ECONOMIC AND WORKFORCE DEVELOPMENT
TODD RUFO, DIRECTOR

CITY AND COUNTY OF SAN FRANCISCO
EDWIN M. LEE, MAYOR

M E M O R A N D U M

TO: **Honorable Members, Board of Supervisors**

FROM: Ken Rich

DATE: July 14, 2014

RE: File No. 140645: Resolution of Intention to Establish Communities Facilities District---Communities Facilities District No. 2014-1 (Transbay Transit Center)

File No. 140644: Resolution of Intention to Incur Bonded Indebtedness for Transbay Transit Center in an Amount Not to Exceed $1,400,000,000

STAFF RESPONSE TO WRITTEN OBJECTIONS TO ADOPTION BY THE BOARD OF SUPERVISORS OF RESOLUTIONS OF INTENTION FOR THE PROPOSED TRANSBAY TRANSIT CENTER COMMUNITY FACILITIES DISTRICT

Set forth below are responses to issues raised in the letter dated June 30, 2014 of James A. Reuben of Reuben, Junius & Rose, LLP (the "Reuben Letter"), on behalf of unspecified clients (referred to in the sub-captions below as the "Developer Objection"), to the Land Use and Economic Development Committee of the Board of Supervisors (the "Board") regarding consideration of the Resolution of Intention to Establish Communities 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 City and County of San Francisco Communities Facilities District No. 2014-1 (Transbay Transit Center) (collectively, the "Resolutions"). The Board is considering the Resolutions as the first step in the establishment under the Mello-Roos Community Facilities Act of 1982, as amended (the "Mello-Roos Act"), of a community facilities district (the "CFD") for the Transbay Transit Center District Plan Area (the "Plan Area"). As made clear in the Transit Center District Plan Implementation Document ("Implementation Document"), in consideration for the substantial benefits to Plan Area properties from the City's up-zoning and other planning allowances relative to the construction of certain high rise buildings around the location of the Transbay Transit Center Project ("Transbay Project"), property owners who wish to take advantage of the increased heights and density are required by the Planning Code and project conditions of approval to participate in the establishment of the CFD to provide a portion of the funding for public infrastructure improvements in the Plan Area.

As discussed more fully below and most relevant for the Board's consideration of this matter:

(i) the Developers and their representatives have been involved in discussions and negotiations with City staff for more than one year with respect to the formation of the CFD and the levy of special taxes, and the City has incorporated changes to the proposed rate and method of apportionment of special taxes within the CFD to respond to several concerns raised by some of the Developers and their representatives;

(ii) the special tax rates (as proposed to be amended -- see further discussion of net vs. gross square footage in paragraph 5, below) are consistent with the Implementation Document; and

(iii) the facilities to be financed with the CFD special taxes are consistent with the Implementation Document.

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.***

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.

In July 2013 the City distributed an initial draft of the proposed rate and method of apportionment for the CFD (the "2013 RMA") to the Developers, with the understanding that the Developers would highlight concerns or request certain changes. Throughout the past year, a number of the Developers and their representatives, City staff and the City's consultants have exchanged numerous communications, held meetings, and exchanged multiple proposals and counterproposals. City staff and its consultants gave serious consideration to all of the input they received from the Developers who responded to the invitation to comment on the 2013 RMA. The Concord Group met a number of times with a real estate economist hired by the Developers to consider all the Developer's comments on the assumptions and methodology used in the Concord Group Studies.

As a result of the City's ongoing interaction with the Developers, the proposed legislation and Proposed RMA introduced on June 3, 2014, and currently before the Board, incorporates some of the changes to the 2013 RMA that they requested, including:

a) New rate for rental residential, lower than the for-sale residential rate. The City added a rate for rental residential housing based on valuation estimates in the Concord Group Studies, which is substantially lower than the for-sale residential rate, responding to Developer concerns that rental residential buildings have lower values than for-sale residential buildings.

b) Revised pre-COO escalation factor for greater certainty. The Proposed RMA calculates the special tax to be levied on a taxable parcel by: (i) establishing a "base special tax rate" for fiscal year 2013-14 based on the valuation estimate in the Concord Group Studies and differentiating among land uses and building height, (ii) providing for annual escalation of the base special tax rate based on the City's Annual Construction Cost Inflation Index, which is currently used to index development impact fees in San Francisco and is annually adopted by the City's Capital Planning Committee, but limiting the annual escalation to a 4 percent floor and 4 percent ceiling, and (iii) calculating the maximum special tax for each parcel at the time a certificate of occupancy is issued and the City elects to begin

levying the special tax, which initiates the 30-year levy period for the parcel, subject to a 2 percent annual escalation.

As described in greater detail below, the Implementation Document required that each new development or net addition of square footage in the Transit Center District that exceeds a 9:1 floor area ratio ("FAR") threshold would pay a special tax equivalent to 0.55 percent of the assessed value of the entire development project. Accordingly, the 2013 RMA included a base special tax rate that was based on the valuation estimates in the Concord Group Studies, and the 2013 RMA included an annual pre-Certificate of Occupancy escalator that would have annually increased the base special tax rate by reference to an annual appraisal of market value in the Transit Center area. In response to concerns from some of the Developers that this annual pre-Certificate of Occupancy escalator was too uncertain for planning purposes, City staff included in the Proposed RMA a new pre-Certificate of Occupancy escalation factor that is based on an established inflationary index (the City's Annual Construction Cost Inflation Index) that reflects changes in economic conditions that could lead to changes in market value, but with a fixed annual 4 percent maximum floor and 4 percent maximum ceiling. Again, the purpose of this change was to provide the greater certainty as to future special tax rates that was requested by some of the Developers, while reflecting the fact that the value of property in the City fluctuates over time.

c) Added rate for taxable public property. At the request of some of the Developers, City staff revised the 2013 RMA to clarify that taxable public property would be charged at the maximum rate for the developed property.

The changes described above are evidence that City staff have considered the input from these Developers through the year-long process and, where appropriate, made changes. City staff, based on consultation with its expert financial consultants and outside bond counsel, believe that the Proposed RMA is reasonable and consistent with the Implementation Document.

Also, as described further in paragraph 5 below, at the Developer's request, City staff had changed the basis for calculating the special tax in the 2013 RMA from the total net leasable square footage of a development to the total gross square footage of the development. But in response to the Reuben Letter, which correctly points out that the rates were not adjusted correspondingly to reflect the change from net to gross, City staff is now proposing to change the Proposed RMA back to provide for the calculation of the special tax based on "Net Leasable/Saleable Square Footage."

2) **Rate Consistency with Implementation Document**

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

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.***

Response: The Proposed RMA (including as it is proposed to be amended – see further discussion of net vs. gross square footage in paragraph 5, below) is 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… In actuality, if a CFD were to be formed, the Special Tax would be established through an election that would authorize the imposition of the Special Tax. 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% of property value.[1]

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."

Based on the two excerpts from the Implementation Document quoted above, the Developers should have reasonably assumed that rates would reflect market values updated closer to the time of CFD formation –

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[1] Transit Center District Plan – Program Implementation Document, p. 10.

and not be locked in at 2007 values. As required by the Implementation Document, the City conducted a detailed CFD formation study, namely, the Concord Group Studies. The City calculated the special tax rate on a per-square foot formula that reflects 0.55 percent of property value based on that study.

The City selected the 0.55 percent benchmark based on an economic feasibility study performed by Economics and Planning Systems, Inc. (EPS), an independent economics consulting firm, with the intention of keeping the overall property tax rate under a City staff recommended ceiling of 1.8 percent. The Implementation Document states: "Based on research into other CFDs, creators of CFDs seem to strive to calibrate the additional tax burden of CFD to a rate that keeps the total property tax rate under 2%, and preferably under 1.8%. (Again, the base tax rate in San Francisco is about 1.15%)…The total tax burden in the Transit Center District Plan area, including the 0.55% CFD rate, would be about 1.7%, which is within the range of other CFDs in San Francisco and statewide."[2] The Implementation Document also stated that the tax rate, once calculated, would be set and levied on a per-square-foot basis adjusted for land use and building height.[3]

The Reuben Letter claims that the tax rates in the Proposed RMA are excessive because they will allow a greater total bonding capacity of the CFD than estimated in the Implementation Document and a net present value more than twice that which was expected in 2012.

As explained above, the Implementation Document -- in Table 5 ("Mello-Roos Community Facilities District Total Revenue Estimates") -- calculated special tax rates using "value estimates based on market analysis conducted by the Concord Group in 2007."[4] Table 5 projects that at the illustrative rates in the draft RMA, the net present value of special tax revenues (assuming a 7 percent discount rate and other assumptions that are not detailed in the Implementation Document) that could be generated by the CFD was $421 million. The Reuben Letter states that the Proposed RMA rates would yield a bonding capacity of up to $1.4 billion. Accordingly, the Developers argue, the City should reduce the tax rates to a level that would yield a bonding capacity of only $421 million.

The Reuben Letter's criticisms are not valid for the following reasons.

First, there is no valid reason to compare the $421 million net present value estimate from the Implementation Document and the $1.4 billion bonded indebtedness limit in the Resolutions. The $421 million net present value estimate was an estimate of CFD revenue based on a variety of assumptions, including a 7% discount rate. The $1.4 billion bonded indebtedness simply places a legal ceiling on the CFD's ability to incur bonded indebtedness. City staff is proposing a $1.4 billion maximum bonded indebtedness limit as a conservative ceiling on authorized bonds because, once the CFD is built-out (including all of the properties in the future annexation area for the CFD), it will be difficult for the City to secure voter approval for increased bonding authority.

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[2] Transit Center District Plan – Program Implementation Document, p. 12.

[3] Transit Center District Plan – Program Implementation Document, p. 10. The Proposed RMA has been designed in accordance with the Mello-Roos Act (see Government Code section 53325.3). The CFD special tax will be levied based upon building type (e.g., residential, office/hotel, retail, et al.) and density (the Proposed RMA establishes a higher per-square-foot tax rate for taller buildings than it does for shorter buildings). Although the City used the Concord Group Studies to set the base special tax rate, which is consistent with the Implementation Document, the CFD special tax has not been designed as an *ad valorem* tax; in other words, the CFD special tax will not be levied on any particular parcel based upon the value of that parcel.

[4] Transit Center District Plan – Program Implementation Document, p. 11.

Second, there is a better point of comparison: the City has projected special tax revenues that may be generated by the rates in the Proposed RMA (including as the Proposed RMA is proposed to be amended – see further discussion of net vs. gross square footage in paragraph 5, below), and, using the same 7% discount rate as the Implementation Document, the City estimates that the Proposed RMA would produce $514 million net present value of special tax revenues. Although the City's projection may reflect assumptions that are different than those used in the Implementation Document, and although it certainly reflects recent increases in property values as contemplated by the Implementation Document, City staff is mentioning the projection here to provide a more reasonable basis for comparison of the Implementation Document and the Proposed RMA.

Third, the Implementation Document never describes the $421 million as the maximum dollar amount that the CFD would yield for infrastructure facilities. In fact, the Implementation Document lists in excess of $4.7 billion in total needs on Table 1: "Transit Center District Plan Public Improvements & Implementation Costs" on page 3. In addition, the Implementation Document makes clear on page 4 that the 2007 values would not be the basis for the rates when the CFD legislation is approved.

The Reuben Letter also contends that the City increased the CFD special tax rates above the rates stated in the Implementation Document to address cost overruns in the Transbay Project: "These changes [from the Implementation Document rates] appear intended to artificially increase the CFD tax to address a project with significant cost overruns."[5] There is no merit to this contention. The 2013 RMA is based on the Concord Group Studies that were completed in April 2013 and the Implementation Document, which was approved by the City in August 2012. The Developers' unsupported statement likely refers to a recent report in the media that the Transbay Project increased its budget in July 2013 and may face further budget increases (due to rising construction costs in an overheated real estate market).

This unsupported claim in the Reuben Letter fails as a criticism of the Proposed RMA for two reasons. First, the Transbay Project is the primary responsibility of the Transbay Joint Powers Authority ("TJPA"), a public agency separate and independent from the City.[6] The TJPA increased the Transbay Project's budget in July 2013, three months **after** the Concord Group completed its valuation studies on which the CFD rates are based. Accordingly, City staff established the proposed CFD rates well before, and were not influenced by, the TJPA's budget increase. Second, City staff set the tax rates in the 2013 RMA and the Proposed RMA based on a study of 2013 values in the Transbay District prepared by the Concord Group. That study, by an independent and reputable real estate economics firm, determined the tax rates using a widely accepted valuation methodology and incorporating current market data, all in conformance with the Implementation Document. There is no evidence that the budget for the Transbay Project was a consideration in setting those rates, and the Developers have submitted none.

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[5] Reuben Letter p. 7.

[6] The City is one of three members of the TJPA.

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.*

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.

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.

By contrast, the winning Block 8 proposal included CFD rates equal to those in the 2013 RMA, which are the same as the rates in the Proposed RMA. Furthermore, the first and only land sale closing for Block 6 occurred after the introduction of the 2013 RMA at the price offered in the team's initial proposal. The developer was aware or should have been aware of the rates upon acquisition of that site.

Also, for the reasons stated in the response to the objection in paragraph 2 above, the Developers could not have reasonably relied on the illustrative rates in the Implementation Document, which were based on 2007 values.

4) CFD Infrastructure Projects Consistency with Implementation Document

Developer Objection: *The infrastructure program funded by the proposed CFD would fund a different set of projects than was proposed in the Implementation Document. Specifically, the City proposes to use a greater share of the revenues to fund the Transbay Project at the expense of other projects.*

Findings: The proposed CFD special taxes would pay for Transbay capital projects (the "Transbay Facilities" identified in the proposed Legislation), which are consistent with the Implementation Document. The timing of final funding of these projects would be determined in accordance with the procedures set forth in the Joint Communities Facilities Agreement ("JCFA") between the City and the TJPA, entered into in accordance with the Mello-Roos Act. The proposed Facilities include the proposed City Park on top of the Transit Center and the Downtown Rail Extension, which includes the train components of the Transbay Project. Similarly, the proportion of funds used for the Transbay Facilities is consistent with the percentage allocation in the Implementation Document.

Response: The Reuben letter states: "…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."

In fact, the proposed list of eligible projects to be funded using the CFD funds is consistent with the Implementation Document. The Implementation Document shows a list of capital projects that would be funded through the CFD special taxes and other sources, including plan-generated impact fees.[7] The

[7] Transit Center District Plan Implementation Document, Table 9.

proposed list of facilities to be financed through the CFD special taxes in the proposed CFD legislation is consistent with Table 9 of the Implementation Document – all capital projects are included. The proposed list of facilities to be funded with CFD special taxes (among other sources) includes "City Park" – the rooftop park on the Transbay Transit Center – and the Downtown Rail Extension of the Transbay Project. The Downtown Rail Extension includes the train box under the Transit Center and the tunnel connecting the existing rail lines now terminating at Fourth and King Streets to the new Transit Center.

In addition, the legislation proposes that at least 82.6 percent of the CFD special tax revenues be allocated towards TJPA projects, including City Park and the Downtown Rail Extension. This figure is consistent with the percentage breakdown between TJPA projects and non-TJPA projects shown in Table 9 of the Implementation Document.

As proposed in the JCFA, which would be approved by the Board under the proposed Resolutions, the City will undertake an annual process to program CFD special tax and impact fee revenues, which will include a 5-year revenue projection and an expenditure plan that will be approved through the City's Capital Budget process, which includes a number of public hearings. Funds would be used towards the facilities listed in the proposed Resolutions, which are consistent with the Implementation Document. In sum, there is no evidence that the proceeds of the CFD special taxes will be used for projects other than those permissible projects identified in the Implementation Document.

5) <u>Use of Net Square Footage as opposed to Gross Square Footage</u>

Developer Objection: *RMA applies rates to gross square footage, not net rentable/saleable square footage, which will exceed 0.55 percent of a property's value.*

Findings: In response to a request received from some of the Developers, City staff previously amended the 2013 RMA to provide for special taxes to be levied based on gross square footage rather than net leasable square footage. At this time, staff is proposing to change the Proposed RMA to provide for the calculation of assessed square footage on the basis of net leasable/saleable square footage rather than gross square footage, which staff believes is consistent with the valuation methodology.

Response: At the Developers' request, City staff changed the proposed basis for calculating the special tax from the total "net leasable square footage" of a development to the total "gross square footage" of the development. A memo from David Taussig Associates to Jim Reuben and forwarded to the City dated November 11, 2013 on behalf of certain Developers states, "…we have included in the Revised RMA the defined term 'Entitled Square Footage,' which is to be utilized for all Land Uses… 'Entitled Square Footage' means, for each Land Use, the square footage which is included in a Development Project's most recent entitlement document…"

To accommodate the Developers, City staff agreed to make this change, and amended the 2013 RMA to use gross square footage as the basis for calculation of the special tax.
As mentioned above, the rates in the Proposed RMA are informed by valuation studies performed by the Concord Group, an independent real estate economics consultant. The City's special tax consultant used net leasable/saleable square footage to calculate the proposed rates in the Proposed RMA. If the rates are applied to gross floor area rather than net floor area, to prevent the proceeds of the tax from exceeding 0.55 percent of development value the Proposed RMA rates would have to be decreased accordingly. But due to an oversight, City staff did not adjust the proposed rates downward in the proposal before the Board to account for the change from net to gross. The Reuben Letter correctly points out this error.

To be consistent with valuation methodology and to remain as true as possible to the objective in the Implementation Document of levying special taxes equivalent to 0.55 percent of property value, City staff is proposing to amend the Proposed RMA so that special taxes levied in the CFD will be calculated based on net leasable square footage.

6) <u>RMA Contains Reasonable Valuation Rates</u>

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

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.

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.

Because the Implementation Document required the special tax rates to be calculated to be equivalent to 0.55 percent of property value, the 2013 RMA included a pre-Certificate of Occupancy escalator pursuant to which the base special tax rates would change annually based on changes in the appraised value of comparable property in the Transit Center District. However, certain Developers complained about the uncertainty of the tax rates for planning purposes.

Accordingly, the base special tax rates in the Proposed RMA reflect current values as of the date of the Concord Group Studies (April 2013), as supported by its analysis of comparable sales. And the base special tax rate included in the Proposed RMA would be adjusted both up and down based on the City's Annual Construction Cost Inflation Index, which is currently used to index the City's development impact fees (but subject to an annual 4 percent floor and ceiling) prior to the setting of the maximum special tax rate for a property. After the maximum special tax rate is set for a specific property, the maximum special tax would thereafter escalate by 2 percent each year. As explained above, the Annual Construction Cost Inflation Index is an established index currently used by the City that reflects changes in economic conditions that could lead to changes in market value. City staff's proposal to use this more predictable index to adjust the base special tax rates rather an annually quantifying market conditions is indicative of its responsiveness to the concerns of some of the Developers.

Property value increases between the date of the Concord Group Studies (April 2013) and today highlight two important facts: (i) the 4% ceiling on annual increases in the base tax rate in the Proposed RMA

dampens the impact on taxpayers of property value increases, and (ii) the base tax rates in the Proposed RMA do not reflect the high point in the current market cycle, as claimed in the Reuben Letter. According to a June 24, 2014, press release by S&P Dow Jones Indices, the S&P/Case-Shiller Home Price Index for San Francisco for April 2014 was 190.83, a 18.2% increase from April 2013.[8] Similarly, Colliers Investment Services Group released a Capital Markets Report (Mid-Year 2014), and reports that the pricing for Class A office space increased 26% between mid-year 2013 and mid-year 2014, while pricing for Class B office space increased 31% and Class C office space increased 33% in the same period. Meanwhile, the City's Annual Construction Cost Inflation Index increased by 4.5 percent from fiscal year 2013-14 to fiscal year 2014-15, and, as a result of the 4 percent cap in the Proposed RMA, the base special tax rates would only increase by 4 percent on July 1, 2014.

The base special tax rates can also decrease if the City's Annual Construction Cost Inflation Index decreases prior to issuance of a COO for a particular building.

Finally, the Reuben Letter includes, in Exhibit A, a regression analysis titled "San Francisco Office Sale History (Sept 1989- Mar 2014)". Assuming for this purpose that the analysis is accurate, it offers useful insight into the valuation claims made in the Reuben Letter:

(i) The analysis shows that the sales price of office space generally rises over time, which belies the claim in the Reuben Letter that the property values reflected in the Proposed RMA are unreasonably high.

(ii) The analysis does not compare values for comparable properties. The valuation ($600/sq. ft.) attributed to the Implementation Document in Exhibit A and the valuation ($873/sq. ft.) attributed to the Concord Group Studies in Exhibit A are correctly stated, but the value from the Implementation Document represents the average of the approximately 20 properties considered by the Concord Group in 2007 as summarized in Tables 5-7 of the Implementation Document, while the value from the Concord Group Studies represents the rate for a hypothetical 50-story office building, the most valuable office building type valued in the Concord Group Studies.

(iii) The Concord Group estimated that a 26-story building (the middle of the 1-50 floor range valued in the Concord Group Studies) had a $623/sq. ft. value in 2007 and a $776/sq. ft. value in 2013. The Concord Group's estimated values were approximately the same percentage higher (73% in 2007; 72% in 2013) than the average sales price shown in Exhibit A to the Reuben Letter (the Concord Group values are higher because it valued new class A buildings in the Transbay Transit Center District Plan Area -- which is considered to be one of the most desirable office locations in the City -- while the sales history in Exhibit A considers buildings of different ages and types across the entire City). In other words, the Concord Group values used to calculate the special tax rates for office space increased 25% between 2007 and 2013, while the average market valuation per square foot increased 26% between 2007 and 2013 according to the Developer's data summarized in Exhibit A to the Reuben Letter. Hence, the estimated values underlying the base special tax rates in the Proposed RMA are not inconsistent with the values used in 2007.

[8] The S&P/Case-Shiller San Francisco Home Price Index measures the average change in value of residential real estate in San Francisco given a constant level of quality.

7) <u>Impact of CFD special tax on property values</u>

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.*

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.

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."

For market-rate condominiums, the Implementation Document concluded: "Given the fact that the improvements to be funded by the Mello-Roos Special Tax will improve property values for condominium owners (potentially by an equal or greater amount than the Special Tax itself), this additional Special Tax burden can be considered relatively minor in the overall cost of purchasing and occupying a condominium in downtown San Francisco, and thus is not expected to result in significant adjustments to the market value of such units."

For commercial office space, the Implementation Document concluded: "Again, given the fact that the improvements funded by the Special Tax will substantially improve the desirability of office space in the area, this level of additional cost burden for the tenants of new office space in downtown San Francisco is not expected to require adjustments to achievable rent levels and building value assumptions."

In this case, staff believes that an assumption that the CFD will not have a significant adverse impact on property values is consistent with the Implementation Document, because the values estimated by the Concord Group Studies are generic values for types of uses, not particular structures, as of April 2013, that do not expressly assume completion of the public infrastructure to be financed by the CFD.

For all these reasons, City staff believes that the rates in the Proposed RMA are reasonable, based on evidence, and consistent with the Implementation Document.

8) <u>Lowering operating expenses</u>

Developer Objection: *In its office building valuation used to set rates, the City arbitrarily and substantially lowered assumed operating expenses between its 2012 and 2013 analysis, and assumed between $11 and $12 per square foot of operating expenses, including all property expenses and assessments (including the CFD special taxes).*

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.

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 <u>not</u> 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.

The Concord Group also reports that the Developers' focus on operating expense assumptions is a red herring because the NOI assumptions embedded in the Concord Group Studies are more important to the overall value conclusions. The Concord Group reports that it used conservative assumptions on operating costs <u>and</u> gross rents to arrive at NOI assumptions, and that these NOI assumptions, which directly translate to the building valuations used to set the special tax rates, are supportable and conservative in the current market. For example, the Concord Group Studies assume a $42.69 NOI for a generic 26-story building, and the LinkedIn lease signed in April 2014 for floors 2 through 26 of 222 Second Street assumes a $49.20 NOI (plus annual escalators, which are not contemplated by the Concord Group Studies), which is approximately 15% higher.

Because the projected gross rents and the estimated operating expenses in the Concord Group Studies were both low, and because the NOI assumptions in the Concord Group Studies are both conservative and supportable in the current market, the Concord Group concludes that the Developers' criticism of its office expense assumptions are not valid.

9) <u>Implementation Document does not discuss escalating factors or different rates for different height buildings</u>

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.*

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.

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…"

a) The annual pre-COO increase reflects the likelihood that values will go up or down over time. As described above, to calculate the base special tax rate in a manner that would be consistent with the Implementation Document, the City initially proposed an annual pre-Certificate of Occupancy escalator based on an annual appraisal of market values in the Transit Center Area. The City heard from some of the Developers that this methodology suffered from too much uncertainty. Accordingly, the City replaced this proposal with an annual escalator based on the City's Annual Construction Cost Inflation Index, with a maximum floor and ceiling of 4 percent change each year, which involves greater certainty, yet still reflects the fact that the value of property in the City fluctuates over time.

b) The 2 percent escalator that applies to the maximum special tax after a property has commenced paying the special tax is consistent with the 2 percent inflationary limitation contained in Proposition 13 that applies to increases in assessed values and is a common feature of special tax formulas for community facilities districts. Based on historical evidence, real estate values, although cyclical in the short-term, rise in the long-term at a rate greater than 2 percent per year.

c) The Proposed RMA proposes varying rates based on building heights because, as described above, the City based its rates in the Proposed RMA on the value estimates in the Concord Group Studies, and the Concord Group Studies found that taller buildings are significantly more valuable on average, based on recent comparable sales. For example, the Concord Group reports that in the LinkedIn lease, floors 2 through 8 are based on a $63/sq. ft. NOE (net of electric) and floors 21 through 26 assume a $76/sq. ft. NOE.