



THE CITY OF SAN DIEGO

## Report to the Planning Commission

DATE ISSUED: July 3, 2019

REPORT NO. PC-19-068

HEARING DATE: July 11, 2019

SUBJECT: PROPOSED AMENDMENTS TO THE CITY OF SAN DIEGO'S INCLUSIONARY HOUSING REGULATIONS

### SUMMARY

Action: Request for recommendation of the Planning Commission to the City Council for approval of an amendment to the City's Municipal Code and Local Coastal Program to amend the City of San Diego's Municipal Code Chapter 14, Article 2, Division 13 to adopt on-site inclusionary housing requirements, alternative compliance measures, including an updated in-lieu fee, and incentives for on-site construction of inclusionary units.

Staff Recommendation: Recommend approval of the proposed regulations to the City Council.

### 2019 CITY COUNCIL WORKPLAN PRIORITIES:

Priority Goal 3: Reinforcing and establishing new tenant protections

Priority Goal 4: Continuing to develop innovative housing solutions

### CITY STRATEGIC PLAN GOAL(S)/OBJECTIVE(S):

Goal 2: Work in partnership with all of our communities to achieve safe and livable neighborhoods

Goal 3: Create and sustain a resilient and economically prosperous City with opportunity in every community

Environmental Review: The amendments to the City of San Diego's Inclusionary Affordable Housing Regulations are exempt from the California Environmental Quality Act (CEQA) under CEQA Guidelines Sections 15378, 15061(b)(3), and 15183. See CEQA Memo, Attachment 1.

Housing Impact Statement: The proposed regulations would apply Citywide, except in the North City Future Urbanizing Area [NCFUA]. The proposed regulations would amend the City of San Diego's inclusionary housing regulations to require the development of on-site affordable housing units as part of new residential and mixed-use development and condominium conversions. This proposal is consistent with Assembly Bill (AB) 1505, passed by the State of California Legislature on September 15, 2017, which allows cities to require, as a development condition, that a certain percentage of rental units be included in the development for moderate, low, very low, or extremely low income households. This proposal also includes a selection of alternative compliance measures, incentives, and other amendments to address implementation and the current state of the law.

## BACKGROUND

An update to the City's Inclusionary Affordable Housing Regulations was included as part of the seven initiatives outlined in Councilmember Gómez's July 2017 [Housing Action Plan](#), and in the Council President's 2019 Work Plan for the City Council. The intent of the proposal is to facilitate building a larger percentage of affordable housing on the same site as market-rate development, in compliance with all applicable laws.

The purpose of the City's Inclusionary Affordable Housing Regulations, initially adopted in 2003, is to "encourage diverse and balanced neighborhoods with housing available for households of all income levels". According to San Diego Municipal Code (SDMC) § 142.1301, the intent is to ensure that when developing the limited supply of developable land, housing opportunities for persons of all income levels are provided.

Currently, the City of San Diego requires residential developers to pay an inclusionary affordable housing fee unless their development meets one of the exemptions specified in the Municipal Code. The revenue from the collections of the inclusionary housing fee, as well as repayment of the loans and associated interest, is an essential source of funds for the creation of affordable housing. The populations who reside in these affordable housing units include low-income families and special populations such as youth transitioning out of foster care, seniors, individuals with disabilities, and individuals experiencing homelessness.

Since the inception of the Inclusionary Housing Fund, collections from the fee have totaled more than \$140 million. In fiscal year 2018, collections from the fee totaled approximately \$18.7 million, though the annual average since inception has been roughly \$9.3 million. For fiscal year 2019, the fee for developments with 10 or more units is \$10.82 per square foot. A sliding scale fee applies to developments with nine units or fewer, (eg. whereby a two-unit development pays 20 percent of the fee, in this case \$2.16 per square foot). For fiscal year 2020, the fee for developments with 10 or more units will be \$12.73 per square foot, and the sliding scale fee rate for developments with fewer than 10 units will start at \$2.55 per square foot.

KMA analysis includes a review of current market-rate sales prices and unit sizes for new units sold within the City (excluding the NCFUA) as part of the fee's annual update. During their analysis for a proposed update to the fee, KMA looked at the fee level required to achieve the targeted inclusionary production in an off-site location, and determined the fee level equivalent in cost to providing affordable units on-site. As part of the proposed regulations, the fee will be updated annually based on the annual change in the Construction Cost Index (CCI).

### 1. Legal Precedent

On November 1, 2011, the San Diego City Council passed ordinance O-20107, amending the Inclusionary Affordable Housing Regulations in response to the *Palmer* decision. The ordinance expressed the City's intent "to remove any on-site rental requirement that would violate the state Costa-Hawkins Rental Act."

The Legislature declared its intent to supersede the holding and the effect of a 2009 decision of

the California Court of Appeals, known as the *Palmer* decision, which found that inclusionary zoning for rental residential development conflicts with California's Costa-Hawkins Rental Housing Act and with a city's authority to impose inclusionary housing ordinances. In response to the court decision, many jurisdictions suspended their inclusionary housing ordinances for rental housing, or moved to a fee-based program, as was the case in San Diego.

In October 2017, California Governor Brown signed Assembly Bill (AB) 1505, which reaffirmed the ability of local governments to require the production of affordable housing as part of their local inclusionary housing policies. AB 1505 requires that any local ordinance requiring on-site affordable housing production provide an alternative means of compliance, including, but not limited to, in-lieu fees, land dedication, off-site production, and the acquisition and rehabilitation of existing housing units. The law went into effect in January 2018.

## 2. Housing SD, Affordable and Middle Income Density Bonus Incentives

Inclusionary housing regulations should be considered in conjunction with the [City's Affordable Housing Density Bonus](#) (AHDB) regulations as well as initiatives undertaken as part of the Mayor's Housing SD policies including the Transit Priority Area (TPA) on-site parking elimination and the proposed Middle Income Density Bonus program.

The intent of the AHDB regulations is to provide incentives for developments that provide housing for very low, low and moderate income households, as well as senior households, transitional age foster youth, disabled veterans, or homeless San Diegans. Affordable housing density bonus is a California state law (Government Code section 65915) that allows a developer to increase density above the maximum set under a city's local land use when a certain percentage of the new homes is reserved for very low, low or moderate income households or seniors.

In San Diego, a developer providing a certain percentage of affordable housing is entitled to the incentives and concessions through State Density Bonus Law even without a request for a density bonus. In addition, developers of qualifying residential projects are entitled to receive certain benefits, including reduced parking standards, "incentives or concessions," and waivers of certain development standards when those standards prevent the applicant from achieving the density authorized under the state law. On March 6, 2018, the San Diego City Council approved changes to the existing Density Bonus program that included increases in density bonus and allowing developers to be eligible for an incentive or waiver even if they do not request a density bonus.

Many of the [Housing SD initiatives](#), including [Transit Priority Area Parking reductions](#) that the City Council adopted on March 19, 2019, eliminating parking requirements for new multi-family development, are important components for promoting new affordable and middle income development. In addition, proposed Moderate Income Housing Regulations have been envisioned to be coordinated with the Inclusionary Affordable Housing Regulations to ensure that they are "stacked" so that the affordable housing component is included.

It is clear that the proposed inclusionary housing regulations and all density bonus initiatives and incentives must be coordinated in order to ensure that the future production of housing can

benefit from the incentives and concessions provided under State Law.

### 3. Summary of KMA Feasibility Analysis

In the Fall of 2018, San Diego Housing Commission (SDHC) engaged Keyser Marston Associates, Inc. (KMA) to prepare a series of real estate financial feasibility analyses related to potential changes to the City's existing Inclusionary Housing Ordinance. The objective of the KMA feasibility analyses was to evaluate the impact of alternative inclusionary housing requirements on market-rate residential development economics in the City of San Diego. The KMA analyses identified a range of rental and for-sale residential development prototypes currently planned, under development, or recently completed in the City. The development prototypes and inclusionary set-aside alternatives were formulated through extensive interaction with, and feedback from, a 25-member Inclusionary Housing Stakeholder Working Group that was convened by Council President Gómez.

For each prototype, KMA prepared base case financial pro forma models and a series of sensitivity tests to evaluate the impacts of a broad range of inclusionary set-asides (percent of affordable units) and targeted household income levels (percent of Area Median Income [AMI]). In addition, where selected inclusionary set-asides triggered the potential for an affordable housing density bonus and/or reduction in parking ratio, KMA factored these incentives into the feasibility models. The models present comparative impacts of the alternative inclusionary requirements, as compared to the current Inclusionary Housing Ordinance, expressed in terms of four alternative measures:

- Impact on residual land value;
- Impact on market value at completion;
- Impact on developer profit; and,
- Change in rent or price for the market-rate units needed to offset the impact of the inclusionary requirement.

The KMA feasibility findings, and all of the supporting financial pro forma models, were presented to the Stakeholder Committee members at their October 25, 2018 meeting. A number of Stakeholder Committee members subsequently submitted extensive comments, suggested revisions, and alternative financial pro formas. KMA thoroughly catalogued these responses, evaluated feedback received, and made substantial modifications to the financial pro forma analyses to reflect this real estate industry input. The revised KMA findings and supporting pro forma models were then presented to the Stakeholder Committee on February 27, 2019. Following the February 27, 2019 meeting, staff and the consultant team began work on preparing the draft regulations and refined alternatives.

At the May 15, 2019 Rules Committee hearing, KMA presented a refined set of inclusionary alternatives. These updated alternatives included updated financial models to reflect the release of 2019 U.S. Department of Housing and Urban Development (HUD) income figures for San Diego County (which reflect a 7% increase over 2018 income limits) and the proposed City of San Diego Development Impact Fee (DIF) exemption for on-site affordable units. KMA also prepared, and updated, a series of financial pro formas for off-site affordable housing developments, both

rental and for-sale, with and without Low Income Housing Tax Credits, in order to measure the financing gap associated with providing inclusionary housing units on an alternative site.

Furthermore, KMA presented findings for the proposed on-site inclusionary requirements of: either 10% at 50% AMI or 15% at 80% AMI for rental housing; and either 10% at 100% AMI or 15% at 120% AMI for for-sale housing. KMA presented the same four measures of impact on developers for selected means of compliance that would be available to developers under the proposed ordinance (impact on residual land value; impact on market value at completion; impact on developer profit; and change in rent or price for the market-rate units needed to offset the impact of the inclusionary requirement).

Following direction received from Rules Committee members at the May 15, 2019 hearing as described on page 8 of this report, KMA completed an economic feasibility study (Attachment 2) based on modifications to the proposed Inclusionary Housing Ordinance recommended by the Rules Committee for proposed on-site inclusionary requirements of: 10% at 50% AMI for rental housing; and either 10% at 100% AMI or 15% at 120% AMI for for-sale housing. It should be noted that AB 1505 studies are only required for "rental" projects. In the feasibility analysis, KMA also addressed for-sale projects. The study methodology followed best professional practices and was sufficiently rigorous to allow an assessment of whether the rental inclusionary requirement, in combination with other factors that influence feasibility, is economically feasible.

A summary of the KMA findings are presented in Exhibits A-H (page 21-28 of the KMA study) that correlate to the eight development prototypes studied in the KMA economic feasibility analysis (four rental, four for-sale). Each exhibit presents the four measures of impact on developers, for each of the specified development prototypes, for selected means of compliance that would be available to developers under the proposed ordinance. Specifically, KMA addressed:

1. Payment of the in-lieu fee at \$22 per square foot (SF) of net residential area;
2. Off-site production at each of the available set-asides/income levels (assuming that inclusionary units are built within same Community Planning Area and City Council District, or within one mile of the premises of the developer's new market-rate development);
3. On-site production at each of the available set-asides/income levels;
4. On-site production at each of the available set-asides/income levels inclusive of any available affordable housing density bonus.

Based on the feasibility studies performed, KMA concludes that the proposed ordinance does not unduly constrain the production of housing. It is anticipated that there would be a period of adjustment as the development marketplace absorbs the new requirements. Specifically, developers and land owners will need to consider how to incorporate the new requirements and evaluate the alternative means of compliance available. KMA found the projected impacts on developer pro formas, as measured against one or more of the metrics described above, to be low.

As currently drafted, the proposed ordinance offers developers a menu of options to comply with the requirement, including the in-lieu fee and building off-site. Finally, both the set-aside requirement and the in-lieu fee are proposed to set in at one-third in the first year, and two-

thirds in the second year, with the program fully vested on July 1, 2021. Based on the extensive review and analysis conducted by KMA, it is KMA's opinion that the proposed ordinance – in combination with the proposed phase-in, incentives for on-site development, and range of alternatives – is economically feasible.

## SUMMARY OF PROPOSAL

The following is the summary of proposed amendments to the City of San Diego's Inclusionary Affordable Housing Regulations (Attachment 3). The amendments have been derived by a combination of the KMA analysis, the Inclusionary Housing Stakeholder feedback, and direction from the City Council Rules Committee.

### 1. On-Site Affordable Requirements:

- Rental -- 10% of the inclusionary units shall be affordable to and occupied by households earning at or below 50%.
- For-sale -- either 10% of the total units made available to and occupied by households earning at or below 100% AMI or 15% of the total units made available to and occupied by households earning at or below 120% AMI or a combination of the on-site percentages that would require SDHC approval to determine if the combination provides substantially the same or greater level of affordability.

### 2. Methods of Compliance:

- The developer may build inclusionary units on the same site as the market-rate development.
- The developer may build inclusionary units on a different site than the market-rate development, but within the same community planning area and City Council District, or within one mile of the premises of the development. If the inclusionary units are provided on a different site further from the market-rate development than state above, then the developer must provide additional inclusionary units equal to 5% of the total units in the development.
- The developer may pay an Inclusionary In Lieu Fee. The initial Inclusionary In Lieu Fee shall be \$22.00 per square foot of net building area of unrestricted market-rate residential development. The Inclusionary In Lieu Fee shall be updated annually based on the annual increase in the Construction Cost Index (CCI) published by Engineering News Record for Los Angeles, or similar construction industry index in the event the CCI index is discontinued.
- Instead of building new affordable units, the developer may rehabilitate existing units at a 2:1 ratio if the value of the rehabilitation work is 25 percent or more than the value of the unit prior to rehabilitation, inclusive of land value. The existing units may be market-rate units or affordable units with expiring affordability restrictions. The existing units may also be existing Single Room Occupancy hotel rooms or converted hotel or motel rooms.
- The developer may dedicate land for affordable housing if the value of the land upon the date of donation is equal to or greater than the Inclusionary In Lieu Fee, in effect at the date of donation, applicable to the applicant's development.
- The developer may utilize affordable units constructed by another developer, including

contracting with an affordable housing developer with experience obtaining tax-exempt bonds, low income housing tax credits, and other competitive sources of financing.

- Projects can have the option to pay a portion of the in lieu fees and build a portion of inclusionary units on site. This option shall be described in the SDHC Inclusionary Affordable Housing Implementation and Monitoring Procedures manual.

### 3. Exemptions:

- The proposed amendment retains the exemption for development in the northern part of the City known as the North City Future Urbanizing Area, which requires housing developers to dedicate 20 percent of their units to affordable buyers or renters, as specified by the San Diego Municipal Code. The North City Future Urbanizing Area includes the neighborhoods of Black Mountain Ranch, Del Mar Mesa, Pacific Highlands, and Torrey Highlands;
- New development projects under 10 units will be exempt from the inclusionary requirement.

### 4. Additional Incentives:

- Inclusionary units will be exempt from Development Impact Fees (DIF) and Future Benefit Assessment (FBA) District fees if the affordable units are provided onsite.

### 5. Timing of Implementation:

- Regulations would be implemented over the course of three years so that applicants will be required to provide one-third of the percentages or the Inclusionary In Lieu Fee during the first year of implementation and two-thirds of the percentages or the Inclusionary In Lieu Fee during the second year with full implementation in effect by the third year.

### Independent Budget Analyst Comparative Analysis

On July 27, 2018, the City's Independent Budget Analyst (IBA) provided a review of efforts by a number of California cities who have embarked or adopted updated inclusionary housing regulations per AB 1505. Attachment 4 provides the analysis completed by the IBA. This comparative analysis was considered as part of the development of the proposal.

### FISCAL CONSIDERATIONS:

Currently, the City's Inclusionary Affordable Housing regulations require developers of two or more housing units to pay an Inclusionary Affordable Housing Fee. Revenue from this fee is deposited into the City's Affordable Housing Fund. The uses of these funds, which are administered by the San Diego Housing Commission (SDHC), include, but are not limited to, the creation of affordable rental and for-sale housing units. The SDHC monitors the affordability of each unit produced under the City's Inclusionary Affordable Housing Regulations. To date, collections from the Inclusionary Affordable Housing Fee have totaled \$140,244,341 and have resulted in providing more than 4,900 affordable rental and for-sale housing units citywide.

#### PREVIOUS COMMITTEE ACTIONS AND/OR COUNCIL ACTIONS:

In 2003, the City of San Diego adopted its original inclusionary housing ordinance. On November 1, 2011, the San Diego City Council passed ordinance O-20107, amending the Inclusionary Affordable Housing Regulations in response to the California Supreme Court's *Palmer* decision.

The City Council received a presentation from the Office of the Independent Budget Analyst at Housing Day on July 31, 2018, that compared several inclusionary housing programs in California. In addition, Councilmembers Chris Ward and Georgette Gómez presented a request to update the City's Inclusionary Affordable Housing Regulations in response to the passage of Assembly Bill 1505. The following initial general framework was presented for consideration:

- Inclusionary on-site requirement above the current 10%, increasing the base-level requirement for on-site affordable housing units;
- Additional percentage requirements for projects that involve a zoning increase, City-owned land, or public financial assistance;
- Additional percentage requirements when affordable units would be provided offsite and when affordable units would be provided outside the project's Community Plan Area;
- Modification of income levels and set-asides; and,
- Providing alternative options to replace an in-lieu fee on large-scale projects and restricting in-lieu fee payments to small projects below a certain number of units.

The Land Use and Housing Committee (formerly Smart Growth and Land Use Committee) received a presentation on September 18, 2018 that presented information related to the current regulations, affordable housing fund revenues and production, affordable housing financing, AB 1505 legislation and the scope and timeline of the economic analysis by KMA. The presentation was informational, and no action was taken.

On May 15, 2019, the Rules Committee voted 3-2 to recommend Council adoption of ordinance amending City of San Diego's Municipal Code Chapter 14, Article 2, Division 13 to adopt on site inclusionary requirements, alternative compliance measures including an updated in-lieu fee and incentives for on-site construction of inclusionary units with the following amendments:

- Remove the 15% requirement at 80% Area Median Income (AMI)
- Reduce the proposed in lieu fee from \$25 to \$22
- Expand alternative compliance options to include the rehabilitation of Single Room Occupancy (SRO) hotel rooms and conversion of non-residential motel units

#### KEY STAKEHOLDERS AND COMMUNITY OUTREACH EFFORTS:

From September 2018 through April 2019, Council District 9 staff, along with the San Diego Housing Commission, convened a series of Inclusionary Housing Stakeholder meetings. These meetings invited 25 members of a variety of development, labor, community and nonprofit entities to provide feedback and input into the development of the housing development pro forma analysis that was completed by Keyser Marston Associates (KMA). The feedback received both from the stakeholder committee, and the KMA analysis, are the basis for the current proposal moving forward.



Respectfully submitted,



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Attachments:

1. CEQA Memo
2. KMA Feasibility Study
3. Inclusionary Housing Proposed Regulations
4. Independent Budget Analyst Comparative Analysis
5. Development Impact Fee Memo