



COUNCIL AGENDA: 6-19-07
ITEM: 9.4

Memorandum

TO: HONORABLE MAYOR, CITY
COUNCIL AND REDEVELOPMENT
AGENCY BOARD

FROM: Les White
Harry S. Mavrogenes

SUBJECT: AMENDMENTS TO INCLUSIONARY HOUSING POLICY AND REVISED INCLUSIONARY IN-LIEU FEES **DATE:** June 1, 2007

COUNCIL DISTRICT: Citywide
SNI AREA: All

RECOMMENDATION

It is recommended that:

- a. The City Council and Redevelopment Agency Board adopt resolutions amending the "City of San Jose Policy on Implementation of the Inclusionary Housing Requirement of Health & Safety Code Section 33413(b)(2)" that applies to most redevelopment project areas to: (1) require 8% very low-income units and 12% low-income units at 60% of area median income in rental projects; and (2) to provide housing developers with other options to satisfy the Agency/City inclusionary housing requirements.
- b. The City Council adopt a resolution amending the annual Fee Resolution to increase the in-lieu fees applicable to the Inclusionary Housing Policy, as follows: (1) \$17.00 per net square foot of market-rate housing with a maximum fee of \$85,500 for rental units, \$90,000 for for-sale units in low-rise condominium/stacked flat projects, \$120,000 for for-sale units in townhouse/row-house projects, \$200,000 for single-family detached units, and \$200,000 for high-rise units not located in the Downtown Core; and (2) \$8.50 per net square foot of market-rate high-rise units located in a Downtown High-Rise Incentive Area, up to a maximum fee of \$65,000 per unit.

OUTCOME

Approval of the proposed amendments to the inclusionary housing policy and revisions to the inclusionary in-lieu fee structure will: (1) provide market-rate housing developers in redevelopment project areas with more alternatives to meet their inclusionary housing obligation; and (2) to the extent that developers choose to pay in-lieu fees, the City will have additional resources to finance housing affordable to extremely low-income (ELI) households.

EXECUTIVE SUMMARY

State Redevelopment Law requires that 15% of residential units developed within Project Areas be affordable. Since the 1980s, the City and Agency have required housing developers in Project Areas to provide those affordable units within each housing development under the Inclusionary Housing Policy. In response to concerns raised by developers about the need for more flexibility in complying with the inclusionary requirement (a position jointly supported by the Nonprofit Housing Association of Northern California and the Homebuilders of Northern California, Southern Division), Agency and City staff are proposing to offer developers options by which they can meet their inclusionary housing obligations, including: (1) providing the affordable units within their projects; (2) building a 100% affordable housing project on an adjacent or nearby site; (3) two or more market-rate developers jointly building a 100% affordable project on an adjacent or nearby site; (4) paying in-lieu fees to the City; or (5) a combination of the above. At the same time, staff is also recommending restructuring and increasing the in-lieu fees and lowering the income levels required under the Policy in rental projects to make the rental inclusionary units truly affordable.

BACKGROUND

State law requires that at least 15% of the housing developed in redevelopment project areas established since 1976 be affordable, with 6% affordable to very low-income households and 9% affordable to low or moderate-income households. Five redevelopment project areas were established prior to 1976 and are therefore exempt from this requirement: San Antonio Plaza, Park Center Plaza, Pueblo Uno, Mayfair One, and original Rincon de los Esteros area.

To comply with this requirement, the City Council and Redevelopment Agency Board jointly adopted the "City of San Jose Policy on Implementation of the Inclusionary Housing Requirement of Health & Safety Code Section 33413(b)(2)" in the 1980s. The Policy was most recently amended on May 15, 2007.

In general, the current Policy requires that the developers of housing in redevelopment project areas make a portion of the units in their projects affordable without any financial assistance from the City or the Redevelopment Agency. The current inclusionary requirements applicable to most projects under the Policy are as follows:

- In rental housing developments, 20% of the units must be affordable, with at least 8% of the units restricted to very low-income households.
- In for-sale developments, the requirement is either 20% affordable to low or moderate-income households or a combination of 9% affordable to low or moderate-income households and 6% affordable to very low-income households.

Projects of 10 or fewer units are exempt from the Policy, and developers of projects of 11 to 20 units may, at their option, pay an in-lieu fee to the Housing Department to help finance the City's affordable housing programs. The current in-lieu fees, established in the annual Fee Resolution adopted in conjunction with the annual City Budget, are \$65,000 for ownership units and

\$71,400 for rental units. In implementing the Policy, Agency and City staff require that the affordable units be spread throughout the housing development and generally have the same sizes, exterior finishes, and base-level finishes and amenities that the developer is providing in the market-rate units.

The inclusionary concept is based on the premise that affordability is being provided by the private sector without City or Redevelopment Agency funding. This would not, however, prevent the City from providing a small amount of funding to get deeper affordability in some inclusionary units (i.e., converting a low- or very low-income units into an extremely low-income units).

Based on concerns raised by housing developers about the rigidity of the current Policy and in working with various developers on certain specific inclusionary issues, the Redevelopment Agency and Housing Department staffs have concluded that a fresh look at the Policy in its entirety is warranted.

ANALYSIS

Agency and City staffs are proposing substantial changes to the Policy. Staff is not recommending any changes to the following provisions:

- Exemption for projects consisting of 10 or fewer units.
- Projects Constructed Pursuant to a Development Agreement which was added to the Policy in May 2006.
- Dedication of Land In Lieu of Construction of Affordable Units, which was added to the Policy on May 15, 2007.

The proposed changes can be grouped under four major topic headings.

Revised Affordability Requirements for Rental Housing

In the planning efforts leading up to the inclusion of the Strong Neighborhoods into the Merged Project Area, it became clear that the affordability levels in the Policy then in effect (6% very low-income and 9% low- or moderate-income) were not feasible for most ownership housing developers. It was this segment of the housing-development industry that was expected to play the biggest role in the Strong Neighborhoods.

Instead of applying the same 6%/9% formula across the board, it was determined that different affordability standards should apply to rental vs. ownership housing development. This conclusion formed the basis for the current affordability requirements described above.

Unfortunately, the requirement that 12% of units in rental housing projects be either low- or moderate-income results in units that are priced above market-rate rents (see Attachment 1). In other words, the current standard is not providing affordable housing as intended or desired.

To remedy this situation, it is recommended that the requirements for rental income be revised to 8% very low-income and 12% low-income, with the latter being pegged at 60% of area median income (AMI), which is the income level required for low-income units under the Low-Income Housing Tax Credit Program administered by the State. Even though rents would be set at 60% of AMI, low-income households up to 80% of AMI would be eligible to occupy the units, thereby giving developers a larger pool of potential tenants.

Greater Flexibility for Developers

Under the existing Policy, most developers of housing in redevelopment project areas are required to integrate the inclusionary units into their projects. This has been based on the policy objective of achieving socio-economic integration in the community at the smallest possible scale (i.e., project-by-project).

While staff wants to retain unit-by-unit integration as the preferred approach for developers, we are offering five other methods for developers of projects exceeding ten (10) units to meet their inclusionary housing obligation that they could choose at their sole option. These alternatives recognize that many market-rate developers are ill-equipped to deal with units subject to affordability restrictions (e.g., marketing to moderate-income buyers or low-/very low-income renters, and having to comply with annual reporting requirements for rental projects).

- a. Provide a stand-alone affordable rental project(s) within the same redevelopment project area. This approach, promoted by several developers, would allow the market-rate developer working with an affordable housing developer to provide some or all of the required inclusionary units on another site(s) within the same redevelopment project area. While normally expressed as the “dedicate-land-to-a-nonprofit-developer” option, the subsidy that the market-rate developer would need to provide could well end up exceeding just the value of dedicated land. For purposes of this option, a market-rate for-sale project could be paired with the stand-alone affordable rental project, though the type of stand-alone project will need to conform to the affordability level required for that product type (e.g., the 100% affordable rental project would need to meet or exceed the required proportion of very low- and low-income units otherwise required by the Policy, which would be a 40%/60% split between very low- and low-income units). Although this alternative would not achieve socio-economic integration on a project-by-project basis, it would achieve that objective on a project area basis. This approach differs with the “land dedication” option approved by the Council and Agency Board on May 15, 2007, in that the land dedication option allows a developer to dedicate land to the City, rather than transfer the land to an affordable housing developer(s).
- b. Stand-alone affordable housing projects and Pooling and Credit Transfers. Two or more market-rate developers can pool resources to satisfy their inclusionary housing requirement through a single stand-alone affordable rental housing project, which must be constructed in a project area where one of the market rate projects is located. Additionally, affordable housing units that exceed the inclusionary obligation of a

market-rate project being built by a developer can be banked as credits toward a future market-rate project that the same developer builds at a future date, or the extra affordable units can be “sold” to another market-rate developer who has an inclusionary obligation to meet. Units that are “banked” may be used to satisfy the inclusionary requirement for up to 20 years after such units are constructed.

If a stand-alone affordable rental housing project under a or b above has an affordability mix where at least 25% of the units are affordable to extremely low-income (ELI) households and at least 75% of the units are affordable to very low-income households (VLI), the market-rate project sponsoring the stand-alone project will be subject to an inclusionary requirement of 15% of units needing to be affordable rather than the standard 20% requirement.

- c. Pay fees in lieu of building inclusionary units. This alternative would allow developers of any size of project – not just projects of 11-20 units – to pay in-lieu fees instead of providing affordable units directly or indirectly. Coupled with a revision to the way inclusionary in-lieu fees are structured (see below), this option would allow developers to place the responsibility for meeting the inclusionary requirement on the City. Though this option will not promote socio-economic integration in developing neighborhoods in redevelopment project areas, it does have the distinct advantage of providing the City with an additional income stream to finance units affordable to extremely low-income (ELI) households, an income level not addressed in the inclusionary housing program but which is necessary to respond to the need for ELI housing.
- d. Combine a stand-alone project with paying in-lieu fees and/or providing affordable units in the market rate project. Under this alternative, part of the inclusionary obligation would be met by a stand-alone affordable rental project and the other part by paying in-lieu fees and/or by providing the remaining required affordable units in the market rate project. So, for instance, a market-rate developer has an inclusionary obligation of 100 affordable units but the site for the stand-alone affordable rental project can only accommodate 80 units. In this case, 80 affordable rental units in a stand-alone affordable project would be built by the developer and in-lieu fees would be paid for the remaining 20 units of the obligation or by providing 20 affordable units in the market rate project. In the end the final total number of affordable units and in-lieu fee payments must reflect the complete satisfaction of the inclusionary housing obligation as set forth in the Policy for the product type involved.

In 2005, the Nonprofit Housing Association of Northern California (NPH) and the California Home Builders Association (HBA) jointly published “On Common Ground.” This report concluded that localities’ inclusionary housing requirements should be as flexible as possible. This objective would be achieved by the proposals to offer developers the alternatives of a stand-alone affordable housing project, paying in-lieu fees, or a combination thereof.

The existing policy contains a “hardship” provision which allows developers to pay an in lieu fee based on “hardship” findings made by the City Council. With the increased flexibility for developers provided by these alternative approaches, staff believes that there is no longer a need

to have a “hardship” provision under which the City Council can reduce, adjust or relieve a developer’s inclusionary obligation.

New Inclusionary In-Lieu Fee Structure

The current inclusionary in-lieu fees are \$65,000 for each for-sale unit and \$71,400 for each rental unit not otherwise provided by the developer. Both were based on the cost to the City to subsidize for-sale and rental units, respectively, in the Spring of 2006 when the fees were last updated. Since that time, construction costs alone have increased more than 20%, and recent City subsidies for affordable rental housing units have been approximately \$92,500.

Staff is proposing a new approach to determine the amount of the in-lieu fees, that of pegging the in-lieu fee at levels equal to or below, on average, what it would cost the developer to provide the affordable unit within the otherwise market-rate project. The following table shows what the average “affordability gap” is, by product type. The rental product affordability gap is based on a recent analysis performed by Keyers Marston and Associates and the for-sale product affordability gap is based on twelve recent housing developments in Redevelopment Project Areas:

AVERAGE AFFORDABILITY GAPS

Product Type	Affordability Gap
Rental Units	\$85,500
For-Sale – Low-Rise Condominium/Stacked Flat Units	\$110,900
For-Sale – Townhouse/Row-House Units	\$128,500
For-Sale – Single-Family Detached Units	\$263,000
For-Sale – High Rise not in “High-Rise Incentive Area”	\$391,000 est.
For-Sale – In Downtown “High-Rise Incentive Area”	\$65,000

Originally staff considered setting a fixed in-lieu fee based on the above average affordability gaps, but this approach was eventually considered to provide too strong of an incentive to build larger-than-average units in order to lessen the effects of the fixed fees and conversely too much of a disincentive to building smaller-than-average units which would likely be more affordable. For this reason, staff is proposing a fee option that is based on the total average net living area of market-rate units in the project up to a fixed maximum fee. In this context “net living area” means the average square footage of all of the units in the project, exclusive of balconies, common corridors, recreation rooms, fitness centers, garages, and other such interior areas. The proposed \$17.00-per-square-foot in-lieu fee is based primarily of the above recent affordability gaps and on their average net unit sizes for the rental, condominium, and townhouse product types. Overall these product types are expected to be the most common product types to be developed within the redevelopment project areas. The high-rise product estimated average affordability gap is based on two recent downtown high-rise projects that have recently started to sell units that do not have inclusionary housing obligations. There estimated affordability gaps ranged from ~\$220,000 to ~\$705,000 which reflects the large differences in their asking sales

prices and HOA fees. By setting the per square foot fee that is close to the lower end of this product's estimated affordability gap the Agency is continuing to encourage high-rise development in redevelopment project areas particularly near areas with access to public transportation.

In the Downtown High-Rise Incentive Area, the fee is proposed to be half of the fee for projects outside the Incentive Area, or \$8.50 per square foot. High-rise, ownership housing (defined as at least ten floors of housing) in the High-Rise Incentive Area is shown at this artificially lower level since this product type is one that the City is actively encouraging and for which the Mayor's Budget Message promoted the development of incentives. If the same "developer's-cost-to-provide-affordable-unit" approach used above was applied to downtown high-rise development, it is estimated that the gap would conservatively be \$390,000 per unit based on the reservations and asking prices of the two projects currently on the market. The \$65,000 figure would apply in the newly defined High-Rise Incentive Area. For this purpose, the High-Rise Incentive Area expands the traditional boundaries of the Core Area to include the blocks between Julian Street and the UPRR tracks to the north and to include the Civic Plaza Redevelopment Project Area to the east (see map on Attachment 2 in the High-Rise Incentive Area).

The proposed new in-lieu fee schedule for each market-rate unit:

PROPOSED IN-LIEU FEES

Product Type	Fee Per Net Square Foot of Living Area	Not to Exceed, Per Affordable Unit
Rental Units	\$17.00	\$85,500
For-Sale – Low-Rise Condominium/Stacked Flat Units	\$17.00	\$90,000
For-Sale – Townhouse/Row-House Units	\$17.00	\$120,000
For Sale – Single-Family Detached Units	\$17.00	\$200,000
For-Sale – High Rise not in "High-Rise Incentive Area"	\$17.00	\$200,000
For-Sale – In Downtown "High-Rise Incentive Area"	\$8.50	\$65,000

The proposed \$17.00-per-square-foot in-lieu fee and the maximum fee per unit are calculated based on the requirement that 20% of the total units in the project are required to be affordable. For example a 300 unit for-sale condominium project with a total net living area of 300,000 square feet would have an in lieu fee per unit of \$85,000, $(300,000/300/.2 \times \$17)$ and a total in-lieu payment of \$5,100,000, $(\$85,000 \times 300 \times .2)$.

The incentive fee level in the High-Rise Incentive Area is proposed to expire after building permits or foundation permits for 2,500 downtown high-rise units have been issued, at which time the incentive program will be re-evaluated.

To the extent that in-lieu fees do get paid, that revenue will supplement the funding available to the City to subsidize the development of affordable units, including housing affordable to ELI households.

Timing

There are three timing issues that need to be addressed in conjunction with the proposed Policy amendments:

1. Developer Decision Deadline. Staff is recommending that the developer choose the method to satisfy its inclusionary housing obligation before the first building permit or foundation permit is issued in order to avoid later confusion and the possibility of failure to comply with the City's Inclusionary Housing Policy. Thus, prior to obtaining a foundation or building permit, the developer would be required to do one of the following: (i) pay the required in-lieu fee; (ii) execute the Agency/City's standard affordability agreement under which the inclusionary units will be built within the project; (iii) enter into an agreement with the Agency/City regarding the construction for a stand-alone affordable project(s); or (iv) enter into an agreement with the Agency/City which provides for a combination of the above. For projects which have already been issued either a foundation permit or building permit, the new options provided in the proposed Policy amendments would not be available. Projects of 11-20 units will still have the option to pay the in-lieu fee up to the point of occupancy.
2. When In-Lieu Fees Are Due. Staff is recommending that developers choosing to pay the in-lieu fee may do so at any time between the approval of the applicable Site Development Permit or Planned Development (PD) Permit and occupancy of the market rate project (measured by the issuance of Temporary Certificate of Occupancy or Certificate of Occupancy for rental projects or the first close of escrow on a unit in for-sale projects). However, the Fee Schedule in effect on the date that the fees are paid determines how much will be collected. In other words, if developers want certainty as to the amount of in-lieu fees that they will pay, they should plan on making payment sooner rather than later to avoid the probability that fees will increase in annual updates to the Fee Resolution.
3. Timing Coordination Between Market-Rate Project and Associated Stand-Alone Affordable Rental Project(s). In cases where the developer has elected to provide a stand-alone, affordable project(s) to meet the inclusionary obligation, the developer of the affordable project(s) may not be able to begin construction concurrently with the market-rate project because of the need to secure tax-exempt bonds, tax credits and other similar funding sources. In recognition that this may be the case, staff is recommending that in order to satisfy the inclusionary requirement by developing a stand alone project, the stand alone affordable rental project shall have received either (1) a foundation permit or building permit by the time the market-rate project is seeking its' first occupancy or first close of escrow or (2) the land for the stand alone project shall have been transferred to the affordable housing developer with recorded City affordability restrictions that require

affordable units sufficient to meet or exceed the developers Inclusionary requirements. If the affordable project is not under construction before the first occupancy of the market-rate project or before the transfer of the land to the affordable developer, the market-rate developer would be required to either (i) make the affordable units available within the market-rate project or (ii) pay the applicable in-lieu fees for the market-rate project for that phase of the project that is ready for occupancy.

Procedures for Complying with the City of San Jose Inclusionary Housing Policy

The Executive Director of the Redevelopment Agency of the City of San Jose shall draft and update as needed a set of procedures for complying with the City of San Jose Inclusionary Housing Policy. This procedure guide shall fully describe for Agency and City staff and for the public the Policy's options and the required practices and administrative procedures needed to fully implement this Policy. The Procedures Guide shall at all time be consistent with the City's Policy.

POLICY ALTERNATIVES

In reaching the recommendations spelled out above, the following alternative was also considered:

Alternative #1: Do not amend the Inclusionary Housing Policy and in-lieu fee schedule.

Pros: The Inclusionary units required by the current Policy would be incorporated into a developer's larger housing development, best meeting a public policy goal of integrating affordable and market-rate units.

Cons: The majority of inclusionary units in rental projects would be priced at market rate. Developers of projects exceeding 20 units would not have any alternatives to meeting their inclusionary obligation by providing affordable units within their projects. The City would not have the potential of receiving in-lieu fees from larger projects and thereby not be able to finance as much ELI housing.

Reason for not recommending: The recommended action offers developers greater flexibility in meeting their inclusionary housing requirement. Additionally, allowing more developers the option of paying in-lieu fees to satisfy their inclusionary requirements should increase the funds available to the City's affordable housing programs, thereby allowing the City to finance more ELI units.

PUBLIC OUTREACH

- Criteria 1:** Requires Council action on the use of public funds equal to \$1 million or greater. (Required: Website Posting)
- Criteria 2:** Adoption of a new or revised policy that may have implications for public health, safety, quality of life, or financial/economic vitality of the City. (Required: E-mail and Website Posting)

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- **Criteria 3:** Consideration of proposed changes to service delivery, programs, staffing that may have impacts to community services and have been identified by staff, Council or a Community group that requires special outreach. (Required: E-mail, Website Posting, Community Meetings, Notice in appropriate newspapers)

Electronic copies of this memorandum will be: (1) e-mailed to a wide spectrum of market-rate and affordable housing developers; and (2) posted on the Redevelopment Agency Board Agenda Website for the June 19, 2007 meeting.

Additionally, over the past several months, the general topic of inclusionary housing has been discussed at the working group advising the Director of Housing on drafting the Five-Year Housing Investment Plan, the Housing and Community Development Advisory Commission, and one-on-one meetings between developers and Redevelopment Agency staff. The proposed policy and in-lieu fee changes, which are based on those discussions, have subsequently been presented in the following forums:

- The Five-Year Housing Investment Plan working group on May 4, 2007.
- The Housing and Community Development Advisory Commission on May 10, 2007.
- A Stakeholders Meeting of market-rate and affordable housing developers on May 22, 2007.
- The Community and Economic Development Committee on May 24, 2007.
- A second Stakeholders Meeting of market-rate and affordable housing developers took place on June 7, 2007 (invitees include all names on: the Planning staff's Developer Roundtable list; the Redevelopment Agency's developer list; the Housing Department's developer list; the sign-up sheet from the May 22nd Stakeholders Meeting; and the membership of the Strong Neighborhoods Project Advisory Committee).

COORDINATION

Preparation of this memorandum was coordinated with Housing Department, the City Attorney's Office, the General Counsel's Office and the Department of Planning, Building and Code Enforcement.

FISCAL/POLICY ALIGNMENT

The proposed amendment to the Inclusionary Housing Policy is consistent with the City's overall housing production objectives and affordable housing program goals, and has the potential to result in additional funding for financing housing affordable to ELI households.

CEQA

CEQA: Not a project.

for Kay White

LES WHITE
City Manager

John Weis (for)

HARRY S. MAVROGENES
Executive Director

Attachments

For questions, please contact Leslye Krutko, Director of Housing, at (408) 535-3851
or John Weis, Deputy Executive Redevelopment Director, at (408) 795-1894

ATTACHMENT 1

**Restricted vs. Market-Rate Rents in San Jose
 First Quarter 2007**

UNIT SIZE	Very Low- Income (50% of AMI)	Low- Income (60% of AMI)	Low- Income (80% of AMI)	Moderate- Income (120% of AMI)	Market- Rate
Efficiency	\$884	\$1,070	\$1,441	\$2,184	\$1053 - \$1,120
One-Bedroom	\$955	\$1,154	\$1,552	\$2,348	\$1,288
Two-Bedroom	\$1,133	\$1,372	\$1,849	\$2,804	\$1,332 - \$1,634
Three-Bedroom	\$1,309	\$1,585	\$2,136	\$3,240	\$1,900

NOTES:

1. All restricted rents by percentage of AMI reflect a utility allowance that may vary from project to project.
2. SOURCE for market-rate rents: Real/Facts
3. Range in market-rate rents for Efficiency Units is between "studio" and "junior one-bedroom" units.
4. Range in market-rate rents for Two-Bedroom Units is between "one-bath" and "two-bath" units.
5. It is understood that there are fluctuations in market rate rents based on locational factors. For example, rents for two-bedroom units in North San Jose can exceed the Real Facts rents by as much as 40%, while rents in other parts of the City may be slightly lower than the Real Facts data."

ATTACHMENT 2
Downtown High-Rise Incentive Area

