INCLUSIONARY ZONING ORDINANCE

IN-LIEU FEE ANALYSIS

DRAFT REPORT

SUBMITTED TO

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CITY OF SEBASTOPOL IN-LIEU FEE ANALYSIS

INTRODUCTION

The purpose of this report is to provide information to the City of Sebastopol's City Council for its consideration in updating the in-lieu fee component of the City's Inclusionary Zoning Ordinance. This fee is required under the City's Inclusionary Zoning Ordinance and is generally used to cover a developer's inclusionary requirement when that requirement results in fractional, not whole units. Since real estate development costs have been escalating in the San Francisco Bay Area, the City of Sebastopol requested that Vernazza Wolfe Associates, Inc. (VWA) update its 2002 In-Lieu Fee Study so that the fee used for fractional unit requirements is based on current development costs.

The basis for the fee study is the housing affordability gap. This gap is defined as the difference between the costs of developing modest housing in Sebastopol and the amount that households can afford to pay for housing. The affordability gap is the amount that must be provided through special financing programs or public subsidies, such as funds from an in-lieu fee, in order to make housing affordable to low- and very low-income households, the income groups to which the Inclusionary Zoning Ordinance is targeted.

This report also presents information that can be used to establish the connection between the affordability gap and an in-lieu fee, and includes information on whether the suggested fee will serve as a constraint to housing development in Sebastopol.

Topics covered in this report are as follows:

- Amount that households can afford to spend on housing;
- Estimated costs to develop housing in Sebastopol;
- The affordability gap;
- Relating the gap to an in-lieu fee;
- Impacts of fees scenarios on the feasibility of new home development, and
- Economic indices to adjust the fee for inflation.

AMOUNT THAT HOUSEHOLDS CAN AFFORD TO PAY FOR HOUSING

The first step in the process of updating the fee is to calculate how much households at targeted income categories can afford to pay for housing. Sebastopol's current Inclusionary Zoning Ordinance states that the inclusionary units shall be provided at the low-income level or below. The State Department of Housing and Community Development (HCD) defines low-income households as those earning between 51 percent and 80 percent of area median income, and defines very low-income households as those earning 50 percent of area median income or below.

Table 1 presents information on how much low- and very low-income households can afford to pay for housing, assuming three different household sizes - two, three and four persons. These household sizes were selected, based on average household sizes for Sebastopol renters (1.94 persons per household) and for Sebastopol owners (2.72 persons per household), as of the 2000 Census. In each case, the maximum income for the particular category is used. This increases the amount that households in each income category are assumed to be able to afford for housing costs and thus decreases the size of the affordability gap for each income group.

As noted in Table 1, we assume that the maximum affordable rent, including utilities, is 30% of income. For homeowners we assume that the maximum monthly housing cost (mortgage payment) is also 30% of income. We also assume a six and a half percent interest rate and a 95 percent loan to value ratio as loan terms. These definitions are used to calculate maximum rents and purchase prices. [1]

[1] Table 1 is based on the 2005 HUD definition of income by household size for the Santa Rosa PMSA. Since the first draft of this study was completed, HUD has issued the 2006 income guidelines. This study still uses the 2005 incomes for two reasons. First of all, information on development costs was collected in 2005 and 2006. Secondly, the income differences between 2005 and 2006 as reported by HUD are very insignificant.

Table 1: Ability to Pay for Housing – City of Sebastopol

Very Low-Income Households at 50% of 2005 Median Family Income			
Unit Size	1 Bedroom	2 Bedroom	3 Bedroom
Household Size	2	3	4
Income Level	$29,850	$33,550	$37,300
Maximum monthly rent (1)	$746	$839	$933
Maximum purchase price@6.5% Interest Rate and 95% LTV (2)	$124,194	$139,588	$155,190
Low-Income Households at 80% of 2005 Median Family Income			
Unit Size	1 Bedroom	2 Bedroom	3 Bedroom
Household Size	2	3	4
Income Level	$46,400	$52,200	$58,000
Maximum monthly rent (1)	$1,160	$1,305	$1,450
Maximum purchase price@6.5% Interest Rate and 95% LTV (2)	$193,052	$217,183	$241,315

Assumptions:

(1) 30% of income devoted to maximum monthly rent, including utilities

(2) 30% of income devoted to mortgage payment, 30 year term.

Sources: HUD and HCD FY 2005 Income Limits (February 2005) for Santa Rosa PMSA and Vernazza Wolfe Associates, Inc.

Table 1 also shows the housing unit size (number of bedrooms) that the households would occupy based on household size.

COSTS TO DEVELOP HOUSING

The next step is to estimate the costs to develop modest housing. Two prototype developments are used; a multifamily rental development and a for-sale, small lot development. The methodology used to determine development costs is as follows:

<u>Select development prototypes for both rental and for-sale housing.</u>

For multifamily rental housing the prototypical project consists of forty, two-bedroom, and one-bath apartment units, each consisting of 850 SF. The for-sale, single-family prototype is a 1,400 SF, three-bedroom, two bath house with a two-car garage sited on a 4,500 SF lot.

<u>Estimate land and development costs for the two prototypes.</u>

For rental units, a $370 per square foot cost was used in this analysis and is assumed to cover total development costs including land. (See Table 2.) Affordable Housing Associates (AHA) provided information on development costs in December 2005 for the rental project AHA will be building at Petaluma and Walker (Petaluma Avenue Homes). Petaluma Avenue Homes, a co-housing rental project, is the only multifamily rental development currently planned in Sebastopol. Petaluma Avenue Homes offers one-, two-, and three-bedroom units. The scale of the AHA project at 45 units is similar to the prototype.

For-sale development costs were based on information provided by a private market developer and Burbank Housing, an affordable housing developer. A unit cost of $498,000 ($356 per square foot) was used. (See Table 2.)

Table 2: Housing Development Costs

	Rental Housing Development Costs (1)	For-Sale Units Development Costs (2)
Unit Prototype	2 BR/1 Bath	3 BR/2 Bath
Size	40 units @850 SF/Unit	1,400 SF Unit W/2 Car Garage
Land Costs	$2,000,000	$112,500
Site improvement costs	$1,169,000	$51,660
Hard Development Costs	$6,789,800	$199,179
Soft Costs	$3,264,400	$82,450
City Fees	$668,000	$25,677
Developer Fees	$900,000	$26,557
Total Costs (3)	$14,791,200	$498,023
Per SF Costs	$370.24	$355.73
Per Unit Costs (rounded)	$314,500	$498,000

(1) Rental housing development costs are based on recent development cost estimates for AHA'S Petaluma Avenue Homes, a 45-unit, co-housing affordable rental project to be built in Sebastopol.
(2) Based on costs provided by a for-profit developer currently building in Sebastopol and Burbank Housing, a local non-profit developer. The Burbank Housing costs are based on a proposed for-sale, affordable co-housing project to be built in Sebastopol. Adjustments have been made to these costs to reflect current land costs and fees. The market rate development costs are based on developer assumptions. Final costs used in this table represent an average between the market rate and non-profit development costs.
(3) Total costs cover the entire 45-unit Petaluma Avenue Homes development.
Sources: Affordable Housing Associates, Burbank Housing, Private Development Company, and Vernazza Wolfe Associates, Inc.

Costs for both rental and for-sale housing have risen substantially since the initial 2002 in-lieu fee study. Rental housing costs increased by 85 percent for two-bedroom units (from $170,000 to $314,500 per unit), and for-sale housing costs for a three-bedroom unit increased by 69 percent (from $294,000 in 2002 to $498,000).

According to Table 2, the costs for a single family house are higher than for a rental unit, but the per SF costs for a rental unit are actually higher than the per SF costs for a single family unit. This may seem contrary to what one might expect, but in fact, there are several explanations for the higher per SF cost for the rental unit defined in Table 2. There are several reasons for this.

- Per SF costs for smaller units are higher than for larger units. In these examples, the multifamily unit is smaller than the single family, ownership unit.

- The ownership unit is based on a combination of an affordable developer's costs (Burbank) and a market rate developer's costs, while we only had one source of information for the multifamily example (AHA). AHA costs reflect prevailing wages, whereas the market rate developer's costs do not.

- The interest rate used for the multifamily example is slightly higher than for the single family example. Interest rates are higher for investors than they are for homebuyers.

- Multifamily housing requires additional features not required in single family housing, for example, fire codes and sound proofing would be different. These requirements increase costs.

- Higher costs defined above for multifamily housing could be offset by lower land costs per unit for multifamily, if residential densities varied significantly between single family and multifamily development. In our examples, the land costs for the single family units are more than twice the costs for the multifamily units. However, this is not a sufficient difference to offset the other factors cited above.

HOUSING AFFORDABILITY GAP ESTIMATES

The next step is to put together the cost estimates and the information on ability to pay to determine the amount of the housing affordability gap. For the purposes of developing an in-lieu fee, it is necessary to calculate an average gap figure across both tenure groups.

Table 3 presents the housing affordability gap information for low-income renter households. It assumes that three person households occupy two-bedroom units. For renters, the gap is defined as the difference between development costs and the first mortgage amount that can be supported by net operating income based on affordable rents. The gap per unit for the 80 percent AMI group is $188,015.

Table 3: Rental Housing Affordability Gap Calculations

PERCENT of MEDIAN INCOME (1)	AREA (Sq feet)	TOTAL # of UNITS	MAXIMUM MONTHLY RENT (2)	GROSS INCOME	NET OPERATING INCOME (3)	AFFORDABLE FIRST MORTGAGE (4)	DEVELOPMENT COSTS (5)	AFFORDABILITY GAP	GAP PER UNIT
80%	850	40	$1,245	$597,600	$407,720	$5,059,414	$12,580,000	$7,520,586	$188,015

(1) Household income figures used here are based on HUD/HCD FY 2005 Income Limits.
(2) Assumes a three-person household for a 2-BR unit. Maximum contract rent reduced by $60 per month for 2 BR units for utilities paid by tenant, per the Sonoma County Housing Authority Utility Allowance schedule.
(3) Net operating income is the amount available for debt service. These calculations assume a five percent vacancy and collection loss and $4,000 per unit for operating expenses.
(4) Assumes 7%, 30 year loan. Although the for-sale financing assumed a slightly lower interest rate, lenders charge a slightly higher interest rate on non-conforming loans used to purchase investment grade real estate.
(5) Based on costs presented in Table 2.

Source: Vernazza Wolfe Associates, Inc.

Table 4 presents detailed affordability gap information for for-sale housing under the financing scenario defined in Table 1. For ownership housing, the gap is defined as the difference between the amortized loan that a household can pay for a mortgage and the loan amount needed to purchase a unit. This gap amount is $256,685. It is important to remember that changes in the development cost assumptions or household incomes will directly impact these gap calculations.

To create an **overall** average gap amount, the gaps for rental and for-sale housing for the 80 percent AMI group are combined. This average gap figure is $222,350, assuming a six and a half percent loan and a 95 percent loan to value ratio.

Table 4: Housing Affordability Gap Summary

Prototype	80% of Median Income
For-Sale Units	
3-BR/2bath - 1,400 Sq. Ft.	
Housing Development Costs (1)	$498,000
Less Affordable Housing Price (2)	$241,315
Affordability Gap (4)	**$256,685**
Rental Units	
2-BR/1 bath - 850 Sq. Ft.	
Housing Development Costs (1)	$314,500
Affordable Rents (2)(3)	$1,245
Affordability Gap Per Unit (4)	**$188,015**
Average Gap (5)	**$222,350**

(1) See Table 2.
(2) See Table 1 for affordable housing costs and affordable rents.
(3) The amount of affordable rent based on income has been reduced by $60 for a 2-BR unit to account for utilities paid for by the tenant.
(4) The gap is the difference between development costs and the mortgage that can be supported by rents.
(5) The average gap is based on the affordability rental gap for renters and buyers @80% AMI.
Source: Vernazza Wolfe Associates, Inc.

RELATIONSHIP BETWEEN THE HOUSING AFFORDABILITY GAP AND INCLUSIONARY ZONING IN-LIEU FEES

Calculating the housing affordability gap is only part of the work needed to calculate an inclusionary zoning in-lieu fee. Ultimately, the City Council will need to decide whether to develop a fee that is based on the total affordability gap figure, or to consider additional factors when translating the housing affordability gap into an updated in-lieu fee.

It is important to note that the ratio of inclusionary units to market rate units, referred to as the inclusionary unit requirement, affects the in-lieu fee. To illustrate, the current policy requires that 20 percent of market rate units be inclusionary units. Changing this percentage to 25 percent (under consideration by the City Council) will increase the number of required units and fractional units for which the fee is paid, and will also result in higher in-lieu fees.

According to present City policy, the size of the in-lieu fee varies by the size of the market rate unit. There is no uniform fee per SF, but rather a stepped-up fee. For example, market rate units below 900 SF pay $2.00 per SF, whereas, units that exceed 2,500 SF pay a $6.37/SF fee. The City is now considering whether to assess a uniform fee per SF across all unit sizes. The tables presented below reflect a uniform fee policy.[2]

Tables 5 and 6 present hypothetical unit and fee requirements for a fourteen-unit project under two inclusionary scenarios (20 percent and 25 percent) for two gap scenarios (100% and 70%).[3]

Tables 5 and 6 are also useful in showing how fees vary by size of housing unit and by the inclusionary requirement. The number of units required varies by the inclusionary requirement (not size of unit); however, fees do vary by size of unit. For example, assuming a 20 percent inclusionary requirement and based on the full gap calculations, a fourteen-unit project consisting of 2,000 SF homes would need to provide two units and pay $177,920 in fees, while a fourteen-unit project consisting of 2,800 SF units would still need to provide two units, and pay a higher fee amount ($249,088) under the same gap scenario. Under the 70% affordability gap scenario, fee amounts would be $124,544 and $174,362 respectively.

[2] City of Sebastopol staff requested a uniform fee per SF.

[3] Table 5 uses the full affordability gap calculation. However, it is also possible to compute in-lieu fees using a percentage of the affordability gap. This is the purpose of Table 6. The reason for considering a fraction of the gap (e.g., 70%) is that funding from public programs is available to help finance affordable housing development costs. The 70% scenario is intended to recognize that in-lieu fees would likely be combined with other subsidies to create affordable housing.

Table 5: Hypothetical Fees and Number of Units Required, Based on a Full Affordability Gap Scenario for a Fourteen-Unit Project

Unit Size (SF)	Twenty Percent Inclusionary Requirement			Twenty-Five Percent Inclusionary Requirement		
	Fee/Unit (1)	# of Units Required	Fractional In-Lieu Fee for Four Units	Fee/Unit (2)	# of Units Required	Fractional In-Lieu Fee for Two Units
800	$17,792	Two	$71,168	$22,232	Three	$44,464
1,000	$22,240	Two	$88,960	$27,790	Three	$55,580
1,200	$26,688	Two	$106,752	$33,348	Three	$66,696
1,400	$31,136	Two	$124,544	$38,906	Three	$77,812
1,600	$35,584	Two	$142,336	$44,464	Three	$88,928
1,800	$40,032	Two	$160,128	$50,022	Three	$100,044
2,000	$44,480	Two	$177,920	$55,580	Three	$111,160
2,200	$48,928	Two	$195,712	$61,138	Three	$122,276
2,400	$53,376	Two	$213,504	$66,696	Three	$133,392
2,600	$57,824	Two	$231,296	$72,254	Three	$144,508
2,800	$62,272	Two	$249,088	$77,812	Three	$155,624
3,000	$66,720	Two	$266,880	$83,370	Three	$166,740
3,500	$77,840	Two	$311,360	$97,265	Three	$194,530
4,000	$88,960	Two	$355,840	$111,160	Three	$222,320

(1)The fee per unit is based on a revised fee amount of $22.24/SF. The revised fee per SF is defined as the total gap of $222,350 divided by a 2,000 SF house and multiplied by 20%, reflecting a **20%** inclusionary requirement.
(2) The fee per unit is based on a revised fee amount of $27.79/SF. The revised fee per SF is defined as the total gap of $222,350 divided by a 2,000 SF house and multiplied by 25%, reflecting a **25%** inclusionary requirement.

Source: Vernazza Wolfe Associates, Inc.

If the City decides to increase the inclusionary requirement from 20 percent to 25 percent, there will be two major changes. The first is that the fee per SF increases, since 25 percent of the gap is used in the fee calculation, instead of 20 percent. In addition, the number of units required increases at a slightly faster rate, as project size goes up. In the example presented here, the consequence of going from a 20 percent to a 25 percent inclusionary requirement is to increase the number of units required for a 14-unit project from two units to three units.

Table 6: Hypothetical Fees and Number of Units Required, Based on Seventy Percent of the Affordability Gap for a Fourteen-Unit Project (1)

Unit Size (SF)	Twenty Percent Inclusionary Requirement			Twenty-Five Percent Inclusionary Requirement		
	Fee/Unit (2)	# of Units Required	Fractional In- Lieu Fee for Four Units	Fee/Unit (3)	# of Units Required	Fractional In-Lieu Fee for Two Units
800	$12,454	Two	$49,818	$15,562	Three	$31,125
1,000	$15,568	Two	$62,272	$19,453	Three	$38,906
1,200	$18,682	Two	$74,726	$23,344	Three	$46,687
1,400	$21,795	Two	$87,181	$27,234	Three	$54,468
1,600	$24,909	Two	$99,635	$31,125	Three	$62,250
1,800	$28,022	Two	$112,090	$35,015	Three	$70,031
2,000	$31,136	Two	$124,544	$38,906	Three	$77,812
2,200	$34,250	Two	$136,998	$42,797	Three	$85,593
2,400	$37,363	Two	$149,453	$46,687	Three	$93,374
2,600	$40,477	Two	$161,907	$50,578	Three	$101,156
2,800	$43,590	Two	$174,362	$54,468	Three	$108,937
3,000	$46,704	Two	$186,816	$58,359	Three	$116,718
3,500	$54,488	Two	$217,952	$68,086	Three	$136,171
4,000	$62,272	Two	$249,088	$77,812	Three	$155,624

(1) Table 6 uses 70% of the affordability gap calculation to recognize the fact that in-lieu fees would likely be combined with other subsidies to create affordable housing.
(2)The fee per unit is based on a revised fee amount of $15.69/SF. The revised fee per SF is defined as 70% of the total gap of $222,350 divided by a 2,000 SF house and multiplied by 20%, reflecting a **20%** inclusionary requirement.
(3) The fee per unit is based on a revised fee amount of $19.45/SF. The revised fee per SF is defined as 70% of the total gap of $222,350 divided by a 2,000 SF house and multiplied by 25%, reflecting a **25%** inclusionary requirement.

Source: Vernazza Wolfe Associates, Inc.

Finally, Table 7 provides a quick comparison between two potential inclusionary requirements (20 percent and 25 percent) for the full gap scenario and for the seventy percent gap scenario. The project again is assumed to consist of 14 units, and the size of each market rate unit is assumed to be 2,000 SF.

Table 7: Hypothetical Fees and Unit Requirements for a 14-Unit Project, Under Two Inclusionary Requirement Scenarios, 20 and 25 Percent (1)

	20% Inclusionary Requirement		25% Inclusionary Requirement	
Percentage of Gap Charged	**Required Units**	**Fees on Four Units**	**Required Units**	**Fees on Two Units**
100% of Gap	Two	$177,920	Three	$111,160
70% of Gap	Two	$124,544	Three	$77,812

(1) Assumes each unit consists of 2,000 SF.
Sources: Tables 5 and 6.

IMPACTS OF REVISED FEE LEVEL ON SEBASTOPOL RESIDENTIAL CONSTRUCTION LEVELS

It is important to understand whether the proposed fee will constitute a constraint to the development of housing. Governmental constraints to the development of housing are monitored by the State of California through its housing element review process. One way to determine if the new fee is a constraint is to compare Sebastopol's potential in-lieu fees with fees charged in surrounding areas. In theory, if the City of Sebastopol's in-lieu fee is much higher than what neighboring jurisdictions impose, then it is possible that developers will build in neighboring cities, rather than pay the higher in-lieu fees in Sebastopol.

Table 8 presents this comparison. It is clear from this table that a revised Sebastopol fee results in a fee that is higher than fees charged in neighboring cities. However, this fee difference may not deter Sebastopol developers since Sebastopol is considered to be a unique and separate market area.

Table 8: 2005 Housing In-Lieu Fee Comparison Sonoma County and Sonoma County Cities

Jurisdiction	Based on a 2,000 SF Housing Unit
Cloverdale (1)	$ 30,160.00
Healdsburg	$ 10,940.00
Petaluma	$ 9,022.00
Santa Rosa	$ 10,423.00
Sebastopol - Current Fee (2)	$ 7,406.00
Sebastopol – Potential Fee (3)	***$ 44,480.00***
Windsor (4)	$ 10,740.00
Sonoma County	$ 10,955.00

(1) Cloverdale's fee is not based on size. Instead the fee is based on a comparison of the price for a median-priced home and what a four-person, moderate income household can afford. The maximum fee is entered in this table.
(2) Based on current formula and fee of $6.37/SF
(3) This fee estimate assumes that 100% of the new affordability gap is used to calculate the fee and the inclusionary requirement is 20%. If 70% of the gap is charged and again assuming that the inclusionary requirement is 20%, the fee would be lower ($31,136).
(4) Windsor approaches the fee calculation somewhat differently than neighboring cities. The fee amount included in this table represents fees for a full unit. (2,000 SF multiplied by $5.37/SF.)

Source: Vernazza Wolfe Associates, Inc.

A second way to assess impacts on new development from the inclusionary requirement and in-lieu fees is to compare the level of new residential development activity in Sebastopol before and after the current Ordinance was passed. In theory, if the fee is a disincentive to new construction, then developers will build in other cities that do not have an inclusionary requirement or have requirements that are less stringent. Since the time that the Inclusionary Zoning Ordinance was revised and an in-lieu fee was adopted (2002), the level of residential building has increased, not decreased. According to the Sebastopol Planning Director, Sebastopol's inclusionary requirement did not appear to affect development activity. In part, this may be due to the fact that the Sebastopol housing market is a "stand alone" market and does not directly compete for residential development with other Sonoma County cities.

ANNUAL ADJUSTMENT MECHANISM

A final recommendation regards the adjustment mechanism used to update the in-lieu fee to compensate for inflation. Since development and land costs have been rising steadily over the last several decades, the selected in-lieu fee based on current development costs will be out of date in a few years.

The 2002 in-lieu fee study recommended that the City of Sebastopol use time series data on new home prices sold in Sonoma County provided by the Construction Industry Research Board. The advantage of this data set is that it included both land and other development costs.

Unfortunately, the Construction Industry Research Board no longer publishes this information.

For another public client, VWA assessed how closely other cost indices, such as the CPI or Marshall & Swift cost data, compared with the Construction Industry Research Board for the time period in which information from all sources was available. From this research, VWA determined that the one index that came closest to tracking the Construction Industry Research Board's new home price information is the CPI (Shelter Only). Thus, in the event that Sebastopol wants to adjust its revised in-lieu fee in the future to reflect general inflation, we recommend the use of the CPI (Shelter Only) that is available on the Bureau of Labor Website. The closest geographical area to Sebastopol would be the data set for the San Francisco-Oakland-San Jose MSA.