



THE CITY OF SAN DIEGO
REPORT TO THE CITY COUNCIL

DATE ISSUED: June 23, 2014 REPORT NO: 14-054
ATTENTION: Economic Development & Intergovernmental Relations Committee
SUBJECT: Economic Development Incentive Agreement – Illumina, Inc.
REFERENCE: Council Policy 900-12 "Business & Industry Incentive Program"

REQUESTED ACTION: Authorize the Mayor to enter into an Economic Development Incentive Agreement with Illumina Inc.

STAFF RECOMMENDATION: Approval the Requested Action

SUMMARY:

Background

Manufacturing

As the relative costs of doing business in coastal California have risen steadily in the last few decades, manufacturing firms have increasingly shifted focus towards the development and production of higher value-added (especially high-technology) products. Higher profit margins on lower overall production volumes for business and government customers has become the principal coping mechanism for manufacturers saddled with high fixed and variable costs for such items as real estate, electricity, water, insurance, labor, and regulatory compliance. San Diego's manufacturing operations tend to have proportionately more employees engaged in the development of products than in the actual production of them. Many of these firms perform the actual production operations in other cities or outsource (or license) the production of their products to other firms located in more cost-effective locations. This trend applies to smaller and medium-sized firms as well, although perhaps to a lesser degree.

Biotechnology

The biotechnology industry has been an important part of San Diego's manufacturing sector and a major contributor to its economic base throughout these last four decades. Unlike other manufacturing industries, biotechnology is dominated by small and medium-sized firms. San Diego has become a model of the commercialization of intellectual property (IP) since the birth of what is arguably the first biotechnology firm, Hybritech, in 1978. Because of its maturity investors and those looking to acquire companies see San Diego as a fertile market particularly

small and medium sized entities (SME's). In order to ensure those companies can grow in San Diego, it is important to provide competitive reasons for companies to stay and expand here.

Within the broadly-defined biotechnology industry (San Diego includes drugs, devices, diagnostics, tools, and biochemicals in this cluster), a relative shift has occurred which favors the City of San Diego (City). In addition to drug development, which is expensive, risky, and may not lead to production within the City, other industries are strengthening in the region. These other industries are more likely to perform production operations adjacent to product research and development (R&D) operations within the City, thus creating relatively more of the critically needed middle-wage jobs. Additionally, devices, diagnostics, tools, and biochemicals are subject to sales tax within California, thus generating General Fund revenues to fund essential municipal services. Location near a company's R&D is not always enough to encourage production, which is why the City should use its existing programs, and develop new programs, to improve the value proposition of locating manufacturing within the City.

Middle-Wage Jobs

As noted in Chapters 3 and 4 of the recently-adopted Economic Development Strategy 2014-2016 (EDS), the creation of middle-wage jobs (annual compensation of \$37,500 - \$62,500) which can be filled by local residents and which provide a decent standard of living in San Diego, is an economic development goal for the City. Electronics and aerospace have traditionally been strong sectors to provide those jobs. Given the fluctuation in jobs provided by those industries, biotechnology is an industry cluster that can provide similar opportunities for those in the middle-wage zone.

San Diego's Tax Base

The manufacturing sector (along with the retail and accommodation sectors) generates significant General Fund tax revenues. The consumption of machinery, equipment, and materials within the manufacturing sector generates local use tax, and the sale of these same products generates local sales tax. The consumption of natural gas during the production process generates gas franchise fees, and the construction of expensive special-purpose manufacturing plants generates relatively higher amounts of local property tax. As shown in Figure C-1 of Appendix C of the EDS, manufacturing plants, on average, are exceeded only by hotels, vehicle dealerships, and large retail establishments in terms of net positive fiscal impacts per acre of land utilized.

Illumina, Inc.

Illumina, Inc. was founded in San Diego in 1998. The company develops, manufactures, and sells a wide variety of medical devices and provides related services to its customers. Its products are based on proprietary genomics technologies and are used by other biotechnology companies, research institutes, pharmaceutical companies, and medical providers, primarily to sequence human genomes. This genomics sequencing technology is principally made available to its customers through the sales of genome sequencing machines which range in size from countertop models to large floor-standing systems. These systems are primarily manufactured in San Diego, Hayward, CA, and at an off-shore location in Singapore. The

company also operates smaller R&D, manufacturing, and administrative operations in Madison, WI, Morrisville, NC, in the UK and in the Netherlands. The San Diego, Hayward, and Singapore locations are the largest.

Illumina reportedly has over 1,000 employees within San Diego, making it second only to Carefusion among San Diego's biotechnology companies. Illumina leases six buildings within the City, totalling approximately 560,000 square feet of office and industrial space from developers Alexandria Real Estate Equities (ARE) and the Irvine Company. These buildings accommodate the company's administrative world headquarters, product development, manufacturing, sales, shipping, and receiving. Illumina has long-term leases with ARE for its headquarters office building, an R&D building, a factory building, a central plant building, and an "amenities" building within Noble Research park (5200 Illumina Way). Additionally, Illumina has a shorter term lease of approximately 60,000 square feet of factory space for its reagents manufacturing operations at 9440 Carroll Park Dr. Illumina is the City's 12th largest sales/use taxpayer.

Potential Relocation of Illumina's Manufacturing Operations

In late 2013, City staff confirmed that ARE's entitlements for Nobel Research Park provided for ministerial approval of new industrial buildings directly adjacent to the four existing buildings under long-term lease to Illumina, at the request of Dowler Grumman Architects (DGA). DGA indicated that ARE was pursuing a build-to-suit opportunity to be presented to Illumina. In early 2014 DGA informed City staff that Illumina was now considering a variety of options for its manufacturing operations, including opportunities outside the City, but within the County, as well as outside of the state.

The San Diego Regional Economic Development Corp. verified through Illumina's real estate broker that Illumina was evaluating manufacturing leases in San Diego, Poway, and Memphis.

City staff contacted Illumina and was informed that Illumina was exploring a number of real estate options, each with its own apparent advantages and disadvantages, including extending its lease of the reagents factory at 9440 Carroll Park Drive, moving the reagent manufacturing to its factory in Singapore, or entering into a new lease with a developer in either San Diego (ARE) or a developer in the region or out of state. Illumina owns no real property, preferring instead to lease office and industrial space from developers in order to preserve operating capital. Illumina confirmed that there was no plan to move its headquarters and R&D operations from 5200 Illumina Way.

City staff independently confirmed that the factory lease at 9440 Carroll Park Dr. was to expire in 2015.

Discussion

Economic Development Incentives

Council Policy, 900-12, the Business & Industry Incentive Program, provides for the provision of financial incentives to businesses which meet certain criteria, justifying the award of any

financial assistance. Illumina clearly has numerous options for the location of its manufacturing operations, many of them outside San Diego. At this point, no preferred site, or specific fee costs have been identified which Illumina would necessarily incur in order to permit the continued growth of its San Diego operations. Cities within California frequently use local sales and use tax rebates to lower a business's overall operating costs, thus providing an incentive for the company to retain or increase the size and scope of its operations within a given jurisdiction. The retention of taxable sales and manufacturing jobs is a typical objective of these agreements.

The proposed Economic Development Incentive Agreement (EDIA) with Illumina

The proposed EDIA with Illumina would require the City to provide a lump sum tax rebate up to \$1.5 million. The rebate would be equal to 70% of local sales tax revenues and 100% of use tax revenues paid and reported by Illumina, and allocated to the City, by the California State Board of Equalization. The 70% rebate formula would only apply to new sales and use tax revenues received by the City in excess of the amount received by the City in the benchmark year prior to execution of the EDIA. The City would not be obligated to pay any tax rebate unless it continues to receive the same amount of sales and use tax revenue that it is currently receiving.

Illumina would be obligated to retain all of its manufacturing jobs within the City, at any site of its choice, during the term of the EDIA. The term of the EDIA would be the lesser of 10 years or the year that Illumina has generated new additional (above the benchmark) sales and use tax revenues of \$1.5 million. Illumina's taxable sales of its medical devices have grown an average of 47% annually and are currently in excess of \$1,300,000 annually, exceeded only by large retailers and by telecommunications manufacturer Qualcomm, Inc. A more conservative 20% projected annual growth rate estimate would result in near term future annual sales and use tax revenues of approximately \$1.5 million annually. Through a negotiated process, the City and Illumina determined that a cumulative total rebate equivalent to approximately one year's worth of tax revenue provided a reasonable inducement for Illumina to continue to optimize its efficiency by keeping its existing San Diego R&D, manufacturing, and product sales operations in close proximity within the City.

Projected Public Benefits

The proposed EDIA would provide Illumina with a substantial financial incentive to retain its manufacturing jobs within the City. "Electromedical apparatus manufacturing" jobs (NAICS 334510) have a multiplier effect of 4.0:1, thus generating 3 additional indirect and induced jobs at other local manufacturing plants, material suppliers, and in the retail, wholesale, and service sectors. An example of indirect jobs created as a result of direct manufacturing jobs occurs when Illumina sources some of its components locally, such as the cabinet housings for its genome sequencers which are manufactured locally by D&K Engineering in Rancho Bernardo.

The retention and generation of sales tax revenue is a core function of municipal economic development. While retail sales are difficult to move from one jurisdiction to another due to customer demographics, business-to-business sales can be moved out quite quickly and easily, by simply moving the sales force in accordance with the company's own efficiency objectives.

Illumina is currently generating approximately \$1.3 million annually in local sales and use tax revenue to the City. Most of this revenue is sales tax revenue from the sales of taxable genomics sequencing machinery within California. The EDIA is structured to encourage Illumina (or any potentially successor) to retain its taxable equipment sales within the City, at least during the term of the EDIA.

EQUAL OPPORTUNITY CONTRACTING INFORMATION:

This action is not subject to the City's Equal Opportunity Contracting (San Diego Ordinance No. 18173, Section 22.2701 through 22.2708) and Non-Discrimination in Contracting Ordinance (San Diego Municipal Code Sections 22.3501 through 22.3517).

FISCAL CONSIDERATIONS:

Fiscal impacts of the proposed Council Action are expected to be revenue positive. In order to retain Illumina's manufacturing and sales operations within the City, the City would forego 70% of any net sales tax revenue and 100% of any use tax revenue gains until the City has completed its payments of sales and use tax rebates of up to \$1.5 million plus three percent (3%) interest compounded annually. The interest shall accrue only on any portion of the tax rebate amount the Company has earned within any fiscal year (July 1 through June 30), and the interest shall begin accruing on July 1 of the fiscal year immediately following the fiscal year in which the company has earned the applicable portion of the tax rebate amount. 100% of any revenue gains subsequent to the payment of the tax rebate to Illumina will accrue to the City.

PREVIOUS COUNCIL and/or COMMITTEE ACTION:

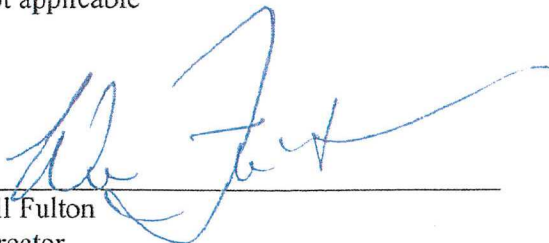
None

COMMUNITY PARTICIPATION AND PUBLIC OUTREACH EFFORTS:

Not applicable – Confidential municipality-taxpayer negotiations

KEY STAKEHOLDERS AND PROJECTED IMPACTS:

Not applicable



Bill Fulton
Director
Planning, Neighborhoods, & Econ. Dev. Dept.



David Graham
Deputy Chief Operating Officer
Neighborhood Services

Attachments(s): 1. Proposed Illumina Economic Development Incentive Agreement