Five-Year Economic Forecast and Revenue Projections

2016-2020

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 decrease slightly from the estimates provided in the 2015-2019 Adopted Capital Improvement Program (CIP). Even with development activity in 2014-2015 remaining strong, activity is anticipated to be lower than the peak that was reached in 2013-2014 and is tapering off as projects are completed. There is a projected decrease of 8% over the 2015-2019 Adopted CIP, from \$354.2 million in the 2015-2019 Adopted CIP to \$325.6 million in the 2016-2020 Forecast. The Construction-Related Revenue chart included at the end of this section provides a year-by-year comparison of this Forecast with the 2015-2019 Adopted CIP.

FORECAST COMPARISON SUMMARY (\$ in Thousands)

	2015-2019 CIP	2016-2020 Forecast	Difference	% Change
Construction and Conveyance Tax	\$195,000	\$175,000	(\$20,000)	(10%)
Building and Structure Construction Tax	66,000	62,000	(4,000)	(6%)
Construction Excise Tax	87,000	83,000	(4,000)	(5%)
Municipal Water System Fees	750	500	(250)	(33%)
Residential Construction Tax	950	950	0	0%
Sanitary Sewer Connection Fee	3,750	3,400	(350)	(9%)
Storm Drainage Connection Fee	750	750	0	0%
TOTAL	\$354,200	\$325,600	(\$28,600)	(8%)

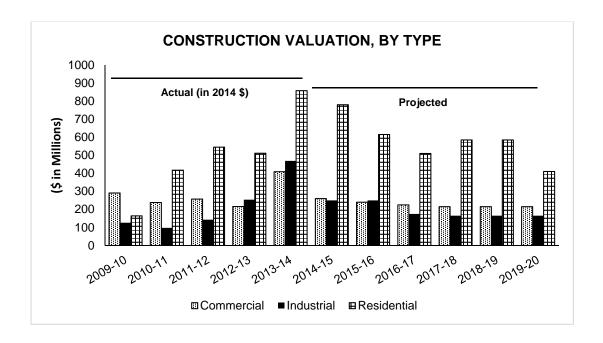
A discussion of major construction activity trends and each of the revenue categories are included in more detail on the following pages.

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 2014 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 (2016-2020)", which is included as Appendix C.

Based on projections provided by the PBCE Department, construction activity valuation is anticipated to continue at high levels but lower than the peak levels experienced last year: \$1.3 billion for 2014-2015, a 26% decrease compared to \$1.7 billion in 2013-2014. This level of activity is expected to drop slightly to \$1.1 billion in 2015-2016, then down to \$910 million in 2016-2017 as projects are anticipated to be completed. PBCE expects a slight increase to \$965 million per year in 2017-2018 and 2018-2019 to reflect a slight surge of accelerated development activity prior to the implementation of the Housing Impact Fee, and then fall to \$790 million in 2019-2020 to reflect the anticipated lower level of development activity.

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



CONSTRUCTION ACTIVITY PROJECTIONS

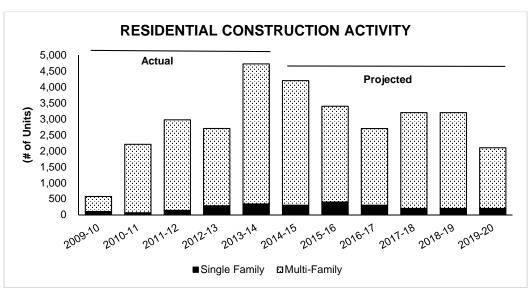
A summary of the PBCE Department construction activity projections and the corresponding revenue estimates are provided below. It should be noted that due to the highly volatile nature of the construction market, the reliability of the estimates can be expected to change over the period of the forecast. 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 peaked in 2013-2014 in this sector with a total of 4,724 dwelling units, and is expected to reach 4,200 new dwelling units in 2014-2015, a decrease of 11%. 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 \$2.7 billion, a 30% increase over the 2015-2019 Forecast. The PBCE Department expects residential construction activity to generate an estimated 3,400 new units in 2015-2016, 2,700 new units in 2016-2017, 3,200 units in 2017-2018 and 2018-2019, and 2,100 units in 2019-2020. This represents an average of 2,920 units per year or 14,600 units over the forecast period. This activity level has increased by 12% compared to the 13,000 units included in the 2015-2019 Forecast. While activity is expected to fall below the peak in this forecast, the drop off is less pronounced than assumed in the previous forecast.

This forecast expects a total of 13,300 multi-family dwelling units or approximately 91% of all dwelling units (single-family and multi-family) to be constructed. This figure represents a 13% increase compared to the projections in the 2015-2019 Forecast for this category. Only 1,300 new single-family dwelling units are anticipated during this forecast period, which is slightly higher than the projections in the 2015-2019 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 2019-2020.



CONSTRUCTION ACTIVITY PROJECTIONS

B. Commercial Construction Activity

In 2013-2014, commercial construction activity totaled \$409 million, a significant increase of 89% from 2012-2013. This increase was primarily due to the doubling of new construction from the previous year and a 57% increase in alterations of existing buildings. However in 2014-2015, the PBCE Department expects commercial activity to drop to \$260 million in total permit valuation as a result of the anticipated slow down in activity.

The total commercial construction valuation projected in this Forecast is \$1.1 billion, which is a 9% decrease from the previous five-year forecast. As discussed in the attached report provided by the PBCE Department, the anticipated commercial construction activity will be lower than the projected 2014-2015 activity, and will be strongly influenced by several hotel projects that are under construction and/or have been approved in the Downtown and North San José area.

Information provided by real estate trade groups for the 4th Quarter 2014 indicated that the San José office and research and development (R&D) vacancy rate was 15.5% and the retail vacancy rate was 3.8%. These rates are slightly below the 4th Quarter 2013 of 17.3% and 4.8%, respectively.

C. Industrial Construction Activity

In 2013-2014, industrial activity was strong and reached the peak levels of 2000-2001 as a result of the continuing improvement in the economy. Overall, activity amounted to \$470 million in 2013-2014, an increase of 85% from 2012-2013. However, without the sustained influx of additional new construction, the PBCE Department expects valuation to decrease to \$250 million in 2014-2015. In 2015-2016, valuation is anticipated to remain at \$250 million, then drop to \$175 million in 2016-2017, and further decrease to \$165 million annually in 2017-2018 through 2019-2020.

Information provided by real estate trade groups for the 4th Quarter 2014 indicated that the San José vacancy rate for industrial space was 5.4%, which is down slightly from the 6.2% vacancy rate for the same period in 2013.

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 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 modified and extended, that reduced construction taxes by 50% for new downtown residential, commercial and industrial

CONSTRUCTION ACTIVITY PROJECTIONS

program was effectively replaced by the Downtown Commercial High Rise Development Incentive Program approved by the City Council in December 2014, which suspends the collection of the Building and Structure Construction Tax and the Construction Excise Tax for a single commercial high rise development project that obtains a building permit by December 31, 2016. 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 (2016-2020) 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 construction not yet commenced, and pending City approval). In addition, the City is divided into 15 planning areas and individual maps that show the projects in all status categories submitted since January 1, 2008 are provided, except for the Calero, Coyote, and San Felipe planning areas as no major development activity has occurred and/or these areas are outside the City's Urban Service Area and Urban Growth Boundary. 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

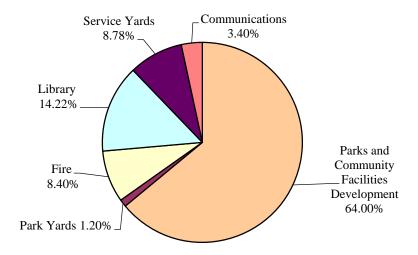
The Construction Tax portion of the Construction and Conveyance Tax category is levied on most types of construction. For residential construction, the tax rate is based upon the number of units constructed and ranges from \$75 per unit located in a building containing at least 20 dwelling units to \$150 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:

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.

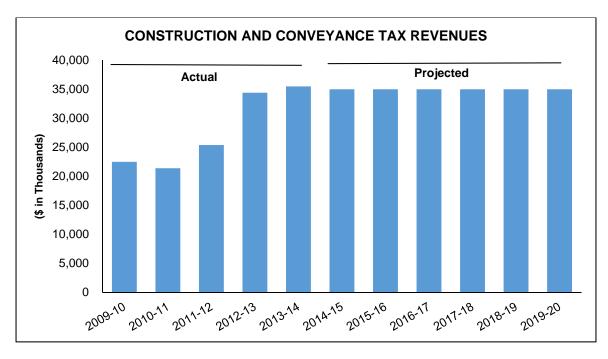
The five-year projection for Construction and Conveyance Tax revenue totals \$175 million, which is 10% lower than the estimate used to develop the 2015-2019 Adopted CIP. The Construction and Conveyance Tax revenue projections are based upon: 1) a review of prior year collection trends; 2) a review of 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.

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. Since that time, collections have risen to \$34.4 million in 2012-2013 and \$35.5 million in 2013-2014, but are anticipated to drop slightly to \$35.0 million in 2014-2015 as a result of a low level of inventory. Revenues are projected to remain at \$35.0 million annually in 2015-2016 and throughout the forecast period.

The median single-family home price in December 2014 was \$750,000, which is an increase of 9.5% from the December 2013 price of \$685,000. In addition, the average days on market for single-family and multi-family homes dropped 46.0% from 37 days in December 2013 to 20 days in December 2014. However, the number of listings of new single-family and multi-family dwellings on the market has dropped 15.5%, from 355 listings in December 2013 to 300 in December 2014. As a result of the lower level of inventory, the number of property transfers (sales) for all types of residences dropped 6.3%, from 654 in December 2013 to 613 in December 2014. As a result of the decreased level of property transfers, the revenues projected in this Forecast represent a 10% decrease from the 2015-2019 Adopted CIP.

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



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 Commercial High Rise Development 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 Commercial High Rise Development Incentive waives taxes for the first commercial tower that receives a building permit prior to December 31, 2016.

In 2014-2015, Building and Structure Construction Tax receipts through January totaled \$9.8 million, well below the \$13.5 million collected through the same period last year. If collections continue at its current pace, revenues are expected to meet the 2014-2015 Adopted Budget estimate of \$17.0 million.

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 \$62.0 million, a decrease of \$4.0 million (6%) from the estimate included in the 2015-2019 Adopted Capital Improvement Program (CIP). However, it should be noted that the collections in 2013-2014 were the highest collection level since the last peak in 2000-2001 as a result of increased development activity. Although collections in 2014-2015 will not reach the same levels as last year, activity remains relatively strong with estimated receipts of \$17.0 million. Collections are projected to drop to \$14.0 million in 2015-2016 and then decrease to \$12.0 million annually in 2016-2017 through 2019-2020 reflecting a return to more moderate development activity levels. 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 the discussion of Construction Excise Tax performance.

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 that 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.

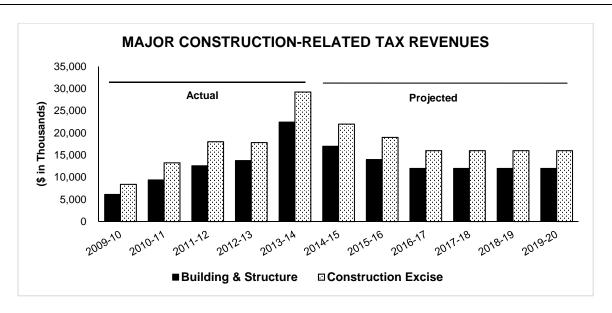
As mentioned above, this tax is a general purpose tax; however, the majority of the proceeds have generally been used for a variety of essential Traffic Capital projects that cannot be funded by the Building and Structure Construction Tax or grants. Typical projects funded with this tax include street 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 has also been used as a budget balancing solution to address General Fund shortfalls in prior years.

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 larger impact on the Construction Excise Tax than the Building and Structure Construction Tax. The Downtown Commercial High Rise Development Incentive waives taxes for the first commercial tower that receives a building permit prior to December 31, 2016.

In 2014-2015, tax receipts through January for the Construction Excise Tax Fund totaled \$12.9 million, lower than the \$15.9 million collected through the same period last year. If collections continue at its current pace, revenues are expected to slightly exceed its 2014-2015 Adopted Budget estimate of \$21.0 million by \$1.0 million.

Based upon the construction projections provided by the PBCE Department and actual collections on this tax, Construction Excise Tax collections are projected to total \$83.0 million over the five-year forecast period, with proceeds estimated at \$19.0 million in 2015-2016, then dropping to \$16.0 million annually in 2016-2017 through 2019-2020, reflecting a return to more moderate development activity levels. This collection level represents a decrease of \$4 million (5%) from the 2015-2019 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 that follows.

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, 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. 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.

Based on projected activity and collection trends, the Municipal Water System fees are projected to total \$500,000 over the Forecast period. This is down from the \$750,000 projected in the 2015-2019 Adopted CIP due to lower estimates for the Advance System Design Fee and Meter Installation Fee. These fees are detailed in the chart below.

MUNICIPAL WATER SYSTEM FEES

(\$ in Thousands)

	2015-2019	2016-2020		
	CIP	Forecast	Difference	Change
Advance System Design Fee	250	125	(125)	(50%)
Meter Installation Fee	250	125	(125)	(50%)
Service Connection Fee	250	250	0	0%
TOTAL	750	500	(250)	(33%)

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.

In 2014-2015, receipts are projected to total \$325,000 due to higher than expected year-to-date activity levels. Based upon construction estimates by the PBCE Department and the actual collection pattern for this tax, collections are expected to drop to \$250,000 in 2015-2016 and to \$175,000 in the out years of the forecast. The drop in receipts reflects a return to more moderate development activity levels. A total of \$950,000 is expected over the five-year period of this forecast, which is consistent with the total in the 2015-2019 Adopted CIP.

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.

In 2014-2015, receipts are projected to total \$950,000 based on year-to-date activity levels. Collections are expected to drop to \$800,000 in 2015-2016 and to \$650,000 in the out years of the forecast. The 2016-2020 Forecast projection for this fee is \$3.4 million, which is a 9% decrease from the 2015-2019 Adopted CIP estimate of \$3.8 million. This estimate is based on the assumptions that development activity will slow down and decline.

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.

In 2014-2015, receipts are projected to total \$225,000 based on year-to-date activity levels. The five-year forecast for Storm Drainage Connection Fees totals \$750,000, with annual receipts of \$150,000. This collection level matches the estimate included in the 2015-2019 Adopted CIP.

ATTACHMENT A

CONSTRUCTION-RELATED REVENUE 2016-2020 FORECAST

(in \$ thousands)

	2014-15	2015-16	2016-17	2017-18	2018-19	2019-20	5 Yr Total		
Construction and Conveyance Tax									
2015-2019 Adopted CIP	39,000	39,000	39,000	39,000	39,000	N/A	195,000		
2016-2020 FORECAST	35,000	35,000	35,000	35,000	35,000	35,000	175,000		
Difference	(4,000)	(4,000)	(4,000)	(4,000)	(4,000)	N/A	(20,000)		
Building and Structure Construction Tax									
2015-2019 Adopted CIP	17,000	13,000	12,000	12,000	12,000	N/A	66,000		
2016-2020 FORECAST	17,000	14,000	12,000	12,000	12,000	12,000	62,000		
Difference	-	1,000	-	-	-	N/A	(4,000)		
Construction Excise Tax									
2015-2019 Adopted CIP	21,000	18,000	16,000	16,000	16,000	N/A	87,000		
2016-2020 FORECAST	22,000	19,000	16,000	16,000	16,000	16,000	83,000		
Difference	1,000	1,000	-	-	-	N/A	(4,000)		
Municipal Water Advance System D	Design Fee								
2015-2019 Adopted CIP	50	50	50	50	50	N/A	250		
2016-2020 FORECAST	25	25	25	25	25	25	125		
Difference	(25)	(25)	(25)	(25)	(25)	N/A	(125)		
Municipal Water Meter Installation	Fee								
2015-2019 Adopted CIP	50	50	50	50	50	N/A	250		
2016-2020 FORECAST	25	25	25	25	25	25	125		
Difference	(25)	(25)	(25)	(25)	(25)	N/A	(125)		
Municipal Water Service Connection	n Fee								
2015-2019 Adopted CIP	50	50	50	50	50	N/A	250		
2016-2020 FORECAST	150	50	50	50	50	50	250		
Difference	100	-	-	-	-	N/A			
Residential Construction Tax									
2015-2019 Adopted CIP	225	200	175	175	175	N/A	950		
2016-2020 FORECAST	325	250	175	175	175	175	950		
Difference	100	50	-	_	_	N/A	-		
Sanitary Sewer Connection Fee									
2015-2019 Adopted CIP	1,000	800	650	650	650	N/A	3,750		
2016-2020 FORECAST	950	800	650	650	650	650	3,400		
Difference	(50)	-	-	-	-	N/A	(350)		
Storm Drainage Connection Fee	,						, ,		
2015-2019 Adopted CIP	150	150	150	150	150	N/A	750		
2016-2020 FORECAST	225	150	150	150	150	150	750		
Difference	75	-	-	-	-	N/A	-		
Difficience	13	-	-	-	-	1 1/ 1	-		
TOTAL									
2015-2019 Adopted CIP	78,525	71,300	68,125	68,125	68,125	N/A	354,200		
2016-2020 FORECAST	75,700	69,300	64,075	64,075	64,075	64,075	325,600		
Difference	(2,825)	(2,000)	(4,050)	(4,050)	(4,050)	N/A	(28,600)		
% Change from 2015-2019 CIP	-4%	-3%	-6%	-6%	-6%	N/A	-8%		