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ADVISORS IN PUBLIC/PRIVATE REAL ESTATE DEVELOPMENT

MEMORANDUM

To: Ken Rich and Ann Taupier
Office of Economic and Workforce Development
City of San Francisco

From: Debbie Kern

Date: September 13, 2013

Subject: Preliminary Draft Assessment of Arts Incentives Options

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As a follow-up to our meeting on Monday, I thought that it would be helpful to provide a brief written summary of our preliminary findings to date regarding the cost of developing arts space and potential incentive structures that could be provided either through special zoning or development agreements.

Cost to Develop Arts Space

As detailed on Table 1, the cost to develop shell and core improvements for arts space approximates \$330 per square foot of building area¹. This does not include the cost of land or finishes, fixtures, and equipment (FF&E), which can exceed \$1,000 per square foot for theater space. Given that it would be cost-prohibitive for the City to off-set the high cost of fixtures and equipment, it is our understanding that the City is interested in limiting any potential incentives program to addressing shell and core construction costs. The arts tenants will be responsible for securing funding for equipment and finishes.

If the arts tenants are exempt from the calculation of GBA pursuant to Section 102.9 (b) (16) of the San Francisco Planning Code, then the inclusion of arts space does not reduce the amount of private development space and there is not an "opportunity cost" associated with the inclusion of the arts space. Given that arts tenants eligible for the GBA exclusion cannot be charged any rent², the cost to the private developer associated

¹ Please see Table 1.

² The existing building code permits the exclusion of certain categories of arts space from GBA calculations provided that the space is made available at no cost (beyond actual operating expenses) to the arts tenant.

with including arts space would consist of the portion of development costs borne by the private developer. If the developer is responsible for shell and core improvements, it is estimated that the cost burden would approximate \$330 per gross foot of arts space.

Financial Incentives to Off-set the Cost of Providing Arts Space

KMA has been asked to review the following incentive options:

- Floor to Area Ratio (FAR) exemptions for arts space;
- Increases in allowable FAR for economic components of proposed real estate projects;
- Additional options for satisfying 1% arts fee: a) deposit funds into an Artwork Trust Fund that can be used to construct arts space; and b) apply the fee expenditure towards funding on-site arts space; and
- Dedication of a portion of property tax revenues generated by new development towards arts space construction costs

FAR Exemptions for Office and Rehearsal Arts Space

Planning Code Section 102.9 (b) (16) exempts cultural uses that are available to the general public from the definition of Gross Floor Area for the purposes of calculating Floor to Area Ratio (FAR). Performing arts space and art exhibit space meet the requirements of this exemption, but administrative offices, class room, and rehearsal spaces that are needed by arts institutions do not generally meet the "available to the general public" requirement and therefore are not eligible for an exemption.

Given that there is reportedly a significant shortage of space for these arts-supporting spaces, we recommend that the City consider expanding the FAR exemption to include these uses. By expanding the list of excluded arts uses, it would enable private development to accommodate these needed uses without reducing the amount of economic uses to be built in new developments, provided that the arts space doesn't render the project to be non-compliant with other building codes, such as height limits.

In order to ensure that the space is occupied by arts tenants over time, we recommend that a use-restriction be recorded on the arts space and that a long-term lease with an arts tenant be conditions for approval. This incentive would be a useful tool for new construction projects, but not renovation projects.

FAR Increases for Economic Uses to Off-set Funding of Arts Space Shell Costs

Permitting additional FAR for projects that incorporate arts space could theoretically be an effective incentive for new construction projects. Land is transacting in the range of \$80 to \$110 per square foot of gross building area, Central Market is a very hot development location, and there are very few new construction development opportunities. Based on this cost analysis, granting approximately 3 to 4 square feet of additional gross building area for economic uses in exchange for every square foot of arts space provided (shell and core improvements) could incentivize a developer to provide arts space.

However, the viability of this tool is limited because: 1) the Downtown General Commercial (C-3-G) zone allows for the base FAR of 6:1 to increase to 9:1 through the purchase of transferrable development rights (TDRS); and 2) it is difficult for development to physically exceed a 9:1 FAR without conflicting with other zoning code limits, such as height limits or set-backs, etc. Therefore, in practice, there may not be an opportunity to use this tool unless it is combined with relaxing height limits and other zoning constraints, which may not be feasible for many properties within a district. If the City does elect to go forward with an FAR program, our analysis would indicate that the program's key elements would be as follows:

- Program would apply to new construction projects that desire an FAR in excess of 9:1 to accommodate uses that are not exempt from the calculation of GBA for purposes of determining FAR;
- An additional 3.5 square feet of GBA would be permitted for every square foot of arts space provided by the project, provided that the developer is responsible for funding shell and core improvements for the arts space;
- Arts space users and the developer would self-certify that shell and core improvements of the arts space are being provided solely at the expense of the developer.

1% Arts Fee Options

Section 429.3 of the Planning Code requires all projects to dedicate and expend an amount equal to one percent of the construction cost of the building or addition as determined by the Director of DBI. Non-residential projects are required to expend up to \$750,000 of the required arts fee on the construction of on-site public art. Residential projects are permitted to construct on-site art or deposit the fee into a Public Artwork Trust Fund.

To assist in the development of arts space, we recommend that options for fulfilling the requirement be expanded. This tool would be effective for both new construction and renovation projects. The recommended options to consider are as follows:

- Expand the function of the Public Artwork Trust Fund to include funding shell and core construction costs for arts space. This would establish a funding source for arts space and provide the City with more flexibility to meet the City's greatest needs.
- Permit both non-residential and residential projects to satisfy the 1% arts fee requirement by depositing the fee into the Trust Fund. This provision would enable the City to accumulate sufficient funds to apply towards a target project.
- Permit both non-residential and residential projects to satisfy the 1% arts fee requirement by using the fee to fund the development of on-site arts space. The amount of arts space that the 1% fee would fund would depend on the specific development costs of each individual project. For example, a project on a 30,000 square foot site with a 9:1 FAR and construction costs approximating \$450 per square foot would have a 1% arts fee obligation of approximately \$1.2 million. This would be sufficient to fund the development of approximately 3,700 square feet of arts space.

Dedication of Portion of Incremental Property Tax Revenues Generated by New Development to Fund Arts Space

New developments will generate a significant amount of incremental property tax revenue to the City and County of San Francisco. If desired by the City, a portion of these revenues could be used to support the development of new arts space. Given the legal framework under which cities can assist new development, this tool would most likely be restricted to implementation through Development Agreements, but it could assist both renovation and new construction projects. One option to consider would be to provide a developer with a rebate of a set amount of property tax increment for every square foot of dedicated arts space that is incorporated in the project, subject to an overall cap. For example, the annual debt service to fund shell costs for each square foot of arts space approximates \$24.00. The City could agree to provide an annual property tax rebate up to \$24 per square foot of dedicated arts space for a period of 30 years, with the annual rebate to not exceed a specified percentage (say 20%) of the City's share of property taxes generated by the project. Under the example of the 30,000 square foot site with a 9:1 FAR and construction costs approximating \$450 per square foot, annual property tax increment would approximate \$1.2 million, with the City

receiving approximately \$693,000 per year. A 20% rebate cap would approximate \$139,000 per year, which would fund the annual debt service on approximately 5,800 square feet of arts space.

Another alternative would be for the City to annually elect to deposit a portion of property tax increment generated by new development in Central Market into the Arts Fund, which would be allocated to support new target projects.

Preliminary Findings and Recommendations

Based on the findings of the financial analysis as well as the program considerations described above, we believe that the most promising tools are as follows:

Potential Arts Incentive Programs

<i>Applicable to both New Construction and Renovation Projects</i>	<i>Applicable to Only New Construction Projects</i>
Permit 1% arts fee to be used to fund on-site arts space	Expand GBA exemptions of the zoning code to include rehearsal space and office space for arts tenants
Permit 1% arts fee to be deposited into a Fund that can be applied to arts space construction costs	Selectively grant additional FAR for projects with FAR >9:1. Bonus would approximate 3.5 square feet for every square foot of arts space.

Potential Application to 950 Market Street Project

Based on the information that we have received, it is our understanding that the 950 Market Street applicant is proposing a 446,000 square foot project, including 75,000 square feet of arts space on a 34,000 square foot site. The Developer is requesting that 100% of the arts space be exempt from GBA for purposes of calculating the project's FAR. With the exemption and other exemptions already permitted by code, the project's FAR is less than 9:1. This FAR is permitted by the zoning code with the purchase of TDRs for approximately 90,400 square feet of space. As proposed, the TDRs will be used for the economic uses of the project – not the arts space.

It is our understanding that under the applicant's financing plan, the cost to develop the 75,000 square feet of arts space would total \$58 million (excluding land). The arts group would be responsible for securing funding for \$46 million and \$12 million would be funded through new market tax credits (NMTC). Of the \$46 million, it is estimated that approximately \$35 million would need to be raised through contributions and \$11 would be debt secured by one of the non-profit arts entities.

The Developer's financial contribution toward the arts space appears to be limited to: 1) funding land acquisition costs; and 2) using \$12 million of NMTC proceeds to fund a portion of the construction costs of the arts space. The degree to which the application of the NMTC proceeds toward funding arts development costs represents a public benefit contribution by the Developer is unclear. If these funds could be raised by the project without an arts component, then they could be used to fund the development costs of the non-arts components of the project and one could make the argument that the funds are a financial subsidy being provided by the Developer. If, however, the project would not receive the NMTC funds without the arts space, then the funds are attributable to the arts space and should not be considered as a financial contribution by the Developer to the arts space.

It is our understanding that in addition to the GBA exemptions, the developer is requesting a reduction in the amount of TDRs that will need to be acquired and other fee exemptions. If it is determined that the allocation of NMTCs constitutes a financial contribution by the Developer to the arts component, then it is our preliminary opinion that some financial assistance is warranted. There may not be enough sources, however to off-set a \$12 million contribution. Based on our analysis of potential tools, an assistance package that could potentially be provided as follows:

<u>Form of Assistance</u>	<u>Value of Assistance</u>
1. Exempting the project from acquiring TDRs	\$2.3 million
2. Applying the 1% arts fee to on-site arts shell costs	\$1.8 million
3. Exempting the arts space from FAR	

If, however, the NMTC contribution is really generated by the arts component, then the Developer's contribution to the arts consists of providing free land, which can be compensated through granting an exemption of the arts space from the calculation of FAR.

Table 1
 Art Space Development Economics
 Central Market Arts District
 San Francisco

		Per GSF		
DEVELOPMENT COSTS		Office	Perf. Arts	Rehearsal
Direct Costs				
Shell Costs		\$220	\$220	\$220
Tenant Improvement Costs		\$80	\$900	\$500
Contingency	10.00%	\$30	\$112	\$72
Total Direct Cost		\$330	\$1,232	\$792
Indirect Costs				
Impact Fee Category		Office	Entertain.	Small Enterprise?
Required TDR Purchase		Yes	No	Yes
Application of Arts Fee		Applies	Exempt	Applies
Impact Fee Amount		\$27.80	\$45.43	\$18.95
TDR Cost		\$25.00	0	\$25.00
1% Arts Fee	1.00%	\$3	\$0	\$8
Other Indirect & Financing Costs	15.00%	\$49.50	\$184.80	\$118.80
Total Indirect Cost		\$105.60	\$230.23	\$170.67
Total Development Costs (excluding Land and Pkg.)		\$436.00	\$1,462.00	\$963.00
Excluding Tenant Improvement/FF&E		\$334.00	\$324.00	\$325.00