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REPORT TO COUNCIL

SUBJECT
Consideration of a Rental Housing Impact Fee for New Market-Rate Rental Housing Developments

REPORT IN BRIEF
In July 2012, Council directed staff to study the nexus between the production of new market-rate rental housing and the demand for affordable rental housing. Staff commissioned Economic & Planning Systems, Inc. (EPS) to conduct this nexus study to assess the impact of new market-rate rental developments on the demand for additional affordable rental housing in the City, and what nexus-based fee would fully mitigate this impact. This rental housing impact fee nexus study, provided in **Attachment 1,** was originally completed in 2013, at which time it was released for public review, culminating with Council consideration in August 2013. The nexus study was revised in December 2014 to update the income and rent data from 2013 levels.

The nexus study is very similar in format and methodology to the commercial linkage fee (a.k.a. "Housing Mitigation Fee") nexus study considered by Council on December 9, 2014; however the study analyzed the impacts of new rental housing developments, whereas the commercial linkage fee study analyzed those of new commercial developments (such as office, retail, and lodging projects).

The nexus study analyzed the economic impacts of new market-rate rental developments, which tend to generate new demand for neighborhood-serving retail, hospitality, and personal services businesses, which then generate demand for additional affordable housing for the newly hired and primarily lower-income workers in those businesses. In short, the household spending of the residents of the new rental projects creates a need for additional affordable housing for the new employees hired to address increased demand primarily at local neighborhood-serving businesses.

The nexus study determined that an impact fee is warranted to mitigate the impact of new market-rate rental housing on the need for affordable housing in Sunnyvale. The study analyzed various typical rental unit sizes, and found that the maximum supportable impact fee for new apartments ranged from $47,200 for a studio apartment to $85,300 for a three-bedroom apartment. Supportable fees could range from $55 to $98 per square foot, depending on unit size. The study notes that charging the maximum impact fee could make future rental projects less feasible and/or possibly hinder the rate of future rental housing development, which could further exacerbate the supply of affordable housing.

During the public outreach conducted on the original version of the nexus study released in 2013, staff presented, for discussion purposes, a fee range of $10 - $20 per habitable square foot. Since that time, Mountain View increased its rental impact fee to $17 per square foot, and San Jose enacted a new rental impact fee, also at $17 per square foot. Given the evolving local context of these fees, staff has proposed several alternatives in this report for Council consideration.

Staff Recommendation:

Alternatives 1, 2, 5 and 6:

1. Direct staff to prepare an ordinance authorizing a rental housing impact fee for new market-rate rental housing developments.

2. Direct staff to set the initial rental impact fee at $17 per habitable square foot, adjusted annually for inflation as part of the City Fee Schedule.

5. Direct staff to include in the ordinance an option to allow developers to provide affordable units within a project instead of paying the impact fee, as well as other possible options such as providing off-site affordable units or dedicating land.

6. Direct staff to return to the City Council within two years to reevaluate and possibly adjust the rental housing impact fee rate and/or fee structure to address any issues that may arise in the first two years of implementation.

Public hearings on this proposal were held by the Housing and Human Services Commission (HHSC) in January and by the Planning Commission (PC) in February. The HHSC voted unanimously to recommend to Council Alternatives 1, 5, 6, and 7. Alternative 7 consisted of setting the initial fee level at $21 per habitable square foot, with the caveat that if the then-pending feasibility study were to indicate that a $21 fee was infeasible, Council could adjust it downward. An excerpt of the minutes from the HHSC meeting is provided in **Attachment 2**. The feasibility study later indicated that the $21 fee level would be feasible.

The PC voted 4-3 to recommend to Council Alternatives 1, 3, 5, and 6. Staff reported verbally during the meeting that Alternative 3 should have shown an initial fee level of $21 (rather than $20 as erroneously noted in the staff report). Two of the three commissioners who voted against this motion were not against the fee in general; they just disagreed on the fee rate, with one preferring $17 per square foot and the other preferring $26 per square foot. The third commissioner voting against the motion objected to adding a new development fee based on his reservations about the nexus study, which he felt relied on several unsupported assumptions. Minutes from the PC meeting are provided in **Attachment 3**.

BACKGROUND

With a growing economy, Sunnyvale and the South Bay are strong markets for new housing, but a sufficient supply of affordable housing continues to be a formidable challenge. In recent years, regional housing costs have escalated sharply, increasing at a faster rate than incomes for most households. Consistent with regional trends, rents in Sunnyvale have steadily increased, and currently range from an average of $2,500 for a studio to $4,600 for a three-bedroom apartment in recently built Sunnyvale rental projects. These rents are not affordable to households with incomes at or below the area median income, which is currently$105,500 for a household of four.

While local rents have increased sharply, public sector funding for affordable housing has declined significantly. Evolving case law has restricted local governments' abilities to regulate housing costs and/or require housing affordability through various regulatory mechanisms, and the primary costs to develop affordable housing have increased sharply (due to increases in land and construction costs, driven by the very high levels of private sector development in the region). Faced with few remaining methods for producing the affordable housing required of them by various state and federal mandates and public expectations, many local governments have recently explored housing impact fees as a tool to replace some of those lost in recent years, including the cities of Mountain View, San Jose, and Sunnyvale, among others throughout California.

As noted above, in July 2012, Council directed staff to prepare a nexus study to determine the nexus between new market-rate rental housing developments and the increase in local demand for affordable rental housing. In order to complete the study, the City retained EPS which has conducted many studies of this type for clients throughout California and several previously for the City. The scope of work provided to EPS for the current rental study included:

- Define the impact that development of new market-rate rental housing has on local demand for affordable housing; and
- Determine a defensible nexus-based fee amount that could be charged to market-rate developers to off-set the increased demand for affordable housing created by their projects.

EPS completed an initial Nexus-Based Affordable Housing Fee Analysis for Rental Housing in early 2013. Staff held outreach meetings with the community, held several public hearings at commission meetings, and presented EPS' report and community comments at a Council study session held on August 13, 2013. During that study session, Council directed staff to report back later with information addressing several questions raised by stakeholders in attendance, as well as some raised by Council, including:

- What gives the City the legal authority to impose a rental impact fee?
- Provide information on the parcel tax and/or construction excise tax ideas proposed by some stakeholders as possible alternatives to a new rental impact fee;
- Analyze the proposed rental impact fee in the context of other City fees already imposed on new rental developments, to show the total financial impact of city fees on development projects; and
- Complete the nexus study of the commercial linkage fee, so the impacts of both rental and commercial projects can be fully considered before taking action on a rental impact fee.

The first three issues listed above are addressed in the Discussion section of this report.

The fourth item listed above was completed on December 9, 2014, when Council held a public hearing on proposed changes to the City's commercial linkage fee (see RTC 14-0673). Following that hearing, Council directed staff to prepare an ordinance to expand the commercial linkage fee to all office/industrial, retail, and lodging development projects in any zone, to set the initial fee at $15 per net new square foot for all office/R&D and industrial projects ($7.50 for the first 25,000 square feet) and $7.50 per square foot for all retail and lodging projects, both adjusted annually for inflation as part of the annual fee schedule adoption. Additional detail on that action is available in the December 9, 2014 meeting minutes. Since this issue has been addressed, it will not be analyzed further in this report, however this action provides important context for the staff recommendation herein.

EXISTING POLICY
Sunnyvale General Pan, Housing Element:

Goal A: Assist in the provision of adequate housing to meet the diverse needs of Sunnyvale's households of all income levels.

Policy A.7: Support collaborative partnerships with non-profit organizations, affordable housing builders, and for-profit developers to gain greater access to various sources of affordable housing funds.

ENVIRONMENTAL REVIEW
This action is not a project for purposes of CEQA because it is an administrative or organizational activity that will not result in a direct or indirect physical change in the environment (Guideline 15378 (b)(4)).

DISCUSSION
The recently updated "Nexus Based Affordable Housing Fee Analysis for Rental Housing" prepared by EPS is provided in **Attachment 1**. This study analyzed the impacts that new market-rate rental apartments have on the local economy by increased demand for local goods and services generated by the residents moving into the new market-rate housing. The study followed several steps, including:

- Estimating the subsidy required to build units affordable to households at various income levels;
- Determining the demand for goods and services generated by the tenants of new market-rate units, the new jobs created by that demand, and the affordable housing needs of workers in those jobs; and
- Combining the per-unit subsidies required with the affordable housing demand projections to compute the maximum supportable nexus-based affordable housing fee per market-rate unit.

The updated analysis demonstrates that a nexus-based fee is warranted for new market-rate rental housing developments. The maximum supportable impact fee for new apartment developments ranged from $47,200 for a studio to $85,300 for a three-bedroom unit. On a square foot basis, the supportable fee levels range from $55 - $98, with the higher amount per square foot on the smaller units, since the project impacts do not increase directly in proportion to the size of the units. The study does not recommend imposing these maximum fee levels due to the potential feasibility impacts on desirable housing developments, which could hinder the City's efforts to meet its regional housing needs allocation (RHNA) and further exacerbate the supply of affordable housing. With this consideration, fee levels in the $17 to $26 per square foot range are presented as alternatives for consideration by Council, as discussed further below.

Survey of Bay Area Cities with Rental Impact Fees

As part of the initial nexus study in 2013, staff surveyed several cities near Sunnyvale and other comparable cities in the Bay Area which had rental impact fees at that time. A relatively small number of cities had such a fee then, while many others were considering establishing such a fee. The fees in these cities ranged from $3 to $19.50 per square foot at that time.

In late 2014, the City of San Jose adopted a new rental impact fee of $17 per square foot, with a 2.4

percent annual adjustment for inflation, and the City of Mountain View increased its rental impact fee from $10.26 to $17 per square foot. Given this evolving regional context, staff analyzed a fee rate consistent with the current rate used by Mountain View and San Jose, as discussed further below.

A nexus study prepared by Keyser Marston Associates (KMA) for the City of San Jose, published in October 2014, included a similar fee survey. The KMA survey also included the City of San Francisco, which has a rental impact fee structured as a per-unit fee that equates to approximately $59 per square foot. Since the time of staff's original fee survey, several additional cities have enacted rental impact fees, including East Palo Alto, Santa Rosa, Daly City, and Emeryville.

Based on the most current data available to staff, as shown in **Attachment 4**, the average rental impact fee in all the Bay Area cities known to have such fees, including San Francisco, is $23.50 per square foot. If San Francisco is not included, because its fee rate is an outlier at the high end and it exhibits considerably different real estate conditions than the South Bay, the average fee rate among the remaining cities surveyed is $20.23 per square foot. Among just the three cities in Santa Clara County with a rental impact fee, the average is $12.33 per square foot, although one of those cities, Cupertino, is an outlier at the low end. Cupertino staff has indicated that the City plans to commission a new nexus study this fiscal year to possibly adjust its housing fees.

As mentioned above, San Jose recently adopted a rental impact fee of $17 per square foot based on a nexus study prepared by Keyser Marston Associates, Inc. (KMA). In addition to the nexus study, KMA also prepared a supplemental report with a comparison of various development fees assessed on new rental developments by cities selected as comparable to San Jose. This comparison included housing impact fees, other impact fees, school fees and construction taxes, but did not include planning and building permit fees, or water and sewer connection fees. For Sunnyvale, KMA showed an estimated possible future rental impact fee range of $10 - $20 per square foot. This chart is provided in **Attachment 5**.

Follow-Up Analysis Requested by Council in 2013

As noted in the Background section, at its August 2013 study session, Council asked staff to address several questions in the final report to be prepared regarding the rental impact fee proposal. Below is a response to those questions:

1. Legal Authority to Impose a Rental Impact Fee

Local governments in California are authorized to require developers to mitigate the identified impacts of their developments under several state laws, including the California Environmental Quality Act (CEQA), the Quimby Act, and the Mitigation Fee Act. Mitigation may include either direct provision of facilities or technical solutions (i.e., storm water filtration systems) by the developer to address the identified impact, or payment of a fee to a public agency which can use those funds to address the impact on behalf of the developer.

A variety of City impact fees are currently imposed based on these authorities, including traffic impact fees, park dedication in-lieu fees, and the recently expanded commercial impact fee. School districts also impose school mitigation fees. The rental impact fee, like the others noted, would be consistent with the City's exercise of its authority to require mitigation of development impacts under state law.

2. Possible Taxes as Alternative Revenue Sources for Affordable Housing

Two of the alternative revenue generators suggested by several stakeholders during the 2013 outreach process included a parcel tax and a construction excise tax. The City currently charges a construction tax at a rate of 0.54 percent of total building valuation for all new construction projects except for residential remodels. This tax, collected at building permit issuance, generates revenues for the City's General Fund, and therefore would not represent a new source of affordable housing funding for the City. If the City were to use a significant portion of these General Fund revenues to address the new affordable housing needs generated by new rental developments, it would have to reduce the level of existing public services provided to current residents using general fund resources.

A ballot measure could be proposed to increase the construction tax or create a new special tax to generate new funds for producing affordable housing. If the funds generated by the new or increased tax were to be reserved for a specific purpose, such as affordable housing, it would be considered a special tax. A ballot measure to enact a special tax must be approved by two-thirds of the voters, while general-purpose tax measures require approval by a majority of the electorate.

The parcel tax idea was also suggested during the outreach meetings, and did not meet with much enthusiasm from local community members in attendance. A parcel tax is a flat fee imposed on all residential and/or all commercial parcels within the taxing agency's boundaries. California law requires such property-based special taxes to be approved by a two-thirds vote of the electorate, and the tax must bear a reasonable relationship to the services provided or made available to the taxpayers.

The parcel tax idea was explored briefly in Mountain View prior to its initial adoption of a rental impact fee in 2012, and it was determined to be unlikely to pass as a local initiative with the two-thirds vote required, based on some initial opinion polling commissioned by the City. Likely voters were asked if they would vote for a property tax to help the City pay for affordable housing development. Fifty-three percent of the Mountain View voters surveyed expressed support for a $59 parcel tax per parcel for single-family or condos/townhomes with an individual parcel number or, in the case of multi-family properties with one parcel number, the parcel tax rate would have been $59 per unit. Their support increased to 59 percent when those polled were given more information about the proposed tax. Support peaked at 66.2 percent, still short of the 67 percent required, when the suggested parcel tax was decreased to $29.

In addition to the challenge of passing a new parcel tax, there are some logical inconsistencies with that approach. Local property owners who would be paying the parcel tax are not the entities realizing significant financial gains from new development projects, nor creating the impacts to be mitigated in the first place. Rather, those entities include the developers of these projects and their investors. It would seem more logical and consistent with current city practice to require developers to mitigate the impacts of their projects rather than to impose new taxes on local property owners, who are largely not gaining any direct financial benefits from new rental developments.

However, the usual rationale for a parcel tax is not necessarily impact-based, but instead reflects the community's priorities and desired benefits from the tax revenues, such as new or improved schools, libraries, parks, public safety or affordable housing. Voters tend to be more likely to vote for a tax that they believe would have tangible direct benefits to them. Likely voters, more of whom tend to be homeowners, may not feel that they would receive any direct benefit from additional affordable housing.

Nonetheless, if Council is interested in exploring the parcel tax idea further, the City would need to commission a similar opinion poll to determine if the idea might be feasible in Sunnyvale. If such polling shows the measure might pass, in order to place a parcel tax measure on the local ballot, Council would need to hold a public hearing and adopt a resolution to place a parcel tax on the ballot at the next general election. Such a tax would also need to consider potentially competing items on the same ballot, such as school tax or bond measures.

3. Total City Development Fees on Rental Projects

Sunnyvale collects various fees to cover the cost of reviewing projects, processing permits, and providing necessary public services and infrastructure related to new development projects. Table 39 of the recently adopted 2015-2023 Housing Element displays the total City fees paid by a recent typical multi-family rental project. As shown in **Attachment 6**, these fees added up to a total of $20,508 per rental unit. These fees do not include school fees, which are charged by and paid directly to various school districts depending on project location. If a rental impact fee was established at a rate of $17 per square foot, assuming an average unit size of 950 square feet, this fee would represent an increase of nearly 79 percent in total City fees imposed on new rental units.

As mentioned above, a supplemental report prepared by KMA for San Jose in October 2014 compared the total of selected development fees and taxes in San Jose and several other cities, including Sunnyvale and Mountain View. A chart provided in KMA's report (and in **Attachment 5)** shows the total of certain fees, including: housing impact fees, other development impact fees, construction taxes, and school impact fees. Permitting and utility connection fees were not included in these fee totals. In contrast to the KMA data, the total Sunnyvale fees provided by staff in **Attachment 6** includes all applicable City fees, such as permitting and utility connection fees, but did not include school fees, which are charged directly by the districts, not the City.

Attachment 7 provides the total City fees for a hypothetical 100-unit project (including the same fees as in **Attachment 6**), with or without a potential rental impact fee (RIF) at three rates: $17, $21 and $26 per square foot, respectively, assuming an average unit size of 950 square feet. The table below illustrates the percentage increase in total City fees on new apartments that would occur if the RIF were enacted at one of the rates shown.

Total of Current City Fees	**Proposed Rental Impact Fee Rate**	**Total City Fees with RIF**	**Percent Increase in City Fees due to RIF**
$2,050,813	$17	$3,665,813	79%
$2,050,813	$21	$4,045,813	97%
$2,050,813	$26	$4,520,813	120%

A number of attendees at the outreach meetings and study sessions, including some Councilmembers, expressed concern that these new fees, particularly if set too high, might create a disincentive and/or feasibility challenges for new rental project development, which could potentially further constrain overall housing supply and would therefore be counterproductive to improving overall housing affordability in the City. Although the feasibility study indicates a $21 fee is feasible under current market conditions, if the City wishes to take a slightly more cautious approach in order to provide a bit more room for error should development costs and/or rental revenues change in the future, a $17 fee would be a more prudent and cautious approach. It would also reflect the same fee recently set by Mountain View and San Jose. Since other cities are considering such a fee, staff further suggests that the Council revisit this fee in two years, similar to the Council's direction on the housing linkage fee.

Alternatives to Fee Payment

During the 2013 public outreach process, many stakeholders, including developers, asked staff to provide alternatives to payment of the fee, such as an option to provide affordable units within their projects, rather than paying the fee.

For various public policy reasons, many communities prefer that new residential developments include dwelling units at a variety of price points or affordability levels within each new project. Sunnyvale has historically encouraged developers to provide affordable units on site rather than pay in-lieu fees, as it takes a considerable staff effort to initiate, fund and produce an affordable housing project, usually requiring a close public/private partnership with an affordable housing developer. Mixed-income projects by market-rate housing developers are typically supported to provide a range of housing options for various income levels within a project, and such projects can be well-integrated into a neighborhood.

Because mixed-income projects only provide a limited supply of affordable units, Sunnyvale and other cities also assist in the development of new housing projects consisting entirely of affordable units, because otherwise the shortage of affordable units would be even greater. Additionally, these affordable housing projects, usually developed by non-profit housing developers, often include beneficial tenant services for lower income residents, and serve tenants with incomes even lower than those served by mixed-income projects. However, these subsidized projects often cost more on a per-unit basis than units provided by private developers, due to a wide variety of requirements imposed on such projects through local, state, and federal regulations, such as prevailing wage requirements or other construction and financing-related costs.

For these reasons, staff has developed a suggested method for allowing developers an alternative of providing affordable units in lieu of paying an impact fee. In order to develop this alternative, staff compared the rental impact fee, shown in the table below at several possible rates, to the subsidies that would otherwise be required to provide the affordable rental units in a subsidized housing project, using the per-unit subsidy levels shown in the updated nexus study. For simplicity's sake, this analysis used very low income units only (50 percent of area median income), as this affordability level is the most common level provided in subsidized housing projects. Staff divided the total rental impact fee that would be imposed on a hypothetical 100-unit project by the per-unit subsidy required per very low income unit, to determine the number of very low-income units that could be provided by the developer as an acceptable alternative to paying the fee.

Potential Rental Impact Fee and Equivalent Very Low Income (VLI) Units

for 100-Unit Rental Project

Impact Fee Per Square Foot	Total Impact Fee for 100-Unit Project*	Subsidy Required per VLI Unit	Equivalent Number of VLI Units
$17	$1,615,000	$302,496	5.3
$21	$1,995,000	$302,496	6.6
$26	$2,470,000	$302,496	8.2

* Assuming an average unit size of 950 square feet.

This alternative could include allowing developers to provide VLI units in lieu of paying all or a portion of the rental impact fee incurred by their projects. The City would set the equivalent fee amount for each VLI unit annually or as often as required subsidy levels are updated. It should be noted that by providing VLI units in a project directly, the units could qualify the project for a density bonus under state law. For example, if a project included at least five percent VLI units, the project would qualify for a 20 percent state density bonus. This might incentivize developers to provide affordable units.

<u>Financial Feasibility</u>

Analysis by consultant and staff concluded that charging developers the maximum nexus-based fee of $55 to $98 per square foot would likely make most development projects in Sunnyvale infeasible. One metric used to check the feasibility of the maximum fee at different fee levels is “return on cost”. A graph illustrating this feasibility test is provided in **Attachment 8**, Slide 25. This graph shows that if the fee were set at $17 or $21 per square foot, the return on cost is within the range currently expected by most investors when determining whether or not to develop a new project (i.e., between approximately 5.75 percent and 6.25 percent). A fee at either of those levels is not expected to have significant impacts on the financial feasibility of such projects. A fee at the $26 level is quite close to the bottom of this range, which indicates a greater risk of infeasibility if, over time, any of the major cost components of the project were to increase and/or if the projected returns (rents) were to decrease significantly.

<u>Expenditure of Rental Housing Impact Fees</u>

Revenue collected from the fees would be used to provide a source of funds to subsidize and assist in the production, preservation and renovation of very low income units. Once a sizeable amount of fees have been collected (i.e., $3 million to $4 million) staff would begin issuing requests for affordable rental housing project proposals. Proposals would be evaluated by staff and reported to the Housing and Human Services Commission with a recommendation being forwarded to the City Council. City Council would hold a public hearing and make a final decision on the funding award. **Attachment 9** provides some general policies proposed for expenditure of the Rental Housing Impact Fee, consistent with those recently accepted by Council regarding the commercial linkage fee.

PUBLIC OUTREACH

Staff held stakeholder outreach meetings on this item on January 7, January 14, and January 21, 2015. The January 21, 2015 meeting was held at HMH Engineering in San Jose, hosted by Building

Industry Association (BIA) Bay Area, at the request of BIA representatives so that local developers who had not attended earlier meetings could have another chance to learn more about the fee proposal.

Overall, the comments from the January 7 and 14 meetings reflected the need for more affordable housing in Sunnyvale and the need for keeping the fee reasonable. Attendees wanted to know how the funds would be spent and how many units could be constructed annually. One point of view was that new job creation drives growth in the City, not residential construction.

At the meeting on January 21, a participant asked why the study assumed that all newly created lower-income households would choose to live in Sunnyvale, while others noted that the City should look at providing affordable housing units in older developments, not just brand new units, and that the responsibility for creating affordable housing should be shared by the entire community, not just the development community. Complete meeting notes can be found in **Attachment 10**. In addition, BIA submitted a formal comment letter (**Attachment 11**) on the Nexus Study and proposed rental impact fee.

FISCAL IMPACT

The fiscal impact of creating a new rental housing impact fee requirement would depend on the fee rate and on future levels of new rental housing development. There would be no direct impact to the General Fund. However, it would likely generate fee revenues for the Housing special revenue fund or sub-fund designated to receive these fees. This special revenue fund can be used to create very low and low income affordable units, provide down-payment assistance loans for income-eligible home buyers, and cover program administrative costs. However, it is also likely that a portion of new rental projects will include affordable units on-site, at the developer's option, rather than paying the fees. Other cities with rental impact fees in place for some time have reported that many projects provide affordable units instead of paying fees, so projected fees could be significantly less if developers prefer providing the units. In addition, when the market for new rental development slows, as it has in prior downturns, there may be some years when few rental projects are proposed or built, in which case fee revenues will be minimal.

Once a significant amount of rental impact fees have been collected by the City, staff would begin issuing requests for affordable rental housing project proposals on a regular basis. In addition to projects, a small portion of the rental impact fees could be used for costs of administering the new funds, making loans, managing the loan portfolio, and monitoring compliance in the affordable rental projects assisted with the rental impact fees.

PUBLIC CONTACT

Public contact was made by posting the Council agenda on the City's official-notice bulletin board outside City Hall, at the Sunnyvale Senior Center, Community Center and Department of Public Safety; and by making the agenda and report available at the Sunnyvale Public Library, the Office of the City Clerk and on the City's website.

The Housing and Human Services Commission (HHSC) and Planning Commission (PC) held a joint study session on this topic on January 12 and held public hearings on this matter on January 28 and February 9, respectively.

The HHSC unanimously voted to recommend that City Council set the initial fee level at $21 per square foot, with the caveat that if a feasibility study shows that level to be infeasible, Council may consider adjusting it downward. An excerpt of the minutes from the HHSC meeting is provided in **Attachment 2**.

The PC voted to recommend that City Council set the initial fee level at $21 per square foot on a 4-3 split vote. Draft minutes from the PC meeting are provided in **Attachment 3**.

<u>February 10, 2015 Council Study Session</u>

Below is a summary of the questions and concerns raised at the February 10 study session, and staff's responses to them. Complete meeting notes are provided in **Attachment 12.**

1. Would there be a minimum project size threshold for this fee, or a lower fee for smaller projects?
   Response: Staff has not yet proposed a minimum size threshold, but this will be developed as part of the draft ordinance establishing the fee. For reference, the City's for-sale below market rate housing requirement applies to projects with eight units or more. Most recent rental projects have been much larger than that, with an average size of about 200 units.

2. How long can the units be restricted as affordable?
   Response: Typically the affordability term is 30 years for density bonus units or 40 to 55 years for subsidized (non-profit) affordable units. This can be established through the draft ordinance.

3. Is it better to have units provided within the market-rate development, or to collect the fee and construct affordable housing projects?
   Response: It is more expedient and less costly if they are provided within the market-rate development, but there can be some advantages to collecting the fee to construct affordable developments, such as deeper levels of affordability and/or provisions for special needs tenants.

4. Can the funds be used to build special needs housing or facilities, such as homeless shelters?
   Response: Within the context of the nexus study, using the fees to build special needs housing can be justified, such as for disabled, elderly, and/or formerly homeless tenants. Typically, these fees are not available for public facilities such as homeless shelters, which are not considered dwelling units.

5. How were the alternative rates of $17, $21 and $26 selected?

   Response: There was no particular formula for selecting these rates. In 2013, staff was considering a range of $10-$20 per square foot. However, since that time, Mountain View increased their fee from $10.26 to $17 per square foot and San Jose had adopted a fee of $17 per square foot; therefore, staff felt that $17 per square foot was a good starting point. In addition, at the time the report to the commissions was initially drafted, Mountain View was considering a possible fee of $26, so staff used that as the high-end alternative. Staff also considered the average of the rates adopted in the other Bay Area cities with a rental impact fee (**Attachment 4**) to verify the range of alternatives. This average (without San Francisco) is close to the middle alternative of $21. EPS also conducted a "return on cost" analysis to verify project feasibility at the three alternative fee rates. The analysis showed that none of the fee rates provided in the alternatives would hinder project feasibility, although the $26 rate might impact feasibility if the project cost factors were to change significantly.

ALTERNATIVES

1. Direct staff to prepare an ordinance authorizing a rental housing impact fee for new market-rate rental housing developments.
2. Direct staff to set the initial fee at $17 per habitable square foot for all new market-rate rental developments, adjusted annually as part of the City Fee Schedule.
3. Direct staff to set the initial fee at $21 per habitable square foot for all new market-rate rental developments, adjusted annually as part of the City Fee Schedule.
4. Direct staff to set the initial fee at $26 per habitable square foot for all new market-rate rental developments, adjusted annually as part of the City Fee Schedule.
5. Direct staff to include in the ordinance an option to allow developers to provide affordable units within a project instead of paying the impact fee, as well as other possible options such as providing off-site affordable units or dedicating land.
6. Direct staff to return to the City Council within two years to reevaluate and possibly adjust the rental housing impact fee.
7. Provide other direction to staff regarding this study.

STAFF RECOMMENDATION

Alternatives 1, 2, 5 and 6: 1) Direct staff to prepare an ordinance authorizing a rental housing impact fee for new market-rate rental housing developments; 2) Direct staff to set the initial fee at $17 per habitable square foot for all new market-rate rental developments, adjusted annually as part of the City Fee Schedule; 5) Direct staff to include in the ordinance an option to allow developers to provide affordable units within a project instead of paying the impact fee, as well as other possible options such as providing off-site affordable units or dedicating land; and 6) Direct staff to return to the City Council within two years to reevaluate and possibly adjust the rental housing impact fee.

Approval of the recommended alternatives would provide the City with an important source of revenue to address the demand for affordable housing generated by new market-rate rental developments, and will result in the development of new housing affordable to lower-income households. This impact fee will complement other existing City programs for providing affordable housing in the City, such as the commercial linkage fee, the inclusionary housing requirement for new for-sale housing, density bonus incentives, zoning for adequate sites, and direct subsidies of affordable units using federal grants and other available resources.

While a higher rental housing impact fee can be justified under the nexus study, staff suggests a more cautious approach for launching this new program. If the fee is set too high, it might create fiscal challenges for the production of rental housing. This could potentially constrain the supply of new housing and could be counter-productive to improving overall housing affordability in the City. It would be beneficial to monitor the effect of a new fee on rental housing production for an initial period. Additionally, while Alternative 2 is equivalent to the fee set by Mountain View and San Jose, other cities are also considering such a fee. Therefore, staff further recommends that the Council review this fee within two years, similar to its direction on the commercial linkage fee.

COMMISSION RECOMMENDATION

At its January meeting, the HHSC voted unanimously to recommend to Council Alternatives 1, 5, 6, and 7 (minutes provided in **Attachment 2**). Alternative 7 consisted of setting the initial fee level at $21 per habitable square foot, with the caveat that if the then-pending feasibility study were to indicate that a $21 fee was infeasible, Council could adjust it downward.

The PC voted 4-3 to recommend to Council Alternatives 1, 3, 5, and 6, with Alternative 3 including an initial fee level of $21. Two of the three commissioners who voted against this motion were not against the fee in general; they just disagreed on fee rate, with one preferring $17 per square foot and the other preferring $26 per square foot. The third commissioner voting against the motion objected to adding a new development fee based on his reservations about the nexus study, which he felt relied on several unsupported assumptions (minutes provided in **Attachment 3)**.

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Reviewed by: Hanson Hom, Director, Community Development Department
Reviewed by: Robert A. Walker, Assistant City Manager
Approved by: Deanna J. Santana, City Manager

ATTACHMENTS

1. Nexus-Based Affordable Housing Fee Analysis for Rental Housing
2. January 28, 2015 Housing and Human Services Commission Meeting Minutes
3. February 9, 2015 Planning Commission Meeting Minutes
4. Survey of Rental Impact Fees in Bay Area Cities
5. City of San Jose Development Fees Comparison Graph
6. Total City Fees on Rental Projects from Housing Element
7. Total City Fees vs. Total Fees with Proposed Rental Impact Fee
8. Rental Housing Impact Fee Presentation from February 10 Council Study Session
9. Proposed Policy for Expenditures of Rental Impact Fees
10. Community Outreach Meeting Summary
11. BIA Comment Letter
12. February 10, 2015 Council Study Session Summary