PC C+O 9/20/11
ITEM D2

DRAFT MEMORANDUM

To: Regina Copic

From: Darin Smith

Subject: University Neighborhood Overlay Affordable Housing In-Lieu Fee Update; EPS #21010

Date: May 24, 2011

The Economics of Land Use

Economic & Planning Systems, Inc. (EPS) has been retained by the City of Austin's Neighborhood Housing and Community Development (NHCD) department to assist in the update of the University Neighborhood Overlay (UNO) affordable housing in-lieu fee. NHCD has requested this work under the direction of Council Resolution 20091210-044, which reads as follows:

> The City Manager is directed to work with stakeholders to make recommendations on a potential revision to the calculation of the in-lieu fee for affordable housing in the University Neighborhood Overlay and initiate the necessary code amendments. This potential revision should include a provision to set the in-lieu fee by ordinance with an annual adjustment to reflect current market conditions in a manner and format similar to the in-lieu fees for affordable housing incentives in CBD, DMU, PUD, and NBG zoning districts. . . The City Council requests both the Planning Commission and the Community Development Commission to consider and make recommendations on the proposed code changes and potential fee adjustments.

This memorandum provides an overview of the current fee program and alternative calculations for updating the existing fee in a manner similar to those other fees referenced above, and then presents additional items for consideration that have emerged through staff and EPS discussions with area stakeholders.

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Summary of Findings

This analysis has led to the following findings:

1. The current in-lieu fee in the UNO area is $0.50 per gross leasable square foot, and has not been updated since 2004.
   The current fee level has not been a significant deterrent to the overall feasibility of new housing construction in the UNO area, which has produced over 2,800 units (with at least 10 percent of those being "affordable") and also generated over $1.0 million in in-lieu fee revenues that have been used to subsidize still more affordable units in the area. Overall, the UNO program has been considered successful at creating new market-rate and affordable housing, and there is concern among stakeholders about changes that would detract from this past success.

2. An update to the fee can occur in several ways, each of which has different implications for the feasibility of development in the UNO area.

   a. An update based on changes to the Consumer Price Index (CPI) since 2004 would be most consistent with the "manner and format" of updates for other housing fees in the City, and would result in a fee of $0.59 per gross leasable square foot. This level of fee increase is marginal and would have a negligible effect on the feasibility of market-rate housing in the UNO area.

   b. An update that resets the fee to reflect the actual cost to subsidize the construction of units affordable at 65 percent of median family income would result in a fee of $1.89 per gross leasable square foot. This fee level would represent a 278 percent increase to the existing fee, and could reduce the feasibility and production of new housing in the UNO area by significantly reducing the achievable profit margins, thus making new projects less attractive than maintaining existing properties or pursuing alternative investments.

   c. An update that resets the fee to reflect the subsidies that have been requested by UNO area non-profit housing providers would result in a fee of $1.00 per gross leasable square foot. This fee adjustment would double the existing fee but should not significantly reduce the feasibility or production of market-rate housing construction.

3. **EPS recommends that the UNO housing fee be updated to $1.00 per gross leasable square foot, consistent with the third calculation approach described above. Compared to the current fee, this fee level would better reflect the actual costs of developing the affordable units that are required under the UNO ordinance but still represent a manageable cost to the developers. Going forward, the fee can be increased each year based on changes in the CPI, as other similar fees in Austin are updated.**

4. While the UNO housing program is widely regarded as successful, certain attributes of the UNO ordinance may be worthy of refinement to enhance and expand upon its successes going forward. These may include the process for setting affordable rents, the imposition and timing of various City development fees, and the elimination of minimum parking standards. These and other potential refinements to the UNO ordinance may enhance the feasibility of private development in the area, and may also enable economic trade-offs that

result in higher affordable housing production and/or funding (including a higher in-lieu fee than has been calculated herein). Analysis of such adjustments is beyond the scope of this current analysis, but may be considered as part of a modest overhaul of the UNO ordinance.

The University Neighborhood Overlay

The UNO ordinance, adopted in 2004, provides landowners and developers in the area west of the University of Texas campus the option to build higher density housing than is allowed under the base zoning. In exchange for exercising this option, the developers must adhere to certain design and use standards, and are required to provide affordable housing units within their projects. Each project is required to provide at least 10 percent of the units at prices affordable to households earning less than 80 percent of median family income for the Austin metropolitan area. In addition, the developers must provide another 10 percent of the units at prices affordable at less than 65 percent of median income, or else pay a fee in lieu of the provision of these units. The in-lieu fees must be used to subsidize affordable housing units within the UNO area, and are intended to provide housing at prices affordable to households earning 50 percent of median income or less.[1]

The in-lieu fee was set in 2004 at $0.50 per gross leasable square foot in the entire building. For example, a building with 200,000 leasable square feet would pay a total fee of $100,000. This approach contrasts with other in-lieu fees set in other Austin areas, which applies the in-lieu fee only to the square footage added through an exercised density bonus. For example, a project exercising a density bonus in the North Burnet Gateway area must pay a fee of $6.00 per square foot of additional building space above the basic zoning allowance, and in the Central Business District, the in-lieu fee is $10.00 per bonus square foot. Though there is significant variation from property to property based on height limits and other factors, developers in the UNO area have indicated that on average the UNO ordinance roughly has doubled the achievable density compared to the underlying zoning allowances. Using this doubling as a rule of thumb, the same 200,000-square foot building cited in the previous example would include 100,000 square feet of "density bonus" square footage as a result of the UNO ordinance, and thus the $100,000 in-lieu fee paid is the equivalent of $1.00 per density bonus square foot.

Clearly, the UNO in-lieu fee is significantly lower per square foot than are the fees required in other Austin areas (essentially, $1.00 per bonus square foot vs. $6.00 to $10.00 per bonus square foot). Some local stakeholders cite this difference as one reason for the UNO ordinance's success at generating high-density housing, whereas few projects elsewhere in the City have exercised their density bonus opportunities. Other reasons may also be equally important, such as the demand for housing in different parts of the City and the timing within the market cycle at which the bonus opportunities became available. For example, the UNO ordinance passed in 2004—several years before the housing market downturn—and affects an area of the City where student housing has been in very high demand and relatively short supply for several decades.

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[1] In certain specific locations within the UNO area, developers seeking to exercise the higher density opportunities are not given the option to pay the in-lieu fee, and instead must provide the additional 10 percent of units, and they must be offered at prices affordable at 50 percent of median income rather than 65 percent of median income. Such locations are not the norm, and because the in-lieu fee is not applied in those locations, those examples are not the focus of this analysis.

It is also important to note that the UNO in-lieu fee represents only a portion of the affordable housing requirements in that area. Unlike elsewhere in Austin where fees are allowed in lieu of a project's total affordable housing requirement, UNO developers must provide on-site units affordable at 80 percent of median income, and can only exercise the in-lieu fee for the units required at 65 percent of median income. As such, it is arguably appropriate that the UNO in-lieu fees would be significantly lower than those imposed in other areas of the City.

Whatever the specific reasons for its success, it is clear that the UNO ordinance has facilitated the addition of many new units to the City and neighborhood's housing stock. Since 2004, NHCD reports that over 2,800 new housing units have been built under the UNO ordinance, with virtually no new development occurring under the base zoning in the same area. This figure includes those units offered at 80 percent or less of median income, which at a minimum of 10 percent has yielded at least 280 affordable units in the area in the past seven years. During this same period, the UNO developments have generated over $1.0 million in in-lieu fee revenues, some of which have already been used to support the construction of one project (College House's "Super Co-op"), and another project seeking to use the fee funds is in the predevelopment stage (Inter-Cooperative Coalition's "Eden House").

Updating the In-Lieu Fee

The UNO in-lieu fee of $0.50 per total leasable building square foot has not been updated since its initial adoption in 2004. There are several potential ways that the fee might be updated, each of which is described and calculated below. For each option, the impact of the fee amendment on the feasibility of new development is generally assessed. In each case, EPS has estimated the total fee and net feasibility impact on a typical UNO two-bedroom unit in a 60-foot building with podium parking. Such units are assumed to have an average size of 950 leasable square feet per unit and cost roughly $200,000 per unit to construct (including land, hard and soft costs, financing expenses, and City fees including the current in-lieu fee at $0.50 per leasable square foot) on which a typical developer may seek a profit of $15,000 per unit (7.5 percent). These assumptions do not represent any specific projects in the UNO area, but have been vetted for general consensus among UNO developers, property owners, and housing advocates.

Option #1: Adjustments based on the Consumer Price Index

The Council Resolution directs the in-lieu fee update to include "an annual adjustment to reflect current market conditions in a manner and format similar to the in-lieu fees for affordable housing incentives in CBD, DMU, PUD, and NBG zoning districts." Taking this direction at its most limited and literal meaning, the existing in-lieu fee would be updated using precisely the same approach outlined for updating fees in other areas.

Ordinance 20080131-132 is entitled "An Ordinance Amending Chapter 25-2 of the City Code to Provide Development Regulation Incentives for Affordable Housing; and Establishing a Fee for Affordable Housing and Community Benefits" and is most instructive for this effort. Among other amendments, that ordinance adds Section 25-2-586 (I), which stipulates the following:

> The fee to be paid for each square foot of gross floor area required by Subsections (C) and (D) for the Housing Assistance Fund and the Community Benefits Fund is established by ordinance and adjusted annually in accordance with the Consumer Price Index all Urban Consumers, US City Average, All Items (1982-84 = 100), as published by the

> Bureau of Labor Statistics of the United States Department of Labor. The city manager shall annually determine the new fee amounts for each fiscal year, beginning October 1, 2008, and report the new fee amounts to the city council.

The CPI reflects changes to the costs of a "representative basket of goods and services," including food, clothing, energy, medical care, transportation costs, and shelter. The CPI is used as a general indicator of the cost of living and can also reflect the costs of selected inputs to business activities, but is not specifically tied to the inputs and outputs of real estate development. Still, it is a widely accepted indicator of current market conditions, and would be readily available as a factor for adjusting the UNO in-lieu fees each year or as often as desired.

According to the Bureau of Labor Statistics, the CPI has increased by 17.2 percent between the end of 2004 and February 2011. Applying this 17.2 percent CPI increase to the $0.50 fee established in 2004, the updated fee in 2011 would be $0.59 per gross leasable square foot. Applying this $0.59 per square foot fee to a typical UNO area unit of 950 square feet, the total in-lieu fee paid for that unit would be $561, whereas the existing $0.50 fee would be $475. The difference is $86 per unit, or 0.6 percent of the $15,000 profit sought for the unit. [2] In EPS's opinion, this very small change to the costs of development in the UNO area will not have a material impact on project feasibility or the overall production of housing in the area.

Option #2: Resetting the Fee Based on Actual Financing Gaps (Maximum Fee)

Many affordable housing in-lieu fees across the country are calculated as the subsidy required to construct the units that the developer is otherwise supposed to be producing. In theory, this approach equalizes the impact of the decision to build the units or pay the in-lieu fee, rather than providing an economic incentive to pay the in-lieu fee. In the UNO example, this would mean that the fee would generate sufficient revenues to fully fund the difference between what it costs to construct a housing unit and the unit's value if it is rented at prices affordable to households earning 65 percent of median income or less. By all accounts, this approach is *not* how the fee was originally set in 2004 at $0.50 per gross leasable square foot.

When calculating an in-lieu fee using this approach, it is important to build consensus regarding the physical and economic assumptions used. EPS has shared our assumptions and calculations with a group of developers, property owners, and housing advocates, and the figures below reflect the general consensus of that group regarding the economic characteristics of UNO projects.

Most UNO projects have met their on-site affordability requirements by offering studio apartments at prices affordable to individuals earning up to 80 percent of median income for a one-person household. This practice has reflected the fact that the "affordable" rent at this income level is actually comparable to the market rates for studio units, whereas "affordable"

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[2] Please note that throughout this analysis, EPS assumes that neither land acquisition costs nor market-rate rents will be adjusted to reflect the added costs of paying the in-lieu fees. This assumption is based on discussions with various stakeholders representing both for-profit and affordable housing interests, who have indicated that UNO property owners have high and inflexible expectations regarding land values, and that student housing rents are too competitive to expect to be able to raise rents in a certain project to cover added capital or operational costs.

rents for larger units (such as two-bedrooms) are well below what the market will bear. As such, there is little or no subsidy or even "opportunity cost" associated with using studio units to meet the affordability requirements at 80 percent of median income.

At 65 percent of median income, however, the results change because the allowable rents fall short of achievable market rates. As shown on **Table 1**, a studio unit built in a building with a 60-foot height limit is estimated to cost roughly $107,000 to develop, including land, hard and soft costs. A developer seeking a 7.5 percent profit on that unit (roughly $8,000) would require a unit value of $115,000. By contrast, the allowable rent at 65 percent of median income would support a unit value of only $97,000, resulting in an $18,000 shortfall or implicit subsidy required to construct that studio unit.

That $18,000 shortfall per affordable unit must be converted into an in-lieu fee. For example, a 200-unit project with an average size of 950 leasable square feet per unit would have 190,000 gross leasable square feet. The same project would be required to provide 10 percent of its units (20 units) at prices affordable at 65 percent of median income, or else pay the in-lieu fee. If the project pays the in-lieu fee, the total fee would be $360,000 ($18,000 per affordable unit times 25 units), or $1.89 per gross leasable square foot.

An in-lieu fee at this $1.89 level would represent a 278 percent increase to the existing fee. While still representing a relatively small proportion of the overall costs of construction, it would significantly detract from the project's profitability. For example, a 950 square foot 2-bedroom unit would pay an in-lieu fee of $1,796. Comparing the $1,796 per unit in-lieu fee cost to the current $475 under the existing fee, the net new cost would be roughly $1,321 per unit. This added cost would reduce the targeted $15,000 profit margin by 9 percent, representing a much less financially attractive development project than with the existing fee or with the CPI-adjusted fee. In EPS's opinion, this fee level would deter the construction of new housing in the UNO area unless offset by corresponding adjustments in market conditions, land costs, or other factors.

Option #3: Resetting the Fee Based on Local Subsidy Examples

An alternative to the maximum fee set under Option #2 above is to calculate a fee based on the subsidies that have been sought by providers of affordable housing in the UNO area. This approach posits that the in-lieu fees should be adequate to produce the otherwise required number of units, but may take advantage of certain efficiencies or extraneous funding sources available to non-profit builders.

Both College House and the Inter-Cooperative Coalition operate multiple co-operative housing projects in the UNO area, and have been engaged in recent development projects. The College House's Super Co-op project received $837,500 of UNO in-lieu fees to help finance the construction of housing for 176 people ("beds"). The Inter-Cooperative Coalition's Eden House project is seeking $500,000 in UNO in-lieu fee assistance for 35 beds. In both cases, the developer/operators are leveraging the value of existing assets (land already owned, cash flow from existing operations, etc.) rather than taking the typical for-profit developer's perspective that the projects are "stand-alone" deals that must be independently feasible.

The average UNO in-lieu fee subsidy received or sought for these two projects is roughly $9,500. Converting this subsidy to a fee per square foot requires several assumptions. Again assuming a 200-unit project with an average of 950 leasable square feet per unit, the project would be required to build 20 units priced up to 65 percent of median income. Applying the $9,500 per bed subsidy to those 20 required units yields a total subsidy requirement of $190,000. That total subsidy divided by the 190,000 square feet of leasable space translates to a fee of exactly $1.00 per leasable square foot.

This $1.00 fee would represent a 100 percent increase over the existing fee level, but would still represent a small fraction of the overall costs of development ($950 per unit out of roughly $200,000 total costs for a 950 square foot, 2-bedroom unit). The additional $475 fee above the existing $475 fee would represent about 3 percent of the desired $15,000 profit margin per unit—not nearly as significant as the 9 percent reduction under Option #2, but still several times the impact on profitability as under the Option #1 CPI-adjusted fee. In EPS's opinion, an impact of this magnitude on profitability is unlikely to deter the construction of new housing in the UNO area.

Recommendation

EPS recommends that the UNO fee be increased from $0.50 to $1.00 per gross leasable square foot. While this is a major increase from the current fee, the resulting fee level is not so significant that it will thwart market-rate development projects. Moreover, it bears a relationship to the subsidies actually required to produce the affordable housing units that the market-rate projects are obligated to provide, albeit reflecting aggressive assumptions about the resources available to other not-for-profit builders through other means. Because the original fee had no such relation to the actual cost of subsidizing affordable units, increasing the existing fee to $0.59 per leasable square foot based on the CPI would only continue that logical and mathematical disconnect. And the "maximum fee" of $1.89 per leasable square foot would represent both a major fee increase and a significant deterrent to the overall goal of increasing the housing supply in the UNO area.

Ongoing Annual Adjustments

The provision of a method to update the housing fee annually is important so that, over time, the fee will continue to generate adequate revenues to fund the desired housing rather than represent a more and more attractive financial alternative to the developer. The UNO fee was established in 2004, and has not been adjusted since that time, despite changes to market conditions, development costs, income limits for qualifying households, etc. For this reason, and for consistency with other similar policies in Austin, City Council directed staff to not only update the UNO fee, but to "include a provision to set the in-lieu fee by ordinance with an annual adjustment to reflect current market conditions in a manner and format similar to the in-lieu fees for affordable housing incentives in CBD, DMU, PUD, and NBG zoning districts."

Ordinance No. 20080131-132 amended the City Code and included the following language in Section 25-2-586(I) regarding "Affordable Housing Incentives in a Central Business District (CBD) or Downtown Mixed Use (DMU) Zoning District":

> The fee to be paid for each square foot of gross floor area required by Subsections (C) and (D) for the Housing Assistance Fund and the Community Benefits Fund is established by ordinance and adjusted annually in accordance with the Consumer Price Index all Urban Consumers, US City Average, All Items (1982-84 = 100), as published by the

Bureau of Labor Statistics of the United States Department of Labor. The city manager shall annually determine the new fee amounts for each fiscal year, beginning October 1, 2008, and report the new fee amounts to the city council.

In addition to the CPI cited above, alternative indicators such as *Engineering News-Record*'s Construction Cost Index, HUD's income limits or median income levels, or the region's median home prices have been used in other jurisdictions across the nation. While each of these indicators may be more directly related to specific inputs in the housing cost and value equation than the CPI, none of these alone captures that full equation. For example, an adjustment based on median income levels may omit critical inputs such as land prices, construction or operating cost fluctuation, changes in lending practices, etc., and is no more likely than the CPI factor to represent the actual annual changes in subsidy required to construct affordable housing. The requirement for such accuracy in annual updates would essentially require a full study such as this one, which is time-consuming and introduces a significant element of uncertainty for a developer planning a project that may take several years to complete.

The CPI adjustment is consistent with existing City policy, is less volatile and more predictable than other indicators may be, and is readily available as a reliable indicator of general economic trends. **For these reasons, EPS recommends the CPI adjustment as the basic approach for annual fee adjustments to the UNO housing fee.** This CPI-based approach to annual adjustments can be applied to *any* fee level selected as a result of this update, not just Option #1 above that was calculated using the CPI adjustment. Many communities opt to use this indicator for regular *annual* updates, but they may include provisions in their ordinances that more thorough recalculations be conducted every five years, ten years, or "from time to time" to ensure that the full and dynamic equation of housing costs and values continues to be reasonably reflected in the fee program.

Other Issues for Potential Refinement

In EPS's discussions with stakeholders, and in past discussions between stakeholders and staff in which EPS did not take part, several issues were raised as being problematic within the UNO affordable housing program. Pursuant to the agreement between NHCD and EPS, analysis and recommendations regarding these issues are outside the scope of EPS's current assignment. However, they are potentially significant in their ability to enhance the feasibility of market-rate development and to provide more funding for affordable housing units. Each such idea recognizes the fact that the UNO area is unique in its orientation toward student housing. Examples include the following:

- **Pricing by Bed** – At present, most housing in the UNO area with more than one bedroom is leased on a per-bed or per-bedroom basis, rather than as a single lease for the entire unit. This practice is typical of university neighborhoods, and reflects the fact that students are co-habitating without actually co-mingling their financial resources the way a typical family would. However, the City's affordable housing policy requires each "affordable" unit in the UNO area to be priced the same as it would be in a more traditional family neighborhood, with the maximum price for a two-bedroom unit being far less than twice the maximum price for a one-bedroom unit. As a result, almost all of the "affordable" units in the UNO area are studios or one-bedrooms. A different approach might allow the developers to have their larger units be acknowledged as meeting the affordability goals if each occupant pays rent priced at or below 80 percent of median for a single-person household, or simply to require that a certain percentage of "beds" rather than "units" in the UNO area be provided at affordable prices.

- **Parkland Dedication** – The original in-lieu fee was adopted before the parkland dedication fee was adopted. Some stakeholders have argued that the parkland dedication fee not only adds a cost to development that was not anticipated when the original in-lieu fee was set, but also that the need for parkland in the UNO area is met by facilities that students have access to (and pay for) through the University of Texas.

- **Parking Requirements** – The UNO ordinance allows developers to reduce their parking requirements compared to other areas of the City. However, some developers have indicated that the minimum parking standards should be eliminated, as many students may not require parking spaces at all and may choose to live in a facility with no parking. If the market would support such buildings, the feasibility of such buildings can be significantly enhanced by removing the parking costs, for which the monthly parking charges typically may cover only a portion of the actual cost of developing and operating the space.

- **Affordable Pricing Tied to Units Rather than to Occupants' Incomes** – In the UNO area and elsewhere in the City, the City's current policy sets a unit's affordable price according to the actual income of the occupants rather than setting a standard affordable rent. For example, a household earning 75 percent of median income would pay less for an affordable unit than would a household earning 80 percent of median income. This approach adds significant administrative costs for both the developer and the City (setting and monitoring a unique rent price for each individual household), introduces uncertainty for the developer's pro forma (how much can they really rent the unit for?), and potentially creates situations in which households are denied housing because the developer is seeking another qualified household with a slightly higher income. An alternative approach, as used in most cities with whose affordable housing programs EPS is familiar, would be to set the affordable price per unit at a certain level (e.g., a 2-bedroom unit can be rented for $1,240) and to require verification that the occupant's income does not exceed the maximum allowed.

Clearly, these and other potential revisions to the UNO ordinance go beyond the update of the in-lieu fee provision. However, given the effect that each such adjustment may have on the feasibility of development and the trade-offs available, it may be possible to refine the UNO ordinance to enhance both the feasibility of market-rate housing development and the number and quality of affordable units built in the area.

Table 1
Conceptual Development Pro Forma Assumptions -- STUDIO UNITS at 65% MFI
UNO Affordable Housing In-Lieu Fee Calculation, EPS #21010

Item	Figure
Development Program Assumptions	
60' Multifamily with Podium Parking	
Density/Acre	100
Average Gross Unit Size	425
Average Net Unit Size (excluding garage)	350
Average Number of Persons per Household	1
Parking Spaces/Unit	1
Cost Assumptions	
Land/SF	$60
Land/Unit	$26,136
Direct Construction Costs/Gross SF	$110
Direct Construction Costs/Unit	$46,750
Parking Construction Costs/Space	$20,000
Subtotal, Direct Costs/Unit	$66,750
Indirect Costs as a % of Direct Costs	20%
Indirect Costs/Unit	$13,350
Parkland Dedication Fee	$650
Total Cost/Unit	***$106,886***
Maximum Supported Home Price	
Monthly Rent Price at 65% MFI	$784
Total Rent/Year	$9,402
Parking Revenues/Year	$1,188
Gross Revenues/Year	$10,590
Operating Expenses per Unit/Year	$2,800
Property Taxes	$2,467
Total Expenses/Year	$5,267
Net Operating Income/Year	$5,323
Capitalization Rate	5.50%
Total Supportable Unit Value	***$96,787***
less Developer Profit at 7.5% of Costs	-$8,016
Financing Gap per Unit	**-$18,115**

Sources: Austin for-profit and nonprofit developers; Travis County Tax Assessor; and Economic & Planning Systems, Inc.

[1] Reflects prices that local developers have indicated that property owners in the UNO area have requested for their properties based on UNO allowances.

[2] Includes costs for architecture and engineering; entitlement and permits; project management, marketing, commissions, and general administration; financing and charges; insurance; and contingency. Proportion diminishes as costs are spread over more units.

[3] Market rate rent assumes $1.70/SF/mo. for 50-60 foot buildings and slight premiums for additional height, based on recent comparables in the UNO area.

[4] Assumes parking spaces rent for $99/mo.

[5] Travis County Tax Office indicates properties in UNO area would pay 2.3079% total taxes per year based on 2010 rates. EPS applied this rate to construction and land costs, excluding profit.