

MEMORANDUM

To: Gian Martire, City of Cupertino

From: Economic & Planning Systems, Inc.

Subject: Fiscal Analysis of 19900 Stevens Creek Boulevard General Plan Amendment Application; EPS #161195

Date: February 10, 2017

The Economics of Land Use



The City of Cupertino retained Economic & Planning Systems, Inc. (EPS) to prepare this impact analysis of an application for a General Plan Amendment (GPA). The site currently is occupied by a 26,000-square foot furniture store. The applicant is requesting an increase of 16,000 square feet of office allocation to be added to the Heart of the City Specific Plan area to allow a change of use from retail to office. With the existing allocation available in the Heart of the City Specific Plan and the additional allocation requested, the applicant could bring either a business start-up incubator or a medical office tenant to the site.

In addition to the use change to office, the proposal calls for increasing the square footage of the existing building from 26,000 to 28,125 by enclosing and finishing an existing arcade.

This EPS analysis assesses both proposed tenant alternatives:

- Start-up Business Incubator and
- Medical Office.

The Summary of Findings below presents the estimated economic impact of each alternative. The detailed calculations that follow document the Start-up Business Incubator alternative, which is identified as marginally more fiscally burdensome than the medical office alternative.

Consistent with previous EPS fiscal analyses of GPA applications, this study focuses on the effect of the proposed development on the City of Cupertino's General Fund. The objective of the analysis is to quantify whether the proposed GPA will generate adequate revenues to cover the costs of providing ongoing services to the project. The analysis does not consider the impact of the proposal on potential capital facilities cost requirements or other one-time costs. The analysis compares the impact

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of the proposed GPA alternatives at buildout to the baseline impact of the existing use in the project area.

Actual fiscal impacts will depend on a number of factors that cannot be predicted with certainty, including the market performance of the project, future changes in City or State budgeting practices, and the efficiency of various City departments in providing services. Key analytical inputs and assumptions used in this analysis are from the development application, City documents, information from City staff, and EPS industry knowledge.

Summary of Findings

1. The proposed project is likely to result in a modest annual net fiscal burden on the City of Cupertino's General Fund.

This analysis estimates that the net annual fiscal impact of the GPA proposal on the City's General Fund is approximately negative \$33,000 to negative \$36,000. The incubator is likely to generate more tax revenue and more cost to the City, as compared to the medical office alternative. This finding is largely attributable to the anticipated employment density that would be achieved with an incubator tenant.

Table 1 Fiscal Impact Comparison

Sensitivity Scenario	Fiscal Impact at Project Buildout	Fiscal Impact Baseline¹	Net Fiscal Impact¹
Start-up Incubator	\$0	\$36,000	-\$36,000
Medical Office	\$3,000	\$36,000	-\$33,000

(1) This is an estimate of the fiscal impact of the existing furniture store, calculations are detailed in **Table 13**

2. An incubator office project likely would generate more tax revenue than the existing furniture store, but also would create more service cost for the City.

This analysis estimates that the net annual fiscal impact of a business incubator on the General Fund is approximately negative \$36,000, as shown in **Table 2**. The net increase in General Fund revenues from the project at buildout is estimated at roughly \$3,000 more annually than existing uses. However, the net increase in General Fund expenditures is estimated at approximately \$39,000 more per year than the current use. If the assessed value of the project is higher than anticipated by this analysis, consistent with the applicant's estimates, the net fiscal impact of the GPA would be negative \$30,000.

Table 2 Fiscal Impact Summary – Start-Up Incubator

Revenue / Expense Category	Fiscal Impact at Project Buildout	Fiscal Impact Baseline	Net Fiscal Impact
General Fund Revenues	\$40,000	\$37,000	\$3,000
General Fund Expenditures	<u>\$40,000</u>	<u>\$1,000</u>	<u>\$39,000</u>
Net Impact on General Fund	\$0	\$36,000	-\$36,000

3. The estimated fiscal burden to the City would be marginally less if the tenant of the proposed office space is a medical office user.

If the applicant is successful in its negotiations with a medical office end user, the net fiscal burden to Cupertino's General Fund could be slightly reduced from the results shown in **Table 2** above. This alternative likely has a lower revenue generation and lower cost implications for the General Fund, as compared with the incubator alternative. A medical office use is anticipated to operate at a notably lower density of employment. The net fiscal impact of the medical office tenant scenario would be negative \$33,000 per year, as shown in **Table 3**.

Table 3 Fiscal Impact Summary - Medical Office

Revenue / Expense Category	Fiscal Impact at Project Buildout	Fiscal Impact Baseline	Net Fiscal Impact
General Fund Revenues	\$27,000	\$37,000	-\$10,000
General Fund Expenditures	<u>\$24,000</u>	<u>\$1,000</u>	<u>\$23,000</u>
Net Impact on General Fund	\$3,000	\$36,000	-\$33,000

Fiscal Impact on the General Fund

This section describes the methodology and key assumptions used to estimate the fiscal impacts of the proposed GPA. The analysis is based on information from three key sources:

- (1) the GPA application material submitted
- (2) interviews with City planning and finance staff
- (3) EPS research and industry knowledge

EPS has developed a fiscal impact framework based on its in-house methodology and Cupertino-specific factors. EPS has not conducted an independent audit of the City's budget, performed in-

depth interviews with service-providing City departments, or conducted detailed market analysis. EPS fiscal estimates differ from those provided by the applicant due to the differences in methodology. There are two notable differences between the studies. First, the applicant's projection does not include an estimate of fiscal costs associated with the project and therefore is not a complete fiscal impact estimate. The second main difference in methodologies is that the EPS analysis only considers fiscal revenues that accrue to the City of Cupertino's General Fund (i.e., only a portion of total sales tax and property tax revenue), while the applicant's analysis includes all property tax and sales tax revenue. In reality, much of the revenue generated through property taxes and sales taxes will be distributed to public entities other than the City.

Proposed General Plan Amendment

The applicant is proposing a use change and slight intensification of a 26,000-square foot retail space on a 1.92-acre property located at 19900 Stevens Creek Boulevard. The proposal envisions increasing the square footage of the existing commercial space to 28,125 square feet and changing the use from retail to office. According to the GPA application, the applicant has been in negotiations with two potential end users, a business start-up incubator and a medical office operation. The supporting table set below presents the analysis of the business start-up incubator. Analysis of the medical office and existing use rely on the same basic methodology.

Table 4 presents the proposed GPA program identified by the applicant. The table also presents EPS assumptions concerning the population and employment that would be supported by the project at buildout. A variety of revenues and costs included in this fiscal analysis are based on the anticipated "service population" which weights a local employee's service burden at 50 percent of a resident's burden.

Table 4 Development Program and Service Population

Item	Formula	Assumption / Units
Start-Up Incubator Space	<i>a</i>	28,125 SF
Worker Density	<i>b</i>	150 SF / Employee
Employment Estimate	$c = a / b$	188
Service Population (1)	$d = c * .50$	94

(1) Per-person employee burden on City services is weighted at 50 percent of residential burden.

General Fund Revenues

General Fund tax proceeds attributable to the proposed GPA will include sales tax, property tax, property tax in lieu of vehicle license fee (VLF), property transfer tax, utility user tax, franchise fees, and business licenses. **Table 5** provides a summary of the Cupertino 2015-16 Adopted General Fund revenue budget and a description of the forecasting method relied upon for each relevant revenue source.

Table 5 FY2015 - 16 Revenue Budget Summary and Fiscal Impact Estimating Factors

Item	FY2015-16 Total	Estimating Factors
Sales Tax		
Business to Business Sales Tax (1)	\$13,905,880	\$0.20 per square foot of office
Other Sales Tax	\$6,454,120	1.0% of estimated taxable sales
Property Tax		
Property Tax in Lieu of VLF (2)	\$5,782,541	2.1% of Citywide Assessed Value
Other Property Tax	\$10,272,459	5.8% of base property tax rate (1%)
Transient Occupancy Tax	\$5,072,000	12% of total TOT revenue
Utility Tax	\$3,100,000	3.4% of utility bills
Franchise Fees	\$2,800,000	\$37.98 per service population
Other Taxes (3)		
Construction Tax	\$2,147	- not estimated
Business License	\$512,649	\$18.34 per employee
Property Transfer Tax	\$553,860	\$0.55 per \$1,000 in value
Other Taxes	\$331,344	- not estimated
Licenses & Permits	\$6,171,000	- not estimated
Fines & Forfeitures	\$550,000	- not estimated
Use of Money & Property	\$742,530	- not estimated
Intergovernmental	\$600,000	- not estimated
Charges for Services	\$10,590,878	- not estimated
Miscellaneous	\$720,895	- not estimated
Total Revenues	\$68,162,303	

(1) FY2015-16 total reflects 68% allocation of the sales tax total. Budget detail provided by the City.

Estimating factor reflects typical business-to-business sales tax generation in Silicon Valley offices.

(2) FY2015-16 total reflects 36% allocation of the property tax total. Budget detail provided by the City.

(3) FY2015-16 total reflects allocation of other taxes based on detail provided by the City.

Retail Sales Tax Revenue

The proposed GPA is expected to generate retail sales tax revenue accruing to the City of Cupertino through the daily project employee spending on retail goods and services in the City of Cupertino.¹ This analysis estimates worker spending based on spending patterns reported in the *Office-Worker Retail Spending in a Digital Age*, a research publication from the International Council of Shopping Centers (ICSC).² These survey data were reviewed to identify taxable spending. The analysis estimates that each office worker spends about \$6,000 annually on taxable sales in the vicinity of their workplace.³ Because this spending is known to be near work, this analysis assumes that 50 percent of the taxable spending by project workers occurs within the city boundary. The taxable spending captured in Cupertino is multiplied by the number of workers supported by the proposed project. Taxable sales in Cupertino are subject to a sales tax rate of 8.75 percent. However, only 1 percentage point of the sales tax accrues to the City's General Fund, while the rest goes to the State and other public entities.

Table 6 Retail Sales Tax Revenue

Item	Assumptions	Annual Total at Buildout
Project Employee Retail Purchases in Cupertino		
Daily Office Worker Taxable Spending (1)	\$25.00 per work day	
Annual Office Worker Taxable Spending	240 workdays / year	\$6,000
Cupertino Spending Capture	50%	\$3,000
Office Workers		188
Daily Retail Worker Taxable Spending	\$16.67 per work day	
Annual Retail Worker Taxable Spending	240 workdays / year	\$4,000
Cupertino Spending Capture	50%	\$2,000
Retail Workers		0
Worker Taxable Spending in Cupertino		\$562,500
Total Retail Sales Tax Revenue	1.0% of taxable sales	\$5,625

(1) ICSC Research in 2012; inflated to current dollars.

¹ Business-to-business (B2B) sales tax revenue is estimated in **Table 10**.

² Michael P. Niemira and John Connolly, International Council of Shopping Centers. "Office-Worker Retail Spending in a Digital Age," 2012. Accessed online at:
https://www.downtowndevelopment.com/pdf/icsc-report_office-worker-spending.pdf

³ The analysis assumes that retail workers spend less, a factor that applies to the estimated fiscal impact of the existing retail store (i.e., baseline estimate).

Property Tax Revenue

Property tax revenue is based on the estimated assessed value of the proposed project. Relying on the applicant's proposed development program, EPS estimates the project's assessed value at \$14.17 million at buildout, as shown in **Table 7**. Since there is no indication that the property will turn over, a complete reassessment of the land and improvements will not be triggered by the Santa Clara County Office of the Assessor. Rather, the value of the interior improvements to accommodate the use modification and the value of the additional construction will be estimated by the County Assessor's Office and added to the existing value of the property.⁴ The City's General Fund captures 5.8 percent of the base 1.0 percent property tax rate. This tax rate factor is specific to the tax rate area that covers the project location.

Table 7 Property Tax Revenue

Item	Assumption / Factor		Total
Assessed Value Estimate			
Existing Land and Improvement Value			\$12,100,000
Interior Improvements for Use Change (1)	\$60	Square Foot	\$1,560,000
Value of Addition (2)	\$240	Square Foot	<u>\$510,000</u>
Total Assessed Value			\$14,170,000
Property Tax	1.0%	Base Property Tax Rate	\$141,700
Cupertino General Fund Revenue (3)	5.8%	Allocation to Cupertino General Fund	\$8,199
Property Tax In Lieu of VLF			
Existing Citywide Property Tax in Lieu of VLF			\$5,782,541
Citywide Assessed Value (4)			\$19,200,000,000
Project Net Assessed Value Increase (5)			0.07%
Property Tax In Lieu of VLF Revenue (6)			\$4,268

(1) EPS review of cost estimates for office fit-out.

(2) RS Means, construction cost estimate

(3) Per Santa Clara County Tax Collector AB8 factor (post ERAF).

(4) FY2014-2015 value based on the Santa Clara County Assessor Annual Assessor's Report.

(5) Calculated by dividing the new assessed value by citywide assessed value.

(6) Calculated by multiplying existing property tax in lieu of VLF by project net assessed value increase.

⁴ Note that the applicant's proposal indicates roughly \$7.7 million in improvement cost while our analysis relies on typical office fit out and construction cost estimates which total \$1.1 million.

Property Tax In Lieu of VLF

In 2004, the State of California adjusted the method for sharing VLF with local jurisdictions. Recent State budget changes replaced the VLF with property tax, which grows proportionately with increases in assessed value of the City. The proposed project will add about 0.07 percent to the current assessed value in Cupertino (assuming no other assessed value growth for simplification purposes) and will generate the same increased percentage in in-lieu VLF revenues (see **Table 7**).

Property Transfer Tax

The project will generate real estate transfer tax revenue associated with future turnover in ownership. This analysis assumes that ownership of all land use types will turnover every 25 years, an annual turnover rate of 4.0 percent.⁵ Unlike existing property tax for this project, the transfer tax will be based on market value of the property achieved in a transaction. The property transfer tax rate accruing to the City General Fund is \$0.55 per \$1,000 of the property value, as shown in **Table 8**.

Table 8 Property Transfer Tax Revenue

Item	Assumption / Factor	Annual Total at Buildout
Property Value¹		
Office	\$600 Per Square Foot	\$16,875,000
Retail	\$600 Per Square Foot	\$0
Total		\$16,875,000
Average Annual Turnover		
General Office	4.0%	\$675,000
Retail	4.0%	\$0
Subtotal		\$675,000
Property Transfer Tax Revenue	\$0.55 per \$1,000 in value	\$370

[1] This table is reporting estimated market value rather than the project's assessed value which is shown on **Table 7**.

⁵ For institutional investors of commercial real estate a typical holding period is five to seven years (Ciochetti and Fisher, 2002). This analysis assumes a significantly longer holding period due to the property tax benefits of long-term ownership in California.

Utility Tax

The City of Cupertino collects tax revenue on utility charges for services provided in the City. New residents and employees will expand the use of utilities in the City. This analysis estimates an average monthly utility expense of \$120 per employee. The City of Cupertino collects 3.4 percent of utility charges. **Table 9** presents utility user tax revenue attributable to the proposed project at buildout.

Table 9 Utility User Tax Revenue

		Annual Total at Buildout
Assumption		
Commercial		
Total Employees	188 employees	
Monthly Utility Cost	\$120 per employee per month	
Annual Total		<u>\$270,000</u>
Total Annual Utility Expenses		\$270,000
Utility User Tax Revenue	3.4% of utility bill	\$9,180

Revenues from Other Taxes and Fees

In addition to the key revenues described above, other taxes and fees are estimated to be generated by the project. Specifically, EPS forecasts additional business-to-business sales for office uses, new franchise fees, and new business license revenues generated by commercial activity associated with the project. This analysis assumes that office uses generate an average of roughly \$20 per square foot in business-to-business sales, which translates to \$0.20 per square foot in sales tax revenue.⁶ This assumption is reflective of a typical office tenant in the Silicon Valley and is believed to hold true for business start-up incubators. Franchise fee revenue and business license revenue reflect averages derived from City budget documents (see **Table 5**). **Table 10** presents forecasting assumptions and revenue estimates.

⁶ Business-to-business sales and tax revenue estimates reflect the findings of prior EPS analyses conducted in Menlo Park and Palo Alto.

Table 10 Revenue from Other Taxes and Fees

Item	Allocation Factor	Project Characteristic	Annual Total at Buildout
Business-to-Business Sales Tax	\$0.20 per square foot of office	28,125 square feet	\$5,625
Franchise Fees (1)	\$37.98 per service population	93.8 service pop.	\$3,560
Business License (1)	\$18.34 per employee	188 employees	<u>\$3,439</u>
Subtotal			\$12,624

(1) Franchise Fee and Business License allocation factors are both based on existing general fund revenue per capita.

General Fund Expenditures

This fiscal analysis estimates the costs attributable to employment growth by characterizing how expenses will change for each City department. For some departments, employment growth in the City will not dramatically alter operations. For example, administrative functions in the City are not likely to scale up significantly to accommodate new projects. Alternatively, departments that provide services directly to businesses likely will increase their operations and costs to accommodate new employment.

It is important to note that a range of external factors may influence responses to growth and cost effects in the future. Examples of factors that are beyond the control of the City and its departments that may act to magnify or reduce department costs over time include the following:

- regional growth
- technology
- state and federal policies
- environmental factors

This study does not speculate regarding the potential effects of such exogenous influences on the general fund expense budget. It focuses only on those factors attributable directly to the employment growth and land use changes generated by the proposed GPA.

The fiscal analysis model relies on categorization of the likely budgetary response to employment growth for each department. The anticipated response to growth is expressed for fiscal modeling purposes in terms of "fixed expenses" and "variable expenses" within the department budget.

The fixed expenses are the portion of a City department's budget which is not affected by population and employment growth. Even a department which is anticipated to grow largely in step with the City's service population likely would have some fixed cost. For example, in most

cases each department has only one director position, which is a fixed expense for the department. While the department may increase staffing to accommodate growth, the department will not add another director.

The variable expenses of a department are those that do increase with growth. As the City grows, increased demand for services requires some departments to scale up operations to meet new demand. The portion of a department's budget that scales up is identified as the variable share of the budget.

EPS uses a per-capita average cost approach to estimate department costs attributable to new residents and workers. The variable portion of each department budget is used to determine the per-capita cost, as shown in **Table 11**. Then, to determine the new General Fund expenditures generated by the proposed project, the per-capita factors are multiplied by the projected increase in service population. Public Affairs and Non-Departmental expenditures are not estimated because the project is not expected to generate new ongoing costs to these service providers.

Table 11 FY2015-16 Expenditure Budget Summary and Fiscal Impact Estimating Factors

Item	City General Fund Expenses (FY2015-16)	Percent Variable (1)	Annual Variable Expenses	Estimating Factors		Per Capita General Fund Expense	Project Population/ Service Population	Annual Total at Buildout
General Government (2)	\$8,551,349	10%	\$855,135	73,731	Service Pop.	\$11.60	93.8	\$1,087
Police (3)	\$10,994,684	90%	\$9,895,216	73,731	Service Pop.	\$134.21	93.8	\$12,582
Public Affairs (4)	\$462,298	N/A	N/A	N/A	N/A	N/A	N/A	N/A
Recreation & Community Services	\$6,157,107	75%	\$4,617,830	59,756	Population	\$77.28	0.0	\$0
Planning & Community Development	\$7,235,383	50%	\$3,617,691.50	73,731	Service Pop.	\$49.07	93.8	\$4,600
Public Works (5)	\$22,563,247	75%	\$16,922,435	73,731	Service Pop.	\$229.52	93.8	\$21,517
Non-Departmental	<u>\$11,610,985</u>	N/A	N/A	N/A	N/A	N/A	N/A	<u>N/A</u>
Total Expenditures	\$67,575,053							\$39,786

(1) Percentage of costs that are population-dependent, as opposed to fixed costs or costs recovered through fees or charges.

(2) Includes Council and Commission, Administration, and Administrative Services.

(3) Reflects the contract portion of the police department's budget. To the extent the cumulative effect of new growth triggers the contract terms exceeding the cap agreed upon in 2014, the cost impact may be above that estimated based on the average cost approach.

(4) Includes public affairs, IT, government channel, and City website.

(5) Includes administration, environmental programs, development services, service center, grounds, streets, trees and right of way, facilities and fleet, transportation, and other programs.

Fiscal Impact of Proposed Project

Table 12 summarizes the fiscal impact of business start-up incubator alternative on the City of Cupertino's General Fund, with forecasted revenues and expenditure estimates based on the methodology described above. EPS estimates that General Fund revenues resulting from the proposed business start-up incubator will match the General Fund costs associated with providing ongoing services to the project.

Table 12 Summary of Fiscal Impact Analysis – Business Start-Up Incubator

Item	Annual Fiscal Impact
<u>General Fund Revenues</u>	
Sales Tax (excl. business-to-business sales)	\$6,000
Business to Business Sales	\$6,000
Property Tax	\$8,000
Property Tax in Lieu of VLF	\$4,000
Property Transfer Tax	\$0
Transient Occupancy Tax	\$0
Utility Tax	\$9,000
Franchise Fees	\$4,000
Business Licenses	<u>\$3,000</u>
Total Revenues	\$40,000
<u>General Fund Expenditures</u>	
General Government	\$1,100
Police	\$12,600
Recreation & Community Services	\$0
Planning & Community Development	\$4,600
Public Works	<u>\$21,500</u>
Total Expenditures	\$40,000
Net Impact on General Fund	\$0

Fiscal Impact of Existing Uses

In order to quantify the fiscal impact of the existing retail use located at 19900 Stevens Creek Boulevard, the same fiscal methodology is applied to existing land use program as the proposed GPA. The site currently is occupied by a 26,000 square foot Scandinavian Designs furniture store. The site's existing conditions provide a positive fiscal impact to the City's General Fund of about \$36,000 a year, as shown in **Table 13**.⁷

Table 13 Summary of Fiscal Impact Analysis – Existing Conditions

Item	Annual Fiscal Impact
<u>General Fund Revenues</u>	
Sales Tax (excl. business-to-business sales)	\$26,000
Business to Business Sales	\$0
Property Tax	\$7,000
Property Tax in Lieu of VLF	\$4,000
Property Transfer Tax	\$0
Transient Occupancy Tax	\$0
Utility Tax	\$0
Franchise Fees	\$0
Business Licenses	\$0
Total Revenues	\$37,000
<u>General Fund Expenditures</u>	
General Government	\$0
Police	\$300
Recreation & Community Services	\$0
Planning & Community Development	\$100
Public Works	\$600
Total Expenditures	\$1,000
Net Impact on General Fund	\$36,000

⁷ This analysis relies on the applicant's reported \$2.56 million in retail sales at the existing store. City review of taxable sales data indicates actual retail sales likely are higher, and thus the actual fiscal benefit of the existing use is higher than reported here.

Net Fiscal Impact

The proposed land use modification from retail to office, specifically a business start-up incubator, will result in an annual net fiscal burden to the City of Cupertino General Fund. This analysis estimates that the net annual fiscal impact of the GPA proposal on the City's General Fund is approximately -\$36,000, as shown in **Table 14**. The net increase in General Fund revenues from the project at buildout is estimated at roughly \$3,000 more annually than the existing use. The net increase in General Fund expenditures associated with the Project is estimated at approximately \$39,000 per year more than the existing use.

Table 14 Net Fiscal Impact Summary

Revenue / Expense Category	Fiscal Impact at Project Buildout	Fiscal Impact Baseline	Net Fiscal Impact
General Fund Revenues	\$40,000	\$37,000	\$3,000
General Fund Expenditures	<u>\$40,000</u>	<u>\$1,000</u>	<u>\$39,000</u>
Net Impact on General Fund	\$0	\$36,000	-\$36,000