such a requirement or opportunities to affect it should be had within the context of the four-year General Plan Review cycle.

4. Consistency and Transparency

Through staff's outreach, developers have emphasized the benefits of providing consistency and transparency in processing timelines, design expectations and requirements, and fees. To the extent that a developer has a clear understanding of costs and requirements early in their process, they can account for them in their pro forma and get to a "go/no go" decision much earlier. City staff often receive feedback that San José is very competitive with other cities in the Bay Area from a processing perspective; however, some concern was raised on the transparency of design expectations and requirements—especially when projects move between departments or project managers. San José has its fee schedules readily accessible online, but the complexity of some of these fees and their calculation can make them effectively inaccessible to the development community. As an example, the City's Prototype 6 referenced above includes 56 separate line items in the cost estimate.

5. Basis for Fees – Per Square Foot Vs Per Unit

Council's direction to prepare the Cost of Development Study Session included direction to address the question of whether the City should assess fees on a square-footage basis, rather than per-unit basis, to account for the substantial differences in residential unit sizes. While Council direction included reference to fees assessed against apartments versus single family residential, staff has focused on the potential difference between per-square-foot and per-unit based on higher-density development. This is because so much of the development planned under the Envision 2040 General Plan is at higher multi-family densities.

State law regulates the way that impact fees are imposed on development projects. Impact fees must (1) identify the purpose of the fee; (2) identify the use to which the fee is to be put, including the public facilities to be financed; (3) show a reasonable relationship between the fee's use and the type of development project; (4) show reasonable relationship between the public facility to be constructed and the type of development; and (5) account for and spend the fees collected only for the purposes and projects specifically used in calculating the fee. In the context of residential development, this often relates to the relative impact of a future resident, whether it's the availability of affordable housing or the provision of public park space. To determine the appropriate level of need and subsequent exaction, fees often consider the number of residents intended to occupy a particular development based on household data available through sources such as the Census and American Community Survey. This information provides details on the average number of occupants per multi- or single-family dwelling unit, which then becomes the basis for determining the impact or need associated with a development per residential unit.

One of the concerns raised by the development community is that a per-unit fee penalizes higher-density, smaller-unit projects by burdening them with the same level of fee that would be assessed against a larger unit. In the case of the parkland fees, where the baseline for the assessment is an averaged occupancy per unit, a per-square-foot fee would similarly need to assess estimated populations per square footage based on census data in order to be consistent with Quimby Act. Other factors, including whether the fee is based on gross or net square feet, could significantly vary the way a fee is assessed against development. The intent of a per-unit baseline is to provide consistency and transparency to a developer as they consider different costs in their pro formas. As such, if a developer is considering a project with an average unit size lower than the citywide average, the transition to a per-square-foot fee could improve the feasibility of the project.

Staff completed an analysis of how this potential change might impact development based on the unit mix included in a number of projects constructed within this development cycle. While the trend over the last 13 years has been for multi-family units to get smaller, dropping from an average of 1,240 sq. ft. in 2005 to 973 sq. ft. in 2018, the unit mix of a particular development can vary significantly based on a number of factors – including the type of renter profile sought after by the developer. Transitioning to a per-square-foot fee assessments (for all city fees) could potentially reduce the fee burden on development, if developments' average unit sizes continue to shrink. This, however, also assumes that the basis for creating those fees would remain consistent. Some reports point to an increased number of occupants per unit. This could result in a change to the assumed occupant per square foot load, which could ultimately increase the cost on development.

Staff has received mixed feedback on this issue to date. Some developers believe that the transition to a square foot fee basis would improve the feasibility of their development. Alternatively, staff has heard that from a financing perspective, based on assessment of a known cost, developers generally adjust other factors in the pro forma rather than attempting to make the fees fit the project. Staff's preliminary conclusion is that pursuing this change in fee basis would not significantly improve development feasibility.

EVALUATION AND FOLLOW-UP

Following the City Council Study Session and May 1 follow-up Council item, staff will bring forward the proposed Urban Village Implementation Framework, and an update on the Response to the Housing Crisis Workplan to discuss which policy alternatives the City could consider to support the development of more housing. Staff will also continue to refine the models contained in this memo into a holistic, baseline model that can be used when considering changes to development fees and taxes to analyze the cumulative impact on development feasibility.

Staff proposes to present a similar "Cost of Development" analysis of commercial and industrial development for Council consideration in the Fall.

PUBLIC OUTREACH

The Office of Economic Development and Department of Planning Building and Code Enforcement met with residential and mixed use developers, development industry professionals and stakeholders and housing advocates on March 23 and 29.

COMMISSION RECOMMENDATION/INPUT

This report was not coordinated with any board or commission.

COORDINATION

Preparation of this Study Session and this staff report has been coordinated with the Departments of Planning Building and Code Enforcement, Housing, Transportation, Parks, Recreation and Neighborhood Services, Public Works, and City Attorney's Office.

CEQA

Not a Project, File No PP17-009 (a), Staff Report, Assessment, Annual Reports and Informational memos that involve no approval of City action.

/s/	/s/
KIM WALESH	ROSALYNN HUGHEY
Deputy City Manager	Director, Planning, Building and
Director of Economic Development	Code Enforcement

For questions please contact Chris Burton, Deputy Director, at (408) 535-8114, or Michael Brilliot, Division Manager, at (408) 535-7831.

Attachment:
Conceptual Pro Forma Analysis, Keyser Marston & Associates, April 17, 2018.