CITY OF CUPERTINO

COMMUNITY DEVELOPMENT DEPARTMENT

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# CITY COUNCIL STAFF REPORT

May 19, 2020

Subject

Cupertino BMR Housing Program Update and recommendation to increase the affordable housing inclusionary requirement for ownership projects: Below Market Rate (BMR) Residential Housing and Commercial Linkage Fees Update and Recommendations to increase fees for office, R&D, and industrial projects and for hotels; Discussion of Related Housing Solutions, Including Opportunities to Increase Housing Supply for Extremely Low-Income Households and Approaches to Encourage BMR Housing Production by Non-Residential Land Uses

Recommended Action

1. Adopt the draft resolution attached as Attachment A, amending the Below Market Rate (BMR) Housing Mitigation Program Procedural Manual (Housing Mitigation Manual) to increase the affordable housing (BMR) requirement for ownership projects from 15% to 20%, and to make other conforming changes consistent with State law.

2. Adopt the draft resolution attached as Attachment B, amending the Housing Mitigation In-Lieu Fees to increase the fees for offices, research and development, and industrial space from $24.60 to $30 per square foot and the fees for hotels from $12.30 to $15 per square foot.

3. Receive report on Housing Solutions, Including Opportunities to Increase Housing Supply for Extremely Low-Income Households and Approaches to Encourage BMR Housing Production by Non-Residential Land Uses and provide further direction to staff.

Discussion

The purpose of this item is: 1) to allow the City Council an opportunity to act upon the Housing Commission and Planning Commission recommendations to increase the inclusionary requirement for ownership projects from 15% to 20% and to increase commercial linkage fees; and 2) to present additional information requested by the City Council for further feedback and direction to staff.

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 BMR units that are affordable to low- and moderate-income households, also called an "inclusionary housing requirement".

The Housing Element's inclusionary housing requirements are implemented through the 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 developments, 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 (see Attachment C). This analysis will inform the BMR Linkage Fees update. On July 25, 2019 and August 13, 2019, respectively, the Housing Commission and the Planning Commission considered the Economic Feasibility Analysis and recommended changes to the City's BMR Housing Program. The City Council considered the Economic Feasibility Analysis and commission recommendations at its September 3, 2019 meeting, and directed staff to return with additional information and analysis.

The remainder of this staff report summarizes the Economic Feasibility Analysis, commission recommendations, and supplemental analysis obtained by staff since the September 3 meeting.

***Current BMR Housing Program Requirements***

The Housing Mitigation Manual currently requires that housing development projects with seven or more new units provide at least 15% of those units as BMR units. BMR units are split as specified in the Housing Mitigation Manual for ownership projects between units for median- and moderate-income households, and for rental projects between very-low and low-income households. A housing impact mitigation fee may also be due from the developer for fractional units. For example, if 15% of the units in a project would equal 13.37 units, then the developer would provide 13 BMR units and pay an impact mitigation fee for the additional 37/100th of a unit required. The City Council may approve alternatives to these requirements, such as proposals to provide off-site BMR units or to donate land for production of affordable housing.

Projects with six or fewer units are allowed to pay a housing impact mitigation fee instead of producing BMR units on-site. An impact fee commonly referred to as a "commercial linkage fee" is also required for new non-residential developments. Commercial linkage fees must be supported by a nexus study to ensure that they are reasonably related to the actual cost of mitigating the impacts of the project on the availability of affordable housing in the City. Feasibility should also be taken into account. Thus, although fees in a particular amount might be supported by a nexus study, adopted fees may be significantly lower. The City's most recent residential and non-residential nexus studies were performed by Keyser Marston Associates, Inc. (Keyser Marston) in 2015. The table below compares the fee amounts supported by the studies with the fees actually adopted by the City Council after considering feasibility. Note that the currently adopted fees shown in the table have been increased for inflation since adoption.

**Housing Impact Mitigation Fees (Comparison of Adopted Fees to Amounts Supported by 2105 Nexus Studies)**

| Use | Supportable Fee Per Square Foot | Current Adopted Fees Per Square Foot |
|---|---|---|
| Larger Single-Family Residential | $30.60 | $18.45 |
| Smaller Single-Family Residential | $30.10 | $18.45 |
| Small Lot Single-Family or Townhouse | $35.60 | $20.29 |
| Condominium | $35.10 | $24.60 |
| Lower Density Apartment | $33.80 | $24.60 |
| Higher Density Apartment | $42.50 | $30.75 |
| Office/R&D/Industrial | $129.05 | $24.60 |
| Hotel | $49.15 | $12.30 |
| Retail/Restaurant | $222.32 | $12.30 |

***Economic Feasibility Analysis Results***

*Increasing Production Requirements and Impact Fees for Residential Units*

The City has an interest in maximizing impact mitigation fees and production of BMR units, but excessive housing impact mitigation obligations that make new development infeasible will minimize production of housing for all income groups, including for lower to moderate-income households. Identifying the point where fees and production can be maximized without making development infeasible is the purpose of the Economic Feasibility Analysis. According to the Economic Feasibility Analysis:

- Increasing the City's existing inclusionary requirement for ownership units from 15% to 20% would be feasible.

- Imposing impact mitigation fees in the maximum amounts supported in the 2015 nexus study in lieu of inclusionary requirements would also be feasible.
- For rental housing, increasing inclusionary requirements would not be feasible, but imposing impact mitigation fees of up to $30/sf in lieu of inclusionary requirements would be feasible for higher density developments.
- Any change in current policies for lower density rental housing would be infeasible without either a 15% increase in revenues or a 15% decrease in development costs.

*Increasing Impact Fee Requirements in Non-Residential Projects*
The Economic Feasibility Analysis also studied the feasibility of increasing commercial linkage fees on non-residential development, and concluded that:

- Office, Research and Development (R&D), and Industrial uses are currently subject to a linkage fee of $24.60/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 $12.30/sf, 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.

1. ***Housing Commission and Planning Commission Review and Feedback***

On July 25, 2019, the Housing Commission held a meeting to receive an update on the efforts described above. The Housing Commission's recommendations to the Planning Commission and City Council included the following suggestions for increasing the supply of BMR housing in Cupertino, which are supported by the Economic Feasibility Analysis:

- Recommended production requirements of:
  - 20% for single family units;
  - Between 20-25% for townhomes and condos; and
  - 15% (no change) for rental housing.
- Recommended commercial linkage fees of:
  - $25 - $30/sf for office, research & development, and industrial;
  - $15/sf for hotel; and
  - 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. However, there was continued support for strategies that would create more opportunities to provide housing for households with extremely low incomes.

2. ***September 3, 2019 City Council Meeting***

The City Council considered the Housing Commission and Planning Commission recommendations on September 3, 2019. The City Council directed staff to return with additional information, including the following:

- Further peer review of the Economic Feasibility Analysis;
- An analysis of historic capitalization rates;
- Options to increase the supply of ELI housing; and
- Information about approaches to encourage affordable housing production for non-residential uses.

3. ***Peer Review***

While the Economic Feasibility Analysis was still in draft form, the City retained LeSar Development Consultants to peer review the analysis. The peer reviewer provided a list of questions about the Economic Feasibility Analysis, which Strategic Economics responded to in a July 16, 2019 memorandum (see Attachment D). Strategic Economics also revised the Economic Feasibility Analysis to make it more clear and comprehensive, but none of the changes affected the conclusions reached by Strategic Economics.

Questions did remain, following the September 3, 2019 meeting, whether the return on cost (ROC) and yield on cost (YOC) approaches to analyzing project feasibility should have been supplemented using another metric for determining feasibility, known as residual land value (RLV). Questions also remained concerning whether Strategic Economics used the best available sources of real estate sales data to arrive at some of its assumptions. To obtain a third perspective on these issues, staff obtained a further peer review from Keyser Marston (see Attachment E). Regarding the approach to measuring feasibility, Keyser Marston's peer review explains that ROC/YOC and RLV represent "distinct, but equally valid ways" of measuring feasibility, which rely on the same underlying data and assumptions. Keyser Marston also explained that: "While the RLV metric can be helpful for understanding how close an infeasible scenario is to becoming feasible, the sensitivity analysis that [Strategic Economics] performed on the rental residential prototypes serves a similar function[.]" Regarding data sources, Keyser Marston confirmed that the sales comparables relied upon by Strategic Economics conform generally with similar market studies.

Based upon this additional peer review, the Economic Feasibility Analysis was comprehensive and supportable at the time it was prepared.

4. ***Historic Capitalization Rates***

One concern raised by the City Council on September 3, 2019, is that a feasibility analysis provides a point-in-time look at the feasibility of housing, and does not necessarily consider long-term economic trends. Strategic Economics addressed this concern in a supplemental memorandum dated December 16, 2019 (see Attachment F), which showed historic capitalization rates in Santa Clara County over the past decade. As explained in the supplemental memorandum, a capitalization rate is a measure of a property's net operating income over expected sales price. Rising capitalization rates suggest that real estate investment is becoming more risky, while falling capitalization rates suggest the opposite. Consequently, higher capitalization rates translate to investors expecting a higher rate of return to invest in a project, making it less likely that the project will be feasible assuming costs and revenues remain the same, and lower capitalization rates make it more likely that the project will be feasible if costs and revenues remain constant.

As shown in Figure 5 of the supplemental memorandum, since 2009, market capitalization rates in Santa Clara County for office space have fallen from a high of more than 8% to a low in 2019 of less than 5%. As shown in Figure 6, multifamily housing capitalization rates have fallen from a high of just under 6% to a low of just under 4%. This means that real estate investors currently are willing to accept some of the lowest rates of return on their investments in over ten years. Counteracting this effect, however, is that construction and land costs have risen steadily over the same time period, making it more challenging for projects to promise the rates of return that investors expect.

### 5. *Effects of COVID-19 Crisis on Economic Feasibility Analysis*

Clearly the COVID-19 pandemic has caused severe economic changes. While it is known that over three million workers in California have filed for unemployment since mid-March, there is insufficient data to assess the impacts on the real estate markets. Neither Strategic Economics nor other economists can confidently predict the medium-term or long-term outcomes on economic feasibility. The need for the affordable housing provided by BMR units is likely to increase, but it is not clear whether construction and land costs will continue to rise and whether the demand for market-rate housing will remain steady. The Legislature has continued to move bills permitting more high-density housing regardless of local zoning and is likely to increase the pressure on cities to provide more affordable housing.

Anecdotally it is reported that even some high-tech companies may implement layoffs, but it is also reported that some have strengthened their dominance and increased revenues. Demand for offices may decline if remote work becomes the norm. The hotel industry has been particularly hard hit because of the limitations on travel, and it is not known how long those limitations, and public fear of travel, will continue.

The City Council could elect to proceed with the proposed changes or delay acting until the long-term economic effects become clearer. If the Council elects to proceed, one of the changes proposed in the Housing Mitigation Manual would allow an applicant to apply for a modification of the BMR requirements should they have an unconstitutional result. Additionally, the Council may adopt resolutions modifying the BMR Housing Program at any time. These provisions would allow for modifications in the requirements if they prevent project feasibility. The Council may elect to proceed or not, depending on its policy preferences.

*Options to Increase the Supply of ELI Housing*

The City's current BMR Housing Program does not require on-site production of housing for ELI households, which is housing for households earning no more than 30% of Area Median Income (AMI). At the September 3, 2019 meeting, the City Council asked for options for increasing the supply of ELI housing in Cupertino, and in particular for adults with developmental disabilities. The law firm of Goldfarb & Lipman LLP has prepared a memorandum (see Attachment G) describing various alternatives. Strategic Economics supplemented Goldfarb & Lipman's analysis by providing a feasibility analysis for a prototype project with ELI units in its December 16, 2019 supplemental memo attached as Attachment F. The City's FY 2019-20 work program includes Housing Strategies as a Priority Setting Item. The project objective is to explore the development of strategies that provides a variety of products across the affordability levels including housing for the developmentally disabled, as well as those with moderate, low, very low, and extremely low income. The information contained in the memorandum will help inform the Housing Strategies work program item.

*Approaches to Encouraging Affordable Housing Production by Non-Residential Uses*

Government Code Section 65915.7 requires cities and counties to provide incentives to commercial developments that partner with a housing project that contains 15 to 30 percent affordable housing and is located within one-half mile of a major transit stop. "Partnering" can mean either building the units, donating land, or donating money.

No particular incentives are specified; the incentives must be mutually agreed to by the City and the developer. The City Council could adopt an ordinance to allow specific development incentives (for example, lot coverage, FAR, or height bonuses, or parking reductions), in exchange for a commercial developer's agreement to provide BMR housing onsite (where allowed by zoning rules), or to donate land or funds to an affordable housing developer to develop BMR units offsite.

Another way to encourage affordable housing development by residential and commercial developers alike is by adopting a community benefits ordinance. Community benefits ordinances offer developers higher density and intensity development in exchange for providing a variety of community benefits, which may include affordable housing production. Often these ordinances provide two tiers of development, with the higher tier requiring the provision of community benefits. In some cases the benefits are specified (such as more affordable housing and higher traffic fees.) In other cases the benefits are negotiated for each project. The December 16, 2019 supplemental memo by Strategic Economics (Attachment F) includes a discussion of community benefits ordinances in other California jurisdictions.

Community benefits ordinances typically target more than just affordable housing. They may be flexible in allowing developers to provide other kinds of benefits, such as funding for traffic mitigation, providing land for open space, providing art in public spaces, or historic resource preservation. A city interested primarily in targeting affordable housing can do so by requiring affordable housing benefits when greater density or intensity of development is allowed.

Community benefits ordinances must be carefully drafted. Communities often require development agreements if certain benefits are proposed (such as monetary contributions for traffic fees) beyond those covered by by a nexus study. An ordinance specifying specific benefits tied to greater density and intensity treats all developers equally.

### *Other Changes to Housing Mitigation Manual*

The Housing Mitigation Manual has not been updated since May 2015. In amending the inclusionary requirement for ownership projects, the draft resolution would make changes to conform to state law. When the Housing Mitigation Manual was last updated, the Costa Hawkins Act prohibited local agencies in California from imposing inclusionary requirements on rental housing projects. In 2017, the Legislature enacted AB 1505 to allow local agencies to impose inclusionary requirements on rental housing, and the draft resolution would update the Housing Mitigation Manual to reflect the current 15% inclusionary requirement for rental housing. Other changes are proposed to respond to current case law and to provide the opportunity for applicants to apply for a reduction or waiver of the requirements.

### *Conclusions and Next Steps*

As indicated above, the Housing Commission recommended an increase in the inclusionary requirement for ownership projects from 15% to 20%. This recommendation received general support from Planning Commissioners. The City Council may implement the Housing Commission's recommendation by adopting the resolution attached as Attachment A. The resolution would approve amendments to the Housing Mitigation Manual to impose the recommended 20% inclusionary requirement on ownership projects and the other changes described above.

The Housing Commission also proposed an increase in commercial linkage fees. Consistent with that recommendation, the resolution included as Attachment B would increase the commercial linkage fee to $30/sf for office, research and development, and industrial uses and to $15/sf for hotels.

The City Council may have additional questions, comments, or feedback about other options discussed in this report for increasing the supply of affordable housing in Cupertino, including ELI housing. As noted above, the City's FY 2019-20 work program includes Housing Strategies as a Priority Setting Item. The information contained in the memorandum will help inform the Housing Strategies work program item.

Sustainability Impact
No sustainability impact.

Fiscal Impact
No fiscal impact.

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Attachments:
A - Resolution Amending the Below Market Rate Housing Mitigation Procedures Manual
B - Resolution Amending the Housing Mitigation In-Lieu Fees
C - July 2019 Economic Feasibility Analysis prepared by Strategic Economics
D - July 2019 Response to LeSar Development Consultants Peer Review
E - February 2020 Keyser Marston Peer Review
F - December 2019 Supplemental Memorandum from Strategic Economics
G - November 2019 Memorandum on Options to Increase the Supply of ELI Housing from Goldfarb & Lipman
H - Below Market Rate Housing Mitigation Procedures Manual redlined