02
Worksession Item

Office of the City Manager

WORKSESSION
May 18, 2021

To: Honorable Mayor and Members of the City Council

From: Dee Williams-Ridley, City Manager

Submitted by: Jordan Klein, Director, Planning and Development Department

Subject: Updating Citywide Affordable Housing Requirements

INTRODUCTION

Berkeley has several ordinances that require developers of market rate housing to make contributions to fund affordable housing in Berkeley. Contributions are required pursuant to Affordable Housing Mitigation Fee (AHMF) requirements on residential development, proposed conversion to condominiums, and demolition of housing units; these are in addition to requirements related to rent control and tenant protections.

In response to several City Council referrals, along with changes to State law, the City has engaged the consulting firm Street Level Advisors to help consolidate these requirements into a more consistent framework, and to propose changes based on specific challenges with the current programs. Proposals for changes to these requirements are summarized in this report and described in detail in **Attachment 1**.

Staff is seeking input on the potential proposals to inform the development of draft ordinance amendments that incorporate the proposed changes. Staff aims to bring draft ordinance amendments to the Planning Commission, Housing Advisory Commission, and City Council later this year.

CURRENT SITUATION AND ITS EFFECTS

City Council has adopted multiple, interrelated referrals to staff and Commissions to explore revisions to the City's affordable housing requirements for new development (**Attachment 2**). There have also been changes to State laws that govern affordable housing requirements and density bonus incentives. In response, the City engaged the consulting firm Street Level Advisors evaluate existing regulations and potential changes, in order to comprehensively update the City's affordable housing requirements.

Five overarching goals guide the work:

- **Centering Racial and Economic Equity in Zoning.** Berkeley has committed to pioneering policies that attempt to undo some of the harm caused by past exclusionary zoning practices. The City's Inclusionary Housing requirements are central to its efforts to build a more racially and economically integrated future. Two key goals are to ensure that affordable housing is included in all parts of the City, and to promote inclusion of affordable units within market-rate housing.
- **Encouraging a Mix of Units and Fees.** Berkeley's current policy makes on-site affordable units the preferred requirement for both rental and ownership projects, but by law must also allow payment of a fee as an alternative. AHMF fees generate significant revenue to support non-profit affordable housing projects throughout the city, and offer flexibility for projects to choose between multiple compliance options depending on different circumstances. The goals of increasing inclusionary units on-site must be balanced with maintaining the collection of fees, which can leverage state and federal funding to maximize the City's production of affordable housing at other sites.
- **Building on Berkeley's Legacy of Value Capture.** The principle of "public value capture" (or land value capture) leads the City to set its housing requirements at a level that captures a share of the market rate developer profits to support housing for lower income residents, which is evident in the City's requirements. Value capture requires close attention to the financing and economic realities of development in order to ensure that the City is capturing the appropriate amount of financial returns without making development infeasible, resulting in no housing at all.
- **Continuing Progress on the City's Housing Goals.** Rapidly rising housing costs and growing displacement pressures are the result of a systemic shortage of housing throughout the region. The latest Regional Housing Needs Allocation (RHNA) requires Berkeley's zoning to allow for nearly 9,000 new homes, across all income levels, between 2023 to 2031. While building more housing alone would not be sufficient to address the current inequities, land use regulations that facilitate building more housing can lead to more affordable housing.
- **Work within the City's Existing Administrative Capacity.** Berkeley's current affordable housing requirements are among the most complex in the region, but the City has proportionally fewer administrative staff than many other jurisdictions. Changes to the City's affordable housing requirements that increase administrative requirements would require that additional resources be identified to support implementation.

The potential changes being evaluated include (for full details see **Attachment 1, pg. 3, Summary of Proposed Changes**):

1. Consolidate affordable housing requirements into a single framework
2. Calculate the fee on a per square foot basis (for both rental and ownership housing)
3. Evaluate the potential for higher fees when the market is stronger
4. Incentivize Extremely Low-Income (30% of AMI) units
5. Adjust the residual fee for “mixed compliance” projects
6. Standardize ownership fees
7. Standardize live-work requirements
8. Add a Land Dedication Option
9. Provide a Family Sized Units Option
10. Simplify the requirements for Condominium Conversions
11. Prohibit on-site units in certain situations
12. Reduce fees for small projects/missing middle projects
13. Administrative changes
    a. Cap annual rate of rent increases
    b. Authorize administrative citations
    c. Authorize annual monitoring fee for ownership units
    d. Deduct required fees/costs from gross rent.

BACKGROUND

The City of Berkeley has a strong history of programs and initiatives to retain existing affordable / rent controlled tenant housing, protect tenants from displacement, and create new supplies of affordable housing. Requirements related to affordable housing are currently codified in several sections of the Berkeley Municipal Code, including:

- BMC 21.28 Condominiums and Other Common Interest Subdivisions
- BMC 22.20 Mitigations and Fees—Conditions of Approval for Development Projects
- BMC 23C.08 Demolition and Dwelling Unit Controls; and
- BMC 23C.12 Inclusionary Housing Requirements.
- BMC 13.76 Rent Stabilization and Eviction for Good Cause

There are also numerous implementing resolutions which set fee amounts and exemptions. In addition, the City has administrative guidelines and practices to implement the requirements.

In October 2020, Street Level Advisors presented a range of identified policy issues and solicited feedback from the public and the Planning Commission. The City also held two focus group meetings with a range of stakeholders including affordable housing developers and advocates, market-rate developers, and the Planning Commission, Housing Advisory Commission, Zoning Adjustments Board, and Rent Stabilization Board.

In a separate process led by the 4x4 Joint Task Force Committee on Housing, proposed changes to the City's regulations around demolitions are also under discussion. Demolition requirements help protect existing rental-controlled housing by regulating and compensating for the elimination of such units which occurs through modifications to existing housing stock (e.g. removing kitchens, combining units). This 4x4 process involves representatives from the Rent Board, City Council, Planning Commission, and other relevant Commissions.

ENVIRONMENTAL SUSTAINABILITY

Creating new affordable housing and housing support services for Berkeley's most vulnerable community members is a City Strategic Plan goal, which also helps advance the environmental goals of being a global leader in addressing climate change, advancing environmental justice, and protecting the environment.

POSSIBLE FUTURE ACTION

Staff will bring a draft ordinance to the Planning Commission, the Housing Advisory Commission and the City Council later this year.

FISCAL IMPACTS OF POSSIBLE FUTURE ACTION

The proposed changes seek to balance any increases in complexity to the rules and administration of these rules by streamlining and eliminating other administrative challenges. Adopting changes to the City's affordable housing requirements that increase administrative requirements would require identification of new City funding to support increased staffing needs.

CONTACT PERSONS

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Attachments:
1: Updating Affordable Housing Requirements for the City of Berkeley: Analysis and Recommendations. Prepared by Street Level Advisors, April 27, 2021.
2: Summary of Council Referrals Related to Citywide Affordable Housing Requirements

STREET LEVEL

Street Level Advisors

Updating Affordable Housing Requirements for The City of Berkeley, CA

Analysis and Recommendations

4/27/21

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Summary of Proposed Changes

	CURRENT	PROPOSED
Ordinance	***Rental***: Affordable Housing Mitigation Fee (BMC 22.20.065) ***Ownership***: Inclusionary Housing Requirements (BMC 23C.12)	Affordable Housing Requirements Ordinance (one ordinance that addresses requirements for rental, ownership, live/work units and condo conversion)
On-site Unit Income Targets	***Rental***: 10% of total units @ 50% of Area Median Income (AMI), 10% of total units at 80% of AMI ***Ownership***:20% of total units @ 80% of AMI	No change
Base Fee	***Rental***: $39,746 per unit ***Ownership***: 62.5% of the difference between market and affordable price.	$45 per gross residential square foot
ELI Incentive	40% of VLI units marketed to Housing Choice Voucher holders, 40% to Shelter+Care holders.	All VLI Units must be offered to voucher holders first, staff manage choice between two voucher programs.
Mixed Compliance Incentive	Projects that provide less than 20% on-site receive the same reduction in fee whether units are VLI or LI	More expensive/higher need VLI units reduce remainder fee by more than LI units.
Live Work	Live Work Ordinance (BMC 23E.20) exempts projects from IH and AHMF, requires 20% of live work units be affordable at 80% of AMI.	Remove special exemption for Live Work. Affirmative marketing to artists/others who need larger units still required.
Land Dedication	None	Create new Land Dedication Option
Family Size Unit Incentive	None	Projects that provide 2 and 3-bedroom BMR units may choose to provide 20% of total Residential Square Feet instead of 20% of units.
Condo Conversion	Nexus Fee calculation or 8% of market value. 50% reduction in fee for owner occupied units	8% of market value. 4% exemption expanded to include tenants who buy units at conversion.
Minimum # of On-site Units	None	Projects may not select the on-site option unless they include at least 5 BMR units
Maximum Unit Size	None	Projects with average unit size >3BR may not choose on-site unit option
Small Project Exemption	Projects with <5 units are exempt	Exemption removed; Reduced fee for projects with fewer than 25 units, phased in as size increases.
Cap on rent increases	BMR Unit rents increase along with HUD median Income	Limit annual rent increases to the change in the Consumer Price Index

Overarching Goals for Updating Requirements:

Center racial and economic equity

Berkeley has committed to pioneering policies that attempt to undo some of the harm caused by past exclusionary zoning practices. The City's Inclusionary Housing requirements are central to its efforts to build a more racially and economically integrated future.

Two key goals of the program are to ensure that affordable housing is included in all parts of the City and to promote the inclusion of affordable units within market-rate housing.

There has been quite a bit of academic research into the benefits of economic integration and the emerging consensus is that the location of affordable housing matters.[1] Much of our affordable housing has been concentrated in neighborhoods with the greatest health and safety challenges and the least economic opportunity. Integrating affordable housing into every neighborhood offers significant health and economic advantages, particularly for low-income children. While the same research has consistently not found additional benefits from locating affordable units in the same buildings as market rate housing (beyond the neighborhood benefits), requiring affordable units in new market rate buildings has been a key way that cities have succeeded in locating affordable housing in certain 'high opportunity' neighborhoods.

Currently both the Affordable Housing Mitigation Fee (AHMF) and Inclusionary Housing Requirements (IHO) ordinances allow developers to choose to either provide on-site units or pay a fee into the City's Affordable Housing Trust Fund. Several recent Council referrals have focused on either reducing or eliminating the fee option in order to encourage more on-site affordable housing units in mixed income buildings. Other council referrals have called on the City to encourage payment of fees, which allow investment in non-profit owned 100% affordable projects. These projects leverage outside affordable housing funding to build more units at deeper levels of affordability and also offer critical social services.

While increasing the share of on-site affordable units continues to be an important community goal, it is important to note that this is not the only way that Berkeley is achieving the goal of overcoming the legacy of segregation. Most of Berkeley falls into what is generally considered a moderate- to high-opportunity area, in part because the City offers high-quality schools to students regardless of which neighborhood they live in. At the same time, Berkeley has been successful in locating nonprofit affordable housing in most parts of the City. These broader realities reduce the pressure on the City's inclusionary housing policy to produce affordable units on-site in every building and allow the City to pursue a balanced strategy of private and

[1] The Urban Institute compiled a very helpful summary of several dozen research studies on the benefits of mixed income communities. *urban.org/uploadedpdf/412292-effects-from-living.pdf*

publicly sponsored provision of affordable housing in every neighborhood. An appropriate goal might be for the City to target a mix of on-site units in most market rate buildings while maintaining the collection of critical fees to support nonprofit affordable properties.

Though our analysis confirmed that Berkeley's current rules appear to strongly favor payment of the fee, the actual record of projects over the past few years paints a different picture and shows that Berkeley's current policy is already achieving this kind of mix, with the majority of projects providing on-site units.

Currently, providing an on-site affordable unit is generally far more costly to a developer than paying the associated fee. Just as an example, Street Level Advisors calculated that for a hypothetical Berkeley rental property, providing one on-site Very Low Income unit would reduce the resale value of a building by about $483,000. One on-site Low Income unit would reduce the building value by $340,000. Opting out of providing either of those units would require payment of an Affordable Housing Mitigation Fee totaling only $198,730.[2] While the specifics differ for each building based on the local market rents, in this example on-site costs more than twice as much as paying the current fee.

We estimate that the current AHMF costs roughly $45 per gross residential foot, and the on-site requirements cost a typical project roughly $114 per foot.

In spite of this, between 2012 and 2020 nearly two-thirds of Berkeley's projects have included some affordable units on-site and just under one-third have fully complied through the on-site option. Figure 3 shows that the mixed compliance option (some units plus some fee) has been the most popular option. There are likely several reasons for this including political pressures, but one clear factor is the State Density Bonus (SDB). The State requires cities to allow developers who include affordable units to build more units on a site than would otherwise be allowed and to take advantage of certain planning and zoning concessions which make it easier to get projects built. Under the current rules, projects that provide at least 11% of their units affordable to Very Low-Income residents qualify for the maximum benefit under the Density Bonus. These benefits cause many Berkeley projects to include 11% affordable units on-site and pay the fee for the remaining units. A recent change to state law will allow a 50% density bonus to projects that provide 15% VLI units (among other options). This change should result in even more on-site units in Berkeley even under the current City ordinance.

[2] Because Berkeley requires $39,746 per unit or 1 on-site unit for every 5 units (20%), every on-site unit that is included reduces the fee by 5 times $39,746.

FIGURE 1: Compliance Option Selected 2012 - 2020

Encourage a mix of units and fees

The changes proposed below clarify Berkeley's policy to make on-site affordable units the preferred default requirement for both rental and ownership projects but allow payment of a fee as an alternative in order to:

1) Continue to generate significant fee revenue to support nonprofit affordable housing projects throughout the City, and
2) Offer flexibility for projects to choose between multiple compliance options depending on different circumstances.

Ideally, the proposed changes will encourage a mix of fees and units over time with fees coming primarily from projects where on-site units would be less desirable or more difficult to monitor.

The proposed Affordable Housing Requirements ordinance would be structured so that providing on-site units is the default requirement for nearly all projects, with an exception for small projects and co-living type projects which would be encouraged to pay the fee. It might be possible to remove the fee option entirely, but state law requires cities to offer multiple compliance options such as a fee in their inclusionary housing ordinances. Ideally, the program would be structured such that the cost to a project of providing units on-site is more similar to the cost of paying the fee. This would maintain flexibility but reduce the incentive to pay the fee rather than provide units.

Over time, strong demand for housing in Berkeley should mean that higher fees are practical, but our analysis of current market conditions suggests that 2021 would be a particularly risky time to raise Berkeley's housing fees. The Covid-19 pandemic has created uncertainty in the real estate market and led to falling rents throughout the region. The multi-family rental prototypes we studied earned returns that were just barely above the minimums required for financial feasibility. The recommendations below call for restructuring the fee to be calculated on a per square foot basis but setting it, for the moment, at a level which is financially comparable to the current fee for most projects. Once the housing market has recovered from the effects of the pandemic, we recommend evaluating a fee increase which would bring the cost of the fee option closer to the cost of on-site compliance.

More immediately, the proposed changes recognize the growing popularity of mixed compliance based on the State Density Bonus and aim to increase the number of on-site units primarily by increasing the prevalence of these mixed compliance projects. Together these changes should increase the number of affordable units provided on-site within market rate projects throughout Berkeley without dramatically reducing the affordable housing fee revenue that the City's Affordable Housing Trust Fund receives.

Continue Berkeley's legacy of value capture

A key goal of Berkeley' inclusionary housing ordinance and Affordable Housing Mitigation Fee has been to ensure that new real estate development projects in Berkeley contribute benefits for the whole community. This principle of Public Value Capture (or Land Value Capture) calls on the City to closely evaluate the profitability of real estate projects and set its housing requirements at a level which captures a share of the profits to support housing for our lowest income residents. Careful value capture requires close attention to the financing and economic realities of development in order to ensure that the City is capturing the appropriate amount of financial returns.

Appendix A contains a detailed description of Street Level Advisors financial feasibility study. Building on past studies conducted in support of Berkeley's Affordable Housing Mitigation Fee, we analyzed a single hypothetical rental and a single condominium building prototype in order to better understand the financial feasibility of these projects under the current program and under the proposed changes described below.

For rental projects, our model suggests that most projects would not be able to feasibly comply with the current 20% on-site requirement but that projects that choose to pay the fee or access the State Density Bonus by providing some units on-site and paying a partial fee would both earn returns that are just barely above the threshold we identified for feasibility (5% yield on cost). The returns for density bonus projects are comparable to the fee alternative because the additional cost of providing some units on-site is offset by the additional benefit of building more units on the same site.

For our rental prototype (described in **Appendix A**), the proposed fee of $45 per gross square foot results in a virtually identical return to what the project would see under the current fee. A higher fee ($55 per foot) would result in a marginal return. The proposed approach of providing more 'credit' for projects that provide on-site VLI units than those that provide LI units results in modest increases in the returns available to mixed compliance projects that take advantage of the State Density Bonus. While this small difference is not critical for this prototype, it is likely that there would be projects where this difference would result in on-site affordable units in projects that would otherwise have paid the fee entirely (or not moved forward at all).

Figure 2: Comparison of Returns - Rental

Scenario	Base Units	Bonus Units	LI Units	VLI Units	Fee $	Yield on Cost	% of Base	% of Total
Current Policy								
$39,746 Per Unit Fee	72	0	0	0	$2,861,712	5.08%	0%	0%
Onsite Units	72	0	7	7	$0	4.94%	19%	19%
Mixed Compliance - 11% VLI	72	25	0	8	$2,265,522	5.07%	11%	8%
Mixed Compliance - 15% VLI	72	36	0	11	$2,106,538	5.10%	15%	10%
Proposed Alternatives								
$45 Per Foot Fee	72	0	0	0	$2,967,750	5.07%	0%	0%
$55 Per Foot Fee	72	0	0	0	$3,627,250	4.99%	0%	0%
Mixed Compliance (Weighted) - 11% VLI	72	25	0	8	$2,350,809	5.10%	11%	8%
Mixed Compliance (Weighted) - 15% VLI	72	36	0	11	$2,184,925	5.12%	15%	10%

For ownership projects, there is no Yield on Cost metric; feasibility is generally evaluated based on the profit from sales as a percent of the total development cost. Because there have been very few recent condo projects in Berkeley, it is not possible to identify the exact threshold for feasibility. One common benchmark considers projects that earn more than 10% profit to be 'feasible." We found that neither the current fee nor the current on-site requirement resulted in profit as a percent of development cost above this 10% threshold. The proposed switch to a $45 per foot fee would result in profit just above 10% while a higher $55 per foot fee would result in profit closer to 9%.

Figure 3: Comparison of Returns - Ownership

Scenario	Total Units	LI Units	Fee $	Profit % of Cost
Current Policy				
Current Fee (based on sale prices)	56	0	$3,810,847	8.00%
Onsite Units	56	11	$0	1.13%
Proposed Alternatives				
$45 Per Foot Fee	56	0	$2,767,050	**10.88%**
$55 Per Foot Fee	56	0	$3,381,950	9.16%

Continue progress on housing goals

The Bay Area needs more housing. Rapidly rising housing costs and growing displacement pressures are the result of a systemic shortage of housing. While building more housing alone would not be sufficient to address the current inequities, we cannot overcome our housing challenges without building significantly more housing. The Regional Housing Needs Allocation (RHNA) requires Berkeley to permit nearly 9,000 new homes at all income levels during the period from 2023 to 2031.

To meet this historic challenge, Berkeley's affordable housing policies must balance two critical but competing goals.

1) We must set affordable housing requirements high enough to produce meaningful levels of affordable housing, and
2) We must ensure that they are not too high for developers to accommodate.

If Berkeley sets its requirements too low, it may see construction that only serves to further existing inequity and racial exclusion. But if requirements are set too high, the result could be that little or no new housing is built, which would itself perpetuate the inequities which drive ongoing displacement of existing residents and push prices and rents up to levels which effectively prevent new low- and moderate-income households, including many households of color, from moving to Berkeley.

Berkeley's current affordable housing requirements (both the on-site requirements and the fee options) are somewhat higher than other East Bay jurisdictions (see Figure 6 below). But in spite of the relatively high costs, construction is continuing in Berkeley. Even during the pandemic, builders continue to undertake new residential projects. This suggests that Berkeley's requirements do not dramatically overburden development. However, Street Level Advisors' feasibility analysis (**Appendix A**) finds that the current requirements are only marginally financially feasible in today's environment. This suggests that Berkeley could see more building overall - including more affordable housing development - by slightly reducing the cost of compliance for some projects.

The proposed changes include many small adjustments to current requirements intended to make it easier for developers to understand and comply with program rules and for the City to oversee and administer. This will also facilitate transparency for the community at large. These changes are explicitly intended to make it easier to build the new housing that Berkeley desperately needs. However, the proposed changes attempt to achieve this while simultaneously maintaining or increasing the overall contribution that new market-rate housing makes to the provision of affordable housing in Berkeley.

Under the proposed changes, some types of projects are asked to contribute more and others less, but the goal is to maintain or increase the number of on-site units and the amount of fees available to the Housing Trust Fund. The proposed changes do this by reducing the fee charged to projects with relatively smaller units and increasing the fee on projects with large or extra large units and by slightly reducing the fee due from projects that provide some units on-site. These changes should encourage more projects to build some units on-site while also improving overall feasibility so that more housing projects are able to move forward.

Work within the City's existing administrative capacity

Berkeley's current affordable housing requirements are among the most complex in the region, but the City has fewer administrative staff than many other jurisdictions. HHCS currently has a total of 1.3 FTE to implement the BMR program:

- 0.20 FTE to work on new projects (apply requirements, meet with applicants, draft and execute regulatory agreements);
- 1.0 FTE monitor for completed projects, funded by an annual monitoring fee on BMR units; and
- 0.10 FTE related policy work and program supervision.

Adopting changes to the City's affordable housing requirements that increase administrative requirements would only be possible if new General Funds could be identified to support the implementation. Implementing local affordability requirements is not an eligible use of federal funds, so local funds are required to support this activity.

The proposed changes described below add complexity to the rules in several places but attempt to offset the complexity by streamlining and eliminating administrative challenges in several other places. The goal is to design a program which the City can successfully implement with existing staffing resources.

Proposed Changes in Detail:

1. Consolidate Affordable Housing Requirements into a single framework

Proposed Changes:

1.1. Combine the requirements of the Affordable Housing Mitigation Fee (AHMF) and Inclusionary Housing (IH) ordinances into a single "Affordable Housing" ordinance which would impose on-site affordable housing requirements for both ownership and rental projects.

1.2. The fee would be structured as an "in lieu fee" offered as an alternative to on-site units, rather than as a mitigation fee.

1.3. The new ordinance would also replace the affordable housing requirements sections of the Condo Conversion and Live/Work ordinances.

1.4. To the extent possible, standardize the requirements that are applied to different projects to simplify implementation of the program.

1.5. The new ordinance would apply to all new project applications received after a date specified several months after adoption.

Background and Analysis:

Prior to 2009, Berkeley had a single Inclusionary Zoning Ordinance (BMC Chapter 23C.12) which applied to both ownership and rental projects. In 2009, a Court of Appeals decision known as Palmer/Sixth Street Properties LP v. City of Los Angeles prevented California jurisdictions from enforcing inclusionary housing requirements on rental properties. Like many other cities, Berkeley responded by adopting an Affordable Housing Mitigation Fee (AHMF) (BMC section 22.20.065). Instead of requiring on-site units and then offering an in lieu fee as an alternative, the AHMF ordinance requires payment of a fee and allows the provision of on-site units as an alternative. This approach allowed Berkeley to achieve its policy goals without violating the restrictions imposed by the Palmer decision. But it created a situation in which the City had two different ordinances that attempt to impose similar requirements. The provisions of the Inclusionary Housing Ordinance that applied to rental housing remained in the Berkeley Municipal Code but were unenforceable and superseded by the AHMF ordinance.

In 2018, the California Legislature passed AB1505 which effectively overturned the Palmer decision and authorized the implementation of inclusionary housing requirements applied to rental properties. This legislation has allowed a number of cities to update their programs to combine rental and ownership requirements under a single inclusionary housing ordinance.

For example, in June 2019, the Mountain View City Council completed a two-phase process to update its Below Market Rate Program requirements. Mountain View now requires any new residential development, whether rental or ownership, to provide 15% of its units at affordable rents.[3] Similarly, after suspending its inclusionary rental housing requirement in 2011 to comply with the Palmer decision, the City of Menlo Park updated its Below Market Rate Housing Program to subject all new residential developments to its affordable housing requirements.[4]

Berkeley's new Affordable Housing Requirements (AHR) ordinance would address both rental and ownership projects (including Live/Work) and would impose an on-site affordable housing requirement for both while allowing payment of an in lieu fee.

2. Calculate the fee on a per foot basis

Proposed Change:

2.1. Calculate affordable housing fees on a per foot basis instead of per unit. Initially set the fee at $45 per gross residential square foot, which is roughly equivalent to the current fee for projects with typically sized units. Collect the fee at the time of Certificate of Occupancy eliminating the current discount for earlier payment. Increase the fee amount automatically based on the change in the California Construction Cost Index.

Background and Analysis:

Some stakeholders have expressed concerns that projects that propose units with large numbers of bedrooms are not being required to pay an appropriate fee. Because Berkeley charges its AHMF on a per unit basis, a project that chooses to include a number of 5-bedroom units for example, would pay far less proportionally than a similarly sized project with studio, 1- and 2-bedroom units. It is not clear whether this savings is enough to cause developers to choose much larger bedroom configurations since these large unit 'co-living' projects are a trend nationwide. But it is clear that Berkeley's ordinance creates an incentive for projects that select this configuration and there does not seem to be a public policy reason for Berkeley to prefer these extra-large units. While there are benefits to projects that include 'family sized' 2 and 3-Bedroom units (discussed in proposed change #9 below), beyond 3 bedrooms, new units are generally housing multiple unrelated individuals rather than families.

A number of cities have changed to calculating in lieu fees on a per square foot basis. San Francisco and Santa Barbara both made this change in 2019 and San Jose made a similar change in early 2021. Instead of charging a flat fee per unit, the City would charge the fee for each square foot of residential space in the building regardless of how the building is divided up into units. As an example, a 25,000 square foot building would pay the same fee whether it was split up into 50 small studios or 15 multi-bedroom co-living units.

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[3] City of Mountain View, Below Market Rate Program, https://www.mountainview.gov/depts/comdev/preservation/homebuying/bmrhousing/default.asp

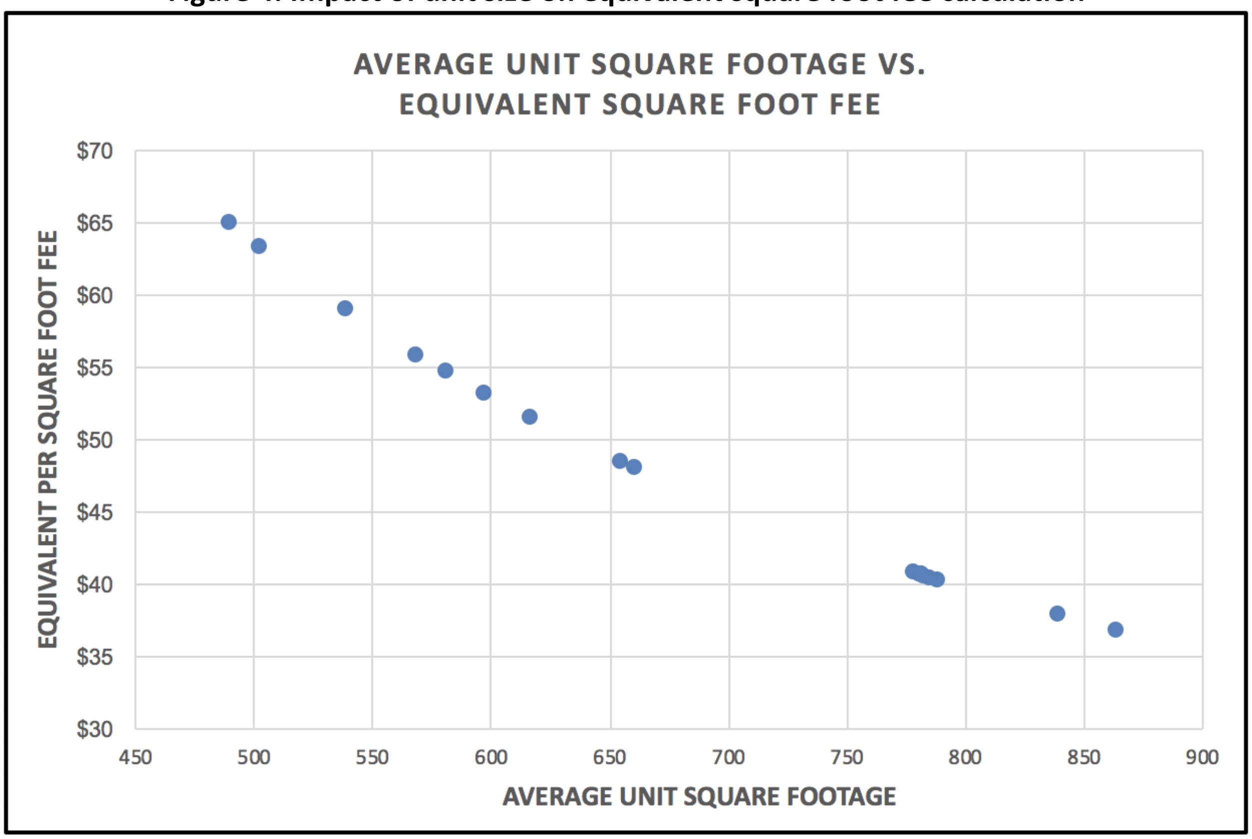
[4] City of Menlo Park, BMR Requirements for Residential Developers, https://www.menlopark.org/DocumentCenter/View/1493/BMR-Requirements-for-Residential-Developers

Currently, in Berkeley, every rental project would pay $39,746 per unit (assuming that they provided no units on-site). For a typical project this is equivalent to a fee of $45 per gross residential foot, as illustrated in the table below.

Gross Square Feet - Residential is defined as all of the square footage of a new building (as defined in BMC 23F.04.010) minus any exclusively commercial space or indoor parking area. In a typical project, the gross square footage is roughly 1.25 times the net square footage.

We conducted a market analysis in order to estimate a per square foot fee which would be equivalent to the current AHMF. We collected data on the unit sizes of 18 recent Berkeley projects. We then multiplied the average unit sizes by 1.25 to estimate the gross square footage of each of these projects. For each project, we calculated an 'equivalent per square foot fee' by dividing the fee that the project would have paid under the current rules (assuming no on-site units) by the gross square footage. The equivalent per square foot fees ranged from $38 to $65. The typical fee was approximately $45 which corresponds to an average unit size of 705 square feet.[5] Figure 4 shows the distribution of average unit sizes and equivalent square foot fees.

Figure 4: Impact of unit size on equivalent square foot fee calculation



[5] This excludes several outlier projects with very large or very small units.

Figure 5 shows a sample of recent projects in order to illustrate the impact of switching to a per square foot fee. Under the current per unit fee, projects that have the same number of units like Avalon and Hillside Village would pay the same amount of fee. The equivalent per square foot fees ($37.91 vs. $48.14) show that Avalon is getting a much better deal by paying less relative to its size.

The per square foot fee adjusts for the difference in project sizes. If Berkeley switched to a standard fee of $45 per square foot, projects with small units such as the Delaware Apartments would pay a lower total fee while projects with large units such as Higby would pay higher total fees.

Figure 5: Equivalent per foot fees for recent projects - Examples

Project Name	Total Units	Average Unit Square Footage	Current Fee (Assuming $39,746 per unit)	Equivalent Per Square Foot Fee	Projected Fee (assuming $45/foot)
Higby	98	864	$3,895,108	$36.82	$4,760,145
Avalon	94	839	$3,736,124	$37.91	$4,434,615
Stonefire	98	782	$3,895,108	$40.65	$4,311,900
Hillside Village	94	661	$3,736,124	$48.14	$3,492,405
The Dwight	99	617	$3,934,854	$51.57	$3,433,680
The Delaware	51	581	$2,027,046	$54.72	$1,667,025

For comparison, Figure 6 provides fee levels for nearby jurisdictions.

Figure 6: Comparison of Inclusionary Housing Requirements and Fee Levels for Other Jurisdictions

City	% Affordable Housing Required On-site	Fee	Notes
Alameda	15% for all multifamily projects	$20,342 Per Unit	No alternative to fee for buildings of 9 or fewer units
Emeryville	20% for all multifamily projects	$31,032 Per Unit	
Fremont	12.9% for rental	$27.00 Per Residential Square Foot	
Hayward	6% for rental, 10% for ownership	$19.37 Per Residential Square Foot	Lower fees for high-density condos

Figure 6 Cont'd			
City	**% Affordable Housing Required On-site**	**Fee**	**Notes**
Livermore	10% downtown, 15% everywhere else	$29.23 Per Residential Square Foot	Projects with 10 or more units may not pay fee
Oakland	10% if low- or moderate- income units, 5% if very low-income units	For multi-family: $22,000 per unit in Zone 1, $17,750 in Zone 2, $12,000 in Zone 3	
Pleasanton	15% for all multifamily projects	$45,083 per unit	
San Francisco	20% for small projects, 25% for large rental, 33% for large ownership	$199.50 Per Gross square foot times affordable percent	Equivalent to $60 per square foot for many projects.
San Jose (proposed)	15% for all multifamily projects	Moderate Market Areas: $18.26 per net residential foot Strong Market Areas: $43	

The current AHMF ordinance allows developers to choose between paying a higher fee (currently $39,746) at the Certificate of Occupancy when a project is nearly complete or a reduced fee (currently $36,746) earlier when a project receives a building permit. Nearly all projects have selected the higher fee because of the high value that developers place on the ability to pay the fee later. Paying later reduces their financing costs and lowers their overall financial risk. Removing the option to pay early would recognize this reality and eliminate an additional element of administrative complexity and communication challenge.

The existing Affordable Housing Mitigation Fee is automatically adjusted by the annual percentage change in the California Construction Cost Index published by the California Department of General Services, every other year. The automatic adjustment is applied to all projects that have not received final approval by the City of Berkeley prior to the date of the automatic adjustment. This automatic adjustment ensures that the fee keeps pace (roughly) with what it costs the City and its nonprofit partners to construct new affordable housing using the fee revenue. This method should remain in place.

3. Evaluate the potential for higher fees when the market is stronger

Proposed Change:

3.1. In order to encourage more on-site units, phase in a slightly higher fee once the housing market has stabilized. Conduct an updated feasibility analysis within 3 years, increase the per square foot fee if the analysis shows that typical projects could support the higher fee.

Background and Analysis:

Under current market conditions, Berkeley's on-site compliance option (20%) is significantly more costly for most projects relative to the cost of the Affordable Housing Mitigation Fee or In-lieu Fee. This creates an incentive for projects to choose to pay the fee instead of providing units on-site. In spite of this incentive, the majority of projects have provided some level of on-site units because the State Density Bonus provides an even stronger incentive to include affordable units on-site, and the units count against the fee obligation as well.

Ideally the on-site unit and in-lieu fee requirements would be more closely aligned so that they represented similar costs for most projects. This kind of alignment would likely result in a higher number of on-site units without entirely eliminating the fee revenue which is critical to Berkeley's Affordable Housing Trust Fund. Aligning the economics of these two options would require either raising the fee or lowering the on-site requirement considerably.

In rough terms, the on-site requirement would need to be lowered to about 15% in order to represent a cost to most rental projects that was equivalent to the cost of the current AHMF. However, none of the local stakeholders we spoke with suggested that there would be public support for lowering Berkeley's on-site requirement.

A number of stakeholders, on the other hand, suggested raising the fee. This seems to be the more obvious path to aligning the cost of the two options and increasing the share of units on-site. However, our feasibility analysis (**Appendix A**) suggests that 2021 would be a particularly risky time to raise the affordable housing fee. The Covid-19 pandemic has created uncertainty in the real estate market. Rents in Berkeley have fallen significantly and rents in high-cost newly constructed buildings may have fallen more than the average. At the same time, construction costs have not (yet) fallen leaving most multi-family housing developments in a precarious position. Builders are still moving forward with new rental buildings in Berkeley but the City's volume of new applications has fallen relative to recent years. It seems likely that Berkeley will continue to be a desirable location for new housing over the longer term but it is not yet clear whether there will be a protracted slow down in new building throughout the region following the pandemic.

While the level of local fees, including affordable housing fees, is just one small factor that developers consider when they decide whether or not to move forward with a project, Berkeley already charges more than most other East Bay jurisdictions and increasing the fee at this time could contribute to a greater slow down in new building.

For this reason, we are recommending that Berkeley allow for a period of housing market recovery before considering an increase in the Affordable Housing Fee. The City could plan on an update to the feasibility analysis in one to three years or wait for evidence that either rents have begun increasing or that construction costs have begun to fall before reconsidering the level of the fee.

4. Incentivize Extremely Low-Income (30% of AMI) units

Proposed Changes:

4.1. Require all VLI Units to be offered to voucher holders before being marketed to other income eligible households.

4.2. In order to simplify administration, allow staff to designate a single voucher program (Housing Choice or Shelter + Care) for use by each project rather than requiring every project to work through both cumbersome systems.

Alternative:

4.3. Retain the current rules which require 40% of VLI units be offered first to Housing Choice Voucher Holders and another 40% be offered first to Shelter + Care Voucher Holders.

Background and Analysis:

A number of local stakeholders have expressed a desire to see Berkeley's program provide relatively more units to serve Extremely Low-income (ELI) households (below 30% of Area Median Income) who face the most acute housing challenges.

Some cities achieve this by creating a formula which allows developers to substitute a smaller number of units targeting Extremely Low Income residents for some portion of otherwise required on-site BMR units. Los Angeles's Transit Oriented Communities (TOC) program requires affordable units in exchange for a significant density bonus. The TOC program allows developers to choose between providing a greater number of low-income units or a smaller number of more deeply affordable Extremely Low Income units. Even though the rents on the ELI units are much lower, many developers have chosen this option because they can provide fewer affordable units (and more market rate units). Between 30% and 50% of the BMR units produced through the program have targeted ELI households and this program has driven a significant increase in the total number of income restricted ELI units produced in LA. In 2020, 34% of new BMR units in LA were restricted to ELI tenants.

While this type of approach might increase the number of ELI units in Berkeley, it is worth noting that Berkeley is already a national leader in serving ELI households through inclusionary housing. *Currently 29% of Berkeley's BMR tenants have incomes below 30% of AMI* and the share of ELI tenants is likely to increase noticeably under current rules. Berkeley's AHMF requires that at least half of BMR units must target 50% of AMI and, *of those*, 40% must be offered first to Housing Choice voucher holders from the Housing Authority and another 40% must be offered first to Shelter Plus Care voucher holders managed by the City's Housing and Community Services division. Voucher holders in both programs generally have incomes well below 30% of AMI. And because of the acute shortage of inexpensive market rate housing, most of the households that receive vouchers in Berkeley are unable to use them in the market. This approach has benefits for developers as well. The City allows the property to receive the contract rent offered by the subsidy program as long as the tenant's share of rent is below the BMR limit. The contract rents are generally far below the market rent for brand new buildings but also quite a bit higher than the BMR affordable rent for 50% AMI units. Because of the voucher, the ELI tenants, on the other hand, generally pay much less than the 50% AMI affordable rent.

In addition, because of the way Berkeley's requirements interact with the State Density Bonus (SDB), developers tend to favor the 50% AMI units. As a result, 77% of Berkeley's BMR units approved since 2012 have been regulated as 50% AMI units. If this pattern continues and, going forward, 80% of these units are reserved for voucher holders, then we would expect voucher holders to make up 62% of new BMR tenants.

A 2020 State law (AB 2345) expands the SDB beginning in January 2021. Developers will now be allowed to build 50% more units if they provide at least 15% VLI units (among other options). This new law should result in a greater number of on-site VLI units and, as a result, a greater number of ELI/voucher tenants. At some point, it is likely that the City would exhaust the supply of unused vouchers and some of these units would ultimately be leased to Very low Income tenants (below 50% of AMI) instead.

In addition to its success in serving ELI tenants in BMR units, the City currently requires that at least 20% of units in all projects funded with the Housing Trust Fund be affordable to ELI tenants.

Requiring that all VLI units first be offered to voucher holders would slightly increase the share of ELI tenants housed going forward while also removing an element of complexity from the program and simplifying otherwise complex rounding issues. Allowing the staff to designate one or the other voucher program for each project would simplify compliance for property managers. Rather than requiring each project to navigate complex rules with two different public agencies, this would create the same number of voucher placements while allowing each building to interact with only one of the two voucher programs.

5. Adjust the residual fee for mixed compliance projects

Proposed Change:

5.1. Encourage more mixed compliance projects by changing the calculation of the remaining fee due when projects provide less than 20% affordable units on-site.

Restructure the remainder fee so that providing VLI (50% AMI) units reduces the fee due by more than providing LI (80% AMI) units.

Alternative:

5.2. Continue the current practice of providing the same reduction in fee for any units, whether they serve VLI tenants or LI tenants.

Background and Analysis:

Currently rental projects that provide 20% affordable units on-site are exempt from the Affordable Housing Mitigation Fee (AHMF). Half of these units must be for Very Low Income (VLI) residents earning less than 50% of AMI and half must be for Low Income (LI) residents earning less than 80% of AMI. When a developer provides a portion of the required units on-site, the City has a formula that is used to determine the remaining fee. For example, if a project provides half of the required on-site units, they also owe half of the fee that would have been due. In order to access the benefits of the State Density Bonus, the majority of recent projects have selected this mixed compliance option.

Under the current rules, providing any on-site affordable housing unit reduces the fee that is due by the same amount regardless of whether the unit provided is a LI or a VLI unit. But because the VLI units rent for much less, they are much more costly to provide on-site. When a developer agrees to provide any permanently affordable unit, they will receive less rental income from that unit throughout the life of the project than they would from a market-rate unit. As a result, each affordable unit in a project decreases the value of a building - the amount that a building could be sold for. Street Level Advisors estimated the cost of providing these units on-site for a hypothetical 6 story project and found that a VLI unit reduces the value by $483,000 while a LI unit reduces value by $340,000.

One way to encourage more projects to provide some units on-site would be to restructure the remainder fee so that providing VLI (50% AMI) units reduces the fee due by more than providing LI (80% AMI) units. Based on the relative affordable rents, providing 10% VLI units could relieve the developer of $30 of the $45 per square foot remainder fee, while providing 10% LI units could relieve them of only $15 of the $45 per square foot fee. Projects providing fewer than the 10% of units required in either category would pay a fee adjusted proportionally.[6]

[6] The formula for calculating the reduction in fee could be (Full Fee* 1.33 / 20) * (actual % of VLI units) + (Full Fee * .67 /20) * (actual % of LI units). If the full fee is $45 per foot, then each 1% of VLI units would reduce the fee due by $3 per foot and each 1% of LI units would reduce the fee by $1.50 per foot.

Figure 7: Examples to illustrate partial compliance - 100 unit project

Example	VLI units	LI Units	Fee
On-site Only	10	10	$0
Fee Only	0	0	$45
Only VLI	10	0	$15
Only LI	0	10	$30
Half Each	5	5	$22.50
11% VLI	11	0	$12
15% VLI	15	0	$0

This change would increase the feasibility of the mixed compliance options and should result in on-site units from some projects that would have otherwise selected to pay the fee. However it is important to note that this mixed compliance option is already the most popular option and appears to be financially feasible without this change.

6. Standardize ownership fees

Proposed Change:

6.1. Apply the same per square foot fee for both rental and ownership units. Continue to require different income targeting for ownership units.

Alternative:

6.2. Charge any project that chooses to record a Condominium Map a higher fee of $55 per square foot.

Background and Analysis:

Many local stakeholders are under the impression that Berkeley's current Inclusionary In-Lieu Fee for ownership projects is higher than the Affordable Housing Mitigation Fee for rental projects. Berkeley has seen very few ownership projects in recent years, so it is difficult to directly compare, but our analysis suggests that this is true, both on a per unit and per square foot basis.

In lieu of each affordable unit, the current Inclusionary Housing Ordinance allows payment of a fee equal to 62.5% of the difference between the market price and the "affordable" price. To estimate the equivalent per square foot fee that this rate yields, we used proprietary data from Property Radar to calculate average square footages and market values for Berkeley condos, shown in Figure 8.

Figure 8: Condo pricing estimates

Berkeley Condo Sales 2021			Prototype (New Building)
Unit Size	**Avg Sqft**	**Avg Value**	**Projected Value**
Studio	646	$620,752	
1-BR	814	$703,556	$725,000
2-BR	1117	$853,125	$925,000
3-BR	1571	$995,797	$1,100,000

It is likely that newly built condos would sell for higher than average prices but there have not been enough Berkeley condo projects in recent years to calculate appropriate projections for new buildings only. We have assumed sale prices for newly built condo units would be roughly 5 to 10% higher than the citywide average condo sales prices.

The IHO defines the affordable price for the purpose of calculating the fee as three times (3x) the Area Median Income (AMI) adjusted for household size. We used those prices to estimate in lieu fees. We then multiplied those numbers by 20% to yield the equivalent per unit fee, which range from $48,000 to $85,000. This suggests that the fees required for ownership projects in the IHO are indeed higher than the $39,746 per unit currently required for rental projects under the AHMF. Our estimates for the equivalent per square foot fees for ownership projects range from $54 to $75, which is higher than the typical equivalent per foot fees that we found for rental projects. Projects with very high cost condo units would face even higher fees.

Figure 9: Estimated BMR Ownership Fees 2021

Unit Size	Sq Ft	Market Price	Affordable Price	In Lieu Fee	In Lieu Fee Per Unit	In Lieu Fee per Sq Ft
Studio	646	$620,752	$234,960	$241,120	$48,224	$75
1BR	814	$703,556	$250,650	$283,066	$56,613	$70
2BR	1117	$853,125	$282,000	$356,953	$71,391	$64
3BR	1571	$995,797	$313,200	$426,623	$85,325	$54

Note that the median condo value in Berkeley has risen dramatically in recent years, from a low of $364,000 in 2012 to $900,000 in January 2021.[7] Because prices have risen much faster than income, the in lieu fee has risen too.

We analyzed the financial feasibility of the current fees for hypothetical affordable ownership projects (**Appendix A**) and found that the current fees resulted in profits that fall below commonly used benchmarks for necessary profit. High cost condos might be able to pay the fee and earn the minimum required profit but projects with sales prices closer to Berkeley's average condo prices would not. However, under current conditions, more typically priced condos would be able to pay the proposed rental fee of $45 per foot and remain financially feasible. While there have not been enough condo projects in Berkeley recently to draw strong conclusions, this exercise lends support to the assertion that the relatively high level of Berkeley's fee for ownership projects is contributing to developer's choice to build rental rather than ownership housing.

The current policy appears to discourage homeownership development. Some local stakeholders have expressed an interest in adjusting the policy to give developers, and ultimately Berkeley residents, more choice between rental and homeownership housing. Setting the fee at $45 per square foot for both types of project would level the playing field considerably. The typical ownership unit would still pay more because ownership units tend to be larger. As an alternative, many cities charge homeownership units slightly more. Setting Berkeley's fee at, for example, $55 per square foot for ownership projects would slightly disincentivize ownership but by less than the current fee approach.

Addressing rental projects that record condo maps

[7] Zillow Home Value Index for Condos/Co-ops, https://www.zillow.com/berkeley-ca/home-values

Another reason to consider standardizing the fee between rental and ownership projects stems from the fact that a growing number of new multi-family buildings are recording condominium maps but opening initially as rental housing projects. This gives project owners the flexibility to later sell the rental units as condos if housing market conditions change. The added flexibility makes it easier for developers to access project financing or to access financing on better terms.

For projects that provide on-site affordable rental units, the City records restrictions which require that the BMR units remain affordable rentals for the life of the project. But the potential for projects that are initially rental and pay the AHMF but later convert to ownership is not addressed in Berkeley's current code. Projects that paid the AHMF as rental projects and later sold condo units would owe an additional fee, but monitoring and collecting this fee is administratively and legally challenging.

Some cities have responded to this trend by requiring projects that record a condo map when they are first built to pay a higher affordable housing fees that would be due for ownership projects even if the building is initially operated as rental housing. This would not be practical under Berkeley's current approach because the ownership in lieu fee is set based on the actual sale price of units but those may not be determined for many years (if ever). Setting a single in lieu fee that would be applied to both rental and ownership projects at the time of development would eliminate this complexity. Alternatively, setting a higher fee per square foot for projects with a Condo Map would also provide a practical alternative, though it might increase costs on rental projects that are not likely to ever actually convert to ownership but need the Condo Map in order to access certain financing sources.

7. Standardizing live-work requirements

Proposed Change:

7.1. Remove the exemption for Live-work projects from IHO/AHMF ordinances; apply the same requirements to Live-work projects as any other project except for the "affirmative marketing" provision

Background and Analysis:

A 2018 Council Referral (2018-09-12, Item 17) called for the elimination of the affordable housing requirements in the Live Work Ordinance and removal of the live/work exemptions from both the IHR and AHMF ordinances. This action would simply apply the Inclusionary Housing or AHMF ordinances to Live Work exactly as they are applied to other projects.

Live/Work units are currently exempt from both the Inclusionary zoning ordinance and the Affordable Housing Mitigation fee. Instead, Berkeley's Live Work Ordinance (Berkeley Municipal Code 23E.20) requires projects that create 5 or more Live/Work units to include 1 inclusionary unit affordable to 80% of AMI for every 5 Live/Work units created. The inclusionary requirements in the Live/Work ordinance differ from the requirements applied to other projects. Affordable units under the Live/Work ordinance are all targeted to 80% of AMI. In addition, the Live Work Ordinance specifically allows inclusionary Live/Work units to be smaller, have lesser finishes and be located anywhere in a project while both the IHR and AMHF ordinances require units to be the same size, have comparable finishes and be distributed throughout a project.

There is one provision of the Live/Work ordinance which is specific to Live/work affordable units which it would make sense to retain or move to the new ordinance. Inclusionary live/work units must be affirmatively marketed to "income-eligible persons performing a work activity permitted in the District where the project is located whose type of work causes them to have a requirement for a space larger in size than typically found in residential units." The ordinance currently provides no standards for documenting tenants' need for live/work space or rules for waiving this requirement in the event that a tenant with this need cannot be found within a reasonable period.

8. Add a land dedication option

Proposed Change:

8.1. Add a land dedication option which authorizes the City Manager to approve donation of land to the City or an approved nonprofit housing developer. Donated land must be appraised for a value of at least 75% of the in lieu fee which would otherwise be due, be sufficiently sized and zoned to support multifamily housing development and otherwise be suitable for affordable housing development.

Alternative:

8.2. Don't add a land dedication option - continue with two compliance options; on-site units or in lieu fee, though this would leave projects newly excluded from the on-site option with only one compliance option.

Background and Analysis:

Some stakeholders have suggested that the program would be stronger if Berkeley allowed developers to comply by providing off-site affordable projects, preserving existing 'naturally occurring affordable housing' or dedicating land for affordable housing development. We evaluated the feasibility of adding off-site and preservation options and concluded that Berkeley currently lacks the staff capacity necessary to effectively implement these complex options. However, it is worth noting that the City can and does use in lieu fee revenue collected to finance both off-site projects and preservation/rehabilitation projects. By collecting fees and then going through the existing procedures for the Affordable Housing Trust Fund, the City avoids the need to develop new detailed rules and closely monitor developer implementation of these alternatives.

The third option, land dedication, however, provides an outcome which the City cannot achieve on its own through the use of fee revenue. While this option also would require detailed rules to avoid abuse, it may be less challenging than off-site or preservation options and is likely to be used in far fewer cases.

Access to sites is one of the key barriers facing affordable housing developers. Market rate developers sometimes end up with control over sites which could be better used for affordable housing. Sometimes market rate projects are large enough to set aside a portion for affordable housing. In these, somewhat rare, cases, it is sometimes more affordable for the developer to donate land for affordable housing than to build on-site units or pay an in lieu fee. If the donated site is really appropriate for affordable housing it can save significant time and make new projects possible. Of course, if sites are not appropriate, land donation can result in a significant burden on City resources. If the policy were to include a land dedication option, the City would need to develop detailed guidelines which outlined site requirements and retain the option to only accept sites when there is a high probability that they will be developable for affordable housing including, for example, expressions of interest from local affordable housing developers.

9. Provide a family sized units option

Proposed Change:

9.1. In lieu of providing 20% of units at affordable prices, allow projects to provide affordable units comprising 20% of the Gross Residential Floor Area in the project provided that at least 50% of those units are in 2 or 3 bedroom units.

Background and Analysis:
Berkeley's IHR and AHMF ordinances currently require that on-site BMR affordable units be of the same type and size as market rate units in the property. As the cost of construction has risen, there has been a trend for market rate projects to include smaller and smaller apartments and this has meant that the BMR units have been shrinking as well. Some stakeholders have asked the City to consider ways to incentivize more 'family sized' units even in buildings where the market rate units are quite small. This request has been made at the same time that other stakeholders have called for the City to actively discourage units with high bedroom counts (i.e., co-living units).

It seems that in the current context the City should be encouraging 2 and 3-bedroom units but not larger ones. One way to achieve this is to require that projects set aside a given percentage of floor area for affordable housing instead of a percentage of units if the majority of those units are 2 and 3-bedroom units.

When New York City adopted their Mandatory Inclusionary policy for the first time in 2016, rather than requiring a percentage of units be affordable, they required that the affordable units make up a percentage of net residential floor area.[8] This allows developers to include larger or smaller affordable units. Projects offering smaller BMR units may need to provide more units and projects offering larger units would provide fewer units. Cambridge, MA, a city with size and demographic similarities to Berkeley, also switched to this method in 2017, but with the additional condition that large developments (30,000 square feet or more) are required to include 3-bedroom affordable units.[9] Both of these approaches would add considerable complexity to already complex rules in Berkeley. The proposed change would continue to require 20% of units for most Berkeley projects, but would add an alternative for projects that chose to offer mostly 2 and 3 bedroom BMR units.

10. Simplify the requirements for condominium conversions

Proposed Changes:

10.1. Calculate the Condo conversion fee at 8% (or 4% for owner-occupants) of the market value of converted units. Market value to be established through an appraisal.

10.2. Reduce the conversion fee to 4% for any unit that is and has been occupied by an owner as his or her principal place of residence for at least 5 consecutive years immediately prior to the date that the fee is paid, including as a tenant in that unit immediately prior to ownership.

10.3. Continue to allow a further 25% discount in the fee if it is paid at the time of conversion rather than at the time of sale of condo units.

10.4. Add flexibility in the use of conversion fees. Allow up to 10% of conversion revenue to be used for Condominium Conversion program delivery and/or Housing Trust Fund program and project monitoring and enforcement or related program administrative costs with the remaining 80% placed into the Housing Trust Fund.

Background and Analysis:

Berkeley's Condominium conversion ordinance (CCO) (Berkeley Municipal Code [BMC] Chapter 21.28 et seq.) requires payment of an Affordable Housing Mitigation Fee at the time that rental properties are converted to condominium ownership. Between 1992 and 2009 this mitigation fee recaptured essentially the entire difference in affordability that resulted from conversion. This had the effect of discouraging conversions. In 2005, the state Court of Appeal held that cities could not prohibit conversion of rental units to Tenants in Common ownership (TIC). Since then, the City has sought to encourage conversion of rental units to condominiums rather than TICs because of difficulties that can arise for people who invest in TIC properties. It has done so by imposing a de facto cap on the affordable housing mitigation fee charged for conversion to condominiums since 2009.

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[8] New York City Mandatory Inclusionary Housing Program, https://www1.nyc.gov/site/planning/plans/mih/mandatory-inclusionary-housing.page

[9] City of Cambridge Inclusionary Housing, https://www.cambridgema.gov/CDD/housing/inclusionaryhousing

Nexus Fee Calculation: Under the current ordinance the AHMF for condo conversions is calculated through a complex 'nexus formula' that considers costs of ownership, rental and mortgage rates. Alternatively, owners can choose to pay 8% of the sales price (or 4% for 2-unit buildings) instead of the Nexus Fee if they agree to limit rent increases for any existing tenants. This alternative calculation generally results in much lower fees. As a result, the nexus-based fee method has been used very rarely. We recommend that all condominium conversions be subject to the 8%/4% fee, and that all sitting tenants be provided protections and an opportunity to purchase.

> Examples:
> **Nexus Formula:** Rental Costs = \$1,500 per month x 12 months/year = \$18,000 annually Ownership Cost (including principal, interest, taxes, insurance, and homeowners' association dues) = \$2,700 per month x 12= \$32,400 Assume a mortgage rate of 6.5 percent. Increased housing cost due to ownership conversion of the unit = \$32,400 - \$18,000 = \$14,400 Mitigation Fee = \$14,400/0.065 = \$221,538
>
> **Alternative Formula**: Sale price for converted unit = \$400,000. If owner agrees to limit rents to existing or future tenants. Mitigation fee = 8% x \$400,000 = \$32,000.

Discount for Owner Occupants/Tenant Conversion: Currently, the condo conversion ordinance provides a 50% reduction in the fee to owners who have lived in their units for the 5 prior years. However, only owners who resided in their units on June 30, 2010 are currently eligible.

> *If the property contains three or more units, the affordable housing mitigation fee for a unit that is occupied by an owner as their principal place of residence for at least 5 consecutive years immediately prior to the date of sale, including as a tenant in that unit immediately prior to ownership, shall be reduced by 50 percent, but only if the owner owned and resided in the unit as of June 30, 2010.*

A Council referral had proposed to extend the 50% reduction to tenants in addition to owners who have lived in a unit for at least 5 years prior to conversion so long as the building was 4 or fewer units.

> *If the property contains 4 units or fewer, the affordable housing mitigation fee for a unit that is and has been occupied by an owner as his or her principal place of residence for at least 5 consecutive years immediately prior to the date of conversion or sale, including as a tenant in that unit immediately prior to ownership, shall be reduced by 50 percent.*

It is not clear why this tenant conversion benefit should be limited based on building size. The current ordinance is limited to properties with 3 or more units while the referral was limited to 4 or fewer units. The proposed change would apply to owner occupied or tenant purchased units in buildings of any size.

Use of Fee Revenue: The current condo conversion ordinance does not allow any of the Mitigation Fee revenue to be used for program administration, but the program can be staff-intensive to implement. The AMHF and IHR Ordinances allow a portion of fee revenue to be used for program administrative staffing.

11. Prohibit on-site units in certain situations

Proposed Change:

11.1. For rental projects, only allow on-site compliance as an option for projects that would include 5 or more BMR units.

11.2. Prohibit projects with an average of more than 3 bedrooms per unit from selecting the on-site option in order to reduce administrative burdens.

11.3. Adopt a local density bonus that enables these projects to access the benefits of the State Density Bonus in exchange for an increased in lieu fee instead of on-site units.

Background and Analysis:

Small Projects: Small projects pose a special challenge for program administration and monitoring. Monitoring compliance for a building with one or two regulated units requires a similar investment of staff time as a project with 20 BMR units. Often the owners of smaller buildings have fewer resources and less outside professional property management support and as a result, they often find the burdens of compliance more challenging, and require relatively more intervention and training from City staff.

Many cities address this by encouraging developers of small properties to select the fee or other option rather than providing on-site BMR units which may prove difficult to monitor. Redwood City prohibits the on-site units option for projects with fewer than 20 total units, effectively requiring these projects to pay the in lieu fee.

In Berkeley, however, because so many projects select mixed-compliance, there is a real risk that projects with more than 20 total units could end up including only a very small number of on-site BMR units. For example a 40 unit project selecting on-site compliance (20%) would provide 8 BMR units but if they chose to only provide 10% on-site and pay a fee for the remainder they would only provide 4 BMR units on-site. Removing the on-site option for projects that would result in fewer than 5 BMR units would force these projects to either pay the fee entirely or fully comply through the on-site option. Either option would simplify monitoring enormously.

Co-living Projects: It is challenging to regulate and monitor BMR units in co-living and group living projects where individuals generally lease bedrooms not apartments. It is difficult to find eligible households who can both qualify for and afford 4-bedroom or larger BMR units and the households that would most benefit from large BMR units might be less interested in living in a building that was primarily targeting students and young adults. Additionally, it is typical for groups of unrelated adults renting larger units together to change composition frequently, which makes maintaining current documentation of eligibility more complicated for owners and therefore compliance more difficult for the City to monitor.

Local Density Bonus: Berkeley cannot prevent developers from providing on-site affordable units in order to qualify for the benefits of the State Density Bonus (SDB). It would be possible for the City to simply require some projects to pay the full fee even if they provide on-site units for the purpose of accessing the density bonus but this would impact the feasibility of small projects and projects that provide large bedroom count units. An alternative would be for the City to adopt a limited local density bonus program which applied only for these two project types which would not be allowed to provide on-site units under the City's ordinance. This local bonus could provide access to all of the benefits of the State Density Bonus (including additional density and other planning concessions) in exchange for a fee rather than on site units. We calculated that, for a typical rental project, providing 11% (of base units) on-site increases the cost of compliance relative to paying the fee only by $10 per foot. If a local density bonus offered the benefits of 35% increased density and other concessions to projects that paid $55 per square foot (instead of $45) this option would be no more or less attractive to developers than the current State Density Bonus option. In other words, if a small project or co-living project could access the density bonus in exchange for a fee of $55 per square foot they would generally choose that option rather than provide onside units.

12. Reduce fees for small projects/missing middle projects

Proposed Changes:

12.1. Eliminate exemption for 1-4 unit projects and replace it with a tiered fee that steps up gradually for projects with 1-25 units by reducing the fee by $1 per foot for each unit count less than 25.

Alternative:

12.2. Eliminate exemption for 1-4 unit projects and expect even very small projects to contribute the full fee.

Background and Analysis:

Currently both the AHMF and the Inclusionary housing ordinance exempt buildings with 1-4 units. Presumably this exemption was motivated by a sense that very small projects would have a harder time absorbing the cost of including affordable housing into their budgets. While this is often, but not always true, there is no reason to think that suddenly at 5 units a project budget can easily afford to comply. There is a much wider range of "missing middle"-type projects that may be feasible in Berkeley at a small scale which may also struggle to meet the City's requirements. Many of these projects may be larger than 5 units.

At the same time there has been significant concern in Berkeley about the potential that developers may segment larger projects into several smaller 4-unit projects in order to circumvent the inclusionary housing or AHMF ordinance. By exempting very small projects but then suddenly imposing the full requirement at a certain point, the current ordinance creates an incentive to build projects in 4-unit increments.

One approach to this challenge would be to impose the fee (at some level) on every project (with the exception of Accessory Dwelling Units), but to reduce the fee for small projects. Many cities just impose a lower fee for smaller projects. San Jose just amended their program to set the fee at a level that is 50% lower for projects with fewer than 20 units. However this approach still creates a big step up at 20 units. An alternative is to gradually phase in higher fees as the number of units increases. Figure 10 shows the schedule that would result from a $1 decrease in the fee for each unit count below 25.

Figure 10: Proposed schedule for small project phase-in

Units	Fee Per Uni	Per Foot	Total Fee
25	39,746	45	993,650
24	38,863	44	932,706
23	37,980	43	873,529
22	37,096	42	816,118
21	36,213	41	760,473
20	35,330	40	706,596
19	34,447	39	654,484
18	33,563	38	604,139
17	32,680	37	555,561
16	31,797	36	508,749
15	30,914	35	463,703
14	30,030	34	420,424
13	29,147	33	378,912
12	28,264	32	339,166
11	27,381	31	301,186
10	26,497	30	264,973
9	25,614	29	230,527
8	24,731	28	197,847
7	23,848	27	166,933
6	22,964	26	137,786
5	22,081	25	110,406
4	21,198	24	84,791
3	20,315	23	60,944
2	19,431	22	38,863
1	18,548	21	18,548

Reducing the fee for small projects would have an uncertain impact on Berkeley's future fee revenue. The City would collect less revenue from 5-24 unit projects but would begin collecting fees from 1 to 5 unit projects. And by encouraging more small projects to select the fee option, the proposed change might reduce the number of projects with 1-5 BMR units that need to be monitored while also increasing total fee revenue.

13. Cap the annual rate of rent increases

Proposed Change:

13.1. Limit the annual increase in BMR affordable rents for occupied units to no more than the annual change in the Consumer Price Index. Allow rents to be marked up to the maximum 'affordable' rents based on HUD AMI calculations whenever units turn over.

Alternative:

13.2. Limit the annual rent increase to no more than 10% in any single year.

Background and Analysis:

Sudden increases in the Area Median Income can result in large changes in the allowable affordable rent which can negatively impact BMR tenants. Similarly, some property owners fail to annually adjust rents as allowed by the current ordinance. They are allowed to 'catch up' by raising the rents by a larger amount later but this too can cause sudden shocks in rent for vulnerable tenants.

Limiting the amount that rent can be increased for occupied BMR units would provide stability and predictability for tenants. This change, however, will have a real impact on the operating budgets of projects with on-site BMR units. The current rules tie rents to changes in the Area Median Income (AMI). Over the past several decades the AMI has risen quite a bit faster than the Consumer Price Index. While the AMI is generally a measure of what people in the area earn, the rapid increase in the AMI has been driven, in part, by the growth of high paying jobs and the influx of higher income residents throughout the Bay Area rather than a rise in the wages and other income that lower-income residents earn. As a result, 'affordable' rents have risen faster than what many low-income tenants can comfortably 'afford.'

Limiting the rate of rent increases will have a real impact on the operating budgets of buildings that include on-site units. As long as units remain occupied, the rents may rise more slowly than building operating costs. It is likely that this change in policy will make the on-site option slightly less attractive to developers and increase the likelihood of projects selecting to pay the fee in lieu. However, a growing number of Berkeley projects are including on-site VLI units and then filling those units with residents who hold housing vouchers. The policy should continue to allow these properties to collect the full voucher payment standard which might increase faster than CPI without impacting affordability for the residents. This reliance on vouchers should mean that many density bonus projects would not be impacted by a rule tying rent increases to CPI.

14. Administrative changes

a. Require compliance plans

Proposed Change:

14.1. Require developers of new projects to submit a simple Affordable Housing Compliance Plan at the time of Building Permit application indicating their proposed strategy for complying with the requirements of the AHR ordinance. Allow revisions to this plan at any time prior to the Certificate of Occupancy.

Background and Analysis:

Currently developers can wait until their projects are built and applying for a Certificate of Occupancy to inform the City of their intended strategy for complying with the AHMF or Inclusionary Housing Ordinance, including whether they intend to pay the fee or provide some or all of the required on-site units. Requiring developers to indicate a proposed strategy earlier in the process a) allows city staff to make plans for monitoring units or project fee revenue so that it can be invested quickly and b) ensures that developers are fully understanding Berkeley's requirements early in the development. Many cities provide a simple fill in the blanks template for this purpose and allow projects to change their plans at a later date by simply submitting a revised plan.

b. Authorize administrative citations

Proposed Change:

14.2. Explicitly authorize the creation of a proposed schedule of fines for monitoring and compliance violations to be included in the program guidelines.

Background and Analysis:

Other jurisdictions have found that having the ability to impose monetary fines is an effective tool for encouraging developer and property manager compliance with monitoring requirements. Explicitly authorizing citations in the ordinance might help clarify staff's authority to impose these penalties.

c. Authorize annual monitoring fee for ownership units

Proposed Change:

14.3. Explicitly authorize the City to charge a fee annually to BMR Homeowners to offset monitoring costs. The fee would be assessed only on new owners going forward. The fee would be included as a housing cost in calculation of the affordable sales prices so that buyers will pay less for their units in order to make the fee affordable.

Background and Analysis:
The City currently charges owners of rental properties an annual monitoring fee but no fee is charged to BMR homeowners.

d. Deduct required fees/costs from gross rent

Proposed Change:

14.4. Clarify this language in the ordinance to make it clear that mandatory fees or costs must be deducted from the maximum allowable rent for BMR rental units.

Background and Analysis:
Currently the AHMF ordinance calls for reduction in the maximum rent based on the anticipated cost of tenant paid utilities. Some properties impose other mandatory costs such as renter's insurance or administrative fees. Current practice is to deduct any cost which is mandatory for BMR tenants from the maximum gross rent to calculate the affordable rent but this requirement is not currently outlined in the ordinance.

Appendix A: Financial Feasibility Analysis

Overview:

The City of Berkeley retained Street Level Advisors to recommend changes to its existing affordable housing requirements. Our policy recommendations are intended to increase the construction of affordable units while maintaining the financial feasibility of market-rate development. We conducted a financial feasibility study in order to understand the current housing development environment and predict how our recommended policies might affect this environment. Our study relies on a static pro forma analysis to estimate the return on investment that can be generated by typical residential developments in Berkeley.

For the rental prototype, we used a common measure of return known as yield on cost (YOC), or a project's net operating income divided by the total development cost. Based on a review of current market conditions in Berkeley and the East Bay, we concluded that projects earning a yield of at least 5.0% would be "feasible" meaning that they would likely be able to secure investment. Projects earning slightly less (between 4.5% and 5%) would be considered "marginal" meaning that some projects in this category might be able to obtain financing while others might not. Projects earning less than a 4.5% yield we considered "infeasible."

For ownership projects, the Yield on Cost cannot be calculated so we used a different measure of profitability: Profit as a percent of development cost, also called Return on Cost. Because of the lack of recent condo projects in Berkeley, we were unable to objectively determine the minimum necessary profit as a percent of cost for local ownership projects. As a point of reference, a common rule of thumb used in other studies considers projects "feasible" when profit exceeds 10-15% of development cost.

Our rental prototype is a 6-story, 72-unit development with a small amount of commercial space on the ground floor and one parking space for every two housing units. We estimate that under current conditions, rental projects that choose to pay Berkeley's Affordable Housing Mitigation Fee (AHMF) earn a Yield on Cost of 5.08% - just barely above the feasibility threshold. Projects that provide on-site units earn a yield of 4.94% just under the threshold into the marginal category. However, economic conditions are in flux due to the COVID-19 pandemic, and new projects could become more feasible in the near future.

Our prototype, revenue, and cost assumptions are based on prior studies, comparable projects, and other market research. The remainder of this memo describes these assumptions and our methodology in more detail.

Prior Studies:

Over the past decade, the City of Berkeley has evaluated the financial feasibility of its affordable housing requirements several times. Our analysis builds on the feasibility studies conducted by these consultants.

The 2015 Bay Area Economics Nexus Study contains one section that addresses the financial feasibility of new rental housing. BAE estimated the Return on Cost for a four-story, mixed-use development in the C-W zoning district at two different fee levels. In their simplified model, all 81 units are 900 square foot two-bedrooms. BAE's analysis suggested that the fee could be increased to $34,000 while maintaining the minimum necessary return on cost.

The 2016 Strategic Economics Feasibility Analysis tested a wider range of fee levels. Using a four-story model that is almost identical to the BAE model, they estimated the Yield on Cost at six fee levels between $0 and $84,391. Strategic Economics considered Yield on Cost because it is a more accurate measure of feasibility for rental housing than Return on Cost. The minimum Yield on Cost required for feasibility in their analysis was 6.5% reflecting the higher interest rate environment in 2016. They found that new developments would be marginally feasible if the fee was $45,000 and infeasible if the fee was any higher.

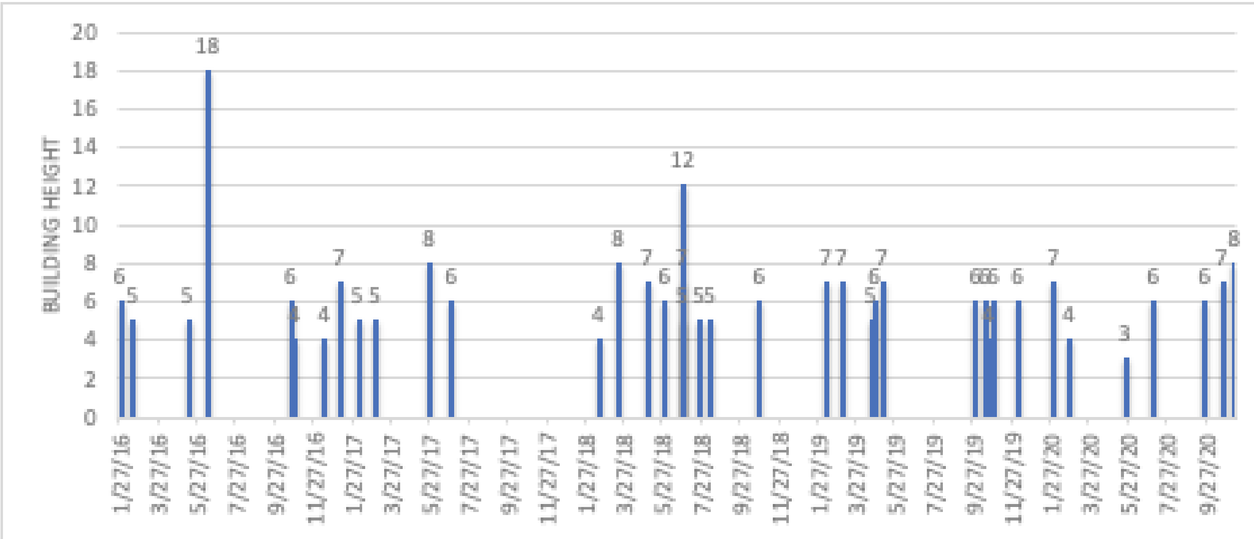
Together, the BAE and Strategic Economics analyses suggested that new rental development would be feasible at fee levels equivalent to and above the current level.

Prototypes Studied:

Rents and construction costs have escalated dramatically since the Strategic Economics analysis was published. Our recent data shows that rents are over 30% higher and the construction costs per square foot in our model below are nearly double those in the Strategic Economics report. Our specific revenue and cost assumptions are described in the next section.

Because of these trends, the type of development project that both BAE and Strategic Economics used as their example would no longer be financially feasible in Berkeley. Driven by these same trends, the types of development projects being undertaken in Berkeley have shifted. Developers have responded to rising construction costs by building smaller units, fewer parking spaces and taller buildings on smaller lots. Figure 1 shows that developers of multi-family buildings in Berkeley have been primarily proposing 5-8 story buildings in recent years.

Figure 1: Permit applications for residential project with >20 units 2016 – 2020



Following these trends, we have used a slightly different prototype to test feasibility in today's market. Our prototype is a 6-story building with wood frame residential over a concrete podium. Where BAE and Strategic Economics assumed a 1-acre lot, we have assumed a half-acre. Our prototype includes 72 housing units and 3,000 square feet of commercial space (see Figure 2). Our model is taller but contains fewer units and less commercial space than the 4-story, 81-unit Strategic Economics prototype. The units in our model are also smaller than the units in the Strategic Economics analysis. Based on a detailed study of recent projects in Berkeley we have assumed a mix of 450 square-foot studios, 725 square-foot one-bedrooms, and 925 square-foot two bedrooms where Strategic Economics had assumed that all units would be 900 square-foot two-bedrooms.

Recent data also suggests that the capitalization rate for residential development is 4.0-4.25%, significantly lower than the cap rate of 5.0% which Strategic Economics used in 2016. Additionally, the parking ratio of 1 space per unit in the Strategic Economics study reflects the minimum parking requirements in much of the city at the time their study was published. As parking minimums have recently been eliminated, we assume a more modest parking ratio of 0.5 spaces per unit, consistent with observed occupancy rates.

Figure 2: Rental Prototype Details

Prototype Feature	Value
Project	
Construction Type	Wood Frame over Concrete Podium
Stories	6
Site Area in Acres	0.5
Gross Sq Ft	68,950
Residential Sq Ft	52,750
Common Area Sq Ft	13,200
Commercial Space Sq Ft	3,000
Residential Units	
Number of Units	72
Number of Studios	14
Number of 1BD Units	36
Number of 2BD Units	22
Studio Sq Ft	450
1BD Sq Ft	725
2BD Sq Ft	925
Parking	
Parking Ratio (Spaces / Units)	0.5
Number of Spaces	36

For the ownership prototype, we assumed larger average unit sizes. In order to facilitate comparison, we assumed a building of the same overall size (square feet) but with fewer units of larger size. We also assumed the same parking ratio (.5) as our rental prototype in order to facilitate comparison, though it is more likely that a condo project would provide 1 space per unit which would lower overall returns.

Figure 3: Ownership Prototype Details

Prototype Feature	Value
Project	
Construction Type	Wood Frame over Concrete Podium
Stories	6
Site Area in Acres	0.5
Gross Sq Ft	61,490
Residential Sq Ft	52,290
Common Area Sq Ft	9,200
Commercial Space Sq Ft	0
Residential Units	
Number of Units	56
Number of 1BD Units	35
Number of 2BD Units	18
Number of 3BD Units	3
1BD Sq Ft	850
2BD Sq Ft	1,025
3BD Sq Ft	1,365
Parking	
Parking Ratio (Spaces / Units)	0.5
Number of Spaces	28

Revenue and Cost Assumptions:

The revenue and cost assumptions used in our pro forma analysis are shown in Figure 4. The main inputs that influence project revenue are the residential rents. Our analysis of data from CoStar, RealPage, and Berkeley's Rent Stabilization Board led us to estimate that typical rents for newly built apartments in Berkeley would be approximately $3,100 for studios, $4,000 for one-bedrooms, and $4,500 for two-bedrooms. Other revenues include commercial rents of $3 per square foot and parking revenue of $200 per space per month. These assumptions reflect rents that would have been assumed by projects prior to the pandemic. During the pandemic, rents throughout the region have fallen dramatically with some estimates showing rent in Berkeley down by 5 to 10% along with significant increases in apartment vacancy rates. The best available evidence suggests that these decreases are likely temporary. Developers in

Berkeley are moving forward on construction of new apartments which would not be financially feasible if the pandemic rents and vacancy rates were permanent.

The key input driving costs is the construction cost estimate of $400 per gross square foot. This assumption is based on actual construction costs for comparable East Bay projects and studies that estimate the construction cost inflation rate. Other important development cost assumptions include land at $8,000,000 per acre and parking construction costs at $50,000 per space. We assume that soft costs - which include architecture, engineering, and inspection fees – equal 22% of hard costs. Our estimates for land, parking, and soft costs rely on data from several comparable Berkeley projects but, of course, these figures vary quite a bit between actual projects. Financing costs include the construction loan interest rate of 4.5% and the initial construction loan fee of 1.0%. Our financing cost assumptions are based on independent estimates of prevailing interest rates and data from comparable Berkeley projects.

The current inclusionary housing rules require that 80% of on-site VLI units be offered first to housing voucher holders. Berkeley allows developers to charge the full Housing Authority Payment Standard rent for these units even when it exceeds the rent that could be charged to a VLI tenant with no voucher. We have assumed these slightly higher rents for 80% of any VLI units on-site.

Note: The COVID-19 pandemic caused an uncommon economic crisis that the US is only beginning to recover from. It is unclear what persistent impacts the pandemic will have on the housing development environment and consequently on our model. We cannot be certain how inputs such as construction costs and rents will change or how investors that finance development will respond to this uncertainty. Over the past year construction costs have continued to rise while rents have fallen across the Bay Area. This combination has made it harder for real estate projects to achieve feasibility, but these trends do not appear to be lasting. Our model reflects conditions as they were at the beginning of 2020.

Figure 4: Revenue and Cost Assumptions

Revenue/Cost	Assumption	Unit of Measure
Residential Revenue		
Studio Rent	$3,100	per unit per month
1BD Rent	$4,000	per unit per month
2BD Rent	$4,500	per unit per month
Ownership Revenues		
1BD Price	$725,000	per unit
2BD Price	$925,000	per unit
3BD Price	$1,100,000	per unit
Other Revenues		
Commercial Rent	$3.00	per sq ft per month
Parking Revenue	$200	per space per month
Development Costs		
Construction Costs	$400-$415	per gross sq ft
Land Costs	$8,000,000	per acre
Parking Costs	$50,000	per space
Soft Costs	20-22%	of hard costs
Financing Costs		
Construction Loan Interest Rate	4.5%	annual rate
Loan to Cost Ratio	70%	of total cost
Period of Initial Loan	24	months
Initial Construction Loan Fee	1.0%	of loan
Average Outstanding Balance	60%	of loan
Operating Costs		
Rental Vacancy Rate	4%	of units unoccupied
Rental Operating Cost	35%	of revenues

Policy Scenarios:

We built a financial model using the project prototypes described above in order to test the impact of potential changes to the City's affordable housing requirements on the feasibility of residential development. We ran the model for the same hypothetical projects under a number of different policy assumptions. First, we established the returns that would be available under the current law depending on which performance option the project selected.

Current Program Scenarios

Rental

Current Fee: Under this alternative, we assume the hypothetical project elects to pay Berkeley's current Affordable Housing Mitigation Fee (AHMF) of $39,746 for each unit in the building. A project paying the fee would not be eligible for the density bonus.

Current On-site Units: Under this alternative, we imagine the project selecting instead to provide on-site units as provided under the current AMHF ordinance. The project would provide 7 Very Low Income (VLI) units (10%) and 7 Low Income (LI) units (10%). For the sake of comparison, we have assumed that the project does not access the density bonus though it would likely qualify.

Current Mixed Compliance – 11% VLI: The most common approach in recent years has been for projects to provide enough units on-site in order to maximize the benefits of the State Density Bonus and pay a fee to cover the remainder of their obligation under Berkeley's AHMF. Prior to 2021, projects that provided 11% of base units as restricted Very Low Income units on-site would receive the maximum 35% density bonus. We have assumed that our hypothetical project could increase the total number of housing units by 35% (from 79 to 97) with no increase in land costs[10].

Current Mixed Compliance – 15% VLI: In 2020 the State Legislature approved an expansion of the State Density Bonus which allows greater increases in density in exchange for more affordable housing units on-site. Now a developer can request a 50% increase in residential density if they provide, for example, at least 15% Very Low Income units. We have analyzed the profitability of a hypothetical

[10] Our analysis does not attempt to capture the full financial value of the density bonus. In addition to the right to build more housing units on a given site, state law allows developers to request a number of planning concessions based on the amount of affordable housing that they provide. These concessions clearly provide real value which can increase the profitability of projects. However, because the dollar value of concessions is abstract and highly dependent on the particular project, we have not attempted to include this in our financial modeling. As a result, our conclusions are likely to slightly understate the difference between the returns from density bonus and other types of projects.

project assuming a 50% increase in units with 15% of base units (10% of total units) restricted to VLI residents under current rules.

Ownership

Current On-site Compliance: A for-sale project that elected to provide on-site affordable units would be required to provide 20% of units to be affordable to and occupied by Low Income households earning less than 80% of AMI.

Current In Lieu Fee (Based on Sales Prices): Alternatively, a developer may pay an in lieu fee calculated based on 62.5% of the difference between the market price and the affordable price. This approach results in a different level of fee for different projects depending on the market prices of units in the project. For the sake of illustration, we estimated a range of current market prices based on average condo sales prices listed on Zillow.com and calculated the fee which would be due.

Figure 5: Condo Pricing Assumptions

Estimated BMR Ownership Fees 2021						
Unit Size	**Sq Ft**	**Estimated Market Price**	**Affordable Price**	**In Lieu Fee**	**In Lieu Fee Per Unit**	**In Lieu Fee per Sq Ft**
1BR	814	$703,556	$250,650	$283,066	$56,613	$70
2BR	1117	$853,125	$282,000	$356,953	$71,391	$64
3BR	1571	$995,797	$313,200	$426,623	$85,325	$54

Alternative Policy Options

In addition to evaluating the performance of the prototype under the current policy rules, we considered several alternative scenarios based on the proposed policy changes.

Rental

$45 Per Square Foot Fee: Under this alternative, we assumed that the City adopted a fee of $45 per gross square foot (excluding parking and commercial space) and we evaluated the returns for a prototype project that elected to pay this fee in full with no on-site BMR units.

$55 Per Square Foot Fee: This alternative assumes full payment of a higher fee per square foot.

Mixed Compliance (Weighted)– 11% VLI: In this alternative we have assumed a $45 per square foot fee is adopted along with an adjusted formula for determining the remainder fee for mixed compliance projects. We assumed that each 1% of VLI units provided would reduce the fee due by $3 per square foot and each 1% of LI units would reduce the fee by $1.50 per square foot. In this alternative, we assume a project that provides 11% of the base units (equivalent to 8% of total units) as VLI in order to receive a 35% density bonus.

Mixed Compliance (Weighted)– 15% VLI: In this alternative we assume a project that provides 15% of the base units (equivalent to 10% of total units) as VLI in order to receive a 50% density bonus under state law. As with the scenario above, this alternative assumes that the formula for calculating the remaining fee for mixed compliance provides greater reductions for projects that provide VLI units.

Ownership

$45 Per Foot Fee: In this scenario, we have assumed that the City adopts a single per square foot rate of $45 which would be applied to all projects whether rental or ownership.

$55 Per Foot Fee: This alternative assumes that the City adopts a higher per square foot fee for ownership projects (or any project that records a condominium map).

Findings:

For rental projects, our model suggests that most projects would not be able to feasibly comply with the current 20% on-site requirement but that projects that choose to pay the fee or access the State Density Bonus by providing some units on-site and paying a partial fee would both earn returns that are just barely above the threshold which we identified for feasibility (5% yield on cost). The returns for density bonus projects are comparable to the fee alternative because the additional cost of providing some units on-site is offset by the additional benefit of building more units on the same site.

For this prototype, the proposed fee of $45 per gross square foot results in a virtually identical return. A higher fee ($55 per square foot) would result in a marginal but very close to feasible return. The proposed approach of providing more 'credit' for projects that provide on-site VLI units than those that provide LI units results in modest increases in the returns available to mixed compliance projects that take advantage of the State Density Bonus. While this small difference is not critical for this prototype, it is likely that there would be projects where this difference would result in on-site affordable units in projects that would otherwise have paid the fee entirely (or not moved forward at all).

Figure 6: Comparison of Returns - Rental

Scenario	Base Units	Bonus Units	LI Units	VLI Units	Fee $	Yield on Cost	% of Base	% of Total
Current Policy								
$39,746 Per Unit Fee	72	0	0	0	$2,861,712	5.08%	0%	0%
Onsite Units	72	0	7	7	$0	4.94%	19%	19%
Mixed Compliance - 11% VLI	72	25	0	8	$2,265,522	5.07%	11%	8%
Mixed Compliance - 15% VLI	72	36	0	11	$2,106,538	5.10%	15%	10%
Proposed Alternatives								
$45 Per Foot Fee	72	0	0	0	$2,967,750	5.07%	0%	0%
$55 Per Foot Fee	72	0	0	0	$3,627,250	4.99%	0%	0%
Mixed Compliance (Weighted) - 11% VLI	72	25	0	8	$2,350,809	5.10%	11%	8%
Mixed Compliance (Weighted) - 15% VLI	72	36	0	11	$2,184,925	5.12%	15%	10%

For ownership projects, we found that neither the current fee nor the current on-site requirement resulted in profit as a percent of development cost above the benchmark of 10%. The proposed switch to a $45 per square foot fee would result in profit just above 10% while a higher $55 per square foot fee would result in profit closer to 9%.

Figure 7: Comparison of Returns - Ownership

Scenario	Total Units	LI Units	Fee $	Profit % of Cost
Current Policy				
Current Fee (based on sale prices)	56	0	$3,810,847	8.00%
Onsite Units	56	11	$0	1.13%
Proposed Alternatives				
$45 Per Foot Fee	56	0	$2,767,050	**10.88%**
$55 Per Foot Fee	56	0	$3,381,950	9.16%

Sensitivity Analysis:

Revenues and Costs: The feasibility projections above are highly sensitive to assumptions about rents and construction costs. These assumptions are different from one project to the next and change in somewhat unpredictable ways over time. The heat table in Figure 8 below shows the yields on cost that our model predicts for a range of different scenarios in regard to construction costs and rents for our prototype. This table shows returns for a 6 story rental project that selects the proposed $45 per square foot fee option. The axes indicate how these scenarios compare with current construction cost and rent levels. The (0%, 0%) cell in the center of the table represents the estimated yield on cost for projects given today's rents and construction costs. The (-10%, 10%) cell in the top right represents the yield for projects if rents decrease 10% and construction costs increase 10% relative to current levels. Green cells represent situations in which projects will be feasible, with expected yields on cost at or above 5%. The redder a cell is, the less feasible projects will be. A rise in construction costs will increase the total development cost of a project, making it less feasible. A drop in market rents will decrease the rental income a project can expect, also making it less feasible.

Figure 8: Yield on Cost Sensitivity to Rents and Construction Costs

		Construction Costs										
		-10%	-8%	-6%	-4%	-2%	0%	2%	4%	6%	8%	10%
Rents	-10%	5.07%	4.96%	4.85%	4.75%	4.65%	4.56%	4.47%	4.38%	4.30%	4.22%	4.14%
	-8%	5.18%	5.07%	4.96%	4.85%	4.76%	4.66%	4.57%	4.48%	4.40%	4.32%	4.24%
	-6%	5.29%	5.18%	5.07%	4.96%	4.86%	4.76%	4.67%	4.58%	4.49%	4.41%	4.33%
	-4%	5.40%	5.29%	5.17%	5.07%	4.96%	4.86%	4.77%	4.68%	4.59%	4.50%	4.42%
	-2%	5.52%	5.40%	5.28%	5.17%	5.07%	4.96%	4.87%	4.77%	4.68%	4.60%	4.51%
	0%	5.63%	5.51%	5.39%	5.28%	5.17%	5.07%	4.97%	4.87%	4.78%	4.69%	4.61%
	2%	5.74%	5.62%	5.50%	5.38%	5.27%	5.17%	5.07%	4.97%	4.87%	4.78%	4.70%
	4%	5.85%	5.73%	5.60%	5.49%	5.38%	5.27%	5.17%	5.07%	4.97%	4.88%	4.79%
	6%	5.97%	5.84%	5.71%	5.59%	5.48%	5.37%	5.26%	5.16%	5.07%	4.97%	4.88%
	8%	6.08%	5.95%	5.82%	5.70%	5.58%	5.47%	5.36%	5.26%	5.16%	5.07%	4.97%
	10%	6.19%	6.06%	5.93%	5.80%	5.69%	5.57%	5.46%	5.36%	5.26%	5.16%	5.07%

With current rents and construction costs, projects are just barely feasible with estimated yields of 5.07%. However, if rents rise by just 2% and construction costs remain flat, projects will become more feasible with expected yields of 5.17%. As expected, yields increase as rents rise and decrease as construction costs rise. Yield on cost is just slightly more sensitive to construction costs than rents. Construction costs falling by 10% will increase yields a bit more than rents rising by 10%.

Parking: The feasibility of new rental development in Berkeley is also highly sensitive to assumptions about the amount of parking provided. The parking ratio is the number of parking spaces divided by the number of residential units. Before 2021, Berkeley's zoning regulations mandated projects in some districts to have parking ratios of at least 1. Berkeley recently eliminated minimum parking requirements, making parking ratios of 0 possible.

Figure 9 shows the yields on cost that our model predicts for a range of parking scenarios. In our model, parking ratios are used to describe the amount of parking provided by a project. Creating parking spaces is expensive and limits the area available for the project's residential or amenity space. As a result, higher parking ratios reduce a project's yield on cost and projected feasibility. Our model predicts that projects that provide no parking will be solidly financially feasible while projects that provide 1 space per unit are not currently feasible.

Figure 9: Yield on Cost Sensitivity to the Parking Ratio

Parking Ratio				
0.00	0.25	0.50	0.75	1.00
5.34%	5.20%	5.07%	4.94%	4.82%

Even with strong financial incentives and no City parking requirements, most projects are likely to include significant amounts of parking. Depending on the location of the project, tenants may see parking as a necessary building amenity. In other cases, project investors insist on some level of parking. When Seattle eliminated parking requirements in many parts of the city, one study found that most projects still included parking. In areas with no parking requirement, nearly 30% of new buildings provided no parking after the mandate was removed. But the remaining 70% provided parking even though it was not required by the city. Figure 10 shows that the average project provided .49 parking spaces per unit.

Figure 10: Seattle parking reform results

Minimum Number of Required Parking Spaces/Unit	Number of Development Projects	Average Parking Ratio	Buildings That Exactly Met Requirement	Buildings That Provide Parking Above Requirement		
				<0.5 Spaces/Unit	0.5-1.0 Spaces/Unit	>1.0 Spaces/Unit
0	570 (65.6%)	0.49	29.5%	24.2%	39.0%	7.4%

Attachment 2: Summary of Council Referrals Related to City Affordable Housing Requirements

Referral	Short Description
Conducting an Analysis of Increasing Inclusionary Housing over Affordable Housing Mitigation Fee (9/10/19)[1]	A companion to 4/23/19 referral to analyze feasibility of ideas from Homeless Commission including: -Requiring on-site units instead of a fee -Requiring an increased number of inclusionary units -Providing an incentive to build on-site instead or pay the fee (similar to the Adeline Corridor Specific Plan) -Prohibit payment of fee in certain geographic areas -Ensure access for extremely low-income persons and persons experiencing homelessness.
Refer to the City Manager and the Housing Advisory Commission to Consider Reforming the Affordable Housing Mitigation Fee (4/23/19)[2]	Evaluate the possibility of changing the City's affordable housing fee structure, including converting the current per-unit calculation to a per-square foot fee, per-bedroom fees and/or whether to apply a different fee methodology in different parts of the city.
Affordable Housing Mitigation Fee Resolution to Close a Loophole for Avoiding the Mitigation Fee through Property Line Manipulation (2/19/19)[3]	Close a loophole allowing avoidance of the affordable housing fees through lot line manipulation by requiring the fee from projects on contiguous lots under common ownership with the potential for 5 or more units across all lots. Modify the structure of the in lieu fee for ownership projects to a flat per unit fee similar to the rental fee. Evaluate the appropriateness of the fee level.
Encourage Long Term Tenant Stability (11/27/18)[4]	Modify the Berkeley Municipal Code (BMC Section 21.28.080) to allow tenants buying their units (through Tenancy-In-Common) to pay only 50% of the Affordable Housing Mitigation Fee at the time of conversion. This is the same benefit offered to owners who convert rental buildings that they also live in to ownership.
Rectify Discrepancy Regarding Inclusionary Units in Live/Work Housing (9/13/2018)[5]	Eliminate the affordable housing requirements in the Berkeley Municipal Code (BMC Sections 23C.12 and 23E.20.080) and instead apply the Inclusionary Housing or AHMF ordinances to Live Work exactly as they are applied to other projects.
Pilot Density Bonus Program for the Telegraph Avenue Commercial District to Generate Revenue to House the Homeless and Extremely Low-Income Individuals (5/30/17)[6]	Create a new City Density Bonus policy for the Telegraph Avenue Commercial District to generate in-lieu fees instead of on-site affordable housing units.

[1] https://www.cityofberkeley.info/Clerk/City_Council/2019/09_Sep/Documents/2019-09-10_Item_62b_Companion_Report_Conducting_an_Analysis.aspx
[2] https://www.cityofberkeley.info/Clerk/City_Council/2019/04_Apr/Documents/2019-04-23_Item_29_Refer_to_the_City_Manager_and_the.aspx
[3] https://www.cityofberkeley.info/Clerk/City_Council/2019/02_Feb/Documents/2019-02-19_Item_21_Refer_to_the_Planning_Commission.aspx
[4] https://www.cityofberkeley.info/Clerk/City_Council/2018/11_Nov/Documents/Item_20_Rev_Maio.aspx
[5] https://www.cityofberkeley.info/Clerk/City_Council/2018/09_Sep/Documents/2018-09-13_Item_17_Rectify_Discrepancy_Regarding_Inclusionary.aspx
[6] https://www.cityofberkeley.info/Clerk/City_Council/2017/05_May/Documents/2017-05-30_Item_41_Planning_Commission_Referral.aspx