CITY OF CUPERTINO

COMMUNITY DEVELOPMENT DEPARTMENT

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CITY COUNCIL STAFF REPORT
September 3, 2019

Subject
Below Market Rate (BMR) Residential Housing Mitigation and Commercial Linkage Fees Update for the Cupertino BMR Housing Program

Recommended Action
Receive update and provide input to staff

Discussion
The City's 2014-2022 Housing Element is a comprehensive eight-year plan to address 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 all new developments to help mitigate project-related impacts on affordable housing needs. Residential development projects are required to include a percentage of their total units as below-market rate units that are affordable to moderate-income and lower-income households. This is 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 non-residential development as described in more detail below.

As part of its current work plan, the City Council is considering modification of the City's BMR Housing Program. Accordingly, the City worked with Strategic Economics to prepare an Economic Feasibility Analysis. This analysis will inform the BMR Linkage Fees update.

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 includes 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 choose to pay the City's Housing Mitigation Fees or to 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 foot for detached single family, $19.60 per square foot for small lot single family/townhomes, $23.76 per square foot 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 include 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 with more specific requirements for affordability levels by income. Table 1 provides a summary of the affordability requirements included in the Housing Mitigation Manual.

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

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

For 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 income levels 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 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 that the Council approve an alternative means of compliance (provided that the alternative gives the City affordable housing equivalent to the applicable BMR requirement). Applicants may request to: provide on-site rental BMR housing instead of for-sale BMR units; 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 one on-site BMR unit. The Housing Mitigation fee is also applied to commercial development and fractional units (as defined in Section 2.3.2 of the BMR Housing Mitigation Program Procedural Manual) required for residential developments with seven units or more. Such fees are placed in the City's BMR Affordable Housing Fund (AHF). These funds may be used to finance affordable housing within the City, often in connection with other public financing sources to provide 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 take different forms, with varying legal requirements. For residential projects, cities' and counties' police power provides authority to require a percentage of new residential projects to be reserved for 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 limitations, as 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 designed to improve the public health, safety, and welfare can be adopted without justification by a nexus study as 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 residential inclusionary requirements provide property owners with an opportunity to earn a fair and reasonable return.

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. The law became effective on January 1, 2018. Under AB 1505, cities can impose inclusionary requirements on rental residential developments provided: (1) the requirements are included in the zoning ordinance and (2) alternatives to on-site compliance are allowed. 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 discussed below.

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 the City 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 for 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 could require rental residential housing to be reserved for extremely-low income households, provided that the requirement is economically feasible, 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 decided 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 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. The feasibility study would need to demonstrate that the City's requirements do not make market rate residential development infeasible.

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 make market-rate housing development economically infeasible. 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. 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 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 (e.g. own the property or have an agreement to acquire or develop it) 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 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 allowing 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
Five different prototypes of residential development that are most likely to be developed in future projects within the City were studied: 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%. 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

Residential Prototype	Feasibility of Program Change		
	20% Inclusionary	**25% Inclusionary**	**In-Lieu Fees**
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 conclusions presented in the Economic Feasibility Study, the City commissioned LeSar Development Consultants to conduct a peer review of the Economic Feasibility Study while it was in draft form. The peer review raised 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 information presented in the pro forma analysis for each prototype. A "track changes" version of the Economic Feasibility Study showing changes in response to the peer review is 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 clearer, and more comprehensive document. It is important to note that none of the revisions changed the Economic Feasibility Study's conclusions regarding feasibility of BMR program changes.

Housing Commission and Planning Commission Review and Feedback
On July 25, 2019, the Housing Commission held a special meeting to receive an update on the efforts described above. The Housing Commission supported the following recommendations to the Planning Commission and City Council:

- Define different on-site BMR production requirements for each studied residential prototype based on that development type's feasibility.
- Recommended production requirements of:
  - 20 % for single family units;
  - Between 20-25 % for townhomes and condos; and
  - 15% (no change) for rental housing.
- Consider setting affordability requirements between the current five percent increments to maximize the feasible BMR production requirement.
- Prohibit in-lieu fees for any residential development project with seven or more units in order to promote BMR unit production.
- Expand alternative compliance options to satisfy BMR requirements through an equivalent number of off-site BMR units, land donation, or acquisition and rehabilitation of off-site market rate units that can be converted to BMR units.
- Consider pending applications when deciding when modified requirements will become effective.
- Explore parking reductions or other incentives to reduce construction cost if cost savings could be used to increase affordable housing production.
- Allow some residential projects to be only housing without ground floor retail if single-use development is more feasible and could yield greater affordability requirements.
- Recommended commercial linkage fees of:
  - $25 - $30 per square foot for office;
  - $15 per square foot for hotel; and
  - $11.88 per square foot (no change) for retail.

On August 13, 2019, the Planning Commission held a regular meeting to receive the Housing Commission's recommendations and provide additional feedback. Planning Commissioners expressed general support for the Housing Commission's recommendations. The strongest support was for increasing impact fees on new office development, and there was discussion about how high such impacts fees should be set without final agreement. Planning Commissioners were generally supportive of increasing inclusionary requirements on ownership housing, but they expressed concern with changing requirements for rental housing. However, there was continued support for strategies that would create more opportunities to provide housing for households with extremely low incomes. Finally, there was discussion between the Commissioners about potentially studying other affordability mixes, for example extremely low income and moderate instead of low- and very-low income housing, depending on the feasibility of those options.

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: (1) increasing on-site production requirements; (2) deepening affordability levels to include extremely-low income households; or (3) 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 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. Site acquisition and construction costs can require subsidies of several hundred thousand dollars per unit, even while leveraging other available funding sources.

Therefore, the City Council should provide direction on recommended modifications, if any, to the City's BMR Program, or what further feasibility analysis may be helpful to inform final policy directions.

Sustainability Impact
No sustainability impact.

Fiscal Impact
No fiscal impact.

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Attachments:

A – July 2019 Economic Feasibility Analysis prepared by Strategic Economics

B – LeSar Development Consultants Peer Review

C – Redline Draft Economic Feasibility Analysis prepared by Strategic Economics

D –Strategic Economics Memorandum Regarding Peer Review