THE CITY OF SAN DIEGO

OFFICE OF THE INDEPENDENT BUDGET ANALYST REPORT

Date Issued: July 26, 2019 **IBA Report Number:** 19-18

City Council and Housing Authority Docket Date: July 30, 2019

Item Number: 334

Proposed Inclusionary Housing Ordinance

OVERVIEW

The item before the City Council on July 30, 2019 is a request to approved proposed amendments to the Inclusionary Housing Ordinance (proposed ordinance), and related documents. The City's Inclusionary Housing Program (program) is one way to address affordable housing and has the distinct goal of achieving balanced communities with housing available for households of all income levels. This proposal was presented to the Rules Committee on May 15, 2019 and received a 3-2 vote recommending Council adoption of the ordinance with several amendments. It was also heard at the Planning Commission on July 11, 2019 which unanimously recommended the Council include other amendments brought forth by a coalition of developer and businesses, as well as other changes.

The purpose of this report is to provide information on the City's Inclusionary Housing Program including outcomes since its inception, highlight several findings of the Keyser Marston Associates, Inc. (KMA) economic feasibility analysis, and offer recommendations for improving future reporting on program outcomes.

BACKGROUND

Inclusionary Zoning

Inclusionary zoning policies require or encourage a certain portion of affordable housing units to be provided within market-rate projects. The purpose of the City's current Inclusionary Housing Program is "to encourage diverse and balanced neighborhoods with housing available for households of all income levels." Further it states that the "intent is to ensure that when developing the limited supply of developable land, housing opportunities for persons of all income levels are provided."

The City adopted an Inclusionary Housing Program June 3, 2003 requiring developers to provide 10% of units in a residential development project to be affordable by either providing units on or off the site of the project, or paying an in-lieu fee. A 2009 court decision[1] determined that the requirement of providing affordable units within residential rental projects conflicted with state law[2] which provides rental housing owners the right to set initial, and all subsequent rental rates for a unit built after 1995. In 2011, the City, along with many other jurisdictions, changed the structure of its policy to be fee-based and to allow, as an alternative to the fee, affordable units to be built within a residential project if developers so choose.

The recent enactment of Chapter 376 of Statutes of 2017 (AB 1505) taking effect in January 2018, supersedes the 2009 court decision allowing jurisdictions to switch back to policies that require a certain percentage of affordable units to be included within rental developments, and offer alternative methods of compliance. This new law has led to the development of the proposed changes to the Inclusionary Housing Ordinance that is before Council.

DISCUSSION

Inclusionary Housing is One Way to Address Affordable Housing

The City addresses affordable housing in many ways, including through its Inclusionary Housing Program. Other approaches include: providing rental assistance, and issuance of loans and multifamily housing revenue bonds by the San Diego Housing Commission (Commission) to finance new or preserve existing affordable units that would otherwise revert to market-rate. The City's density bonus program encourages affordable housing production by allowing an increase in development density in exchange for setting aside a percentage of units at affordable income levels. Many other initiatives have been pursued through the Mayor's Housing SD Plan to increase housing affordability and supply, such as eliminating parking requirements for multi-family residential development near a major transit stop.

Council is also being asked to approve revised Moderate Income Housing Regulations on July 30. These regulations, among other things, provide an increase to the maximum allowable density bonus a project near transit can receive if it makes 10% of its units affordable to moderate income households while also providing a certain percentage of units affordable to very low or low-income households. Many of these initiatives can be used together, as applicable and feasible, to help mitigate the cost of housing production in the City.

Affordable Housing Needs

As required by state law, the state, in consultation with the San Diego Association of Governments, determines the region's housing need, prior to revising the City's General Plan Housing Element. This is referred to as the Regional Housing Needs Allocation (RHNA). The current RHNA cycle

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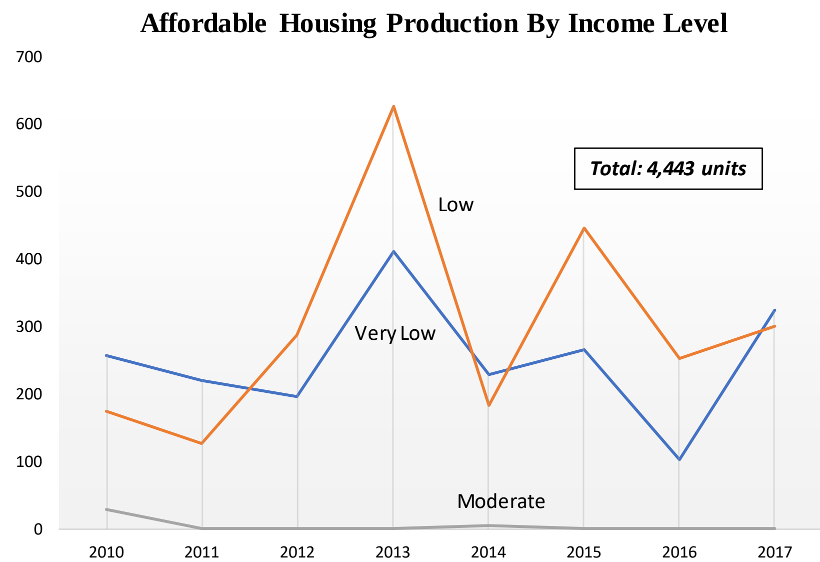
[1] Commonly referred to as the "Palmer Decision"
[2] Costa-Hawkins Rental Act

goes from 2010 to 2020. The figure below reflects actual affordable housing production. By the end of 2017, a total of 4,443 deed-restricted affordable units had been constructed, which meets 8% of the affordable housing need in the RHNA cycle at all income levels (54,142 units). The percent broken down by each income level includes: 9% for very low, 14% for low, and 0.2% for moderate.



Source: City of San Diego 2018 Housing Inventory Annual Report

Current Inclusionary Housing Program Outcomes

Generally, the City's current Inclusionary Housing Program requires that when new residential development occurs, an Inclusionary Housing Fee must be paid unless the project sets aside 10% of its units as affordable. Fee revenue is deposited in the Affordable Housing Fund and is a major revenue source the Commission uses for loans to support the creation and preservation of affordable housing. When loans are repaid, revenue recycles back into the Affordable Housing Fund. The fees are also significantly leveraged with other resources to provide financing for affordable housing projects. According to the FY 18 Affordable Housing Fund Plan, $25.2 million in Affordable Housing Fund revenue was used to attract an additional $199 million of revenue from outside sources in support of affordable housing projects.

Fee-supported projects target households earning between 30% and 60% area median income of a family (AMI)[3] and often serve special populations such as homeless individuals and seniors. The City's Municipal Code requires fee revenue to be prioritized for use in the community from which it was collected to support the goal of providing economically balanced communities. However, if no investment opportunity exists in the applicable community, the revenue may be invested elsewhere in the City.

[3] AMI for a family size of four is $86,300 in San Diego.

The table below reflects the number of affordable rental units produced since the inception of the Inclusionary Housing Program. As indicated, many more units have been produced by leveraging the Inclusionary Housing Fee. Our Office estimates that the Inclusionary Housing Program has contributed roughly 50% towards the total affordable housing production since 2004.

Inclusionary Housing Affordable Rental Units Produced Since 2004

	Units	Projects
Developer-built affordable units on or off-site	1,027	52
Units produced by leveraging fees[1]	3,027	32
Total	**4,054**	**84**

Source: San Diego Housing Commission

[1] Figures includes some projects under construction.

Note: Though the ordinance was adopted in 2003, production results began in 2004.

Proposed Ordinance

According to the staff report, the intent of the proposed ordinance is to facilitate building a larger percentage of affordable housing on the same site as market-rate development. In response to AB 1505, the proposal restructures the Inclusionary Housing Ordinance from a fee-based policy, to one based on on-site production of affordable units. Other significant changes include, targeting lower income levels for rental units; providing an option to build a larger percentage of affordable units at a higher income level for for-sale projects; and increasing the Inclusionary Housing Fee. The proposed ordinance provides several additional ways to comply, including building the required affordable units off the site of the market-rate development; rehabilitation of existing units; or paying a portion of the fee and building a portion of the required units on site. The table below summarizes the proposed changes to the percentage of units required to be affordable at targeted income levels (AMI) and the fee level.

Proposed Changes to Targeted AMI and Fee Level

Current	Proposed
Rental	**Rental**
10% up to 65% AMI	10% up to 50% AMI
For Sale	**For Sale**
10% up to 100% AMI	10% up to 100% AMI 15% up to 120% AMI
Fee	**Fee**
$12.73 per sq ft	$22.00 per sq ft

The proposed ordinance also adds to existing reporting requirements. Of note is tracking the number of inclusionary units along with methods of compliance. Our Office also recommends reporting on how often density bonus is used.

Key take-aways of KMA Analysis

KMA conducted an economic feasibility analysis on the impacts of the proposed Inclusionary Housing Ordinance. The purpose of the analysis was to assess whether the proposed ordinance unduly constrains the production of housing and to evaluate whether residential development would be financially feasible.

KMA determined that the proposed ordinance is economically feasible given the phase-in of the policy, incentives for on-site development, and the alternative options available to comply with the affordability requirements. Therefore, the analysis concludes that the proposed ordinance will not unduly constrain residential development in the City.

The analysis modeled the additional economic burden that developers would bear to comply with the proposed ordinance as compared to base case projects under the City's current policy.[4] The proposed ordinance offers ways for developers to mitigate these impacts by: building units off-site; paying the Inclusionary Housing Fee; and the ability to have Development Impact Fees and Facilities Benefit Assessments waived if affordable units are provided on-site. KMA accounted for these factors and other programs available to developers outside of the Inclusionary Housing Program such as density bonus, parking reductions, and tax credit financing. The net impact using several metrics allowed KMA to determine the feasibility of a project subject to the proposed ordinance. In several cases there was actually a net positive outcome where the use of density bonus, for example, resulted in increased developer return on investment as compared to the base case.

KMA includes the anticipated three most likely methods of compliance in its analysis assuming the new requirements are fully phased-in starting July 1, 2021. In both rental and for-sale developments, building off-site was the most likely method of compliance among the various prototypes tested. We note that the use of density bonus appeared in the top three most likely methods of compliance 25% of the time for both rental projects and for-sale projects.

Most Likely Method of Compliance	
Rental	**For-Sale**
Build Off-site	Build Off-site

It is important to note that these projected results are based on hypothetical projects and many variables can affect the economics of a project. Actual responses in the market to the proposed ordinance may not mirror these results. There are also additional methods of compliance provided in the proposed ordinance that were not tested such as dedicating land for affordable housing and rehabilitation of existing housing units. Though there are no guarantees on which method of

[4] The base case prototypes assumed a lower Inclusionary Housing Fee than is in place today. The fee increased July 1, 2019 which occurred as part of the current policy. Therefore, some of the impacts from this fee increase is reflected in KMA's analysis of the proposed ordinance due to timing of the report.

compliance will be most attractive to developers, it is worth describing in more detail what building off-site entails as it is projected to be the most likely means of compliance.

What does building inclusionary affordable units off-site look like?

According to the Commission, developers typically fulfill the off-site inclusionary requirement by partnering with affordable housing developers. Affordable units are typically built in an adjacent building near the market-rate development (often on the project site itself) and must be completed no later than market rate units. Affordable housing developers seek tax credits and bonds to help finance the project. However, no local public funds may be used to meet the inclusionary requirement, such as accessing Notices of Funding Availability (NOFA) for affordable housing project financing (for which Inclusionary Housing Fees partially fund). Because larger affordable housing projects are more efficient, sometimes an affordable housing developer will fulfill inclusionary requirements from multiple market-rate developments.

One example of inclusionary affordable units provided off-site is an ongoing development called Civita, located in Mission Valley Community Plan area. The inclusionary requirement comes from the development of a master plan community permitted to a maximum of 4,780 residential units. Since the project is in development, it is uncertain what the exact market-rate unit count will be, but to date about 450 affordable units are planned. To fulfill the inclusionary requirement, a partnership with an affordable housing developer was created to produce two standalone rental projects within the community; one with about 150 units for seniors and the other with about 300 units for families. About three-fourths of the affordable units target 30% to 60% AMI to get competitive tax credits and the rest target 50% to 60% AMI households. The funding sources for these affordable projects include tax credits, bonds, federal grants, and private sources. No local funds such as Commission loans provided through a NOFA are being used, in compliance with current regulations.

CONCLUSION

The Inclusionary Housing Program aims to increase affordable housing production while achieving balanced communities. The proposed ordinance is designed to result in additional and integrated affordable housing in the City. The proposed ordinance would allow developers to choose the compliance option that best fits, or least burdens, their project. This could involve building affordable units: on-site; off-site; pay the increased in-lieu fee; use a combination of on-site and in-lieu fee, dedicate land for affordable housing, or other options.

A coalition of developer and business organizations have expressed concern that the proposed ordinance will create economic impediments to the creation of additional affordable and market rate housing. They have recommended additional amendments to reduce the potential economic burden associated with the proposed ordinance. The Planning Commission considered these amendments and voted unanimously to recommend Council include them, as well as several other changes.

The City hired Keyser Marston Associates, Inc. (KMA) to perform an economic feasibility analysis which analyzed many of the concerns cited by the coalition. KMA performed the analysis and found that residential development subject to the proposed ordinance – in combination with the phase-in, incentives for on-site development, and range of alternatives – is economically feasible. They ultimately concluded that "the proposed ordinance would not unduly constrain residential development in the City, nor would it deprive property owners of a fair and reasonable return." However, it remains unclear how developers will respond to the proposed ordinance going forward given the options available to them, and therefore how it will impact the supply and cost of new housing in the City.

To facilitate monitoring the impacts of the proposed ordinance, it is critical that the City improve reporting on program outcomes. Though the proposed ordinance adds to existing reporting requirements which we believe is valuable, the data reported on the current program is not easily identifiable. In addition, it would be very useful for the public and Council to know how much affordable housing production is attributable to each program. For example, our Office has been informed that the current Inclusionary Housing Program has produced 4,054 affordable units to date (largely due to leveraged fee revenue) but it is not currently reported how much this contributes to total affordable housing production. Our Office estimates this to be roughly 50% since 2004. The City should also report how often projects use density bonus.

Going forward, in order to better assess the City's progress on affordable housing production and guide future policy decisions, **our Office recommends**:

- Reporting all program data specified in the proposed ordinance in an easily identifiable section within the Affordable Housing Fund annual report.
- Within the annual Housing Inventory Report, break down affordable housing production by the program generating the units to enable the reader to determine which programs have the greatest impact.

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