Analysis of Affordable Housing Requirements Incorporated in the Housing Element of the General Plan (2004 Update)

City of San Luis Obispo

Prepared by:

Mundie & Associates
Consultants in Land Use and Economics
3452 Sacramento Street
San Francisco, California 94118

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I. INTRODUCTION

BACKGROUND

The City of San Luis Obispo General Plan contains requirements for the provision of affordable housing on by all new development projects – both residential and nonresidential – that are built in the city. "Affordable housing" is housing that is offered at a sales price or rent that is within reach of moderate-income households (those with incomes not exceeding 120 percent of the County median household income), low-income households (those with incomes not exceeding 80 percent of the median), or very low-income households (those with incomes not exceeding 50 percent of the median).[1]

As it originally considered the imposition of affordable housing requirements in 1991 and as it has reconsidered the issue in subsequent years, the City Council has been aware that requiring development projects to provide affordable housing may conflict with other city priorities. For example, requiring residential development projects to provide affordable housing may reduce the feasibility – and, consequently, the production – of market-priced housing. Similarly, requiring nonresidential development projects to provide affordable housing may reduce the feasibility – and, consequently, the production – of new retail, office, and industrial building space, and thereby make it more difficult for San Luis Obispo to attract and retail jobs and capture retail sales.

PURPOSE OF THIS REPORT

This report examines the affordable housing requirements proposed in the current update of the Housing Element of the General Plan. These proposed requirements are, in general, more aggressive than the requirements currently in effect; that is, they would require the production of more affordable units, or payment of higher in-lieu fees, as a condition of development.

The report considers the potential effects of the proposed requirements on the feasibility of new residential and nonresidential development in the City and its expansion areas. It asks – and attempts to answer – the question, "Will the new requirements reduce the returns from new projects to such a degree that they would not be built?"

This report is an update of two previous analyses of the same issue. The first, prepared in 1991, considered the effects of the then-proposed affordable housing requirements on 13 hypothetical development projects that were defined based on actual applications that had been received by the City of San Luis Obispo. An update in 1997 focused on five of those case studies, representing an array of project types and locations. This update examines the same five cases that were reviewed in 1997.

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[1] Median income and affordable housing prices are established for each county or metropolitan area by the U.S. Department of Housing and Urban Development.

Why this update at this time? For several reasons. First, the current process of updating the City's Housing Element provides an opportunity to consider whether the affordability requirements currently in place are appropriate, given the experience of recent years and current market conditions. Second, a dramatic change in housing and financial market conditions since the 1997 update have prompted City officials to consider whether currently-obtainable profits in the housing market may enable the City to provide more affordable housing to meet current and future needs.

OVERVIEW OF THE REPORT

Chapter II of this report provides additional background for the analysis of the proposed affordable housing requirements. It describes the theoretical framework for the analysis and establishes a vocabulary for the study. The information in this chapter parallels information presented in Chapter I of the 1997 study.

Chapter III presents findings of the updated analysis for each development case study in turn. Each case study begins with a brief description of the development characteristics and the affordable housing requirements. It then outlines the characteristics of a "feasible" development project, identifies the land budget for such a project in the absence of affordable housing requirements, and evaluates the impacts of the existing requirements on development feasibility. The format of this chapter closely parallels Chapter II of the 1997 report.

Chapter IV summarizes the conclusions of the 2004 update. The conclusions are based on the findings of the 2004 analysis and on a comparison of the 2004 findings to the 1997 findings.

Information about 2004 income limits as well as affordable rents and housing purchase prices for low- and moderate-income households are presented in Appendix A. Appendix B compares the financial assumptions used in the 2004 update to those used in the 1997 and 1991 analyses.

II. FOUNDATIONS FOR THE ANALYSIS

THE PROPOSED AFFORDABILITY REQUIREMENTS

The City of San Luis Obispo imposes requirements for the provision of affordable housing on all development projects in the City. These requirements typically provide for either the production of housing units affordable to low- and/or moderate-income households (as defined by the U.S. Department of Housing and Urban Development) or the payment of a fee in lieu of housing production (an "in-lieu fee"). The affordable housing requirements vary from project to project depending on (1) the type of use proposed (residential vs. non-residential) and (2) the location of the project (within the existing city limits vs. in an expansion area, requiring annexation prior to development).

The affordable housing requirements proposed in the Housing Element update currently being prepared would add two new considerations to the calculation: (3) the size of a residential project and (4) a combination of project density and average housing unit size. For projects that contain 20 or more housing units, the new requirements would apply a sliding scale to adjust the total in-lieu fee or number units to be produced.

Table 1 compares the existing and new affordability requirements. The recommended affordability requirements are different for projects in major expansion areas from those within the existing city limits. The rationale for this difference is that land values would increase significantly upon annexation to the city, because annexation would bring with it the potential for more intensive development than could be achieved in the unincorporated area, and the City is entitled to capture some of the significant increase in land value.

THEORETICAL FRAMEWORK FOR ASSESSING IMPACTS

This analysis of the effects of proposed affordable housing requirements on development in San Luis Obispo recognizes that applying the requirements increases the costs of producing the proposed development or reduces the revenues generated by the proposed development. Specifically:

- The costs of development are increased if the requirement is satisfied by payment of the fee.
- Revenues generated by the development are reduced by the difference between the market price for housing and the allowed price of the affordable unit(s), which is established by the City of San Luis Obispo.

If the cost increase or the revenue reduction is too great, the return, or profit, generated by the project will decrease to a level that makes it an unattractive investment, and development activity will decrease as well. In an extreme case, development activity may cease altogether until market conditions adjust, the affordability requirements are revised, or other changes occur that make development of new projects profitable once again.

Table 1A
Existing and Proposed Housing Affordability Requirements

Location	Type of Project	Affordability Requirement	
		Fee	**or[a] Production**
In City	Commercial	*Current:* Pay in-lieu fee equal to 2% of building valuation.[c]	*Current:* Build 1 ADU[b] per acre, but not less than 1 ADU per project.
		Proposed: Pay in-lieu fee equal to 2% of building valuation.[c]	*Proposed:* Build 2 ADUs per acre, but not less than 1 ADU per project.
	Residential	*Current:* Pay in-lieu fee equal to 5% of building valuation.	*Current:* Build 3% low or 5% moderate cost ADUs, but not less than 1 ADU per project.
		Proposed: If <20 units, same as current requirement. If 20+ units, current requirement adjusted (see Table 1B).	*Proposed:* If <20 units, same as current requirement. If 20+ units, current requirement adjusted (see Table 1B).
In Expansion Areas	Commercial	*Current:* Pay in-lieu fee equal to 2% of building valuation.[c]	*Current:* Build 1 ADU per acre, but not less than 1 ADU per project.
		Proposed: Pay in-lieu fee equal to 2% of building valuation.[c]	*Proposed:* Build 2 ADUs per acre, but not less than 1 ADU per project.
	Residential	*Current:* Pay in-lieu fee equal to 10% of building valuation.	*Current:* Build 5% low- and 10% moderate-cost ADUs, but not less than 1 ADU per project
		Proposed: If <20 units, pay in-lieu fee equal to 15% of building valuation. If 20+ units, pay in-lieu fee equal to 15% as adjusted (see Table 1B).	*Proposed:* If <20 units, same as current requirement. If 20+ units, current requirement adjusted (see Table 1B).

Note: ADU = Affordable Dwelling Unit

a Developer may build affordable housing in the required amounts, *or* pay in-lieu fee based on the City's formula.

b. ADUs must meet City affordability criteria listed in the Housing Element of the General Plan.

c. "Building Value" shall mean the total value of all construction work for which a permit would be issued, as determined by the Chief Building Official using the Uniform Building Code.

Source: City of San Luis Obispo, Housing Element, September 1994 (Table 1);
Planning Commission Staff Report, Item #1, Meeting of 11/12/03

Table 1B
Proposed Adjustments to Housing Affordability Requirements for Larger Residential Projects (20 or More Units)*

Density (Units per Net Acre	Average Unit Size					
	Up to 1,000	1,000-1,500	1,501-2,000	2,001-2,500	2,501-3,000	3,000+
36+	0.25	0.50	0.75	1.00	1.25	1.50
24-35.99	0.50	0.50	0.75	1.25	1.25	1.50
12-23.99	0.75	0.75	1.00	1.25	1.50	1.75
7-11.99	1.00	1.00	1.25	1.5	1.50	1.75
<7	1.00	1.25	1.50	1.75	1.75	2.00

* Adjustment factors apply to the fee and production requirements shown in Table 1A. In this analysis, for example, Case 14, with 353 units (see Table 2 and Chapter III), is subject to an adjustment factor of 1.25 because the average unit size is 1,567 square feet and the average density is less than 7 units per acre. Therefore, the production requirement is scaled up from 10 percent moderate income units and 5 percent low income units to 12.5 percent and 6.25 percent, respectively, and the fee requirement is increased from 15 percent to 18.75 percent.

Source: Planning Commission Staff Report, Item #1, Meeting of 11/12/03

In this conceptual context, the potential impact of the proposed housing affordability requirements may be evaluated by addressing the following questions:

- **What effect would the proposed requirements have on developers' profits?** Would the revenue reductions resulting from the recommended requirements have such a severe impact on developers' profits that it would no longer make sense to build new development projects?
- **What effect would the proposed requirements have on land values?** Faced with increased costs and/or reduced revenues, developers are likely to seek ways to reduce their production costs. The obvious target for cost reductions is the land budget: while most production costs are inelastic, the price a developer is willing to pay for a site is subject to negotiation with the prior owner of the land. Would the affordability requirements reduce land values to such an extent that landowners would no longer be interested in selling their property to developers?
- **What effect would the proposed requirements have on the prices of market-priced units?** If the land prices were not reduced and the developers attempted to recoup their foregone profits from the affordable units by increasing the prices of the market-priced units, by how much would the prices of the market-priced units rise? How much additional income would be required to buy a house at the higher price?

If the requirements were determined to reduce expected profits, reduce land values, or increase the prices of market-priced housing to an excessive degree, then they would be likely to reduce the feasibility of new development:

- **Lower profits for developers** could drive them out of the development business in search of investments that provide a more attractive return.

- **Lower land values** might discourage some landowners from selling their property to developers; instead, they may choose to use the land for some other purpose (e.g., keep it in agriculture) and wait until prices rise once again. If landowners are unwilling to sell their property for development (or develop it themselves), then the number of sites available for new urban uses will decline. (Ultimately, such a decline could lead to an increase in the price that developers are willing to pay for the sites that *are* available, but only if they can charge high enough rents/sales prices to cover the increased cost.)
- **Higher prices for market-priced housing units** mean that some households that would have been able to afford those units at the "original" lower prices will be excluded from the market, or that households will decide to live in lower-priced communities within commute distance of San Luis Obispo. If enough households are excluded or decide to live elsewhere, it will become too difficult to sell whatever units *are* produced.

The bottom line result of this effect would be a reduction in the amount of new housing (for all income groups) produced in San Luis Obispo, and a further tightening of the housing market.

METHODOLOGY

This update uses the same approach as the 1991 and 1997 analyses: it considers the impact of affordable housing requirements on land value, developer profit, and the sales prices of market-priced housing units based on a series of cash flow simulations for alternative development projects. The alternative development projects, which are the same as those evaluated in the 1997 study,[2] are summarized in Table 2. Table 2 also identifies the proposed affordable housing requirements that would apply to each project.

Staff provided updated information about construction costs and fees. Mundie & Associates interviewed local (San Luis Obispo) real estate professionals to update information about rents, sales prices, construction and mortgage lending terms, and other factors that are incorporated into the financial analysis. Assumptions used in the 1997 analysis are compared to those used in the 1991 and 1997 analyses in Appendix B.

As in the previous editions of this analysis, the following calculations were performed:

1. Given assumed costs, expected revenues, and assumed threshold profits, a **land budget** was calculated for each scenario. This calculation incorporates an assumption that no contribution to affordable housing – either in the form of housing units or as a contribution to offsite production – is required. This calculation is used to establish the value of the land for each type of project. The threshold profit is assumed to be an internal rate of return (IRR) of 11 percent in operating year 10 for

[2] All together, 14 case studies were evaluated in 1991. Five cases described in the 1991 report and reexamined in the 1997 update were determined to provide a comprehensive look at the impacts of the proposed affordable housing requirements. The same five cases are reviewed in this report.

Table 2
Summary List of Project Types Evaluated

Case	Project Description					2003 Affordable Housing Requirements
	Location	Description	Site Area	Building Area	Comments	
2	existing city	downtown mixed use	7,000 s.f.	18,390 s.f.	5,990 s.f. retail, 12,400 s.f. office	At least 1 unit or pay 5% fee
3	expansion	retail	20 acres	225,000 s.f.	3 structures	40 units or pay 5% fee
4*	expansion	industrial	4 acres	60,000 s.f.		8 units or pay 5% fee
13	existing city	infill condominiums	1.79 acres	24,900 s.f.	18 units (10.06 du/ acre; 1,383 s.f./unit)	1 low or 1 moderate (or pay fee)
14	expansion	residential	139.5 acres (excluding streets)	580,000 s.f.	353 units (0.39 du/acre; 1,643 s.f./unit	22 low and 44 moderate (or pay fee)*

* Cases 4 and 5 are synthesized into Case 4. In 1991, the two cases were expected to have slightly different construction costs and different housing affordability requirements resulting from location within vs. outside the city limits. The current study omits any price differences, and City regulations have omitted differences in the affordability requirements.

Source: City of San Luis Obispo Planning Department; Mundie & Associates

commercial and industrial projects, and a profit on sale equal to 20 percent of revenue for for-sale housing projects. These profit assumptions are based on accepted industry norms.

The calculation of a land budget as a starting place for the analysis is based on the concept that the price a developer can afford to pay for a development site is determined by subtracting the costs of all other components of production (including, but not limited to, construction, architects and engineers, government fees and exactions, marketing, and profit) from the expected revenues (rents or sales). The difference between total revenues and total costs is the "residual land value" and is equal to the land budget.

This step defines the "1997 Base Case" for this study: it is the set of costs and revenues, and resulting land values, associated with new development, exclusive of an affordable housing requirement.

2. Given costs and revenues, and holding constant the land budget calculated in Step 1, the effect of the existing affordable housing requirements on **developer profits** is estimated. This calculation provides some indication of whether developers would still

consider their projects feasible if they have to bear the entire impact of the requirements (that is, if land prices are relatively non-negotiable and rents/sale prices cannot be increased).

3. Given costs, revenues, and required threshold profits, the effect of the existing requirement on the **land budget** is calculated. Comparing the land budget with the proposed affordable housing requirement to the land budget in the 2004 base case provides a quantitative estimate of the impact of these requirements, assuming that the entire impact is borne by the pre-development landowner.

4. Given costs, the land budget calculated in Step 1, and required threshold profits, the effect of the existing affordable housing requirements on **prices of market-priced units** or **rents** is estimated. For residential projects, this calculation provides information about the potential subsidy to affordable housing that would be contributed by other home buyers, as well as a ballpark indication of how much higher those buyers' incomes would have to be if the entire affordable housing subsidy were passed through to the purchasers of market-priced units. For commercial and industrial projects, this calculation provides an indication of whether the required contribution to an affordable housing fund would drive the price of nonresidential space in San Luis Obispo into a range that is unaffordable or noncompetitive.

   As in 1991 and 1997, this aspect of the analysis is not intended to suggest that market-priced units (that is, those units not reserved for low- and moderate-income households) with higher prices will indeed be marketable. The earlier reports noted the City Council's awareness that every increase in the price of a home puts that home beyond the financial reach of additional households. This evaluation of impacts on housing prices is simply intended to show the amounts by which asking prices would have to rise in order to replace the revenue that a developer would have to forego by offering the required number of affordable units, or by paying the alternative contribution to the housing fund.

For comparison:

The 1997 analysis assumed that developers would require an internal rate of return of 12 percent for commercial and industrial (and apartment) projects and a profit of 12.5 percent on for-sale housing projects.

The current study reduces the required IRR to reflect current low inflation and interest rates, and increases the profit on for-sale projects to recognize the financial effect on developers of long project processing times.

As in the 1991 and 1997 studies, the conclusions of this analysis describe the effects of the affordable housing requirements on the feasibility of new development, based on the change in developer's profit, land budget, and asking rents/prices. In each case, the quantified changes assume that the entire impact of the requirements is borne by one of the three indicators (profit, land price, or occupant/purchaser). In reality, the impacts may be shared among the three; in that case, the change in any one of these indicators would be smaller than indicated in this report.

DEFINITIONS

This report makes frequent use of the following terms, which are defined here for convenient reference:

- **Household:** the person or group of people occupying a single housing unit.
- **Affordable housing/affordable dwelling unit:** housing that is affordable to households with low or moderate incomes. (See Appendix A for a summary of upper income limits, maximum allowable rents, and maximum allowable housing purchase prices for low- and moderate- income households.)
- **Low income:** annual household income that is no more than 80 percent of the area's median household income. In 2003, a three-person low-income household would have had an income of no more than $41,550. A housing unit affordable to such a household would rent for no more than $779 per month and would sell for no more than $103,875.
- **Median income:** the middle income of all households in the area. In San Luis Obispo County, the median income in 2003 for three-person households was $51,950.
- **Moderate income:** annual household income that is between 80 percent and 120 percent of the area's median household income. In 2003, a three-person moderate-income household would have had an income of no more than $62,350; a housing unit affordable to a household with this income would rent for no more than $1,666 per month and would sell for no more than $187,050.
- **Major expansion area:** one of the five areas that the city has considered for potential annexation at some time in the future. These areas are (1) the Dalidio area, lying generally U.S. 101 between the Madonna Area and Los Osos Valley Road; (2) the Margarita area, located north of Prado, generally between South Higuera and Broad; (3) the Airport area, located between Prado on the north, a line midway between Tank Farm and Buckley on the south, South Higuera on the west, and Broad on the east; (4) the Irish Hills area, located west of Los Osos Valley Road between Madonna Road and U.S. 101; and (5) the Orcutt area, located east of the Southern Pacific Railroad Tracks south of Orcutt Road.
- **Feasibility.** In this report, a project is considered to be theoretically feasible if it would yield a positive land value given the production costs, financing terms, and rents/sale prices assumed (see Appendix B). Although the report comments on whether development should be expected given the land budgets indicated by the analysis or other conditions that might affect demand for various types of space, it does not consider the full dimensions of the market for residential and nonresidential development in San Luis Obispo at this time.

Appendix A provides additional information about income limits for households of various sizes and the amount of rent or sales prices expected to be affordable to those households.

LIMITATIONS

This approach to evaluating requirements for the production of affordable housing, as noted in the 1991 and 1997 reports, provides a rigorous, quantitative system for testing the effects of alternatives. It is nevertheless subject to certain limitations that should not be ignored as the results are considered. These limitations include the following:

- **All cost and revenue assumptions are subject to challenge.** Because every case is different, and the assumptions used in the analysis are intended to represent general scenarios, questions about the particular values used may arise.
- **The number of potential development sites – both within the existing city limits and in the major expansion areas – is limited, as is the number of ownerships.** Every land transaction will be subject to a set of expectations and dynamics specific to that site. Therefore, the land budgets calculated in Step 1 above are unlikely to be identical – and may not even be close – to those already mentally assigned to sites with development potential by either the owners of those sites or by the development community.
- **It is unlikely that the impact of affordable housing requirements will fall entirely on land value, or on developer profit, or on housing prices**; instead, it will most probably be distributed among those three factors, depending on the relative bargaining position of the landowner, developer, and households or businesses seeking to purchase or rent building space.

III. FINDINGS OF THE CASE STUDIES

CASE 2: DOWNTOWN MIXED USE (OFFICE/RETAIL)

Development Characteristics

Site Area		7,000 square feet
Building Area		
Ground floor:	*Retail*	*5,990 square feet*
Second and third floors:	*Office*	*12,400 square feet*
Total		18,390 square feet
Parking		37 spaces*

* Requirement met through payment of fees totaling $407,000.

Affordable Housing Requirements

The affordable housing requirement proposed in the new Housing Element may be satisfied by either:

- Construction of one unit that is affordable to low or moderate income households[3], or
- Payment of a fee equal to five percent of the construction cost. Under the construction cost assumptions used in this study, this fee would total $97,147.[4]

For comparison:

The housing affordability requirement currently in effect would require the construction of one unit or payment of a fee equal to two percent of construction cost ($38,859).[4]

For all commercial and industrial development projects, it was assumed for this analysis that the developer would find payment of a fee preferable to construction of a housing unit. Therefore, the new requirement would effectively represent no change.

3 The City requires construction of two affordable units per acre, with a minimum of one unit. Because the site area for this project is less than one-half acre, the requirement would be one unit.

4 According to the Housing Element, the fee is calculated based on the "total value of all construction work for which a permit would be issued, as determined by the Chief Building Official using the Uniform Building Code."

Assumptions for the Analysis

Two sets of rent assumptions were used to evaluate Case 2:

- In Case 2A, market rents are assumed to $2.50 per square foot per month for retail space and $1.30 per square foot per month for office space. The leases for office space are assumed to be gross.[5] For the office space, fixed operating costs are assumed to amount to $1.50 per square foot per year and variable costs are assumed to amount to $2.50 per square foot per year. These assumed costs reduce the effective rent per occupied square foot of office space to about $0.97 per square foot per month.
- In Case 2B, market rents are assumed to be the same as in Case 2A ($2.50 per square foot per month for retail space and $1.30 per square foot per month for office space). All leases – both retail and office – are assumed to be triple net; that is, all costs of operating the building are passed through to the tenant.

  This case reflects current market conditions in downtown San Luis Obispo; that is, office leases are likely to be made on a triple net basis. This type of lease arrangement for office space is a change from the conditions that prevailed at the time the 1991 and 1997 studies were conducted.

> ***For comparison:***
>
> In the 1997 analysis, the rent for retail space was assumed to be $2.00 per square foot per month and the rent for office space was assumed to be $1.50 per square foot per month. Operating costs for office space were assumed to be the same as the costs used here for Case 2A.

As noted in Chapter I, development is assumed to be feasible if the developer can reasonably anticipate an internal rate of return (IRR) on investment of 11 percent in operating year 10.

Results of the Analysis: Case 2A

In Case 2A, the project owner is expected to pay the operating costs of the project associated with the office space.

Land Budget with No Affordable Housing Requirement

With no affordable housing requirement, Case 2A would have an estimated total land budget of $100,800. This total is equal to $14.40 per square foot for the 7,000-square-foot site.

> ***For comparison:***
>
> In the 1997 analysis, the land budget with no affordable housing requirement was $15.00 per square foot of site area.

Impact of Affordable Housing Requirements

The effects of paying a fee equal to two percent of construction costs (the current requirement) or five percent of construction costs (the proposed requirement) are compared in Table 3.

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[5] Retail rents are triple net; that is, tenants pay all operating costs. Office rents are full service; that is, landlords pay operating costs. Detailed revenue and cost assumptions are presented in Appendix B.

Table 3
Effects of Current and Proposed Affordable Housing Fee Requirements: Case 2A

Variable	Value in 2004 Base Case	Value if this Variable Bears the Full Impact of Affordable Housing Requirement	
		2% Fee (Current Requirement)	5% Fee (Proposed Requirement)
Land Budget (value/sq. ft.)	$14.40	$9.00	$1.00
Profit (IRR in operating year 10)	11.0%	10.7%	10.3%
Rent (per sq. ft. per year)			
Retail	$30.00	$30.30	$30.78
Office	$15.60	$15.76	$16.01

Source: Mundie & Associates

In sum, payment of a two percent fee (the current requirement) would:

- Reduce the developer's profit (IRR in year 10) from 11.0 percent to 10.7 percent (an approximate three percent change[6]), *or*
- Reduce estimated land value from $14.40 to $9.00 per square foot of site area (about a 38 percent change), *or*
- Increase the rents required to maintain the base case land budget by about one percent; *or*
- Some combination of these results that yields developer's profit *between* 10.7 percent and 11 percent *and* land value *between* $9.00 and $14.40 per square foot *and* rents *between* $1.30 per square foot per month for office space/$2.50 per square foot per month for retail space and $1.31 for office space and $2.53 for retail space.

Increasing the affordable housing fee payment to five percent would especially affect the land budget affordable for this type of project. Impacts on developer profit and rents would be smaller than the effect on land value, but greater than with the current two percent fee. As shown in Table 3, payment of a fee equal to five percent of construction costs would:

- Reduce the developer's profit by from 11.0 percent to 10.3 percent (about a seven percent change); or
- Reduce the land budget by from $14.40 to $1.00 per square foot of site area (a change of about 93 percent); or
- Increase rents from $2.50 per square foot to $2.57 per square foot for retail space and from $1.30 per square foot to $1.33 per square foot for office space (a change of about 2.6 percent); or

6 The percentage change in return is calculated as follows: 10.7% (the new value) divided by 11.0% (the base case value). The result – 97.3%– represents an approximate 3% reduction.

- Some combination of these results that yields developer's profit *between* 10.4 percent and 11 percent *and* land value *between* $1.00 and $14.40 per square foot *and* rents *between* $1.30 per square foot per month for office space/$2.50 per square foot per month for retail space and $1.33 for office space and $2.57 for retail space.

Results of the Analysis: Case 2B

In Case 2B, the project owner is not expected to pay any of the operating costs of the project: both the retail and office tenants pay the operating costs associated with the space they occupy.

Land Budget with No Affordable Housing Requirement

With no affordable housing requirement, Case 2B would have a total land budget of $598,500. This total is equal to $85.50 per square foot of site area. The substantial increase in the value of the site to the developer is a direct result of the assumed change in lease terms, so that the tenant rather than the building's owner is expected to pay all costs of operating the building.

Impact of Affordable Housing Requirements

The effects of paying a fee equal to two percent of construction costs (the current requirement) or five percent of construction costs (the proposed requirement) for Case 2B are compared in Table 4.

Table 4
Effects of Current and Proposed Affordable Housing Fee Requirements: Case 2B

Variable	Value in 2004 Base Case	Value if this Variable Bears the Full Impact of Affordable Housing Requirement	
		2% Fee (Current Requirement)	5% Fee (Proposed Requirement)
Land Budget (value/sq. ft.)	$85.50	$80.25	$72.25
Profit (IRR in operating year 10)	11.00%	10.74%	10.35%
Rent (per sq. ft. per year)			
Retail	$30.00	$30.30	$30.77
Office	$15.60	$15.76	$16.00

Source: Mundie & Associates

In this case, payment of a two percent fee (the current requirement) would:

- Reduce the developer's profit (IRR in year 10) from 11.0 percent to 10.7 percent (about a three percent change), *or*

- Reduce estimated land value from $85.50 to $80.25 per square foot of site area (about a six percent change), *or*
- Increase the rents required to maintain the base case land budget by about one percent; *or*
- Some combination of these results that yields developer's profit *between* 10.7 percent and 11 percent *and* land value *between* $80.25 and $85.50 per square foot *and* rents *between* $1.30 per square foot per month for office space/$2.50 per square foot per month for retail space and $1.31 for office space and $2.53 for retail space.

For all three variables – profit, land value, and rent – the absolute value of the impact is approximately the same in Case 2B as in Case 2B. The change in land budget represents a much greater percentage impact in Case 2A, however, because the base case value of the land is so much smaller in that case.

Imposition of a five percent affordable housing fee in Case 2B would further reduce the land budget and developer's profit, or would further increase the rent asked for space in the project. These effects are similar to those identified for Case 2A and, except for the percentage change in land value, would be of similar magnitude. Increasing the affordable housing fee to five percent fee would:

- Reduce the developer's profit from 11.0 percent to 10.4 percent (a change of about six percent); or
- Reduce the land budget from $80.50 to $72.25 per square foot of site area (a change of about 15 percent); or
- Increase rents from $2.50 per square foot to $2.56 per square foot for retail space and from $1.30 per square foot to $1.33 per square foot for office space (a change of about 2.6 percent); or
- Some combination of these results that yields developer's profit *between* 10.4 percent and 11 percent *and* land value *between* $72.25 and $80.50 per square foot *and* rents *between* $1.30 per square foot per month for office space/$2.50 per square foot per month for retail space and $1.33 for office space and $2.56 for retail space.

Additional Conditions that May Affect Project Feasibility

Interviews with real estate professionals active in the downtown San Luis Obispo market for retail and office space indicate that demand for retail space is strong, especially in the heart of the downtown area.

They also indicate, however, that it may be difficult to secure tenants for office space in a building with no onsite parking.

The land values estimated in Case 2A (in which the landlord pays operating costs for the office tenants) appear to be relatively low compared to the values for some other types of uses. If the land budget for a different type of project (e.g., the infill condominiums tested in Case 13, later in this report) could be expected to yield a greater land value, or if the existing land use on a downtown parcel yields a greater value, then sites might not become available

for the type of mixed-use project considered in this case. For example, if a surface parking lot yields income of $5 per space per day, six days per week, then a reasonable estimate of its land value might be in the range of $45 (based on 350 square feet per parking space and a capitalization rate of 10 percent). This value is higher than any of the values estimated for Case 2A, but lower than any of the values for Case 2B. It is therefore reasonable to conclude that if office leases return to a formulation in which the landlord pays operating costs, little development of this type will be seen in downtown San Luis Obispo.

It is also important to consider that, in downtown San Luis Obispo, sites that would be considered for a mixed-use project similar to Case 2 are probably already occupied by some type of revenue-generating development. To acquire those sites, the developer must pay for both the land and improvements, and may have to relocate any tenants currently occupying the improvements. All of these costs must be covered by the land budget. In Case 2B, the land budget may be adequate; in Case 2A, it almost certainly is not.

Summary: Case 2

The impacts of either the current two percent affordable housing fee requirement or the proposed five percent fee requirement do not appear to compromise developer profitability or building rents to a degree that would inhibit new development in downtown San Luis Obispo. Similarly, the change from a two percent fee to a five percent fee does not appear to have a significant impact on profits or rents. It is considered unlikely, therefore, that the shift from a two percent fee to a five percent fee would disrupt development of new mixed-use buildings of the type considered here.

At the same time, both fees have a significant impact on land values. The current fee (two percent) would reduce the land budget by between $5.25 and $5.40 per square foot of land (Case 2B and Case 2A, respectively); the proposed fee (five percent) would reduce the land budget by between $13.25 (Case 2B) and $13.40 (Case 2A). In Case 2A, the latter reduction represents 93 percent of the land value absent an affordable housing requirement; in Case 2B, it represents 16 percent. Such a dramatic change in land values is likely to give some owners pause as they consider whether to make their properties available for new development.

The scenario that characterizes Case 2B is considered to be a better reflection of the current market for nonresidential building space in San Luis Obispo than the scenario that characterizes Case 2A. If the expectation that office space will be leased on a triple net basis continues, it is reasonable to expect new downtown mixed use development to occur if sites are available for sale *and* agreements about land price and rents in the ranges described above can be reached by the landowner, prospective developer, and prospective tenant(s).

It remains possible, however, that other, noneconomic factors could affect the ability of the respective parties to reach agreement. In that case, development may not occur even if the asking price for land is no more than $72.25 per square foot (the estimated value with a five percent fee for affordable housing) *and* the asking rents are no more than $2.57 per square foot per month for retail space and $1.33 per square foot per month for office space *and* the developer is willing to accept an internal rate of return as low as 10.3 percent.

CASE 3: EXPANSION AREA RETAIL

Development Characteristics

Site Area		20 acres
Building Area	*Three single-story buildings averaging 85,000 square feet*	255,000 square feet
Parking		1,275 spaces 510,000 sq. ft.
Streets		106,200 sq. ft.

Affordable Housing Requirements

The affordable housing requirement proposed in the new Housing Element may be satisfied by either:

- Construction of 40 units (two units per acre) affordable to low or moderate income households, or
- Payment of a fee equal to five percent of construction cost. Under the construction cost assumptions used in this study, this fee would total $1,137,300 for the three buildings.

For comparison:

The affordable housing requirement currently in effect may be satisfied by construction of 20 units (one unit per acre) affordable to low or moderate income households or payment of the five percent fee.

As noted in the discussion of Case 2, however, it is assumed that developers of commercial and industrial development projects would find payment of a fee preferable to construction of any housing units. Therefore, the new requirement, which increases the production requirement but not the fee, would effectively represent no change.

Assumptions for the Analysis

Based on information obtained from real estate professionals familiar with the market for retail centers in outlying areas of San Luis Obispo, two sets of rent assumptions were used for the analysis of Case 3.

- In Case 3A, approximately one-half of the project was assumed to be occupied by "anchor"-type tenants; that is, large stores that are expected to be the primary attractions of the center. These tenants typically pay lower rents than the smaller stores that are assumed to occupy the remaining one-half of the project. Anchor-type tenants are assumed to pay rent of $0.95 per square foot per month, and smaller

For comparison:

In the 1997 analysis, the rent was assumed to be $1.00 per square foot per month.

stores are assumed to pay $1.65 per square foot per month. The overall average rent in this case would be $1.30 per square foot per month. All rents are triple net; that is, the tenants pay all operating costs.

- In Case 3B, anchor-type tenants are assumed to occupy 80 percent of the center and smaller stores are assumed to occupy the remaining 20 percent. Given the same rents for the respective store types as in Case 3A, the overall average rent would be $1.09 per square foot per month.

The target return on investment is an IRR of 11 percent in operating year 10.

Results of the Analysis: Case 3A

In Case 3A, the building space in the retail center is evenly divided between anchor-type tenants and smaller stores.

Land Budget with No Affordable Housing Requirement

With no affordable housing requirement, this project would have a total land budget of approximately $11,282,000. This total is equal to approximately $12.95 per square foot for the 20-acre site.

For comparison:

In the 1997 analysis, the land budget with no affordable housing requirement was $8.75 per square foot of site area.

Impact of Affordable Housing Requirements

Payment of a fee equal to five percent of construction costs would have the following potential effects:

- Reduce developer's profit (IRR in year 10 of operation) from 11.0 percent to 10.3 percent (a change of about seven percent); *or*
- Reduce estimated land value from $12.95 to $11.70 per square foot (a change of nearly 10 percent); *or*
- Increase the rents required to maintain the base case land budget and IRR by about three percent; *or*
- Some combination of these results that yields developer's profit *between* 10.3 percent and 11.0 percent *and* land value *between* $11.70 and $12.95 per square foot *and* rents *between* an overall effective level of $1.30 and $1.34 per square foot per month.

These results are summarized in Table 5.

Table 5
Effects of Affordable Housing Requirements: Case 3A

Variable	Value in 2004 Base Case	Value if this Variable Bears the Full Impact of Affordable Housing Requirement (5% Housing Fee)
Land Budget (value per sq. ft.)	$12.95	$11.70
Profit (IRR in operating year 10)	11.0%	10.3%
Rent (per sq. ft. per month)*	$1.30	$1.34

* Overall effective rent. In this case, the base case assumes rents of $1.65 per square foot for one-half of the space and $0.95 per square foot for one-half.

Source: Mundie & Associates

Results of the Analysis: Case 3B

In Case 3B, 80 percent of the building space in the retail center is occupied by anchor-type tenants and 20 percent by smaller stores. As a result, the overall rent – and, consequently, the land value – is lower in this case.

Land Budget with No Affordable Housing Requirement

With no affordable housing requirement, this project would have a total land budget of approximately $5,157,500. This total is equal to approximately $5.92 per square foot for the 20-acre site.

Impact of Affordable Housing Requirements

Payment of a fee equal to five percent of construction costs would have the following potential effects:

- Reduce developer's profit (IRR in year 10 of operation) from 11.0 percent to 10.1 percent (a change of about eight percent); *or*
- Reduce estimated land value from $5.92 to $4.67 per square foot (a change of about 21 percent); *or*
- Increase the rents required to maintain the base case land budget and IRR by between three and four percent; *or*
- Some combination of these results that yields developer's profit *between* 10.1 percent and 11.0 percent *and* land value *between* $4.67 and $5.92 per square foot *and* rents *between* an overall effective level of $1.09 and $1.13 per square foot per month.

These results are summarized in Table 6.

Table 6
Effects of Affordable Housing Requirements: Case 3B

Variable	Value in 2004 Base Case	Value if this Variable Bears the Full Impact of Affordable Housing Requirement (5% Housing Fee)
Land Budget (value per sq. ft.)	$5.92	$4.67
Profit (IRR in operating year 10)	11.0%	10.1%
Rent (per sq. ft. per month)*	$1.09	$1.13

* Overall effective rent. In this case, the base case assumes rents of $1.65 per square foot for 20 percent of the space and $0.95 per square foot for 80 percent.

Source: Mundie & Associates

Additional Conditions that May Affect Project Feasibility

A comparison of the base land values estimated for Case 3A vs. Case 3B indicates the critical effect of obtainable rents on the feasibility of a large retail project in the San Luis Obispo expansion area. A shift in the assumed tenancy of the hypothesized shopping center from 50 percent anchor tenants to 80 percent anchor tenants would reduce the land budget for the project by more than one-half. This impact is much greater than the calculated impact of the five percent affordable housing fee. Therefore, it is reasonable to conclude that market conditions – specifically, expectations about the mix of tenants that could be achieved – would have a greater influence on whether a retail project such as Case 3 would proceed than would the affordable housing fee at the five percent level.

Summary: Case 3

As with Case 2, it is reasonable to expect retail development to occur in the expansion area if sites are available for sale *and* agreements about land price and rents in the ranges described above can be reached by the landowner, prospective developer, and prospective tenant(s). It is possible in this case as well, however, that other, noneconomic factors could affect the ability of the respective parties to reach agreement. In this case, development may not occur even if the asking price for land is no more than $5.92 per square foot *and* the overall average asking rent is no more than $1.09 per square foot per month for retail space *and* the developer is willing to accept an internal rate of return as low as 10.1 percent.

CASE 4: EXPANSION AREA INDUSTRIAL

Development Characteristics

Site Area:		4 acres
Building Area:	*Single-story building, suitable for dry goods manufacturing or publishing*[7]	60,000 square feet
Parking		150 spaces 60,000 sq. ft.
Loading, outdoor storage, setbacks, etc.		54,240 sq. ft.

Affordable Housing Requirements

The affordable housing requirement proposed in the new Housing Element may be satisfied by either:

- Construction of eight units (two units per acre) affordable to low or moderate income households, or
- Payment of a fee equal to five percent of construction cost. Under the construction cost assumptions used in this study, this fee would total $191,100.

As in Cases 2 and 3, it was assumed for this analysis that developers of commercial and industrial projects would find payment of a fee preferable to construction of a housing unit. Therefore, the new requirement would effectively represent no change.

For comparison:

The housing affordability requirement currently in effect would require construction of one unit per acre (a total of four units) or payment of the five percent fee.

Assumptions for the Analysis

This project was tested with two market rents: $0.65 per square foot per month and $0.85 per square foot per month. Rents were assumed to be triple net. No interior tenant improvements were assumed.[8]

For comparison:

In the 1997 analysis, market rent was assumed to be $0.50 per square foot per month.

Two scenarios were considered: one with no interior finish and one with interior finish supplied by the developer.

7 The 1991 and 1997 versions of this analysis assumed that this building would be used for industrial activity; its characterization as a service commercial building represents a change in that assumption.

8 The 1991 versions of this analysis assumed that no interior finish was provided; the 1997 version considered one scenario with interior finish and one without.

As in Cases 2 and 3, development is assumed to be feasible if the developer can reasonably anticipate an IRR of 11 percent in operating year 10.

Results of the Analysis

Land Budget with No Affordable Housing Requirement

With no affordable housing requirement and rent at $0.65 per square foot per year, this project would not yield sufficient returns to be feasible. Even with free land, the return to the developer (IRR in operating year 10) would be less than 11 percent.

If the project could be rented at a rate of $0.85 per square foot per year, it could afford a land budget of $871,200, or $1.00 per square foot.

For comparison:

In the 1997 analysis, the land budget with no affordable housing requirement was $8.50 per square foot if no interior finish was provided by the developer.

Impact of Affordable Housing Requirements

Although the base case land value of $1.00 per square foot is considered too low to attract development, the analysis was nevertheless completed for a case with rents of $0.85 per square foot per month.

Payment of a fee equal to five percent of construction costs would have the following potential effects:

- Reduce developer's profit (IRR in year 10 of operation) from 11.0 percent to 10.2 percent (about seven percent); *or*
- Reduce estimated land value from $1.00 to $0.79 per square foot (about 21 percent); *or*
- Increase the rents required to maintain the base case land budget and IRR by about three percent; *or*
- Some combination of these results that yields developer's profit *between* 10.2 percent and 11.0 percent *and* land value *between* $0.79 and $1.00 per square foot *and* rents *between* $0.85 and $0.88 per square foot per month.

These results are summarized in Table 7.

Table 7
Effects of Affordable Housing Requirements: Case 4

Variable	Value in 2004 Base Case	Value if this Variable Bears the Full Impact of Affordable Housing Requirement (5% Housing Fee)
Land Budget (value per sq. ft.)	$1.00	$0.79
Profit (IRR in operating year 10)	11.0%	10.2%
Rent (per sq. ft. per month)	$10.20	$10.52

Source: Mundie & Associates

Additional Conditions that May Affect Project Feasibility

The very low land value indicated by this analysis suggests that development of industrial properties may not be feasible at the present time in San Luis Obispo. Real estate professionals interviewed for this update indicated that space offered at the lower rent considered here ($0.60 per square foot per month) would "rent all day long," but – as indicated above – that level of rent will not support new development. This conclusion was confirmed by the observation of a City staff member that no new industrial projects had been proposed recently. As was observed for Case 3, therefore, it is reasonable to conclude that market conditions – in this case, the amount of rent that could be obtained for new industrial building space – would have a greater influence on whether a project such as Case 4 would proceed than would the affordable housing fee at the five percent level. Given current cost estimates, industrial rents would have to rise to between $1.35 and $1.40 per square foot per month to support a land budget of $5.00 with or without a housing affordability fee.

In this analysis, the project was assumed to be located in the Airport-Margarita expansion area. This location assumption increases the cost of the project: in this particular area, a surcharge of about 22 percent is imposed on the wastewater connection charge. In this analysis, the surcharge amounted to $2,984, or $0.003 per square foot of land. Although this fee is substantial, this surcharge by itself cannot be considered responsible for inhibiting the development of new industrial space in the SLO expansion area.

Summary: Case 4

As in the previous cases, it is reasonable to expect that development will occur if land is available and rents are offered in the ranges indicated above. The imposition of a five percent fee for affordable housing does not appear to have a great enough impact to inhibit development that would otherwise occur. Nevertheless, as was observed for Cases 2 and 3, agreement between the landowner and developer on land price, and between the developer and tenant(s) on rent, does not guarantee that development will occur.

CASE 13: INFILL CONDOMINIUMS

Development Characteristics

Site Area:		1.79 acres
Building Area:		
Two-bedroom units	*11 units @ 1,220 sq. ft.*	*13,420 square feet*
Three-bedroom units	*7 units @ 1,640 sq. ft.*	*11,480 square feet*
Total	18 units	24,900 square feet
Parking		45 spaces

Affordable Housing Requirements

This project may satisfy the affordable housing requirement proposed in the new Housing Element by either:

- Construction of five percent of the units at prices affordable to moderate income households (one unit would be required), or
- Construction of three percent of the units at prices affordable to low income households (one unit would be required), or
- Payment of a fee equal to five percent of construction cost (in this case, $107,008).

For comparison:

The proposed affordable housing requirement is the same as the existing requirement for this project.

Assumptions for the Analysis

This analysis assumes that the two-bedroom units will command an average market price of $400,000 (between $325 and $330 per square foot) and that the three-bedroom units will command an average price of $425,000 (about $260 per square foot).

Development is assumed to be feasible if the developer can reasonably anticipate a profit on sale equal to 20 percent of the production cost (including land and marketing costs).

For comparison:

The 1997 analysis considered three average price scenarios: (1) $150,000, (2) $175,000, and (3) $195,000. Only the third case yielded a feasible project. In that scenario, 2-bedroom units would be priced at $172,200 and 3-bedroom units would be $231,250.

Results of the Analysis

Land Budget with No Affordable Housing Requirement

With no affordable housing requirement, this project would have a total land budget of approximately $1.98 million, equal to about $25.40 per square foot for the 1.79-acre (77,970-square-foot) site.

> ***For comparison:***
>
> In the 1997 analysis, the land budget with no affordable housing requirement was $2.66 per square foot of site area.

Impact of Affordable Housing Requirements

The project may meet its affordable housing requirement in any of three ways: payment of a fee, sale of five percent of the units at prices affordable by moderate-income households, or sale of three percent of the units at prices affordable by low-income households.

Payment of a fee equal to five percent of construction costs would have the following potential effects:

- Reduce developer's profit on sale from 20 percent to 19.8 percent (a change of about one percent); *or*
- Reduce estimated land value from $25.40 to $23.30 per square foot (a change of about eight percent); *or*
- Increase the sales price for market-priced units from an overall average of $409,700 per unit to an overall average of about $419,300 per unit (a change of about two percent); *or*
- Some combination of these results that yields developer's profit *between* 19.8 percent and 20 percent *and* land value *between* $23.30 and $25.40 per square foot *and* average sales prices for market-priced units *between* $409,000 and $419,300.

Sale of five percent of the units at prices affordable to moderate income households would have the following effects:

- Reduce developer's profit on sale from 20 percent to 18.1 percent (a change of about 10 percent); *or*
- Reduce estimated land value from $25.40 to $23.20 per square foot (a change of 8.5 percent); *or*
- Increase the sales price for market-priced units from an overall average of $409,000 to an overall average of $422,800 (a change of about three percent); *or*
- Some combination of these results that yields developer's profit *between* 18.1 percent and 20 percent *and* land value *between* $23.20 and $25.40 per square foot *and* average sales prices for market-priced units *between* $409,000 and $422,800.

Sale of three percent of the units at prices affordable to low-income households would have the following effects:

- Reduce developer's profit on sale from 20 percent to 16.7 percent (a change of about 16.5 percent); *or*
- Reduce estimated land value from $25.40 to $22.40 per square foot (a change of about 12 percent); *or*
- Increase the sales price for market-priced units from an overall average of $409,000 to an overall average of $427,700 (a change of about four percent); *or*
- Some combination of these results that yields developer's profit *between* 16.5 percent and 20 percent *and* land value *between* $22.40 and $25.40 per square foot *and* average sales prices for market-priced units *between* $409,000 and $427,700.

These results are summarized in Table 8.

Table 8
Effects of Affordable Housing Requirements: Case 13

Variable	Value in 2004 Base Case	Value if this Variable Bears the Full Impact of Affordable Housing Requirement		
		5% Housing Fee	5% Moderate Income Units	3% Low Income Units
Land Budget (value per sq. ft.)	$25.40	$23.30	$23.22	$22.41
Profit on sale (% of sale price)	20.0%	19.8%	18.1%	16.7%
Average price of market-priced units	$409,720	$419,270	$422,820	$427,710
Average for 2-BR Units	*$400,000*	*$409,320*	*$412,790*	*$417,560*
Average for 3-BR Units	*$425,000*	*$434,900*	*$438,590*	*$443,660*

Source: Mundie & Associates

Additional Conditions that May Affect Project Feasibility

The analysis assumes that the availability of low- or moderate-priced units in the complex will not affect the prices obtainable for the market-priced units.

Summary: Case 13

As in the previous cases, it is reasonable to expect that development will occur if land is available and rents are offered in the ranges indicated above. The results indicate that, all other things being equal, a prospective developer would find it most advantageous to satisfy the affordable housing requirements by paying the five percent contribution to the affordable housing fund, and least advantageous to meet the requirements by selling three percent of units in this project at prices affordable to low income households.

CASE 14: EXPANSION AREA RESIDENTIAL

Development Characteristics

Site Area:		
Custom homes		*25.2 acres*
Single family tract units		*16.9 acres*
Condominiums		*6.6 acres*
Apartments		*1.8 acres*
Open space easement		*75.0 acres*
Linear park		*13.0 acres*
Minipark		*1.0 acre*
Total		139.5 acres, excluding streets
Building Area:		
Case 14.1: Original Unit Sizes		
Custom homes	*111 units @ 2,200 sq. ft. (average)*	*244,200 square feet*
Single family tract units	*134 units @ 1,500 sq. ft. (average)*	*201,000 square feet*
Condominiums	*88 units @ 1,200 sq. ft. (average)*	*105,600 square feet*
Apartments	*20 units @ 1,000 sq. ft. (average)*	*20,000 square feet*
Total	353 units	570,800 square feet
Case 14.2: Larger Custom and Tract Homes		
Custom homes	*111 units @ 2,500 sq. ft. (average)*	*277,500 square feet*
Single family tract units	*134 units @ 1,800 sq. ft. (average)*	*241,200 square feet*
Condominiums	*88 units @ 1,200 sq. ft. (average)*	*105,600 square feet*
Apartments	*20 units @ 1,000 sq. ft. (average)*	*20,000 square feet*
Total	353 units	644,300 square feet

Affordable Housing Requirements

The affordable housing requirement applicable to this project that is proposed in the new Housing Element may be satisfied by either:

- Construction of 12.5 percent of the units at prices affordable to moderate income households *and 6.25* percent of the units at prices affordable to low income households (44 moderate-income units and 22 low-income units would be required), or
- Payment of a fee equal to 18.75 percent of construction cost. In this study, the new fee for all housing units totals between $9.7 and $11 million, depending on the sizes of the housing units.

For comparison:

The affordability requirements currently in effect would mandate:

- Construction of 10 percent of the units at prices affordable to moderate income households *and* 5 percent of the units at prices affordable to low income households, or

The new requirements reflect both an increase in the "base case" fee requirement (from 10 percent at present to 15 percent) and a new sliding scale adjustment factor for large projects (more than 20 units) in expansion areas

Comparison (cont'd)

- Payment of a fee equal to 10 percent of construction cost. In this study, , the fee for all housing units totals between $5.1 and $5.8 million, depending on the sizes of the housing units (Case A vs. Case B in the table above; see explanation below).

Assumptions for the Analysis

A complex project such as this one requires a series of explicit assumptions. Assumptions for this analysis are:

Unit Sizes

The unit sizes identified in the table above for Case 14.1 were originally hypothesized in 1991, when this analysis was first undertaken. Since then, living patterns and market demand characteristics have changed to some degree. For this analysis, therefore, Case 14.2 – with larger custom units and larger tract homes – was added to the study.

Market Prices

Prices assumed in the current analysis are summarized in Table 9

Table 9
2004 Market Prices for New Housing Units: Case 14

Type of Unit	Price/Rent	
	Case 14.1	Case 14.2
Custom Home	$675,000	$767,045
Single Family Tract Home	$500,000	$600,000
Condominium	$385,000	$385,000
Apartment*	$1,000	$1,200

* Two rent levels for apartments were tested. To maintain simplicity in the report, the lower rent level is included in Case 14.1 and the higher rent level with Case 14.2.

For comparison:

In the 1997 analysis, custom homes were priced at $325,000, single family tract homes at $225,000, and condominiums at $175,000. Apartments were assumed to rent for $775 per month.

Because the apartments did not yield a positive land budget at the assumed rent, they were omitted from the analysis of the impacts of housing affordability requirements in the 1997 analysis.

Timing of Development

A project of this magnitude is unlikely to be built all at the same time. Table 10 outlines the construction schedule assumed for this project. This schedule is the same as was assumed in the 1997 analysis.

Table 10
Construction Schedule: Case 14

Component	Units Constructed in Year:					
	1	2	3	4	5	Total
Custom Homes	25	25	25	25	11	111
Single Family Tract Homes	50	50	34	0	0	134
Condominiums	24	24	20	20	0	88
Apartments	20	0	0	0	0	20
Total	119	99	79	45	11	353

Affordable Units

None of the custom units are marketed as affordable units; instead, all of the affordable units are single family tract homes, condominiums, and apartments.

The rents hypothesized for the apartments - $1,000 per month in Case 14.1 and $1,200 per month in Case 14.2 – would qualify those 20 units as moderate income housing. To meet the proposed affordability requirements, the project would have to provide 22 low-income for-sale units and 24 moderate-income for-sale units in addition to the 20 apartments.

Two approaches to meeting these requirements were tested.

- In Scenario A, all of the low- and moderate-income units are assumed to be condominiums.
- In Scenario B, all of the low-income units are assumed to be condominiums and all of the for-sale moderate income units are assumed to be tract homes.

Scenario A and Scenario B were tested for both Case 14.1 and Case 14.2.

The distribution of affordable units in both scenarios is summarized in Table 11.

Calculation of the Land Budget

The land budget for the project is the total value of the land for all four residential components discounted to the net present value in the first year of construction. In other words, the "real" land value of the project components built after the first year is lower than the nominal value, because the money used to pay for those portions of the site could have been invested elsewhere instead of being tied up in the project (and, if it were invested elsewhere, could have been generating interest or dividends).

The land budget for this project must also cover the cost of the water tank, park improvements, and other costs incurred for development that are not explicitly included in the pro forma.

Table 11
Distribution of Affordable Housing Units: Case 14

Scenario A

Component	Total Units	Market-rate Units		Moderate-Income Units		Low-Income Units	
		#	Pct.	#	Pct.	#	Pct.
Custom Homes	111	111	100.00%	0	0.00%	0	0.00%
Single Family Tract Homes	134	134	100.00%	0	0.00%	0	0.00%
Condominiums	88	42	47.73%	24	27.27%	22	25.00%
Apartments	20	0	0.00%	20	100.00%	0	0.00%
Total	353	287	81.30%	44	12.46%	22	6.23%

Scenario B

Component	Total Units	Market-rate Units		Moderate-Income Units		Low-Income Units	
		#	Pct.	#	Pct.	#	Pct.
Custom Homes	111	111	100.00%	0	0.00%	0	0.00%
Single Family Tract Homes	134	134	100.00%	24	17.91%	0	0.00%
Condominiums	88	42	47.73%	0	0.00%	22	25.00%
Apartments	20	0	0.00%	20	100.00%	0	0.00%
Total	353	287	81.30%	44	12.46%	22	6.23%

Results of the Analysis: Case 14.1

Case 14.1 considers a project with custom homes and tract homes of the originally-defined sizes. These homes are smaller than those considered in Case 14.2.

Land Budget with No Affordable Housing Requirement

For Case 14.1, the total land budget for this project is approximately $47.7 million. This total is equal to an average of $7.85 per square foot for the 139.5-acre site, or $21.69 per square foot for the 50.5 acres assumed to be occupied by residential development. (The remainder is devoted to parks and open space.)

The estimate of value derived in this analysis relies on a series of assumptions, most of which are described above and detailed in Tables 9 through 11. An additional critical assumption is the discount rate used to adjust future

For comparison:

In the 1997 analysis, the land budget with no affordable housing requirement was $1.38 per square foot for the 139.5-acre entire site area.

revenues to current dollars. The discount rate used in this analysis is eight percent (in other words, $1.08 in 2005 is worth $1.00 in 2004).

Impact of Affordable Housing Requirements

The project may meet its affordable housing requirement in either of two ways: (1) payment of a fee equal to 18.75 percent of the construction cost or (2) provision of 12.5 percent of the units (44 units) at prices affordable by moderate-income households *and* 6.25 percent of the units (22 units) at prices affordable by low-income households.

Payment of a fee equal to 18.75 percent of construction costs would have the following potential effects:

- Reduce developer's profit on sale from 20 percent to about 19 percent (a change of by about four percent); *or*
- Reduce estimated land value from $7.85 to $6.29 per square foot (a change of about 20 percent); *or*
- Increase the sales price for market-priced units from $675,000 to $731,600 for custom homes, from $500,000 to $539,900 for single family tract homes, and from $385,000 to $416,100 for condominiums (a change of between eight and nine percent); *or*
- Some combination of these results that yields developer's profit *between* 19 percent and 20 percent *and* land value *between* $6.29 and $7.85 per square foot *and* average sales prices for market-priced units *between* $675,000 and $731,600 for custom homes, $500,000 and $539,900 for tract homes, and $385,000 and $416,100 for condominiums.

Sale of 12.5 percent of the units at prices affordable to moderate-income households and 6.25 percent of the units at prices affordable to low-income households would have the following effects:

In Scenario A (all for-sale low- and moderate-income units are condominiums):

- Reduce developer's profit on sale from 20 percent to 15.1 percent (a change of about 21 percent); *or*
- Reduce estimated land value from $7.85 to $6.67 per square foot (a change of 15 percent); *or*
- Increase the sales price for market-priced units by between six and eight percent, depending on the unit type (from $675,000 to $720,600 for custom homes, from $500,000 to $531,600 for tract homes, and from $385,000 to $413,500 for condominiums); *or*
- Some combination of these results that yields developer's profit *between* 15.1 percent and 20 percent *and* land value *between* $6.67 and $7.85 per square foot *and* average sales prices for market-priced units *between* $675,000 and $720,600 for custom homes, $500,000 and $531,600 for tract homes, and $385,000 and $413,500 for condominiums.

In Scenario B (all for-sale low-income units are condominiums and all for-sale moderate-income units are tract homes):

- Reduce developer's profit on sale from 20 percent to about 12.9 percent (about 35 percent); *or*
- Reduce estimated land value from $7.85 to $6.25 per square foot (about 20 percent); *or*
- Increase the sales price for market-priced units from $675,000 to $727,500 for custom homes, from $500,000 to $547,300 for tract homes, and from $385,000 to $418,600 for condominiums (a change of between 8 and 10 percent, depending on the unit type); *or*
- Some combination of these results that yields developer's profit *between* 13 percent and 20 percent *and* land value *between* $6.25 and $7.85 per square foot *and* average sales prices for market-priced units *between* $675,000 and $727,500 for custom homes, $500,000 and $547,300 for tract homes, and $385,000 and $418,600 for condominiums.

These results are summarized in Table 12.

Table 12
Effects of Affordable Housing Requirements: Case 14.1

Variable	Value in 2004 Base Case	Value if this Variable Bears the Full Impact of Affordable Housing Requirement		
		18.75% Housing Fee	12.5% Moderate and 6.25% Low Income Units	
			Case A[a]	Case B[b]
Land Budget (value per sq. ft.)[c]	$7.85	$6.29	$6.67	$6.25
Profit on sale (% of sale price)	20.0%	19.0%	15.1%	13.1%
Price of market-priced units[d]				
Custom homes	$675,000	$731,600	$720,600	$727,500
Single family tract homes	$500,000	$539,900	$531,500	$547,300
Condominiums	$385,000	$416,100	$413,500	$418,600

a All for-sale low- and moderate income units are condominiums.

b Low-income for-sale units are condominiums; moderate-income for-sale units are tract homes.

c For 139.5 acres.

d Non-discounted average of values for all phases (values vary by phase as a result of the mix of unit types assumed). Apartments, which are all moderate-income units, are omitted from this table.

Source: Mundie & Associates

The results in the table indicate that, all other things being equal, a prospective developer would find it more advantageous to satisfy the affordable housing requirements by paying the 18.75 percent contribution to the affordable housing fund, but that the production of low- and moderate-income condominiums would have the smallest effects on land prices and the prices of market-rate units. This conclusion assumes, as in Case 13, that the inclusion of the low- and moderate-income units would not have a negative impact on the obtainable prices for other units in the project.

Results of the Analysis: Case 14.2

Case 14.2 considers a project with larger custom homes and tract homes than were originally assumed for this project. In this case, the custom homes would average 2,500 square feet (compared to 2,200 square feet in Case 14.1) and the tract homes would average 1,800 square feet (compared to 1,500 square feet in Case 14.1).

Land Budget with No Affordable Housing Requirement

With the larger single-family units, the total land budget for this project is approximately $56.9 million. This total is equal to an average of $9.36 per square foot for the 139.5-acre site, or $25.84 per square foot for the 50.5 acres assumed to be occupied by residential development.

Impact of Affordable Housing Requirements

Payment of a fee equal to 18.75 percent of construction costs would have the following potential effects:

- Reduce developer's profit on sale from 20 percent to 19.1 percent (a change of about four percent); *or*
- Reduce estimated land value from $9.36 to $7.56 per square foot (a change of nine percent); *or*
- Increase the sales price for market-priced units from $747,045 to $819,900 for custom homes, from $600,000 to $646,700 for single family tract homes, and from $385,000 to $415,400 for condominiums (a change of between 8 and 10 percent, depending on the unit type); *or*
- Some combination of these results that yields developer's profit *between* 19 percent and 20 percent *and* land value *between* $6.29 and $7.85 per square foot *and* average sales prices for market-priced units *between* $747,045 and $819,900 for custom homes, $600,000 and $646,700 for tract homes, and $385,000 and $415,400 for condominiums.

Sale of 12.5 percent of the units at prices affordable to moderate-income households and 6.25 percent of the units at prices affordable to low-income households would have the following effects:

In Scenario A (all for-sale low- and moderate-income units are condominiums):

- Reduce developer's profit on sale from 20 percent to 15.8 percent (a change of about 21 percent); *or*
- Reduce estimated land value from $9.36 to $8.17 per square foot (about 19 percent); *or*
- Increase the sales price for market-priced units from $747,045 to $803,400 for custom homes, from $600,000 to $632,700 for tract homes, and from $385,000 to $410,000 for condominiums (between six and eight percent, depending on the unit type); *or*
- Some combination of these results that yields developer's profit *between* 15.8 percent and 20 percent *and* land value *between* $8.17 and $9.36 per square foot *and* average sales prices for market-priced units *between* $747,045 and $803,400 for custom homes, $600,000 and $632,700 for tract homes, and $385,000 and $410,000 for condominiums.

In Scenario B (all for-sale low-income units are condominiums and all for-sale moderate-income units are tract homes):

- Reduce developer's profit on sale from 20 percent to about 13.1 percent (about 35 percent); *or*
- Reduce estimated land value from $9.36 to $7.55 per square foot (about 19 percent); *or*
- Increase the sales price for market-priced units from $747,045 to $819,100 for custom homes, from $600,000 to $659,800 for tract homes, and from $385,000 to $419,600 for condominiums (between 9 and 10 percent, depending on the unit type); *or*
- Some combination of these results that yields developer's profit *between* 13.1 percent and 20 percent *and* land value *between* $7.55 and $9.36 per square foot *and* average sales prices for market-priced units *between* $747,045 and $819,100for custom homes, $600,000 and $659,800 for tract homes, and $385,000 and $419,600 for condominiums.

These results for Case 14.2 are summarized in Table 13. With the larger unit sizes, the least impact would occur in the effect on the developer's profit (about a four percent reduction, from 20 percent to 19.1 percent). This result is similar to Case 14.1. As with Case 14.1, too, satisfying the affordable housing requirement through the production of low- and moderate-income condominiums would have the smallest effects on land prices and the prices of market-rate units.

Table 13
Effects of Affordable Housing Requirements: Case 14.2

Variable	Value in 2004 Base Case	Value if this Variable Bears the Full Impact of Affordable Housing Requirement		
		18.75% Housing Fee	12.5% Moderate and 6.25% Low Income Units	
			Case A[a]	Case B[b]
Land Budget (value per sq. ft.)[c]	$9.39	$7.56	$8.17	$7.55
Profit on sale (% of sale price)	20.0%	19.1%	15.8%	12.9%
Price of market-priced units[d]				
Custom homes	$747,045	$819,900	$803,400	$819,100
Single family tract homes	$500,000	$646,700	$632,700	$659,800
Condominiums	$385,000	$415,400	$410,000	$419,600

a All for-sale low- and moderate income units are condominiums.

b Low-income for-sale units are condominiums; moderate-income for-sale units are tract homes.

c For 139.5 acres

d Non-discounted average of values for all phases (values vary by phase as a result of the mix of unit types assumed). Apartments, which are all moderate-income units, are omitted from this table.

Source: Mundie & Associates

Additional Conditions that May Affect Project Feasibility

The land budget for this project, as noted earlier, must cover the cost not only of the land, but also the provision of certain major infrastructure improvements – including at least a water tank and park improvements – as well as other costs incurred for development that are not explicitly included in the pro forma. These costs have not been estimated for this analysis. If they are too high in relation to the land budget, they will affect the feasibility of development.

Further, as was assumed for Case 13 and noted above, this analysis assumes that the availability of low- or moderate-priced units in the complex will not affect the prices obtainable for the market-priced units.

Summary: Case 14

Although the impacts of affordable housing requirements for Case 14 would be noticeable, they are unlikely to make the development of this proposed project infeasible. As noted above, payment of the 18.75 percent fee would have the least impact on the project if it were absorbed by the developer, reducing expected profits by less than five percent.

The impacts of the various approaches to satisfying the affordability requirements for Cases 14.1 and 14.2 are summarized and compared in Table 14.

Table 14
Summary of Effects of Affordability Requirements: Cases 14.1 and 14.2

	Case 14.1		Case 14.2		
	Value	Impact of Affordable Housing Requirements	Value	Impact of Affordable Housing Requirements	Impact of Larger Units*
Land Value					
Base Case	$7.85		$9.36		19%
18.75% Fee	6.29	-19.9%	7.56	-19.1%	20%
Case A (Original Units)	6.67	-15.1%	8.17	-12.7%	23%
Case B (Larger Units)	6.25	-20.5%	7.55	-19.3%	21%
Profit					
Base Case	20.0%		20.0%		0%
18.75% Fee	19.0%	-4.8%	19.1%	-4.3%	1%
Case A (Original Units)	15.1%	-24.3%	15.8%	-21.2%	4%
Case B (Larger Units)	13.1%	-34.3%	12.9%	-35.4%	-2%
Average Price					
Base Case	$527,943		$592,198		12%
18.75% Fee	571,117	8.2%	643,301	8.6%	13%
Case A (Original Units)	563,360	6.7%	630,759	6.5%	12%
Case B (Larger Units)	573,370	8.6%	649,421	9.7%	13%

* Change in value from Case 14.1 to Case 14.2.

Source: Mundie & Associates

The table suggests the following observations:

- Increasing the sizes of the custom homes and single family tract homes as assumed in Case 14.2 would offset the land value impacts of the affordability requirements. For example, the land value in Case 14.2, Scenario A, would be $8.17 per square foot, which is greater than the land value with no housing affordability requirement in Case 14.1.

- The increase in overall average housing price (combined average for all for-sale unit types) would be 12 to 13 percent greater in Case 14.2 than in Case 14.1. The reason for this difference is that the difference between the market price of the larger units and the prices of the affordable units would be greater, and this greater amount would be divided among the same number of market-priced units.

  In general, the increase in market housing prices would increase the income required to buy a home by between $7,000 and $9,000 for Case 14.1 and between $7,000 and $11,000 in Case 14.2.

- When the City Council originally considered the application of substantial affordability requirements to land in expansion areas in 1991, their expressed intention was to set the requirements at a level that would capture approximately one-half of the land value in that area after annexation. The fee requirement evaluated in this study is estimated to reduce the land value by about 20 percent. The housing production option(s) increase the impact by a small amount in some scenarios but not others (e.g., about 23 percent in Case 14.2, Scenario A, and 15 percent in Case 14.1, Scenario A). The issue of fees is discussed further in Chapter IV.

  Whether it would be possible to increase the affordability requirements further, to achieve the 50 percent capture level originally envisioned by the Council, depends in large part on the demand for housing and whether there is flexibility in the marketplace for land. More specifically, apparently-developable land sometimes remains unavailable for development because the owner has an expectation of the obtainable market price. If that price is unrealistically high and the owner is not especially motivated to sell, then he or she may retain ownership – and the land may remain vacant – rather than accept the perceived reduction in value that would result from the application of affordability requirements.

IV. CONCLUSIONS

FINDINGS OF THE FEASIBILITY ANALYSIS

The analysis presented in Chapter III leads to the following conclusions:

- **For the most part, the City's proposed housing affordability requirements would not discourage new development.** For convenience, the impacts are summarized in Table 11.

  In some cases the figures shown in Table 11 indicate that the affordability requirements would yield dramatic reductions in land value. For example, in Case 2A (which assumes that the building owner is responsible for the operating costs of the office space), the land value would decline 93 percent if the project were assessed a five percent in-lieu fee for housing affordability. With an underlying (base case) land value of $14.40 per square foot, however, this project would not be able to compete for sites with Case 13, the infill condominiums, which generates a base case land value of $25.40 per square foot and values in the range of $23.00 even after application of the proposed affordability requirements. Therefore, while the proposed requirements would have a significant effect on land values for Case 2, they would not be the factor that determines infeasibility.

  Similarly, the underlying (base case) land value for Case 4 is $1.00 per square foot. It is unlikely that land would be sold for this amount in today's market, where expectations of value are likely to be governed by the value for retail projects (at a minimum, close to $6.00 per square foot in Case 2) or even housing (apartments in Case 14 yield at least $5.10 per square foot; other housing types would yield more). Therefore, the impact of housing affordability requirements is unlikely to be the determining factor in whether additional service commercial space is built in the San Luis Obispo expansion areas.

- **The indicator of impact most affected by the affordable housing requirements – both within the existing City and in the expansion areas – is land value** (if it absorbs the entire impact of the requirements); rents and housing prices are affected least. It is reasonable to expect that if a potential developer cannot negotiate land prices down to level that would pass all of the impact of the requirements through to the pre-development landowner, he or she would attempt to pass on part of the impact to project occupants in the form of higher rents/sales prices. (This conclusion is the same as in earlier editions of this study.)

- **Based on the assumptions used for this study, impacts on the feasibility of new development are most severe in Case 2A, which is a mixed-use retail/office project located downtown.** It is possible that the effects of the applicable requirements on land values would discourage a landowner from making the project site available for development: it is likely that a developer would consider the profits to be expected from such a project to be unreasonably low *if none of the impact can be passed on to either the landowner or the tenants (in the form of higher rents)*.

Table 15
Summary: Impacts of Affordable Housing Requirements on Feasibility of New Development

Case	Location (In City or Expansion)	Method of Satisfying Requirement	Scenario	Land Value/ per Sq. Ft.	Profit[a]	Rent/Sq. Ft. or Sale Price/ Unit
2	In City	5% Fee	A[b]	-93%	-7%	+3%
			B[c]	-16%	-6%	+3%
3	Expansion	5% Fee	A[d]	-10%	-7%	+3%
			B[e]	-21%	-8%	+3%
4	Expansion[2]	5% Fee		-21%	-7%	+3%
13	In City	5% Fee		-8%	-1%	+2%
		5% Moderate Income Units		-9%	-10%	+3%
		3% Low Income Units		-12%	-17%	+4%
14.1[f]	Expansion	18.75% Fee		-20%	-5%	+8%
		12.5% Moderate Income Units *and* 6.25% Low Income Units	A[g]	-15%	-24%	+7%
			B[h]	-21%	-34%	+9%
14.1[i]	Expansion	18.75% Fee		-20%	-4%	+8%
		12.5% Moderate Income Units *and* 6.25% Low Income Units	A[g]	-13%	-21%	+7%
			B[h]	-19%	-35%	+10%

a Internal rate of return in operating year 10 for rental projects; profit on sale for for-sale projects.
b Assumes project owner incurs operating costs for office space.
c Assumes project owner incurs no operating costs (all leases are triple net).
d Assumes 50 percent of project is occupied by anchor-type (lower-rent) tenants and 50 percent is occupied by smaller (higher-rent) tenants.
e Assumes 80 percent of project is occupied by anchor-type (lower-rent) tenants and 20 percent is occupied by smaller (higher-rent) tenants.
f Assumes that custom homes are 2,200 square feet and single family tract homes are 1,500 square feet (size assumption from previous analyses).
g Assumes all for-sale low- and moderate-income units are condominiums.
h Assumes that for-sale low-income units are condominiums and for-sale moderate-income units are single family tract homes.
I Assumes that custom homes are 2,500 square feet and single family tract homes are 1,800 square feet (larger than previously assumed).

Source: Mundie & Associates

Impacts on land value are also significant – in the range of 20 percent – in both versions of Case 14 (major expansion area residential project). In this case, the impacts of the housing production requirements are also significant (20 to 25 percent for Scenario A, in which all affordable for-sale units are condominiums; 34 to 35 percent for Scenario B, in which low-income for-sale units are condominiums and moderate-income for-sale units are single family tract homes). These impacts could be substantially reduced, however – to the range of four percent – by paying the in-lieu fee. *The relatively slight impact of the fee on profitability suggests that the amount of the fee should be increased or the amount of housing production required should be decreased to reduce the attractiveness of the fee option, which is ultimately likely to produce fewer units.*

ADDITIONAL DISCUSSION OF THE FEE OPTION

Of particular concern to the City at this time is whether the option of satisfying the housing affordability requirement compromises the ability to achieve housing production goals. Another more specific way of considering this question is to compare the theoretical housing yield from different methods of meeting the requirement. A comparison of yields is presented in Table 16.

Table 16
Housing Yields from Different Methods of Meeting the Affordable Housing Requirements

Project Type	Yield from Fees	Yield from Production	Greater Yield from:
Case 13 18 Infill Condominiums	5% of the construction cost of 18 units = 90% of the construction cost of 1 unit	1 low-income unit *or* 1 moderate-income unit	Production
Case 14 353 Expansion Area Housing Units (mixed unit types)	18.75% of the construction cost of 333 units* = construction cost of 62.4 units	22 low-income units + 44 moderate-income units = 66 units	Production

* Fees are not applied to the 20 apartments, which are affordable to moderate-income households.

Source: Mundie & Associates

For both Case 13 and Case 14, satisfying the requirement by building affordable housing units would yield more units. The difference appears to be marginal in both cases, but the table ignores the costs in addition to bricks and mortar that are incurred to produce a housing unit: costs that the entity ultimately producing the housing (the City, Housing Authority, or another developer) would incur in applying the funds to a construction project.

These costs include, for example, project design, engineering, and architecture; land; site preparation; fees and exactions; construction financing: and marketing. In Case 13, the construction cost comprises approximately 38 percent of the total production cost (including land); in Case 14, it comprises approximately one-third. (This estimate for Case 14 excludes the costs of infrastructure improvements, such as the water tank and park, which have not been estimated). When these additional costs are considered, then, the fee option underfunds provision of units (it is a bargain to the developer).

Table 14 also indicates the potential advantage to the developer of the fee option. The column headed "Profit" shows:

- In Case 13, payment of the fee would reduce the developer's expected profit by about 1 percent, while production of one moderate income unit would reduce the profit by 10 percent and the production of one low-income unit would reduce it by 17 percent.
- In Case 14.1, payment of the fee would reduce the developer's expected profit by about 5 percent, while the less-costly production alternative (low- and moderate-income condominiums) would reduce the profit by 24 percent. In Case 14.2, the comparable reductions are 4 percent with the fee payment and 21 percent with the production of low- and moderate-income housing units.

At the same time, Table 14 indicates that the impact of paying a fee on land value or on the prices of market-rate units is comparable to the impact of the housing production options. The difference in impact appears to be related to the fact that the amount of the fee is based on construction cost, which is similar for market-priced units and affordable units, while the amount of revenue foregone with the production option is based on the difference in price for the units.

One result of the differing bases of impacts (cost vs. revenues) is that the effects of the production option are more volatile with respect to housing market conditions: any closure of the gap between market prices and affordable prices would reduce the impact of the production option and any widening of the gap would increase the impact of the production option, but neither change would affect the impact of the fee option on the financial feasibility of development.[9] Thus, if the gap between market prices and affordable prices were to decrease, the fee option would become relatively less attractive and if the gap were to increase, the fee option would become relatively more attractive. Because the cost basis of the fee represents only a part of the full housing production cost, however, the changes in the size of the gap would have to be considerable before the production option would become an attractive strategy for developers.

9 As was noted in Chapter II, market feasibility – in this case, whether a change in the relationship between market housing prices and affordable housing prices as an indicator of economic health and market housing demand – is not considered in this report.

APPENDIX A
INCOME LIMITS, RENTS, AND SALES PRICES

Unit Type:	1 BR	2 BR	3 BR	
Permitted Household Size:	**2 people**	**3 people**	**4 people**	**5 people**
Upper Limit of Income for:				
Lower-income Households	$36,950	$41,550	$46,150	$49,850
Moderate-income Households	55,400	62,350	69,250	74,800
Upper Limit of Rents/Month				
Lower-income Households	$692.25	$779.25	$865.50	$934.50
Moderate-income Households	1,480.65	1,666.73	1,851.21	1,998.79
Upper Limit of Purchase Prices				
Upper Limit of Rents/Month	$92,375	$103,875	$115,375	$124,625
Moderate-income Households	166,200	187,050	207,750	224,400

Source: City of San Luis Obispo

APPENDIX B
DETAILED ASSUMPTIONS FOR 1991, 1997, AND 2004

CASE 2: DOWNTOWN MIXED USE BUILDING

			1991	1997	2004
Construction Costs (per sq. ft.)	Retail:	Shell	$95.00	$80.00	$82.40
		Tenant Finish	None	None	None
	Office:	Shell	$75.00	$90.00	$106.80
		Tenant Finish	$25.00	$20.00	$30.00
Construction Period (months)			12	12	12
Occupancy	Retail:	End of Year 1	50%	50%	50%
		End of Year 2 and after	95%	95%	95%
	Office:	End of Year 1	50%	50%	35%
		End of Year 2	95%	95%	75%
		End of Year 3 and after	95%	95%	95%
Efficiency (net:gross ratio)	Retail		95%	95%	95%
	Office		90%	90%	90%
Soft Costs (% of hard costs)			10%	10%	10%
Additional Costs					
Developer-built infrastructure	Sidewalk and tree wells		$5,100	$13,600	$39,168
Permits and Plan Check			8,400	20,788	41,515
Developer-funded (fees)	Water		5,255	12,456	33,491
	Sewer		4,435	5,131*	13,720
	Circulation/Traffic		46,070	43,396	51,195
	Parking (37 spaces)		148,000	148,000	407,000
	Public Art		n.a.	n.a.	9,215
Non-City impact fees	School district		4,597	4,598	4,598
Total (excl. housing fee)			$221,857	$247,969	$599,902
Rent (per sq. ft. per month)	Retail		$2.00	$2.00	$2.50
	Office		$1.50	$1.50	$1.30
Operating Costs (per sq. ft. per year)	Retail		None	None	None
	Office		Fixed: $1.50 Variable: $2.50	Fixed: $1.50 Variable: $2.50	(A): Fixed: $1.50 Variable: $2.50 (B) None

* Assumes no restaurant

CASE 3: EXPANSION AREA RETAIL

		1991	1997	2004
Construction Costs (per sq. ft.)	Retail: Shell	(1) $85.00 (2) $70.00	$75.80	$82.40
	Tenant Finish	None	None	None
	Parking	$8.30	$8.30	$8.30
Construction Period (months)		12	12	12
Occupancy	End of Year 1	100%	100%	50%
	End of Year 2 and after	100%	100%	95%
Efficiency (net:gross ratio)	Retail	100%	100%	98%
Soft Costs (% of hard costs)		10%	10%	10%
Additional Costs				
Developer-built infrastructure	Parts of streets, bus shelter/turnout, highway interchange contribution, drainage culverts	(Not estimated, unless as part of circulation fee)	(Not estimated, unless as part of circulation fee)	(Not estimated, unless as part of circulation fee)
Permits and Plan Check			$220,185	$378,509
Developer-funded (fees)	Water	$118,000	37,368	66,982
	Sewer	99,788[a]	15,393	13,720
	Circulation/Traffic	1,275,000	508,725	153,586
	Public Art	n.a.	n.a.	112,230
Non-City impact fees	School district	63,750	63,750	63,750
Total (excl. housing fee)		$1,556,538	$845,421	$788,777
Rent (per sq. ft. per month)	Retail	(1) $1.00 (2) 0.70	$1.00	(A) $1.30[b] (B) $1.09[c]
	Parking	None	None	None
Operating Costs (per sq. ft. per year)	Retail	None	None	None
	Parking	None	None	None

[a] Assumes no restaurant

[b] Assumes 50% of building space is rented by anchor-type tenants at $1.05/sq. ft./month and 50% is rented to smaller stores at $1.65/sq. ft./month.

[c] Assumes 80% of building space is rented by anchor-type tenants at $1.05/sq. ft./month and 20% is rented to smaller stores at $1.65/sq. ft./month.

CASE(S) 4 (AND 5): EXPANSION AREA INDUSTRIAL

		1991	1997	2004
Construction Costs (per sq. ft.)	Industrial: Shell			
	Case 4	$37.00	$36.30	$63.70[a]
	Case 5	$40.00	$36.30	[b]
	Tenant Finish	$3.75	$3.75	None
	Parking	$8.30	$8.30	$8.30
	Site Improvements	None	None	$5.00
Construction Period (months)		12	12	12
Occupancy	End of Year 1	100%	100%	75%
	End of Year 2 and after	100%	100%	95%
Efficiency (net:gross ratio)	Industrial	100%	100%	95%
Soft Costs (% of hard costs)		10%	10%	10%
Additional Costs				
Developer-built infrastructure	none			
Permits and Plan Check		$11,872	$30,454	$69,764
Developer-funded (fees)	Water	$57,807	12,456	54,800
	Sewer	48,785	5,131	16,704
	Circulation/Traffic	18,000	43,980	97,320
	Public Art	n.a.	n.a.	18,610
Non-City impact fees	School district	15,000	15,000	15,000
Total (excl. housing fee)		$151,464	$107,021	$272,198
Rent (per sq. ft. per month)	Industrial	$0.50	$0.50	(A) $0.65 (B) $0.85
Operating Costs	Industrial	None	None	None

a Use is changed from industrial to service commercial in 2004.

b Case 5, which was originally distinguished from Case 4 by a difference in construction costs between the City and the expansion area, has been eliminated.

CASE 13: INFILL CONDOMINIUMS

		1991	1991	2004
Construction Costs	Site Improvements (per unit)	$15,000	$15,000	$18,000
	Structures (per sq. ft.)	$45.50	$69.10	$98.95
Construction Period (months)		12	12	12
Sale Period (months)		6	6	6
Soft Costs (% of hard costs)		10%	10%	10%
Additional Costs				
Building permit		$10,973	$32,180	$44,334
Plan Check		7,235	25,589	
Developer-funded (fees)	Water	37,837	89,694	121,698
	Sewer	31,932	35,532	47,718
	Circulation/Traffic	23,400	20,196	23,814
	Parks and Recreation	28,662	48,042	63,810
Non-City impact fees	School district	37,350	37,350	37,350
Total (excl. housing fee)		$177,389	$288,583	$338,724
Other Costs: Marketing (% of sale price)		4%	4%	4%
Profit (% of sale price)		12.5%	12.5%	20.0%
Sale Price (per unit; average)	Low-priced Scenario	$150,000[a]	$195,000[c]	$409,722[d]
	Moderate-Priced Scenario	175,000[b]		
	High-priced Scenario	195,000[c]		

[a] Two-bedroom units @ $132,300; three-bedroom units @ $177,875. This scenario did not yield a positive land budget in 1997, and therefore is not included in that report.

[b] Two-bedroom units @ $154,375; three-bedroom units @ $207,520. This scenario does not yield a positive land budget in 1997, and therefore is not included in that report.

[c] Two-bedroom units @ $172,000; three-bedroom units @ $231,250.

[d] Two-bedroom units @ $400,000; three-bedroom units @ $425,000.

CASE 14: EXPANSION AREA RESIDENTIAL

Custom Homes

		1991	1997	2004
Construction Costs	Site Improvements (per unit)	$15,000	$15,000	$18,000
	Structures (per sq. ft.)	$70.00	$69.10	$98.95
Construction Period (months)		12	12	12
Sale Period (months)		12	12	6
Soft Costs (% of hard costs)		10%	10%	10%
Additional Costs[a]				
Building permit		$120,590	$183,864	$825,639
Plan Check		78,384	263,647	
Developer-funded (fees)	Water	291,664	691,308	933,843
	Sewer	246,145	273,837	367,854
	Circulation/Traffic	210,900	140,415	165,501
	Parks and Recreation	0	0	0
Non-City impact fees	School district	366,300	366,300	366,300
Total (excl. housing fee)*		$1,313,982	$1,919,371	$2,659,083
Other Costs: Marketing (% of sale price)		4%	4%	4%
Profit (% of sale price)		12.5%	12.5%	20.0%
Sale Price (per unit; average)[b]		$325,000	$325,000	$675,000

* Detail and total do not agree because of independent rounding.

a For comparability to prior years, costs are shown for Case 14.1 (original-sized custom units). Additional costs for Case 14.2 (larger units) are:

Building permit/plan check		$901,509
Developer-funded (fees)	Water	933,843
	Sewer	367,854
	Circulation/Traffic	165,501
	Parks and Recreation	0
Non-City impact fees	School district	416,250
Total (excl. housing fee)*		$2,784,929

* Detail and total do not agree because of independent rounding.

b For comparability to prior years, the sale price shown is for Case 14.1 (original-sized custom units). The price assumed for Case 14.2 (larger units) is $767,045.

CASE 14 (CONT'D)

Single-family Tract Homes

		1991	1997	2004
Construction Costs	Site Improvements (per unit)	$15,000	$15,000	$18,000
	Structures (per sq. ft.)	$50.00	$69.10	$98.95
Construction Period (months)		12	12	12
Sale Period (months)		12	12	6
Soft Costs (% of hard costs)		10%	10%	10%
Additional Costs[a]				
Building permit		$115,749	$202,790	$785,339
Plan Check		75,237	253,162	
Developer-funded (fees)	Water	352,098	834,552	1,127,342
	Sewer	297,145	330,578	444,076
	Circulation/Traffic	254,600	169,510	199,794
	Parks and Recreation	0	0	0
Non-City impact fees	School district	301,500	301,500	301,500
Total (excl. housing fee)*		$1,396,330	$2,092,092	$2,858,079
Other Costs: Marketing (% of sale price)		4%	4%	4%
Profit (% of sale price)		12.5%	12.5%	20.0%
Sale Price (per unit; average)		$225,000	$225,000	$500,000

* Detail and total do not agree because of independent rounding.

a For comparability to prior years, costs are shown for Case 14.1 (original-sized single family tract units). Additional costs for Case 14.2 (larger units) are:

Building permit/plan check		$873,931
Developer-funded (fees)	Water	1,127,342
	Sewer	444,076
	Circulation/Traffic	199,794
	Parks and Recreation	0
Non-City impact fees	School district	361,800
Total (excl. housing fee)		$3,010,002

* Detail and total do not agree because of independent rounding.

b For comparability to prior years, the sale price shown is for Case 14.1 (original-sized single family tract units). The price assumed for Case 14.2 (larger units) is $600,000.

CASE 14 (CONT'D)

Condominiums

		1991	1997	2004
Construction Costs	Site Improvements (per unit)	$15,000	$15,000	$18,000
	Structures (per sq. ft.)	$45.50	$63.05	$98.95
Construction Period (month)		12	12	12
Sale Period (month)		9	9	6
Soft Costs (% of hard costs)		10%	10%	10%
Additional Costs				
Building permit		$38,562	$68,451	$147,533
Plan Check		25,067	92,754	
Developer-funded (fees)	Water	184,985	438,504	594,968
	Sewer	156,112	173,712	233,288
	Circulation/Traffic	114,400	98,736	116,424
	Parks and Recreation	0	0	0
Non-City impact fees	School district	158,400	158,400	158,400
Total (excl. housing fee)		$677,525	$1,030,557	$1,250,613
Other Costs: Marketing (% of sale price)		4%	4%	4%
Profit (% of sale price)		12.5%	12.5%	20.0%
Sale Price (per unit; average)	Low-priced Scenario[a]	$150,000	$150,000	$385,000[c]
	High-priced Scenario[b]	175,000	175,000	

[a] Two-bedroom units @ $132,300; three-bedroom units @ $177,875.

[b] Two-bedroom units @ $154,375; three-bedroom units @ $207,520.

[c] Two-bedroom units @ $$372,500; three-bedroom units @ $405,000.

CASE 14 (CONT'D)

Apartments

		1991	1997	2004
Construction Costs (per sq. ft.)	Site Improvements[a]	$3.00	$3.00	$5.00
	Structures	$42.50	$63.05	$79.00
Construction Period (months)		12	12	12
Efficiency (net:gross ratio)	Residential	90%	90%	95%
Soft Costs (% of hard costs)		10%	10%	10%
Additional Costs				
Building permit/plan check		$10,408	$23,053	$35,974
Developer-funded (fees)	Water	42,042	99,660	132,802
	Sewer	35,480	39,480	53,020
	Circulation/Traffic	26,000	22,440	26,460
	Parks and Recreation	0	0	0
Non-City impact fees	School district	30,000	30,000	30,000
Total		$143,930	$214,633	$278,256
Rent (per unit per month)		$775	n.a.[b]	(A) $1,000[c] (B) $1,200[c]
Operating Costs (% of rent)		25%	25%	25%

a Applies to 58,408 sq. ft. of site area not occupied by structure.

b Rent of $930 per unit per month would yield the target return of 12 percent IRR in operating year 10 *with no land budget* (that is, free land); rent of $1,015 per unit per month is required to yield the target return with land budget of $1.95 per square foot (the 1991 land budget).

c Lower rent (A) was used in Case 14.1 (original-sized custom and single family tract units); higher rent (B) was used in Case 14.2 (larger custom and single family tract units). Both rents are affordable to moderate-income households.

GENERAL ASSUMPTIONS

For-Rent Projects

		1991	1997	2004
Lease Term	Apartments	1 year	1 year	1 year
	Downtown Mixed Use	5 years	5 years	5 years
	Expansion Area Retail	20 years	20 years	5 years
	Industrial	20 years	20 years	5 years
Lease Commission	Apartments	None	None	None
	Downtown Mixed Use	25% of first year[a]	25% of first year[a]	25% of first year[a]
	Expansion Area Retail	25% of first year[a]	25% of first year[a]	25% of first year[a]
	Industrial	None	None	25% of first year[a]
Percent of Lease Renewals	For Tenant Imp. Calc.			
	Apartments	0%[b]	0%[b]	0%[b]
	Downtown Mixed Use	25%	25%	25%
	Expansion Area Retail	0%	0%	25%
	Industrial	100%	100%	25%[c]
	For Lease Comm. Calc.			
	Apartments	0%[b]	0%[b]	0%[b]
	Downtown Mixed Use	50%	50%	50%
	Expansion Area Retail	100%	100%	50%
	Industrial	100%	100%	50%
Depreciation	Type	Straight Line	Straight Line	Straight Line
	Period			
	Building	31.5 years	31.5 years	31.5 years
	Tenant Finish	Same as lease term	Same as lease term	Same as lease term
	Lease Commissions	Same as lease term	Same as lease term	Same as lease term

[a] Equivalent of 5 percent per year for the first five years of the lease.

[b] No lease commissions or tenant improvement costs.

For-Rent Projects (cont'd)

		1991	1997	2004
Construction Financing	% of Construction Cost	100%	75%	75%
	Interest Rate	10.5%	10.25%	7.0%
	Points	2.0	1.5	1.5
Mortgage	% of Construction Cost			
	Nonresidential	70%	75%	65%
	Apartments	70%	75%	75%
	Interest Rate	10.0%	9.25%	7.0%
	Points			
	Nonresidential	2.0	1.5	1.5
	Apartments	1.5	n.a.	1.5
	Term[d]			
	Downtown Mixed Use		25 years	
	Expansion Area Retail	30 years	20 years	20 years
	Industrial		25 years	
	Apartments		n.a.	
Tax Rate	Federal	28.0%	28.0%	28.0%
	State	9.3%	9.3%	9.3%
Inflation Rate		5.0%	5.0%	3.0%
Capitalization Rate on Sale	Apartments	8.5%	8.5%	6.00%
	Downtown Mixed Use	8.0%	8.0%	7.75%
	Expansion Area Retail	8.0%	8.0%	8.75%
	Industrial	8.5%	8.5%	8.50%
Commission on Sale		6.0%	6.0%	6.0%
Discount Rate for NPV		12.0%	12.0%	8.5%

d For mortgage amortization schedule; typically, loans on commercial and industrial property amortize over 20 or 25 years, but are due after 10 years or so.

For-Sale Projects

		1991	1997	2004
Financing Costs	Amount of construction loan	100% of construction costs	85% of construction costs	75% of construction costs
	Points on construction loan	2.0	1.5	1.5
	Interest rate on construction loan	10.5%	10.0%	7.0%
Construction Term (months)	Custom homes			
	25-unit phase	12	12	12
	11-unit phase	6	6	12
	Single-family tract homes			
	50-unit phase	12	12	12
	34-unit phase	9	9	12
	Condominiums			
	18 unit project	12	12	12
	20 unit phase	12	12	12
	24-unit phase	12	12	12
Sale Period (months)	Custom homes			
	25-unit phase	12	12	6
	11-unit phase	6	6	6
	Single-family tract homes			
	50-unit phase	12	12	6
	34-unit phase	9	9	6
	Condominiums			
	18 unit project	6	6	6
	20 unit phase	9	9	6
	24-unit phase	9	9	6