
Mercer Island Town Center

Ground Floor Use Restrictions and Bonus Height

May, 2016

Prepared for:
City of Mercer Island

DISCUSSION DRAFT REPORT

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Acknowledgments

For over 40 years ECONorthwest has helped its clients make sound decisions based on rigorous economic, planning, and financial analysis. For more information about ECONorthwest: www.econw.com.

ECONorthwest prepared this report to the city of Mercer Island.

That assistance notwithstanding, ECONorthwest is responsible for the content of this report. The staff at ECONorthwest prepared this report based on their general knowledge of land and development economics and on information derived from government agencies, private statistical services, the reports of others, interviews of individuals, or other sources believed to be reliable. ECONorthwest has not independently verified the accuracy of all such information, and makes no representation regarding its accuracy or completeness. Any statements nonfactual in nature constitute the authors' current opinions, which may change as more information becomes available.

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Summary

The City of Mercer Island is reviewing its development code and design guidelines for its Town Center Area. The Town Center zone is located at the northern end of the island and is the principal area for commercial and higher density housing on the island. Over the past year, the city has embarked on an extensive review of the area's future land use, zoning, and design guidelines in an effort to align community desires with city policy. The city has contracted with ECONorthwest to review two elements of the planning:

- Ground floor use requirements in Town Center zones
- Bonus height provisions in Town Center zones

Retail Market Conditions

Retail demand in Town Center has historically been oriented at “neighborhood” scale commercial uses aimed at primarily serving local demand for retail and services. In comparison to other “town centers” in the region that have demand from larger market areas (e.g. not geographically constrained to island residents), those retail centers have performed better in terms of productivity (rents charged) and occupancy. That said, Mercer Island Town Center is a “healthy” environment that has shown resilience through the recession but whose growth has been limited primarily to personal consumption growth of only on island residents.

Population growth of 700 to 900 individuals (a rough estimate of planned growth in Town Center by 2030) could generate between \$3.6 and \$4.7 million in additional captured-demand for retail sales in Town Center. In practical terms, one can think of with future population growth in Town Center being able to support in the range of additional 3-5 small to mid-size retail businesses on the island, most likely all in the Town Center vicinity. The additional residents, buildings, and the high quality pedestrian environments (that would come with new development) would also provide a more robust customer base and physical setting that cumulatively contribute a more vibrant retail environment in Town Center the benefits current and future island businesses and residents.

Ground Floor Use Restrictions

The Town Center planning process has recommended changes to ground floor requirements that regulate use (i.e. retail, restaurant, office, services, personal services, etc.). Streets are currently categorized as Type 1 place restrictions on the relative distribution of uses along the street front.

While it is difficult to assess the exact degree use restrictions have had on Town Center, there is likely enough evidence that the use restrictions are not producing

their intended purpose; and, may be introducing unintended consequences. Consider the following:

- Town Center's retail spaces are generally well occupied and productive, but the area has not seen robust growth in sales. When aggregate demand is a challenge, explicit supply-side controls are not likely to be an effective policy tool.
- There is no evidence-based practice that these use restrictions are effective at activating ground floor uses and producing better performing retail environments.
- There are higher vacancies in restricted buildings. While correlation does not confer causation, there is some evidence in the increased vacancies of restricted versus non-restricted buildings that it might make them harder to lease.
- There is evidence of "tax avoidance" behavior. The use restrictions could be seen as an "effective tax" where it creates an incentive to avoid paying the "tax". The allowance for use of public parking to lower the retail restriction down from 60% to 40% on a property might be seen as a way owners are trying to avoid conforming to the use regulation, or at least, a sign that the use restriction is burdensome.

Bonus Height Provisions

The Town Center planning process has also recommended changes to the incentive program that grants additional height and floor area in exchange for the provision of a range of public benefits and amenities (referred to as the bonus height program). The mandatory and elective provisions vary by the height of the project and base zoning.

ECONorthwest conducted a preliminary strategic review of the January 2016 interim Development and Design Guidelines from the Joint Commission. A summary of that assessment is currently contained in this draft report. The April 22 Joint Commission recommendations to the bonus height program are currently under review.

However, a review of the draft January guidelines showed that the current bonus height provisions provided no financial benefit to deliver affordable housing and public plaza/open space benefits in exchange for heights over two stories.

- On smaller lots (20,000 square feet and less) at current construction costs and rents, the TC zoned mixed-use projects have to trade-off install parking for retail uses relative to building mass (larger site utilization means expensive structured and/or underground parking relative to cheaper surface parking). The result is to select surface parking and

smaller and smaller building footprints, thus minimizing the amount of building space.

- The plaza and step back requirements further eat into the envelope and the economies of scale start to move away from the project when it accesses the bonus height. In cases in TCMF zones where ground floor housing is allowed, less parking is required (and that parking can generate revenue where currently there is no market for paid private retail parking) so project performance improves.
- Larger sites in both the TCMF and TC zones perform better at larger scale. In these projects, there are economies of scale because they can be more efficiently parked. Further plaza and step back requirements don't restrict building envelope as much and don't impact building performance as much.

A variety of sensitivity analyses examining the role of rent growth, construction cost decrease, affordable housing, and plaza space were conducted. In summary, the following observations are offered with regard to the sensitivity tests:

- At current market rents and construction costs:
 - Parking is a large driver of project performance, thus a decrease in required parking (to efficient market rates) will drive the provision of public benefits through participation in the bonus height option.
 - Consider the feasibility of offering a buy-out option (or fee-in-lieu) for smaller sites.
 - Step backs can be relaxed as an easier means to create more bonus height value for the development.
 - Affordable housing works best at 60% AMI at 10% set-aside amount.
- In a world where rents increase faster than today's construction costs:
 - A decrease in parking requirements will drive stronger uptake of the public benefits in the bonus height.
 - Relaxing the step backs creates more bonus height value to the development and delivers more of the public benefits.
 - It is likely the city can target deeper AMI in the affordability or greater set-aside, not likely both.
 - Consider the feasibility of offering a buy-out option (or fee-in-lieu) for smaller sites.

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1 Introduction

1.1 Background and Work Program

The City of Mercer Island is reviewing its development code and design guidelines for its Town Center Area. The Town Center zone is located at the northern end of the island and is the principal area for commercial and higher density housing on the island. Over the past year, the city has embarked on an extensive review of the area's future land use, zoning, and design guidelines in an effort to align community desires with city policy. The city has contracted with ECONorthwest to review two elements of the planning:

- Ground floor use requirements in Town Center zones
- Bonus height provisions in Town Center zones

These elements and ECONorthwest's approach are discussed further below.

1.2 Review and Assessment of Ground Floor Use Requirements

The scope of work for this project included the following elements and considerations:

Understanding: The Town Center planning process has recommended changes to ground floor requirements that regulate use (i.e. retail, restaurant, office, services, personal services, etc). Based on conversation with city staff, the requirements were put into place many years ago to "activate" the ground plane with more active uses (with the presumption that "retail" uses would provide more activity than "office" uses). Streets are currently categorized as Type 1 or Type 2 with the relevant restrictions applying to Type 1 streets (see exhibit below for location of street types):

- **Peer comparisons:** Brief review of other city-town centers experience with limiting retail and services uses.

1.3 Review and Assessment of Bonus Height Program

The Town Center planning process has also recommended changes to the incentive program that grants additional height and floor area in exchange for the provision of a range of public benefits and amenities (referred to as the bonus height program). The mandatory and elective provisions vary by the height of the project and base zoning. The following exhibit shows the geography and zoning configurations from a January 2016 Joint Commission document on which the analysis is based.

TC5 Zone

- Base stories: 2
- Bonus stories: 5

TC4 Zone

- Base stories: 2
- Bonus stories: 4

TC3 Zone

- Base stories: 2
- Bonus stories: 3

TCMF-4 Zone

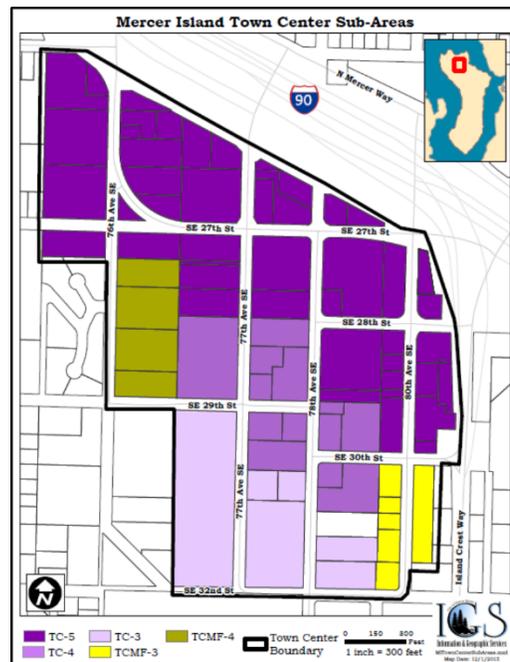
- Base stories: 2
- Bonus stories: 4

TCMF-3 Zone

- Base stories: 2
- Bonus stories: 3

Exhibit 2. Town Center Draft Zoning (January 2016)

Source: City of Mercer Island



To assess the potential of different development incentives, ECONorthwest analyzed the impacts of various incentives and requirements on development feasibility and financial return. Specifically, this work included:

- **Framework for bonus height (more commonly known as incentive zoning) programs:** This assessment provided the background on how incentive zoning programs function. Items discussed include development product types and construction costs, base and incentive zoning, public benefit valuation, incentive zone valuation, market dynamics, and implementation mechanisms. Establishing this framework is necessary to advance assessments and trade-offs of proposed changes.

- **Economic Assessment:** The development economic analysis tested the base financial performance of building prototypes under the proposed changes and the impact of elective public benefits such as affordable housing, increasing the availability of public open space, and other community benefits as identified in the Town Center planning on development feasibility of projects.
- **Assessment:** This included the evaluation and assessment of the impacts of the proposed incentive zoning changes. The work would include (currently in progress) recommendations for revising the development code that could include changes to base and incentive height/FAR, mandatory vs. elective incentive provision, and structure and pricing of incentives and public benefits.

2 Town Center Ground Floor Restrictions

2.1 What are the local commercial conditions in Town Center?

The following set of charts assess the past trends and current performance of Mercer Island and Town Center to better understand to the context for ground floor use restrictions in the Town Center development and design code. The brief assessment examines changes in fundamental demand driven by population and employment in the area and how those drivers impact the fundamentals of price and supply for commercial real estate.

Population growth and household income are the primary drivers for the demands of local goods and services. As the demand for local goods and services increases, new retail and commercial buildings are needed to accommodate the growing demand. On these measures, Mercer Island has lagged behind growth in the in the region and in comparison to other jurisdictions. However, due to the higher household incomes of people on the island, it has been able to support demand for retail and services.

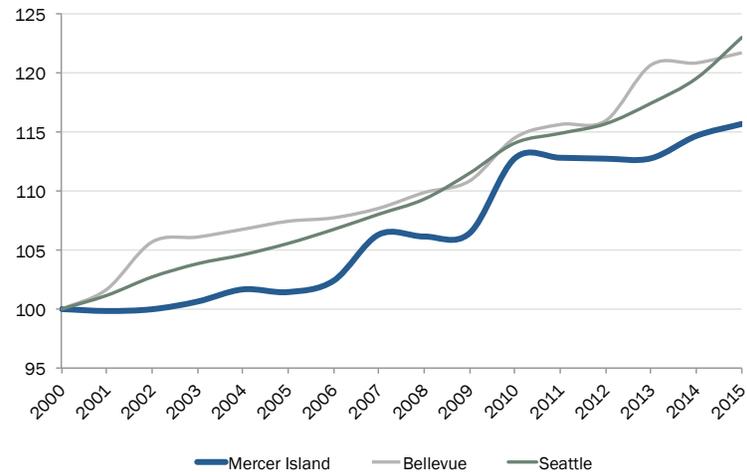
That demand has historically been oriented at “neighborhood” scale commercial uses aimed at primarily serving local demand for retail and services. In comparison to other “town centers” in the region that have demand from larger market areas (e.g. not geographically constrained to island residents), those retail centers have performed better in terms of productivity (rents charged) and occupancy. That said, Mercer Island Town Center is a “healthy’ environment that has shown resilience through the recession but who growth has been limited primarily to personal consumption growth of only on island residents.

Mercer Island population growth has lagged its closest neighbors

Population has grown dramatically in the region since 2000. The chart shows percent growth indexed to the year 2000. While not at the scale of its two larger neighbors, indexed population growth on Mercer Island has not moved as fast as Seattle and Bellevue.

Exhibit 3. Percent Population Growth, 2000-2015 Indexed to 2000 = 100

Source: Washington Office of Financial Management

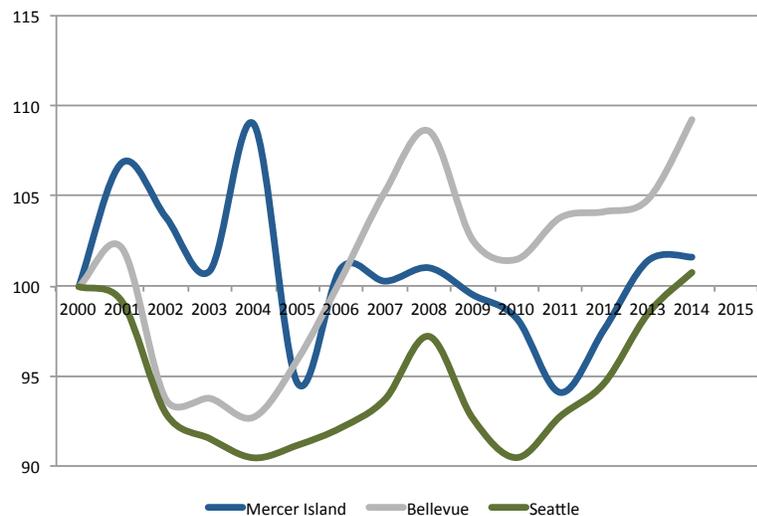


Mercer Island employment levels are below the pre-recession high

Employment on Mercer Island is still below its pre-recession high. However, the island has shown positive, robust growth in the past few years.

Exhibit 4. Percent Employment Growth, 2000-2014 Indexed to 2000 = 100

Source: Washington Office of Financial Management



Mercer Island has a comparable demographics to other “town centers”

Mercer Island has comparable demographics to places with similar suburban “town centers” or “main streets” (i.e. less intensely urban places that mix housing and commerce) that. The chart summarizes characteristics within three miles of the respective center. Mercer Island has large surrounding population base and household purchasing power. However, the island nature of Mercer Island and transportation challenges hamper access to surrounding markets.

Exhibit 5. Demographic Comparisons Within Three Mile Radius, 2015

Source: US Census and CoStar

	Mercer Island Town Center	Edmonds Downtown	Kirkland Downtown	Bellevue Main Street
Total Population 2015	73,849	70,226	111,119	88,886
Number of Households	32,756	29,647	47,878	43,726
Median HH Income 2015	\$101,527	\$68,588	\$97,347	\$95,424
Avg HH Size	2.25	2.37	2.32	2.03

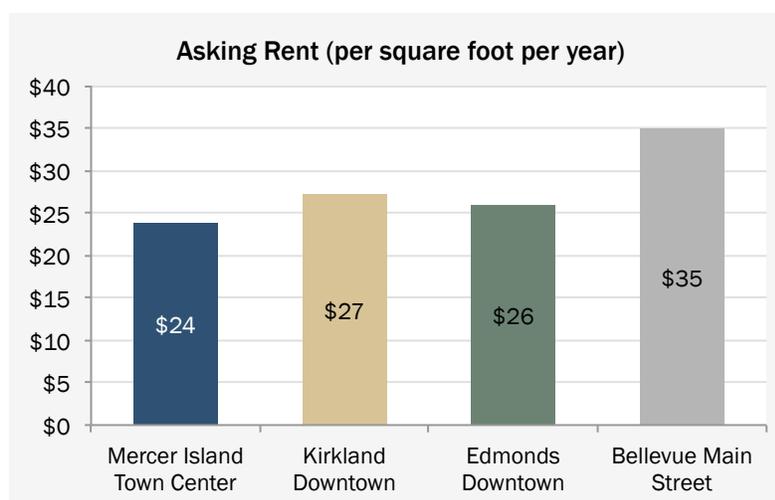
Retail rents are less competitive than other centers

Asking rents for retail on Mercer Island are comparable to other centers with exclusion of Bellevue. Asking rents have been flat (inflation adjusted) over the past decade. Centers in Bellevue and Kirkland have rents growth outpacing Town Center in recent years.

Exhibit 6. Asking Rents for Retail, 2016

Source: CoStar

Note: Rates are quoted on a per square foot (SF) and annual basis.

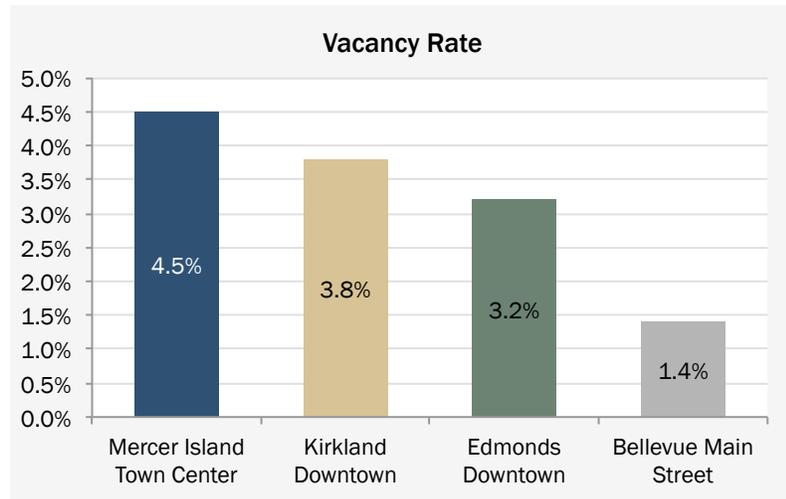


Retail occupancy is softer in Town Center

Overall, Town Center is fairly well occupied (5% vacancy is a good rule for a subarea.) However, these rates are not as tight other comparable centers that send signals that new investment is warranted.

Exhibit 7. Retail Vacancy Rates, 2016

Source: CoStar



Office rents are comparable to other centers

Asking rents for office on Mercer Island are comparable to other centers. Rents have been flat over the last 15 years (inflation adjusted); however, rents are still below their pre-recession highs.

Exhibit 8. Asking Rents for Office, 2016

Source: CoStar

Note: Rates are quoted on a per square foot (SF) and annual basis.

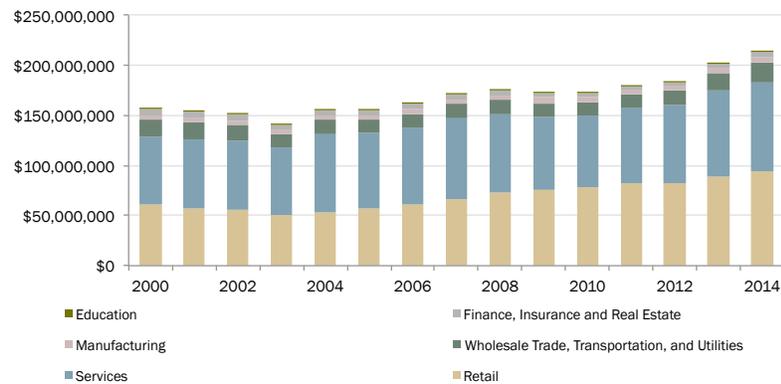


Retail sales are growing on Mercer Island

Real taxable retail sales on Mercer Island have grown. Meaning, the amount of goods and services consumed on the island have shown solid growth over the past 15 years. The rate of consumption has increased in the last few years and the regional economy has recovered. The majority of sales are generated in the retail and services sectors which are comprised of mostly the sale of goods, restaurants, and personal service outlets.

Exhibit 9. Taxable Retail Sales (inflation adjusted), 2000-2014

Source: Washington State Department of Revenue

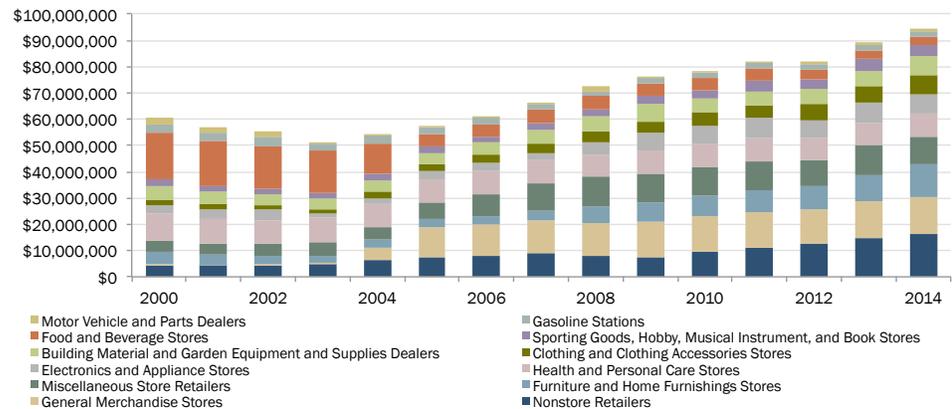


E-commerce is driving retail sales on the Mercer Island – part 1

E-commerce (non-store retailers in the chart), home furnishings, and health and personal care (typically drug and personal care stores) are driving growth in sales for retail goods on Mercer Island.

Exhibit 10. Selected Retail Sales Sectors (inflation adjusted), 2000-2014

Source: Washington State Department of Revenue



E-commerce is driving retail sales on the Mercer Island – part 2

Adjusting Mercer Island's retail sales by the Washington State sector per capita average allows one to normalize the data and provide a rough proxy for market size (not necessarily in geographic reach, but in sheer scale). The chart to the right illustrates the strength of the e-commerce market for retail goods in Mercer Island. In other words, e-commerce spending is equivalent to approximately 80,000 Washingtonians; roughly four times the population of the island.

Exhibit 11. Per-capita Adjusted Sales Reach, 2014

Source: Washington State Department of Revenue

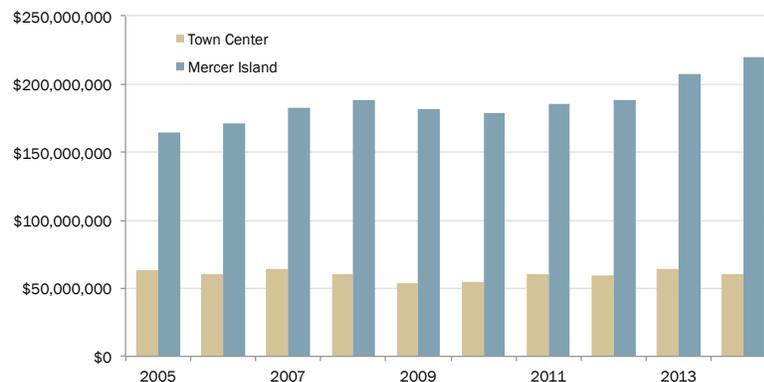


Town Center accounts for a declining fraction of retail sales on Mercer Island

While retail sales are growing on the island, Town Center retail sales have been: 1) declining as a share of total retail consumption on the island, and 2) have been essentially flat for the past decade. Much of the growth in Mercer Island taxable retail sales have been in e-commerce and health/personal care sectors.

Exhibit 12. Taxable Retail Sales Comparison (inflation adjusted), 2005-2014

Source: Washington State Department of Revenue

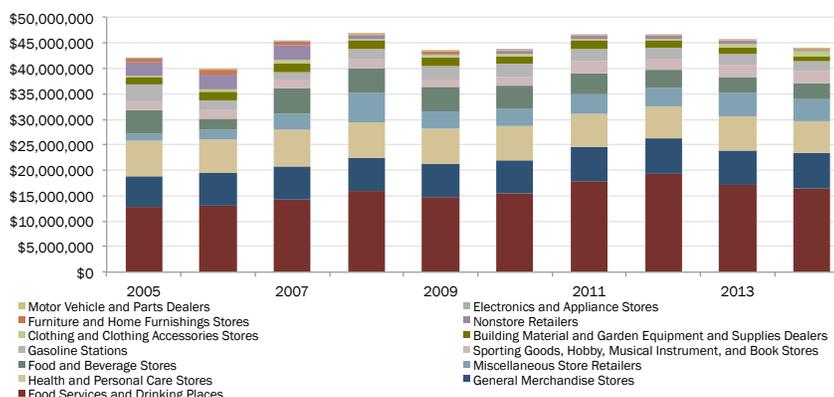


Food and beverage services account for over a third of Town Center sales

Food service and drinking places (e.g. restaurants, fast food, and bars) anchor the sales base in Town Center.

Exhibit 13. Town Center Taxable Retail Sales Breakdown (inflation adjusted), 2005-2014

Source: Washington State Department of Revenue



2.2 How might future residential growth support Town Center retail uses?

Broadly, demand for additional retail sales in Town Center will be driven from consumption growth from residents and employees from islanders and visitors. Future population growth from increases in housing will provide a needed boost to consumer demand for neighborhood scale commercial uses (i.e. retail goods, food and beverage services, personal services, etc.) and support a more vibrant Town Center retail base.

Based on current per-capita adjusted retail productivity rates (about \$5,200 per capita in 2014) for Mercer Island residents, population growth of 700 to 900 individuals (a rough estimate of planned growth in Town Center by 2030) could generate between \$3.6 and \$4.7 million in additional captured-demand for retail sales in Town Center. This is a planning level estimate meant to approximate future conditions and not a forecast.

While not all future demand will translate into the occupation of net new retail spaces, a simple metric would equate the above new captured demand at roughly 12,000 to 15,000 square feet of supportable retail (assuming \$300 sales/square feet). In practical terms, one can think of with future population growth in Town Center being able to support in the range of additional 3-5 small to mid-size retail businesses on the island, most likely all in the Town Center vicinity. The additional residents, buildings, and the high quality pedestrian environments (that would come with new development) would also provide a more robust customer base and physical setting that cumulatively contribute a

more vibrant retail environment in Town Center the benefits current and future island businesses and residents.

Why regulate ground floor use in Town Center?

The Town Center planning process has recommended changes to ground floor requirements that regulate use. Based on conversations with city staff, the requirements were originally put into place to “activate” the ground floor with more active uses (with the presumption that “retail” uses would provide more activity than “office” uses. Following that logic, it was presumed the activation of the ground floor uses would create a more “vital” and productive retail environment in Town Center.

The restrictions were amended in 2013 to provide more flexibility if public “walk-off” parking was provided, lowering the minimum requirement for retail uses from 60% to 40% of the total leasable ground floor street frontage of a building.

Land use regulations are typically enacted to correct for some market failure. Market failures are conditions where the quantity of a product demanded by consumers does not equate to the quantity supplied by suppliers. Correcting for market failures is chief reason to regulate the resulting inefficiency where people can be made better off without making other people worse-off.

The implicit reasoning behind the Town Center ground floor restrictions is that demand from non-retail uses would out-compete retail uses, thereby creating a sub-optimal retail environment (e.g. non-activated ground floors). The cumulative effect of this would be a retail environment not in-line with community preferences and the vision for the Town Center. However, attempts to correct for perceived failures may introduce unintended consequences where either the initial market failure is not corrected or impacts to residents, businesses, and property owners are created.

2.3 What might the unintended consequences look like?

The ground floor restrictions were designed to artificially create a built in supply for retail uses within newer mixed-use buildings on Type 1 streets. This presumed that non-retail uses would out-compete retail uses for space. If indeed this were true, setting the supply at lower than the market-clearing price for commercial space might produce non-desirable outcomes such as:

- Commercial spaces rented out to lower “productive” retail.
- Increased vacancies where the demand for retail does not exist and the increased financial cost on property owners.

- Imposes a “cost” on residents where they might not be able to access the non-retail services that they are demanding in the Town Center and may have to travel off-island to satisfy.
- Damages overall retail environment through a combination of lower productive commercial space and vacancies.

2.4 How have the ground floor restrictions impacted buildings?

The ground floor restrictions have been in places for some time. Azose Commercial Properties assisted ECONorthwest in conducting an inventory of Town Center ground floor leasing occupancy status and use. This allowed a comparison of restricted and non-restricted buildings. From this, it is clear that the occupancy characteristics in restricted and non-restricted buildings differ.

Ground floor vacancies are higher in restricted buildings

Vacancy rates surveyed by the commercial real estate data firm CoStar have retail vacancies at 4.5% in Town Center. Azose commercial properties custom survey estimates the vacancy rate closer to 3.7%. However, it finds that the vacancy rate in restricted buildings is almost six times the rate in non-restricted buildings. While the comparison does not adjust for individual or spatial characteristics, the higher rate in the restricted buildings is pronounced in the Town Center.

Exhibit 14. Town Center Vacancy Comparison

Source: CoStar, ECONorthwest, and Azose Commercial Properties
Note: Survey conducted in March 2016.

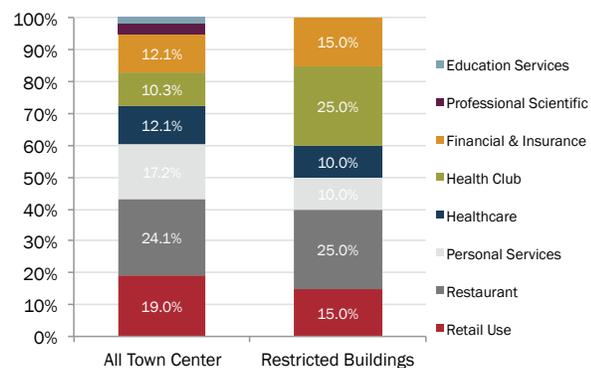
Source	Vacancy Rate
CoStar TC Retail Spaces	4.5%
Azose TC Retail Spaces	3.7%
<i>Restricted Buildings</i>	12.0%
<i>Non-Restricted Buildings</i>	2.4%

The tenant mix differs in restricted buildings

The tenant mix differs from restricted and non-restricted buildings. The biggest difference is in higher percentage of health clubs in restricted buildings. Buildings allowing public parking can count personal services (health clubs) toward their 60% requirement for retail uses. This suggests that property owners have an incentive to meet the restrictions through the flexibility offered through the public parking provisions. In other words, they have worked around the 60% requirement for retail uses.

Exhibit 15. Town Center Tenant Mix Comparison

Source: CoStar, ECONorthwest, and Azose Commercial Properties



2.5 Real estate professionals perspectives on commercial ground floor restrictions

ECONorthwest interviewed two prominent commercial real estate brokers familiar with Mercer Island and other proximate retail centers to understand the how the use restrictions are affecting retail leasing.

Finding retail oriented businesses to fill commercial spaces is more challenging in Mercer Island for a number of reasons. First, Mercer Island's retail market is primarily oriented towards island residents and has a limited demand for retail oriented businesses. Second, they noted that the retail market is changing rapidly. Small-scale retailers are facing increasing competition from online shopping and warehouse stores. As a result, retailers have shifted to target more high-end or value-oriented customers. In addition, retailers are looking to shrink their total square footage footprint of the space they are leasing. These baseline challenges are accentuated in the restricted buildings.

Overall, the brokers' take-away was that the rules makes it more difficult to lease retail spaces in affected buildings, which has resulted in higher vacancies in those buildings. The brokers noted that the portions of the spaces that allow office or personal service oriented business are able to find tenants for those spaces relatively easily. Landlords are also filling spaces restricted to retail uses with fitness and spa tenants because they count as "retail" under the current rules. Property owners are also reluctant to lower rents to fill the retail space because they don't want to have to lower rents for current tenants when they renegotiate leases.

2.6 What can be learned from other jurisdictions that regulate ground floor uses?

ECONorthwest surveyed the professional literature and networks to identify jurisdictions that regulate ground floor use in a proscriptive fashion similar to the existing Mercer Island Town Center zoning. The focused survey revealed that these use restrictions are not commonly used for ground floor uses. It also surfaced the city of Milwaukie, OR had some experience that might be portable to the Mercer Island context. Milwaukie is a southwestern suburb of Portland with a population of roughly 20,000 people.

In the early 2000s, the city embarked on series of downtown planning meant to align resident interests for a thriving downtown center. The resulting zoning and design guidelines put in place proscriptive use regulations that regulated use by downtown zone. These rules were put into place to create a more vibrant downtown. In the subsequent years, downtown merchants and property owners struggled to fill buildings and attract new investment.

By 2009, city leadership convened a planning process, dubbed “Moving Forward Milwaukie” to revisit and revise existing plans, zoning, and design guidelines. Specifically, the process recommended changes to the ground-floor retail requirements/restrictions. In portions of downtown, City code required ground floor uses to be either retail or eating/drinking establishments. In other portions of downtown, city code prohibited individual retail and eating/drinking establishments from being more than 5,000 SF. While in many cases properties might be able to work within these code restrictions, more often, the restrictions acted as an obstacle to new development by eliminating flexibility for properties to choose what ground floor uses are most feasible in the marketplace. The resulting plan chose to regulate the design of the ground floor rather than the uses. It included enhancing the pedestrian environment and better design guidelines for the ground plane in buildings.

2.7 Should ground floor use restrictions be maintained or revised?

There is not irrefutable evidence to suggest that the ground floor restrictions are having a strong impact one-way or another on the Town Center retail environment. However, a preponderance of the evidence suggests that the regulation is not producing the outcome it originally was intended for and might be creating some unintended consequences. That assessment is reached under the following observations:

- There is **no evidence-based practice** that these use restrictions are effective at activating ground floor uses and producing better performing retail environments. The professional planning literature does not have much practical or evidence-based guidance that use restrictions are an effective tool at promoting vibrant retail environments. Further, this approach is not widely used by local governments and the only instance ECONorthwest could find of a jurisdiction using similar use restrictions was less than self-recommending. Most practical guidance from retail and planning professionals tends to stress the need to create great physical environments along the ground plane accomplished through design guidelines and programming flexibility that can respond to changing market conditions.
- Use restrictions **are blunt tools** to deal with retail performance. The retail environment is constantly changing as evidenced by the growth in e-commerce. Land markets tend to be fairly efficient in that they allocate supply to where the demand exists. For a fairly closed and local serving marketplace like Town Center it means that demand is driven by island residents and restrictions that regulate the supply might impact the availability of services or employment that would otherwise benefit island residents.

- The Town Center **retail performance has been flat** for the past decade. Taxable retail sales and real rent performances in Town Center have been stagnant. The reasons for this are complex but suggest that the measures that regulate the supply side of the commercial real estate equation will likely not have as great an impact as measures that support more overall aggregate demand for retail uses.
- There are **higher vacancies in restricted buildings**. While correlation does not confer causation, there is some evidence in the increased vacancies of restricted versus non-restricted buildings that it might make them harder to lease. The simple crosstab presented above in Exhibit 14 combined with the anecdotal observations of leasing professionals should suggest to policy makers to seriously consider whether the restrictions are imposing “costs” on those properties and whether those costs are producing the benefits they were designed to achieve.
- There is **evidence of “tax avoidance” behavior**. The use restrictions could be seen as an “effective tax” where it creates an incentive to avoid paying the “tax”. The allowance for use of public parking to lower the retail restriction down from 60% to 40% on a property might be seen as a way owners are trying to avoid conforming to the use regulation, or at least, a sign that the use restriction is burdensome.

3 Bonus Height Provisions

The City of Mercer Island is engaged in a review of regulations that guide Town Center development and land use activity, particularly looking at opportunities to revise the current Bonus Height Provisions. These provisions provide the opportunity to tie higher allowable building heights and greater floor area to the provision of public amenities. The current incentive system is a key land use regulation used to support the Town Center development.

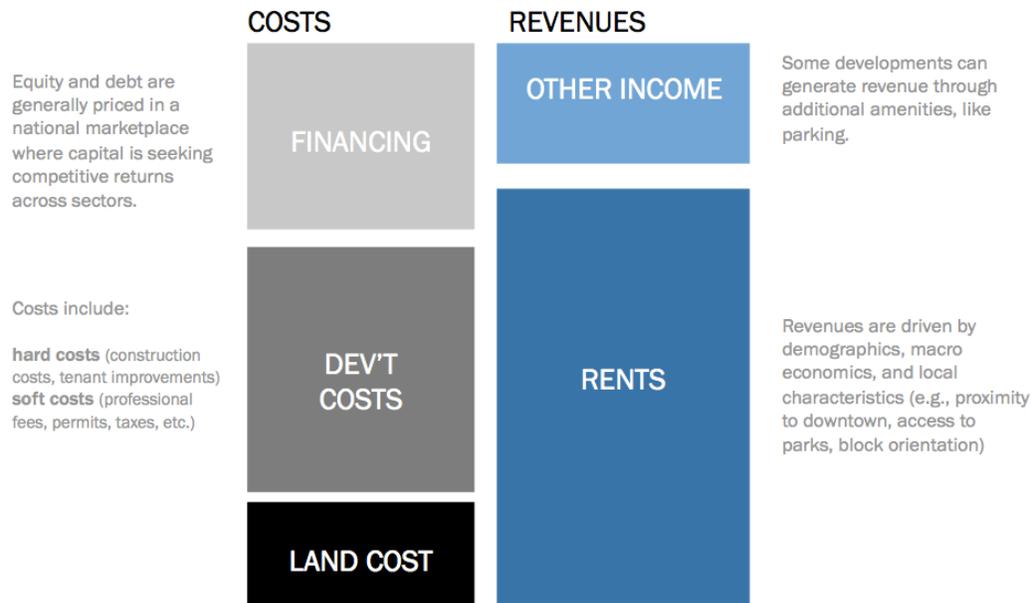
3.1 What are bonus height programs?

Bonus height programs, more commonly known as incentive zoning is a voluntary program in Washington that offers property owners the option of obtaining an increased intensity of development over existing limits. To obtain the bonuses, developers must provide stipulated types of improvements or other public benefits as proscribed by a jurisdiction's program. Importantly, there must be demand to exceed the base zoning. Incentive zoning is a voluntary program and the value of the incentive should seek to induce, rather than discourage, participation.

3.2 How do bonus height provisions impact the development economics of real estate?

Incentive zoning (bonus height) policies exist to leverage new market rate development for the production of affordable housing and other public amenities. These policies can **only** work when new development is occurring. At its' most simple level; development happens when developers have the resources for development and when project profitability is higher than alternative investments. Several factors drive the development equation, as shown in the following Exhibit.

Exhibit 16. Development Costs and Revenues: Proforma elements



Development feasibility varies across markets based on a convergence of the above factors. In weak markets, most development is infeasible due to the inability to achieve high enough rents to justify new construction. In moderately strong markets, low to mid density development is feasible. In strong markets, higher density development is feasible due to high achievable rents and land costs driving increased densities.

Predicting whether a developer will accept the proposed height incentives (and which incentives offer the best financial returns) requires an analysis that reflects the developer's decision-making process and cash flow equation. Would the additional density create more value than the cost of construction and operations of the public amenity required? If not, a developer is unlikely to accept the additional density, and may choose to just develop to the base zoning instead (or to not develop at all). The purpose of this analysis is to summarize the results of our evaluation and provide implications for the City as it moves towards implementation of revised Town Center zoning and other similar policies.

ECONorthwest, together with MapCraft, our partner software development and real estate firm, created a financial pro forma model to test the value of the height bonuses among developers in achieving the goals of creating new affordable housing and open space. The model tested millions of permutations of market inputs, building configurations and density, bonus configurations, and other variables to predict which development types would offer the greatest financial returns based on the take-up of the bonuses. Compared to standard methods, our approach to pro forma analyses is a more thorough testing of development options. There are numerous inputs into financial pro forma real estate assessments and, using standard tools like Excel spreadsheets, it is only

reasonable to manipulate a relatively small number of inputs to test the implications of variations in supply-side and demand-side alterations relative to a base case scenario.

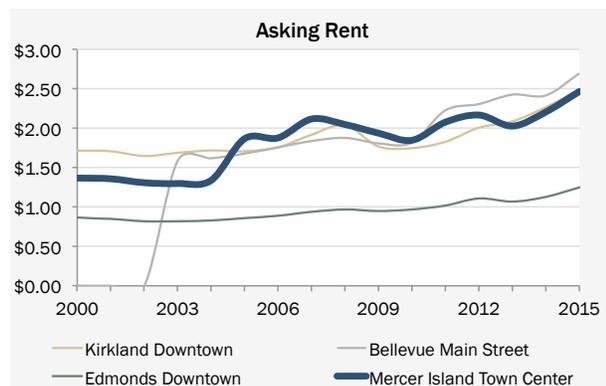
Our computational approach allows a standard pro forma to be translated into fast running scripts that can be varied to produce millions of permutations to conduct sensitivity analysis and determine the optimal financial performance. Our custom models allow users to test real estate investment proposals that vary in scale and scope (for example, different building heights and ground floor use mixes) under different market realities (for example, varied construction costs and achievable rents) while constrained by local policies (for example, zoning restrictions and parking requirements). See Appendix A for a fuller description of the modeling process and our assumptions.

3.3 What are the housing rent trends in Town Center?

Housing rents are climbing in Town Center

Asking rents for rental housing in Town Center average about \$2.50 per square foot. Since 2000, rents have grown an average of 4% a year (nominal terms). These trends have mirrored other close in urban centers in the Puget Sound Region. Reported vacancy rates in buildings are also tight at 3% of leasable inventory (generally, anything lower than 5% is sign that demand is outstripping supply). A quick survey of available units in building built after 2000 showed an average rental rate of \$2.75 per square foot with maximum rates of \$3.19 per square foot.

Exhibit 17. Town Center Tenant Mix Comparison
Source: CoStar, ECONorthwest



3.4 What bonus height provisions were analyzed?

This section provides an overview of the proposed height bonuses and incentives under consideration. Based on conversations with city staff, our team worked to narrow the list to two candidate public amenities: (1) affordable housing and (2) plaza/open space. The parameters for these proposed height bonuses are described in Exhibit 18 in terms of additional stories of development granted. Exhibit 19 summarizes the conditions analyzed to inform conversations amongst the Joint Commission based on their draft January 2016 Town Center development and design guidelines. Please note that ECONorthwest is revising its analysis to evaluate the April 22 Joint Commission recommendations to the City Council.

Exhibit 18. Bonus Height Structure by Zone

Zone	Base Zone Height	MAX Height with Bonus
TC-5	2	5
TC-4	2	4
TC-3	2	3
TCMF-4	2	4
TCMF-3	2	3

Exhibit 19. Overview of modeled requirements of interim Joint Commission proposals (January 2016)

Category	Variable	Proposed requirements as modeled in this analysis
Development Types	Use	Modeled housing only, office, and mixed use with ground floor retail.
	Scale	Modeled development on 20,000 and 50,000 square foot lots.
Base Zoning	Zones	TC-5, TC-4, TC-3, TCMF-4 TCMF-3
	Parking Req.	Modeled parking requirements per building use: 3 stalls per gross square foot for retail/office. 1 stall per unit for residential.
	Façade Step back	Modeled 10 foot step back per story.
Affordable housing	Bonus Provision	10% of the bonus square footage must be dedicated to affordable housing units to achieve additional height allowed with the bonus.
	AMI Targets	60% and 80% AMI. Ownership units were not modeled for this exercise.
	Unit sizes	Assumed a proportionate mix of unit sizes in the units allowed in the bonuses area (including for affordable units)
Plaza/Open Space	Bonus Provision	A single plaza shall be a minimum size equal to three percent of the gross floor area of the development, but not less than 4,000 square feet in area. The plaza shall be at least 20 feet in width.

3.5 How is financial impact of bonus provision measured?

To assess the financial feasibility of each development and the bonus incentive, ECONorthwest conducted a financial analysis of each development prototype across zones. The outputs estimate the total cost to construct the project and compares it to total value of the development when complete (i.e. how much the development could be sold for in the local market). The value of a project is based on how much income (in the form of rental revenue) the project can generate each year and the assumed rate of return for the development when sold.

Specifically, the analysis used a residual land value approach for the analysis. A residual land approach calculates the full cost to construct the project, including

the developer's desired profit, but excludes the cost of purchasing the property. The difference between the total value and total costs excluding the property (or residual land value) indicates how much a developer would be willing to pay for the property. Exhibit 20 shows the equation for calculating the residual land value.

Exhibit 20. Development Equation – Understanding Residual Land Values

+ Project Value (Sale price when finished)

- Project Costs

- Site Preparation
- Design, Permits, etc.
- Construction
- Parking
- Infrastructure (road, stormwater, etc.)
- Operation & Maintenance
- Profit (return on cost)

= Residual Land Value

(Amount can pay for land and achieve expected financial return)

Source: ECONorthwest

If the residual land value is close to the current market price for the property, the project is likely feasible. If the residual land value is negative, the project does not generate enough income to turn a profit and is not feasible.

3.6 How to interpret residual land metrics?

For this analysis, residual land values (RLV) should be viewed as normalized metric for evaluating how a development performs between the base zoning and the bonus height zoning. Decreases in RLV from the base to bonus zoning should be viewed as a decrease in the financial incentive to access the bonus height and deliver the public benefits. It should be noted that decreases in RLV do not mean a project would not be “feasible”. It is difficult to understand the idiosyncratic characteristics of owners, investors, and developers from property to property and there are instances where less financial gain in the bonus zone might not keep a project from going forward. For example, a property owner might have a very low basis in the land and be able to carry a lower return on investment. Regardless, public policy should weigh the structure of the program against its intent: to deliver concurrent development projects and public benefits.

3.7 How do the draft bonus height provisions perform?

To test the sensitivity of findings to different market conditions, we created two scenarios:

- Mid scenario (current average market conditions) where market rents for housing are \$2.75 per square feet for apartments and \$25 per square feet rents (NNN) for retail and office uses.
- High scenario (assumes future revenue growth) where market rents for housing are \$3.00 per square feet for apartments and \$30 per square feet rents (NNN) for retail and office uses.

Based on this modeling, development in feasibility in Town Center is tilted in the following directions:

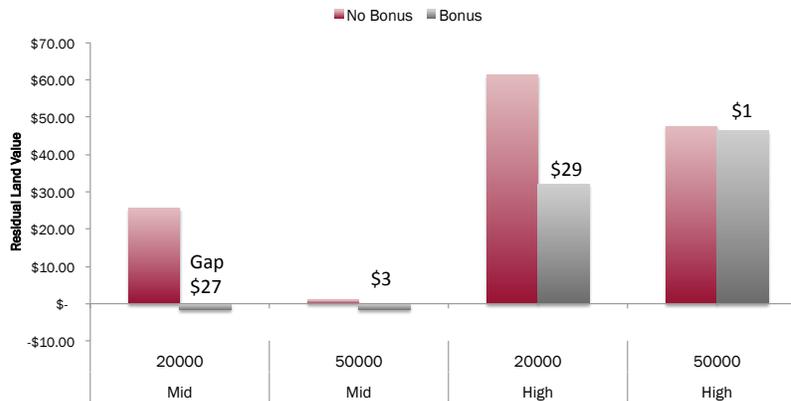
- Mixed-use residential is generally preferred to office in all scenarios across TC subareas where office is allowed.
- Office is preferred in the high and mid scenarios in the base zoning in TC-3, TC-4 and TC-5 for 50,000 square foot lots.
- Office is not attractive in any bonus height configuration in all TC subareas in 50,000 or 20,000 square foot lots in the mid and high scenarios.

No financial incentive for bonus use in TCMF Zones

Under the proposed January Joint Commission draft examining zoning, parking, and bonus height provisions, there is little financial incentive for bonus use in the TCMF zones. 20,000 square foot lots are closer to market feasibility with a higher rent profile. 50,000 square foot lots have a smaller gap between than 20,000 square foot lots.

Exhibit 21. Comparison of RLVs in Bonus Height in TCMF Zones

Source: ECONorthwest

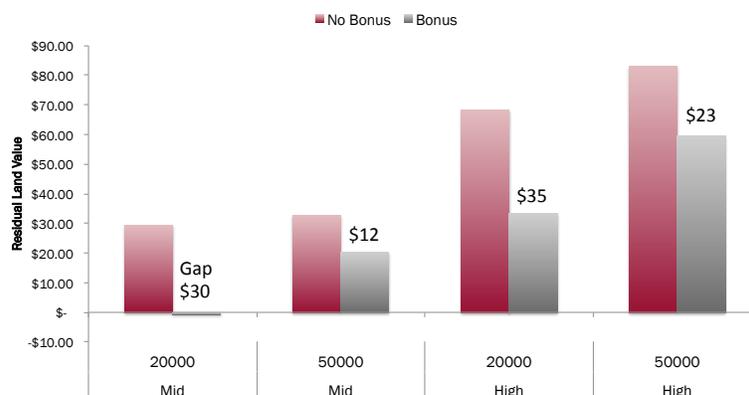


No financial incentive for bonus use in TC Zones

Under the proposed January Joint Commission draft examining zoning, parking, and bonus height provisions, there is little financial incentive for bonus use in the TCMF zones. 50,000 square foot lots are closer to market feasibility with a higher rent profile. 50,000 square foot lots have a smaller gap between than 20,000 square foot lots.

Exhibit 22. Comparison of RLVs in Bonus Height in TC Zones

Source: ECONorthwest



On smaller lots (20,000 square feet and less) at current construction costs and rents, the TC zoned mixed-use projects have to trade-off install parking for retail uses relative to building mass (larger site utilization means expensive structured and/or underground parking relative to cheaper surface parking). The result is to select surface parking and smaller and smaller building footprints, thus minimizing the amount of building space. The plaza and step back requirements further eat into the envelope and the economies of scale start to move away from the project when it accesses the bonus height. In cases in TCMF zones where ground floor housing is allowed, less parking is required (and that parking can generate revenue where currently there is no market for paid private retail parking) so project performance improves. Larger sites in both the TCMF and TC zones perform better at larger scale. In these projects, there are economies of scale because they can be more efficiently parked. Further plaza and step back requirements don't restrict building envelope as much and don't impact building performance as much.

The analysis thus far both points to the role that rents, construction costs, and parking play in project feasibility even in the base zoning – specifically, parking. Parking provision has a profound impact on pro forma outputs, so changes in parking policies can be a determinant of project feasibility. Parking demand varies considerably based on location. A reduction in required parking is only valuable where requirements are set higher than the market demand.

If a community has an inefficient parking policy, making a parking requirement reduction can be an offsetting benefit for those delivering affordable units or other public amenities. Many parking policies are inefficient, so any means of better aligning them with the market (what a development would build absent explicit requirements) is helpful especially if it can help to deliver affordable units and other public amenities.

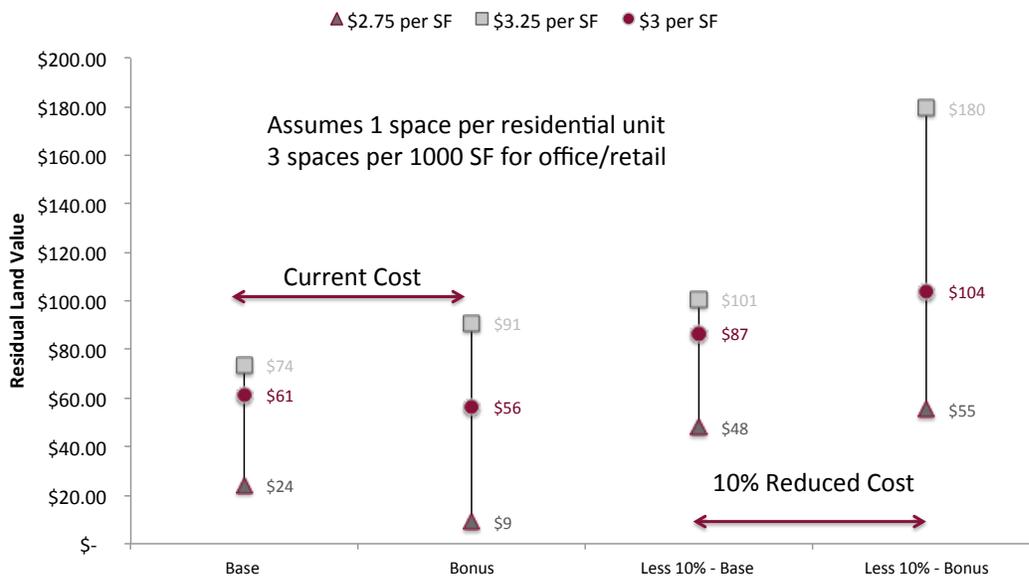
3.8 How do changes to rents, construction costs, parking, step backs, plaza provisions, and affordable housing impact development feasibility and bonus provisions?

Based on some discussion with the Joint Commission, ECONorthwest provided a range of sensitivity tests to examine the impact of:

- Higher rents
- Lower construction costs
- Lower parking requirements
- Relaxed step-back facades
- Relaxed plaza/open space requirements

Current parking rates impacts bonus height incentive performance

Exhibit 23. Bonus height RLV comparisons at current minimum parking rates



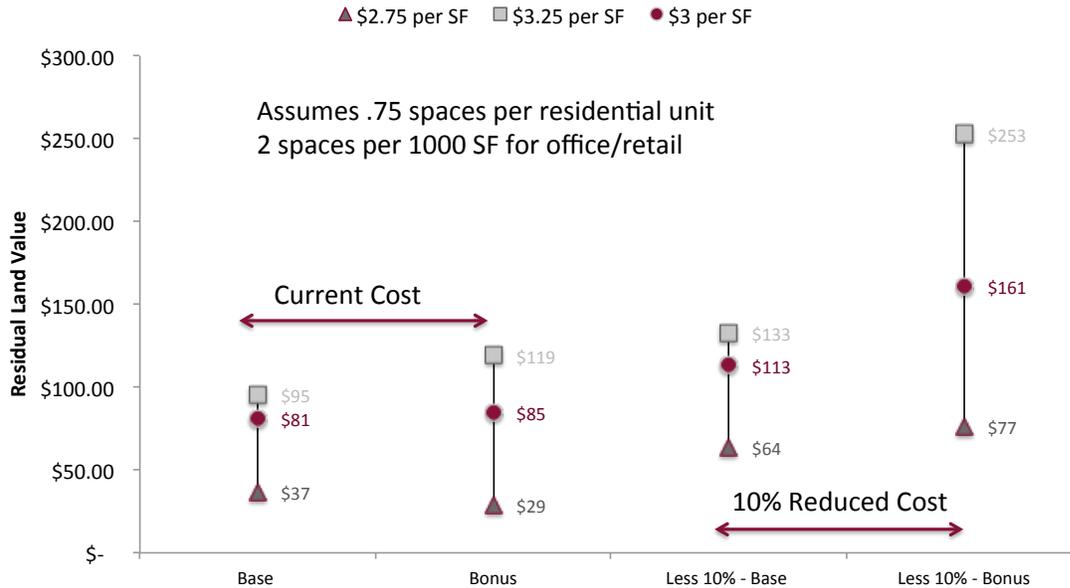
Source: ECONorthwest:

Note: Bonus Scenario assumes 10% set aside of units for affordable housing @ 60% AMI and no plaza requirement or vertical step back in order to isolate the role of parking and changes in rents/costs.

- At current construction costs and parking standards, only significantly higher average rents (\$3.25 versus \$2.75) create an incentive use the bonus height.
- At lower construction costs and current parking standards, there is a financial incentive to move into the bonus height at current market rents.

Reduced parking improves the performance of bonus provisions

Exhibit 24. Bonus height RLV comparisons at reduced parking rates



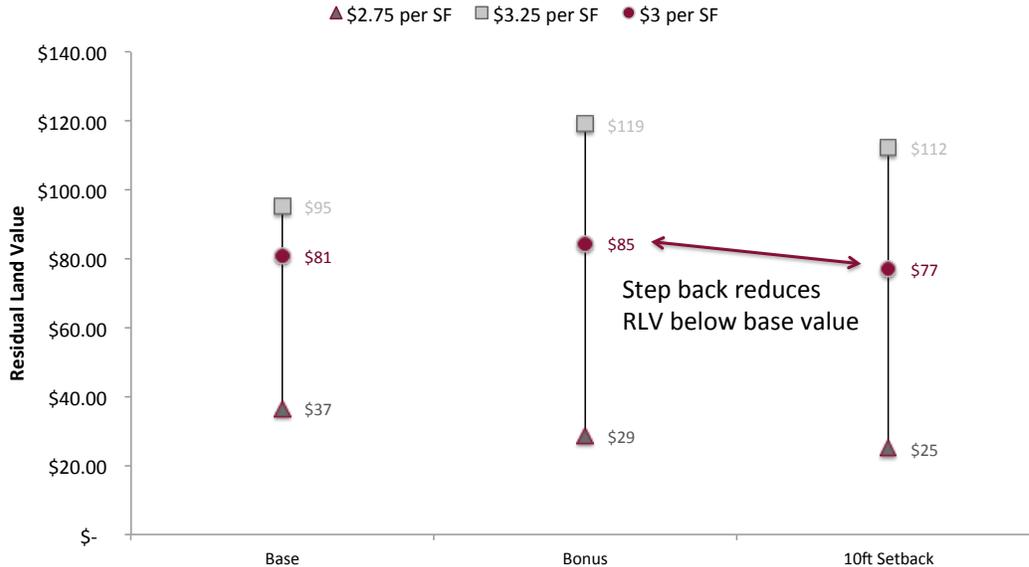
Source: ECONorthwest:

Note: Bonus Scenario assumes 10% set aside of units for affordable housing @ 60% AMI and no plaza requirement or vertical step back in order to isolate the role of parking and changes in rents/costs.

- At current construction costs and reduced parking standards, only slightly higher average rents (\$3.00 versus \$2.75) create an incentive use the bonus height.
- At lower construction costs and reduced parking standards, there is a financial incentive to move into the bonus height at current market rents.

Step back and plaza provisions similarly impact bonus height performance

Exhibit 25. Bonus height RLV comparisons for daylight plane step back provisions



Source: ECONorthwest:

- There is a similar financial impact of 10ft vertical step back and 3% plaza requirement (only the step back is shown above) at current minimum parking rates.
- A reduced parking scenario creates financial incentive for step back (or plaza) bonus only at the high rent or lower construction cost scenario.

How does affordable housing impact the bonus height provision?

We modeled how total and affordable unit production varies when the incentive targets different affordability thresholds: 60%, 80% and 100% of area median income (AMI).

While we would expect a significant difference in outcome based on the change in AMI requirements, given the structure of the bonus in the TC zones, we find only a modest effect on overall development feasibility when we vary the AMI requirement between 60% and 80% of AMI. In this case, because the overall bonus financial performance is lower than in the base on most sites and the overall number of units produced in each building is small, however, the difference in affordability and in development feasibility is nearly inconsequential from a policy perspective.

We modeled how development pro formas respond if the incentive requires 15% of bonus units to be set aside as affordable, as opposed to 10% of bonus units. Not surprisingly, the incentives perform best from a financial perspective when the 10% set aside is chosen. At 15% of bonus floor area, the rent from the

affordable units is generally too low to support development feasibility. To achieve the production of units at 60% AMI, greater subsidy would be required. Without this additional subsidy, the policy risks lowering overall unit production through less take of the bonus height and floor area. The analysis finds that a developer would be likely to choose to develop at the base zone height or not at all, rather than taking the bonus of the additional density at the 15% set aside rate.

3.9 Summary Observations and Guidance offered to the Joint Commission

In summary, the following observations are offered with regard to the sensitivity tests:

- At current market rents and construction costs:
 - Parking is a large driver of project performance, thus a decrease in required parking (to efficient market rates) will drive the provision of public benefits through participation in the bonus height option.
 - Consider the feasibility of offering a buy-out option (or fee-in-lieu) for smaller sites.
 - Step backs can be relaxed as an easier means to create more bonus height value for the development.
 - Affordable housing works best at 60% AMI at 10% set-aside amount.
- In a world where rents increase faster than today's construction costs:
 - A decrease in parking requirements will drive stronger uptake of the public benefits in the bonus height.
 - Relaxing the step backs creates more bonus height value to the development and delivers more of the public benefits.
 - It is likely the city can target deeper AMI in the affordability or greater set-aside, not likely both.
 - Consider the feasibility of offering a buy-out option (or fee-in-lieu) for smaller sites.

3.10 How do the Joint Commission's Recommendations perform?

The April 22, 2016 Joint Commission recommendations to the bonus height program are currently under review. This section will be updated once that evaluation is complete.

Appendix A – Real Estate Development Modeling and Assumptions

ECONorthwest’s MapCraft uses computational processing power to expand the potential of standard real estate pro forma analyses. Real estate professionals use financial feasibility assessments to determine if a potential investment—procuring an operating property, purchasing and renovating an existing asset, or developing a property from the ground up—is a worthwhile use of their resources. Policymakers can use the same analytical methods to understand how public sector rules, regulations, and taxes might impact private real estate investors.

MapCraft’s approach to pro forma analyses provides significantly more visibility for both the private and public sectors into potential financial outcomes than standard methods. There are numerous inputs into pro forma real estate assessments and, using standard tools like Excel spreadsheets, it is only reasonable to manipulate a relatively small number of inputs to test the implications of variations in supply-side and demand-side alterations relative to a base case scenario.

MapCraft’s computational approach allows a standard pro forma to be translated into fast running scripts that can be varied in a myriad of ways and millions of times. MapCraft’s custom models allow users to test real estate investment proposals that vary in scale and scope (for example, different building heights and ground floor use mixes) under different market realities (for example, varied construction costs and achievable rents) while constrained by local policies (for example, zoning restrictions and parking requirements).

For ECONorthwest’s assessment of the City of Mercer Islands proposed Town Center Zoning (TC) code, MapCraft customized a scalable mixed-use residential model to reflect Mercer Islands’s local market, construction, and policy conditions. To test the application of the proposed code, particularly its density bonus policies, MapCraft modeled real estate development proposals that varied incrementally in size from the base zoning thresholds to the maximums allowed in the proposed density bonus policy.

Further, MapCraft modeled the proposed TC code so that pro forma variants could be limited to real estate development options that adhered to the full suite of the City of Mercer Island’s land use policies, including setbacks, use restrictions, height restrictions, retail minimums, parking requirements, and other considerations. Building envelopes for the following situations were modeled: Zones TC5, TC4, TC3, and TCMF 3/4 with variants on parcel prototypes that had various sizes and orientations on city blocks, faced various

street types, abutted various zones/land uses, and were across rights-of-ways from various zones/land uses. The customized scalable real estate development model was used to produce feasibility results that varied across the following attributes during at least one phase of the analysis:

- Parcel size
- Zoning designation,
- Building scale (including building footprint scale, building height, and FAR)
- Ground floor use mixes (including various proportions of commercial, residential, and parking space)
- Parking configuration mixes (including surface, podium, and underground parking stalls)
- Parking policy requirements
- Market rents
- Operating expenses
- Vacancy rates
- Construction costs
- Capitalization rates
- Bonus combinations (including various amounts of Public plaza, Affordable housing)
- Density bonus policy options (including various ratios of FAR feet of bonus space per unit of bonus-related feature provided, depth of affordability, and proportion of affordable space within the development)

MapCraft's models were designed to yield land residuals for each potential development option. The models and their financial results varied over time as the models were updated to reflect an evolving TC policy specification. Ultimately, MapCraft generated more than 60 million development options for ECONorthwest to carry out their analysis of the City of Mercer Island's TC Zones' bonus options.

Analysis steps:

1. Developed computational model of proposed TC zoning code as it related to building envelopes
2. Ran the TC zoning code model for a variety of parcel sizes and a nearly comprehensive set of contexts (e.g., north side of parcel on a transit street, south side adjacent to low density residential)
3. Ran regression models on TC zoning code outputs to understand patterns in the data and to define the most accurate linear simplification of the zoning code
4. Added TC zoning constraints to MapCraft’s scalable prototype for podium housing development, including modeled envelope constraints, land use requirements, landscaping minimums, and parking requirements
5. Added cost factors to the scalable prototype related to TC zoning requirements (e.g., façade articulation for large building frontages)
6. Added bonus policies to the scalable prototype.
7. Identified the most profitable and feasible prototypes at various bonus levels.

Specific pro forma inputs included the following assumptions:

Variable	Values Tested	Values Used for Report
Parcel Sizes	20,000; 40,000 sq ft	20,000; 40,000 sq ft only
TC and TCMF Zones	TCMF 3-4 TC 3/4/5	TCMF 3-4 TC 3/4/5
Ground Floor Commercial	0%-100% of sq ft in 20% increments	20%-80%
Min Ground Floor Commercial	0% & 20% of sq ft	20% minimum
Ground Floor Housing	0%-100% of sq ft in 20% increments	20%-80%
Parking policy application	Parking minimums apply to: (a) All units; (b) Market rate units; (c) Units in base FAR; (d) Units in base FAR and commercial-related bonus	Parking minimums apply to units in base FAR and commercial-related bonus area

	area	
<i>Height Bonuses</i>		
Public Plaza Bonus	3% of max bonus FAR in 10% increments	N/A
Affordable Housing Set Aside	15%-25% of bonus units in 5% increments	10% of bonus units
Depth of Housing Affordability	60%, 80%, 100% of AMI	80% of AMI
<i>Residential Unit Mix</i>		
Average unit size	850 to 1,000 gross sq ft per	850 sq ft
Studio units	40% of units	" "
One bedroom units	30% of units	" "
Two bedroom units	30% of units	" "
Residential efficiency	75% of gross sq ft	" "
<i>Demand</i>		
Market rate residential rent	\$1.75-\$3.25 per sq ft in various amounts	\$2.75 per sq ft
Retail NNN rent	\$10-\$30 per sq ft in \$5 increments	\$26 per sq ft
Parking revenue	\$75-\$125 per stall in \$25 increments	\$100 per stall
<i>Operations</i>		
Residential Operating Expenses	30% of gross revenues	" "
Operating Expenses for Retail	0% of gross revenues	" "
Operating Expenses for Parking	10% of gross revenues	" "

Residential Vacancy	4% of gross revenues	“ ”
Retail Vacancy	10% of gross revenues	“ ”
Parking Vacancy	0% of gross revenues	“ ”
<i>Construction Costs</i>		
Cost of surface parking space	\$7,000 per stall	“ ”
Cost of podium parking space	\$30,000 per stall	“ ”
Cost of podium double puzzle stacker space	\$28,000 per stall	“ ”
Cost of underground parking space	\$45,000 per stall	“ ”
Cost of speed ramp	\$120 per sq ft	“ ”
Hard Cost of Podium Buildings	\$145-\$185 per sq ft	\$175
Landscaping Cost	\$5 per sq ft	“ ”
Hard Cost of Public Plaza Space	\$35 per sq ft	“ ”
LEED Hard Cost Multiplier	0% to 5% of hard costs	N/A
LEED Application Costs	\$0-\$150,000	N/A
Articulation for Large Scale Facades	1% of hard costs	“ ”
Construction Contingency	5% of hard + soft costs	“ ”
Construction Soft Costs	30% of hard costs	“ ”
Developer Fee	4% of construction costs	“ ”

<i>Return Metrics</i>		
Project CAP Rate	4.5% CAP	“ ”
Target Return On Cost Spread	1.5% above Going-in CAP	“ ”