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REPORT TO COUNCIL

SUBJECT
Consideration of Housing Mitigation Fee Nexus Study Findings and Alternatives

REPORT IN BRIEF
In 2009 Council directed staff to study possible expansion and/or increase of the City's Housing Mitigation Fee, which is currently imposed only on certain industrial or office projects. This study, initiated originally as a study issue (**Attachment 1**), required the completion of a nexus study to meet legal requirements for imposition of a new development impact fee. Staff engaged a consultant to complete the nexus study and other analysis related to this project. The nexus study is provided in **Attachment 2** to this report. A feasibility study is provided in **Attachment 3**, a slide presentation is provided in **Attachment 4**, and a comparison of several fee alternatives is provided in **Attachment 5.** Background on the City's past and projected uses of the Housing Mitigation fees is provided in **Attachment 6**, and the commissions' meeting minutes are provided in **Attachments 7** and **8**.

Staff recommends that Council adopt Alternatives 1, 2 and 4:

1. Direct staff to prepare an ordinance to expand the Housing Mitigation Fee to all net new square footage of all office/R&D, industrial, retail, and lodging development projects in any zone;
2. Set the initial fee rate in the draft ordinance at $12 per square foot for office/R&D/industrial projects ($6 per square foot for first 25,000 square feet), and $6 per square foot for retail and lodging projects, both adjusted annually for inflation as part of the annual fee schedule adoption; and
4. Clarify that the new fee rates shall apply to all covered projects for which a complete planning application is submitted on or after the effective date of the ordinance.

The fee would apply to net new square footage, with credit for any existing square footage. This recommendation would expand the fee program to retail and lodging uses that are not currently subject to the fee. While the rates in Alternative 2 are relatively similar to the current fee rate, most projects that are already subject to the fee would experience a significant increase in the total fee amount due, because the entire net new building square footage would be subject to the fee, rather than just the portion of the building that exceeds allowable floor area ratio for that site.

Although the nexus study demonstrates that a much higher fee could be assessed on all use types, other considerations, such as regional competitiveness, feasibility of desired uses (i.e., retail), the need for local jobs, and other City revenues generated by these developments (sales, property, and occupancy taxes) provide compelling reasons not to charge a rate significantly higher than that of Alternative 2. The feasibility assessment highlights significant impacts to feasibility that would occur if the fee were set at a rate much higher than $20 per square foot.

The Housing and Human Services Commission and Planning Commission held public hearings on this matter on October 22 and 27, respectively. Both commissions voted unanimously to support the staff recommendation (with two absences at the Housing and Human Services Commission meeting).

BACKGROUND

This study was suggested originally as part of the City's 2008 Housing Strategy, then as a study issue in 2009, and was also included in the 2009 Housing Element implementation plan. **Attachment 1** provides the study issue paper, updated in 2013, with a brief background and description of the proposed study. This study issue was dropped only because it was already included in the 2009 Housing Element implementation plan. To complete this study, staff recently commissioned a nexus study of the City's current commercial linkage fee, also known as the Housing Mitigation Fee. This fee was adopted by resolution in 1983, codified in 2003, and updated in 2008. It is contained in Sunnyvale Municipal Code section 19.22.035.

The purpose of this report is to share the findings of the nexus study and allow the community to discuss the findings and some possible ways to adjust the current linkage fee consistent with the study findings and other community concerns and priorities. The nexus study, provided in **Attachment 2**, is a rather technical document. Some useful definitions are provided here for background.

- A commercial linkage fee is a fee that links new employment-generating development, such as new offices, stores or factories, with the need for more affordable housing for the new workers who will work in those developments.
- A nexus study is a study of the connection between new development of a defined type and size, and its potential impacts on a community, such as increased traffic, increased air or water pollution, increased demand for public facilities and services such as schools or policing, or increased demand for housing, to name a few types of potential impacts. Each nexus study usually focuses on one particular type of impact, such as increased demand for housing or for parks.
- A nexus study also examines how the particular impact of the development might be mitigated or resolved. Mitigation usually occurs in one of two ways: either by the developer providing the needed services, land or facilities directly, or by paying a fee which the City (or the school district or other agency imposing the fee) could use to mitigate the identified impact of the development.
- The California Mitigation Fee Act requires that any requirements placed on land development projects by the city or county, such as the requirements to pay a fee, dedicate land, or construct community facilities, be connected to, or "have a nexus with" the identified impacts of that project. It also requires that the amount of the fee or other required mitigation measure be proportional to the degree or scale of the impacts of that development. Typically this legal requirement is addressed by completion of a nexus study by the city or county that identifies both the type and scale or size of likely impacts of a project.

The nexus study provides important information about the type and scale of the impacts of new commercial development on the City's needs for affordable housing. This information will be helpful for the City and community to consider when evaluating potential adjustments to the City's current housing mitigation fee.

EXISTING POLICY

General Plan, Housing Element

Policy A.4: Continue to require office and industrial development to mitigate the demand for affordable housing.

ENVIRONMENTAL REVIEW

N/A

DISCUSSION

Current Housing Mitigation Fee

The City's current Housing Mitigation Fee has been in effect since 1983 and was last updated in 2008, at which time the fee was indexed to inflation. The fee, which was $9.49 per *applicable* square foot at the time the study was completed (currently $9.74/square foot), only applies to development in the City's industrial zones, and only on the portion of the new building that exceeds the maximum floor-area ratio (FAR) allowed at the site of the development (i.e., "applicable" square feet). In other words, if the zoning on a particular site in an industrial zone only allows a 50,000 square foot development due to the FAR limits in place, and the applicant seeks and obtains a discretionary approval to build a project of 80,000 square feet, the fee would only apply to the extra 30,000 square feet built in the project. In fact, a developer wishing to replace a 40,000 square foot building with a 50,000 square foot project on that same site would currently pay no housing mitigation fee at all (because the project, despite representing a net increase in square footage, would not exceed the maximum FAR allowed on site).

In addition, if an identical office project is built in a non-industrial zone, such as in areas zoned Office, Commercial, or within any of the specific plan zones such as Downtown Specific Plan or El Camino Precise Plan, it is not subject to the Housing Mitigation Fee. Similarly, this fee does not apply to any type of project, such as hotels, stores, or other places of employment, outside of the industrial zones, although all of those projects are employment-generating. Due to the somewhat limited application of the current Housing Mitigation Fee, many have suggested expanding the fee to apply to all employment-generating uses to better address the need for affordable housing generated by all types of employment-generating projects.

Study Procedure and Findings

In order to complete the nexus study, the City retained Economic Planning Systems, Inc., based in Oakland (EPS), a firm that has completed many studies of this type for clients throughout California. The scope of work included the following primary tasks:

- Define the nexus between new employment-generating (non-residential) development and the need for new affordable housing in the City. For this study, commercial development was divided into three main types, to allow for more accurate analysis of the number and wage levels of workers in the developments. These three types included: office/industrial/research and development (R&D); retail; and lodging.
- Identify the maximum supportable nexus-based fee levels for each of the three development

types.

- Study the financial feasibility of the various development types under the current Housing Mitigation Fee structure, the maximum supportable fee level, and a "suggested" fee level that would not impede development, but would generate additional fees to support the housing needs generated by these developments. This suggested fee level was not a staff recommendation, but simply a fee level selected for feasibility testing.
- Survey the rates and structures of commercial linkage fees in other communities in the vicinity and the region for comparison.

The full report prepared by EPS is provided in **Attachment 2**. The third and fourth tasks listed above are summarized in a memorandum from EPS provided in **Attachment 3**.

The primary findings of the study are as follows:

1. The maximum nexus-supported fees calculated by EPS for Sunnyvale, shown in the table below, greatly exceed those currently imposed in Sunnyvale and other jurisdictions.

Project Type	**Maximum Supportable Fee Level Per Square Foot** *(net new space)*	**Silicon Valley Average***
Lodging	$76	$9
Retail / Restaurants	$295	$9
Office / Light Industrial / R&D	$114	$11-12

All figures rounded to the nearest dollar.
** Data used to determine average is described further in Attachment 3.*

2. Commercial fees charged by other Bay Area jurisdictions vary significantly based on geography and local development costs.
3. Jurisdictions have taken different approaches to how they apply the fees to the square footage of new projects.
4. EPS suggests charging well below the maximum nexus-based fee to all evaluated commercial uses (lodging, office/R&D, light industrial/flex, and retail), nearer the range of fees charged by comparable cities.

The report and Memorandum explain the logical basis for the analysis that produced these findings, and shows all the background data used for the calculations in the appendices.

Feasibility Analysis
The report acknowledges that the maximum fee levels shown in Finding 1 above would likely make most development projects infeasible, and could lead to future difficulties in increasing local employment opportunities and/or retaining desired employers who wish to expand in the City.

One metric used in the feasibility study to test project feasibility at different fee levels was "return on cost", as explained further in **Attachment 3**. This test showed that if the fee were to be set at the maximum levels shown in the nexus study, all project types would fall well below the feasibility threshold, which is a seven percent return on cost at project stabilization. Under the maximum fee levels, the return on cost would fall to the following rates, which are well below the minimum return on cost typically expected by most investors when determining whether or not to undertake a project at a particular location:

- Office/R&D Projects: 5.97%
- Light Industrial/Flex Projects: 5.44%
- Retail: 3.44%
- Lodging: 6.37%

Given the feasibility impacts of the maximum fee, if a fee were imposed at such a high rate, it is likely developers would look for properties in nearby jurisdictions that have a lower linkage fee or no linkage fee at all, such as Santa Clara or San Jose. If that were the case, the City would not receive any revenues from linkage fees, nor other project-related economic benefits, such as sales taxes, property taxes, local employment opportunities, and derivative corporate and employee spending at local retail, services, and hospitality businesses.

To address this concern, EPS tested a fee level, referred to in the Memorandum (**Attachment 3**) as Scenario A, that was closer to the average fee levels in those nearby cities that currently have linkage fees (Cupertino, Palo Alto, Mountain View and Menlo Park). This average ranges from $9 to $12 per square foot, depending on project type, as shown on page 4 of **Attachment 3**. However, after the report was completed, Mountain View representatives indicated that the City of Mountain View is considering raising its housing mitigation fee from $10.26 per square foot to $20-26 per square foot. The Mountain View Council will consider this proposal at a hearing on December 16.

The feasibility test of Scenario A assumed the fee would apply only to net new square footage, which is the total square footage of the new project minus the square footage of any existing workplaces to be demolished on the site, in order to reflect the net increase in employment level created by the new project.

Another adjustment made to the Scenario A fee level to minimize impacts on relatively small projects, which may have less financial basis from which to pay higher fees, was to reduce the fee level by half for any projects of 25,000 square feet or less, and also for the first 25,000 square feet of any larger projects, as shown below. The rate for lodging is less than the rate for other development types because its impacts on housing demand are significantly less, as shown on the prior page, due to the lower number of employees per square foot of lodging developments compared to the other types of development.

Project Type	**Scenario A Fees Per Square Foot** *(net new space)*	
	First 25,000 SF	***Any Additional***
Lodging	$3	$6
Retail / Restaurants	$5	$10
Office / Light Industrial / R&D	$5	$10

EPS tested the feasibility of fees under Scenario A, and found that they would not have significant impacts on the financial feasibility of such projects, measured in terms of impact on developer "return on costs," as explained in **Attachment** 3 and depicted graphically in **Attachment 4.**

Public Outreach
The nexus study reports were published on the City's website at *LinkageFee.inSunnyvale.com* on September 12. Staff held two outreach meetings in late September and invited various stakeholders and community members to attend and comment on the study. Invitations to these meetings were sent by email to more than 2,700 emails on various outreach lists of community contacts and stakeholder groups, and posted in the City Manager's Blog, housing e-newsletter, and sent to several associations such as the Moffett Park Business Association and several regional housing groups.

Approximately 25 people attended the outreach meetings, including representatives of NAIOP, an industry group representing office and industrial developers, the Building Industry Association, various housing advocacy groups and housing providers, area residents, one representative of a company located in Moffett Park, and various others. Most of the attendees expressed support for expansion of the fee and for fee levels higher than Scenario A but not as high as the maximum fee level. Some attendees suggested testing a fee of $20 per square foot for feasibility. Following the outreach meeting, EPS tested the feasibility of this fee level, referred to as Scenario B in the Memorandum. The results of that test showed slightly higher, but not significantly different impacts on feasibility compared to Scenario A. However, a fee rate much higher than Scenario B could begin to impact project feasibility, particularly for retail, lodging, and light industrial/flex space projects. Scenario B would bring feasibility rates down to the following levels, compared to the Existing Fee:

Return on Cost

Project Type	Existing Fee	Scenario B
Office/R&D	7.83%	7.57%
Light Ind/Flex	7.51%	7.13%
Retail	6.53%	6.22%
Lodging	7.82%	7.38%

While the seven percent return on cost measure is a general rule of thumb for determining project feasibility, it is not a guarantee of investor interest. For that reason, it would be prudent to set the fees at a rate that would not significantly reduce the return on cost rate from its current percentage. As shown above, retail is the only project type for which the return on cost rate is already below seven percent. This is reflected in the relatively few applications submitted in recent years for development of new retail space in stand-alone retail projects. For this reason the recommended alternatives provide a reduced fee rate for retail projects. In addition, any of the factors other than the fee itself that are used in calculating return on cost, including land or construction costs, can change over time, therefore it would be prudent to set the rate in such a way as to allow a certain "margin of error" or cushion to account for such changes.

Industry representatives asked questions but did not express specific concerns or suggestions about fee levels, but indicated they would review the EPS reports and provide written comments later. The presentation provided at the outreach meetings, revised to add the results of the Scenario B feasibility test and an additional project example, is provided in **Attachment 4**.

The Planning and Housing and Human Services Commissions held a joint study session on this topic at the Planning Commission's October 13 meeting. Some commissioners expressed interest in providing lower fees for retail, due to the community's need for more of certain types of retail projects, and also due to the weaker market feasibility of retail projects in general, as shown in the feasibility study. Attendees also noted that all three use types provide sales and occupancy taxes and other types of revenue to the City.

The Housing and Human Services and Planning Commissions held public hearings on this matter on October 22 and 27, respectively. Both commissions voted unanimously for the staff recommendation (with two absences at the Housing and Human Services Commission meeting). Minutes of those hearings are provided in **Attachments 7** and **8**.

In response to requests by the Planning Commission at its hearing and by several Council members during the Council study session on October 28, additional information regarding past and projected uses of the fees, public review procedures and City policies involved in use of the fees is provided in **Attachment 6**.

Upon request, staff made presentations on this proposal to the Moffett Park Business and Transportation Association Board of Directors (MPBTA) and the Silicon Valley Leadership Group's Land Use and Housing Committee (SVLG) on November 10 and 12, respectively. Both groups asked questions about the history and uses of the fee and rationale for the proposed changes, and indicated that their organizations had not yet developed a formal position on the topic. Some attendees were somewhat alarmed about the maximum fee levels (i.e., $114/SF for office). Others were concerned about restructuring the fee to apply to all net new square feet. Attendees also expressed interest in exemptions for amenity space and parking structures.

Alternatives Analysis

A table provided in **Attachment 5** compares the actual Housing Mitigation Fee amounts that would be due from the sample projects described in **Attachment 4** under various scenarios: the current Housing Mitigation Fee ordinance, Scenarios A and B as described in the feasibility study, and two other alternatives discussed herein. These include:

- Alternative 2: a rate of $12 per square foot for office/R&D projects ($6 per square foot for first 25,000 square feet) and $6 per square foot for retail and lodging; and
- Alternative 3: a rate of $15 per square foot for office/R&D projects ($7.50 per square foot for first 25,000 square feet); and $7.50 per square foot for retail and lodging.

The rate for retail is lower in both alternatives in light of concerns expressed at the Joint Study Session regarding the community's desire for certain types of retail, and the more challenging feasibility context for retail in general, as shown in **Attachments 3** and **4**. In all cases, the fee would be apply to the net increase in square footage with credit provided for existing buildings to be demolished.

The range from Scenario A to Scenario B, which encompasses Alternatives 2 and 3, is considered to be a reasonable range within which to set the fees, given the regional context, as some neighboring cities, such as Mountain View, have fees similar to Scenario A, while other cities, such as Palo Alto, have fees similar to Scenario B, while others don't charge linkage fees at all, such as San Jose and Santa Clara. The average rates of the cities in Silicon Valley that have linkage fees are shown in **Attachment 4** (Slide 9).

Although the nexus study demonstrates that a fee much higher than that of Scenario B could be assessed on all use types, other considerations, such as regional competitiveness, feasibility of desired uses (i.e., retail), the need for local jobs, and other City revenues generated by these developments (sales, property, and occupancy taxes) provide compelling reasons to set the fees within the range described above.

Alternatives 2 and 3 provide a good balance between the need to generate funds to address the housing impacts of these projects, and the other considerations noted above. Both alternatives would significantly raise the fee for future projects compared to the current fee. Alternative 2, using the fee revenue estimates explained in **Attachment 6**, would provide approximately the amount of funding estimated to be needed to subsidize development of the “Quantified Objectives” for lower-income housing units included in the City’s Draft 2015-2023 Housing Element.

Alternative 3 would provide a slightly higher amount of estimated fee revenues than Alternative 2, which would provide the City more of a hedge against future increases in affordable housing development costs, and potentially allow the City to make even more progress toward the overall Regional Housing Needs Allocation (RHNA) goals, which are higher than the Quantified Objectives.

FISCAL IMPACT

The fiscal impact of a possible expansion or adjustment of the Housing Mitigation fee would depend on the fee rate and its application, and on future levels of development subject to the fee. One preliminary estimate of the potential impact, based on average annual square footage of non-residential development since 2000, indicate that a fee rate in the $12 - $15 range as provided in Alternatives 2 and 3 could generate annual revenues to the Housing Mitigation fund ranging from $7.3 to $9.2 million per year, assuming future development levels are similar to past levels. However, if the fee is set at levels that significantly impact project feasibility, it could have the unintended impact of halting or significantly decreasing levels of commercial development, which could have a negative impact on the General fund and various other funds supported by development fees, including the Housing Mitigation fund.

PUBLIC CONTACT

Public contact was made by posting the Council agenda on the City's official-notice bulletin board outside City Hall, at the Sunnyvale Senior Center, Community Center and Department of Public Safety; and by making the agenda and report available at the Sunnyvale Public Library, the Office of the City Clerk, and on the City's website. Additional public outreach efforts are described in the Discussion section above.

The Housing and Human Services and Planning Commissions held a joint study session on this topic on October 13 and held public hearings on this matter on October 22 and 27, respectively. Both commissions voted unanimously for the staff recommendation (with two absences at the Housing and Human Services Commission meeting). Minutes of both meetings are provided in **Attachments 7** and **8**. Council held a study session on this topic on October 28.

ALTERNATIVES

1. Direct staff to prepare an ordinance to expand the Housing Mitigation Fee to all net new square footage of all office/R&D, industrial, retail, and lodging development projects in any zone.

2. Direct staff to set the initial fee rate in the draft ordinance at $12 per square foot for office/R&D/industrial projects ($6 per square foot for first 25,000 square feet), and $6 per square foot for retail and lodging projects, both adjusted annually for inflation as part of the annual fee schedule adoption.
3. Direct staff to set the initial fee rate in the draft ordinance at $15 per square foot for office/R&D/industrial projects ($7.50 per square foot for first 25,000 square feet), and $7.50 per square foot for retail and lodging projects, both adjusted annually for inflation as part of the annual fee schedule adoption.
4. Include a provision to clarify that the new fee rates shall apply to all covered projects for which a complete planning application is submitted on or after the effective date of the ordinance.
5. Adopt a modified fee schedule with rates for each development type as directed by Council.
6. Provide other direction to staff regarding this study.

STAFF AND COMMISSION RECOMMENDATIONS

Alternatives 1, 2, and 4: 1) Direct staff to prepare an ordinance to expand the Housing Mitigation Fee to all net new square footage of all office/R&D, industrial, retail, and lodging development projects in any zone; and 2) Direct staff to set the initial fee rate in the draft ordinance at $12 per square foot for office/R&D/industrial projects ($6 per square foot for first 25,000 square feet), and $6 per square foot for retail and lodging projects, both adjusted annually for inflation as part of the annual fee schedule adoption; and 4) Include a provision to clarify that the new fee rates shall apply to all covered projects for which a complete planning application is submitted on or after the effective date of the ordinance.

Staff recommends the approach provided in Alternatives 1, 2 and 4 as a fair way to require new employment-generating developments to at least partially mitigate the need for affordable housing for the workers who will be employed at these new workplaces.

While a rate of greater than $12 per square foot could be fully justified based on the nexus study, other considerations balance the arguments for a higher fee. These include: meeting the City's economic development goals for attracting employment, retail and hospitality uses, the fiscal benefits (property, sales and occupancy taxes) that these uses bring to the City, and the objective of staying within the range of fees charged by other nearby cities that charge such a fee. Staff also acknowledges that although Sunnyvale's housing mitigation fee has been in place since the 1980s, many surrounding cities do not levy such a fee on commercial development.

There are not many other sources of funding available to address local affordable housing needs. The proposed alternatives would be consistent with the Mitigation Fee Act and the nexus study findings, and would provide approximately the amount of funding needed to meet the quantified objectives in the City's 2015-2023 Housing Element, based on current cost estimates.

While the rates in Alternative 2 are similar to the current rate, most projects that are already subject to the fee would experience a significant increase in the total fee amount due, as shown in Attachments 4 and 5, because the entire net new building square footage would be subject to the fee. Additionally, Alternative 2 would expand the fee program to retail and lodging uses that are not currently subject to the fee. While staff is not recommending Alternative 3 at this time, it could be incorporated through adoption of a phased increase.

The Housing and Human Services and Planning Commissions both voted unanimously (among those present) to support the staff recommendation during their respective meetings in late October.

If so directed, staff would return to the appropriate commissions and Council within several months with a draft ordinance implementing the proposed changes to the Housing Mitigation Fee for consideration and possible adoption by Council.

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Reviewed by: Hanson Hom, Director, Community Development Department
Reviewed by: Robert A. Walker, Assistant City Manager
Approved by: Deanna J. Santana, City Manager

ATTACHMENTS

1. Study Issue Paper CDD 09-11 Review of the Housing Mitigation Fee
2. Nexus Study Report
3. Feasibility Study Memorandum
4. Outreach Presentation
5. Comparison Table
6. Historic and Projected Uses of the Fee
7. October 22, 2014 Housing and Human Services Commission Minutes
8. October 27, 2014 Planning Commission Minutes