TO: HONORABLE CITY COUNCIL

FROM: CITY MANAGER DEPARTMENT: PUBLIC WORKS

DATE: MAY 3, 2004 CMR:249:04

SUBJECT: SECOND READING OF CHANGES TO FLOOD HAZARD REGULATIONS (PALO ALTO MUNICIPAL CODE CHAPTER 16.52) PERTAINING TO THE REVIEW OF IMPROVEMENTS TO EXISTING STRUCTURES IN THE SPECIAL FLOOD HAZARD AREA

RECOMMENDATION
Staff recommends that the Council approve and adopt the attached ordinance (Attachment A) revising the City’s Flood Hazard Regulations (Palo Alto Municipal Code Chapter 16.52). The ordinance adds a definition for the term “market value”, an exemption from the Regulations for locally-designated historic structures, and language to clarify problematic issues regarding health and safety exclusions, crawl space construction standards, and basement prohibition in the existing Regulations. Staff also recommends that Council approve a revised cost valuation methodology for determining whether building projects modifying existing structures constitute a “substantial improvement” that must comply with special floodplain construction standards.

BACKGROUND
On April 22, 2004, Council approved the first reading of the attached ordinance by a vote of 5 to 3 (with Council members Morton, Cordell, and Freeman opposed, and Council member Kleinberg absent). Council requested that staff provide some additional clarifying information in the report submitting the ordinance for final approval. Staff was asked to provide information comparing current building valuation procedures with the proposed procedures and examples showing the effect of the use of depreciation factors to determine the market value of existing structures. The requested information is provided in the following sections of this report and the accompanying attachments.

DISCUSSION
The method used to establish the value of commercial buildings for purposes of enforcing the Flood Hazard Regulations will remain unchanged under the proposed procedures. The market value of existing commercial structures will continue to be determined by establishing the depreciated replacement cost of those structures. Replacement costs and depreciation factors will continue to be determined from either the latest edition of Means.
Square Foot Costs, a nationally-recognized cost estimating guide, or professional appraisers. Adoption of a “market value” definition utilizing the replacement cost methodology into the Municipal Code will formalize and clarify the valuation methodology for commercial building permit applicants.

The valuation method for single-family residential structures will change under the proposed procedures. Under current practice, staff applies a one-size-fits-all depreciated replacement cost of $120 per square foot for all single-family structures. During an audit of the City’s floodplain management program in 2000, the California Department of Water Resources auditor (acting on behalf of the Federal Emergency Management Agency [FEMA]) directed staff to develop a revised valuation methodology that recognizes the differences between individual structures. Staff presented the revised valuation methodology in the April 22 staff report (CMR:212:04). The proposed valuation procedure is based on cost data contained in Means Square Foot Costs, a nationally-recognized cost estimating guide that is updated annually and adjusted for local construction costs. Staff has input cost data from the estimating guide into a customized software application that will allow custom valuations of residential structures based upon the following factors:

- Age of the structure
- Square footage of the structure
- Quality of construction (average vs. custom)
- Exterior finish
- Type of roofing materials
- Number of bathrooms
- Building upgrades (fireplaces, air conditioning, premium kitchen, etc.)

The software also applies an adjustment factor for depreciation of the structure based on its age.

The unit cost figures generated by this valuation method are generally lower than the standard $120 per square foot figure currently used by staff to establish the value of existing structures. In response to Council’s April 22 request for more information, staff has identified two residential remodeling projects that were determined to be below the “substantial improvement” threshold using the $120 per square foot cost figure and has reviewed those applications using the new cost estimating software. Attachment B is a matrix summarizing the differences in the “market value” figures generated by the two methodologies and the impact of applying various depreciation factors.

As expected, the new valuation methodology for residential structures produces lower “market value” figures, and, therefore, a lower “substantial improvement” threshold than the current practice. In reviewing the results of this analysis, however, there are two important points that should be considered. First of all, staff believes that the existing
methodology is fundamentally flawed in at least two ways. As noted by the State auditor, the $120 per square foot figure does not reflect the differences between individual residential structures. In addition, the $120 per square foot cost (which is intended to represent a depreciated (i.e. lowered) replacement cost) is higher than the $109 per square foot cost accepted by the Building Inspection Division as the cost of new construction on building permit applications. This discrepancy in unit costs results in an unbalanced “substantial improvement” calculation. The new methodology generally produces depreciated replacement costs that are lower than $109, resulting in a fairer comparison of construction cost to “market value”.

The second factor that should be considered in reviewing the impacts of the new valuation methodology is the fact that it is only the initial step in the permit review process. A project that is determined to be a potential “substantial improvement” through the initial screening process will not necessarily be forced to conform to the Flood Hazard Regulations. As described in the new “market value” definition, an applicant whose project is determined to be a potential “substantial improvement” using figures from the cost estimating guide may retain a professional appraiser to perform a custom appraisal of the existing structure, using the depreciated replacement cost method. The appraised “market value” will be compared to a detailed estimate of actual costs for the new construction to make the final “substantial improvement” determination. It is anticipated that many projects initially screened as “substantial improvements” may ultimately be found to be “non-substantial” using this more detailed analysis technique.

During the April 22 Council meeting, additional concerns were raised by Council members and members of the public. It was opined that the proposed “market value” definition is not consistent with techniques commonly used by professional appraisers. Staff does not agree with this position. The attached standard appraisal form includes a section labeled “Cost Approach” that demonstrates that the depreciated replacement cost methodology specified in the “market value” definition is consistent with standard appraisal practices (Attachment C). Although this appraisal form is for use on residential appraisals, and the “cost approach” may not be as commonly used for commercial appraisals, the form demonstrates that professional appraisers should be familiar with this appraisal method. In addition, it should be noted that the regulations use the term “market value,” not “fair market value.” On April 22, it was pointed out that for the purposes of valuing property in eminent domain cases, federal law defines “fair market value” in terms of the price a willing seller and a willing buyer would find mutually agreeable. Staff believes that the term “market value” needs to be construed in this case in a manner consistent with the insurance program of which it is a part and the regulatory scheme that implements the insurance program. In order to participate in the National Flood Insurance Program, Congress has required the City to adopt flood hazard regulations with “effective enforcement provisions consistent with federal standards to
reduce or avoid future flood losses.” Congress has declared that the purpose of the flood insurance program is, among other things, to “complement and encourage preventive and protective measures” and to encourage “sound land use by minimizing exposure of property to flood losses.” Commercial property appraisals based on a property’s income potential generate values significantly higher than building replacement costs. Consequently, if the City were to allow income-based valuations for commercial properties, the fifty percent substantial improvement threshold would seldom be exceeded. Such a methodology, which allows an inordinately large amount of building improvements to be implemented without compliance with the flood protection requirements of the Flood Hazard Regulations, is unreasonable and inconsistent with Congress’ declaration of the purpose of the National Flood Insurance Program. The depreciated replacement cost valuation method is consistent with the stated purpose and context of the insurance program.

It was also noted by several people that the replacement costs in the *Means Square Foot Costs* reference guide are significantly lower than local prevailing construction costs. While this observation may be true, the costs in the *Means* guide are consistent with building costs submitted by building permit applicants. The use of comparable cost figures for construction cost and “market value” results in a fair “apples to apples” comparison in the “substantial improvement” calculation. If staff were to use higher costs to determine “market value”, then building permit applicants would be required to submit higher construction cost figures on their applications, resulting in substantially higher permit costs.

**RESOURCE IMPACT**
Council adoption of the attached modifications to Palo Alto Municipal Code Chapter 16.52 (Flood Hazard Regulations) will ease the workload on existing staff by clarifying ambiguities or omissions in the existing regulations.

**POLICY IMPLICATIONS**
Council adoption of the attached modifications to Palo Alto Municipal Code Chapter 16.52 (Flood Hazard Regulations) will bring Palo Alto’s floodplain management program into full compliance with National Flood Insurance Program (NFIP) standards. Adoption of a “market value” definition and approval of the modified methodology for valuation of existing single-family residential structures will represent a change from the current valuation methodology and will comply with the requirements of the Spring 2000 audit by the California Department of Water Resources. Failure to comply with the audit could result in the loss of the 15% flood insurance premium discount enjoyed by Palo Alto residents and businesses due to Palo Alto’s good standing in the NFIP. In a worst case scenario, Palo Alto could be suspended from the NFIP, which would make federally-backed mortgages unavailable to borrowers on properties located in the floodplain.
On April 26, staff received notification from the California Department of Water Resources that the next audit of Palo Alto’s floodplain management program has been scheduled for mid-May 2004. This development increases the urgency for adopting the proposed “market value” definition and structure valuation methodology at this time.

**TIMELINE**
The attached ordinance will take effect on the 31st day following the second reading of the ordinance.

**ENVIRONMENTAL REVIEW**
Adoption of the attached ordinance is exempt from the provisions of the California Environmental Quality Act (CEQA) as a minor alteration in land use limitations in an area with an average slope of less than 20% which does not result in any changes in land use or density (CEQA Guidelines Section 15305).

**ATTACHMENTS**
Attachment A: Ordinance
Attachment B: Matrix comparing current valuation methodology with proposed methodology
Attachment C: Uniform Residential Appraisal Report

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