Conley Consulting Group

MEMORANDUM

March 13, 2006
REVISED: April 5, 2006

To: Ms. Arlinda Heineck
City of Menlo Park
From: Conley Consulting Group

cc: Thomas Rogers

Subject: Peer Review, Bohannon Development Fiscal Impact Analysis

Conley Consulting Group (CCG) has been asked by the City of Menlo Park to perform a peer review of a fiscal impact report prepared for a proposed rezoning to permit redevelopment of two sites totaling 13.5 acres under single ownership in Menlo Park. The fiscal impact report titled "Fiscal Impact Analysis of Bohannon Properties: Independence and Constitution Sites" was prepared for The David Bohannon Organization by Brion & Associates in October 2005 ("Brion Study").

The Bohannon Organization seeks a development agreement that would secure development approvals for redevelopment of the sites over a 15-year build-out period. The Brion fiscal impact report projects significant net fiscal benefits from operation of the proposed higher density mixed-use project in comparison with either the current building improvements at full occupancy or a full build-out scenario based on the current zoning for the sites.

CCG Review

To undertake this review, CCG completed the following tasks:

- Review and testing of the assumptions and underlying methodology in the Brion Study
- Independent research into the property tax rates and assessed values for the subject parcels
- Review of relevant studies and correspondence regarding fiscal impacts that were part of the 2002 analysis of rezoning of this area

Real Estate Economics
Development Strategy
Economic Development

Tel 510.625.1448
Fax 510.625.1151

311 Oak Street, Suite 110
Oakland, California 94607
ccg@conley-group.com
www.conley-group.com

- Interviews with key Menlo Park staff to review fiscal analysis assumptions
- General review of the Menlo Park hotel market conditions and transient occupancy tax trends

I. CONCLUSIONS

The Brion analysis represents a detailed assessment of the possible costs and revenues associated with increased development of the two Bohannon parcels. While the majority of the methodologies used are appropriate, the analysis overestimates the potential fiscal or tax revenues from the proposed development because it does not consider whether revenues are net new to the City, or whether a portion represents a transfer of tax revenues that already flow to the City. On the other hand, the analysis seeks to estimate fiscal costs on a marginal, or net new cost, basis. Because revenues and costs are not treated in a parallel manner, the net fiscal benefits of the project are likely overstated.

The Brion analysis does not fully measure the net new revenue potential of the three alternatives, as it only considers revenues currently generated from the current uses on the two subject sites. Because there is currently no hotel on the subject sites, it treats all hotel-generated revenues as new revenues, and fails to consider the impact of the proposed hotel on the operations of, and therefore the tax revenues already generated by, other hotels within the City.

CCG's analyses and comments are summarized below and detailed in the attached memo of March 7th.

The Brion analysis overestimates revenues, in these categories:

- Transient Occupancy Tax (TOT) revenues, since an unidentified portion of these revenues will be transferred from TOT revenues from other Menlo Park hotels
- Sales Tax revenues, given the unreliability of projections of sales taxes from businesses based solely on from land use or building type information
- Business License Taxes, which were calculated incorrectly

The Brion analysis also likely underestimates the cost of providing City services to the new development, since the costs were calculated on a modified marginal cost basis, which results in a projected cost roughly $108,000 less than what CCG feels is appropriate.

While CCG concurs with the Brion conclusion that the proposed mixed-use development program will, at completion, generate higher revenues than costs and higher net revenues than the current use of the two sites, it is likely that revenues will exceed costs by a smaller margin than estimated by Brion.

Further, it should be noted that the timing of the proposed mixed-use development is uncertain, and is dependent upon recovery of the Silicon Valley office and hotel markets, which is now projected to be several years in the future. It is possible that redevelopment of the site over time may result in years where the benefits of the proposed new development are not available, and the current fiscal revenue stream for the site is interrupted. For those years the fiscal impact could be the opposite of the projected positive impact based on the final build-out.

II. REVENUE IMPACTS

A. Overview of Fiscal Impact Methodology

Fiscal impact analysis is intended to determine the net effects of new development on the cost of providing government services, considering new taxes generated and additional public costs associated with the new project. The determination of new revenues and costs is actually a complex undertaking. A careful analysis of the revenue impact of a new project should consider whether projected revenues are actually new revenues to the city, or rather a transfer of revenues caused by a transfer of economic activity from one location in the city to the new location.

Analysis of the fiscal cost impact of a project is also challenging given that the costs of providing many government services is “lumpy,” i.e. only subject to change incrementally after periods in which larger demand can be accommodated without any apparent change in service levels or costs. As discussed later, the Brion report applies a modified marginal cost approach to its analysis of municipal costs. This approach risks understating the service costs of the project over the long run and overestimating the net fiscal benefit to the City.

B. Scenarios Considered

The two subject parcels contain a number of existing buildings – several of which are currently vacant – as well as vacant land. We understand that the site currently has an average 40% vacancy rate. The proposed rezoning would permit significant intensification of development on the site. Currently the sites, as improved, have a Floor Area Ratio (FAR) of 0.29. The existing zoning would permit a maximum FAR of 0.45 while the proposed zoning allows for a 1.0 FAR.

The Brion analysis evaluates 3 scenarios for the sites, of which the later two involve new development on the site:

- The existing buildings if fully occupied
- The sites fully built-out to the maximum of the existing zoning
- Proposed mixed-use zoning, evaluated based on a specific development scenario that includes office, health club, and a hotel. Note that this development program is one of many that could be allowed under the proposed rezoning

CCG concludes that the lack of specificity of the development program is a major risk to relying on the result of the fiscal impact analysis in decision making about the site. As we understand it, the proposed development agreement would permit considerable flexibility about the timing and the nature of the uses built on the site.

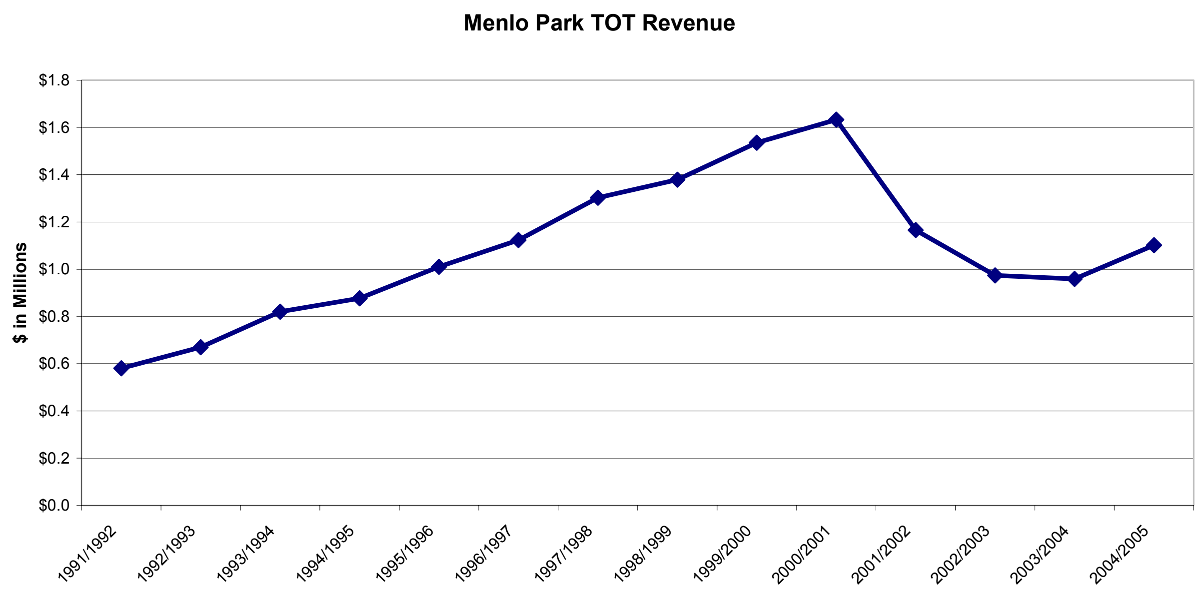
C. Projected Revenues

a. Transient Occupancy Tax

Development of a new hotel, which is permitted but not required by the proposed development agreement, generates nearly $569,000 in projected tax revenues or roughly 65% of the projected tax revenues in the mixed-use scenario.

The largest source of projected tax revenues from the hotel is Transient Occupancy Taxes (TOT), which is levied at 10% of the room revenue charges. The chart below shows the TOT revenue trends for Menlo Park for the last ten years. TOT revenues dropped dramatically with the changes in the economy and new additions to supply in the competitive region. The Stanford Park Hotel is by far the largest lodging facility in Menlo Park and, given its size and higher rate structure, represents a significant portion of the City's total TOT revenues.

Exhibit A. Historic TOT revenues



Hotel occupancy has been strongly impacted by the dot-com bust and decline in business-related travel in the Silicon Valley, falling from a high of 80% in 2000 to 60% and below in 2001 and 2002. Recently the hotel market has shown signs of recovery, and occupancy rates and room rates have begun to stabilize. However, in early 2006 occupancy rates are still below the 75% level typically considered an indicator that new supply can be absorbed.

The Brion Report includes a hotel analysis that suggests the site would either be developed as an extended stay hotel or a mid-priced/upscale hotel. The analysis, prepared in 2004 by RSBA & Associates, projects that for either segment it would take until about 2007 or 2008 for the market to stabilize due to general Silicon Valley economic conditions. The Brion analysis assumes a 74% occupancy rate at an average room rate (ADR) of $123 per night, representing substantial recovery from the market area hotel performance conditions on which the RSBA assessment was based. Thus, the Brion analysis is predicated on a substantially recovered hotel market. There is risk that the hotel will not perform as projected, or development of the hotel will be delayed, if recovery of the overall economy and the hotel sector is delayed.

Menlo Park currently has a 308 hotel room inventory in 6 properties, as shown in Exhibit 2. The proposed project at 130 rooms will result in a substantial increase in the number of hotel rooms. (Note that, when considered with the 120-room hotel proposed at Sand Hill Road and Interstate 280, there are proposals to add 250 new rooms to Menlo Park's hotel inventory, more than an 80% increase).

In the absence of substantial growth in the local demand for lodging it is reasonable to assume that at least some of the projected activity at the proposed new hotel will be as a transfer of hotel room demand from other properties in the market area. The Brion analysis, and the underlying RSBA analysis, does not attempt to measure the extent to which hotel room revenue at the new hotel is actually new room demand to the City of Menlo Park, and thus what portion of the projected TOT revenue is new revenue to the City.

While a detailed study of the hotel market is beyond the scope of this analysis and would require more concrete information on the type of hotel to be built, CCG concludes that it is likely that some portion of the projected TOT revenues would be a transfer from existing Menlo Park revenues.

Hotel-generated TOT revenues are projected by Brion at $430,000 or 48% of the total tax revenue in the highest revenue alternative. If all of the projected TOT revenue is omitted from the projection entirely, the mixed-use scenario still generates more revenue than the other two alternatives.

b. Sales Tax

The Brion analysis estimates gross sales tax generation by land use for the three alternatives. There is no analysis of whether the sales tax estimates for the two new development alternatives represent net new revenues for the City.

1) Sales Taxes from Non-Retail Uses

Tenants in office and light industrial buildings often, but not always, generate sales tax. Sales taxes may be generated from sales activities with a designated local point of sale or from industrial buildings that serve as showrooms again if the location is designated as the point of sale. Thus it is possible that two identical commercial or industrial buildings may be occupied by the same company and generate very different amounts of sales tax revenues. Thus this source of sales tax generation is a not a direct function of the space provided or even the specific tenants who occupy that space but rather of the nature of the business activities that occur within space. For instance, new office space located within the subject sites occupied by professional service firms would generate little or no sales tax revenues.

In partial recognition of this uncertainty, the Brion analysis provides a range of assumed sales tax generated per square foot of office space based on the historic sales tax generated by 1) the current office tenants of the existing Bohannon properties, and 2) the office tenants currently located in the broader M-2 district (the Brion analysis omits mention of any sales tax revenue from the existing R&D space on site).

However, neither of these measures recognizes that it is fully possible that new tenants on the site, either new tenants in the existing buildings, or new tenants in newly constructed space, could have different sales tax-generating characteristics than the tenants who now occupy space in the area. The fact that the sales tax generated by tenants of the existing buildings on the sites has fluctuated over time reinforces that estimates of this source of sales tax revenue based solely on land use are unreliable.

In the absence of designation of a specific tenant **and** designation of the location as a point of sale for specific functions (as would only be possible or likely with a build to suit development), the portion of the tax revenue in the alternative analysis that is projected to be generated by non-retail development must be considered highly risky.

Sales tax collections from business tenants represent 3% of the total projected revenues for the mixed-use, alternative moderate-sales-tax scenario.

2) Other Projected Sales Tax Revenues

The assumptions about sales taxes to be generated by operation of the restaurant and health club appear reasonable or even conservative in terms of the assumed volume of taxable activity. These uses represent two thirds of the estimated “Sales Tax from Development” in the “Low” sales tax scenario, and 42% of that source of revenue in the “Moderate” sales tax scenario.

c. Property Tax

The Brion analysis estimated the assessed value for each scenario and applied the relevant tax rates. The assessed valuation rates used in the analysis seem reasonable or even conservative compared to other similar developments in Northern California.

d. Business License Taxes

The Brion analysis assumes business license revenues are assessed at $59.57 per employee, based on the ratio of business license revenues divided by the number of employees in the city. This methodology is inaccurate, as demonstrated by the inset table below. CCG calculated the business license revenue for the proposed hotel and restaurant based on the

	Quantity		Jobs	Gross Receipts (1)	Bus Lic. Per website	Bus Lic. /employee
Hotel	130	rooms	39	$4,300,000	$1,500	$38
Restaurant	9312	SF	23	$1,862,400	$750	$32

Source: Conley Consulting Group, Menlo Park Website: Business License Fee Schedule
March, 2006

sales and employment characteristics in the Brion analysis and the Business License Fee Schedule posted on the Menlo Park website. In total, business license revenue is projected to generate about $106,000 per year.

e. Other Revenues

Since the four revenue sources above represent more than 90% of the maximum projected tax revenue, this analysis does not consider Fines and Franchise Fees or one-time revenue sources.

III. COST IMPACTS

Identifying the additional governmental costs associated with any one increment of new development can be difficult. Clearly, adding one new resident or employee would not likely change the cost of providing government services in the City, while there is equally clearly a point at which multiple new residents or employees would affect the cost of providing government, assuming service levels remain constant.

An important question in fiscal impact analysis is whether to measure fiscal costs on the basis of average cost or marginal cost (defined as the cost of providing the new increment of government services necessitated by the new development). The measurement of marginal costs is a complicated process and necessarily requires many judgments and assumptions. Indeed there is an argument to be made that since all residents and employees enjoy the benefit of having government services available, the costs of providing government services should be calculated using an average cost methodology.

Government functions serve local residents, businesses, and visitors. Fiscal analysis methodologies typically use residents and employees of proposed developments to measure of the future demand for additional services. A common methodology is to weigh an employee as a portion of a resident (Brion uses a 50% Resident Equivalency factor, which is typical) to develop per capita measures of municipal costs. It must be noted that the conventional employment-based cost methodology does not allocate costs to the customers of a facility, such as a hotel or a retail outlet, that attracts guests that are neither City residents nor employees.

In addition to allocating costs between residents and employees, the Brion analysis segregates costs by department using the City Budget, and making a distinction between variable and fixed portions, develops an approach to measuring something close to the marginal cost of new employment. The Brion calculations estimate an annual cost of almost $169 per new job.

CCG prepared an alternative methodology that developed an average or allocated cost estimate of the costs per job in Menlo Park as discussed in the attached technical memorandum. Using this more conservative estimate of annual costs of $229 per job, the estimated municipal costs would increase by nearly 37% or $108,000 per year.

EXHIBIT B
MENLO PARK HOTEL INVENTORY
BOHANNON FISCAL IMPACT PEER REVIEW

Hotel/Motel	Rooms	Suites	Price Range	Notes
Stanford Park Hotel 100 El Camino Real Phone: 650/322-1234	163	8	$295-$725	Four Star Hotel. Complimentary coffee and tea; apples; freshly baked cookies in lobby nightly at 9:30 p.m.; complimentary San Jose Mercury News and Wall Street Journal delivered Mon-Fri; free courtesy van within the Menlo Park/Palo Alto area; Business Center; turn-down service upon request; 24-hour room service; on-command 24-hour movie system in all rooms.
Menlo Park Inn 1315 El Camino Real Phone: 650/326-7530	30	2	$125-$165	Broadband access; restaruant in hotel, hot tub
Best Western Riviera 15 El Camino Real Phone: 650/321-8772	36		$129-$189	Complimentary continental breakfast, free high-speed Internet access, sauna, pool, Jacuzzi and fitness center. Complimentary fresh fruit, freshly baked cookies and coffee served all day. Same day dry-cleaning services available. Laundry facilities on property. Each room equipped with iron and ironing board, hair dryer, microwave and refrigerator.
Red Cottage Inn and Suites 1704 El Camino Real Phone: 650/326-9010	27	2	$79-$159	Garden-style setting, Personalized service. Complimentary continental breakfast, fax/copy services, guest voicemail, microwave/mini-fridge, cable 25-inch TV, iron with ironing boards, direct dial phones with modem data port, and a private patio adjoining each room. Heated pool. DVD VCR and free high-speed Internet access. Each room has a large sliding glass door leading to a private patio garden patio with redwood deck and bistro table set.
Mermaid Inn 727 El Camino Real Phone: 650/323-9481	38		$76-$105	Serves continental breakfast. Microwaves and refrigerators in each room. Cable TV (CNN, HBO, Showtime, HBO, ESPN) and iron/ironing board.
Stanford Inn 115 El Camino Real 650-325-1428	14		$50 to $80	Planning to undergo renovation and will be shutting down for about a month
TOTAL	**308**	**12**		

Source: Conley Consulting Group
March, 2006

Conley Consulting Group

M E M O R A N D U M

March 7, 2006

To: Carol Augustine, Finance Director
City of Menlo Park

From: Denise Conley, Principal
Conley Consulting Group

Subject: City Service Costs for Fiscal Analysis

Conley Consulting Group (CCG) has been asked by the City of Menlo Park to provide peer review of the fiscal impact analyses of two proposed projects in the City. The purpose of this memo is to serve as the foundation for a conversation on the appropriate approach to measuring fiscal cost impacts for these two projects and for other projects in the future.

We understand that over the years there has been some level of public debate on the subject of fiscal review in the City, and that the authors of the two studies have been active parties in this debate.

Fiscal impact analysis is, at its most basic level, a comparison of the new revenues generated by new development with the costs to provide municipal services the new development. The two studies reviewed are:

Study:	Fiscal Impact Study for Proposed Hotel /Office Development atI-280 and Sand Hill Park
Prepared for:	Stanford Management Company
Date:	January 2006
Prepared by:	CBRE Richard Ellis Consulting/Sedway Group

Study:	Fiscal Impact Analysis of Bohannon Properties: Independence and Constitution Sites
Prepared for:	The David Bohannon Organization
Date:	October 2005
Prepared by:	Brion & Associates

Real Estate Economics
Development Strategy
Economic Development

Tel 510.625.1448
Fax 510.625.1151

311 Oak Street, Suite 110
Oakland, California 94607
ccg@conley-group.com
www.conley-group.com

These two fiscal impact studies differ significantly in the methodology used to estimate the costs of municipal services for the new development. CCG reviewed the cost methodologies in these two analyses and the fiscal impact model developed for the City in 2002 by Applied Development Economics, Inc. and Vernazza Wolfe Associates, Inc. The Brion study relied in part on the 2002 Fiscal Model, but made certain assumptions that reduced the projected fiscal costs of the Bohannon development. The CBRE study differed more substantially from the 2002 Fiscal Model, and assumed that there will be no fiscal costs associated with the proposed Stanford development.

The fiscal analysis prepared by the City's consultants in 2002 developed a per employee average cost factor of $227 using the 2001/2002 City Budget and a city employment base of 31,400 jobs. The Brion analysis relies on the 2004/05 budget and the current estimated employment base of 25,180 jobs to develop a modified marginal fiscal cost estimate of $169 per employee.

In addition to the different base years, these two analyses used different methodologies to attribute the costs of providing City government services to residents and workers and to allocate costs between variable and fixed costs.

The Brion analysis assumes a portion of City costs are fixed and will not increase with growth and then allocates the portion of the City budget deemed variable, by Department, to residents and workers. The 2002 City model allocates all costs by Department to residents and workers without a reservation of a portion of costs as fixed.

Table 1 presents the allocation of the 2004/5 City Budget as presented by Brion and as updated to allocate costs on an average basis.

Recent experience provides an interesting cross check on the fiscal analysis. Both the jobs base and the City's expenditures have declined significantly in recent years. The table below compares jobs and City Budget expenditures in 2001/02 and 2004/05.

	2001/02	**2004/05**	**Change**	**% Change**
Jobs	34,100	25,140	(8,960)	-36%
Residents	30,934	30,648	(286)	-1%
Total City Expenditures	30,171,687	26,461,273	(3,710,414)	-12%
Drop in City Expenditures per Job Lost			**$414**	

Given that the population was relatively unchanged, if the reduction of City services was allocated solely to reduced employment, then the per job cost of City services could be calculated at $414 per year in 2005. Of course we recognize that broader economic forces and statewide budget reallocations affected the budget trends and service levels to both residents and businesses were reduced along with the reductions in expenditures. One useful check on the subject of fixed versus variable costs is whether the costs designated as fixed in the Brion analysis have actually varied over time.

Based on this review of fiscal cost studies and City data, CCG concludes that $229 per job per year is a conservative estimate of the municipal costs associated with new employment.

TABLE 1
FISCAL ANALYSIS SERVICE COST CALCULATION
MENLO PARK FISCAL ANALYSIS

Expenditures	FY 2004-5 City Budget Expenditures	Less Depart-mental Revenues	Net Dept Cost	% of Costs that are Fixed	Net Variable Costs	Amount Attributable to Employment Uses		Current per Employee Cost Factor
						%	Amount	
FISCAL ANALYSIS IN OCTOBER 2005 BRION ANALYSIS								
Administration Services	7,132,021	$208,022	$6,923,999	50%	$3,462,000	25%	$865,500	$34.37
Community Development	1,957,131	$1,395,500	$561,631	0%	$561,631	25%	$140,408	$5.58
Community Services	5,353,316	$2,850,213	$2,503,103	10%	$2,252,793	25%	$563,198	$22.37
Library	1,669,602	$162,500	$1,507,102	25%	$1,130,327	10%	$113,033	$4.49
Police	9,312,203	$310,222	$9,001,981	15%	$7,651,684	25%	$1,912,921	$75.97
Public Works	3,804,817	$301,500	$3,503,317	25%	$2,627,488	25%	$656,872	$26.09
Total General Fund	**$29,229,090**	**$5,227,957**	**$24,001,133**	**26%**	**$17,685,921**	**24%**	**$4,251,931**	**$168.86**
2005 Employment per ABAG		25,180						
REVISED COST ANALYSIS (1)								
Administration Services	7,132,021	$208,022	$6,923,999	0%	$6,923,999	25%	$1,731,000	$68.75
Community Development	1,957,131	$1,395,500	$561,631	0%	$561,631	25%	$140,408	$5.58
Community Services	5,353,316	$2,850,213	$2,503,103	0%	$2,503,103	25%	$625,776	$24.85
Library	1,669,602	$162,500	$1,507,102	0%	$1,507,102	10%	$150,710	$5.99
Police	9,312,203	$310,222	$9,001,981	0%	$9,001,981	25%	$2,250,495	$89.38
Public Works	3,804,817	$301,500	$3,503,317	0%	$3,503,317	25%	$875,829	$34.78
Total General Fund	**$29,229,090**	**$5,227,957**	**$24,001,133**	**0%**	**$24,001,133**	**24%**	**$5,774,218**	**$229.32**

(1) cost to provide services to employees based on average cost of that portion of services attributed to employees.
Source: Brion 2005, ADE/Vernazza Wolfe 2002, Conley Consulting Group.