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September 2, 2014

Ms. Angela Calvillo  
Clerk of the Board  
Board of Supervisors  
City and County of San Francisco  
City Hall  
1 Dr. Carlton B. Goodlett Place  
San Francisco, California 94102

Re: **Written Protest Against the Formation of, the Levy of Special Taxes Within, and the Incurrence of Bonded Indebtedness in, the City and County of San Francisco Community Facilities District No. 2014-1 (Transbay Transit Center), as proposed by Resolution of Intention No. 247-14 and Resolution of Intention to Incur Bonded Indebtedness No. 246-14; Public Hearing on September 2, 2014.**

Dear Ms. Calvillo;

Pursuant to Section 53323 of the California Government Code ("**Section 53323**"), this letter is a formal written protest (the "**Protest Letter**") submitted to the "clerk of the legislative body" by 41 Tehama LP ("**Land Owner**") against (i) the formation of the City and County of San Francisco Community Facilities District No. 2014-1 (Transbay Transit Center) (the "**CFD**"), the levying of special taxes in the CFD pursuant to the "Rate and Method of Apportionment of Special Tax" (the "**RMA**") proposed by Resolution of Intention No. 247-14 (the "**Resolution of Intention**"), adopted by the Board of Supervisors (the "**Board**") of the City and County of San Francisco (the "**City**") on July 15, 2014, and (iii) the incurrence of bonded indebtedness within the CFD, as described in the Resolution of Intention to Incur Bonded Indebtedness No. 246-14 (the "**Resolution to Incur**"), adopted by the Board on July 15, 2014. This Protest Letter is being delivered pursuant to the Mello-Roos Community Facilities Act of 1982, as amended (the "**Act**").

The Land Owner owns approximately 0.504 acres (the "**Land Owner Property**") within the proposed boundaries of the CFD, as shown on the Boundary Map attached hereto as Exhibit "A" and identified as Block 3736, Lot 190. The Land Owner Property is one of the parcels that are identified in the Boundary Map as "Property within the CFD Boundary" (herein, all such parcels are referred to as the "**Subject Property**"). The Land Owner Property is not exempt from the special taxes under the RMA. As the owner of property within the boundaries of the CFD that is not exempt from the special taxes under the RMA, the Land Owner is a landowner as defined in California Government Code Section 53317, is an "interested person" that may file a protest pursuant to Section 53323, and is authorized to submit this Protest Letter.

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## Background

To assist in the financing of various improvements to the Transbay Transit Center (the "Project"), the City proposed financing a portion of the Project through the formation of the CFD. The City went further and determined to condition projects (i) with a floor area ratio in excess of 9:1 or (ii) that would create a structure that exceeds the City's height limit on annexing into the CFD. The City, through various consultants, studied the amount of revenues needed to be raised and the impact of requiring those revenues from the development community, and created the Transit Center District Plan (the "Plan"). In April 2012, the City's Planning Department prepared the "Transit Center District Plan Program Implementation Document" (the "Implementation Document").

Pursuant to the Implementation Document, "[t]he purpose of [the Implementation Document] is to summarize the Plan's public infrastructure program, sources of funding, relative allocation of revenues from the various sources among the infrastructure projects, and implementation processes and mechanisms." Furthermore, the Implementation Document provides that "[t]he purpose of this analysis and the Plan is to create a set of zoning controls and a fee structure that will remain in place for decades to come" (underlining added).

The Implementation Document was approved by the Board of the City in 2012. Further, on May 24, 2012, the Planning Commission adopted the Implementation Document. In August 2012, the Board incorporated the Implementation Document into newly-created Section 424.8 of the San Francisco Planning Code. Section 424.8 provides, in relevant part, as follows (underlining added):

### **SEC. 424.8. TRANSIT CENTER DISTRICT MELLO ROOS COMMUNITY FACILITIES DISTRICT PROGRAM.**

(a) **Purpose.** New construction that increases the density of the downtown area, and the C-3-O(SD) district in particular, will require the City to invest in substantial new infrastructure and services. By increasing height limits, relieving density and floor area ratio limitations, reducing requirements for acquisition of Transferrable Development Rights, and making other regulatory changes to the C-3-O(SD) district, the Transit Center District Plan, confers substantial benefits on properties in the district. In order to exceed base densities in the district, the City will require sufficient funding to supplement other applicable impact fees for infrastructure, improvements and services as described in the Transit Center District Implementation Document, including but not limited to the Downtown Extension of rail into the Transit Center, street improvements, and acquisition and development of open spaces.

(b) **Requirement.** Any development on any lot in the C-3-O(SD) district that meets the applicability criteria of subsection (c) below shall participate in the Transit Center District Mello Roos Community Facilities District ("CFD") and successfully annex the lot or lots of the subject development into said CFD prior to the issuance of the first Temporary Certificate of Occupancy for the development.

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To the best of the Land Owner's knowledge, at no time between August 2012 and July 2013 did the City consult with any private land owner within the Subject Property about the formation of the CFD.

In July 2013, the City supplied the Land Owner – for the first time just weeks before it was scheduled to be approved by the Board – the proposed rate and method of apportionment of special tax for the CFD (the “2013 RMA”) and the boundary map identifying the Subject Property. Immediately after receipt of the 2013 RMA, the Land Owner and their consultants went to work reviewing the 2013 RMA, its consistency with the Implementation Document, and its impact on the economics of the Land Owner's projects. The Land Owner identified several major issues with the 2013 RMA, and presented those findings to the City in a series of meetings and correspondence commencing in the fall of 2013.

After pointing out several problematic issues with the 2013 RMA, the City amended the 2013 RMA. However, the City did not alter the special tax rates in the 2013 RMA.

In June 2014, the City presented the revised 2013 RMA as the RMA and began the CFD formation process. On July 15, 2014, both the Resolution of Intention (with the RMA attached as an exhibit) and the Resolution to Incur were adopted by the Board.

Having not received any of the relief that the Land Owner sought, the Land Owner is now forced to formally protest the formation of the CFD, the levying of special taxes pursuant to the RMA, and the incurrence of bonded indebtedness in the CFD.

## **Protest Against the Proposed CFD**

### **The CFD Is Not Consistent with the Implementation Document**

The CFD referenced in Section 424.8 is to be based on the Implementation Document. However, the proposed RMA is not consistent with the Implementation Document. The Land Owner, along with other developers, has been objecting to the proposed RMA for over a year. Most recently, certain developers documented their disagreement with the RMA in a June 30, 2014 letter from James Reuben on behalf of certain developers addressed to the Land Use and Economic Development Committee (the “**June 30 Letter**” attached hereto as Exhibit “B”) and a follow-up letter to the Board by Mr. Reuben on August 12, 2014 (the “**August 12 Letter**” attached hereto as Exhibit “C”). Both the June 30 Letter and the August 12 Letter explain the objections that certain developers have to the RMA in great detail, and these letters, and the arguments contained in such letters, are hereby incorporated into this Protest Letter as if set forth herein. Set forth below is a summary of the main objections to the CFD:

1. **Special Tax Rates Significantly Increased.** The special tax rates in the proposed RMA are substantially and significantly higher than the special tax rates set forth in the Implementation Document. As such, the special tax rates in the RMA are not “as described in the Transit Center District Implementation Document” as required by Planning Code Section 424.8. For example, in the Implementation Document, the special tax rate for an Office Building is \$3.30 per square foot. In the proposed RMA, for a 50+-story building, the rate is \$4.91 per square foot, an increase of nearly 50%. Similar substantial increases occurred for Residential, Hotel, and Retail uses.
2. **No Escalators Authorized.** The Implementation Document does not discuss, authorize, or suggest that the special tax rates in the CFD would be subject to any kind of escalators. In addition, escalators are not mandatory under the Act, and there are a large number of CFDs in California that do not have any kind of escalator. Yet, without authorization from the Implementation Document and without compulsion by the Act, the City included two distinct escalators in the RMA. The first occurs prior to the Certificate of Occupancy (“**Pre-COO Escalator**”), wherein the special tax rates applicable to a taxable building are subject to increases equal to changes in a construction cost index (defined in the RMA as the “Initial Annual Adjustment Factor”), not to exceed 4% per annum.<sup>1</sup> The second escalator occurs after the Certificate of Occupancy for a taxable building is issued (the “**Post-COO Escalator**”), wherein the special tax rates for that taxable building are subject to a 2% increase each year for 30 years.

Together, the Pre-COO Escalator and the Post-COO Escalator increase the tax burden on the Subject Property significantly, as shown in the two charts of Exhibit “D.” The first chart shows the impact of the escalators on a 50-story office building that receives its Certificate of Occupancy after application of the Pre-COO Escalator for five years (at the maximum increase of 4% per year). Compared to the special tax rates in the Implementation Document, in the first year that the office building is taxed, the special tax rates in the RMA are 77% greater than the rates that would apply under the Implementation Document. Under the RMA, after the Certificate of Occupancy is provided, the special tax rates escalate annually by the Post-COO Escalator of 2%. In the thirtieth year of the building’s existence, the special tax rates in the RMA will be an astonishing 214% higher than the special tax rates in the Implementation Document, resulting in a 78% increase in the tax burden over the 30 year taxing period on the building between an RMA with no escalators and the current draft of the RMA with both the Pre-COO Escalator and the Post-COO Escalator.

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<sup>1</sup> The Pre-COO Escalator could also result in a reduction in the special tax rates if the cost index is negative, not to exceed 4.0%. Whether the Pre-COO Escalator results in an increase or decrease in the special tax rates in any given year is immaterial. The Implementation Document does not authorize or suggest that any escalator would be imposed.

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The impact on a 50-story for-sale residential building is shown in the second chart. In this example, using the same assumptions as to the receipt of the Certificate of Occupancy, the initial special tax rates are 60% higher and the final special tax rates are 185% higher.

These percentages and the impact on the overall burden will be higher for each additional year it takes to get to Certificate of Occupancy. For property that will be complete construction in later years, the increase could be astounding.

3. ***Pre-COO Escalator Violates Equal Treatment of Similar Buildings.*** The Pre-COO Escalator will have the effect of causing the tax burden on one building to differ (perhaps dramatically) from the tax burden on another similarly-sized building (of the same land use) that happens to develop at a later date. See "The RMA Creates a Competitive Disadvantage" for more details.
4. ***Only a Single Rate Per Land Use is Authorized.*** The Implementation Document does not discuss or authorize the levy of special taxes at different rates depending on the number of floors in the building. The Implementation Document differentiates between Office, Residential, Hotel, and Retail uses, and sets different rates for each, but it does not further differentiate within such uses by the size of the buildings. The proposed RMA creates different levels of taxation depending on the size of the buildings in violation of the Implementation Document. This embellishment increases the tax burden on the Subject Property and treats similar land uses differently.
5. **2013 Concord Valuation is Flawed.** There is nothing in the Implementation Document that authorizes the revision of the special tax rates set forth in the Implementation Document. Yet, the City engaged The Concord Group to conduct a market study (the "2013 Valuation") of the property in the City of San Francisco, so as to determine the projected value of the property proposed to be in the CFD. The special tax rates in the proposed RMA were based on the 2013 Valuation. However, the 2013 Valuation is seriously flawed in numerous ways, including:
  - a. The 2013 Valuation determines the value based upon, among other things, the projected revenues and expenses of the buildings. However, the 2013 Valuation does not take into consideration as a projected expense the significant cost of the CFD special taxes themselves. Whether the developer incurs these expenses or passes them through to tenants, there is an economic consequence of such levy. ***But the 2013 Valuation does not include the special taxes as an item of expense.*** This violates not only common sense, but also the California Debt and Investment Advisory Commission's Appraisal Standards for Land-Secured Financings and its Recommended Practices in the Appraisal of Real Estate for Land-Secured Financings. In both documents, the California

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Debt and Investment Advisory Commission requires the inclusion of the special taxes as a cost item in evaluating the value of land subject to the special taxes.<sup>2</sup>

- b. In addition to excluding the special taxes as a cost item, the 2013 Valuation inexplicably reduced the overall non-CFD operating expense amounts by approximately 46% over the operating expenses assumed in the Implementation Document. The reduction of operating expenses improperly increases the valuation of the land, which results in the improper increase in the special tax rates set forth in the proposed RMA.

### **The RMA Creates A Competitive Disadvantage**

It is axiomatic that the property within the CFD will be at a competitive disadvantage to similarly-sized and similar-type buildings that are outside of the CFD. The Land Owner understands that. However, it is quite another thing to have an RMA that structures a competitive disadvantage to similarly-sized and similar-type buildings *within* the CFD. Yet that is what the Pre-COO Escalator will do.

For example, assume that a 40-story office building ("Building A") receives its Certificate of Occupancy in 2017 such that the special taxes commence in tax year 2017-18. Assume that rate to be \$4.50 per square foot. Under the RMA, once Building A receives its Certificate of Occupancy, its special tax rates are no longer subject to the Pre-COO Escalator and instead are subject to the Post-COO Escalator of 2% per annum, so that Building A will pay \$4.59 per square foot in 2018-19, \$4.68 per square foot in 2019-20, \$4.78 in 2020-21, and so on. A second 40-story office building ("Building B") receives its Certificate of Occupancy in 2020, but its special tax rates for the 2020-21 year are established based on the Pre-COO Escalator. Assume that the Pre-COO Escalator is 4% in each of the three years after Building B received its Certificate of Occupancy. In tax year 2020-21, Building B's initial tax rate will be \$5.07 per square foot, escalating at 2% thereafter.

In this example, in tax year 2020-21, Building A's tax is \$4.78 per square foot, escalating at 2% thereafter, but Building B's tax is \$5.07 per square foot, escalating at 2% thereafter. For buildings of 800,000 square feet, the difference is over \$200,000. If the owner of Building B has a triple net lease, it will pass through a higher special tax than the owner of Building A, which means Building A is the more attractive space economically. Same sized building, same land use, but far different special tax rates.

This kind of structural inequality is unfair to the builders in the CFD who already must compete against non-CFD projects in the area surrounding it.

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<sup>2</sup> The CDIAC documents do not expressly apply to valuations for the purpose of setting special tax rates, but the logic of including such special taxes as an item of expense is nonetheless applicable to any valuation made in connection with a CFD.

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### **The Bonded Indebtedness Is Not Consistent with the Implementation Document**

The Resolution to Incur states the City's intention to issue up to \$1.4 billion in bonded indebtedness. This bonded indebtedness figure is outrageously high because the overall tax burden on the property in the CFD has doubled due to the increased special tax rates and the escalators. The Implementation Document never contemplated a bond authorization of such large amounts. The Implementation Document estimated that the Net Present Value of the special tax revenues at a 7% discount would be approximately \$420 million. That revenue stream would never support a \$1.4 billion bond authorization. Even under the most generous of interest rates, the amount generated would be under \$1 billion.

While the Implementation Document did indicate that the revenues to be generated from the CFD may vary from the figures set forth in the Implementation Document, something is terribly wrong when the potential bond capacity jumps by almost \$500 million. What changed between 2012 when the Implementation Document came out and 2013 when the very high special tax rates were first proposed? Answer: The 50% increase in the special tax rates, the addition of the escalators, and the differentiation of building size among the same land use class.

### **The RMA Has Structural Flaws**

The proposed RMA has numerous structural flaws, including the following (capitalized terms used in this section that are not defined have the meanings provided such terms in the RMA):

1. **Timing of the Initial Special Tax Levy:** Under the RMA, the Special Tax is initially levied during the Fiscal Year following the issuance of the first Certificate of Occupancy ("COO") for a Taxable Building. However, during that same fiscal year, the RMA requires that the special tax be levied on all Assessor's Parcels within the Taxable Building, irrespective of whether a Parcel within the Taxable Building is completed, inhabitable, and/or sold or leased to a third party and generating income to pay for these significant new special tax amounts.

As a result of this policy, a property owner may be subjected to a special tax bill of millions of dollars based on the development of a building which is only partially completed and may, in fact, be mostly under construction. A realistic example of this type of anomaly is a Taxable Building with 750 apartments created within "air parcels," of which only 150 have received COOs. Even in Fiscal Year 2013-14, prior to the application of the Pre-COO Escalator and the Post-COO Escalator, a property owner of a 50-story building would be paying \$3,984 in special taxes for each 800-square foot apartment in the entire Taxable Building in that fiscal year as soon as the first COO is issued. In other words, if COOs have been issued for any one of those apartments, the property owner's special tax bill for all of these 750 apartments would jump from \$0 to \$2,988,000 per year. Assuming that only 150 of these apartments

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have COOs and are rented out, the property owner's special tax bill should only be \$597,600 for those 150 dwelling units. The additional \$2,390,400 in special taxes is unnecessarily burdensome.

This situation is exacerbated in the case of for-sale residential units.

But in its drive to maximize revenues, the City appears to have prepared an RMA that directly contradicts this concept, thereby creating disincentives to economic development that are contrary to both the City's and the property owners' interests, as further explained below.

2. **Date for Determining Tax Levy Burdensome:** As stated above, special taxes under the RMA are initially levied during the Fiscal Year following the issuance of the first COO for a Taxable Building. This means that for COOs issued in June of a fiscal year would require taxation less than a month later when the new fiscal year starts in July. The potential for immediate special tax levy is too burdensome on the property owners.

In order to give property owners some breathing room, it would be appropriate to provide for a minimum period of six (6) months after the issuance of the first COO for a specific Assessor's Parcel before the special tax could be levied, thereby providing a building owner with a brief period in which to sell or lease that Assessor's Parcel prior to the initiation of the special tax.

3. **Pre-COO Escalator Creates An Unlevel Playing Field:** Please see "The RMA Creates a Competitive Disadvantage" for a discussion about this flaw in the RMA.

The flaws in the RMA described above are unnecessarily overly burdensome on the property owners. Taxing the entirety of the building before construction is complete and before revenue sources become available is a recipe for a disaster. These flaws may be easily fixed, and probably would have been had the Land Owner been involved in the CFD formation process like it would be in any other CFD formation.

In addition, these flaws will make the administration of this CFD unnecessarily more difficult, which will, in turn, increase the administrative expense billed to the property owners.

#### **The Land Owner Reasonably Relied on the Implementation Document**

The Land Owner is a rational developer, and no rational developer could or would commit to a project without a clear understanding of the potential expenses associated with that project. Land Owner's successor, which entitled the project based on the Transit Center District Plan's new zoning, relied on the special tax rates set forth explicitly in the Implementation Document. This reliance on the Implementation Document was both reasonable and foreseeable.



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The City has claimed that the Land Owner should have known that the special tax rates in the Implementation Document were “merely illustrative”. However, as explained in detail in the August 12 Letter, the Implementation Document is very clear that it is the revenues – not the special tax rates – that may vary depending on the real estate market, bond interest rates, and the pace of development. There is no language in the Implementation Document that suggests the special tax rates are subject to change.

The special tax rates in the RMA are nearly 50% higher than the rates in the Implementation Document. With the two escalators, the overall tax burden on the Land Owner *more than doubled* between the Implementation Document and the RMA. A tax burden that doubles is a classic case of “bait and switch.”

#### **The City Has Gerrymandered the Subject Property to Ensure Approval**

Neither the Land Owner, nor to its knowledge, any other private developer that may be subject to the CFD, were consulted prior to creation of the boundary map and the designation of the Subject Property. After reviewing the Subject Property, a disturbing fact was revealed: approximately 68% of the Subject Property is owned by TJPA, OCII, and Caltrans, public entities that will never be subject to the special taxes. The ownership of 68% of the property in the CFD by the public agencies virtually guarantees that the CFD will survive any protest and will be approved at the special election.

We note that the City is now suggesting an amendment to the RMA to eliminate the exemption for public property. The City is doing this with the express intention of allowing the public agencies to vote in the election and for the public agencies’ property holdings to be counted in any protest hearing. Moreover, it is highly unusual to have public agencies’ as voters in the formation of a CFD. Having the public agencies dominate a landowner election is unprecedented. According to our consultants, *nearly every CFD* formed in California exempt public agencies from taxation, which makes them ineligible to vote on formation of the CFD.

By allowing the public agencies to vote in the special election, and by picking and choosing which properties will be part of the Subject Property and eligible to vote, the City is effectively *nullifying* the vote of the parties that will be paying these taxes and who could otherwise use their voting power to rectify the improper increase in the special tax rates.

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## **Procedural Arguments Against the CFD**

### **The Public Agencies are Not Landowners For Purposes of Protest or Voting**

According to the boundary map, the Land Owner understands that a significant amount of the Subject Property is owned by TJPA, OCII, and CalTrans (each a “Public Agency” and, collectively, the “Public Agencies”). None of these Public Agencies is a “landowner” under the Act. Under Section 53317(f), the term “landowner” or “owner of land” specifically excludes public agencies unless one of four exceptions is satisfied. The only relevant exception is found in Section 53317(f), which allows a Public Agency to be considered a landowner if:

The public agency states in the proceedings that its land is intended to be transferred to private ownership and provides in the proceedings that its land will be subject to the special tax on the same basis as private property within the district and affirmatively waives any defense based on the fact of public ownership, to any action to foreclose on the property in the event of nonpayment of the special tax.

For this exception to apply to a Public Agency, the Public Agency is required to “state in the proceedings” *all of the following*:

- a. that the land it owns is intended to be transferred to private ownership;
- b. that the land it owns will be subject to the special tax on the same basis as private property within the CFD; and
- c. that it affirmatively waives any defense based on the fact of public ownership to any action to foreclosure on the property in the event of nonpayment of the special tax.

This exception does not apply to the Public Agencies because none of the Public Agencies have made any such declarations in the proceedings. Without these declarations, it is irrelevant if the property of the Public Agencies is subject to the special tax on the same basis as other property owners. These declarations are a condition precedent to the Public Agencies being allowed to protest or vote (as discussed further below), and, to date, to the Land Owner’s knowledge, no such declarations have been made in the proceedings.

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It should be noted that separate declarations are required from each Public Agency. To the extent that one or more Public Agencies do not make the declarations, then those Public Agencies will not be allowed to protest or vote (as discussed further below).<sup>3</sup>

Moreover, even if the Public Agencies were inclined to make such declarations, they could not because the RMA exempts all public agencies from taxation under all circumstances. Section G of the RMA provides (underlining added):

Notwithstanding any other provision of this RMA, no Special Tax shall be levied on: (i) Public Property, except Taxable Public Property, (ii) Square Footage for which a prepayment has been received and a Certificate of Exemption issued, (iii) Below Market Rate Units except as otherwise provided in Sections D.3 and D.4, (iv) Affordable Housing Projects, including all Residential Units, Retail Square Footage, and Office Square Footage within buildings that are part of an Affordable Housing Project, except as otherwise provided in Section D.4, (v) Exempt Child Care Square Footage, and (vi) Parcels in the CFD that are not yet Taxable Parcels.

“Public Property” is defined in the RMA as “any property within the boundaries of CFD No. 2014-1 that is owned by the federal government, the State of California, the City, or other public agency.” This definition includes all of the Public Agencies.

“Taxable Public Property” is defined in the RMA as “any Parcel of Public Property that had been a Taxable Parcel in a prior Fiscal Year, and for which the Special Tax obligation was not prepaid when the public agency took ownership of the Parcel.” This definition is inapplicable to the Subject Property owned by the Public Agencies because this definition refers to property that was non-exempt at formation that was then conveyed to public ownership subsequent to formation. Since all of the Subject Property owned by the Public Agencies are exempt by definition, their property is not considered Taxable Public Property.

As you can see, the Public Property is not subject to the special tax “on the same basis as private property within the CFD” as required by Section 53317(f). And this is true whether the property is developed or undeveloped. Under the RMA, property becomes taxable only after a Certificate of Occupancy is provided. However, so long as the property is Public Property, the land will remain exempt even if the land is developed and a Certificate of Occupancy is provided. Unlike private property where

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<sup>3</sup> The Land Owner understands that the City is going to attempt to adopt an amended and restated RMA that eliminates the public agency exemption from special taxes. The Land Owner further understands that TJPA will be submitting a letter that purports to meet the requirements of Section 53317(f)(3). Even if true for TJPA, the other Public Agencies will not be able to vote unless they submit similar declarations.

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it becomes taxable upon Certificate of Occupancy, Public Property remains exempt after Certificate of Occupancy. By definition, the Public Property is not being taxed on the same basis as private property.

Thus, the third exception under 53317(f) is not applicable to the Public Agencies and could never be applicable with the proposed RMA. Accordingly, the Public Agencies are not considered "landowners" under the Act. This has two consequences:

1. In evaluating whether a majority protest exists under Section 53324, the land owned by the Public Agencies is not counted in determining whether 50% or more of the land protests the formation of the CFD. Section 53324 provides that if "the owners of one-half or more of the area of the land in the territory proposed to be included in the district and not exempt from the special tax" file written protests against the establishment of the district, no further proceedings to create the CFD shall be taken for a period of one year from the date of decision of the legislative body. Since, under the RMA, all of the land owned by the Public Agencies is exempt from taxation, the Subject Property owned by the Public Agencies is not counted when determining whether there is a majority protest. Moreover, once the Public Agencies are not considered owners of land under Section 53317(f) then the Subject Property owned by the Public Agencies is not counted when determining whether there is a majority protest.
2. The Public Agencies are ineligible to vote in the proposed election; only the property owned by private parties are qualified electors for purposes of the voting. Moreover, once the Public Agencies are not considered owners of land under Section 53317(f) then they may not vote in the special election. This means that 2/3 of the land owners' votes (excluding the Public Agencies) is required to approve the CFD and the bonded indebtedness.

**Introduction of Changes to RMA is Not Allowed by Mello-Roos Act**

The Land Owner understands that the City is going to be introducing an Amended and Restated Rate and Method of Apportionment of Special Tax for the CFD (the "Amended RMA") that makes various changes, most notably the elimination of the exemption for public property. This change is being made for the express purpose of allowing the various Public Agencies that own part of the Subject Property to vote in the CFD elections. This change to the RMA is being made pursuant to Section 53325 of the Act. However, Section 53325 of the Act requires additional actions on the part of the Board before it may conclude the public hearing. Section 53325 provides (underlining added):

53325: The hearing may be continued from time to time, but shall be completed within 30 days, except that if the legislative body finds that the complexity of the proposed district or the need

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for public participation requires additional time, the hearing may be continued from time to time for a period not to exceed six months. The legislative body may modify the resolution of intention by eliminating proposed facilities or services, or by changing the rate or method of apportionment of the proposed special tax so as to reduce the maximum special tax for all or a portion of the owners of property within the proposed district, or by removing territory from the proposed district. Any modifications shall be made by action of the legislative body at the public hearing. If the legislative body proposes to modify the resolution of intention in a way that will increase the probable special tax to be paid by the owner of any lot or parcel, it shall direct that a report be prepared that includes a brief analysis of the impact of the proposed modifications on the probable special tax to be paid by the owners of lots or parcels in the district, and shall receive and consider the report before approving the modifications or any resolution of formation that includes those modifications. The legislative body shall not modify the resolution of intention to increase the maximum special tax or to add territory to the proposed district. At the conclusion of the hearing, the legislative body may abandon the proposed establishment of the community facilities district or may, after passing upon all protests, determine to proceed with establishing the district.

The introduction of the Amended RMA presents two problems.

First, the removal of the exemption in the Amended RMA results in an "increase" in the maximum special taxes of the Public Agencies. Under the RMA attached to the Resolution of Intention, the Public Agencies had a maximum special tax liability of \$0 (as they were exempt). In the Amended RMA, the property of the Public Agencies is subject to the special taxes in the same manner as privately-owned property. To go from \$0 to being subject to the special tax rates like everyone else, the City will be increasing the maximum special taxes at the public hearing, and this is prohibited by Section 53325. Consequently, the City must re-adopt the Resolution of Intention with the Amended RMA attached thereto, provide notice of a new public hearing, and proceed according to the Act. The Board has no authority to adopt the Amended RMA under the Act without re-noticing the public hearing.

Second, at the very least, the changes in the Amended RMA increase the "probable special tax" to be paid by the Public Agencies. Accordingly, the Board must order a report and consider it before approving the change to the RMA. The Board has no authority to proceed without that report.

The amendment of the RMA to remove the exemption for public agencies is a game-changer, and should not be accomplished without adequate time and notice to review the implications of the changes. The Amended RMA is intended to allow the Public Agencies to vote, and that changes the entire landscape of the approvals needed for the CFD to be formed. On a practical and fairness level alone, the Board should not proceed with the CFD formation without providing published notice of the Amended RMA.

Ms. Angela Calvillo  
Clerk of the Board  
Board of Supervisors  
City and County of San Francisco  
September 2, 2014  
Page 14

### **Conclusion**

Due to the various objections described above, it is unreasonable and unfair for the Board to proceed with the CFD with an RMA that is not consistent with the Implementation Document. Moreover, the Board does not have the authority to proceed with a CFD that has an RMA that is inconsistent with the Implementation Document.

Pursuant to the Act, please indicate for the record at the Public Hearing on September 2, 2014 that the Property Owner has filed a formal written protest letter pursuant to Section 53323.

Signature on following page.

Ms. Angela Calvillo  
Clerk of the Board  
Board of Supervisors  
City and County of San Francisco  
September 2, 2014  
Page 15

41 Tehama, LP, a Delaware limited partnership

By: 41 Tehama GP, Inc., a Texas corporation, its general partner

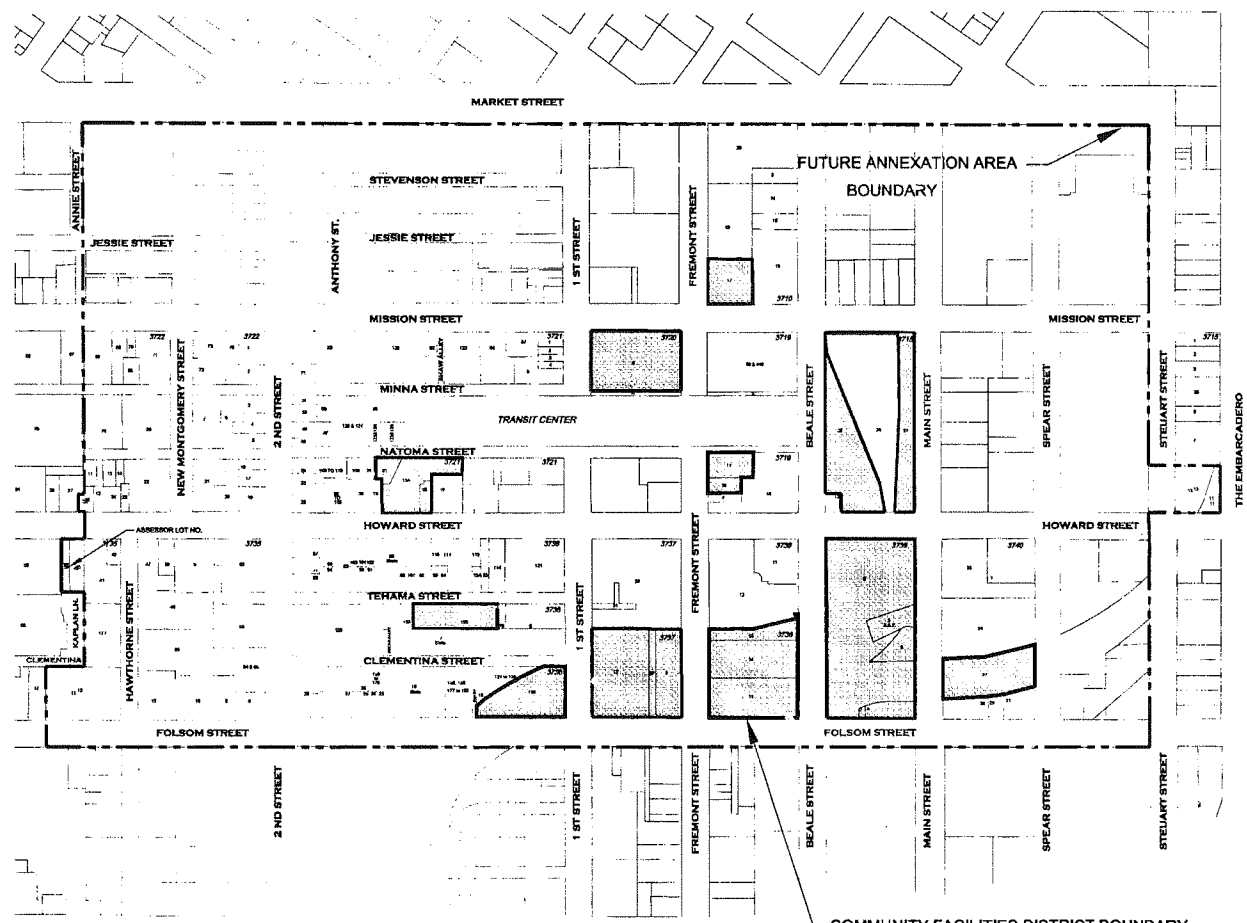
By: 

Name: RON RAGSDALE

Title: VICE PRESIDENT

Assessment/CFD Map

Proposed Boundaries of  
**City and County of San Francisco**  
**Community Facilities District No. 2014-1**  
**(Transbay Transit Center)**  
 State of California



COMMUNITY FACILITIES DISTRICT BOUNDARY  
 SEE SHEET 2

1. Filed in the office of the Clerk of the Board of Supervisors of the City and County of San Francisco this 3<sup>rd</sup> day of June, 2014.

*Angela Calvillo*  
 Angela Calvillo  
 Clerk of the Board of Supervisors

2. I hereby certify that the within map showing proposed boundaries of City and County of San Francisco Community Facilities District No. 2014-1 (Transbay Transit Center), State of California, was approved by the Board of Supervisors of the City and County of San Francisco, at a meeting thereof, held on the 15<sup>th</sup> day of June, 2014, by its Resolution No. 241-14.

*Angela Calvillo*  
 Angela Calvillo  
 Clerk of the Board of Supervisors

3. Filed this 3<sup>rd</sup> day of June, 2014, at the hour of 2 o'clock p.m., in Book 1 of Maps of Assessment and Community Facilities Districts at Page 75 in the office of the County Assessor-Recorder in the City and County of San Francisco, State of California.

*Carmen Chu*  
 Carmen Chu  
 Assessor-Recorder  
 City and County of San Francisco

**LEGEND**

PROPERTY WITHIN THE CFD BOUNDARY

FUTURE ANNEXATION BOUNDARY LINE

San Francisco Assessor-Recorder  
 Carmen Chu, Assessor-Recorder  
**DOC- 2014-J915559-00**  
 Rec'd 45-Mayor's Office of Economic Development  
 Tuesday, JUL 29, 2014 14:38:11  
 Ttl Pd \$0.00 Rpt # 8004979746  
 cfo/jl/l1-2

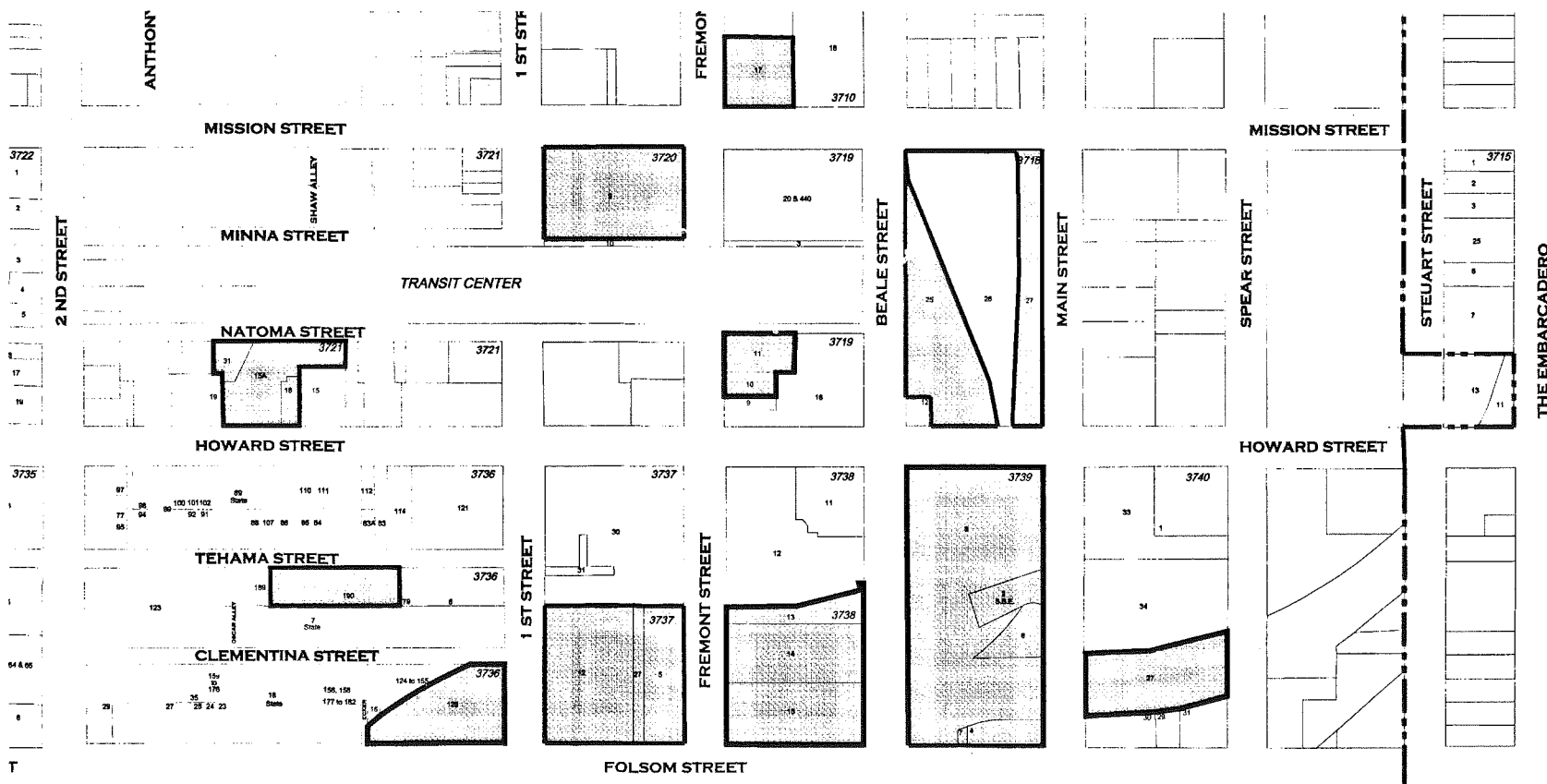
**FILED**  
 Not Returnable

**GCG**  
 GOODWIN CONSULTING GROUP





Proposed Boundaries of  
 City and County of San Francisco  
 Community Facilities District No. 2014-1  
 (Transbay Transit Center)

Book **001** Page **76**  
 Assessment/CFD Map



**LEGEND**

-  PROPERTY WITHIN THE CFD BOUNDARY
-  FUTURE ANNEXATION BOUNDARY LINE
- 3740** ASSESSORS BLOCK NUMBER
- 34** ASSESSORS LOT NUMBER



**GCG**  
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# REUBEN, JUNIUS & ROSE, LLP

June 30, 2014

## Delivered by Hand

San Francisco Board of Supervisors  
Land Use & Economic Development Committee  
1 Dr. Carlton B. Goodlett Place  
San Francisco, CA 94102  
Attn: Andrea Ausberry, Clerk

**Re: Resolution of Intention to Establish San Francisco Community Facilities  
District No. 2014-1 (Transbay Transit Center);  
Resolution of Intention to Incur Bonded Indebtedness in an Amount Not to  
Exceed \$1,400,000,000 for the San Francisco Community Facilities  
District No. 2014-1 (Transbay Transit Center)  
Board of Supervisors File Nos. 140644 and 140645**

Dear Supervisors Cohen, Kim and Wiener:

The Office for Community Investment and Infrastructure (“OCII”) and the Transit Joint Powers Authority (“TJPA”), along with the City and County of San Francisco have proposed to create Community Facilities District No. 2014-1 (Transbay Transit Center) (the “CFD”). The CFD today is radically different from the one first authorized by the Board of Supervisors in 2012 when the Mello-Roos Special Tax was estimated to generate \$420,000,000+ of Net Present Value (“NPV”). Today’s CFD Resolution allows for bonded indebtedness up to \$1,400,000,000 and a NPV more than twice that which was expected in 2012. The current CFD proposal contains major deviations from and costly provisions not authorized by the Implementation Document (as defined below), and the substantial growth in bond proceeds arises out of increased special taxes and amounts based upon significant technical errors in property valuation. Additionally, significant infrastructure that the 2012 proposal was intended to finance has been excluded or materially changed. These problems are not entirely surprising since following the adoption of the Implementation Document in 2012 the CFD has been structured with no real input from the land owners. The purpose of this letter is to provide context on the CFD formation process, identify errors and inconsistencies in the CFD as currently proposed, and to continue to invite collaborative discussions about how best to address the issues.

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Sheryl Reuben<sup>1</sup> | David Silverman | Thomas Tunny | Jay F. Drake | John Kevin  
Lindsay M. Petrone | Melinda A. Sarjapur | Kenda H. McIntosh | Jared Eigerman<sup>2</sup> | John McInerney III

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## I. The Transit Center District Formation Process.

In 2012, as part of the Transit Center District Plan (“TCDP”) formation process—which involved the City, property owners, developers, the TJPA, and other stakeholders—in 2012 the City adopted the TCDP Implementation Document (“Implementation Document”). The Implementation Document sets forth the TCDP’s public infrastructure program and funding sources, and explains how the development projects in the Plan Area will contribute to funding infrastructure improvements through the CFD taxes.

The Planning Commission adopted the Implementation Document on May 24, 2012, followed by the Board of Supervisors a few months later. The City then explicitly incorporated the Implementation Document into the Planning Code. Specifically, the Planning Code section authorizing the CFD provides that the CFD’s “purpose” is to provide the “sufficient funding” that “the City will require . . . to supplement other applicable impact fees for infrastructure, improvements and services *as described in the Transit Center District Implementation Document*, including but not limited to the Downtown Extension of rail into the Transit Center, street improvements, and acquisition and development of open spaces.” S.F. Planning Code § 424.8. The City’s actions underscored what all of the parties involved in forming the TCDP understood: that the Implementation Document would govern development within the TCDP and the use of the CFD tax funds.

With the respect to taxes and fees, the expectation has been accurate – except for the CFD. The Implementation Document sets forth various impact fees, including the Transit Center Open Space Fee and the Transit Center Transportation and Street Improvement Fee. The City continues to stand by those fees at the rates established in the Implementation Document, with minor inflation adjustments. It is only the CFD that the City has now taken a radically different tack. The before and after is stark.

The Implementation Document adopted unanimously in 2012 provides that development projects in the Plan Area will pay a special tax “equivalent to 0.55 percent of the assessed value of the affected property” and that “regardless of the ultimate methodology and tax structure, the final Special Tax assessed to each property will be calculated to be equivalent to 0.55 percent of property value.” The City even took it a step further, however, what the special tax would be per net square foot (see Table 5 of the Implementation Document). Project sponsors and property owners justifiably relied on the Implementation Document when calculating the value of land purchased from OCII and from private parties, and the City and other public bodies involved in the TCDP were well aware of such reliance.

For example, as part of the process for purchasing land from OCII, buyers were required to submit pro-forma financial analyses with their bids. These analyses clearly showed that buyers relied on rates in the Implementation Document when taking the cost of the CFD into account. OCII never objected to the buyers’ assumptions or suggested that the assumptions were in anyway incorrect. Indeed, OCII received land value consideration derived from these

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estimates. For those buyers that purchased property based on these pro formas, the land value was inflated because of the undervaluation of the ongoing tax liability.

In July 2013, more than a year after adopting the Implementation Document and just weeks before it was scheduled to be approved, the San Francisco Planning Department, OCII, and TJPA released the Transit Center Mello-Roos District's proposed legislation and associated special tax formula to project builders. The legislation effectively disregards the Implementation Document. The 2013 tax rates – the same as those currently being considered – were issued without any prior notice to or collaboration with owners, which is simply unheard of for a CFD of this scope and sophistication. And, despite the CFD guidelines in the Implementation Document, the CFD tax formula will, in many instances, impose special tax rates 30-50% higher than those found in the Implementation Document. In addition, between the 2013 RMA and the RMA attached to the current legislation, the definition of square footage was changed from net leasable/saleable square footage to gross square footage per Section 102.9 of the Planning Code (i.e., "Gross Floor Area"). This change increases the tax liability again, particularly for residential projects, which will see their annual tax increase by *an additional* 30-40%. The sum of these changes means that tax burdens will in all likelihood exceed 0.55% of a property's assessed valuation by a significant margin.

Moreover, in conjunction with this markedly different tax structure, the City has proposed radically changing the projects that the tax funds will support. Specifically, the City is abandoning a host of public infrastructure improvements throughout the Transit Center District. Facing hundreds of millions of dollars in cost overruns on construction of the Transit Center itself—a crisis that has forced the TJPA to eliminate a host of design features and indefinitely postpone construction of the Center's signature rooftop park—the City apparently intends to use the tax funds to make up the difference.

## II. City's Response to Owners' Concerns.

Fourteen months after the 2012 TCDP formation and passage of the Implementation Document (see I. above), the City provided owners with a first draft of proposed CFD legislation along with the Rate and Method of Apportionment document ("RMA"). That 2013 legislation proposed increasing bonded indebtedness up to \$1,000,000,000 or roughly two times what was published in the Implementation Document 14 months earlier in 2012. That CFD legislation and RMA was crafted by the City without any input of owners who were expected to ultimately pay the tax. Although there had been no real collaboration, the City did postpone the consideration of that 2013 legislation until now. The 2014 legislation and tax formula is essentially identical to the 2013 drafts with the exception of significantly expanding the definition of square footage, while the owners' concerns have yet to be addressed. The owners' concerns fall into two main categories:

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1. The CFD tax rates were established based on a property valuation conducted by The Concord Group (“TCG Valuation”)<sup>1</sup>, but that TCG Valuation was flawed in numerous ways, as discussed in the pages that follow. The documented errors in the TCG Valuation result in the tax rates being set 30-50% higher than they should be. Furthermore, between the 2013 and 2014 RMA drafts, the definition of square footage, to which the CFD rates would be applied, was changed, resulting in substantial further increases in tax burdens, particularly for residential projects (total increases of up to +/- 75% vs. the 2012 Implementation Document).
2. The tax formula expands the parameters of the tax structure set forth in the Implementation Document by adding various embellishments not referenced in the Implementation Document, resulting in taxes being an additional 20% more than they should be.

The City’s response to concerns regarding discrepancies between the Implementation Document and the proposed legislation has been to tell owners they should not have relied on the Implementation Document at all. This position is untenable.

The Implementation Document was adopted by the Planning Commission on May 24, 2012<sup>2</sup> and then by the Board of Supervisors a few months later.<sup>3</sup> The Planning Code section authorizing the CFD and requiring annexation into the special tax district provides that the funding will be “as described in the Transit Center District Implementation Document.”<sup>4</sup> Simply, there were no other sources of information upon which property owners could rely on other than the Implementation Document, and the City and other public entities both invited and accepted such reliance. A rational owner could only expect that the valuation methodology and underlying assumptions, ultimately used to establish the CFD, would not deviate radically from the Implementation Document.

### III. Significant Errors in Methodology Underlying CFD Tax Rates.

Setting aside the fundamental changes in methodology from the Implementation Document described above, the City’s current proposed CFD rates contain significant math errors and incorrect assumptions which result in arbitrarily high values, and biases in valuation methodologies. Although the City and OCII have acknowledged at least one error in the CFD valuation methodology that artificially increased the CFD’s tax rates significantly, they did not change the rates to reflect their admitted error. While not the full list, the following errors stand out as the most egregious, which have a substantial impact on projected valuation and therefore Mello-Roos special tax rates and annual payments:

- **Cyclical highs depicted as normal.** The City chose data from two high points in market cycles, 2007 and 2013, to project values for office buildings. In practice, buildings’ tax basis changes regularly with the cyclical nature of the market, given the ability for

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owners to file Prop 8 appeals. As shown on the attached **Exhibit A**, the CFD would set the valuation at a sale price that has only been achieved twice in San Francisco history.

- The City clearly recognizes the cyclical effect of interest rates when it calculates the bond sales proceeds, but ignores them in the building valuations. For its CFD bond sale calculations, the City projects higher interest rates in the future when the bonds will be sold, recognizing today's interest rates are the lowest in history and are not expected to be maintained in the future when the bonds will be sold, thereby setting reasonable expectations of bond proceeds over time. By contrast, in the building valuations the City projects that today's interest rates (and by extension capitalization rates) will be maintained in perpetuity, which significantly increases building valuations. The same assumption for the trend in interest rates should be applied to both the properties and the bond sales.
- **Ignoring the cost of the CFD tax itself.** The City failed to take into account the operating expense cost of the CFD tax itself, which artificially inflates income (or artificially reduces cost of ownership in the case of condos) and therefore property value. The City acknowledged this error but has failed to readjust its valuation accordingly.
- **Arbitrarily lowering operating expenses.** In its office building valuation used to set rates, the City arbitrarily and substantially lowered assumed operating expenses between its 2012 and 2013 analyses. This reduction in operating expenses resulted in a massive increase in projected values. The 2013 analysis assumed between \$11 and \$12 per square foot of operating expenses, including all property taxes and assessments (including the Mello). Assuming the RMA's stated Mello rate of +/- \$5 per square foot for a 50-story building, the remaining \$6-7 per square foot would barely cover property taxes, leaving nothing for the operations of the building itself (which typically run \$12-15 per square foot). Correcting this error would bring the 2013 projected values much closer in line with the City's own 2012 analysis. There is no reasonable explanation for this change in assumed expenses.
- **Applying rates to Gross Floor Area, not net rentable/saleable square footage:** The TCG Valuation calculated values based on net rentable square footage (in the case of office, retail, and rental residential) and net saleable square footage (in the case of for-sale residential) reflecting a fair attempt to tax only revenue-producing square footage. The City's CFD rates, which were drawn directly from the TCG Valuation's results (0.55% was applied to TCG's values to determine rates), should for consistency also be applied to net rentable/saleable square footage. This was the case in the 2013 version of the RMA, but the 2014 version applies rates to Gross Floor Area, which for residential projects in particular is much larger than net rentable/saleable square footage.

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In drafting the tax formula, the City was required to achieve the equivalent of 0.55% of the assessed value of the property in the CFD. The City has offered the TCG Valuation as a proxy for the assessed value of the property in the CFD, and it is that valuation that is multiplied by 0.55% to produce the special tax rates. The owners question the use of the TCG Valuation as being equivalent to assessed value, but there is no question that if such a valuation is used, it must be consistent with customary valuation standards. To accept an incorrect valuation is inconsistent with the Implementation Document and patently unfair to the owners. The valuation used to set the tax rates has to be calculated correctly in order to achieve the 0.55% equivalency that the Implementation Document requires. By implementing an incorrect valuation, the City is artificially increasing the tax rates in violation of the Implementation Document.

#### **IV. Other Significant Changes from Implementation Document**

Other provisions in the tax formula that was presented to the builders went beyond what is in the Implementation Document, each of which results in an increase in tax rates from the Implementation Document. For example:

A. There is nothing in the Implementation Document that discusses, authorizes, or directs that the tax rates increase annually prior to obtaining a Certificate of Occupancy (“COO”), yet the proposed tax formula imposes annual adjustments prior to the first COO up to 4% per year.

B. There is nothing in the Implementation Document that discusses, authorizes, or directs that the tax formula include a 2% escalator on the special taxes after the COO is received, yet the proposed tax formula has an annual 2% escalator, resulting in a 20% additional tax burden.

C. There is nothing in the Implementation Document that specifically requires that different tax rates be applied to buildings with different numbers of floors. In fact, Table 5 indicates the opposite.<sup>5</sup> The result – increased tax rates not contemplated by the Implementation Document.

#### **V. What Changed?**

In the past year, construction of the Transit Center has gone hundreds of millions of dollars over-budget; the construction of the Transit Center’s signature rooftop park has been postponed indefinitely; and a host of design features to the Transit Center were eliminated for good.<sup>6</sup> Additionally, despite assurances in the Implementation Document that the CFD funds would be used to construct a number of public infrastructure projects around the Transit Center District, it now appears the majority of these funds will initially be used only on the Transit Center itself. These changes, plus setting the tax rates based on errors in valuation methodology and additions to the tax formula, all result in significantly higher taxes being used for different facilities than contemplated by the Implementation Document.

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## VI. Conclusion.

The legislation before this Committee is inconsistent with the CFD contemplated by the Implementation Document and adopted by the Board of Supervisors in 2012. The tax formula is based on a property valuation that contains errors, and the tax rates are applied to square footages inconsistent with both the Implementation Document and the analysis underlying the 2013 rates. The tax formula contains significant additions that are not found in the Implementation Document. These changes appear intended to artificially increase the CFD tax to address a project with significant cost overruns. As noted, the best illustration of this: in 2012, the Implementation Document projected net proceeds of \$420+ million (on an Net Present Value ("NPV") basis), but just one year later, in 2013, the CFD projected net proceeds of up to \$1 billion, and now, in 2014, CFD bond proceeds in the current legislation are proposed not to exceed \$1,400,000,000. To raise taxes by orders of magnitude over a two-year period - while simultaneously abandoning the infrastructure improvements they were intended to fund - is unreasonable and unfair.

Very truly yours,

REUBEN, JUNIUS & ROSE, LLP



James A. Reuben

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<sup>1</sup> The Staff Report that accompanied the Resolution of Intention indicates that "rates were developed by the City's consultant, Goodwin Consulting Group, based on criteria set forth in the TCDP Implementation Document." It is clear from careful study of the 2013 RMA and the Concord Group's analysis that the rates were based on the Concord Group's work. We assume this is an error in the Staff Report.

<sup>2</sup> San Francisco Planning Commission Motion No. 18635.

<sup>3</sup> San Francisco Board of Supervisors Ordinance No. 184-12.

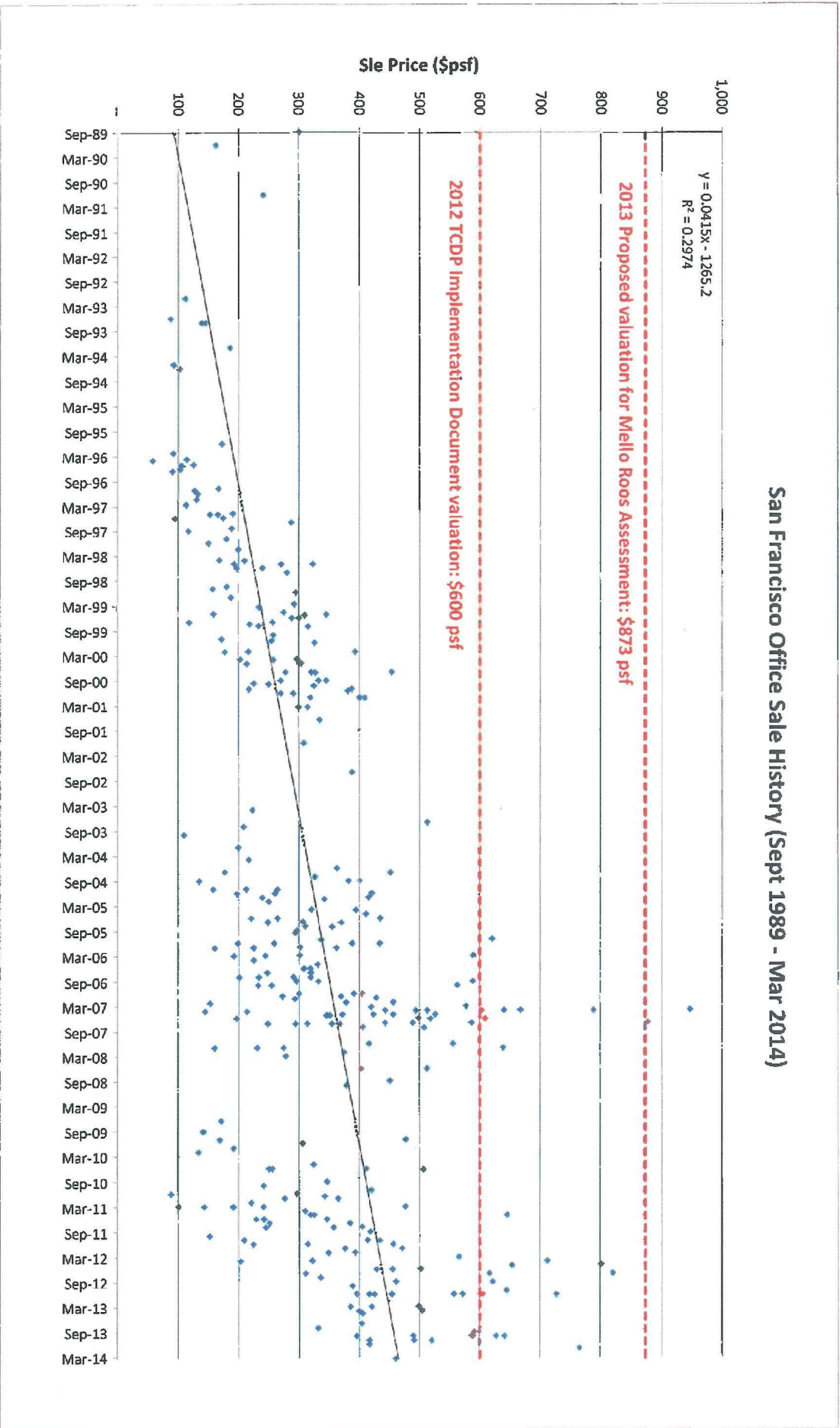
<sup>4</sup> San Francisco Planning Code, § 424.8.

<sup>5</sup> Transit Center District Plan Program Implementation Document, Table 5, pg. 11 (adopted May 24, 2012, Plan. Commission Resolution No. 18635).

<sup>6</sup> "Transbay Transit Center will open without signature park." J.K. Dineen, *SF Gate*, Wednesday, June 25, 2014.



### San Francisco Office Sale History (Sept 1989 - Mar 2014)



# REUBEN, JUNIUS & ROSE, LLP

August 12, 2014

**Delivered by Hand**

San Francisco Board of Supervisors  
1 Dr. Carlton B. Goodlett Place  
San Francisco, CA 94102  
Attn: Angela Calvillo, Clerk of the Board

**Re: San Francisco Community Facilities District No. 2014-1 (Transbay Transit Center) Legislation  
Board of Supervisors ("Board") File Nos. 140644, 140645, 140814, 140815, and 140816  
Reply to Ken Rich Memo of July 14, 2014 Addressed to Honorable Members, Board of Supervisors  
Our File No. 7868.02**

Dear Honorable Members:

On June 30, 2014, we submitted our letter (the "Reuben Letter") to your Land Use and Economic Development Committee regarding the Resolution of Intention to Establish Community Facilities District No. 2014-1 (Transbay Transit Center) and Resolution of Intention to Incur Bonded Indebtedness in an amount not to exceed \$1,400,000,000 for the San Francisco Community Facilities District No. 2014-1 (Transbay Transit Center) (the "CFD").

On July 14, 2014, we were provided a copy of a memorandum response from Ken Rich on behalf of the Mayor's Office of Economic and Workforce Development (the "Rich Letter"). This letter is our reply to the Rich Letter.

Before addressing the Rich Letter, it is important to understand the basic objections that the developers, owners, and project sponsors (herein, the "Owners") have to the proposed rate and method of apportionment (the "RMA") for the CFD. The Owners understood they would be required to join a CFD and have never objected to paying a special tax based on the Implementation Document. The Owners understood that in adopting the ordinance that created Section 424.8 of the Planning Code, the City incorporated the CFD parameters contained in the Implementation Document. The Implementation Document contained the calculation and justification of special tax rates (the "Rates") for the CFD. In crafting the RMA, instead of

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Sheryl Reuben<sup>1</sup> | David Silverman | Thomas Tunny | Jay F. Drake | John Kevlin  
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incorporating the Rates established by the Implementation Document, the City unilaterally increased the special tax rates and added escalators to the special tax rates based on a new valuation study by The Concord Group (the “2013 Concord Group Study”).

No such re-valuation study was even alluded to in the Implementation Document, and yet it was used to justify the provisions in the RMA. If implemented, the provisions in the RMA that were unilaterally created by the City will increase the Rates by approximately 50% over the Rates in the Implementation Document and then escalate these higher rates both before and after certificate of occupancy, resulting in a further increase of the Rates in the Implementation Document by another 50%. To put this in perspective, these changes add over \$100 million in additional tax burden to the Salesforce Tower alone and similar order of magnitude increases to the other projects in the Transbay Plan Area. No reader of the Implementation Document could have reasonably anticipated any such changes.

The unilateral action by the City is representative of the basic problem that has existed with this process since the publication of the Implementation Document. Rather than forming the CFD collaboratively as is done in every other instance of CFD formation, the City has acted unilaterally, treating the CFD like a fee that is imposed by the City. Having explained the Owners’ objections in the Reuben Letter in detail, we are extremely disappointed by the response you received from Ken Rich. The response makes misleading statements, mischaracterizes the content of the Implementation Document adopted by the Board and the Planning Commission, seeks to avoid critical valuation questions, and characterizes errors pointed out by the Owners as concessions made by the City as part of a public-private collaboration. We have to laboriously review the City’s responses to the Board regarding the Reuben Letter to demonstrate the underlying misunderstanding of the Implementation Document and problems in the attempted dialogue by the Owners with the City.

We hope that you can take the time to review this letter closely as we believe it exhaustively examines this issues and responds to the Rich Letter. A summary of the issues covered in this letter:

1. **The Implementation Document Did Not “Expressly State” That the Rates Were “Merely Illustrative”** This contention in the Rich letter is false. There is no express statement in the Implementation Document that the Rates are “merely illustrative”. Further the words “merely illustrative” or even “illustrative” do not appear in the Implementation Document, nor is there any language in it which could lead its readers to the conclusion the Rates were expressly stated as merely illustrative. This is a fundamental mischaracterization of what the Implementation Document expressly states. By contrast, there are other impact fees in the Implementation Document which are clearly described as “For Descriptive Purposes Only”.
2. **City Confuses “Revenue” and “Rates”** This is a fundamental misunderstanding illustrated by the Rich Letter. The revenue projections in the Implementation Document

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are expressly stated to be estimates only because the pace and type of development are unknown (and therefore the timing of CFD payments is unknown), but the per square foot Rates are not uncertain or subject to change, modification, or additional study. The Rates were fixed in the Implementation Document as passed unanimously at the Planning Commission and the Board of Supervisors.

3. **Annual Escalators Clearly Never Included or Contemplated by Implementation Document:** The Rich Letter's conclusory claims that annual escalators are consistent with the Implementation Document are contradicted by the plain language of, and the notable omissions in, the Implementation Document. The City improperly added features to the CFD that could not have been reasonably anticipated by readers of the Implementation Document, including annual escalators, increasing a property's CFD tax liability by up to 81% (in the final year of the tax) --a staggering increase. Moreover, annual increases fail to reflect the reality that a property's assessed value is highly cyclical.
4. **Developer Pro forma for OCII Demonstrated Reliance on Rates:** The Rich Letter misleadingly claims that there are no pro formas for redevelopment parcels purchased from OCII that demonstrate the Owners' reliance on the Implementation Document's Rates. Block 9's pro forma did just that.
5. **The Formation Study Called For By The Implementation Document Did Not Call for Re-Valuation:** The Implementation Document calls for a "detailed CFD formation study" not a new valuation based on an updated study. The formation study is intended to define the non-value criteria for the per square foot rates because it is illegal to have the rates tied to value (which is the basis the City used for developing the per square foot tax assessments). The claim that the 2013 Concord Group Study is the CFD formation study called for in the Implementation Document is absurd as it does not evaluate alternative rate arrangements or anything else called for in the Implementation Document. Once again, there simply is no language in the Implementation Document informing its readers that an updated valuation study would be undertaken, and the Implementation Document itself justifies the values and Rates as stated.
6. **Implementation Document Expressly Demonstrates That Mello-Roos Special Tax Adversely Affects Property Value:** The Implementation Document itself actually demonstrates that the CFD tax will adversely affect property (Table 5). Additionally, common sense dictates that landlords participating in the CFD will have substantial difficulty raising rents to offset the CFD costs, as competing properties in the Transit Center District that will not have to join the CFD will also benefit from the infrastructure improvements.
7. **Failure to Account for Impact of Mello-Roos Special Tax in 2013 Concord Group Study is Inconsistent with Implementation Document and Valuation Standards.** The

2013 Concord Group Study fails to account for the costs of the CFD special taxes themselves in evaluating values. This is a fundamental flaw as it is inconsistent with the Implementation Document, violates California Debt and Investment Advisory Commission appraisal guidelines and common sense. The proffered reason for not including the CFD special taxes as a cost – the offset against the benefits of the CFD improvements – is belied by the fact that the 2013 Concord Group Study makes no attempt to subtract out the supposed benefits of the CFD improvements (which is required if there is to be an offset).

8. **Assessed Value:** The City's analysis and value conclusion in the RMA fails to adhere to a critical requirement of the Implementation Document – that the Special Tax not exceed .55% of Assessed Value. Because of the cyclicity of property values, careful consideration is required for value determination and resulting per square foot rates. Assessed values both rise and fall. If a cyclically high value is selected for the base value and property values fall significantly, the Special Tax will be in excess of .55% of Assessed Value. Unlike actual property taxes, Owners have no ability to appeal their CFD Special Taxes and have taxes adjusted to reflect reduced value like they do the Real Estate Taxes (Proposition 8).
9. **Operating Expense Error Not Addressed – This Error Accounts for 75% of the Contested Valuation Increase:** The Rich Letter glosses over arbitrarily lowering operating expenses in the RMA. This unexplained and unsupportable 46% reduction in operating expenses (between the Implementation Document and the RMA) results in an erroneous increase in projected building values of almost \$250 per square foot.
10. **Owner's Objections Ignored:** Although City representatives have occasionally agreed to the Owner's requests for meetings, to-date, the City has only made changes to the RMA designed to address errors and mistakes in the initial CFD formation process, and has disregarded other problematic aspects of the CFD as currently drafted.

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For clarity, we have organized our reply by the issues identified in the Rich Letter, with relevant excerpts from the Rich Letter followed by our response. Portions the Rich Letter appear in italics below. Highlights have been added for emphasis.

**A. The Proposed Rates are Inconsistent with the Implementation Document.**

The proposed rates in the RMA are inconsistent with the Implementation Document. The Rich Letter's conclusions and citations are misleading and do not reflect the true intent of the Implementation Document approved by this Board.



The Rich Letter states:

*Developer Objection #2: The proposed rates are inconsistent with proposed rates and revenues as shown in the Implementation Document.*

**City Finding #2 - Rate Consistency with Implementation Document**

*City Findings: The proposed rates are consistent with the Implementation Document, which states that "new development...would pay a Special Tax equivalent to 0.55 percent of the assessed value of the entire development project," updated to reflect 2013 values (as proposed to be amended – see further discussion of net vs. gross square footage in paragraph 5, below). Similarly, the City updated projected revenues and expenditures to reflect rates based on 2013 values and current development assumptions consistent with the Implementation Document. The Implementation Document provided illustrative special tax rates for the different types of land uses to be covered by the CFD, which rates were lower than the rates in the Proposed RMA. The Implementation Document expressly stated that the rates listed in that document were merely illustrative, were based on 2007 values, and would be updated as part of the CFD formation process. Accordingly, it is not reasonable for the Developers to have concluded that the rates approved in the CFD legislation would not exceed the rates provided in the Implementation Document.*

*City's analysis*

*The Reuben Letter ignores this provision of the Implementation Document and, instead, relies instead on tax rates listed on page 11 of the Implementation Document. However, as explained in the Implementation Document, these rates were merely illustrations of potential rates, were based on a market analysis conducted by the Concord Group in 2007, were for purposes of projecting future revenues only, and were expressly intended to vary over time based on actual revenues. The Implementation Document makes clear on page 4 that the values in the Implementation Document would not apply: "It should be noted that the revenue projections discussed below are based on market data gathered in 2007 and updated in 2012 to reflect the best estimate of potential full-build-out of likely development sites in the Plan area over a 20- year period (and as analyzed in the Transit Center District Plan Environmental Impact Report). Actual revenues may be greater or lesser depending on economic cycles, pace of development, and the specifics of future development in the district."*

Our response:

1. Per Square Foot Rates not Merely Illustrative.

The City's contention that the Mello-Roos special tax rates in the Implementation Document were "expressly stated" as "merely illustrative" is false and misleading. A search of the Implementation Document clearly reveals that the words "merely illustrative" or "illustrative"

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never appear in the Implementation Document, nor is there any language in the Implementation Document that could lead the reader to the conclusion that the per square foot rates were “expressly stated” as “merely illustrative”. To claim otherwise is false and misleading.

By contrast, in the section of the Implementation Document relating to the new impact fees for both Open Space and Streets & Transportation, the Implementation Document includes the following language:

“The description of the Fee that follows is for descriptive purposes only. Fee amounts and procedures are established in the Planning Code in Section 4XX.X, et. seq., and may vary over time as periodically amended and as allowed or required by law.” (emphasis added) (Page 5 under Impact Fees, Open Space and page 7 under Impact Fees, Streets & Transportation Fee - see highlighted language in attachment.)

Clearly, the author of the Implementation Document understood how to reserve the right to alter the fees that appeared in the Implementation Document and did precisely that with the language cited above. No similar language appears in the Implementation Document anywhere in the sections related to the description of the Mello-Roos Community Facilities District and the Rates to be charged.

2. Rates Based on 2012 Analysis, not 2007.

City’s response that the Implementation Document Rates are not valid because they were based on a market analysis conducted by the Concord Group in 2007 is contradicted by the very passage the City cites where the Implementation Document states clearly that the market data was already updated in 2012 for the Implementation Document:

“It should be noted that the revenue projections discussed below are based on market data gathered in 2007 and updated in 2012” (Page 4)

Under any circumstances, there is no passage, footnote, or other language suggesting that the market data and valuation in the Implementation Document is unreliable.

3. Rates Used in Implementation Document Were Not Just for Future Revenue Projections.

City’s response that the Rates used in the Implementation Document “were for purposes of projecting future revenues only” is found nowhere in the Implementation Document and is in fact contradicted by the Implementation Document itself.

“Table 5 shows the total revenues that would be generated by a CFD in the Plan Area if implemented as envisioned in the Funding Program.” (Page 11, emphasis added)

“The table shows the total Special Tax revenues and Net Present Value of those revenues assuming that the Plan is adopted in 2012 and build-out begins in 2015” (page 11)

This paragraph clearly implies that the Rates are established if the Plan is adopted in 2012, which it was.

Indeed, the Implementation Document goes to great lengths to make it clear to the reader (Board of Supervisors, Planning Commission, and the public) that uncertainties in projections of future CFD revenue were not in the per square foot Rates themselves, but rather in the timing and nature of development, i.e., which land uses would be constructed (each paying at a different rate), and when the resulting Special Taxes would start:

“Actual revenues may be greater or lesser depending on economic cycles, pace of development, and the specifics of future development in the district.” (Page 4 – see further discussion below)

If the Rates were intended to be revised, the Implementation Document would have said so in this passage.

#### 4. The Proposed Rates are Inconsistent with the Implementation Document

The City’s contention that the proposed Rates in the RMA are consistent with the Implementation Document is misleading as the rates in the RMA are not the same as the Rates in the Implementation Document, the contention ignores a fundamental valuation error in the 2013 Concord Group Study, i.e., the significant reduction in operating expenses and the omission of the special tax cost, and the RMA adds escalators which were not considered in the Implementation Document.

The operating expense error alone results in 75% of the increase in the value estimates that were used to calculate the rates in the RMA. Owners have been attempting get the City to respond to this error for months with no explanation for the reduction in operating expenses – see more detailed discussion later in this letter (pages 17 - 19).

Additionally, the City’s contention that the proposed rates in the RMA are consistent with the Implementation Document is misleading as it ignores a fundamental change in the rate methodology. The RMA includes two escalators: (i) a pre-Certificate of Occupancy (“Pre-COO”) escalator and (ii) a post-Certificate of Occupancy (“Post-COO”) escalator of 2% per annum. There is nothing in the Implementation Document that discusses, implies, or authorizes any Rate escalator. These Rate escalators increase the tax burden by 81% (by the final year of the Special Tax). Suggesting that this is consistent is disingenuous at best – see more detailed discussion later in this letter (pages 24 - 25).

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Please note that the Pre-COO escalator also has the potential effect of causing the tax burden on a building to differ (perhaps dramatically) from the tax burden on another building developed later of similar size and use, causing one Owner in the CFD to have a competitive advantage over another Owner in the CFD.

The City cites the following statement in the Implementation Document to justify that Owners should not rely on the Rates in the Implementation Document:

“It should be noted that the revenue projections discussed below are based on market data gathered in 2007 and updated in 2012 to reflect the best estimate of potential full-build-out of likely development sites in the Plan area over a 20- year period (and as analyzed in the Transit Center District Plan Environmental Impact Report). Actual revenues may be greater or lesser depending on economic cycles, pace of development, and the specifics of future development in the district.”

What this statement CLEARLY says is the actual *revenues* may vary due to economic cycles. This statement does NOT say that the Rates would be different or that different values would be used to set the Rates, or that escalators or other methodological or assessment changes were going to be proposed that would change the revenue projections. If changes in the per square foot Rates or the addition of escalators had been envisioned or contemplated, these factors would be much more significant variables in the projected revenues than the effects from timing and would clearly have been mentioned.

The Implementation Document goes to great lengths to make the reader (Board of Supervisors, Planning Commission, and the public) aware that the revenues were only estimates because the pace and type of development was uncertain, therefore the timing of revenues would be uncertain:

“The projections of revenue in the plan are based on historical trends and the reasonable assumption that demand for commercial and residential development will at least match these average trends over time accounting for expected economic cycles” (page 4)

“New development in the Plan Area is expected to occur over many years. The amount and type of development will be affected by market fluctuations and subjective decisions of individual property owners and developers.” (page 11)

“Because it is not possible to predict which properties might be developed in which years, the projections assume an even spread of the total Plan build-out over a 15-year period. For comparative purposes with historic construction and absorption, this build-out schedule represents an average annual production and net absorption of 400,000 gross square feet of office space. This is on par with San Francisco’s downtown average production and absorption over the past two decades (and represents a little less than half

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of the annual citywide production). In actuality, development and revenues will likely occur in much more concentrated and larger lumps spread out over the build-out horizon.” (page 11)

The Implementation Document is extraordinarily clear that projecting the revenues – based on the Rates established by the Implementation Document – is only uncertain due to the unpredictable timing of development. The Implementation Document makes no mention that the Rates were uncertain.

The City continuously attempts to blur the critical distinction between “revenues” and “Rates” to mislead this Board.

**B. Owners Reasonably Relied on the Implementation Document Rates.**

Owners reasonably relied on the Rates in the Implementation Document. Unlike revenue projections, the Implementation Document does not state that the Rates listed in Table 5 were subject to change or were projections that would be modified upon completion of additional studies. The Rich Letter attempts to explain this away with an outright false statement about the data in the Implementation Document.

The Rich Letter states:

*City Contention - the Developers should have reasonably assumed that rates would reflect market values updated closer to the time of CFD formation – and not be locked in at 2007 values.*

Our response:

This is another incorrect statement meant to mislead the Board.

First, this statement is actually a misrepresentation of the “lock-in” date. As noted above, the Implementation Document states that market data collected in 2007 was updated in 2012 for the Implementation Document (underlining added).

“It should be noted that the revenue projections discussed below are based on market data gathered in 2007 and updated in 2012 to reflect the best estimate of potential full-build-out of likely development sites in the Plan area over a 20- year period (and as analyzed in the Transit Center District Plan Environmental Impact Report). Actual revenues may be greater or lesser depending on economic cycles, pace of development, and the specifics of future development in the district.” (Page 4)

The Rich Letter conveniently omits the data update in 2012 from its argument because it knows that relying on the Rates in the Implementation Document is reasonable.

Second, there is no language in the Implementation Document that says Rates will be updated to reflect “market values closer to time of CFD formation.”

As explained above, the revenue projections do not include any statement that the Rates applied in creating those projections were subject to change; it is the revenues that are subject to change based on the pace of development. The Implementation Document assumes that the CFD will be adopted along with the Transit Center District Plan in 2012, which it was, and that the Rates are based on the Implementation Document:

“The table shows the total Special Tax revenues and Net Present Value of those revenues assuming that the Plan is adopted in 2012 and build-out begins in 2015”  
(page 11)

**C. Block 9’s Pro Forma Demonstrates Reasonable Reliance on the Implementation Document Rates.**

The Rich Letter falsely claims that there are no pro formas for redevelopment parcels purchased from OCII demonstrating the Owners’ reliance on the Implementation Document’s Rates. Block 9 did just that.

The Rich Letter states:

**3. Consistency of Proposed RMA with Developers’ pro formas submitted to OCII**

**Developer Objection:** *Project sponsors and property owners relied on the Implementation Document when calculating the value of land purchased from OCII and from private parties, and the City and other public bodies involved in the Transit Center District Plan were aware of such reliance.*

**City Findings:** *The Developers selected by the TJPA to negotiate and eventually purchase the publicly- owned parcels in Zone 1 of the Transbay Redevelopment Project Area were aware of the per-square-foot rates included in the 2013 RMA prior to purchasing the land at the purchase price offered at the time of submittal.*

**City Response:** *The pro formas included in the winning proposals responding to the Blocks 6/7 and Block 9 RFPs included operating assumptions that OCII considered reasonable. But the CFD payments were not listed as separate line items; therefore, the actual rates assumed by the bidders were not explicitly indicated and were not validated by OCII.*

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Our response:

For Block 9, the City's statement is simply incorrect.

From the Avant/BRIDGE team's RFP response, Section 7b, Financial Proposal, pages 99-100, it clearly shows the Operating Expense Summary for the Market Rate portion of the Project. The last section is Taxes, in which a separate line item for Mello-Roos is also clearly shown. The figure is \$1,086,827, and the assumption of 0.55% is shown to the right of that figure. The figure was not explicitly expressed in terms of dollars per rentable square foot (at that time, the City's guidance was still given as 0.55%, not as a dollar per-square-foot number). However, the net area of the Market Rate Portion is clearly shown in a table on page 98 – 291,945 sq ft. It is clear within a simple division that the pro forma Mello-Roos assessment was \$3.72 per sq ft, which is substantially less than the \$4.92 per sq ft. figure from the 2013 RMA (for buildings 41-45 stories).

**D. The Implementation Document Does Not Call for Valuation Based on an Updated Study.**

The Rich Letter misleadingly intimates that the Implementation Document calls for an updated valuation study after its adoption. This is contradicted by both the plain language of the Implementation Document and a fair reading of the four-page feasibility assessment included in the Implementation Document.

The Rich Letter states:

**6) RMA Contains Reasonable Valuation Rates**

**Developer Objection:** *The City chose data from high points in the market to project values for office buildings.*

**City Findings:** *The Implementation Document called for the special tax rates to be based on a property value study at the time of approval of formation of the CFD. The values used to determine the initial CFD rates are based on value estimates in the Concord Group Studies (as of April 2013), consistent with the requirements of the Implementation Plan. Prior to the City's issuance of a Certificate of Occupancy, the rates can adjust within a floor and ceiling of 4 percent, instead of open ended adjustments based on changes in value – a feature that was introduced in response to a request from some of the Developers for greater certainty about future special tax rates.*

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*City Response: As outlined above, the Implementation Document provided for the special tax rates to be based on a study of real estate values at the time of approval of formation of the CFD (“The Special Tax structure would likely not be directly related to property value. Rather, it will likely be assessed based on a variety of factors, as determined through a detailed CFD formation study, such as the amount of development on the property and other factors, and the Special Tax will be a per-square foot assessment. However regardless of the ultimate methodology and tax structure, the final Special Tax assessed to each property will be calculated to be equivalent to 0.55 percent of property value.” Implementation Document, p. 10). In other words, the base special tax rates in the Proposed RMA are not, as suggested in the Reuben Letter, based on 2013 property values because the City chose data from high points in the market. Rather, the base special tax rates in the Proposed RMA simply reflect property values at the time of the approval of formation of the CFD because that is what is required by the Implementation Document.*

Our response:

This is another misleading statement. The highlighted language “the Implementation Document provided for the special tax rates to be based on a study of real estate values at the time of approval of formation of the CFD” does not appear in the Implementation Document.

The City supplies the following passage from the Implementation Document to support this contention that there will be another study of real estate values.

“The Special Tax structure would likely not be directly related to property value. Rather, it will likely be assessed based on a variety of factors, as determined through a detailed CFD formation study, such as the amount of development on the property and other factors, and the Special Tax will be a per-square foot assessment. However regardless of the ultimate methodology and tax structure, the final Special Tax assessed to each property will be calculated to be equivalent to 0.55 percent of property value.”(Implementation Document, p. 10.)

To suggest that this statement requires another valuation study is a complete mischaracterization of this quote. The Mello-Roos Act requires that certain officers of the City prepare a detailed report in connection with the CFD formation. The Owners would be correct in assuming that the “detailed CFD formation study” was a reference to the report required by the Mello-Roos Act. The CFD Formation Report is intended to identify factors that will be utilized for the per square foot assessment rates since property value, which the City plan utilizes to derive per square foot rates in the Implementation Document (and the disputed RMA), is illegal under the Mello-Roos Act.

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For the City to claim that the 2013 Concord Group Study constitutes a “detailed CFD formation study” that outlines the “variety of factors” used to determine the Rates is ludicrous. The 2013 Concord Group Study is nothing more than a valuation analysis of property in the City.

If another real estate valuation was called for, the Implementation Document would have stated that (as it mentioned by name the 2007 study and 2012 update) as it could have significant implications for the per square foot Rates and the resulting revenue projections.

In the page four (4) introduction, the Implementation Document states:

“Lease rates are rising substantially, vacancies are falling substantially, and new construction of several recently entitled buildings in underway in 2012. The projections of revenue in the plan are based on historic trends and the reasonable assumption that demand for commercial and residential development will at least match these average trends over time accounting for expected economic cycles”

If the intent was a future re-valuation and setting of CFD per square foot Rates, it would have been simple and obvious to revise the above statement to state that the substantially rising lease rates are anticipated to increase building values and as a result when the final CFD Rates are set, Rates and revenues could be substantially higher.

In fact, it was assumed in the Implementation Document that this CFD would be formed at the time the Plan was adopted in 2012, and that the Rates would be the Rates in the Implementation Document and that the CFD formation study would come up with variables other than value, which had been established in the Implementation Document, as the basis for the per square foot Rates.

The Implementation Document contains a four page Mello-Roos CFD Feasibility Assessment (pages 11-14) wherein the proposed values and per square foot Rates are justified as supportable. There is no suggestion in the Feasibility Assessment that the values or Rates are “illustrative” or that other Rates or structures will be analyzed or implemented.

**E. Both the Implementation Document and Common Sense Demonstrate that the CFD Tax Is a Significant Cost Factor That Will Adversely Affect All Types of Buildings.**

The Owners demonstrated – and the City admits – that the cost of the CFD taxes levied against property in the CFD were not taken into consideration as an expense in the 2013 Concord Group Study. As shown below, the City asserts that there is no need to account for the significant cost of the CFD because the costs would be offset by increases in value coming from the infrastructure financed by the CFD.

The Rich Letter states:

**7. Impact of CFD special tax on property values**

*Developer Objection: The City failed to take into account the operating expense cost of the CFD tax itself, which results in an overstatement of property values and special tax rates that are too high.*

*City Findings: There is **no conclusive evidence** to support a conclusion that the CFD will have a significant adverse impact on property values in the CFD. The Proposed RMA is consistent with the Implementation Document, which concludes that the property values used to establish the special taxes should not be reduced to reflect the costs of paying the CFD special taxes because the costs would be largely off-set by the increase in value stemming from the infrastructure financed by the CFD.*

*City Response: The Implementation Document addressed this issue (pp. 12-14 and Tables 5-7): "While no conclusive studies exist on the subject, many professional economic analysts have concluded that at the rates proposed for the Transit Center District Plan, there is no evidence, including in San Francisco specifically, to conclude that Mello-Roos special taxes have a significant or even appreciable negative impact on either development feasibility or property values."*

Our response:

The Implementation Document expressly recognizes and includes the negative impact of the CFD Special Tax on property values:

"New calculations conservatively assume that Mello-Roos payments are factored into Net Operating Income for commercial properties, thus reducing their capitalized value" (page 11, Table 5 footnote 2)

Further, Table 7 of the Implementation Document - Conservative Scenario (rents are as projected in the Implementation Document and commercial owner bares the cost of the tax) documents that a 9.16% reduction in value results from the proposed \$3.33 per square foot Special Tax.

The references to the CFD not having an impact are all anecdotal and unsupported by the analysis. In fact, the analysis suggests that only if rents are higher than expected by an amount equal to the tax (\$3.33 per square foot for office), then returns and values will not be adversely affected by the CFD tax – this is obvious, but doesn't change the conclusion about the negative value impact which is why it was included in the analysis. The un-discussed corollary to this sensitivity analysis is this: if rents are lower than forecast, the negative effect on value from the proposed Special Tax will be magnified.

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The failure to include the Special Tax is a fundamental flaw in the 2013 Concord Group Study for a number of reasons:

1. It is fallacious to state that the benefits from the CFD-financed improvements offset the costs of the CFD special taxes when the 2013 Concord Group Study does NOT subtract the “benefits” from the valuation in any way. When there is an offset in a valuation study, both the revenue item and the cost item would be eliminated. Yet, there is nothing in the 2013 Concord Group Study that subtracts out the “value” associated with the CFD facilities.
2. In connection with the issuance of Bonds by a CFD, the issuer must commission an appraisal of the property in the CFD to demonstrate that there is sufficient value to support the Bond issue. That appraisal must meet the standards of the California Debt and Investment Advisory Commission (“CDIAC”) in their Appraisal Standards for Land-Secured Financings (the “Standards”) and the Recommended Practices in the Appraisal of Real Estate for Land-Secured Financings (the “Practices”).<sup>1</sup> Not surprising, these guidelines make very clear that in evaluating the value of property, the cost of the CFD special taxes must be taken into account as a cost factor, as demonstrated by the excerpts below:
  - a. **Infrastructure Financed through Special Taxes and Assessments.** Privately financed infrastructure improvements represent a direct cost to the developer that should be deducted from gross cash flow, as these costs depress the return on the initial land investments .... In other words, the value of the land should take into consideration the funding for the improvements that are financed by improvement bonds paid from special taxed or assessments levied on the property. (Standards, page 15)
  - b. **Sales Comparison Approach: Discounting Retail Values to Reflect Special Tax and Assessment Liens.** Appraisals under the Sales Comparison Approach should be adjusted to reflect the differences between the subject of the appraisal and the comparable properties that affect value. These differences include not only physical differences in location, square footage, and construction quality, but also differences in tax burdens. (Standards, page 23)
  - c. **Value Subject to Lien.** Appraisals for properties in a CFD must be based on the value of the property taking into consideration the infrastructure improvements that will be funded by the proposed bond issue. The appraiser

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<sup>1</sup> The CDIAC Standards and Practices are intended for the appraisal that must be used before bonds are issued but should apply equally when valuing property in a CFD prior to a bond issue.



must also take into account the contributing value of the infrastructure improvements financed by the special tax lien and adjust the price of the subject property accordingly. (Practices, page ii)

3. The City also asserts that the CFD will have no adverse impact on the property in the CFD. However, the Implementation Document itself actually demonstrates that the CFD tax will adversely affect property. The Implementation Document itself shows that the CFD would have an adverse impact on property value. Table 5 from the Implementation Document analyzes the Assumed Value Impact % from the CFD and finds an impact on value. Commercial uses are shown to have a 6.875% value decrease from the Special Tax at the Rates proposed in the Implementation Document. If the study had used the valuation capitalization rate of 6% instead of 8% (it is telling that no reason is given for why a different rate would possibly be used, as there is not one) the impact would be 9.1% value decrease. This 9.1% value decrease is confirmed by Table 7 of the Implementation Document - Conservative Scenario. In fact, using the 5.5% capitalization rate and proposed assessment in the RMA, reduces value by 10%. The study assumes, without any evidence that the value impact would be half as much for residential as it believes buyers would not discount their offers because of the tax.

Many buildings in and around the Transit Center District that are not subject to the CFD tax, but will also benefit from the future transit improvements. This will significantly diminish the ability of a landlord who is subject to the CFD to raise rents to offset the cost of the CFD tax (another point made by the Rich Letter). This straightforward logic—in contrast to the Rich Letter's somewhat tortured explanation in reliance on the 2013 Concord Group Study—is reflected in the CDIA Standards and Practices discussed above.

#### **F. The Rich Letter Glosses Over the Effect of Lowering Operating Expenses.**

The Rich Letter glosses over the effect of lowering operating expenses. The City's unexplained 46% reduction in operating expenses leaves less than \$1 per square foot to run a building. Once again, the City's response to the Owners is to disavow a document—this time the RMA—and introduce a new set of assumptions to justify its errors.

The Rich Letter states:

#### **8. Lowering operating expenses**

*City Findings: The Reuben Letter mischaracterizes the operating expense assumptions made in the Concord Group Studies. In addition, the Concord Group reports that the office operating expenses used in the Concord Group Studies were conservative and reasonable for the purpose of its study, which analyzed value potential for generic buildings in the plan area. The Concord Group also believes that*

*the net operating income (“NOI”) assumptions embedded in the Concord Group Studies (NOI is calculated by subtracting operating expenses from gross rental income) are significantly more important to the Concord Group Studies’ valuation conclusions than operating expense assumptions viewed in a vacuum, and that the NOI assumptions are supportable and conservative.*

*City Response: In the Concord Group Studies, the Concord Group analyzed value potential for very generic buildings in the plan area, without specifying architecture, massing, layout and location, among others factors. The Concord Group then compared its high-level pro-forma with specific market information, including comparable sale and leasing data, to ensure supportable conclusions.*

*Specifically with respect to office operating expense assumptions, the Concord Group reports that it modeled office operating expenses as a percentage of gross potential rent so that operating expenses could grow with rents from the base of a tower to its highest floor. The Concord Group Studies did not assume, as claimed by the Reuben Letter, between \$11 and \$12 per square foot of operating expenses. Rather, its analysis assumes office operating expenses (without identifying the CFD special tax as a separate cost item, as discussed in paragraph 7 above) between \$11 per square foot (for very small buildings) to nearly \$20 per square foot for a 50-story building.*

Our response:

We did re-examine the Concord Group’s 2013 study and found it used a +/- \$16 per square foot operating expense assumption for a 50-story building, not the \$11-12 per square foot we had previously understood it to be. While not as egregious as previously thought, the 2013 Concord Group Study represents an **unexplained 46% reduction in assumed operating expenses** from the \$29.65 used in the Implementation Document to \$16.00 per square foot. We would also point out that referring to \$16 per square foot as “nearly \$20 per square foot” is gross exaggeration (25%) and seeks to minimize the error. See attached chart comparing operating expenses in the 2007, 2012 and 2013 studies by The Concord Group for the City.

The inappropriateness of the 2013 Concord Group Study’s \$16.00 per square foot TOTAL operating expense assumption is easy to document as it barely covers the real estate taxes and Special Tax assessment based on their \$875 per square foot valuation as follows.

<b>Real Estate Taxes</b>	<b>1.1188%</b>	<b>x \$875psf Value</b>	<b>= \$10.3950 per square foot</b>
<b>Special Taxes</b>	<b>0.5500%</b>	<b>x \$875psf Value</b>	<b>= \$04.8125 per square foot</b>
<b>TOTAL Taxes</b>	<b>1.6688%</b>	<b>x \$875psf Value</b>	<b>= \$15.2075 per square foot</b>

\$16.00 per square foot leaves less than \$1.00 per square foot to operate the buildings after paying the combined Real Estate Taxes (1.188%) and the Special Tax (.55%) at Concord’s concluded value of \$875 per square foot. This is just plain untenable.

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Conversely, the unsubstantiated \$13.65 per square foot reduction in operating expenses (from \$29.65 per square foot in the Implementation Document to \$16.00 per square foot in the 2013 Concord Group Study), increases projected Net Operating Income by \$13.65 per square foot, which in turn is capitalized at 5.5% for a resulting unsubstantiated value increase of \$248 per square foot.

Further, this error should have been readily apparent to The Concord Group in both their income approach and comparable sales approaches to value. In their income approach, despite some methodology changes (height premium, etc.) and a 50bp reduction of cap rate, the basic assumed rent was not materially different than in the Implementation Document, but the resulting values had gone up almost fifty percent (50%) and the projected values were now greater than all but two sales in the history of the City of San Francisco office building sales. See attached historic chart of all San Francisco office building sales. Compounding the obviousness of that error was the fact that none of the sales in the history of San Francisco had a Mello-Roos assessment anywhere close to the proposed assessment. Thus, these comparable sales would need to be adjusted downward for the effect of the Mello-Roos (per previous discussion). Once an adjustment was made for the Mello-Roos, the conclusion was that all tall office buildings in the Transbay would be worth more than any office building in the history of San Francisco. See attached chart adjusting sales for the effect of Mello-Roos.

The City is now attempting to both minimize the importance of this error and attempt to introduce a single transaction after the RMA to obviate their error. Single transactions do not make a market, nor can they be used as a proxy for all values. Once again, the City is attempting to disavow aspects of a document passed by this Board that it finds inconvenient—in this instance, the operating costs inherent in the Rates established by the Implementation Document—by not addressing the issue and attempting to change the assumptions.

**G. The Implementation Document Demonstrates the City Improperly Added Annual Escalators to the CFD**

The Rich Letter's conclusory claims that the RMA is consistent with the Implementation Document are contradicted by the plain language of, and the notable omissions in, the Implementation Document. The City improperly added features to the RMA that could not have been reasonably anticipated by readers of the Implementation Document, including annual escalators. These escalators increase the tax burden by up to 81% over the Rates in the Implementation Document.

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The Rich Letter states:

**10. Implementation Document does not discuss escalating factors or different rates for different height buildings**

**Developer Objection:** *There is nothing in the Implementation Document that discusses, authorizes, or directs that the tax rates a) increase annually prior to obtaining a Certificate of Occupancy ("COO"); b) include a 2 percent escalator on the special taxes after the COO is received; or c) apply different tax rates to buildings with different numbers of floors.*

**City Findings:** *The proposed RMA is consistent with the Implementation Document. The factors described above are all inputs that factor into the tax rates to more accurately reflect the true value of a proposed development project over time.*

**City Response:** *As explained above, the base special tax rates in the Proposed RMA are consistent with the Implementation Document, which states: "new development...would pay a Special Tax equivalent to 0.55 percent of the assessed value of the entire development project..."*

Our response:

The Implementation Document clearly states on page four that **"calculation methodologies and total revenues projections of these two funding mechanisms (impact fees and CFD) are discussed in turn below."** No escalators were included, either by written reference or in the revenue projection table. There is no mention of the potential use of an escalator anywhere in the Implementation Document, and there is no direction or authorization provided to the City to include escalators in the RMA. Escalators are very significant and increase the tax burden tremendously.

The Pre-COO escalator and the Post-COO escalator increase the maximum tax over the life of the CFD. The post-COO escalator alone increases the CFD tax rate by 81% (in the final year of escalation). This is a hugely material fact that Owners could not have reasonably anticipated.

Escalators are significant enough that the California Legislature requires that homeowners be notified of any escalators before they buy a home. Because of their large impact, escalators are always an item of deliberation when forming a CFD, and just as many CFDs in California do not have escalators as those that do. It is simply not reasonable for the City to assume that the Owners would assume two separate escalators as part of the Implementation Document when there is not one word about it in the entire document.

Moreover, the notion that instituting an annual escalator more accurately reflects the true value of a proposed development project over time completely **ignores the requirement that the**

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**Special Tax be equivalent to 0.55% of Assessed Value.** The owners have spent months trying to get the City to reflect true building values over time (consider cyclical) and how this is reflected in Assessed Values. The City has consistently stonewalled the Owners who have pointed out that:

1. Assessed Values go down regularly via use of a Proposition 8 appeal, not up every year. We would welcome input from the Assessor's office on data on Prop 8 appeals;
2. Assessed value represents an average of the up and the down markets as a result of Proposition 8 appeals and a limit on increases;
3. Values do not consistently go up every year – this is an incredibly cyclical market;
4. Trajectory of value is hugely dependent on starting point (e.g., if you begin at cyclical low vs. cyclical high vs. the average);
5. Current interest rate market is historically unprecedented and has resulted in asset inflation. Interest rate normalization will result in asset deflation; and
6. Current Rent environment is a cyclical up market.

It should be noted that the only building (One Market Plaza) which has ever sold for the base value the City is ascribing to all the tall office buildings - \$875 per square foot (in 2007) - recently sold in 2014 for \$750 per square foot. Utilizing the City's proposed formula for the Special Tax (base value plus 2% compound annual growth), the building would be valued today at \$1,005 per square foot or 25% more than its actual current value. This demonstrates the clear fallacy in this suggested valuation and approach to value over the long term.

It is also noteworthy that One Market Plaza does not have a Mello-Roos tax which would have reduced income and therefore value by another approximately \$90 per square foot. If the Mello-Roos tax had been \$4.81 per square foot at inception, it would have grown to \$5.53 per square foot over seven years (2007 sale to 2014 sale). This would be a 1.9% tax rate. Assuming a 5.5% cap rate, the \$4.81 per square foot, the Special Tax would have reduced value \$87.46 per square foot, or 11.66%. If the Mello-Roos special tax had indexed for seven years to \$5.46, the impact to value from a Mello-Roos special tax would have been \$100.46 per square foot, or a 13.39% reduction.

**H. The City Mischaracterizes Correcting Mistakes with Making Reasonable Concessions.**

Although City representatives have occasionally agreed to Owners' requests for meetings, to-date the City has only made changes to the RMA designed to address errors and mistakes in the initial CFD formation process, and has disregarded other problematic aspects of the CFD as currently drafted.

The Rich Letter states:

**1) Developer Participation in Determination of Rate and Method of Apportionment**

*Developer Objection: Since adoption of the Implementation Document, the CFD has been structured with no real input from property owners.*

*Findings: In 2013, City staff and expert financial consultants developed a proposed rate and method of apportionment of special tax for the CFD (the "2013 RMA") based on the Implementation Document, and asked the Developers for their input. The Rate and Method of Apportionment of Special Tax included in the proposed Resolutions (the "Proposed RMA") incorporates several changes requested by a number of the Developers and their representatives.*

*City Response: In August 2012 the Board adopted the Transit Center District Plan and associated Implementation Document. Subsequent to the adoption of the Transit Center District Plan, City staff, together with the City's outside consultants and bond counsel, worked over several months to develop, among other matters, a proposed rate and method of apportionment for the CFD, that was informed by valuation studies performed by the Concord Group, an independent real estate economics consultant (the "Concord Group Studies"). The process involved the evaluation of alternatives for the CFD before determining which ones were most consistent with the Implementation Document and California law and would further the funding goals for the Transbay Project and the Transit Center District Plan.*

Our response:

The Rich Letter mischaracterizes the City's actions over the last year as honest negotiations. The City has only made changes to the RMA designed to address errors and mistakes in the initial CFD formation process, and has disregarded other problematic aspects of the CFD as currently drafted. The City attempts to illustrate a collaborative approach with the Owners by citing the following as examples of concessions. A closer look reveals that there have been no real concessions made by the City.

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- *Rental Property Category:* Even before the Owners had an opportunity to meet with the City, the City indicated it was going to add a separate use category for rental residential buildings, recognizing the clear error in conflating rental and for-sale properties.
- *Pre-COO Escalator:* The Owners pointed out that the Pre-COO adjustment concept that was initially included in the RMA violated the Mello-Roos Act in that it did not allow for a taxpayer to estimate his or her maximum special tax, as required by law. The City “fixed” this issue, but did not do so as a concession to the Owners who “wanted more certainty”. The “certainty” is required by the Mello-Roos Act, and the City incorporated this change because it was required to do so to comply with the law. The Owners did not agree to an escalator.
- *Construction Cost Index Escalator:* In “fixing” the Pre-COO escalator, the City inserted a 4% construction cost index, and then stated that it was inserted due to the Owners’ request for certainty. In fact, the Owners never suggested the 4% construction cost index that is currently in the RMA, and have objected to it since it was introduced. City staff unilaterally created the 4% cost index mechanism and put it into the RMA without private sector input or consent. It is disingenuous to suggest that including this was a result of the City accommodating to project sponsors’ request.
- *Public Property Rate:* The addition of text into the RMA stating that taxable public property would be charged at the maximum rate for the developed property is another change meant to bring the RMA into compliance with the Mello-Roos Act. It was not a concession to project sponsors, but the correction of an error that would have been revealed earlier had project sponsors been provided the RMA earlier in the process.

That a year has passed since the City first presented the Owners with a courtesy copy of the RMA is a convenient but misleading fact: had the Owners not engaged their own consultants, identified clear errors in the first draft RMA, and performed what amounts to a peer-review of the City’s RMA and the 2013 Concord Group Study, the City would have passed the CFD immediately. Unlike all other development Community Facilities Districts formed under the Mello-Roos Act, City staff did not include the Owners at the table. In reality, **the Owners were provided the RMA for the first time in early July, 2013. In the accompanying cover letter, the City said it intended to bring the RMA before the Board of Supervisors for approval later that month. The City did not seek the Owners’ input or comments; it simply gave the Owners a courtesy copy prior to scheduling the CFD for approval. For such a large CFD as this, the lack of private sector involvement is unheard of.**



**Conclusion**

The Implementation Document adopted by the Planning Commission and this Board of Supervisors is clear in how the revenue estimates were developed and expressly states that the factors which are expected to affect the projection are the pace and type of development, not a change in the Rates. There is no suggestion that the Rates are not final, that the Rates or projected values of the buildings were not final and to suggest otherwise is unsupported by the Implementation Document. The Rich Letter misleadingly characterizes the past year as a legitimate negotiation between the City and the Owners. The City has only made changes necessary to conform with legal requirements of the Mello-Roos Act, but the City continues to refuse to acknowledge the meaning and import of the Implementation Document (as can be clearly seen in their response to you), fundamental flaws in its unnecessary re-valuation methodology, or that the annual escalators were invented after the publication and passage of the Implementation Document by the Planning Commission and this Board. We have worked with the City to correct the methodological errors and come to a compromise agreement on the per square foot assessment rates. We urge this Board to require that the City accept the import and meaning of the Implementation Document and require that the provisions of the Implementation Document be incorporated in the proposed legislation and form the basis for a compromise with the Owners.

Very truly yours,

REUBEN, JUNIUS & ROSE, LLP



James A. Reuben

**Attachments**

cc (by email):

Ken Rich, Mayor's Office of Economic and Workforce Development  
Nadia Sesay, Office of Public Finance  
Jesse Smith, Office of the City Attorney  
Mark Blake, Office of the City Attorney

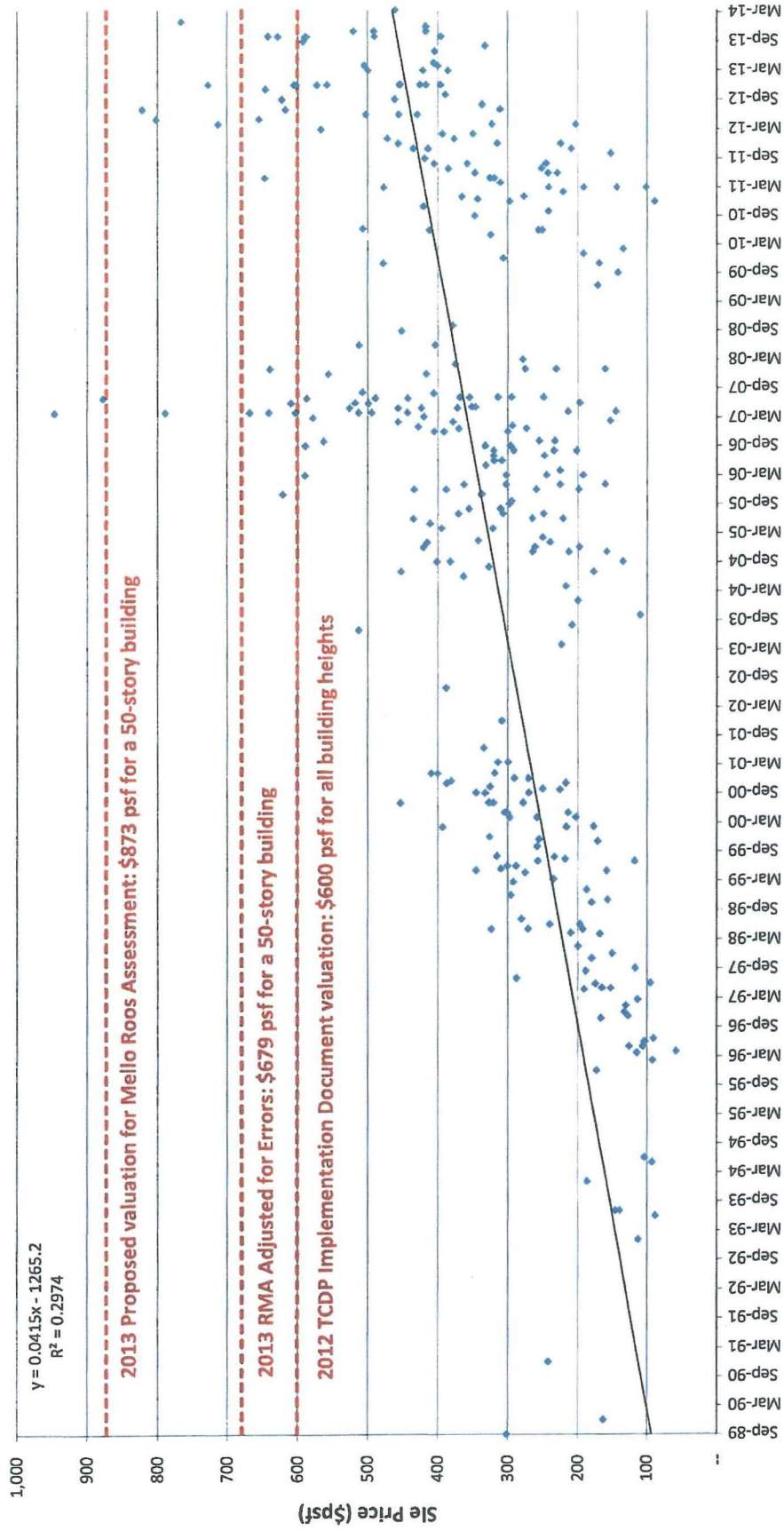
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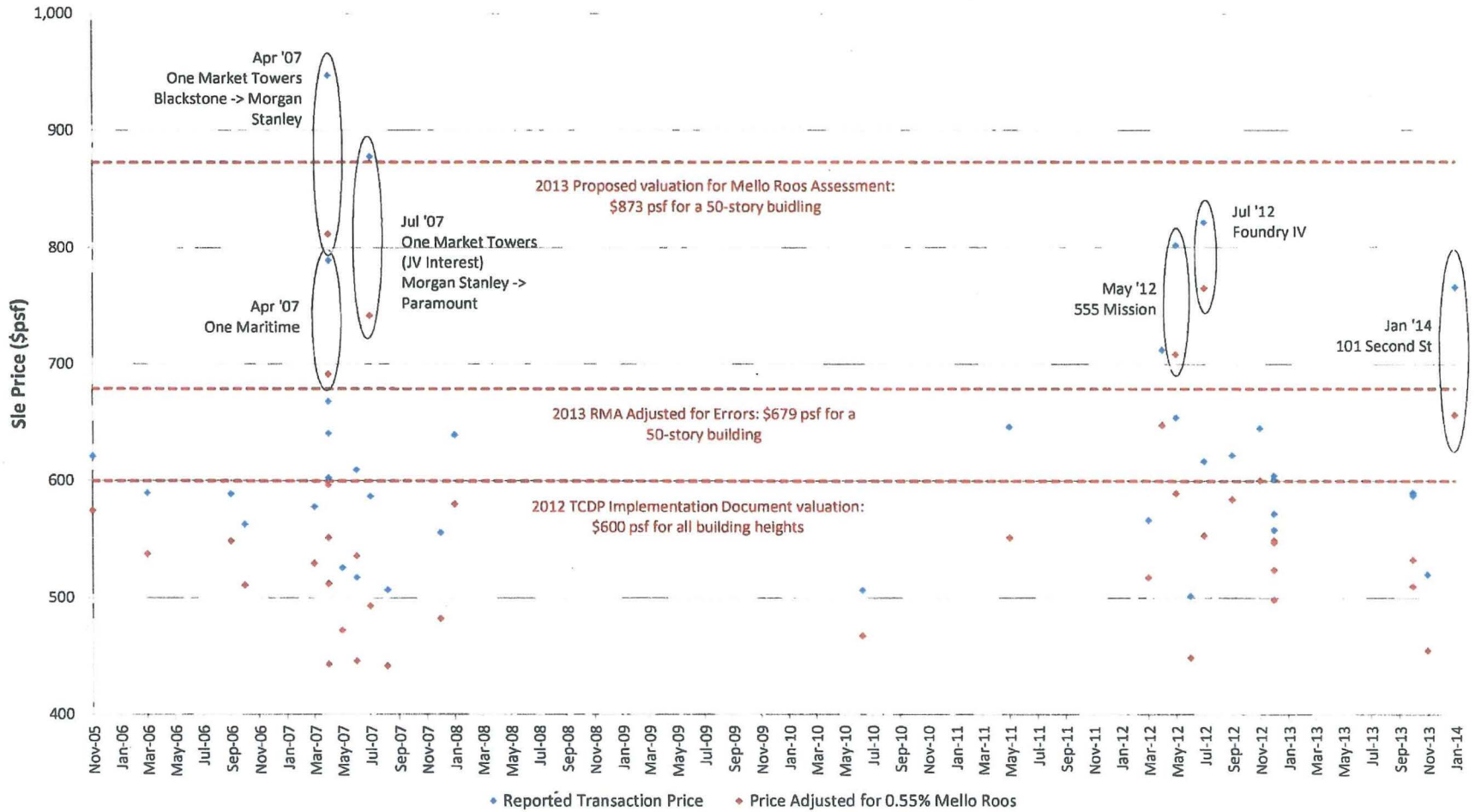
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# San Francisco Office Sale History (Sept 1989 - Mar 2014)

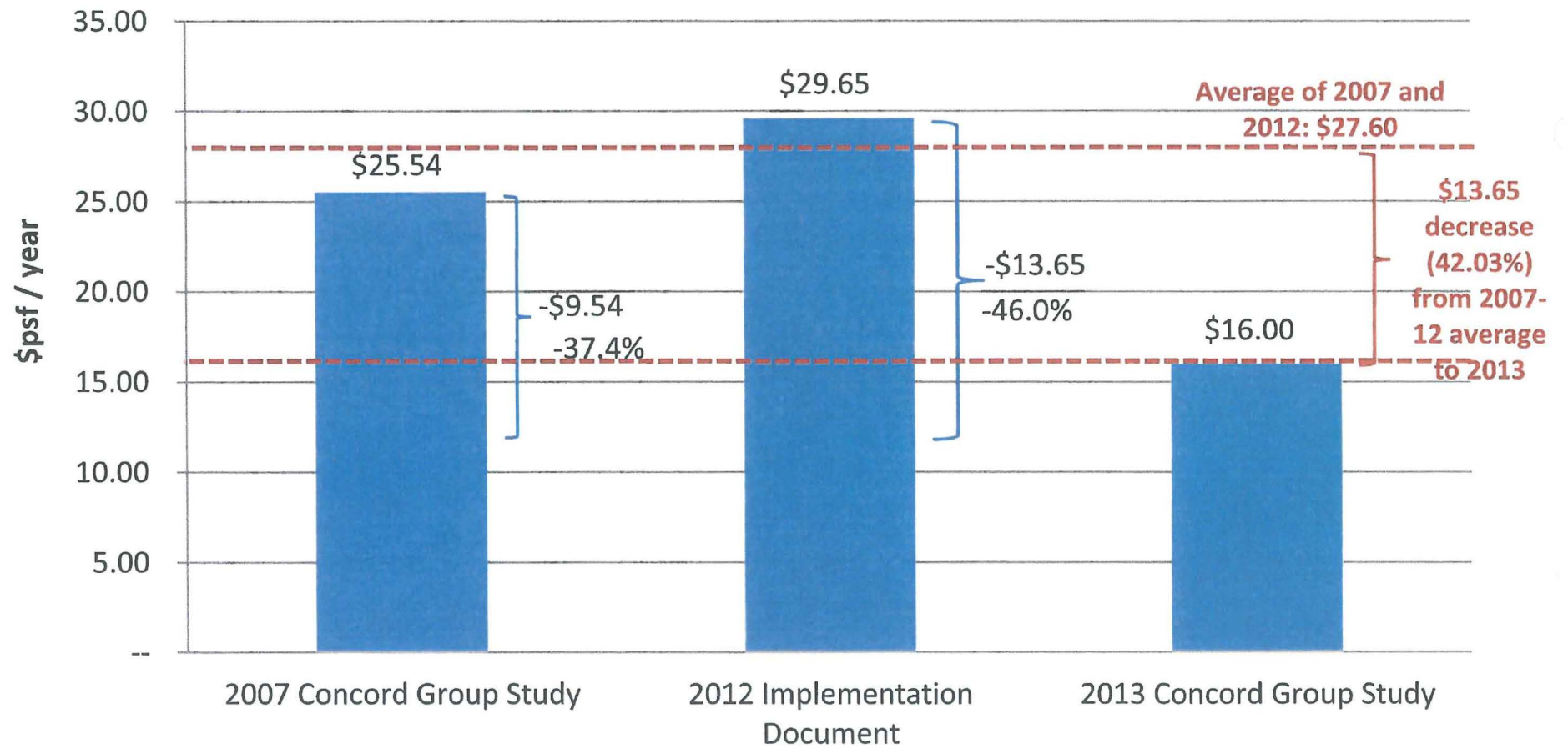


**SF Office Sale History**  
 (Jan 2005 - Mar 2014; transactions >\$500 psf with reported cap rates)  
 Adjustment for 0.55% Mello Roos



Note: Buildings' Net Operating Income (NOI) calculated from transaction price and reported cap rate. NOI adjusted downward by Mello-Roos assessment at 0.55% of Adjusted Price. Adjusted Price calculated as Adjusted NOI divided by reported cap rate.

## Assumed Operating Expenses Decreased by 37-46%





**Mello Roos rates for 50-story Office Building  
2012 Implementation Document vs. 2013 RMA**  
*With 5 years pre-COO escalation at 4%/year*



**Mello Roos rates for 50-story For-Sale Residential Building  
2012 Implementation Document vs. 2013 RMA  
With 5 years pre-COO escalation at 4%/year**

