CITY OF CUPERTINO

COMMUNITY DEVELOPMENT DEPARTMENT

CITY HALL
10300 TORRE AVENUE • CUPERTINO, CA
95014-3255 TELEPHONE: (408) 777-3308 • FAX: (408) 777-3333
CUPERTINO.ORG

# HOUSING COMMISSION STAFF REPORT

July 25, 2019

Subject

Below Market Rate (BMR) Linkage Fees Update for the Cupertino BMR Housing Program

Recommended Action

Receive update and provide any input to staff

Discussion

The City's 2014-2022 Housing Element is a comprehensive eight-year plan to address the housing needs in Cupertino. During the planning process to prepare the Housing Element, City officials, staff, and the public discussed strategies to increase the supply of affordable housing in Cupertino. As adopted by the City Council in 2014, the Housing Element includes a "Residential Housing Mitigation Program" that requires certain residential development projects to include a percentage of their total units as below-market rate units that are affordable to moderate-income and lower-income households (commonly called an "inclusionary housing requirement").

The Housing Element's inclusionary housing requirements are implemented through the Below Market Rate (BMR) Housing Program required by Chapter 19.172 of the Cupertino Municipal Code (BMR Ordinance) and the BMR Housing Mitigation Program Procedural Manual (Housing Mitigation Manual). The BMR Housing Program also includes Housing Mitigation Fees for residential projects of less than seven units and commercial linkage fees for certain non-residential development.

As part of its current work plan, the City Council is considering modifying the City's BMR Housing Program. Accordingly, the City worked with Strategic Economics to prepare an Economic Feasibility Analysis to inform the BMR Linkage Fees Update to study options for increasing the affordable housing supply within the City.

The remainder of this staff report discusses the City's current BMR Housing Program, the legal framework for modifying the BMR Housing Program, the results of the Economic Feasibility Analysis, and policy topics for further consideration.

*Current BMR Housing Program Requirements*
The City's current BMR Housing Program imposes an inclusionary housing requirement of 15% on for-sale and rental residential developments with seven or more units. For rental developments, the BMR units must be affordable to very-low (up to 50% Area Median Income "AMI") or low-income (up to 80% AMI) households. For-sale developments must provide BMR units affordable to median- (up to 100% AMI) and moderate-income (up to 120% AMI) households.

Small residential projects of less than seven units can pay the City's Housing Mitigation Fees or provide one BMR unit. The Housing Mitigation Fees are based on the City's 2015 Residential Below Market Rate Housing Nexus Analysis and Non-Residential Jobs-Housing Nexus Analysis (2015 Nexus Study). Housing Mitigation Fees are currently set at $17.82 per square feet for detached single family, $19.60 per square feet for small lot single family/townhomes, $23.76 for attached multifamily residences (ownership and rental), and $11.88 per square foot for commercial/retail uses.

The City first adopted linkage fees for office and Research and Development (R&D) projects in 1992, and expanded the program to apply to retail and hotel developments in 2004. The City updated the commercial linkage fees in 2015 (based on the 2015 Nexus Study) to the current levels of $23.76 per square foot for office/R&D uses, and $11.88 per square foot for hotel and retail uses.

The City's Housing Mitigation Manual (most recently amended by Resolution 15-037 on May 5, 2015) includes rules and regulations for implementing the policy direction in the Housing Element and the Municipal Code. The Housing Mitigation Manual restates the Housing Element's general requirements for on-site affordable housing production, but it includes more specific requirements for affordability levels by income. Table 1 provides a summary of the affordability requirements pursuant to the Housing Mitigation Manual.

**Table 1: Affordability of BMR Units (15% of development total)**

| Ownership BMR Units | | Rental BMR Units | |
|---|---|---|---|
| **% of Median-Income Units** | **% of Moderate-Income Units** | **% of Very-Low Income Units** | **% of Low-Income Units** |
| 8% of ownership units | (7% of ownership units | 9% of rental units | 6% of rental units |

For purposes of the BMR Housing Program, the City uses household income limits established by the California Department of Housing and Community Development (HCD) that are based on adjustments to the median income in Santa Clara County. Table 2 summarizes the incomes associated with the various affordability requirements.

**Table 2: 2019 Household Income Limits**

| Income Category | Approximate Percent of Area Median Income* | Income Limit for 4-Person Household |
|---|---|---|
| Very Low | Up to 50% | $73,150 |
| Low | Up to 80% | $103,900 |
| Median | Up to 100% | $131,400 |
| Moderate | Up to 120% | $157,700 |

**HCD makes various adjustments to very-low and low-income limits, which do not precisely equal 50% and 80% of the median.*

In addition to on-site BMR requirements, the Housing Mitigation Manual gives developers the option of requesting the Council to approve an alternative means of compliance, provided that the alternative gives the City affordable housing that is equivalent to the applicable BMR requirement. Applicants may request to: provide on-site rental BMR housing where for-sale is required; purchase off-site units to be dedicated and/or rehabilitated as BMR units; develop off-site BMR units; or donate land for the development of BMR units.

As noted above, residential developments with six or fewer units may pay the Housing Mitigation fee instead of producing on-site BMR units. The Housing Mitigation fee is also applied to commercial development and fractional units required for residential developments with seven units or more. Such fees are placed in the City's BMR Affordable Housing Fund (AHF), which may be used to finance affordable housing within the City, often in connection with other public financing sources to achieve larger numbers of affordable housing units or deeper affordability than can feasibly be required in connection with market rate development.

***Legal Framework***

Affordable housing policies in California can take different forms, with varying legal requirements for each. For residential projects, cities' and counties' police power provides authority to require a percentage of new residential projects be reserved as affordable housing. For non-residential projects, cities and counties can collect impact fees to mitigate new development's impact on the demand for affordable housing. Both approaches are subject to certain limitations, discussed below.

*Residential Projects*

In its 2015 decision *California Building Industry Ass'n v. City of San José* (*CBIA*), the California Supreme Court determined that inclusionary requirements for residential projects are land use provisions, similar to rent and price controls. Because land use and price control authority comes from a city's general police power, residential inclusionary requirements that are designed to further the public health, safety, and welfare can be adopted without being justified by a nexus study so long as the requirements do not prevent a property owner from having the opportunity to earn a fair return on its property. To date, efforts to overturn the *CBIA* case at the United States Supreme Court have failed. Therefore, a nexus study is not currently required for residential inclusionary requirements; however, an economic feasibility study can be used to demonstrate that such requirements are not confiscatory.

The *Palmer/Sixth Street Properties L.P. v. City of Los Angeles* (*Palmer*) case was decided in 2009, and for a time, *Palmer* precluded California cities from requiring long term rent restrictions or inclusionary requirements on rental units. On September 29, 2017, Governor Brown signed AB 1505 to restore cities' and counties' ability to require on-site affordable units within rental projects, and the law became effective on January 1, 2018. Under AB 1505, cities can impose inclusionary requirements on rental residential developments provided that: (1) the requirements are imposed in the zoning ordinance; (2) if more than 15 percent of rental units are required to be affordable to low-income households, HCD may require that the requirement be justified by an economic feasibility study under certain circumstances; and (3) alternatives to on-site compliance are allowed.

*Non-Residential Projects*

For non-residential projects, cities and counties are permitted to collect fees from new development to mitigate that development's impact on affordable housing, provided that the impact fees are reasonable and there is a sufficient nexus between the amount of the impact fee and the impact that the proposed development will have on the need for affordable housing. A nexus study is used to determine the upper limit for impact fees that may legally be imposed on new non-residential development and is required to justify affordable housing requirements for non-residential projects. Nexus study results are often combined with economic feasibility studies to ensure that impact fees do not preclude development.

*Legal Requirements for Modifications*

If the City desires to modify its BMR Housing Program, it has several options. Changes to the Housing Mitigation Manual may be adopted by Resolution, and the City Council can modify its BMR Ordinance. Unless it also amends the Housing Element, which would require HCD approval, changes to the BMR Ordinance or the Housing Mitigation Manual would need to be consistent with the policies included in the Housing Element. For example, the Housing Element does not specify an income range requirement applied to for-sale residential development. Therefore, the City could amend the Housing Mitigation Manual to adjust the percentages of median- and moderate- income housing required and still be consistent with the Housing Element. Similarly, the City likely could require rental residential housing be reserved for extremely-low income households, provided that the requirement is not confiscatory, as such housing would also be affordable to very-low and low-income households as required by the Housing Element.

In addition, if the City were to amend its BMR Housing Program to require more than 15% of rental units be reserved for low-income households, HCD could require the City to prepare an economic feasibility study demonstrating that the requirements do not make market rate residential development infeasible if the City fails to meet at least 75% of its share of the regional housing need for the above-moderate income category for five years or more or if it does not submit its annual housing element report for at least two consecutive years.

Even if HCD does not require an economic feasibility study, such a study can be useful to inform the City's policy-making efforts and to ensure that its requirements are not overly burdensome. To meet the applicable legal standard for inclusionary policies, the City's requirements must not be so high as to be confiscatory. To update the BMR Housing Program's requirements related to commercial projects, the 2015 Nexus Study establishes a theoretical legal maximum for impact fees, but as with residential projects, any increases should be considered in the context of economic feasibility.

***Economic Feasibility Analysis Results***

The City retained Strategic Economics to evaluate potential changes to the BMR Housing Program in an Economic Feasibility Analysis. Specifically, the Economic Feasibility Analysis examined the following issues: (1) increasing on-site affordability requirements in residential projects; (2) requiring units for extremely-low income households or individuals with disabilities; (3) requiring units for median- and moderate-income households in rental residential projects; and (4) increasing commercial linkage fees on non-residential development projects. The Economic Feasibility Analysis also summarizes inclusionary housing programs and commercial linkage fees in other cities in Santa Clara County.

As discussed above, the 2015 Nexus Study establishes the legal maximum for impact fees that may be imposed on commercial projects. It also analyzed the "affordability gap" that creates increased demand for affordable housing when market rate housing is developed. The Economic Feasibility Analysis provides a more current analysis of what increased affordability requirements and impact fees may be feasible in connection with future development in Cupertino by analyzing the economic effects of various affordability requirements on future projects. By analyzing the costs of development (such as land acquisition, soft costs, construction costs, and City requirements) in comparison to projected revenues, the Economic Feasibility Analysis evaluates whether the expected returns would be enough to support development in the City if affordability requirements were increased.

Although the Economic Feasibility Analysis is a helpful tool to aid the City in its policymaking decisions, all studies of this kind have limitations. For example, the Economic Feasibility Analysis provides an overview-level assessment of development economics in Cupertino generally, because it is based on project prototypes rather than specific projects. Any individual future project will have unique characteristics that affect market returns and developer profit requirements. Based on individual project economics individual projects may look more or less feasible to developers than the Economic

Feasibility Analysis shows. In addition, the Economic Feasibility Analysis focuses on market conditions in 2019, making its conclusions most applicable to projects that have site control and are in the pre-development stage.

As construction costs, rents, and sales prices continue to change, project feasibility will change as well. Similarly, the Economic Feasibility Analysis results are very sensitive to land price assumptions, which are a major cost of development and impact a project's ability to support other costs. It is generally assumed that developers will only purchase land at a price that will allow for financially feasible projects and that development costs, including affordability requirements, are reflected in land sale prices.

However, it is possible that if the City increases affordability requirements, the increase would depress land values to accommodate what developers can afford to pay while meeting the City's requirements. Accordingly, over time, the market may adjust to this cost pressure in the form of reduced land costs, potentially making certain projects more feasible than they appear today.

The final Economic Feasibility Analysis, which includes a full discussion of its methodology and conclusions, is attached to this Staff Report as Attachment A. The Analysis's key findings are summarized below.

*Increasing On-Site Affordability Requirements in Residential Projects*
The Economic Feasibility Analysis studied five different prototypes of residential development that are most likely to be developed in future projects within the City: detached single family; small lot single family/townhome units; condominiums; lower-density rental apartments; and higher-density rental apartments.

For each prototype of ownership housing, the Economic Feasibility Analysis studied project feasibility under five different scenarios of affordability requirements: basic feasibility (no affordability requirements); 15% inclusionary (existing City policy of 8% to median income households and 7% to moderate income households); 20% inclusionary (10% to median income households and 10% to moderate income households); 25% inclusionary (13% to median income households and 12% to moderate income households); and in-lieu fees only.

Similarly, for each prototype of rental housing, the Economic Feasibility Analysis studied project feasibility under five different scenarios of affordability requirements: basic feasibility (no affordability requirements); 15% inclusionary (existing City policy of 9% to very low income households and 6% to low income households); 20% inclusionary (10% to very low income households and 10% to low income households); 25% inclusionary (5% to very-low income households, 10% to very-low income households, and 10% to low income households); and in-lieu fees only.

The Economic Feasibility Analysis concludes that increasing the on-site affordability requirement from 15% to 20% of units is feasible for ownership housing prototypes (single-family detached, small lot single-family/townhouse, and condominium developments). However, neither lower-density nor higher-density rental apartments would be economically feasible if the requirement was increased above 15%, and using the assumptions regarding current market rents, construction costs, and land costs, any production requirement could be challenging for the studied prototypes. Moreover, none of the residential prototypes would be feasible if the on-site affordability requirement increased to 25% of units. The Economic Feasibility Study concludes that in-lieu fees can be increased for all but the lower density rental apartments without impacting project feasibility. (The City currently charges Housing Mitigation Fees ranging from $17.82 to $23.76 per square foot.) Table 3 summarizes key findings with respect to increasing affordability requirements in residential projects.

**Table 3: Increased Inclusionary/In Lieu Fee Feasibility Summary**

| Residential Prototype | Feasibility of Program Change | | |
|---|---|---|---|
| | **20% Inclusionary** | **25% Inclusionary** | **In-Lieu Fees** |
| **Detached Single Family** | Feasible | Currently Infeasible | Increase to $30/sf Feasible |
| **Small Lot SF and Townhomes** | Feasible | Currently Infeasible | Increase to $35/sf Feasible |
| **Condos** | Feasible | Currently Infeasible | Increase to $35/sf Feasible |
| **Lower-Density Rental Apartments** | Currently Infeasible | Currently Infeasible | Increase Currently Infeasible |
| **Higher-Density Rental Apartments** | Currently Infeasible | Currently Infeasible | Increase to $30/sf Feasible |

*Increasing Impact Fee Requirements in Non-Residential Projects*

The Economic Feasibility Analysis also studied the feasibility of increasing its commercial linkage fees on three non-residential development prototypes: office/R&D, hotel, and retail. The building characteristics of each development prototype, including size, density (floor-area-ratio), and parking assumptions are based on a review of projects that were recently built, and in planning stages in Cupertino, as well as recently built and pipeline projects in surrounding areas.

For each non-residential prototype studied, the Economic Feasibility Analysis tested various fee levels to determine if increases would be feasible. Office and R&D uses are currently subject to a linkage fee of $23.76/sf, which can feasibly be increased to $25/sf, with an increase to $30/sf remaining marginally feasible. Hotel uses are currently subject to a linkage fee of $11.88/sf that is feasible, with an increase to $15/sf remaining marginally feasible; however, increases to $20/sf are projected to be currently infeasible. Based on the prototype assumptions, stand-alone retail uses are barely feasible without any linkage fee, so no increase is projected to be supported. However, the Economic Feasibility Analysis concludes that retail uses may be feasible when developed in conjunction with office or residential uses in a mixed-use environment, but it does not identify linkage fee levels for this development style.

*Peer Review*
As discussed above, the Economic Feasibility Study's conclusions are sensitive to assumptions regarding land cost, construction costs, market potential, and developer profits. Therefore, to further test the methodology and the conclusions presented in the Economic Feasibility Study, the City commissioned LeSar Development Consultants to perform a peer review of the Economic Feasibility Study while it was in draft form. The peer review identified a number of questions and requested additional information related to the Economic Feasibility Study's methodology and data sources that may have influenced the Economic Feasibility Study's conclusions. The peer review is included as Attachment B.

In response, the Economic Feasibility Study was revised to include additional discussion of its approach to analysis and to provide additional analysis in support of the assumptions related to housing demand, which drives potential developer revenues and feasibility. The revised Economic Feasibility Study also expanded upon the information presented in the pro forma analysis for each prototypes. A track changes version of the Economic Feasibility Study showing changes in response to the peer review in included as Attachment C, and a supplemental memo from Strategic Economics directly answering questions from the peer review is included as Attachment D.

The revisions result in a more clear and comprehensive document, but it is important to note that none of the revisions changed the Economic Feasibility Study's conclusions regarding feasibility of BMR program changes.

*Conclusions and Next Steps*
Based on its assumptions and analysis, the Economic Feasibility Study shows the potential to increase inclusionary requirements for for-sale residential development to 20% from 15% and to increase in-lieu fees.

With respect to rental residential development, higher-density rental apartments appear to be able to support an increased in-lieu fee. Most developments that include affordable units for extremely-low income households or for people with disabilities require public subsidies to operate; therefore, the City could choose to prioritize fee collection over on-site inclusionary requirements, which could increase the amount of public funds the City would have available to contribute to projects. As discussed above, rental residential projects are not good candidates for increasing on-site production requirements or deepening affordability levels to include extremely-low income households or from increasing requirements above 15% to require units affordable to median- or moderate-income households in addition to existing requirements.

In addition, it may be possible to increase linkage fees for office/R&D uses and hotels to increase the resources available in the City's BMR AHF. Even with additional funding at its disposal, the City would have a challenge meeting the need for these housing types, because site acquisition and construction costs can require subsidies of several hundred thousands of dollars per unit, even while leveraging other available funding sources.

Therefore, the Housing Commission should provide direction about whether the City should continue to prioritize on-site production of housing affordable to very-low, low-, median-, and moderate income households to be built in conjunction with market rate projects over time, or whether the City should prioritize fee collection in an effort to subsidize projects with smaller numbers of more deeply affordable housing units.

<u>Sustainability Impact</u>
No sustainability impact.

<u>Fiscal Impact</u>
No fiscal impact.

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<u>Prepared by</u>: Kerri Heusler, Housing Manager
<u>Reviewed by</u>: Richard Taylor, Assistant City Attorney
<u>Approved for Submission by</u>: Benjamin Fu, Director of Community Development

<u>Attachments</u>:
A – July 2019 Economic Feasibility Analysis prepared by Strategic Economics
B – LeSar Development Consultants Peer Review
C – Track Changes Draft Economic Feasibility Analysis prepared by Strategic Economics
D –Strategic Economics Memorandum Regarding Peer Review