City of San Jose
Cost of Development Memo
February 2019

Summary

In order for the City of San Jose to meet the Mayor's goal of building 25,000 housing units without converting additional employment lands to residential use, the City must find mechanisms within its control to boost new residential construction activity in priority development areas like downtown.

With the limited number of new construction projects underway, it stands to reason that the City's fee structure, even with the current high-rise incentive program, is inhibiting new high-rise construction projects from reaching acceptable return metrics in order to attract capital in the marketplace.

Although it is reasonable to anticipate that rents and prices will continue to increase if the regional economy stays strong, there is the chance that those conditions may not occur. If the City does nothing to align fees with the current economic environment, there will undoubtedly be very little change in construction activity.

Background

Over the last five years, San Jose produced the lowest amount of building permits among the major Western US markets except for the City of Oakland. The City of Oakland's permit activity has risen dramatically over the last five years and eclipsed San Jose last year. The City of Seattle which is most similar to San Jose in terms of economic base, geographical constraints, and demographics produced nearly 3x the number of building permits. Seattle has no impact fees and the affordable housing fee is offset by an increase in building heights in the downtown core.

Table 1: Western US Building Permit Activity 2013-2017

	2013	2014	2015	2016	2017	Total	5-Year Avg
Los Angeles, CA	8,392	11,264	16,013	13,890	14,846	64,405	12,881
Seattle, WA	6,677	7,445	11,340	9,999	9,887	45,348	9,070
Denver, CO	5,870	5,958	7,901	7,842	10,525	38,096	7,619
Phoenix, AZ	3,131	5,138	4,611	6,972	6,806	26,658	5,332
San Diego, CA	5,308	2,743	6,185	6,612	5,692	26,540	5,308
San Francisco, CA	4,474	2,711	3,665	4,087	4,254	19,191	3,838
San Jose, CA	3,703	4,445	2,019	2,728	2,441	15,336	3,067
Oakland, CA	509	257	866	2,136	3,501	7,269	1,454

The cities of San Diego and Los Angeles which produced substantially higher building permit volume also have significantly lower fee burdens. According to the Terner Center for Housing Innovation at UC Berkeley in *It All Adds Up: The Cost of Housing Development Fees in Seven California Cities* in March 2018 and our review of project specific fee schedules in San Diego and and San Jose, here's how the fee burdens stack up.

Table 2: Fee Comparison of California Cities

	Los Angeles	San Diego	Oakland	San Jose
Total Fees	$1,174,642	$1,803,800	$3,455,593	$5,698,200
Per Unit	$11,746	$18,038	$34,455	$56,982

*Prototypical 100-Unit MF per Terner for Los Angeles and Oakland; fee estimates for 4th and C in San Diego and Aviato in San Jose. San Francisco information was unavailable.

In 2016, the City extended the high-rise incentive program to spur development in downtown. To date, only two high-rise rental projects (The Graduate and Miro) and one for-sale project (Silvery Towers) have obtained financing in the capital markets and have been able to take advantage of the City's high-rise incentive program. Rising construction costs and flattening rents have clearly mitigated the impact of the incentive program.

There are approximately 2,100 approved residential units in the downtown pipeline attempting to obtain financing and commence construction. The City's planning efforts such as establishing Downtown Core Zoning and streamlining the environmental review process have been successful as evidenced by this robust development pipeline.

Table 3: Downtown Pipeline

Project	**Developer**	**Units**
Post & San Pedro	Simeon Properties	202
NSP Tower 3	Z&L Properties	313
Park View Towers	Z&L Properties	220
Montgomery 7	Montgomery 7 LLC	54
Gateway Towers	Core Companies	300
Greyhound	Z&L Properties	708
Aviato @ NSP	KT Urban	302
Total		2,099

City of San Jose Fees & Taxes on New Residential Construction

The City of San Jose charges the following fees & taxes for new residential development: planning & mapping fees, building permit & inspection fees, construction taxes and impact fees including parks and affordable housing. Using Aviato @ North San Pedro (302 units) as an example, the City's total project fees & taxes are broken down as follows:

Table 4: City of San Jose Fee Detail

	Rental			For-Sale		
Description	**Amount**	**%**	**Per Unit**	**Amount**	**%**	**Per Unit**
Planning & Mapping	$588,099	3%	$1,947	$588,099	3%	$1,947
Building Permit	$696,208	4%	$2,305	$696,208	4%	$2,305
Construction Taxes	$3,965,087	23%	$13,129	$3,965,087	21%	$13,129
Impact Fees						
- Park Fees	$4,409,200	26%	$14,600	$4,409,200	23%	$14,600
- AHIF	$7,550,000	44%	$25,000	$9,268,682	49%	$33,441
Total	**$15,251,315**	**100%**	**$56,982**	**$16,969,997**	**100%**	**$65,422**

*excludes high-rise incentive or IHO exemption

As you can see, two categories of taxes and fees account for more than 90% of the economic burden imposed on new residential construction: construction taxes and impact fees. Impact fees including park fees and the AHIF account for approximately 70% of the costs under both scenarios.

Construction Taxes

Based on our review of other California cities like Los Angeles, San Diego and San Francisco, construction taxes appear to be unique to San Jose. Unlike other fees charged which are used to mitigate project impacts under the Mitigation Fee Act, the Building & Structures Tax and the CRMP are general revenue producing levies. In the past, the City has studied the cost of residential development and noted that projects in excess of 55 units to the acre are revenue positive. Since high-rise developments in the downtown core are substantially more dense than other areas of the City, these taxes could be eliminated to help spur construction activity and replace lost revenue from the elimination of these fees.

Impact Fees

The City currently charges two impact fees for new residential construction. Park fees are levied through the City's PDO | PIO and affordable housing fees through the City's Inclusionary Housing Ordinance. (Note: The City has migrated from the AHIF to the IHO.)

Park Fee

In December 2017, the City adopted a new fee rate for high rise units by adopting modified occupancy estimates. All park in lieu fees are still based on a PDO | PIO level of service at 3 acres per 1,000 residents. This change resulted in an $8,000 decrease of the park fee per unit. City staff and the Council should be commended for thinking outside the box in their approach here.

In comparing park fees to other major California cities like Los Angeles, San Diego and San Francisco, the new park fee is still extremely high. Los Angeles recently updated its park mitigation fees and exempts affordable housing projects. Oakland had traditionally not charged a park impact fee under the Mitigation Fee Act or the Quimby Act. The City of Oakland recently adopted a capital improvement fee that includes parks. San Francisco does not charge a park impact fee for downtown projects as a utilization study found that office and hotel uses generated the majority of daytime park use.

Table 5: Park Fee Comparison

City	Amount
San Jose	$14,600
Los Angeles	5,374
Oakland	750
San Diego	5,619
San Francisco	--

San Jose is currently updating its Greenprint for how San José's parks, trails and community centers will change over the next 20 years. While there are several neighborhoods within the City of San Jose that need parks according to the study, the Council District 3 Park Need Map which covers the downtown area illustrates that ample land inventory for parks already exists.

By reducing the level of service assumptions in the Downtown Core Area from 3 acres per 1,000 residents to a lower level, the City could reduce the PDO | PIO to make it more in-line with other major California cities. By reducing the level of service, a project like Aviato @ North San Pedro would see its park impact fee decrease from $14,600 per unit to the following based on a level of service reduction to 1.5 acre per 1,000 residents.

Table 6: LOS and Park Fee Per Unit

	Occupancy	Total Population	PDO Obligation	Total Fee	Fee Per Unit
Current LOS	1.51	456	1.37	$4,409,600	$14,600
Reduced LOS	1.51	456	0.46	$2,204,800	$7,300

*assumes Aviato @ North San Pedro with 302 units

Affordable Housing Fee

The City adopted an Inclusionary Housing Ordinance in January 12, 2010. *On November 18, 2014, the San José City Council approved the adoption of an Affordable Housing Impact Fee (AHIF) to help address the need for affordable housing connected with the development of new market rate residential rental units. On September 29, 2017, the Governor signed AB 1505, explicitly authorizes cities and counties to adopt ordinances that require, as a condition of the development of residential rental with 20 or more units. As a result, on December 19, 2017, the San José City Council approved a transition from the Affordable Housing Impact Fee (AHIF) to the Inclusionary Housing Ordinance due to AssemblyBill (AB) 1505.*

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. 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 AHIF program currently contains an exemption for downtown high-rise rental developments. In its December 2017 staff memo regarding the AHIF and Inclusionary Program, staff noted the high-rise exemption was instituted as an incentive due to the height restriction over downtown, high costs of construction, high land prices, rising labor costs, and stabilizing rents. Staff correctly concluded that these factors make building high-rise developments in the downtown much more challenging.

The current AHIF for rental projects is $125,000 per affordable unit ($125,000 x 20%=$25,000 per unit) or approximately $25 per square foot (assuming 1,000 SF unit). When the Inclusionary Ordinance was originally adopted, rental projects located within Redevelopment Project Areas and the Downtown High-Rise Incentive area were subject to a fee of $8.50 per square foot. Since inception, the In-Lieu fee has increased by 194% for rental projects.

Downtown for-sale developments within Redevelopment Project Areas and the Downtown High-Rise Incentive area were originally required to pay $65,000 per affordable unit ($65,000 x 20% = $13,000 per unit) or $13 per square foot. The current fee is $167,207 per affordable unit ($167,207 x 20% = $33,441), a 157% increase.

Four high rise rental development have been completed or started construction since the Inclusionary Ordinance became effective. One South Market, Centerra, The Graduate and Miro were all exempt from the fee as rental developments. One condominium project, Silvery Towers, is currently under construction and was subject to the fee at $8.50 per square foot. The impact of the meteoric rise in the AHIF for both rental and for-sale developments is currently being felt as no new rental or for sale developments are under construction.

The in-Lieu fee ("ILF") is especially challenging for developers due to the unpredictable nature of the fee calculation and the timeline associated with previous exemptions or incentives. Developers need certainty when developing project budgets and project approvals can span multiple fiscal years subjecting projects to multiple increases in the ILF. (Note: changed from AHIF to ILF for clarity.)

In order to stimulate increased activity in Downtown High-Rise construction, the ILF must be reduced substantially and should be tied to the City achieving its residential production goals in the downtown core rather than an arbitrary timeline. With billions of dollars for affordable housing now available through bond initiatives and billions more coming to the ballot, new homeowner and renters can ill afford to continue to bear a disproportionate burden of fixing the affordable housing crisis.

A substantially reduced ILF combined with park fee reductions and construction tax elimination would spur new construction activity. Returning the ILF to levels originally levied under the former Redevelopment Project Areas would result in the following fee schedule.

Table 7: Proposed Fee Structure

	Rental			For-Sale		
Description	**Amount**	**%**	**Per Unit**	**Amount**	**%**	**Per Unit**
Planning & Mapping	$588,099	4%	$1,947	$588,099	8%	$1,947
Building Permit	$696,208	5%	$2,305	$696,208	9%	$2,305
Construction Taxes	--	0%	--		0%	--
Impact Fees						
- Park Fees	$2,204,600	30%	$7,300	$2,204,600	30%	$7,300
- AHIF	$2,567,000	50%	$8,500	$3,926,000	53%	$13,000
Total	**$6,055,704**	**100%**	**$20,052**	**$7,414,907**	**100%**	**$24,552**

Current Fees	$15,251,315		$56,982	$16,969,997		$62,673
Reduction	$9,195,611		$36,930	$9,282,090		$38,121

Conclusion

- **Adoption of New Impact Fee Levels Can Make a Difference in the Feasibility and Timing of Development.**

  Real estate feasibility is at a pivotal point right now and adopting new impact fees (thereby reducing development costs) will make a positive difference in the feasibility and timing of development within the Downtown core and help the City meet its General Plan objectives.

- **Differences in Location Support Impact Fee Zones for Residential Development.**

There are significant differences among parts of San Jose in the rents and prices of existing housing as well as the types of new housing being built and proposed. Impact fee structure must be consistent with development feasibility and ability to pay new impact fees. The City should establish impact fee zones and not take a blanket approach to City fees.

- **Key Implications of the Current Cost of Development Discussion.**

Scenarios evaluated in this analysis indicate that City fee levels even with the current high-rise incentive and IHO exemption are ahead of the necessary revenue increases to support them, particularly for multi-family housing development and for projects in the Downtown Core where construction costs have risen dramatically. Although it is reasonable to anticipate that rents and prices will continue to increase if the regional economy stays strong, there is the chance that those conditions may not occur. If the City does nothing to align fees with the current economic environment, there will undoubtedly be very little change in construction activity.

- **Potential Incremental Revenue Generation for City**.

The City stands to generate significantly more revenue even with lower per unit fees. If the City does nothing and maintains the current fee structure, the City will definitely see lower construction activity than if it lowers fees to the recommended levels. If we assume that only 10% of the units in the downtown pipeline get built with the current fee structure and 50% get built under a new fee program, total park fees collected would increase by $4.38 million and ILF would rise by $3.5 million. Property tax revenue would also surge as a result of the 800 additional units delivered in the marketplace.

Table 8: Incremental Revenue

	Do Nothing	Lower Fees
Construction Activity as % of Pipeline	10%	50%
No. Units	200	1,000
Average Fees	$56,982	$20,052
Total Revenue	$11,396,400	$20,052,000