MEMORANDUM

To: Rachel Cohen, City of San Luis Obispo

From: Ashleigh Kanat and Jake Cranor

Subject: Recommendations for San Luis Obispo's Proposed Affordable Housing Fees Inclusionary Requirements, In-lieu Fees and Commercial Linkage Fees; EPS #191142

Date: February 2, 2022

The Economics of Land Use

Economic & Planning Systems, Inc. (EPS) was retained by the City of San Luis Obispo (City) to help identify the parameters of an updated affordable housing program, and recommend updated inclusionary requirements, associated in-lieu fees and new commercial linkage fees.

EPS's work follows and builds on the Affordable Housing Nexus Study prepared by David Rosen and Associates (DRA) in 2019, which established the *maximum* allowable fees that could be charged to new residential and nonresidential development following nexus logic but did not evaluate the feasibility of those fees (i.e., the effect the maximum fees would have on the financial feasibility of new development).

This analysis recommends a framework for updating the City's affordable housing requirements and conducts a feasibility analysis to refine the recommended inclusionary requirements and fee levels. The following memorandum discusses the key findings of the analysis, examines the City's current inclusionary housing program, provides an overview of the DRA Affordable Housing Nexus Study, and outlines the methodology used for the feasibility analysis before providing EPS's suggested updates and revisions to the City's affordable housing program.

Summary of Findings

1. ***The maximum nexus-based affordable housing impact fees and commercial linkage fees calculated in 2019 cannot be absorbed by developers without negatively affecting the financial feasibility of new development*.**
   The David Rosen and Associates Nexus Study calculated a maximum fee of between $48.33 and $113.99 per square foot for new residential development, depending on the residential product type, and between $65.85 and $173.09 per square foot for non-residential uses. While such fees may be technically justifiable, it is

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not uncommon for the maximum nexus-based fees to render new development infeasible and, as such, cities typically adopt affordable housing fees at much lower levels. This is a typical result of nexus-based fee calculations, and DRA notes in its report that it often recommends cities adopt fees lower than the maximum allowable level.

2. ***The City's existing percent-of-value approach to calculating in-lieu fees is not consistent with best practices as the amount of the fee can vary from unit to unit, even among similar product types, and EPS recommends that the in-lieu fees be calculated based on technical analysis and made publicly available on the City's fee schedule.***
The City's current inclusionary program requires that market-rate developments include a certain percentage of affordable units to be built onsite. Developers may elect to pay a fee in lieu of building the affordable units as part of the market-rate project. The City currently charges an in-lieu fee equal to 5 percent of building value should developers elect not to provide the required amount of inclusionary units onsite. This process requires judgement on the part of City staff who need to determine if the value as submitted by the developer at the time of application is accurate. Such self-reporting can lead to variability among fees paid by developers of similar product types, potential underreporting, and inconsistencies in how different developers are complying with the inclusionary requirements.

3. ***EPS's preliminary recommendations include several revisions to the City's existing affordable housing inclusionary program for new residential development and the introduction of a nexus-based commercial linkage fee for non-residential uses.***
For new, market-rate, for-sale residential development, EPS recommends an inclusionary requirement of 10 percent, meaning that a 100-unit development would be required to provide 10 onsite units that are affordable to income-constrained households. Inclusionary units for for-sale development would be targeted half to low-income and half to moderate-income households. For new rental developments, a 6 percent inclusionary requirement is recommended, which would again be targeted half to low-income and half to moderate income households. Developers opting to pay a fee rather than providing the units onsite as part of the development would pay an in-lieu fee charged per square foot of $25 for new for-sale housing and $20 per square foot for new rental housing. For new commercial developments, EPS recommends a per square foot commercial linkage fee amount of $5.00 for office, service, hotel, and retail uses, and $4.00 for industrial and institutional uses. Recommendations for the City's inclusionary housing requirements, in-lieu fee levels, and affordable housing commercial linkage fee levels are summarized in **Figure 1**.

Figure 1 Recommended Inclusionary Requirement and Fee Levels

Use	Affordable Housing Impact Fee	Inclusionary Housing Requirement		
		Onsite Requirement	In-lieu Fee (max per unit)	In-lieu Fee (per sq.ft.) [1]
Residential				
For Sale	n/a	10% (1/2 Mod and 1/2 Low)	$37,795 per unit	$25.00 per sq.ft.
Rental	n/a	6% (1/2 Mod and 1/2 Low)	$19,839 per unit	$20.00 per sq.ft.
Nonresidential				
Office	$5.00 per sq.ft.			
Retail	$5.00 per sq.ft.			
Service	$5.00 per sq.ft.			
Hotel	$5.00 per sq.ft.			
Institutional	$4.00 per sq.ft.			
Industrial	$4.00 per sq.ft.			

[1] The per square foot fee assumes approximately 1,500 square feet for a for sale unit and 990 square feet for a rental unit.

4. ***EPS recommends eliminating "Table 2A," which currently adjusts the inclusionary requirement of residential projects, with lower requirements for higher density projects and smaller units because current market data suggests that Table 2A is no longer furthering the "affordable by design" objectives that it was originally intended to support.***
   Table 2A outlines inclusionary requirement adjustment factors based on both unit size and project density. For example, developments consisting of 1,100 square-foot units or smaller are only required to provide one inclusionary unit onsite, regardless of how many total units are being built. EPS analysis finds that under current market conditions, new units of these sizes rent for approximately $3,000 per month (as shown on **Figure 2**), which is not affordable even for moderate-income households (households earning 120 percent of AMI). Therefore, units of at least 1,100 square feet are no longer 'affordable by design', as was the intent of Table 2A, and as the City anticipates more development at smaller unit sizes, there is an opportunity to ensure that affordable housing is included as part of new, market-rate development.

Legal Background

Prior to 2017, there was some uncertainty about the legal parameters of inclusionary housing programs and whether inclusionary programs could apply to ownership and rental projects. For some time, there were two California Court of Appeals decisions from 2009 that informed the legal parameters of inclusionary zoning and related in-lieu fees. These are "Palmer/Sixth Street Properties L.P. v. City of Los Angeles" (Palmer) and "Building Industry Assn of Central California v. City of Patterson" (Patterson). The former found that local governments must implement their inclusionary housing requirements so that developers of rental housing are allowed to determine the initial rents of all units on site. The latter suggests that inclusionary housing ordinances should be viewed as "exactions" that must be justified by nexus studies.

More recently, in 2015, the California Supreme Court decided in favor of the City of San Jose, which had passed an inclusionary requirement in 2010. The California Building Industry

Association filed a lawsuit claiming that the San Jose ordinance was invalid because the conditions imposed by the ordinance constituted "exactions" under the takings clauses of the state and federal Constitutions. The California Supreme Court held that the conditions that the San Jose ordinance imposes on future developments do not impose "exactions" upon the developers' property.

More concretely, Assembly Bill 1505 (2017) now clarifies that cities and counties may adopt inclusionary housing ordinances requiring residential rental housing developments to include a specified percentage of affordable units as a condition of development.

Existing Affordable Housing Program

The City's existing affordable housing program is outlined in San Luis Obispo Municipal Code Chapter 17.91, and requires that new development projects satisfy the inclusionary housing requirements, as specified by Table 2 (and adjusted by Table 2A). The program also allows non-exempt developments to contribute an in-lieu fee equal to 5 percent of the development's value instead of physically constructing the inclusionary units.

Table 2 states that, within the City limits, residential development must set aside 3 percent of units as affordable to low-income households or 5 percent of units as affordable to moderate income households (but not less than one affordable unit per project). In the Expansion Area, the requirement is increased to 5 percent affordable to low-income households or 10 percent affordable to moderate income households. Residential developments of less than four units are exempt. Table 2 also specifies that commercial developments both within the City limits and in the Expansion Area must build two affordable units per acre, but no less than one affordable unit per project. Commercial projects of less than 2,500 square feet are exempt.

Developers often elect to pay the 5 percent in-lieu fee, which presents several issues. Upon reviewing recent in-lieu fee data provided by City staff, EPS notes that: 1) residential construction values reported by the developers are sometimes significantly lower than what market data sources imply; and 2) there is significant variability in the construction value per square feet for similar product types. These findings suggest that an in-lieu fee based on a developer-reported construction value is not the most transparent or equitable means of levying such a fee.

Table 2A provides adjustment factors to be applied the inclusionary requirements for residential development. For example, a 100-unit development with an average unit size of 1,800 square feet is assigned an adjustment factor of 0.75. Therefore, instead of being required to build 3 low-income units or 5 moderate income units, as specified by Table 2, it is given a 25 percent reduction in the number of affordable units it must provide. This means the developer could satisfy the inclusionary requirement with just 4 (rounded up from 3.75) moderate income units. Table 2A strives to encourage development of smaller units and greater density, and developments with units of 1,100 square feet or less are only required to provide one inclusionary unit on site, regardless of the total number of units proposed. As another example, the same requirement of building one affordable unit onsite applies to 1,500 square-foot units, in cases where the development consists of 24 or more units. Conversely, units of more than 2,500 square feet are required to provide more affordable units than the baseline listed in Table 2.

While this concept does indeed encourage smaller, and thus less expensive units, the market has shifted such that even 1,100 square foot units are no longer affordable to moderate and some above moderate households. **Figure 2** shows the affordability gap for unit sizes exempted from inclusionary requirements under some or all scenarios, compared to a unit that is truly affordable to moderate income households. While an 800 square foot unit is affordable to a moderate-income household of two, a family of three would experience an affordability gap of $15,400 for an 1,100 square foot unit. A moderate-income household of four would experience an affordability gap of $32,650 for a 1,500 square foot unit, despite having a higher income than the household of three. This analysis shows that 1,100 and 1,500 square foot units are unaffordable and thus contributing to an affordable housing shortage, because their construction is not required to contribute to the development of housing that is affordable in the community.

Figure 2 Affordability Gaps for Units Adjusted by Table 2A

Item	Unit Size		
	800 Sq. Ft. *(2-person HH)*	1,100 Sq. Ft. *(3-person HH)*	1,500 Sq. Ft. *(4-person HH)*
Average Market Rate Rent[1]	$2,280	$3,025	$3,750
Moderate Income for Typical Household Size[2]	$93,900	$105,600	$117,350
Income Required to Rent[2]	$91,200	$121,000	$150,000
Affordability Gap	$2,700	($15,400)	($32,650)

[1] Based on CoStar and Apartments.com data on typical rents per square foot for new construction in San Luis Obispo in November 2021.
[2] Assumes families of the specified sizes can pay up to 30 percent of gross income on rent without becoming rent burdened. Does not include other housing related costs such as utilities

Sources: HCD Income Limits 2021; CoStar; Apartments.com; City of San Luis Obispo; Economic & Planning Systems, Inc.

Overview of DRA Nexus Studies

The City retained DRA to prepare a nexus study, completed in 2019, establishing a rational nexus between market-rate residential development and non-residential development and the need for affordable housing in the City. The purpose of the of the nexus study was to determine the extent to which new market-rate residential and non-residential development in the City increases demand for housing and exacerbates the City’s shortage of affordable housing. DRA states that the basis for the fee is that development increases employment, which also increases the demand for housing for the added employees. Since the private housing market, with no public assistance, will not provide housing affordable for lower-earning employees, a nexus fee is justified to help create that housing. DRA also notes that non-residential development, such as retail/services, office, and industrial uses, have a direct employment impact since employees work from these buildings.

In its residential nexus study, DRA calculates fees for three categories of residential development: owner-occupied single-family units, owner-occupied townhomes, and renter-occupied multifamily units. Maximum fees calculated were $113.99 per square foot for single-family, $48.33 per square foot for townhomes, and $55.31 for multifamily units. For commercial uses, DRA calculated fees for retail, hotel, service, office, industrial and institutional space. The maximum fees calculated per square foot were: $69.60 for retail; $86.12 for hotel; $65.85 for service; $173.09 for office; $84.47 for industrial; and $151.64 for institutional.

DRA states in its report that it does not recommend the maximum nexus fees for adoption, and notes the need to evaluate development feasibility, along with a range of other policy factors, in determining appropriate fee levels. The DRA report also shows a set of other municipalities' commercial linkage fees to demonstrate typical fee levels elsewhere.

Defining the Inclusionary Program and Fee Levels

EPS used separate methods of identifying appropriate fee levels for residential and commercial uses. For residential, EPS developed a feasibility model to compare different fee levels and inclusionary requirement scenarios. EPS calibrated the inclusionary requirement inputs based on inclusionary programs in other jurisdictions. The approach for defining affordable housing commercial linkage fees relied principally on a survey of commercial linkage fees in other jurisdictions, building off a similar exercise performed by DRA in 2019. Details on these approaches are outlined in the subsections below

Defining the Inclusionary Program for Residential Uses

EPS has prepared financial pro formas reflecting the expected costs of new development, based on DRA's analysis, and compared those costs to the revenues that could be generated from the projects given various mixes of market-rate and affordable housing.

Ownership Scenarios

In evaluating various inclusionary and impact fee scenarios for ownership housing, EPS analyzed the development economics of a hypothetical development consisting of 1,550 square feet units and two bedrooms each, with an average of three persons per household. This prototype based on the average size of units analyzed in the DRA analysis. The seven scenarios are:

Current Ordinance – This scenario assumes 5 percent of units are priced for moderate income households.

Current In-Lieu Fee – This scenario assumes an in-lieu fee equal to 5 percent of total cost of construction of the market rate units.

No Inclusionary or Fee – This scenario shows the estimated return that could be achieved by developers if they are not required to pay any fee or provide any inclusionary units.

Maximum Nexus-Based Fee – This scenario assumes a fee of $48.33 per square foot, based on results of DRA Nexus Study.

Maximum Feasible Fee – This scenario assumes the maximum fee that still allows developer to achieve a 15 percent return. Calculated to be $34.60 per square foot.

Recommended In-Lieu Fee - This scenario assumes an in-lieu fee of $25.00 per square foot.

Feasible Inclusionary Requirements – This scenario shows 10 percent of total units as inclusionary, all provided onsite. Assumes ½ of units are priced for Moderate income households and ½ are priced for Low-income households.

Key revenue assumptions are based on RedFin sales data for San Luis Obispo over the period from December 2020 through December 2021, which suggest that a home of this type and size in San Luis Obispo could sell for about $540 per square foot, or roughly $840,000. For the affordable units, maximum value by income category is shown in **Figure 3**. Construction cost estimates are based on assumptions used in the DRA analysis, adjusted for inflation, with total direct and indirect costs (except affordable housing fees) assumed to be approximately $650,000 per unit.

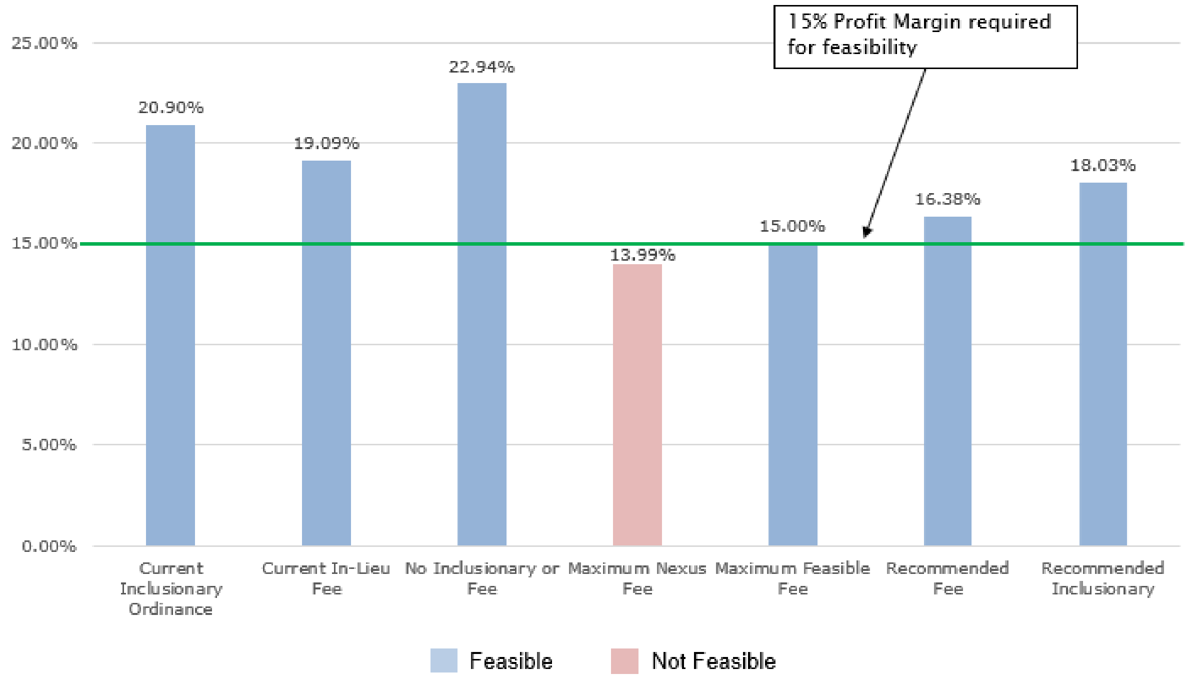
Figure 3 Affordable Home Value for a 3-Person Household by Income Category

Affordability Category	2021 Max Income 3-person household	Maximum Home Price
Very Low Income (VLI)	$44,050	$163,000
Low Income (LI)	$70,450	$265,000
Moderate Income (Mod)	$105,600	$405,000

Sources; HCD 2021 Income Limits; San Luis Obispo County Housing Authority; EPS

The scenarios presented test the feasibility of incorporating different fee levels and affordability requirements, feasibility being measured by an estimated profit margin. These revenue and cost estimates inform a range of profit margins (net revenue divided by gross revenue), which vary by scenario, as shown in **Figure 4.** Based on recent experience with developers and lenders in the region, EPS assumes that developers would require at least a 15 percent profit margin in order to accept the risk associated with the project. The results show that, unsurprisingly, the 'No Inclusionary or Fee' scenario yields the highest return, while all others except the maximum nexus fee also appear feasible.

Figure 4 For-Sale Feasibility Results by Scenario



Rental Scenarios

On the rental side, EPS modeled a market rate multifamily development. Units are assumed to average 900 square feet with two bedrooms, and a household size of three people. As with the for-sale scenarios, development costs are based on those used by the DRA analysis, adjusted for inflation. For income assumptions, EPS compiled market-rate and affordable rents based on conditions and requirements in San Luis Obispo. As the standard metric for feasibility, EPS modeled the annual yield on cost, calculating aggregate Net Operating Income (NOI) divided by development costs. A 5 percent yield on cost was deemed the threshold for feasibility. Again, EPS evaluated a number of scenarios, adjusting the inclusionary requirements and fee levels in each. Outlined below are the tested against the current rental ordinance:

Current Ordinance – This scenario assumes 5 percent of units are priced at levels affordable for Moderate income households

Current In-Lieu Fee – This scenario assumes an in-lieu fee equal to 5 percent of total cost of construction of the market rate units.

No Inclusionary or Fee – This scenario shows the estimated return achieved by developers when they are not required to pay any fee or provide any inclusionary units.

Maximum Nexus-based Fee – This scenario assumes a fee of $55.31 per square foot, based on DRA Affordable Housing Nexus Study results for this product type.

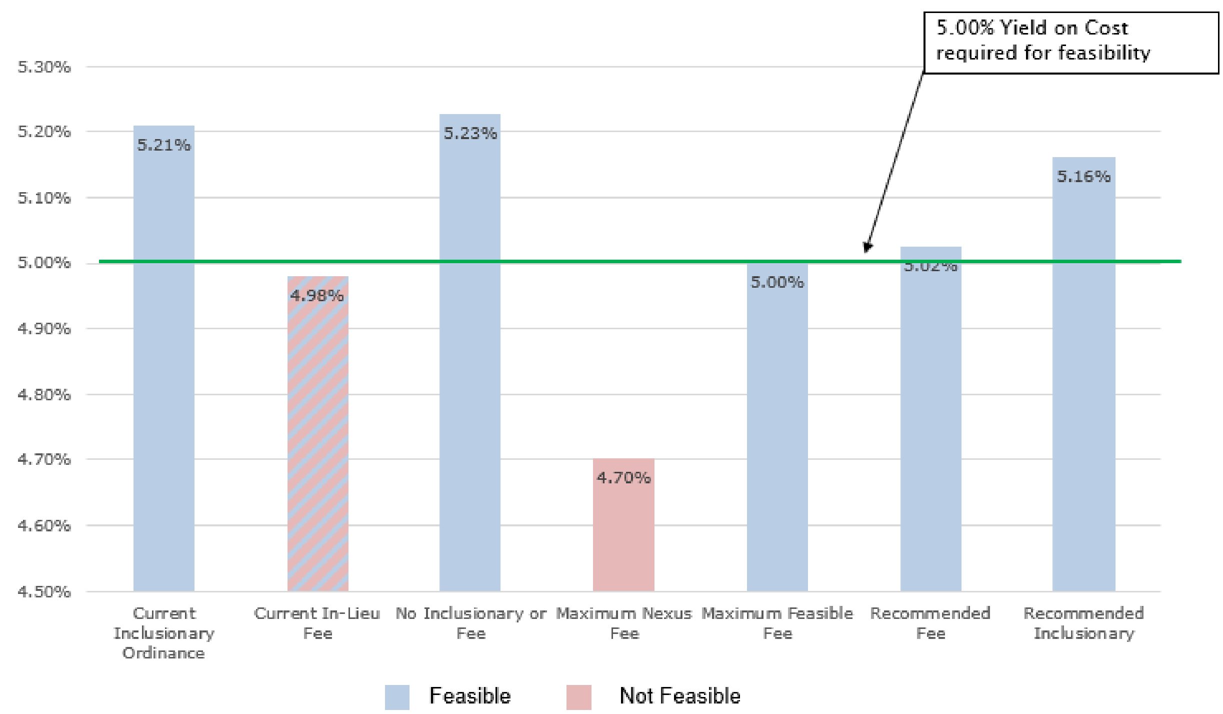
Maximum Feasible Fee – This scenario shows the maximum fee that still allows developer to achieve 5 percent yield-on-cost. Calculated to be $22.50 per square foot

Recommended In-Lieu Fee – This scenario assumes an in-lieu fee of $20.00 per square foot.

Recommended Inclusionary – This scenario shows 6 percent of total units as inclusionary, provided onsite. Assumes ½ of units are priced for Moderate income households and ½ are priced for Low-income households.

Income assumptions for market rate units equal a net operating income (revenue minus operational costs) of $23,000 per year, or roughly $2,900 per month in rent. This reflects typical rents for newly constructed multifamily in the Greater San Luis Obispo area. Affordable rents were informed by the 2021 income limits for San Luis Obispo County, with the assumption that these households can spend up to 30 percent of gross income on housing. On the cost side, EPS again relied on assumptions from the DRA analysis, adjusted for inflation. These revenue and cost estimates inform a range of yield on cost percentages, which vary by scenario, as show in **Figure 5**. In the case of rental, the current in-lieu fee is borderline infeasible, while the maximum nexus-based fee is almost certainly infeasible. The remaining scenarios all appear to generate sufficient returns based on the assumptions used.

Figure 5 Rental Feasibility Results by Scenario



Survey of Other Jurisdictions' Residential Affordable Housing Programs

As part of the feasibility analysis for residential uses, EPS aggregated key features of inclusionary programs in nearby jurisdictions, or jurisdictions of similar size and character. While the market conditions informing these jurisdictions' inclusionary housing policies can vary substantially, it can nevertheless be informative to use other local governments' policies as a benchmark for reasonableness. Key aspects of several jurisdictions' inclusionary programs are listed below:

- *Arroyo Grande*
  - Inclusionary requirement, but varies from 5 percent (VLI) to 15 percent (Mod) depending on affordability depth provided
  - In-lieu fee a percentage of construction value
- *County of San Luis Obispo*
  - Inclusionary requirement of 8 percent (25 percent reduction, if onsite) for ownership housing over 2,200 sq. ft., with 2 percent each for workforce, moderate, low-income and very low-income households. Commercial developments greater than 5,000 also subject to inclusionary requirements or in-lieu fee.
  - Fee charged on a per square foot basis, but rate escalates as unit size increases (first 2,200 SF are exempt)
- *Morro Bay*
  - Inclusionary requirement, either 1 unit, or 10 percent of all units, whichever is greater
  - Onsite and offsite inclusionary units must be demonstrably non-feasible for the City to accept a fee
- *Atascadero*
  - Inclusionary requirement of 20 percent moderate in place, but projects utilizing density bonus program are exempt
- *Pismo Beach*
  - Inclusionary requirement of 10 percent for projects of 10 or more units. Projects of 5-9 units pay fee
- *Santa Barbara*
  - 15 percent for ownership housing, rental developments of between 5-9 units required to set aside 1 unit
- *Davis*
  - Single-family ranges from 10 percent to 25 percent depending on lot size, while townhomes require 10 percent. Multifamily ranges from 5 percent for condos to 35 percent for rental projects of 20+ units

Determining Commercial Linkage Fee Level for Non-Residential Uses

In determining an appropriate commercial linkage fee level, EPS examined fee levels charged elsewhere in California. Existing fee levels in other jurisdictions serve as a proxy for development feasibility, given each of the jurisdictions has seen commercial development since the adoption of their affordable housing commercial linkage fees. In most cases, this involved obtaining updated information on the fee levels reported by DRA. The exception to this was the inclusion of the County of San Luis Obispo's commercial linkage fee program. **Figure 6** shows the commercial linkage fees by use (on a square foot basis) for Berkeley, Oakland, Petaluma, and San Luis Obispo County. Fees range from less than $1 for industrial uses in San Luis Obispo County to $5.90 for office and industrial uses in Oakland. Unsurprisingly, the Bay Area cities of Berkeley and Oakland have the highest commercial linkage fees, reflecting the higher cost of housing in the region. It should be noted that each city, with the exception of Berkeley, has updated its fees since 2019. No other cities in San Luis Obispo County have adopted commercial linkage fees.

Figure 6 Commercial Linkage Fee Amounts in Other California Jurisdictions

Jurisdiction	2021 Commercial Linkage Fee Amount					
	Office	Retail	Industrial	Hotel	R&D	Other Non-Res
Berkeley	$4.50	$4.50	$2.25	$4.50	$4.50	-
Oakland	$5.90	-	$5.90	-	-	-
Petaluma	$2.93	$5.07	$3.02	-	-	-
SLO County	$2.46	$2.11	$0.98	$2.11	-	$1.84
City of San Luis Obispo	$5.00	$5.00	$4.00	$4.00		

Sources: David Rosen and Associates; Keyser Marston Associates; City of Berkeley; City of Oakland; City of Petaluma; County of San Luis Obispo; Economic & Planning Systems, Inc.

Preliminary Affordable Housing Program Recommendation

Based on the feasibility study and comparative analysis of existing fee levels in other municipalities, EPS recommends adopting a per square foot approach for both the residential in-lieu fee and the commercial linkage fee, both to be applied citywide. Fees should be paid according to land use, not necessarily zoning. For example, a mixed-use development would pay impact fees on the nonresidential development and the residential development would need to comply with the inclusionary requirements.

Inclusionary Requirements

EPS's recommended inclusionary approach would see an increase in the percentage of required affordable units, from 3-5 percent (depending on affordability) to 10 percent. Residential developers may choose to comply with the inclusionary housing requirement by providing units onsite or by paying an in-lieu fee.[1] In-lieu fees are calculated to be approximately equivalent to

[1] AB1505 specifies that inclusionary programs must provide alternative means of complying with the requirement. Alternatives often include: land dedication, building affordable units off-site, payment of an in-lieu fee, and various combinations.

complying onsite. If provided onsite in a for-sale development, 10 percent of the units would be required to be affordable, with the inclusionary units split between low-income units (5 percent) and moderate-income units (5 percent). For rental properties, 6 percent of units would be required to be affordable, again split between low-income units (3 percent) and moderate-income units (3 percent).

EPS also recommends the removal of Table 2A. As discussed, EPS analysis finds that under current market conditions, units of these sizes are not affordable even for moderate-income households (households earning 120 percent of AMI). Therefore, units of at least 1,100 square feet are not 'affordable by design', as was the intent of Table 2A, and developers of these units are providing lower levels of affordable housing in the community.

If developers elect to pay an in-lieu fee instead of providing inclusionary units, EPS recommends a per square foot fee as opposed to a percent-of-value fee. For for-sale residential, the recommended fee level is $25 per square foot, while for rental units, the recommended fee level is $20 per square foot. In-lieu fees are paid on a per square foot basis up to the per unit fee maximum determined by the DRA Affordable Housing Nexus Study. Regarding fractional units (i.e., the inclusionary requirement results in a non-whole number of affordable units), the City currently requires that fractional units be rounded up to the nearest whole number of units.

Affordable Housing Commercial Linkage Fee Levels

For commercial developments, EPS recommends a commercial linkage fee as opposed to an inclusionary program. The proposed fee amounts are $5.00 per square foot for office, service, hotel, and retail uses, and $4.00 per square foot for industrial and institutional uses.