CITY OF SAN JOSE
CAPITAL OF SILICON VALLEY

Memorandum

TO: HONORABLE MAYOR AND CITY COUNCIL

FROM: Jacky Morales-Ferrand

SUBJECT: SEE BELOW

DATE: February 11, 2021

Approved D. DSyL

Date 02/12/21

SUBJECT: ACTIONS RELATED TO AMENDMENT OF THE INCLUSIONARY HOUSING ORDINANCE

RECOMMENDATION

(a) Accept the staff report;
(b) Approve an ordinance amending Chapter 5.08 of Title 5 of the San José Municipal Code, Inclusionary Housing, to modify and add definitions, compliance options, and affordable housing requirements;
(c) Adopt a resolution amending the 2020-2021 Schedule of Fees and Charges (Resolution No. 72737, as amended) to modify and establish amounts for the compliance options in Sections 5.08.520 and 5.08.525 of Chapter 5.08 of Title 5 of the San José Municipal Code; and
(d) Adopt a resolution defining geographical areas for use as market areas in connection with Chapter 5.08 of Title 5 of the San José Municipal Code and designating certain areas as Strong Market areas.

OUTCOME

Accepting staff's recommendation and adopting the amended Inclusionary Housing Ordinance, as directed by the City Council in 2019, will support the production of residential developments for both market-rate and affordable housing for all income levels. The City has set a goal of producing 15,000 new market-rate homes and 10,000 affordable homes by 2023. The Inclusionary Housing Ordinance is one tool that can be utilized to contribute to the citywide goals.

The amendments are intended to produce more on-site inclusionary units that are integrated into the market-rate housing and encourage new affordable housing built simultaneously with market-rate. In addition, the Inclusionary Housing Ordinance allows developers additional flexibility and additional compliance options for developments to move forward. These amendments will help facilitate market-rate developments in a challenging market and increase density by encouraging more units to be built. These actions implement the City Council direction given to staff on November 5, 2019. In addition, staff is proposing an updated Fee Resolution to modify the 2020-2021 Schedule of Fees and Charges and establish fee amounts for the compliance options under the Ordinance.

EXECUTIVE SUMMARY

The Housing Department is returning to City Council to adopt amendments to Chapter 5.08 of Title 5 of the Municipal Code, the Inclusionary Housing Ordinance (the "Ordinance") as directed by the City Council in 2019. The research for the Ordinance updates findings and impacts of COVID-19 on the housing market, including decreased housing production, decreased market-rate rents, and increased vacancy rates, as well as an increased shortage of affordable housing. The Ordinance updates include definitions that have been added and modified, new compliance options, and new affordable housing requirements. The summary of amendments is included in the Briefing Sheet as **Attachment A**. In addition, staff is returning with a Resolution to define the geographical areas for use as market areas and designate certain areas as "Strong Market Areas" and "Moderate Market Areas" (**Attachment B**). The initial fees will be at $43/ft^2 in Strong Market Areas and $18.70/ft^2 in the Moderate Market Areas. Lastly, staff is recommending amendments to the Fee Resolution and methodology of calculating the in-lieu fees for rental and for-sale (**Attachment C**).

BACKGROUND

The Inclusionary Housing Ordinance (the "Ordinance"), also referred to as Inclusionary Zoning, is a land use restriction that requires developers to set aside a certain number of units for low-income households. It is an opportunity to integrate affordable housing units into market-rate housing developments throughout the City.

The background includes a summary timeline of the City's Inclusionary Housing policy from 1988 to the current Inclusionary Housing Ordinance. In addition, Keyser Marston Associates, Inc. (KMA) completed a Cost of Development study for the City's Housing Department in 2019. The report provides market context for how development costs have been rising over the past several years at approximately twice the historical average rate of increase. Staff used the KMA Report to provide updates to City Council on the Inclusionary Housing Ordinance updates on November 5, 2019. At that meeting, the City Council approved staff recommendations for proposed amendments to the Inclusionary Housing Ordinance but directed staff to return with amendments to the Ordinance. Staff is also providing additional amendment recommendations that were not directed by City Council. All major amendments to the Ordinance and additional recommendations are summarized in **Attachment A**.

SUMMARY TIMELINE OF INCLUSIONARY HOUSING

Over the past 30 years, San José has used a range of tools to respond to the need for affordable housing in the community. These tools include using tax increment financing, inclusionary housing policies, and, most recently, an affordable housing impact fee. The memorandum from November 5, 2019, City Council meeting provides a more detailed history of the Ordinance. More information can be found on the Housing Department's website. A summary of the development and implementation of the Ordinance is included below:

- ***1988 – Inclusionary Policy (Redevelopment Areas only):*** Since 1988, the City has administered the Inclusionary Housing Policy. This Policy required that 20% of all for-sale developments of greater than ten units located in Redevelopment Project Areas be price-restricted and sold to moderate-income purchasers (120% of the Area Median Income – AMI). In addition, it also included that 20% of all rental developments of ten or more units be restricted to very-low income and low- or moderate-income households. The Inclusionary Housing Policy still applies to some older projects. At its peak, the Policy generated approximately $40 million a year.

- ***2009 – Judicial Action Suspending Enforcement of IHOs for Rental Construction:*** In 2009, the California Court of Appeals pre-empted local inclusionary housing ordinances for rental construction when it sided with developer Geoff Palmer in *Palmer v. City of Los Angeles*. The courts agreed that Los Angeles' inclusionary housing ordinance, which required Palmer to set aside 60 of 350 planned residential units for low-income residents or pay an in-lieu fee, violated the state's Costa-Hawkins Act. Since 2009, cities and counties in California have only enforced inclusionary housing ordinances on for-sale developments.

- ***2010 – Replacement of Policy with Ordinance for New Residential Units:*** On January 12, 2010, the City Council adopted the Inclusionary Housing Ordinance (Ordinance) as Chapter 5.08 of the San José Municipal Code, replacing the Policy administered since 1988. The Ordinance applies to for-sale and rental market-rate developments of 20 or more units. Although the Ordinance was adopted in 2010, it did not become operative until January 1, 2013.

- ***2013 to 2016 – Judicial Action Suspending City's Ordinance for For-Sale Construction:*** On January 1, 2013, the implementation of the Ordinance's for-sale construction provisions was suspended by a "stay" decision issued by the Santa Clara County Superior Court in *California Building Industry Association (CBIA) v. City of San José.* The Superior Court's decision was overturned by the 6th District Court of Appeal. The "stay" was terminated in 2015 after the California Supreme Court affirmed the Sixth District ruling, upholding the Ordinance and remanding the case to the Superior Court. The CBIA filed a petition for a writ of certiorari with the U.S. Supreme Court seeking review, but the U.S. Supreme Court denied CBIA's petition for certiorari on February 29, 2016. On March 29, 2016, the City Council adopted a resolution providing a grace period suspending the Ordinance requirements for projects that had acquired all their Planning Permits on or before June 30, 2016.

- ***2014 – Suspension of the Ordinance Rental Implementation that led to Creation of the Rental Affordable Housing Impact Fee (AHIF):*** City Council on November 18, 2014, adopted the Affordable Housing Impact Fee (AHIF). The City created the AHIF Program because the *Palmer* decision from 2009 was preventing the City from imposing inclusionary housing requirements on rental projects. The AHIF Program required rental developments with three or more units to pay an "impact fee" at a cost of $17 per ft^2 with a 2.4% increase in fees at the start of each fiscal year, July 1. Since the end of Fiscal Year 2019-2020, June 30, 2020, approximately $11.2 million has been collected in AHIF fees. Staff estimates an additional $20 million will be collected by 2021.

- ***2017 – Transition between the AHIF and the Ordinance:*** On September 29, 2017, Assembly Bill (AB) 1505 passed, clarifying the State Legislature's intent to supersede the court decision in *Palmer v. City of Los Angeles* from 2009. AB 1505 ended the suspension of implementation of local affordable housing ordinances and allowed application to rental residential developments effective January 1, 2018.

  As a result of AB 1505, on December 19, 2017, the City Council adopted Resolution 78473 amending the AHIF Resolution to provide a framework for a transition process between the existing AHIF and the Ordinance between January 1, 2018, and June 30, 2018, for projects with 20 or more rental units. Staff also clarified that rental developments with three to 19 units would still be subject to the AHIF and that for-sale projects with 19 or fewer units would be exempt from both the Ordinance and AHIF.

- ***2018 – Current Implementation of the Ordinance and the AHIF:*** The City currently implements two separate affordable housing programs that apply to new residential projects. The Ordinance applies to rental and ownership projects with 20 or more units while the Affordable Housing Impact Fee (AHIF) applies to rental projects with 3-19 units. For-sale residential projects of 19 or fewer units are not covered under either program.

2019 COST OF DEVELOPMENT STUDY

In 2019, Keyser Marston Associates, Inc (KMA) completed a Cost of Development Study for the City's Housing Department. KMA's report found that high density apartments and condominium projects in the City were projected not to meet the minimum threshold on returns necessary for developers and investors to move forward, except in the most favorable locations. The current Ordinance requirements represent approximately 4-5% of the total development costs for new high-density condominiums and apartments. The KMA Report did not include a study on the ability of projects to produce units on-site.

According to the KMA report, development costs have been rising over the past several years at approximately twice the historical average rate of increase. Before the pandemic, the cost of development exceeded the rising rents and sales prices, and COVID-19 created challenging conditions for projects to move forward. Given that the KMA study was conducted based on 2019 pre-COVID market data, it is important to consider the economic impacts that the pandemic has on the market for for-sale and rental new construction. Class A rent trends are important for developers to determine the feasibility for moving forward with new development. Since the start of the pandemic, trends have indicated increased vacancy rates due to decreased demand for newer Class A apartments. Meanwhile, for-sale prices have not suffered the same decreases. Specifically, single family homes have increase by 16% from year over year $1,381,000 to $1,402,500.

The proposed changes to the Ordinance are designed to allow developers flexibility and more options to choose from to meet the affordable housing requirements. Currently, there are ten projects underway that have selected the in-lieu fee compliance option – none of the projects have selected to build units on-site. However, City Council has expressed interest in incentivizing the production of on-site units in the neighborhoods where new market-rate housing developments are being built. The challenge is to provide an option that will result in developers choosing to build some portion of the affordable units on site, without increasing the developers' net cost of complying with the Ordinance.

SUMMARY OF PROPOSED AMENDMENTS TO CURRENT ORDINANCE

On November 5, 2019, the City Council approved staff recommendations for proposed amendments to the Inclusionary Housing Ordinance and directed staff to return with five amendments to the Ordinance, including:

1. Lower the minimum threshold for the Ordinance to apply to developments with ten or more units and set the fee at half of the rate that would otherwise apply for developments with fewer than 20 units that provide at least 90% of the maximum density allowed by the General Plan;
2. Revise the On-Site and Off-site Inclusionary affordability level requirements for rental developments;
3. Restructure the in-lieu fee from a per-unit to a per-square-footage basis, setting the initial fee for Rental at $43/ft^2$ and For Sale at $25/ft^2$, determine strong market areas, in-lieu fees for moderate areas initially set to be consistent with the AHIF, and establish an annual fee escalator reflecting the prior year's construction cost index;
4. Add four new Compliance Options to encourage affordable housing production: Mixed Compliance Option (On-Site Rental with adjusted in-lieu fee combination), Option to Purchase real property, Option to Dedicate SB 35 entitled property, and Option for Partnership for Clustered units; and
5. Extend the period of affordability to 99 years with voluntary demolition after 55 years, and relocation benefits for residents of the inclusionary units.

Staff is also recommending three additional amendments for the City Council to consider:

6. Allow streamlining for 100% affordable housing developments and allowing 100% affordable housing developments funded and restricted by the City of San José exempt from the Ordinance;
7. Establish a transition process for existing residential developments; and
8. Provide more flexible marketing rules for projects that are consistent with the City's goals regarding affirmatively furthering fair housing and anti-displacement.

If the recommendations are approved by the City Council, the amended Inclusionary Housing Ordinance will be effective 30 days after the second reading and adoption. However, the intended operative date of the amendments is May 1, 2021. The transition provisions allow for existing residential developments with planning permit approvals prior to May 1, 2021, to remain under the current Inclusionary Housing Ordinance.

ANALYSIS

The purpose of the Inclusionary Housing Ordinance is to encourage development of housing affordable to households from extremely-low to moderate incomes and meet the city's regional share of housing needs. There are two parts of the analysis for updates to the Inclusionary Housing Ordinance. The first part of the analysis focuses on research of the current housing market in the City. The second part focuses on amendment recommendations to the Ordinance, as well as amendments to the Ordinance Fee Resolution and methodologies to calculate rental and for-sale in-lieu fees.

RESEARCH ON HOUSING MARKET IN THE CITY

A. COVID-19 Effects on Housing Production

On March 11, 2020, the World Health Organization declared the coronavirus (COVID-19) outbreak a pandemic. On March 16, 2020, the County of Santa Clara issued a shelter in place order directing all individuals to shelter in their place of residence unless they must obtain or perform vital services. All businesses, except essential businesses, are required to cease all activities at facilities located within the County. The order was effective on March 17, 2020, and further clarifying restrictions were imposed on March 31, 2020. Most construction had to cease and, for residential construction, only projects with an on-site affordable housing of at least 10% income-restricted units could continue, along with homeless shelters. On May 4, 2020, the County of Santa Clara allowed all construction activity to resume, subject to safety protocols to reduce the spread of the coronavirus. Due to San José City Hall closure, many City services transitioned from in-person to new virtual processes for service. The City Manager signed an Emergency Order on May 5, 2020, to extend construction hours and other strategies to facilitate development services. These strategies included extending planning and building permit expiration dates to help alleviate the impacts.

A survey of multifamily construction firms conducted by the National Multifamily Housing Council from October 6 to October 27, 2020, showed that 57% of respondents are still facing construction delays.[1] Many have also reported that:

- Since March 2020, the multifamily construction firms have closed down at least one construction project due to the COVID-19 pandemic;
- While 26% have paused projects, they are confident the projects will resume;

[1] https://www.nmhc.org/news/nmhc-news/2020/surveys-fifth-installment-shows-significant-impact-on-availability-and-price-of-construction-materials-due-to-ongoing-covid-19-pandemic/

- 9% of projects have paused and are unsure of date to resume;
- 31% have paused earlier during the pandemic but have since resumed, and
- 33% have indicated firms have not paused or canceled production at this point.

As the pandemic continues, the construction industry will continue to experience short-term declines. Meanwhile, the availability of the vaccine will impact the speed of the housing market recovery. Zillow recently projected that with vaccine distribution underway, local economies may begin to experience recovery as businesses and schools reopen and residents move back into more densely populated areas.[2]

B. Market Rental Rates Decreasing, Vacancy Rates Increasing

Staff reviewed the Housing Market Report quarterly updates with data from CoStar. CoStar reports trends on median sale prices of homes, average rental rates, interest rates, and foreclosures. According to Q3 2020 data, the average monthly rent for a two-bedroom unit is $2,652, compared to $2,759 in the Q3 2019.[3] This represents a 3.88% decrease in the year-over-year change in average cost of rent. **Table 1** compares rents and incomes needed to afford deed-restricted, rent stabilized, and Class A market-rate housing in San José.

Table 1: Comparison of Rents and Incomes

Income Level	1-Bedroom		2-Bedroom	
	Max Income	**Rent**	**Max Income**	**Rent**
Extremely Low-Income (30% AMI)	$37,900	$849	$42,650	$955
Very Low-Income (50% AMI)	$63,200	$1,416	$71,100	$1,592
Rent Stabilized	**N/A**	**$1,718**	**N/A**	**$2,060**
Low-Income (80% AMI)	$89,750	$2,266	$100,950	$2,548
Market-Rate Class A	**N/A**	**$2,613**	**N/A**	**$3,249**
Moderate-Income (100% AMI)	$113,300	$2,832	$127,450	$3,185
Moderate-Income (120% AMI)	$135,900	$3,399	$152,900	$3,822

Low vacancy rates typically signal a healthy rental market when there is high rental demand, and there is sufficient supply to meet the demand. Generally, a healthy vacancy rate is 5%. According to CoStar Q3 2020, the vacancy rates were:

- 7.4% for average residential vacancy for all housing,
- 16.3% for Class A housing

[2] https://www.zillow.com/research/zillow-2021-housing-predictions-28516/
[3] https://www.sanjoseca.gov/your-government/departments/housing/data/housing-market

- 5.5% for Class B housing, and
- 5.2% for Class C.[4]

In **Table 2**, the vacancy rates and percentage of rental stock for Class B and C housing decreased from 2019 in 2020. Class B and C housing have lower rents and are older construction. Tenants are not moving out of these units in significant numbers. By comparison, Class A housing increased in vacancy rates and percentage of overall rental stock. Much of that movement resulted from renters moving out of Class A housing.

Table 2: Comparison of Vacancy Rates and Rental Stock by Building Class in 2020

Building Class	Vacancy Rate	Rental Stock	Definition for Building Class (CoStar)
Class A	**16.3%** **7.1% in 2019**	**19.3%** **16.2% in 2019**	In general, a Class A building is an extremely desirable investment-grade property with the highest quality construction. It may have been built within the last 5-10 years, but if it is older, it has been renovated to maintain its status and provide it many amenities. Class A buildings are currently experiencing a high vacancy rate meaning there is more supply than demand for the units.
Class B	**5.5%** **3.5% in 2019**	**33%** **33.4% in 2019**	In general, a Class B building offers more utilitarian space without special attractions. It will typically not have the abundant amenities and location that a Class A building will have. Although vacancy rates have increased by 2% in 2020, the supply and demand for the units are almost balanced.
Class C	**5.2%** **3.7% in 2019**	**47.5%** **50.2% in 2019**	In general, a Class C building is a no-frills, older building that offers basic space, has below-average maintenance and management, and inferior elevators and mechanical/electrical systems. Class C apartments tend to be some of the most affordable units available which results in the lowest vacancy rate out of the three building classes.

As housing instability mounts due to increased unemployment rates and continued rent burdens, there may be more movements out of Class A housing and even out of the City, resulting in even higher vacancy rates.[5]

[4] https://www.sanjoseca.gov/home/showpublisheddocument?id=67724
[5] https://www.forbes.com/sites/forbesrealestatecouncil/2020/12/01/are-people-really-moving-out-of-cities-due-to-the-pandemic/?sh=27a995186279

C. Shortage of Affordable Housing in the City

Although San José has historically provided much of the housing affordable to Santa Clara County's workforce, housing development has been inadequate to meet the demand for housing. As a result, there is a severe shortage of adequate, affordable housing for extremely-low, very low-, lower-, and moderate-income households:

- ***City behind RHNA Goals:*** According to the most recent 2015-2023 Regional Housing Needs Allocation (RHNA), the City of San José has a total housing need of 35,080 units through the year 2023, out of which approximately 60% is for lower- and moderate-income households (20,849 units). Of the affordable units: 9,233 units (26%) for very-low-income households; 5,428 units (15%) for low-income households; and 6,188 units (18%) for moderate-income households. These housing needs represent substantial increases from previous RHNAs. In particular, the need for very low-income housing increased by 19% from the previous RHNA and 73% from the 1999-2006 RHNA. This need only represents current need and does not factor the unmet demand from previous RHNA cycles. Yet, these goals fall far short of the actual need for households in these income categories.

- ***Households are cost burdened:*** Due to the shortage of affordable housing in San José, many households are cost burdened, and thus, are paying more than 30% of their income for their housing. A housing payment is considered affordable when a household is paying 30% of their gross income towards their housing cost according to standards of the U.S. Department of Housing and Urban Development (HUD). The 2018 American Community Survey found that approximately 28% of San José households who own their homes pay more than 30% of income for their mortgage, while 51% of renter households pay more than 30% of income for housing.[6] These housing costs exceed what households should pay and still have enough left to pay for other expenses.

- ***Research has identified links between the shortage of affordable housing and negative consequences for low-income residents***.[7] This research illustrates the threat to the health and welfare of San José's low-income residents who are experiencing challenges finding and keeping affordable housing. The findings have linked unaffordable housing and poor housing quality to children being less prepared for kindergarten, being exposed to higher levels of lead, suffering higher levels of maltreatment, and enjoying fewer enrichment activities than children with stable affordable housing. Additionally, households with significant housing cost burden suffer from worse self-reported health conditions.

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[6] https://www.census.gov/acs/www/data/data-tables-and-tools/data-profiles/2018/
[7] https://www.macfound.org/media/files/HHM_-_Affordable_Housing_-_Stronger_Cognitive_Development.pdf

RECOMMENDATIONS

Staff is recommending the following amendments to the Inclusionary Housing Ordinance for City Council to consider:

- Definitions for "Strong Market Areas" and "Moderate Market Areas;"
- Amendments to the Ordinance directed by the City Council;
- Additional Amendments to the Ordinance recommended by staff; and
- Amendments to the Ordinance Fee Resolution and methodologies to calculate rental and for-sale in lieu fees.

A. Definitions for "Strong Market Areas" and "Moderate Market Areas"

Staff recommends that City Council adopt the definition of market areas based on Market Areas and designating certain areas as strong market areas in connection with Chapter 5.08 of Title 5 of the San José municipal code. Staff is recommending approval of a Resolution to define the geographical areas for use as market areas and designate certain areas as "Strong Market Areas" and "Moderate Market Areas" (**Attachment B**). The Housing Crisis Workplan directs the City to provide housing in all market areas throughout San José, and this Resolution is an opportunity to develop a plan to meet this direction by establishing market areas boundaries. Staff will continue to work with the Office of Economic Development to review and revise the Market Areas over time.

Staff's recommendation is to set the initial fees at $43/ft^2$ in Strong Market Areas and $18.70/ft^2$ in the Moderate Market Areas as directed by City Council in 2019. These amounts are adjusted to reflect the cost of development study in 2019. The Office of Economic Development working with the Housing Catalyst Team, will complete periodic updates to the Cost of Residential Development Study to evaluate the feasibility of residential development over time. In addition, it is anticipated that market information will be updated every five years.

To develop definitions for the proposed Market Areas, staff collaborated with the Department of Planning, Building, and Code Enforcement (PBCE) and used their Planning Areas Map as a basis to develop the market area boundaries and determined unique market characteristics. Then, staff designated certain areas as Strong Market Areas and Moderate Market Areas by analyzing two reports: Cost of Development study by KMA and Development Activity Highlights and Five-Year Forecast.

- ***Findings from KMA Report:*** KMA's Cost of Development Study compares the economics of the conceptual development programs based on market conditions, specifically in submarkets where each development type is likely to occur. Subsequent to the production of the KMA study which captured increasing housing construction activities in the fall of 2019, the COVID-19 pandemic in winter 2020 halted the progression of the construction industry. The impact on the progress of the construction workforce resulted in an increase in construction costs. While there is optimism in the development community that the San José market will recover relatively quickly once the pandemic situation improves, the current uncertainty of the fluctuating housing market has made it difficult for new projects to begin construction.

In the study, the submarkets used were low-rise, mid-rise and high-rise protypes, and the study focused on the locations of South, East, Central, West, North and Downtown San José. These market areas are not intended to make any changes to the existing Downtown High-rise Incentive program. The study found that the estimated developer return for rental projects increased with calculations proposed under the Ordinance Updates, compared to the calculations under the existing Ordinance (**Table 3**). Developers in West San José demonstrated rents high enough to support current development costs and generate profit levels consistent with the expectations of developers and investors. There are indications that Central low- and mid-rise rentals projects are still below the minimum 10% to 15% developer profit levels but the return slightly improves along with the Ordinance update.

Table 3: Estimated Developer Return for Rental Projects

Developer Profit for Rental Projects per Cost of Development Study With Existing Inclusionary Housing Ordinance (IHO) and Update			
	Existing IHO	**IHO Update**	
Prototype – Location	**In lieu fee of $125,000 per required affordable unit (~$28/FT^2)**	**Strong Market Area Mixed Compliance: 5% on-site at 100% AMI + $18.70/FT^2 fee**	**Moderate Market Area In lieu fee $18.70/FT^2 $0 for high-rise**
Achieve or Exceed Target Developer Return: 10% – 15%			
Mid-Rise – West	17%	17%	N/A
Substandard Developer Return: 5% – 9%			
Low-Rise – Central	7%	8%	9%
Mid-Rise – Central	6%	7%	8%
Mid-Rise – North	5%	6%	7%
Low or No Developer Return			
Low-Rise – South and East	0%	0%	0%
High-Rise – Downtown	0%	0%	3%

Note: KMA analysis completed in 2019, updated to reflect the in lieu fee of $18.70/ft^2.

- ***Findings from Annual Report of Development Activity Highlights and Five-Year Forecast (2021-2025):*** From this report, staff analyzed the market-rate rental development unit count by market areas. **Table 4** summarizes the total number of low and mid-rise units that are built or under construction, as well as proposed or approved, from 2017 to February 2020. The table excluded for-sale and affordable projects and included only market-rate rental developments given these are the projects for which in-lieu fees are proposed to be distinguished based on market strength. There has been consistent interest in rental market-rate residential development in Central and West

Valley Market Areas with over 2,000 residential units in production, while all other market areas have a far fewer unit count. Central Market Area includes 13 urban villages, two specific plan areas of Midtown and Jackson-Taylor and the City's Downtown Planned Growth Area. The West Valley Market Area consists of 11 urban villages including Valley Fair/Santana Row, Stevens Creek, and Winchester Boulevard. As a result, staff determined that Central and West Valley Market Areas would be designated as "Strong Market Areas" and all other areas as "Moderate Market Areas."

Table 4: Low and Mid-Rise Market-rate Rental Developments by Market Areas

Market Areas	Built or Under Construction (2017-Feb 2020)	Proposed or Approved (2017-Feb 2020)	Total
Strong Market Areas			
Central East of Hwy 87	2,261	0	2,261
Central West of Hwy 87	1,530	541	2,071
West Valley	636	1,807	2,443
Moderate Market Areas			
Berryessa	551	0	551
Edenvale	301	0	301
South	55	0	55
Alum Rock	0	913	913
Willow Glen	0	590	590
Other Planning Areas	0	0	0
Total	**5,334**	**3,851**	**9,185**

The Development Activity Highlights and Five-Year Forecast (2021-2025) is posted annually by PBCE every February. The 2021 report with current development activity data may be available after this memorandum is posted.

B. Amendments Directed by City Council

Staff completed five amendments to the Ordinance as directed by the City Council and summarized the amendments in the briefing sheet included as **Attachment A**:

Amendment #1: ***Lower the minimum threshold for the Ordinance to apply to developments with ten units or more and set the fee at half of the rate that would otherwise apply for developments with fewer than 20 units that provide at least 90% of the maximum density allowed by the General Plan (Section 5.08.250 & 5.08.520)***

Council Direction: On November 5, 2019, staff recommended to set the minimum Ordinance threshold at five units and phase in the in-lieu fee for projects between five and 20 units. However, City Council directed staff to complete additional analysis on how to incentivize density and explore the feasibility of small residential developments. Staff was directed to explore three alternative options: 1) continue to apply the Ordinance to projects of 20 units or more, 2) apply to projects of 15 units or more, or 3) add language to identify infill developments through the planning process to have special circumstances such as environmental mitigation required or other significant development obstacles.

Rationale:

- ***Ten units or more threshold:*** KMA reviewed City permitting activity from July 1, 2010 through June 30, 2018 for projects that are smaller than 20 units. The study found that an average of 77 units per year were permitted within projects under 20 units and approximately 93% were for-sale units. Extending the Ordinance to projects with 10-20 units (as proposed) would impact approximately 35 units per year. Small rental projects between three and 19 units currently pay the Affordable Housing Impact Fee at $18.70 per square foot (2020-2021 rate). For-sale projects between three and 19 units are not covered by AHIF or the Ordinance.
    - The Ordinance provides an opportunity to provide additional affordable housing. At a rate of 35 units permitted per year and in a timespan of five-years, the Ordinance could provide approximately 175 new housing units. A majority of the projects deemed for-sale could have an affordable housing obligation. Or alternatively, an in lieu fee would be paid.
    - The ten-unit minimum threshold is consistent with the City's prior Inclusionary Housing Policy, which applied to projects with more than ten units located in Redevelopment Project Areas.
    - By lowering the threshold to ten or more units, this amendment will also support Opportunity Housing initiative as part of the General Plan 4-Year Review which is expected to allow up to four units per parcel.

  If City Council approves staff's recommendation, there will be one program moving forward for both rental and for-sale housing. The Affordable Housing Impact Fee will sunset and all future developments will be subject to the Ordinance.

- ***At least 90% of the maximum density allowed by the General Plan Density:*** City Council directed staff to consider setting the threshold of at least 90% of the maximum General Plan density to provide a lower in lieu fee in order to achieve greater density. However, achievable densities may vary in some areas and setting the threshold at 90% allows the project some flexibility. When calculating the allowable density on a site, the density will be based on net developable acreage that would exclude, Right-of-Ways, internal private streets or drives and riparian areas setbacks. Housing staff will work directly with Planning to determine if the project meets the 90% density threshold.

Amendment #2: Revise the On-Site & Off-Site Inclusionary Affordability Level Requirements for Rental Developments (Section 5.08.500 & 5.08.500)

On-Site:

- 5% at 100% of AMI
- 5% at 60% of AMI
- 5% at 50% of AMI
  OR
- 10% at 30% AMI

Off-Site

- 5% at 80% of AMI
- 5% at 60% of AMI
- 10% at 50% of AMI

Council Direction: The City Council accepted staff recommendation to serve a wider range of target income levels. The City Council also asked staff to consider a strategy to provide housing for moderate-income households.

Rationale: This change creates an opportunity for market-rate developers to provide housing at 100% of the AMI without subsidy from the City. Many of the City's funding sources for affordable housing are limited to 60% AMI housing units and below. Adding 100% AMI units to the options under the Ordinance allows the City to meet the needs of a broader range of income levels. A recent change to the Low-Income Housing Tax Credit (LIHTC) program now allows units up to 80% of the AMI to be funded with tax credits. Affordable housing developers have proposed developments with a range of incomes up to 80% of the AMI.

For rental projects that can take advantage of LIHTC funding, providing 10% of units at a rent affordable to 30% AMI residents would be less costly than providing 15% of the units at the mix of incomes (50-100%) without use of LIHTC financing. Projects choosing this option would likely be able to access additional outside affordable housing subsidies to bring the cost down further. The amendments allow a developer to choose an alternative to build 10% of the units at 30% of the AMI, allowing the developer to provide fewer units by serving ELI households. This is consistent with the City's priority to increase the production of ELI units.

Amendment #3: Restructure the in-lieu fee from a per-unit to a per-square-footage basis, setting the initial fee for Rental at $43 per square foot and For Sale at $25, determine strong market areas, in-lieu fees for moderate areas initially set to be consistent with the AHIF, and establish an annual fee escalator reflecting the prior year's construction cost index (Section 5.08.520)

Council Direction: On November 5, 2019, the City Council accepted staff recommendation to restructure the in lieu fee option. The change would apply the fee on a square-foot basis and change the amount to $43/ft^2 for rental development and $25/ft^2 for for-sale development. Additionally, the City Council directed staff to develop geographic market areas to phase in the in-lieu fee adjustments over time.

Rationale:

- ***Per-square-footage change:*** The per-square-footage methodology will be used across the development fee framework to ensure consistency between City programs. Both the current Ordinance and proposed amendments ensures that projects that choose not to provide on-site units contribute the funding necessary to replace the inclusionary affordable units elsewhere in the City. However, because the current Ordinance imposes the same per-unit fee on projects with large units and projects with small units, the result is a much higher cost for projects with small units. The square footage change will result in lower fees for projects with smaller units, and higher fees for projects with larger units. This change will help to incentivize higher density rental and condominium projects. In-lieu fees for townhomes and single-family projects are estimated to increase with the change to a per-square-foot fee due to larger average unit sizes. The KMA analysis indicates these projects are still estimated to achieve minimum profit levels required by developers and investors with this change.

  To calculate the in-lieu fee cost for a rental project, the in-lieu fee is multiplied by all net rentable square feet. All net rentable square footage includes measurements from the outside surface of the exterior stud walls and include all finished living space. It does not include parking areas, common hallways, common rooms, building lobbies, balconies, elevator shafts, common stairways, utility shafts, janitorial closets, common recreation areas, and storage lockers not located within unit.

- ***Setting the initial fee for rental developments:*** The in-lieu fee calculation results in a $74/ft^2 fee. The updated calculation was provided to developers during a stakeholder outreach meeting (**Table 5**). Developers suggested that the fee calculation use current market rents for 2020. This resulted in a $68/ft^2 fee calculation. Instead, staff is recommending a $43/ft^2 in lieu fee consistent with the City Council direction, which is the amount originally circulated in 2019 and is justified given current market conditions.

Table 5: In Lieu Fee Recommendation

Tenure	In-Lieu Fee Based Calculations with 20% Requirement	In-Lieu Fee Set Recommendation
Rental	$74	$43
For-Sale	$35	$25

- ***Setting the initial fee for Strong Market Areas***: Strong Market Areas, which includes Central and West Valley, would have an in-lieu fee rate of $43/ft^2. For moderate market areas, the in-lieu fee is equivalent to the Affordable Housing Impact Fee, which is $18.70 for 2020-2021. According to the Affordable Housing Impact Fee Fund Annual Report for Fiscal Year 2019-2020, market-rate rental developments are moving forward and are willing to pay the impact fee. Since 2017, the City has collected $11 million in impact fees from nine projects. Currently, market areas only apply to rental developments. Council may direct staff to charge different fees on for-sale developments for certain market areas.

- ***Setting the initial fee for for-sale developers:*** The methodology is similar to the current ordinance. Instead of basing the fee calculation on the median price of all attached units sold in the past three years, the amendment analyzes only the sales in buildings built within the past five years. This analysis of sale prices should more closely reflect prices of units in newly developed projects. When calculating the in-lieu fee and using the 20% off-site requirement, the in-lieu fee for-sale development results in a fee of $35/ft^2. However, staff is recommending a $25/ft^2 in-lieu fee on for-sale development to be consistent with the City Council direction in 2019. To calculate the net square footage for for-sale projects (applies to detached homes and townhomes), the measurements were made from the outside surface of the exterior stud walls, including all finished living space and common areas inside the single family units. It does not include unheated areas such as parking and balconies.

Amendment #4: Add four new Compliance Options to encourage affordable housing production: 1) Mixed Compliance Option (On-Site Rental with adjusted in-lieu fee combination), 2) Option to Purchase real property, 3) Option to Dedicate SB35 entitled property, and 4) Option for Partnership for Clustered units (Section 5.08.525, 5.08.580 & 5.08.590)

Council Direction: City Council directed staff to include an option to provide 5% of the affordable units on site and the remaining portion paid an in-lieu fee; include flexibility to allow affordable housing developments that incorporate innovative or unique partnerships with affordable housing developers to accomplish City goals, and explore an option to utilize a permit streamlining state law (SB 35) and develop as other options to purchase land and dedicate the entitled land to the City.

Rationale:

- ***Mixed Compliance Option***: Adding a Mixed Compliance On-Site rental with adjusted in-lieu fee combination is the most significant change in terms of potential project economics. The "mixed compliance fees" are roughly 55% lower than the fees which would be due if no units were provided on-site. At this level, the combined cost of compliance for projects building 5% inclusionary rental units on-site would be slightly less than the cost of the current Ordinance in-lieu fee. This mixed compliance option would be significantly less costly than either the proposed on-site production option or the proposed in-lieu fee for projects that include no units on-site. As a result, it is likely that a large share of future rental projects within strong market areas subject the full in-lieu fee rate would select this mixed compliance alternative. Finally, it provides funding for the affordable housing program that will result in the production of more deeply affordable units than the inclusionary housing program target levels.

- ***Option to Purchase Real Property***: This compliance option allows developers to purchase a property and dedicate the entitled property to the City.

- ***Dedication of a SB 35 Site:*** Consistent with City Council direction, staff amended the dedication of land compliance option to include a choice allowing a developer to dedicate land that meets requirements for SB 35 to facilitate affordable housing development.

- ***Option for partnership for Clustered units:*** The clustered units compliance option will more likely be used by developers who have larger projects and can choose to set aside a portion of their project site to build 100% affordable housing developments adjacent to their market-rate buildings. This may result in more units in high opportunity neighborhoods even though those units would not be integrated in the market-rate buildings. Clustered units must have Low Income Housing Tax Credit Financing or other public financing that requires separation. If the clustered units are located on an immediately adjacent parcel and within close proximity to the market-rate building, then the project is subject to the 15% on-site requirement. The affordable units must have equivalent amenities or access to the same amenities as the market-rate units. Also, under this new compliance option, a minimum contribution from the market-rate developer to the affordable developer is established. Thus, the contribution is equivalent of 75% of the required in-lieu fee obligation. If the affordable building does not begin construction before the earlier of five years or the issuance of the first Certificate of Occupancy for the market-rate building, a "Letter of Credit" of in-lieu fees is required. This ensures that affordable units are built; if the units are not built, an in-lieu fee is required.

Amendment #5: Extend the period of affordability to 99 years with voluntary demolition after 55 years, and relocation benefits for residents of the inclusionary units (Section 5.08.600)

Council Direction: Council directed staff to report back with the targeted outreach to market-rate, affordable housing developers, and funders regarding impact on financing by extending period of affordability to 99 years. In addition, Council directed staff to study and consider "life of the project," similar to how the City of San Francisco applies to their affordable projects.

Rationale:

- ***For Rental Housing:*** The Housing Department held multiple public outreach meetings to discuss with stakeholders on extending the period of affordability to 99 years and consider life of the project. Staff also researched the potential impact of a 99 year restriction on financing for the market-rate development. The feedback and findings were supportive of including the life of project concept and financing was not raised as a potential concern. As a result, staff is proposing amending the Ordinance to extend the affordability restriction to 99 years with voluntary demolition only after 55 years and relocation benefits for the inclusionary units. This amendment was created in consideration of "life of the project" in the City of San Francisco. Extending the term past 55 years can significantly expand the number of families that can benefit from an affordable housing unit without impacting the feasibility of the development.

- ***Affordable Housing Developments:*** As part of the research, staff learned from other cities that affordable developers with Low Income Housing Tax Credits financing have expressed concerns about the length of the affordability restriction. These developers may face a financing challenge with the "true debt" test, an analysis to show the projects ability to generate enough net operating income to repay all debt, typically by showing the rents the project could charge after the affordability restriction ends. To address this concern, staff learned that many cities with a period of affordability to 99 years – like the City of San Francisco, allow exceptions for affordable projects that need shorter-term restrictions for financing. As a result, staff incorporated in this amendment to allow the City Manager to accept a shorter period of affordability no less than 55 years, if the proposed affordable projects need shorter-term restrictions in order to obtain financing.

- ***For-Sale:*** The 99 year affordability restriction would not apply to for-sale tenure because of the City's re-sale options. For-sale inclusionary units currently has an affordability restriction of 45 years and will remain at 45 years. Any sale of the inclusionary units will be intended to be sold to a new qualified affordable purchaser at an affordable sales price. In addition, the sale to a non-qualified buyer must be consistent with the terms of the City's adopted equity share program and the Ordinance.

C. Additional Amendments Recommended by Staff

During the drafting of the Ordinance changes, staff realized there were additional opportunities to provide further clarification to the Ordinance and improve its efficiency. Staff is recommending three additional amendments for City Council to consider that are included in the draft Ordinance. A summary of the additional amendments proposed by staff are also included in **Attachment A**.

Amendment #6: Allow streamlining for 100% affordable housing developments and allowing 100% affordable housing developments funded and restricted by the City of San José exempt from the Ordinance (Section 5.08.620)

Rationale: This recommendation originated from affordable developers at an Ordinance outreach meeting. The affordable developer expressed concerns that additional barriers were being added for an already challenging process to create affordable housing. This amendment ensures that the City does not create an unnecessary barrier to financing 100% affordable projects. Currently, the City requires an affordability restriction for new projects with City funding that requires units that are more affordable than the proposed Ordinance. Since most City funded affordable housing has several restrictions, adding the inclusionary housing agreement can contribute to an unnecessary delay due to the additional review and commenting from all key stakeholders. Thus, 100% affordable developments funded and restricted by the City may be deemed exempt from the Ordinance, if documentation of affordability levels meet or exceed the Ordinance requirements are provided.

Additionally, where the City is not a funder of the affordable project, there are still opportunities to allow for further streamlining. Currently, the Ordinance requires the Inclusionary Housing Agreement to be a separate recorded agreement. In order to improve streamlining for affordable project, the amendments will allow the Inclusionary Housing Agreement affordability restriction to be incorporated into the density bonus agreements. Developments funded and restricted by the City may also be deemed to meet the Ordinance requirements. Eligible developments will have a recorded affordability agreement recorded on the property for the benefit of a public agency consistent with City funding requirements.

Amendment #7: Establish a transition process for existing residential developments (Section 5.08.740)

Rationale: The amendments directed by City Council from 2019 would lower the minimum threshold to apply to residential developments with ten units or more. Once effective, this new amendment would impact current projects in the pipeline. Staff recognized a need to create a transition process for projects already under review by the City once the updated Ordinance becomes effective. Developers that have residential developments submitted to the City and currently in the pipeline participated in the outreach meetings and expressed the need for additional clarity.

Therefore, staff is proposing a transition process for existing residential developments by allowing developers an option to comply with the new Ordinance regulations if the following projects requirements are met:

- Have planning permits before May 1, 2021,
- Not been issued a Building permit,
- Not paid any inclusionary in-lieu fees,
- No recorded an inclusionary agreement, and
- Agree to submit a replacement affordable housing compliance plan and record the inclusionary agreement.

Developers with unexpired planning permits before May 1, 2021, may comply under the current Inclusionary Housing Ordinance requirements. For small projects with fewer than ten units, developers must have planning approvals prior to May 1, 2021, to remain exempt under the current Ordinance. The operative date for the proposed amendments is May 1, 2021.

Upon the implementation of the updated Inclusionary Housing Ordinance, staff will return to City Council to sunset the Affordable Housing Impact Fee program. There are very few rental housing developments with fewer than ten units. Moving forward, this change simplifies the administrative process for residential development by implementing one program for both rental and for sale projects.

Amendment #8: Allow marketing of inclusionary units to a subpopulation that is smaller than the general public, so long as the marketing is nondiscriminatory, affirmatively furthers fair housing, and provides an anti-displacement policy (Section 5.08.610.B.5)

Rationale: This change is intended to maintain the requirement for fair housing compliance and better align the marketing requirement with the City's ongoing anti-displacement efforts. Affirmatively furthering fair housing promotes diverse and inclusive communities ensuring that a development expands housing choices and provides equal access to the affordable housing. It requires that the inclusionary units will be proactively marketed to the general public with the goal of informing those least likely to know about opportunities. The below outlines legislation related to fair housing:

- The Affirmatively Furthering Fair Housing provision is part of the Fair Housing Act that was passed by Congress in 1968. While this program was suspended under the previous administration, President Biden has indicated that his administration will require communities receiving certain federal funding to proactively examine housing patterns and address policies that have a discriminatory effect. Under the Obama Administration, the obligation to affirmatively further fair housing was part of the approval process for jurisdictions' use of federal funding from the U.S. Department of Housing and Urban Development.

- In 2018, the State of California passed AB 686. This fair housing law obligates the City to administer its programs and activities relating to housing and community development in a manner to affirmatively further fair housing. This would be a part of its State-mandated Housing Element. AB 686 requires that the Housing Element support the development of housing for residents of all income levels throughout the community. This goal is to overcome patterns of segregation and foster inclusive communities without restricted access to opportunity.

If a developer chooses to not market the units to the general public, the guidelines will provide a process for a developer to demonstrate that the marketing to a subpopulation will not result in a fair housing violation or have a disparate impact on condition of continued occupancy based on employment.

D. Amendments to the Ordinance Fee Resolution and Methodology

Staff is also recommending amendments to the Fee Resolution and methodology of calculating the in-lieu fees.

Fee Resolution: The updated Ordinance Fee Resolution would modify the 2020-2021 Schedule of Fees and Charges, as well as establish fee amounts for the compliance options.

Methodology of Calculating Rental and For-Sale In-Lieu Fees: The updated methodology calculations for rental and for-sale in-lieu fees will be included in the updated Ordinance and guidelines. **Attachment C** summarizes the in-lieu fee process.

For rental housing, the in-lieu fee calculation methodology requires five steps:

- Step 1: Market-rate rents are obtained from CoStar, market-rate data provider, for projects representing the most recently built 3,000 market-rate apartment units. Affordable units and projects for special populations such as seniors would be excluded.
- Step 2: The affordable rents are determined for each income category applicable to the on-site inclusionary requirement, weighted according to the average bedroom size reflected in the data for the market-rate units.
- Step 3: The affordability gap is determined based on the difference between market-rate and affordable rents for each income category divided by a published capitalization rate. Capitalization rate or "cap rate" is a percentage relating market value to annual net income.
- Step 4: The in-lieu fee is then calculated by multiplying the affordability gap for each income category by the offsite affordable unit requirement (20%), and dividing by the average unit size to convert to a per square foot basis. Results for each of the three income categories are added to calculate the total in-lieu fee.
- Step 5: When projects provide at least 5% Inclusionary Units on-site, the in-lieu fees are reduced through application of two factors: a) affordability percentage for on-site units,

which represents the portion of the in-lieu fee which is not owed because the units are provided on-site, and b) on-site adjustor, which reduces the remaining in-lieu fee as an incentive for projects to provide Inclusionary Units on-site.

For the for-sale in-lieu fees calculation, the methodology is based on the affordability gap associated with providing attached for-sale affordable units off-site and requires four steps:

- Step 1: Market-rate prices are obtained for attached units built in the last five years and identify by average prices, unit size and bedroom mix.
- Step 2: Determine the affordable sales prices weighted to reflect the same bedroom mix as the market-rate units in Step 1.
- Step 3: The affordability gap represents the estimated cost of setting aside a unit as affordable. The calculation is based on the difference between market-rate and affordable prices.
- Step 4: The in-lieu fee is reflective of the cost of providing affordable units at 20% level applicable to the off-site alternative expressed on a per square foot basis. The affordability gap is multiplied by the off-site affordable unit requirement and divided by the average unit size to convert to a per square foot basis.

By using the methodology of calculations above, the in-lieu fees for rental would have been $68 per square foot and for-sale at $34/ft^2. To be consistent with City Council's direction from November 5, 2019, staff is recommendation $43/ft^2 for rental and $25/ft^2 for-sale. The in-lieu fees for rental developments are further adjusted when projects select to provide 5% inclusionary units on-site at 100% AMI. The on-site adjuster is initially selected such that the in-lieu fee in strong market areas is equal to the 2020-2021 AHIF rate of $18.70/ft^2. As mentioned earlier in this report, market-rate rental developments are moving forward and are willing to pay the impact fee. The on-site adjuster reduces the in-lieu fees to incentives projects to include units on-site and may be modified as part of periodic in-lieu fee updates to help ensure incentives under the Ordinance continue to align with City objectives.

CONCLUSION

Adopting these changes to the Inclusionary Housing Ordinance will facilitate residential development and help to achieve the City's housing production goals of 15,000 new market-rate homes and 10,000 affordable homes by 2023. Additionally, these changes will produce integrated inclusionary housing units on site and encourage new affordable housing built simultaneously with market-rate. These amendments would also allow developers additional flexibility and compliance options for projects to move forward. Staff recommendations have carefully analyzed the economic impact of these requirements to ensure that the Ordinance does not impose an undue burden on typical residential development projects.

EVALUATION AND FOLLOW-UP

The Inclusionary Housing Ordinance will have a second reading anticipated to be held on March 9, 2021. The ordinance will be effective 30 days after the second reading, anticipated to be April 8, 2021. However, the amendments are intended to become operative on May 1, 2021. Then, the Housing Department will submit to the City Manager for approval the amended guidelines for the Inclusionary Housing Ordinance and update all administrative documents.

Staff will return to City Council with a Resolution to sunset the Affordable Housing Impact Fee program and only apply the Ordinance to both rental and for-sale residential developments moving forward.

CLIMATE SMART SAN JOSE

The recommendation in this memo aligns with one or more Climate Smart San José energy, water, or mobility goals.

PUBLIC OUTREACH

Since the November 5, 2019 City Council, the Housing Department hosted six public outreach meetings to members of the development community and other stakeholders to discuss the propose changes to the Ordinance, totaling 124 attendees.

Table 5: Summary of Public Outreach Meetings

Meeting Date and Audience	Attendees
March 4, 2020 – Developers & Stakeholders	20
July 29, 2020 – Developers & Stakeholders	12
July 31, 2020 – Developers & Stakeholders	10
October 8, 2020 – Developers & Stakeholders	13
January 15, 2021 – Developers & Stakeholders	34
February 8, 2021 – Developers & Stakeholders	35
TOTAL	**124**

Overall, developers and shareholders shared concerns regarding:

- Lack of incentive for on-site performance;
- Challenging project economics;
- Uncertainty about future in-lieu fee levels; and
- On-site (adjacent) 100% affordability projects were not incentivized.

From the outreach meetings, affordable developers welcomed the opportunity to streamline the Ordinance process. Many developers and stakeholders were interested in partnering up with an affordable developer to build affordable housing. In addition, the Housing Department met with small projects developers to discuss the propose changes. Small project developers shared that the Ordinance minimum threshold to be ten units or more was feasible.

COORDINATION

This memorandum was coordinated with the City Attorney's Office, City Manager's Office of Economic Development and the City Manager's Budget Office.

COMMISSION RECOMMENDATION/INPUT

The Housing Department's recommendations was presented to the Housing and Community Development Commission special meeting on October 21, 2020. The Commission made the following recommendations:

- Encourage consideration of other policy options other than "clustering" which may result in segregation in market and non-market housing units;

- Support staff recommendation to extend the period of affordability to 99 years with voluntary demolition after 55 years and relocation benefits for residents of the inclusionary units. The motion passed 7-1;

- Support staff recommendation to apply the Inclusionary Housing Ordinance to developments with ten units or more and set the fee at a lower rate for projects with fewer than 20 units that provide at least 90% of the density allowed on-site. The motion passed 7-1; and

- Support staff recommendation to encourage innovative partnerships in order to maximize affordable housing through the SB 35 Streamlining option, and to allow streamlining of Inclusionary Housing Ordinance compliance requirements for 100% affordable housing developments. The motion passed 8-0.

FISCAL/POLICY ALIGNMENT

Policy actions in the Housing Crisis Workplan are consistent with Goals H-1 and H-2 of the Envision San José 2040 General Plan to provide housing throughout the City that addresses the needs of all San José residents, and to increase, preserve, and improve San José's affordable housing stock; and the City's *Consolidated Plan 2020-2025*, adopted by City Council on August 11, 2020, to provide homes for very low- and extremely low-income households.

COST SUMMARY/IMPLICATIONS

The proposed changes to the Inclusionary Housing Ordinance are expected to have limited impact on the revenue anticipated in the Affordable Housing Investment Plan through Fiscal Year 2022-2023, which currently has a projection of $30 million and assumes revenue of $26 million from Affordable Housing Impact Fees to be paid by Fiscal Year 2022-2023.

In future years, the Housing Department is expecting the revenue resulting from the Inclusionary Housing Ordinance to track similarly to the amounts received by the Affordable Housing Impact Fee. If a developer has a proposed rental project in an area where the $18.70/ft^2 is charged, they are most likely to pay the fee. If the developer's project is located in the West portion of the City, they are most likely to provide 5% of the affordable apartments on-site and pay the remaining obligation at the $18.70 per square foot rate. In either case, the projected revenue will be approximately $18 per square foot on market-rate housing development.

As a result of the new Inclusionary Housing Ordinance implementation process of obtaining in-lieu fees at Certificate of Occupancy, it is anticipated that there will be no fee revenue received in 2020-2021 with new revenue beginning to be received in 2022-2023.

CEQA

Not a Project. File Nos. PP17-009, Staff Reports, Assessments, Annual Reports, and Informational Memos that involve no approvals of any City action; and PP17-008, General Procedure & Policy Making resulting in no changes to the physical environment.

/s/
JACKY MORALES-FERRAND
Director, Housing Department

For questions, please contact Rachel VanderVeen, Deputy Director, at (408) 535-8231.

ATTACHMENTS:

- **Attachment A:** Briefing Sheet – Summary of Amendments
- **Attachment B:** Geographical Areas Map for "Strong Market Areas" and "Moderate Market Areas"
- **Attachment C:** Overview of Rental & For-Sale In-Lieu Fee Update Process

ATTACHMENT A

Inclusionary Housing Ordinance

Briefing Sheeting — Amendments to the Ordinance — Rental & For-Sale Properties

<table>
<tr><th colspan="6">DIRECTED BY CITY COUNCIL</th></tr>
<tr><th colspan="3">Current</th><th colspan="3">Amended</th></tr>
<tr><td colspan="6">Base Requirement & Small Projects: Study how to incentivize density where appropriate for small projects between 1 -4 units' and between 5-20 units. Return to Council after outreach to small-project builders about the viability of those projects, and offer recommendations to incentivize densifying these projects including, but not limited to, considering bonuses to small projects that are substantially densifying infill sites.</td></tr>
<tr><td rowspan="3">Rental & For-Sale</td><td colspan="2">Applicability: 20 or more units</td><td>➤</td><td colspan="2">10 or more units</td></tr>
<tr><td colspan="2">Base Requirement: Minimum 15% IHO On Site Obligation</td><td>➤</td><td colspan="2">No Change</td></tr>
<tr><td colspan="2">Small Projects: Small rental developments pay an impact fee only & Small for-sale are not subject to AHIF or IHO</td><td>➤</td><td colspan="2">10 to 19 unit developments are now under IHO but may pay half the in lieu fee rate if providing at least 90% of maximum density allowed by the General Plan</td></tr>
<tr><td colspan="6">Serve a Wider Income Range: Accept staff recommendation to serve a wider range of target income levels as listed (5% at 100% AMI, 5% at 60% AMI, 5% at 50% AMI)</td></tr>
<tr><td>Rental</td><td>Target income levels On-Site:
• 9% at 80% AMI
• 6% at 50% AMI</td><td>Target income levels Off-Site:
• 12% at 60% AMI
• 8% at 50% AMI</td><td>➤</td><td>Income levels On-Site:
• 5% at 100% AMI
• 5% at 60% AMI
• 5% at 50% AMI
OR
• 10% at 30% AMI</td><td>Income levels Off-Site:
• 5% at 80% AMI
• 5% at 60% AMI
• 10% at 50% AMI</td></tr>
<tr><td colspan="6">In-lieu Fee Option & Geographic Market Areas: Accept staff recommendation to restructure the in-lieu fee option to apply the fee on a square foot basis and change the amount to $43 per square foot for rental development and $25 per square foot for for-sale development; Direct staff to develop geographic market areas to phase in the in-lieu fee adjustments over time.</td></tr>
<tr><td rowspan="2">Rental</td><td colspan="2" rowspan="2">Applied to 20% of the units at $125,000 ($28/ ft^2) set by Council resolution in 2018</td><td>➤</td><td colspan="2">Applied to all units based on square footage based on 20% in lieu requirement – applied to rentable square footage</td></tr>
<tr><td>➤</td><td>Strong Market
$43/ft^2</td><td>Moderate Market
$18.70/ft^2</td></tr>
<tr><td>Rental</td><td colspan="2">In-Lieu Fees are set at the same rate across the City</td><td>➤</td><td colspan="2">• Strong Market Areas are Central and West Valley
• All other Market Areas are moderate</td></tr>
<tr><td>For-Sale</td><td colspan="2">Per unit applied to 20% of the units $157,858 (~$27.45/ ft^2)</td><td>➤</td><td colspan="2">Per square footage applied to all units $25/ ft^2</td></tr>
<tr><td colspan="6">Encourage On-Site Compliance (New Option): Accept staff recommendation to encourage rental developments to choose on-site compliance option by setting the in-lieu fee to $17.60 per square foot where at least 5% of the units are provided on-site and allowing affordable units to be in a separate building on-site.</td></tr>
<tr><td rowspan="2">Rental</td><td colspan="2" rowspan="2">Combination of on-site apartments and in-lieu fees, but each proposal must be evaluated.</td><td>➤</td><td colspan="2">Building 5% of total units at 100% AMI On-Site</td></tr>
<tr><td>➤</td><td>Strong Market
$18.70/ ft^2 in-lieu for all rentable areas</td><td>Moderate Market
$11.87/ ft^2 in-lieu for all rentable areas</td></tr>
<tr><td colspan="6">Longer Deed-Restriction Affordability: Report back with the specific outreach to, and resulting responses from, market rate and affordable housing developers and financiers regarding impact on financing by extending period of affordability to 99 years.'" Study and consider "life of the project" as San Francisco applies to their affordable projects.</td></tr>
<tr><td>Rental</td><td colspan="2">55 years</td><td>➤</td><td colspan="2">• 99 years with voluntary demolition after 55 years and relocation benefits for inclusionary units
• Affordable developers may request a term of no less than 55 years</td></tr>
<tr><td colspan="6">Land Dedication: Purchasing land that meets the requirements to utilize Senate Bill 35(SB 35) and land requirements for the IHO; Entitling the land with the City of San Jose; Giving the entitled land to the City of San Jose (which the City will then solicit to developers to build 100% affordable projects)</td></tr>
<tr><td>Rental & For-Sale</td><td colspan="2">Current Dedication of Land Compliance option does not require use for housing</td><td>➤</td><td colspan="2">Added New option for SB 35 entitled land to be used for housing</td></tr>
</table>

Inclusionary Housing Ordinance

Briefing Sheeting — Amendments to the Ordinance — Rental & For-Sale Properties

CITY OF SAN JOSE
CAPITAL OF SILICON VALLEY
Housing

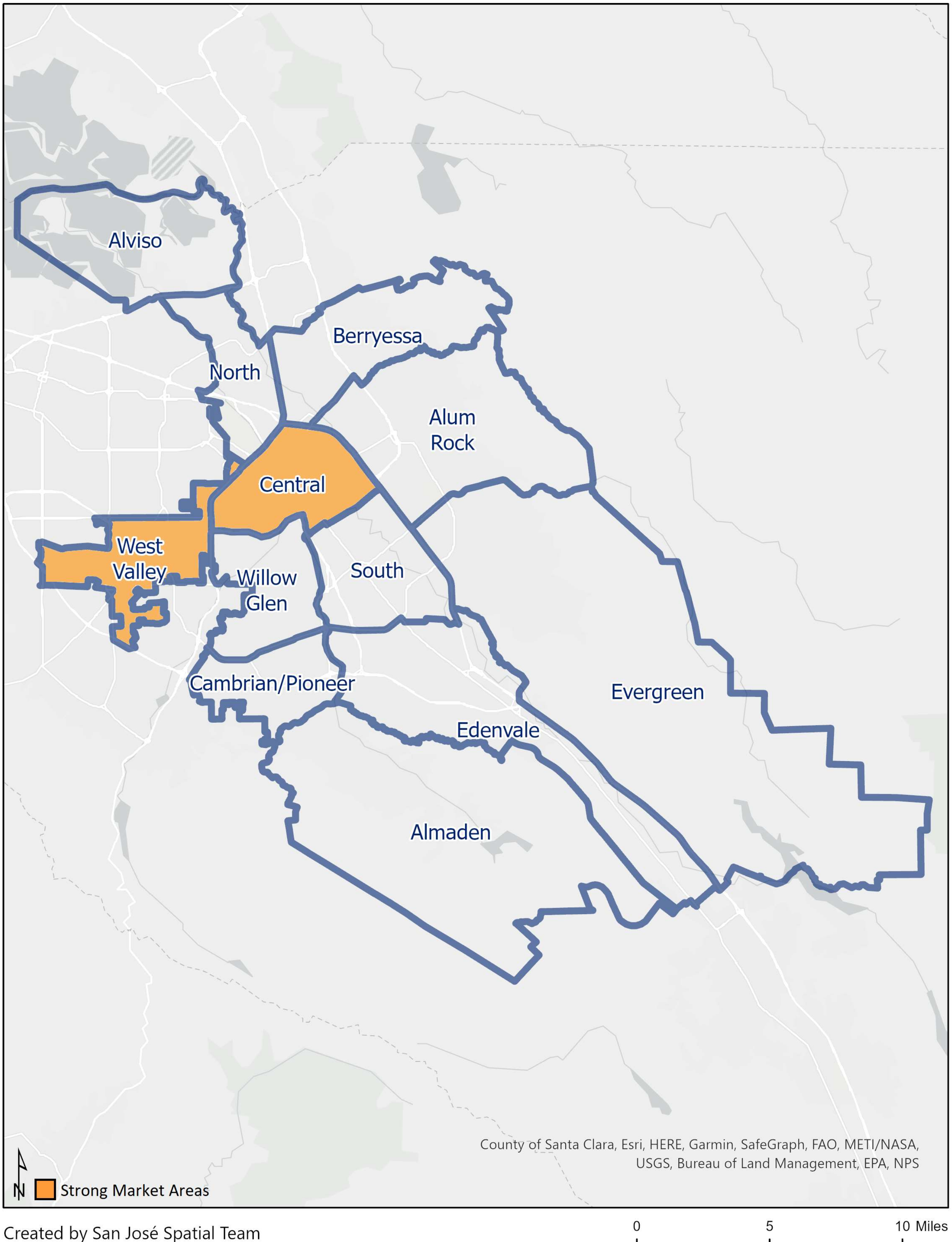
DIRECTED BY CITY COUNCIL - CONTINUED			
Current			**Amended**
Clustering of Affordable Units On-Site Expanded: Include explicit flexibility for the City Manager/Housing Director to approve offsite (unintegrated) affordable housing plans that do not meet the minimum standard for contributions (currently proposed at 75% of in-lieu fee value) if the project incorporates innovative or unique partnerships with affordable housing developers that better accomplish City goals. Explore lowering percentage threshold in order to encourage innovative partnerships to maximize affordable housing as part of a project.			
Rental	No clustering option and must be dispersed within market-rate development	➤	• If located on an immediately adjacent parcel and in close proximity to the market rate building, then subject to only the 15% requirement • Must have Low Income Housing Tax Credit Financing or other public financing that requires separation • Establish a minimum contribution from market rate developer to affordable developer equivalent of 75% of the required in-lieu fee obligation • Provide a Letter of Credit of in-lieu fees, if affordable building does not begin construction before the earlier of 5 years or the issuance of the first Certificate of Occupancy for the market rate building • Clustered affordable units must have equivalent amenities as market rate
Incentive: Direct the Director of Parks, Recreation and Neighborhood Services to explore an amendment to the Park Impact Ordinance (SJMC 14.25) to clarify that on site deed restricted 100% AMI rental units qualify for a 50% per unit credit towards the payment of park impact in-lieu fees			
➤ PRNS will return to City Council this spring with an amendment to the Park Fees ordinance.			

RECOMMENDED BY STAFF FOR CITY COUNCIL REVIEW			
Current			**Amended**
Streamlining for Affordable Developments			
Rental	Required all developments to have a stand-alone inclusionary housing agreement.	➤	• Inclusionary Affordability restrictions may be incorporated into density bonus agreements • Developments funded and restricted by the City may be deemed to meet the IHO requirements
Transition Process for Projects			

Rental	Developers who has a planning permit before May 1, 2021 may stay under the existing IHO requirements.	➤	• Developers may choose the new IHO regulations if they meet the following criteria:
			  ○ Have planning permits before May 1, 2021, or otherwise final under state law
			  ○ Building permit has not been issued
			  ○ Has not paid any inclusionary in-lieu fees
			  ○ Has not recorded an inclusionary agreement
			  ○ Submit a replacement affordable housing compliance plan and record the inclusionary agreement

Rental & For-Sale	Transition for Small Projects	➤	Projects less than 10 units must have planning permit prior to May 1, 2021, or otherwise final under state law, to remain exempt from the current IHO
Inclusionary Unit Requirements			
Rental & For-Sale	The purpose of the IHO program is to enhance the public welfare and market the Inclusionary Units to the public consistent with Fair Housing Laws	➤	Allow marketing of inclusionary units to a subpopulation if the marketing is nondiscriminatory, affirmatively furthers fair housing, and provides an anti-displacement policy

Inclusionary Housing Ordinance Areas



Created by San José Spatial Team
February 4th, 2021

ATTACHMENT C

Overview of Rental In-Lieu Fee Update Process

(updates occur every five years)

Step 1: Market Rate Rents

Identify average rents, unit size and bedroom mix for most recently built 3,000 market rate apartments.

Step 2: Affordable Rents

Determine affordable rents by income level weighted to reflect the same bedroom mix as the market rate units in Step 1.

Step 3: Affordability Gap

The affordability gap represents the estimated cost of setting aside a unit as affordable. The calculation is based on the difference between market rate and affordable rents in each income category divided by a capitalization rate(1).

Step 4: In-Lieu Fee

The in-lieu fee is reflective of the cost of providing affordable units at the 20% level applicable to the off-site alternative expressed on a per square foot basis. The affordability gap is multiplied by the off-site affordable unit requirement for each income category and divided by the average unit size to convert to a per square foot basis. Results for each of the three income categories are added to calculate the total in-lieu fee.

Step 5: Adjusted In-Lieu Fee for Projects Providing On-Site Units

When projects provide at least 5% Inclusionary Units on-site, an adjusted in-lieu fees applies based on the cost of providing affordable units at the 15% level applicable to the on-site alternative and reduced through application of two factors:

1. *Affordability Percentage for on-site units* - this factor represents the portion of the adjusted in-lieu fee which is not owed because the units are provided on-site.
2. *On-Site Adjustor* - this factor reduces the adjusted in-lieu fee as an incentive for projects to provide Inclusionary Units on-site.

(1) Capitalization rate or "cap rate" is a percentage relating market value to annual net income. Here it is applied to estimate the value forgone in making a unit affordable.

Supporting Information for Rental In-Lieu Fee Update Process

The supporting data, calculations, and further description of each step in the determination of the proposed in-lieu fee are presented below. Calculations would be updated every five years.

Step 1: Market Rate Rent for Most Recently Built Apartments in San Jose

Identify the average effective rents, unit size and bedroom mix for properties that include the most recently built 3,000 market rate apartments in San Jose. Use data from market data provider CoStar. Include apartment properties beginning with the most recently built until at least 3,000 units are represented. Do not include affordable units or projects for special populations such as seniors. Weight averages based on number of units.

Address	Year Built	No. Units	% Studios	% 1-Bed	% 2-Bed	% 3-Bed	Avg Net Unit SF	Avg Effective Rent Per Month
130 Stockton Ave	2020	162	7%	41%	48%	3%	986	$2,335
955 S 1st St	2020	50	0%	38%	62%	0%	982	$2,718
5 E Reed St	2020	105	20%	70%	10%	0%	703	$2,546
1785 Almaden Rd	2020	55	0%	36%	64%	0%	998	$2,795
28 N Almaden Ave	2020	201	30%	35%	35%	0%	573	$2,813
6670 Emergent Way	2020	301	7%	50%	44%	0%	952	$2,547
171 W Julian St	2020	381	13%	51%	29%	7%	666	$2,988
355 Sunol St	2020	269	26%	37%	37%	0%	847	$2,452
919 S Winchester Blvd	2020	636	0%	72%	28%	0%	854	$2,972
98 N 1st St	2019	190	22%	51%	28%	0%	853	$2,595
138 Balbach St	2019	101	0%	62%	30%	8%	949	$2,672
1501 Berryessa Rd	2019	551	7%	49%	40%	3%	929	$2,583
Weighted Average			**10%**	**53%**	**35%**	**2%**	**844**	**$2,712**

Source: CoStar 2021

Step 2: Affordable Rents

Affordable rents are based on the City's published schedule for Inclusionary Units minus the required utility allowance. Affordable rents are weighted based on the bedroom mix applicable to the market rate units from Step 1. The objective is to determine the affordable rents that would apply if the average market rate unit from Step 1 were an Inclusionary Unit. Affordability levels applicable to off-site units are applied.

	Studios	1-Bed	2-Bed	3-Bed	
Bedroom Mix from Step 1	10%	53%	35%	2%	
Gross Affordable Rents per City Affordable Rent Schedule					
80% AMI	$1,982	$2,266	$2,548	$2,832	
60% AMI	$1,486	$1,699	$1,911	$2,124	
50% AMI	$1,238	$1,416	$1,592	$1,770	
Less: Utility Allowance	($92)	($100)	($129)	($157)	
Affordable Rents Net of Utilities					**Average Affordable Rent (1)**
80% AMI	$1,890	$2,166	$2,419	$2,675	**$2,236**
60% AMI	$1,394	$1,599	$1,782	$1,967	**$1,649**
50% AMI	$1,146	$1,316	$1,463	$1,613	**$1,355**

Sources: City of San Jose 2020 Affordable Rent Schedule applicable to Inclusionary Units. County Housing Authority 2020 utility allowances for gas heat, hot water and cooking, electricity and water.

(1) Weighted based on the bedroom mix for the market rate units determined in Step 1.

Step 3: Affordability Gap

This step calculates the Affordability Gap based on the amount by which market rate rent determined in Step 1 exceeds affordable rents from Step 2. The Affordability Gap is calculated by dividing the annual rent difference by a published capitalization rate. The result represents the estimated gap associated with providing the affordable units within the project.

	80% AMI	60% AMI	50% AMI
Difference Between Market Rate and Affordable Rent			
Market Rate Rents Per Month (Step 1)	$2,712	$2,712	$2,712
Less: Affordable Rents Per Month (Step 2)	$2,236	$1,649	$1,355
Rent Difference Per Month (positive amounts)	$476	$1,063	$1,357
Rent Difference Per Year	**$5,717**	**$12,759**	**$16,279**
Capitalization Rate [(1)]	4.50%	4.50%	4.50%
Affordability Gap [=Rent Difference / Cap Rate]	**$127,000**	**$284,000**	**$362,000**

(1) Integra Realty Resources cap rate for Class A urban multifamily in San Jose published April 2020.

Step 4: In-Lieu Fee (for Projects not Providing On-Site Units)

The rental in-lieu fee is calculated by multiplying the affordability gap from Step 3 by the off-site affordable unit requirement for each income category and dividing by the average unit size from Step 1 to convert to a per square foot amount. Figures are rounded to the nearest whole number. The per square foot figures for each income category are added to determine the total in-lieu fee. While, as updated, the fee calculates as $68/SF, it is proposed to be set at $43/SF for strong market areas and $18.70/SF for moderate market areas consistent with the prior calculation and Council direction.

	80% AMI	60% AMI	50% AMI	Total
Affordability Gap Per Affordable Unit (Step 3)	$127,000	$284,000	$362,000	
Inclusionary percentage requirement	5%	5%	10%	20%
Average Net Unit Size (Step 1)	844 sq ft	844 sq ft	844 sq ft	
Calculated In-Lieu Fee for Rentals (Per Net SF) [= affordability gap X affordable unit % / unit SF]	$8 /SF	$17 /SF	$43 /SF	**$68 /SF**
Proposed In-Lieu Fee for Rentals (Per Net SF)				
Strong Market Areas				**$43 /SF**
Moderate Market Areas				**$18.70 /SF**
Consistent with Council Direction in Nov. 2019				

Step 5: Adjusted In-Lieu Fees for Projects Providing at Least 5% Inclusionary Units

This step establishes adjusted in-lieu fees for projects providing at least 5% Inclusionary Units on-site. Application of an Affordability Percentage removes that portion of the adjusted in-lieu fee applicable to the affordable units provided on-site. Multiplying by an On-Site Adjuster reduces the adjusted in-lieu fees to incentivize projects to include units on-site. The On-Site Adjustor is initially selected such that the adjusted in-lieu fee in strong market areas is equal to the FY20-21 Affordable Housing Impact Fee rate of $18.70 per square foot when 5% of units are provided on-site at 100% AMI. The On-Site Adjustor may be modified as part of periodic updates to help ensure incentives under the program continue to align with City objectives.

	Strong Market Areas	Other Areas
In-Lieu Fee Before Adjustment	**$43 /SF**	**$18.70 /SF** *(20-21 AHIF rate)*
Adjusted In-Lieu Fee With 5% of Units On-Site at 100% AMI		
Affordability Percentage for 100% AMI units	9.30%	9.30%
On-Site Adjustor	52.05%	30%
Adjusted In-Lieu Fee	**$18.70**	**$11.87**
[= (Full Fee) * (1-Affordability Percentage) * (1-On-Site Adjustor)]		
Adjusted In-Lieu Fee With 5% of Units On-Site at 60% AMI		
Affordability Percentage for 60% AMI units	39.53%	39.53%
On-Site Adjustor	52.05%	30%
Adjusted In-Lieu Fee	**$12.47**	**$7.92**
[= (Full Fee) * (1-Affordability Percentage) * (1-On-Site Adjustor)]		
Adjusted In-Lieu Fee With 5% of Units On-Site at 50% AMI		
Affordability Percentage for 50% AMI units	51.16%	51.16%
On-Site Adjustor	52.05%	30%
Adjusted In-Lieu Fee	**$10.07**	**$6.39**
[= (Full Fee) * (1-Affordability Percentage) * (1-On-Site Adjustor)]		

Overview of For-Sale In-Lieu Fee Update Process

(updates occur every five years)

Step 1: Market Rate Prices

Identify average prices, unit size and bedroom mix for attached market rate units built in last five years.

Step 2: Affordable Prices

Determine affordable sales prices weighted to reflect the same bedroom mix as the market rate units in Step 1.

Step 3: Affordability Gap

The affordability gap represents the estimated cost of setting aside a unit as affordable. The calculation is based on the difference between market rate and affordable prices.

Step 4: In-Lieu Fee

The in-lieu fee is reflective of the cost of providing affordable units at the 20% level applicable to the off-site alternative expressed on a per square foot basis. The affordability gap is multiplied by the off-site affordable unit requirement and divided by the average unit size to convert to a per square foot basis.

Supporting Information for For-Sale In-Lieu Fee Update Process

The supporting data, calculations, and further description of each step in the determination of the proposed in-lieu fee are presented below. Calculations would be updated every five years.

Step 1: Market Sales Prices for Most Recently Built Attached Units in San Jose

Identify the average market sales price, unit size and bedroom mix for new attached for-sale units built within the last five years and sold within the last two years in San Jose. Use data from market data provider CoreLogic.

Number of Bedrooms	No. of Sales	% of Sales	Avg Net Unit SF	Average Sales Price
One-Bedroom	4	1%	935	$612,500
Two-Bedrooms	108	25%	1,229	$819,394
Three-Bedrooms	269	62%	1,670	$970,859
Four-Bedrooms	55	13%	2,113	$1,060,264
Total / Average	436	100%	**1,610**	**$941,000**

Source: CoreLogic 2021

Step 2: Affordable Sales Prices

Affordable sales prices are calculated based on the City's Inclusionary Housing Ordinance guidelines. Affordable sales prices are then weighted based on the bedroom mix applicable to the market rate units from Step 1. The objective is to determine the affordable sales price that would apply if the average market rate unit from Step 1 were an Inclusionary Unit.

	1-Bed	2-Bed	3-Bed	4-Bed	Average Affordable Sales Price (1)
Bedroom Mix from Step 1	1%	25%	62%	13%	
Affordable Sales Prices *(110% AMI)*	$545,600	$620,100	$675,800	$733,300	**$668,000**

(1) Weighted based on the bedroom mix for the market rate units determined in Step 1.

Step 3: Affordability Gap

This step calculates the Affordability Gap based on the amount by which the market rate sales price determined in Step 1 exceeds the affordable sales price from Step 2. The result represents the estimated gap associated with providing the affordable units within the project.

Average Market Rate Price (Step 1)	$941,000
Average Affordable Price (Step 2)	$668,000
Affordability Gap [=Market Rate Price - Affordable Price]	**$273,000**

Step 4: In-Lieu Fee

The for-sale in-lieu fee is calculated by multiplying the affordability gap from Step 3 by the off-site affordable unit requirement and dividing by the average unit size from Step 1 to convert to a per square foot amount and rounding to the nearest whole number. While, as updated, the fee calculates as $34, it is proposed to be set at $25/SF consistent with the prior calculation and Council direction.

Affordability Gap Per Affordable Unit (Step 3)	$273,000
Inclusionary percentage requirement (off-site %)	20%
Average Net Unit Size (Step 1)	1,610 sq ft
Calculated In-Lieu Fee for For-Sale (Per Net SF) [= affordability gap X affordable unit % / unit SF]	**$34 /SF**
Proposed In-Lieu Fee for For-Sale (Per Net SF) Consistent with Council Direction in Nov. 2019	**$25 /SF**