

*Five-Year Economic Forecast
and
Revenue Projections*

2015-2019

CAPITAL REVENUE FORECAST

MAJOR CAPITAL REVENUES

Overview

The major revenues that support the City of San José's capital programs are bond proceeds, grants, transfers between funds, and a number of taxes and fees levied on construction and property resale (conveyance) activity. This document provides a five-year forecast for the following taxes and fees: Construction and Conveyance Tax; Building and Structure Construction Tax; Construction Excise Tax; various Municipal Water System Fees; Residential Construction Tax; Sanitary Sewer Connection Fee; and Storm Drainage Connection Fee.

Construction-related Capital Program revenues are anticipated to increase significantly from the estimates provided in the 2014-2018 Adopted Capital Improvement Program (CIP), reflecting improvements in the current economic environment. There is a large projected increase of 25% over the 2014-2018 Adopted CIP, from \$280.7 million in the 2014-2018 Adopted CIP to \$352.2 million in the 2015-2019 Forecast. The Construction-Related Revenue chart included at the end of this section provides a year-by-year comparison of this Forecast with the 2014-2018 Adopted CIP.

FORECAST COMPARISON SUMMARY (\$ in Thousands)

	2014-2018 CIP	2015-2019 Forecast	Difference	% Change
Construction and Conveyance Tax	\$150,000	\$195,000	\$45,000	30%
Building and Structure Construction Tax	55,000	65,000	10,000	18%
Construction Excise Tax	70,000	86,000	16,000	23%
Municipal Water System Fees	750	750	0	0%
Residential Construction Tax	925	950	25	3%
Sanitary Sewer Connection Fee	3,250	3,750	500	15%
Storm Drainage Connection Fee	750	750	0	0%
TOTAL	\$280,675	\$352,200	\$71,525	25%

A discussion of major construction activity trends and each of the revenue categories are included in more detail on the following pages.

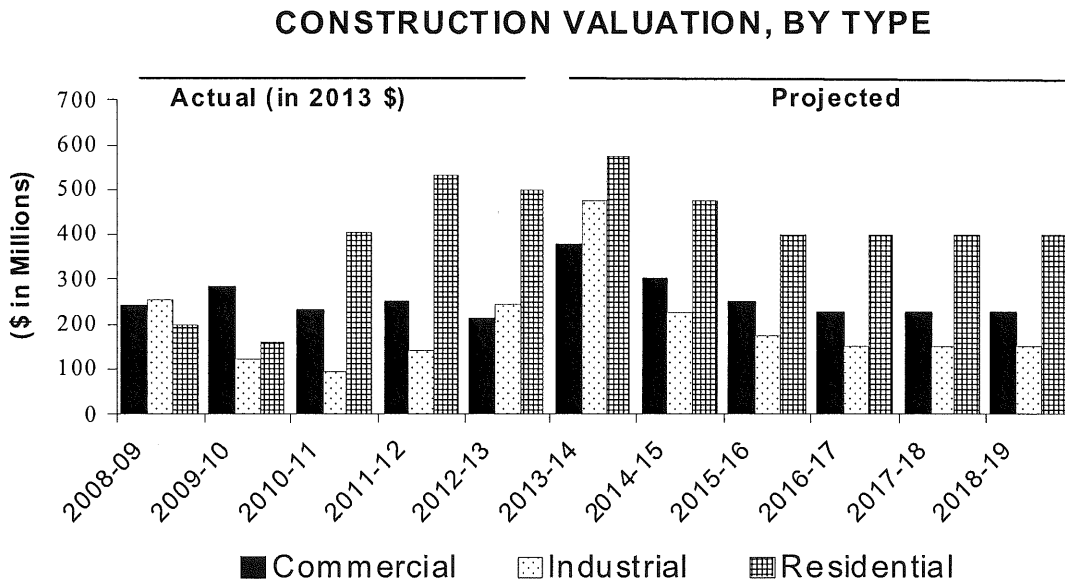
CAPITAL REVENUE FORECAST

CONSTRUCTION ACTIVITY PROJECTIONS

With the exception of the Construction and Conveyance Tax Fund, the capital revenues described in this Forecast are construction-related taxes and fees. Revenue projections are derived from actual revenue collection patterns and construction activity estimates provided by the Planning, Building and Code Enforcement (PBCE) Department. Each year the PBCE Department provides projections of construction activity related to residential, commercial and industrial development. The valuation figures have been adjusted to 2013 dollars per Bureau of Labor Statistics Consumer Price Index, San José-San Francisco-Oakland all items index. A more complete discussion of these estimates is provided in a technical report prepared by PBCE entitled “Development Activity Highlights and Five-Year Forecast (2015-2019)”, which is attached as an appendix to this document.

Based on projections provided by the PBCE Department, construction activity valuation is projected to continue at substantially higher levels than experienced last year: \$1.5 billion for 2013-2014 or 52% increase compared to \$956 million in 2012-2013. This level of activity is expected to drop to \$1.0 billion in 2014-2015, down to \$825 million in 2015-2016, and then drop slightly again to \$775 million per year from 2016-2017 through 2018-2019. The assumptions for the five-year forecast show a slight improvement of 9%, or a \$350 million increase from the levels presented in the 2014-2018 Forecast where activity ranged from \$775 million in 2013-2014 through 2014-2015 and decreased to \$700 million in 2015-2016 through 2017-2018.

The following graph illustrates the level of projected construction activity by type.



CAPITAL REVENUE FORECAST

CONSTRUCTION ACTIVITY PROJECTIONS

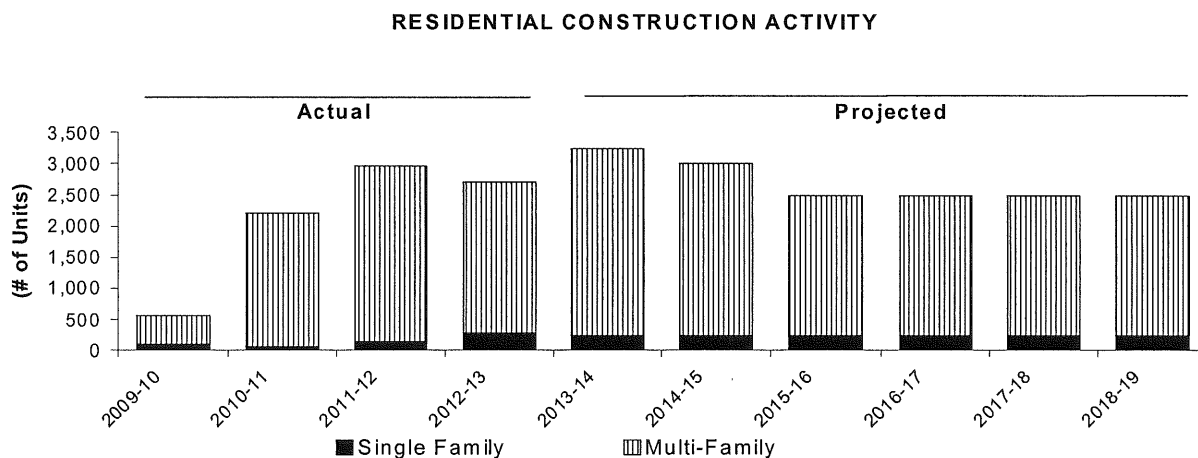
A summary of the PBCE Department construction activity projections and the corresponding revenue estimates are provided below. It should be noted that due to the highly volatile nature of the construction market, the reliability of the estimates can be expected to change over the period of the forecast. As new information becomes available, these estimates will be refined.

A. Residential Construction Activity

A significant portion of development-related revenue in San José has traditionally been generated by residential construction. New construction activity in 2012-2013 in this sector totaled 2,702 dwelling units, and is expected to reach 3,250 new dwelling units in 2013-2014, an increase of 20%. This compares to an all-time low of just 573 new dwelling units in 2009-2010.

The total value of residential construction activity projected in this Forecast is \$2.075 billion, a 14% increase over the 2014-2018 Forecast. The PBCE Department expects residential construction activity to generate an estimated 3,000 new units in 2014-2015, and then decrease to 2,500 new units per year from 2015-2016 through 2018-2019. This represents an average of 2,600 units per year or 13,000 units over the forecast period. This activity level has increased by 8% compared to the 12,000 units included in the 2014-2018 Forecast.

This forecast expects a total of 11,750 multi-family dwelling units or approximately 90% of all dwelling units (single-family and multi-family) to be constructed. This figure represents a 9% increase compared to the projections in the 2014-2018 Forecast for this category. Conversely, only 1,250 new single-family dwelling units are anticipated during this forecast period, flat compared to projections in the 2014-2018 Forecast, demonstrating that high-density developments will continue to drive residential construction for the foreseeable future. The following chart shows the number of new units, by housing type, anticipated in San José through 2018-2019.



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CONSTRUCTION ACTIVITY PROJECTIONS

B. Commercial Construction Activity

In 2012-2013, commercial construction activity totaled \$212 million, a 15% decrease from 2011-2012. New construction fell to its lowest levels in almost 20 years, yet alterations of existing buildings continued to be strong, amounting to double the value of new construction for the third consecutive year. However in 2013-2014, the PBCE Department expects commercial activity to reach \$375 million in total permit valuation, a decade-plus high primarily driven by the San Jose Earthquakes soccer stadium and new retail developments at the “Hitachi site.”

The total commercial construction valuation projected in this Forecast is \$1.225 billion, which is a 9% increase from the previous five-year forecast. As discussed in the attached report provided by the PBCE Department, the outlook for commercial construction activity is to modestly slow down from the anticipated 2013-2014 activity, but will be driven somewhat by a handful of hotel projects in North San José, the Airport vicinity, and Downtown.

Information provided by real estate trade groups for the 4th Quarter in 2013 indicated that the San José office and research and development (R&D) vacancy rate was 17.3% and the retail vacancy rate was 4.8%. These rates are similar in comparison to the 4th Quarter in 2012 of 17.0% and 5.5%, respectively.

C. Industrial Construction Activity

In 2012-2013, industrial activity was mixed; new construction remained slow, yet alterations rose to a twelve-year high. Overall, activity amounted to \$247 million in 2012-2013, an increase of 76% from 2011-2012. Led by Samsung Semiconductor’s construction of a 680,000-square foot headquarters in North San José, industrial activity is in the midst of an industrial rebound in 2013-2014, with total permit valuation expected to reach \$475 million – its highest since the “dot com” boom. Without the sustained influx of additional new construction, the PBCE Department expects valuation to decrease. Beginning in 2014-2015, activity is anticipated to drop to \$225 million, drop again to \$175 million in 2015-2016, and fall to \$150 million from 2016-2017 through 2018-2019.

Information provided by real estate trade groups for the 4th Quarter in 2013 indicated that the San José vacancy rate for industrial space was 6.2%, which is down slightly from the 8.0% vacancy rate for the same period in 2012.

It should be noted that the City Council has undertaken several actions to reduce the cost of new development in San José to create a predictable and competitive environment that supports the City’s economic development goals of filling industrial buildings and encouraging new workplace development. To that end, in November 2013, the City Council extended a partial

CAPITAL REVENUE FORECAST

CONSTRUCTION ACTIVITY PROJECTIONS

suspension of construction taxes placed on new construction or alteration of office, research and development uses, data center uses and installation of solar photovoltaic systems until March 31, 2017 (R&D Facilities Incentive). The Council has directed staff to target voter approval of a ballot measure in November 2016 to make the incentive program permanent. Additionally, the City Council enacted the Downtown High Rise Incentive Program in May 2012, subsequently extended in February 2013, to stimulate investment by reducing construction taxes by 50% for new downtown residential high rise buildings for those projects that obtain a building permit by December 31, 2014. That program was again modified in August 2013 to apply the 50% reduction to commercial and industrial new construction in the Downtown that obtain a building permit by December 31, 2014. How these incentive programs are applied to the Building and Structure Construction Tax and the Construction Excise Tax are discussed in the following pages.

Major Development Activity Data

As part of the attached Development Activity Highlights and Five-Year Forecast (2015-2019) document prepared by the PBCE Department, information is provided on development activity that serves as the foundation for their forecast. Data is provided on “major” projects (residential projects greater than 50 units, commercial projects greater than 25,000 square feet, and industrial projects greater than 75,000 square feet), and is broken down by the three major land use categories – residential, commercial, and industrial. The projects are further subdivided into four categories based on their status (completed, under construction, approved but not yet commenced, and pending City approval). In addition, individual maps are provided for each of the City’s 15 planning areas that show the projects in all status categories submitted since January 1, 2008. These maps can be used in conjunction with the activity data to help analyze the rate, type and location of major development activity in San José.

CONSTRUCTION AND CONVEYANCE TAX

The Construction Tax portion of the Construction and Conveyance Tax category is levied on most types of construction. For residential construction, the tax rate is based upon the number of units constructed and ranges from \$75 per unit located in a building containing at least 20 dwelling units to \$150 for a single-family residence. The commercial and industrial rate is eight cents per square foot of floor area constructed. The Construction Tax accounts for a very small portion (approximately 1%) of the total Construction and Conveyance Taxes collected.

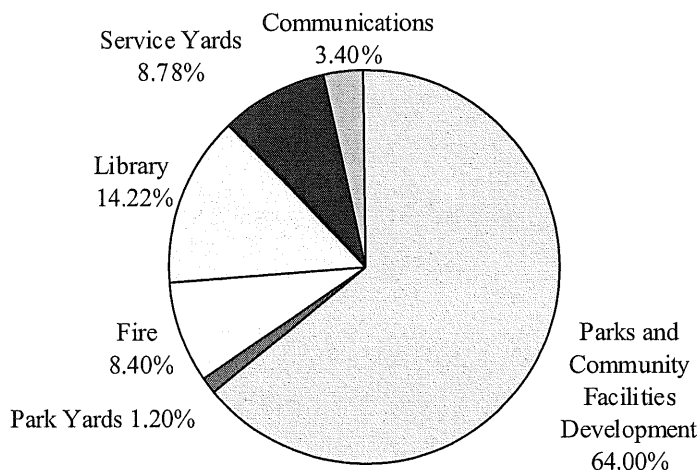
The Conveyance Tax portion of the Construction and Conveyance Tax category is imposed upon each transfer of real property where the value of the property exceeds one hundred dollars. The tax is imposed at a rate of \$1.65 for each \$500 of the value of the property. The Conveyance Tax accounts for approximately 99% of the total Construction and Conveyance Taxes collected.

Under current ordinance, Construction and Conveyance Tax receipts are allocated to six different capital programs per the following distribution formula:

CAPITAL REVENUE FORECAST

CONSTRUCTION AND CONVEYANCE TAX

CONSTRUCTION AND CONVEYANCE TAX DISTRIBUTION



Under the current City ordinance, the combined proceeds from the Construction and Conveyance Tax may be used for facility acquisition, construction, equipment, furnishings, and limited operating and maintenance expenses.

Consistent with the Construction and Conveyance Tax Task Force recommendations adopted by the City Council in June 1989, the Parks and Community Facilities Development portion of the estimated revenues, less non-construction costs and transfers to the General Fund, is allocated for all years of the forecast using a two-to-one ratio, with two-thirds of the proceeds going to neighborhood/district park projects and one-third to city-wide park projects. Per the current City Council policy, 20% of funds for neighborhood/district projects are set aside and equally allocated to meet special needs. The balance of the funds is then distributed to district funds based on a formula using the following criteria:

- neighborhood and community-serving park acres per 1,000 population;
- developed neighborhood and community-serving park acres per 1,000 population;
- square feet of neighborhood and community-serving center space per 1,000 population; and
- developed park acres and/or facilities in good condition per 1,000 population.

The five-year projection for Construction and Conveyance Tax revenue totals \$195 million, which is 30% higher than the estimate used to develop the 2014-2018 Adopted CIP. The Construction and Conveyance Tax revenue projections are based upon: 1) a review of prior year collection trends; 2) a review of year-to-date residential sales activity in San José; 3) a review of year-to-date tax receipts; and 4) projections of the future strength of the San José real estate market.

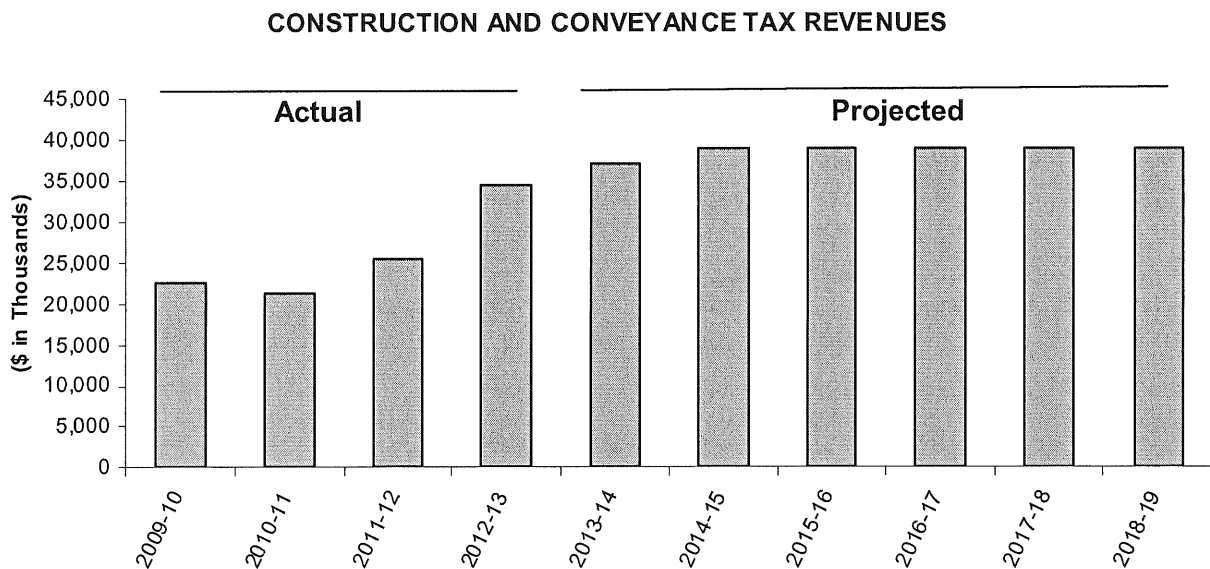
CAPITAL REVENUE FORECAST

CONSTRUCTION AND CONVEYANCE TAX

Historically, Construction and Conveyance Tax revenues have been very volatile, reflecting the impacts of the ups and downs of the local economy and particularly the real estate market. After reaching a record setting high of \$49 million in 2005-2006, tax collections continuously fell for several years following the real estate slowdown and financial market crisis, dropping to \$20.5 million in 2008-2009. Collections rose slightly in 2009-2010 to \$22.5 million and fell slightly to \$21.4 million in 2010-2011. Since that time, collections have risen sharply, \$25.4 million in 2011-2012, \$34.4 million in 2012-2013, and are on pace to reach \$37.0 million in 2013-2014. Revenues are projected to increase to \$39.0 million annually in 2014-2015 and throughout the forecast period, though these estimates could vary significantly due to the historically volatile real estate market.

The median single-family home price in January 2014 was \$660,000, which is an increase of 7.6% from the January 2013 price of \$613,500. In addition, the average days on market for single-family and multi-family homes dropped slightly from 44 days in January 2013 to 42 days in January 2014. However, available inventory continues to be tight, as the number of property transfers (sales) for all types of residences in January 2014 totaled 398, which represents a decrease of approximately 12.7% from the 456 sales that occurred in the same month in the prior year. These figures point to a strong real estate market that is moderating from last year's sharp growth rates.

The graph below shows actual and projected revenues for the combined Construction and Conveyance Tax revenues over a 10-year period.



CAPITAL REVENUE FORECAST

BUILDING AND STRUCTURE CONSTRUCTION TAX

The Building and Structure Construction Tax is imposed upon the construction, repair or improvement of any building or structure where a building permit is required. Current rates are:

- 1) Residential – 1.75% of 88% of the Building Official's valuation.
- 2) Commercial – 1.5% of the Building Official's valuation.
- 3) Industrial – 1.0% of the Building Official's valuation.

The proceeds from the Building and Structure Construction Tax are restricted by ordinance for use for traffic capital improvements on major arterials and collectors. These improvements can include the acquisition of land and interest in land and the construction, reconstruction, replacement, widening, modification and alteration (but not maintenance) of City streets. This tax revenue provides the Traffic Capital program with funds to complete major street infrastructure projects, particularly those that improve the Level of Service (LOS). LOS refers to the efficiency with which streets and roadways accommodate peak level traffic.

As discussed above, the R&D Facilities Incentive and the Downtown Incentive programs impact the Building and Structure Construction Tax. The R&D Facilities Incentive acts to reclassify buildings that were previously identified as commercial – such as research and development facilities and data centers – and treats them as industrial, which results in projects moving from a tax rate of 1.5% to 1.0%. The Downtown Incentive acts to cut the tax rate in half for all categories for qualifying projects. It is likely that these targeted incentive programs have played a role in the recent uptick in construction activity.

Building and Structure Construction Tax receipts through January totaled \$13.5 million, well above the \$7.2 million collected through the same period last year. Due to this dramatic increase, the 2013-2014 Mid-Year Budget Review included an action to increase the revenue estimate from \$11.0 million to \$19.0 million. Revenues are still on pace to achieve this revised budget estimate.

Based on the construction activity forecasts supplied by the PBCE Department and an analysis of actual collection patterns, the five-year projection for the Building and Structure Construction Tax collections totals \$65.0 million, an increase of \$10.0 million (18%) from the estimate included in the 2014-2018 Adopted Capital Improvement Program (CIP). While annual collections are not anticipated to maintain the high pace experienced in 2013-2014, the next two years will still see relatively high revenues when compared to the recent past. Collections are projected to be \$16.0 million in 2014-2015, \$13.0 million in 2015-2016, and remain at \$12.0 million from 2016-2017 through 2018-2019. A comparison of the five-year forecast with actual collections in previous years for the Building and Structure Construction Tax is shown in the chart that follows.

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CONSTRUCTION EXCISE TAX

The Construction Excise Tax (also referred to as the Commercial-Residential-Mobile Home Park Building Tax) is imposed upon the construction, alteration, repair or improvement of any building or structure, which is for residential or commercial purposes or is associated with a mobile home. This general purpose tax may be used for any “usual current expenses” of the City. However, the City Council has historically used the majority of these funds for traffic improvements. The current rates are:

- 1) Residential – 2.75% of 88% of the Building Official’s valuation.
- 2) Commercial – 3.0% of the Building Official's valuation.

As mentioned above, this tax is a general purpose tax; however, the majority of the proceeds have generally been used for a variety of essential Traffic Capital projects that cannot be funded by the Building and Structure Construction Tax or grants. Typical projects funded with this tax include street maintenance and resurfacing, streetlights, bicycle and pedestrian facilities, and most strategic planning programs, which improve the City’s ability to obtain State and federal grants. A portion of these taxes have also been used as a budget balancing solution to address General Fund shortfalls.

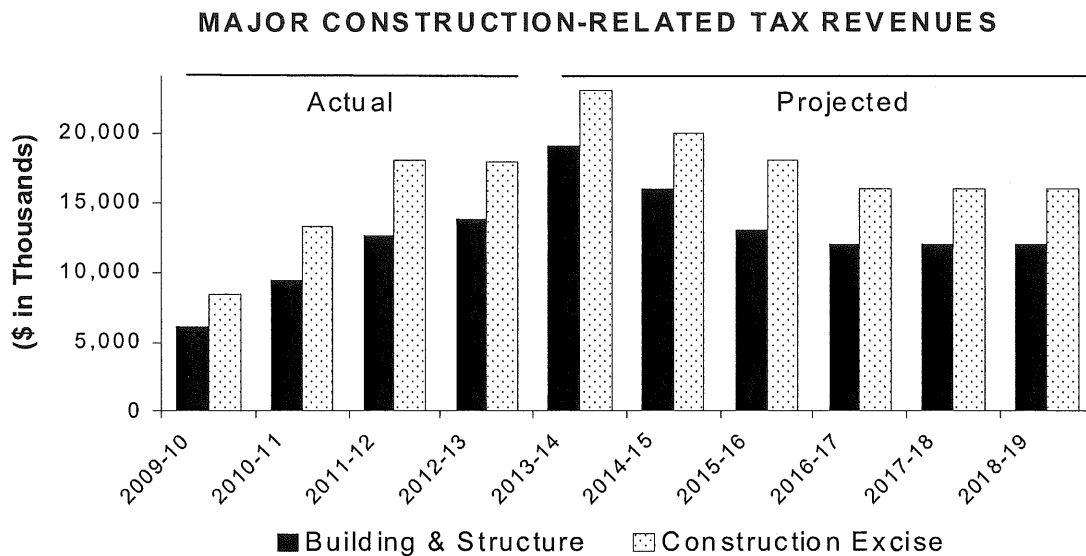
Unlike the Building and Structure Construction Tax, this tax does not apply to industrial development. As a result, changes in industrial building activity do not affect these tax receipts. However, the R&D Facility Incentive reclassifies certain building uses from commercial to industrial. As the Construction Excise Tax does not levy a tax on industrial uses, these facilities would be exempt, resulting in the R&D Facility Incentive having a large impact on the Construction Excise Tax than the Building and Structure Construction Tax. The Downtown Incentive acts to cut the tax rate in half in both residential and commercial categories for qualifying projects. As noted above, it is likely that these targeted incentive programs have played a role in the recent uptick in construction activity.

Tax receipts through January for the Construction Excise Tax Fund totaled \$15.9 million, much higher than the \$9.2 million collected through the same period last year. Due to this dramatic increase, the 2013-2014 Mid-Year Budget Review included an action to increase the revenue estimate from \$14.0 million to \$25.0 million. However, the January data indicates that the total amount of revenue expected in 2013-2014 may decrease slightly to \$23.0 million. The Administration will continue to carefully monitor this revenue source to determine if any further budgetary adjustments are needed prior to year-end.

Based upon the construction projections provided by the PBCE Department and actual collections on this tax, Construction Excise Tax collections are projected to total \$86.0 million over the five-year forecast period, with proceeds estimated at \$20.0 million in 2014-2015, \$18.0 million in 2015-2016, and \$16.0 million from 2016-2017 through 2018-2019. This collection level represents an increase of \$16 million (23%) from the 2014-2018 Adopted CIP. A comparison of the five-year forecast with actual collections in previous years for the Construction Excise Tax is shown in the chart below.

CAPITAL REVENUE FORECAST

CONSTRUCTION EXCISE TAX



MUNICIPAL WATER SYSTEM FEES

Various Municipal Water System fees are charged for connecting to the City's water system. These fees include the Advance System Design Fee, Major Facilities Fee, Meter Installation Fee, and Service Connection Fee. Advance System Design Fees are charged to developers to cover engineering and inspection costs for water facilities required in new developments. Major Facilities Fees are charged based on average daily water use for new or expanded developments. Meter Installation Fees are charged to developers to recover costs based on the size of the meter and/or fire hydrant installation necessary. Service Connection Fees are charged to developers to recover the actual costs associated with the construction of water main or fire hydrant installations when improvements are constructed by the City.

Fee collections for the Municipal Water System in 2013-2014 are tracking at or near the budgeted estimate. This level of activity is expected to continue in the near term and \$750,000 in revenue is expected over the five-year period of this forecast for the fees detailed in the chart below.

MUNICIPAL WATER SYSTEM FEES

(\$ in Thousands)

	2014-2018 CIP	2015-2019 Forecast	Difference	Change
Advance System Design Fee	250	250	0	0%
Meter Installation Fee	250	250	0	0%
Service Connection Fee	250	250	0	0%
TOTAL	750	750	0	0%

CAPITAL REVENUE FORECAST

MUNICIPAL WATER SYSTEM FEES

The forecast for Municipal Water System fees remains unchanged from the 2014-2018 Adopted CIP, reflecting a relatively steady pace of the combined development activity in the Municipal Water System service areas which include North San José, Evergreen, Alviso, Edenvale, and Coyote Valley areas.

RESIDENTIAL CONSTRUCTION TAX

The Residential Construction Tax is imposed upon the construction of residential dwelling units and mobile home lots in the City. The rates are imposed on each dwelling unit and differ according to the number of units located in the building. Rates vary from \$99 for each dwelling unit in a multiple dwelling of at least 20 units to \$180 for a single-family residence.

This tax is collected and placed in the Residential Construction Tax Contribution Fund and is used to reimburse developers that have constructed a wider arterial street than their residential development required. The funds are also used to construct median island landscaping and other street improvements.

Collections for this tax in 2013-2014 are tracking high and are expected to exceed the budgeted estimate. Based upon construction estimates by the PBCE Department and the actual collection pattern for this tax, \$950,000 in revenue is expected over the five-year period of this forecast, which is a 3% increase from the 2014-2018 Adopted CIP revenue estimates of \$925,000, and reflects expectations that development activity will continue to increase.

SANITARY SEWER CONNECTION FEE

The Sanitary Sewer Connection Fee is charged for connecting undeveloped parcels to the City's sewer system. The fees collected may only be used for the construction and reconstruction, including land acquisition, of the San José sanitary sewer system. The fee is based on the number of single and multi-family residential units built and the acres developed on commercial and industrial properties.

Fee collections in 2013-2014 are tracking high and are expected to exceed the budgeted estimate. The 2015-2019 Forecast projection for this fee is \$3.8 million, which is a 15% increase from the 2014-2018 CIP estimate of \$3.3 million. This estimate is based on the assumptions that development activity will continue to increase.

CAPITAL REVENUE FORECAST

STORM DRAINAGE CONNECTION FEE

The Storm Drainage Connection Fee is charged to the owner of any land that discharges storm water, surface water or ground water runoff into the City's storm drainage system. The fees are charged by acreage or lot and vary by land use and by the number of units located in the development. Storm Drainage Connection Fees may only be used for the construction, reconstruction, land acquisition and maintenance of the San José storm drainage system.

Fee collections in 2013-2014 are tracking lower and may fall short of the budgeted estimate. The five-year forecast for Storm Drainage Connection Fees is \$750,000, which matches the estimate included in the 2014-2018 Adopted CIP.

ATTACHMENT A
CONSTRUCTION-RELATED REVENUE
2015-2019 FORECAST
(in \$ thousands)

	2013-14	2014-15	2015-16	2016-17	2017-18	2018-19	5 Yr Total
Construction and Conveyance Tax							
2014-2018 Adopted CIP	30,000	30,000	30,000	30,000	30,000	30,000	150,000
2015-2019 FORECAST	37,000	39,000	39,000	39,000	39,000	39,000	195,000
Difference	7,000	9,000	9,000	9,000	9,000	N/A	45,000
Building and Structure Construction Tax							
2014-2018 Adopted CIP	11,000	11,000	11,000	11,000	11,000	N/A	55,000
2015-2019 FORECAST	19,000	16,000	13,000	12,000	12,000	12,000	65,000
Difference	8,000	5,000	2,000	1,000	1,000	N/A	10,000
Construction Excise Tax							
2014-2018 Adopted CIP	14,000	14,000	14,000	14,000	14,000	N/A	70,000
2015-2019 FORECAST	23,000	20,000	18,000	16,000	16,000	16,000	86,000
Difference	9,000	6,000	4,000	2,000	2,000	N/A	16,000
Municipal Water Advance System Design Fee							
2014-2018 Adopted CIP	50	50	50	50	50	N/A	250
2015-2019 FORECAST	50	50	50	50	50	50	250
Difference	-	-	-	-	-	N/A	-
Municipal Water Meter Installation Fee							
2014-2018 Adopted CIP	50	50	50	50	50	N/A	250
2015-2019 FORECAST	50	50	50	50	50	50	250
Difference	-	-	-	-	-	N/A	-
Municipal Water Service Connection Fee							
2014-2018 Adopted CIP	50	50	50	50	50	N/A	250
2015-2019 FORECAST	50	50	50	50	50	50	250
Difference	-	-	-	-	-	N/A	-
Residential Construction Tax							
2014-2018 Adopted CIP	175	175	175	200	200	N/A	925
2015-2019 FORECAST	325	225	200	175	175	175	950
Difference	150	50	25	(25)	(25)	N/A	25
Sanitary Sewer Connection Fee							
2014-2018 Adopted CIP	650	650	650	650	650	N/A	3,250
2015-2019 FORECAST	1,800	1,000	800	650	650	650	3,750
Difference	1,150	350	150	-	-	N/A	500
Storm Drainage Connection Fee							
2014-2018 Adopted CIP	150	150	150	150	150	N/A	750
2015-2019 FORECAST	125	150	150	150	150	150	750
Difference	(25)	-	-	-	-	N/A	-
TOTAL							
2014-2018 Adopted CIP	56,125	56,125	56,125	56,150	56,150	N/A	280,675
2015-2019 FORECAST	81,400	76,525	71,300	68,125	68,125	68,125	352,200
Difference	25,275	20,400	15,175	11,975	11,975	N/A	71,525
% Change from 2014-2018 CIP	45%	36%	27%	21%	21%	N/A	25%

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