Regional Housing Needs Allocation

Unit Production Plan

In-Lieu Fee Analysis

CITY OF MERCED

July 24, 2023

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EXECUTIVE SUMMARY

RSG, Inc. ("RSG") prepared this In-Lieu Fee Analysis ("Analysis") for the City of Merced ("City") to support a Regional Housing Needs Allocation Unit Production Plan ("Plan") adopted on April 4, 2022. The Plan establishes policies to promote housing development at all income levels to meet the City's Regional Housing Needs Allocation ("RHNA").

In broad terms, the Plan requires 12.5% of total units in new residential developments to be restricted and made affordable to households with extremely low to moderate incomes. The policy is limited to development projects where the City Council has discretionary authority over specific land use entitlements. Multi-family projects with less than 36 units and single-family projects with less than 60 units are exempt. One alternative to producing affordable units on-site is paying an in-lieu fee that is deposited into the City's Housing Trust Fund. The fees will be leveraged with other resources to produce, preserve, and protect affordable housing in Merced through subsidy and grant programs.

RSG conducted an in-depth financial analysis of prototypical development in Merced that is subject to the Plan. An affordable unit production requirement of 12.5% results in a maximum *supportable* in-lieu fee of $23,084 per unit for single-family and $31,696 for multi-family residential. The supportable fee considers the financing gap per affordable unit. However, the supportable fee is not financially feasible for developers because it results in a low return on cost (as detailed in Section 5). The maximum *feasible* fee is **$15,200** per unit for single-family and **$23,000** per unit for multi-family residential (rounded to the nearest $100).

The City could consider setting a universal fee for all affordable income levels by housing type, or a different fee for Very Low-, Low-, and Moderate-Income units:

Table i-1: Maximum Supportable In-Lieu Fee and Maximum Feasible In-Lieu Fee per Unit

	Single Family	Multi-Family
Maximum Supportable In-Lieu Fee	$23,084	$31,696
Maximum Feasible In-Lieu Fee	$15,187	$23,045

Report Organization

This Report contains six sections, as follows:

- Section 1 – Background: This section includes a summary of the current Plan, Merced's housing needs and the use of inclusionary housing programs similar to the Plan to create affordable housing.

- Section 2 – Merced Housing Market and Product Types: This section provides an overview of the residential market in and around the city, including prototypical types and sizes of housing units, rental rates and sale prices, development costs, and projected investment returns to developers.

- Section 3 – Affordable Housing Costs: This section examines the cost to produce affordable housing units in the city. This is determined by the "affordable funding gap", which is the difference between the development cost for different unit types and sizes and the amount which households of varying sizes and income levels can reasonably afford to purchase or rent.

- Section 5 – Plan Design Options and Best Practices: This section answers common questions about inclusionary housing programs similar to the Plan and describes the range of program design variability.

- Section 5 – Analysis of Plan Affordable Unit Production Options and In-Lieu Fee Levels: This section details the calculations involved in determining a feasible Plan production requirement, as well as an appropriate in-lieu amount for the City.

- Section 6 – Conclusion and Policy Options: This section summarizes RSG's findings and alternative options for the City.

SECTION 1: BACKGROUND

Merced Regional Housing Needs Allocation Unit Production Plan

The following summarizes the requirements of the Plan approved on April 4, 2022:

On-site affordable unit production requirement	12.5%
Affordability Mix	Spread across Extremely Low-, Very Low-, Low-, and Moderate-Income Levels at the discretion of City staff
Affordability Term	Rental 55-Years Owner 45-Years
Development subject to Plan	When land use entitlements require the execution of the following discretionary actions: • Pre-Annexation Development Agreement ("PADA") • Development Agreement ("DA") • Legislative Action Agreements (General Plan Amendment, Zone Change, Establishment of a Planned Development District or "PD" and Site Utilization Plan, Other legislative actions subject to the applicant entering into an agreement with the City)
Exclusions	• Multi-family projects with less than 36 units • Single-family projects with less than 60 units • An executed DA or PADA that limits or excludes applying new entitlement requirements to a project • When an amendment to a DA or PADA is only for purposes of a Time Extension or Minor Amendment as defined within the Plan • Approval of Site Utilization Plan or Revision to an existing PD that only involves nonresidential uses

	• Any Permitted, By Right, Site Plan, CUP, and non-discretionary entitlements • Any residential project undertaken by a public entity that is not the City (ie County Housing Authority) • Any proposed project wherein the City Council at sole discretion determines that meeting the production requirements is infeasible due to costs or other factors such as health and safety issues
Alternatives	• Land dedication within the development project area to an affordable housing non-profit that includes a production plan, financial proforma, and development schedule • Acquisition of regulatory covenants on existing housing units within the City • Rehabilitation of existing housing units within the City with the implementation of new regulatory covenants • Other means subject to City Council approval
In-lieu fee alternative / Housing Trust Fund:	The City intends to establish an in-lieu fee to be deposited into the City's Housing Trust Fund
City Assistance	The City may provide financial assistance and/or entitlement streamlining from available Local, State, and Federal financing sources

This Analysis presents options for an in-lieu fee as an alternative to producing affordable units at development subject to the Plan.

Meeting Merced's Regional Housing Needs Assessment (RHNA) Allocation

The City's affordable housing needs are largely defined by the RHNA allocation determined by the Merced County Association of Governments ("MCAG"). RHNA determines the total number of new homes that need to be built in a region to support housing demand by income category. Merced's Housing Element identifies sites where new housing can be built to support RHNA targets.

California's Department of Housing and Community Development ("HCD") defines household income levels for affordable housing as "Very Low-", "Low-", and "Moderate-income" for households that earn less than 50, 80, or 120% of the area median income ("AMI") for Merced County ("County"), respectively. "Affordable housing cost" is set based on these income limits, and generally may not exceed 30% of household income. For renters, housing cost includes rent plus utilities. For homeowners, housing cost includes mortgage principal and interest plus taxes and insurance.

Merced's RHNA for the 6th Housing Element Cycle period of 2023 through 2032 reflects a target of 10,517 new residential housing units, of which 24% are for Very Low-income households, 17% are for Low-Income households, 17% are for Moderate-Income households, and 42% are for Above Moderate-Income households. Table 1-1 shows this breakdown both exclusive and inclusive of Above Moderate-income housing, which is not considered affordable housing. Note that RHNA numbers exclude "Extremely Low-Income" housing, which is for households that earn less than 30% of the AMI, but this income level is grouped with Very Low-income housing in Table 1-1.

Table 1-1: City of Merced RHNA Allocation

Income Category (% of County AMI)	6th Cycle	Percent	Percent of Affordable
Extremely and Very Low (<51%)	2,543	24%	42%
Low (51 to 80%)	1,742	17%	29%
Moderate (81 to 120%)	1,838	17%	30%
Above Moderate (> 120%)	4,394	42%	
Total	10,517		
Source: Merced County Association of Governments 6th Cycle Final RHNA Plan November 17, 2022. Percentages are rounded.			

Absent land use regulations, incentives, and subsidies, the real estate development market will seldom provide affordable housing on its own. Either market rate developers must be required to provide it, or affordable developers must be subsidized by local, regional, state, or federal programs or, more often, all of the above. Because cities have limited means to incentivize or subsidize production of affordable housing, they are increasingly looking to multi-pronged and integrated strategies to encourage the production of housing at all income levels. Merced's Plan aims to produce affordable units within a project or generate funding with an in-lieu fee option to support a wider range of housing opportunities in the City.

Inclusionary Housing Programs in California

Merced's Plan is not an inclusionary housing ordinance because it is limited to development subject to discretionary City Council approvals and implemented with a negotiated development agreement. The Plan's affordable unit production requirement does not apply to all residential development. Nevertheless, it can be helpful to understand inclusionary housing programs implemented in other California communities to inform Merced's policies.

Inclusionary housing ordinances are enacted by cities and counties to require, as a condition of approval, that residential development applications include a portion of the units constructed in a project to be set aside for purchase or rent by lower income households. Inclusionary policies attempt to capture some of the value from new residential development to provide a community benefit, using local land use controls to ensure that much-needed affordable housing is produced along with market rate units. It is a flexible tool that can be tailored to local circumstances. There is no one model policy, but rather several best practices to consider when designing one. An inclusionary housing ordinance is only one part of an affordable housing strategy and should not be viewed as the sole way to address the need for affordable housing, which may still require public subsidies and other programs and tools.

Affordable housing units are typically restricted by covenants recorded on the property to ensure that the units remain affordable for a long duration, usually 55 years for rentals and 45 years for ownership housing. During the covenant term, it is not uncommon for units to be rehabilitated and the covenants to be extended, often requiring additional public subsidies. In some cases, such as when a land trust or other public entity retains ownership of the land or units, the units can remain affordable in perpetuity.

Inclusionary housing policies are typically enacted by ordinances passed by the legislative body. Over 170 such ordinances or policies have been enacted in California. To RSG's knowledge, no inclusionary housing policies have been adopted in Merced County and only a few have been adopted in the San Joaquin Valley.

Legal Authority for Establishing Inclusionary Requirements and Affordable Housing Fees

In California, cities can regulate the use of buildings, structures, and land pursuant to Government Code Section 65850. This includes the type of land uses, building heights, parking requirements, and other improvements to property. In some cases, this can also include inclusionary housing requirements on residential and mixed-use projects.

Inclusionary housing policies have been in place throughout California since the 1970s. However, cities temporarily lost their ability to apply inclusionary policies to rental housing in 2009, when an appellate court determined that inclusionary housing requirements on new rental housing were in violation of the Costa Hawkins Act, a state law that limits local rent control implementation. In 2017, Assembly Bill ("AB") 1505 (Bloom) reinstated cities' ability to adopt and enforce inclusionary housing ordinances that apply to both rental and ownership housing projects, thereby restoring a tool for cities to facilitate affordable housing development in their communities. Under Government Code Section 65850.01(a), HCD has the authority to review inclusionary housing ordinances adopted after September 2017 that require more than 15% of the units to be affordable. The purpose of this review is to ascertain whether a jurisdiction is impairing the production of market rate housing by requiring an excessive number of inclusionary units.

In 2015, in another case, the California Supreme Court ruled that inclusionary housing requirements are not an "exaction" that needs to be justified by the impact of a project, like traffic and other development impact fees. Inclusionary policies may be based on the existing and projected housing needs of the region and other factors related to the regional welfare, and not based on a demonstrated additional need for affordable housing generated by new residential development. This means that a "nexus study" is not required under Government Code Section 66000, commonly known as the Mitigation Fee Act.

Regardless of the threshold of inclusionary housing required, Government Code Section 65850(g) requires that inclusionary housing ordinances contain alternative means for compliance, including, but not limited to, the payment of in-lieu fees, land dedication, off-site construction, and preservation of existing units. Most ordinances provide several such alternatives.

Although Merced's Plan is not an inclusionary housing ordinance subject to Government Code Section 65850(g), it does offer alternative means for compliance.

SECTION 2: MERCED HOUSING MARKET AND PRODUCT TYPES

RSG reviewed historical developments, the City's existing zoning code, and the residential development pipeline for the City and determined that the most common development patterns in the City and surrounding market area include single-family residences and multi-family rental apartments. While townhomes and condominiums are also permitted, RSG did not observe trends indicating that these residential housing types represent common development in the City or surrounding market area. Two additional product types were also observed in the City and market area: planned development single-family and planned development multi-family. RSG analyzed the planned developments concurrently and determined that there is not an appreciable difference in the conclusions between single-family and planned development single-family, and between multi-family and planned development multi-family.

Accordingly, the product types used in this analysis include single-family residential development and multi-family rental apartment developments of varying sizes and densities. Based on the data reviewed, conversations with City staff, and RSG's knowledge of the city's residential market, RSG believes that these product types provide an accurate cross section of the potential residential developments affected by the Plan.

RSG analyzed sales data since 2017 and currently listed home prices to develop assumptions about ownership residential product types within the City. RSG utilized ParcelQuest to obtain a database of all residential properties sold in the City since 2017. ParcelQuest utilizes County Assessor data to provide property information, including sales information and property characteristics. RSG supplemented historical sales data from ParcelQuest with an online survey of home sale listings on Zillow.com.

For multi-family rental residential properties, RSG used market analytics and current rent advertisements to develop assumptions. RSG relied on CoStar market and submarket analytics reports, which summarize market rental rates by number of bedrooms. RSG supplemented CoStar rental rates by reviewing current apartment listings on Apartments.com. The product types are summarized in Table 2-1 below, including the typical unit size, number of bedrooms, and pricing/rent levels.

The estimated development costs for market rate housing were based on independent construction cost data obtained from Marshall and Swift Valuation Services, which is a national comprehensive cost-estimating tool and methodology that is updated monthly and serves the appraisal, development, and insurance industries. This methodology reflects the assumptions used for prototypical development types seen in the Merced market. Table 2-1 shows the cost per square foot and cost per unit.

Table 2-1: Development Prototypes and Characteristics[1]

	Single-Family	Multi-Family
Dwelling Units per Acre	6.2	21.8
Lot Square Feet per Unit	7,000	1,998
Average Unit Square Footage	1,700	906
Average Number of Bedrooms	3 BR	2 BR
Development Cost per Square Foot	$213	$373
Development Cost per Unit	$362,792	$337,549

[1] Sources: ParcelQuest, City of Merced Development Pipeline, Marshall Valuation Service, and RSG

SECTION 3: AFFORDABLE HOUSING COSTS

Monthly rents and sale prices for affordable housing units are usually established in accordance with the California Health & Safety Code ("HSC"). Calculations for rental housing are made pursuant to HSC Section 50053(b); calculations for owner-occupied housing are made pursuant to HSC Section 50052.5(b). Affordable housing costs are a function of the AMI, adjusted for family size appropriate to the unit, which is assumed to be one person in a studio unit, two persons in a one-bedroom unit, three persons in a two-bedroom unit, four persons in a three-bedroom unit, five persons in a four-bedroom unit, and so on.

The qualifying income limits for Extremely Low-, Very Low-, Low-, and Moderate-Income households and the applicable AMIs adjusted for family size are established annually by HCD for each California county in accordance with data provided by the United States Department of Housing and Urban Development ("HUD"). For Merced County, the 2022 median income is $80,300 for a household of four. Table 3-1 below shows a summary of the 2022 Merced County AMIs and qualifying income limits.

Table 3-1: HCD Income Limits by Household Size[2]

		Income Limit by Household Size (Persons)				
Income Category	**AMI**	**1**	**2**	**3**	**4**	**5**
Extremely Low	30%	$16,860	$18,975	$21,675	$24,090	$26,010
Very Low	50%	28,100	31,625	36,125	40,150	43,350
Low	60%	33,720	37,950	43,350	48,180	52,020
Median	100%	56,200	63,250	72,250	80,300	86,700
Moderate	110%	61,820	69,575	79,475	88,330	95,370

This analysis incorporates the data in Table 3-1 above to establish the income category of a household based on the applicable qualifying income limits established by HCD. The calculation of affordable housing rents or prices is based on the income category of the household, adjusted for family size and multiplied by the AMI for that household size. The calculations in the following sections of this analysis use a variety of affordability levels and adjusted household sizes to generally reflect market data, which is identified as the information is presented.

Affordable Rental Values

The maximum affordable rental costs are calculated per HSC Section 50053(b) to reflect the affordable housing cost by income category, adjusted for household size as a percentage of gross AMI, as well as a deduction of a utility allowance. The calculation of annual affordable rental housing cost may not exceed the following:

[2] Source: California Department of Housing and Community Development

- For Very Low-income households, the product of 30% times 50% of the AMI adjusted for family size appropriate for the unit.
- For Low-income households, the product of 30% times 60% of the AMI adjusted for family size appropriate for the unit.
- For Moderate-income households, the product of 30% times 110% of the AMI, adjusted for family size appropriate for the unit.

The Merced County 2022 maximum affordable monthly rents for each income category by unit size is summarized in Table 3-2 below. Note that the amounts shown are prior to deducting a utility allowance.

Table 3-2: Affordable Rent Limits[3]

	Number of Bedrooms				
Income Category	**0**	**1**	**2**	**3**	**4**
Very Low	$703	$791	$903	$1,004	$1,084
Low	$843	$949	$1,084	$1,205	$1,301
Moderate	$1,546	$1,739	$1,987	$2,208	$2,384

The value of an affordable rental unit is a function of the annual gross income generated by the unit reduced by vacancies and operating expenses to determine the net operating income ("NOI"). Lenders' underwriting standards generally incorporate a 5% vacancy factor. Comparable annual operating expenses (excluding real estate taxes) for affordable rental units are about $6,000 per unit plus $250 per unit annual reserve fund deposits. Real estate taxes are generally excluded for affordable apartments because most affordable apartments are constructed in conjunction with non-profit housing developers and are thus exempt from property taxes. The industry practice of establishing the value of rental units is to apply a reasonable market capitalization rate, or "cap rate", to the NOI to identify the value based on the ability to achieve an investment rate comparable to similar properties. RSG assumed a 5.5% cap rate based on current market data. Table 3-3 below shows the capitalized value per rental unit based on affordable cost for varying unit sizes and income levels.

Table 3-3: Capitalized Value of Prototype Affordable Rental Units[4]

	Capitalized Value by Number of Bedrooms				
Income Category	**0**	**1**	**2**	**3**	**4**
Very Low	$0	$9,470	$22,853	$34,471	$42,582
Low	19,588	35,120	52,152	67,035	77,742
Moderate	133,543	163,370	198,651	229,857	253,540

[3] Source: California Department of Housing and Community Development

[4] Source: RSG, California Department of Housing and Community Development

Affordable Sale Prices

Maximum affordable sale prices are calculated per HSC Section 50052.5(b) to reflect the affordable housing cost per income category, adjusted for household size, as a percentage of the gross AMI, allowing for the deduction of related housing expenses.

The calculation of annual affordable ownership housing cost may not exceed the following:

- For Very Low-income households, the product of 30% times 50% of the AMI, adjusted for family size appropriate for the unit.
- For Low-income households, the product of 30% times 70% of the AMI, adjusted for family size appropriate for the unit.
- For Moderate-income households, not less than 28% of the household's gross income, or more than the product of 35% times 110% of the AMI, adjusted for family size appropriate for the unit.

Table 3-4 below identifies the Merced County 2022 monthly affordable ownership housing cost limits by income category and unit size, as calculated in accordance with the above formulas.

Table 3-4: Monthly Affordable Ownership Cost Limits[5]

	Cost Limit by Number of Bedrooms				
Income Category	**0**	**1**	**2**	**3**	**4**
Very Low	$703	$791	$903	$1,004	$1,084
Low	984	1,107	1,264	1,405	1,517
Moderate	1,803	2,029	2,318	2,576	2,782

For this analysis, affordable sale prices were calculated for single-family residences reflecting similar homeowner expense categories (i.e., taxes, insurance, maintenance costs, and utilities). The analysis also assumes a 5% down payment and a 30-year amortized loan at a 3.5% interest rate. The maximum affordable sale prices by income category and unit size are summarized in Table 3-5 below.

[5] Source: California Department of Housing and Community Development

Table 3-5: Affordable Sales Prices[6]

	Cost Limit by Number of Bedrooms				
Income Category	**0**	**1**	**2**	**3**	**4**
Very Low	$50,965	$57,771	$64,460	$68,157	$66,838
Low	103,908	117,355	132,522	143,803	148,514
Moderate	258,325	291,144	331,039	364,439	386,734

Affordable Housing Development Funding Gap

The affordable housing development funding gap reflects the difference between the estimated cost to develop the unit, which is based on construction costs in the market area, and the value that a developer can expect to receive from the affordable unit, which is determined by the affordable rent or sales price. Therefore, the development funding gap is an indication of the net cost to create an affordable housing unit, which is funded either by a developer or through a subsidy program or source.

The cost per unit for affordable housing units is similar to those for market rate units, with an exception perhaps for somewhat smaller unit sizes, slightly lower quality materials and finishes, and a lower developer fee (profit). The methodology herein reflects the assumption of all things being equal for each prototype, such as unit size, construction costs, and land costs. RSG calculated a weighted average affordable development funding gap for each of the prototypes by blending the affordable values of the different bedroom unit sizes for each prototype project. Table 3-6 below shows the development funding gaps for affordable units by product type and income level.

Table 3-6: Affordable Development Funding Gap

	Single-Family	**Multi-Family**
Development Cost per Unit	$362,792	$337,549
Very Low Affordable Housing Value	68,157	22,826
Very Low Affordable Housing Gap	(294,635)	(314,723)
Low Affordable Housing Value	143,803	52,149
Low Affordable Housing Gap	(218,989)	(285,401)
Moderate Affordable Housing Value	364,439	198,761
Moderate Affordable Housing Gap	0	(138,788)

[6] The affordable sales price for Very Low-income units shows a decline with larger unit sizes because the incremental increase in utility and other costs is greater than the increased income for larger households.

The development funding gaps shown in Table 3-6 reflect the financial impacts associated with producing these affordable units without the benefit of tax credits or other funding sources often used by affordable housing developers, thus reflecting the full amount to produce an affordable unit for each income category. Developers of affordable housing projects are often awarded financial assistance from local, state, and federal funding sources, such as 4% or 9% Low-Income Housing Tax Credit ("LIHTC") equity, to reduce the funding deficits to make the development more financially feasible. However, these subsidies are not available to market rate developers complying with inclusionary programs, or in Merced's case a RHNA Unit Production Plan. Accordingly, this analysis uses the full funding gap amounts as the initial basis for determining the cost of compliance with the RHNA Unit Production Plan housing requirement and an equivalent in-lieu fee amount.

SECTION 4: PLAN DESIGN OPTIONS AND BEST PRACTICES

Should Merced consider amending its Plan from time to time, following are a series of design element questions and a brief discussion of the options and best practices based on the experience of communities with affordable unit production requirements. The goal of the Plan is to reasonably achieve the community's affordable housing production goals while balancing financial feasibility of development. The program should be backed by data and research that establishes both the need and feasibility of producing affordable housing in the regional housing market.

- <u>What percentage of affordable units should be included in a project?</u>

Most inclusionary policies in California are in the range of 5 to 20%, with 15% the most common requirement. The percentage a community establishes is dependent on its affordable housing needs, local market conditions, financial incentives available, and the mix of affordability required. Ultimately, the percentage should not be so high as to discourage development due to the cost of providing the affordable units making the entire project infeasible.

- <u>At what income levels should affordable units produced under the Plan be sold or rented?</u>

There is wide variability among communities for the required target distribution of units by income level within the overall inclusionary percentage. For some jurisdictions, the distribution among income levels may be set to approximate their RHNA allocation. For many others, the inclusionary requirement is split only between Low- and Very Low-Income levels (for example, if 15% of the total units are to be affordable, 10% may be for Low-income and 5% for Very Low-income households). Moderate-income units may be required in some communities with very high cost and relatively higher incomes, but in many other markets, housing is already being produced that is naturally affordable to Moderate-income households. Ownership and rental housing may also have a different income target, reflecting the differences in development economics for each. Some communities include a target for Extremely Low-income households, but housing at this level is generally better served by other programs and targeted funding sources.

- <u>Should the Plan's' affordable unit production requirement change over time?</u>

Housing markets are constantly changing, including rents, sale prices, and construction and financing costs. Developer profitability rises and falls over time based on a variety of factors and the cost of compliance with an inclusionary policy may be a relatively minor consideration. A modest inclusionary requirement that is evaluated to be feasible when adopted should likely remain feasible over time. It is also possible that, when profitability increases, a higher inclusionary requirement could be feasibly absorbed by the development community. Periodic review can determine how feasibility is impacted by market changes. It can also allow the community to assess whether changes in the target income levels may be necessary to better meet housing targets. Every three to five years is a reasonable review period. Coupling the review with the update of the local housing element is another good option.

- <u>What alternative methods of compliance should be provided?</u>

In California, State law requires that alternative methods of compliance with inclusionary housing requirements be provided to developers. Common alternatives include in-lieu fees, off-site construction, land donation, and the acquisition and rehabilitation of existing units.

In-lieu fees are generally paid into a local affordable housing trust fund to finance future construction of affordable housing at other locations in the community. The greatest advantage of in-lieu fees is that they provide a local funding source that can be leveraged with state and federal funds that otherwise would not be available to a developer, allowing an even greater number of affordable units to be built, often at much deeper affordability levels. By leveraging local affordable housing trust funds, developers may be able to produce four to six times more units than would otherwise be developed as inclusionary housing units.

- <u>How should the amount of an in-lieu fee be set?</u>

As a starting point, the in-lieu fee should reflect the true cost of producing on-site units. If the fee is lower than the actual cost of production, developers are very likely to pay it rather than designate any units in the project as affordable. Even at an equivalent or comparable cost, developers are still more likely to pay the fee rather than assume long-term management of affordability covenants associated with a small fraction of units.

The cost of providing an inclusionary unit will vary by which income levels are required and the size and type of unit. A range of such costs can be projected using current market economics and prototypical development. A standardized in-lieu fee can only approximate these costs based on the range of policy options being included.

The in-lieu fee should be reviewed and revised over time to reflect changes in construction costs, inflation, and other market factors. While an inclusionary policy is usually adopted by an ordinance, the in-lieu fee is best adopted by resolution since amending the ordinance on a regular basis can be more costly and time-consuming.

In-lieu fees are often denoted as the amount a developer would need to pay *per market rate unit* in a project to meet its obligation, rather than the net cost of each inclusionary unit that otherwise would be required to be built on-site. In other words, if there was an inclusionary requirement of 10%, the in-lieu fee per market rate unit multiplied by ten should approximate the average net cost of providing one inclusionary unit. Establishing the in-lieu fee on a per-market-rate-unit basis is quite common because developers typically evaluate development projects in terms of cost per unit. However, the drawback with establishing a fee on a per-market-rate-unit basis is that it does not adjust for the size of units in a project and can lead to inequities in implementation. For example, a developer creating large multi-bedroom homes would pay the same fee per unit as a developer of small one-bedroom or studio units, even though the construction costs and affordable funding gaps are widely different. RSG typically recommends establishing the in-lieu fee on a *per square foot* basis that can then be multiplied by the total residential square footage in a project to calculate the inclusionary obligation. Conversely, establishing the in-lieu fee on a *per unit* basis can simplify program administration.

- <u>What is the process or standard for requesting a waiver or reduction of the requirement?</u>

The inclusionary requirement should provide a clear and specific process for a developer to request a waiver or reduction, and the standards by which the request will be evaluated. The process should only be used in rare cases, and the developer should be required to demonstrate economic hardship (the inability to achieve a profit), which can be verified by an independent third-party review.

- What other communities in the region have inclusionary housing requirements?

When setting an affordable unit production requirement, it can be helpful to look at surrounding communities with similar policies so the City does not price itself out of new development. RSG researched communities in the San Joaquin Valley and throughout California as a whole. There are no nearby jurisdictions that have an inclusionary housing or similar policy. Merced is setting the first policy of its type in the immediate region. For this reason, Merced's policy is best informed by looking at the financial feasibility of affordable unit production and in-lieu fee requirements set by the Plan. This is evaluated in Section 5.

Table 4-1 provides examples of inclusionary housing policies in four San Joaquin Valley communities for reference purposes only. These jurisdictions are not near Merced and should not impact Merced's in-lieu fee decision as they are in different housing markets and are not comparable to the City.

Table 4-1: Inclusionary Requirements in Other Jurisdictions

<table>
<tr><th rowspan="2">City</th><th colspan="2">Inclusionary Requirement</th><th colspan="2">Minimum Units</th><th colspan="2">AMI Requirement</th><th rowspan="2">Fee Type</th><th colspan="2">In-Lieu Fee per Unit[1]</th><th colspan="2">In-Lieu Fee per Sq Ft[1]</th></tr>
<tr><th>Rent</th><th>Own</th><th>Rent</th><th>Own</th><th>Rent</th><th>Own</th><th>Rent</th><th>Own</th><th>Rent</th><th>Own</th></tr>
<tr><td>Merced</td><td>12.5%</td><td>12.5%</td><td>36</td><td>60</td><td colspan="2">Spread across Ext. Low to Mod</td><td>S.F.</td><td>$39,057</td><td>$23,084</td><td>$25</td><td>$9</td></tr>
<tr><td>Ripon</td><td>Exempt</td><td>10% FHA loan standards, 5% affordable</td><td>Exempt</td><td>0</td><td>Exempt</td><td>75% Mod
25% Low</td><td>Unit</td><td colspan="2">$21,600</td><td colspan="2">$13</td></tr>
<tr><td>Patterson</td><td>15%</td><td>15%</td><td>No Min.</td><td>No Min.</td><td>60% Low
40% Very Low</td><td>60% Mod
50% Low</td><td>Unit</td><td colspan="2">$8,960</td><td>$5</td><td>$10</td></tr>
<tr><td>Escalon</td><td>10-15%</td><td>10-15%</td><td colspan="2">4</td><td colspan="2">1/3 split between Very Low, Low, and Mod</td><td>Unit</td><td colspan="2">$305,252
(Calculated based on a percentage of median home price)</td><td>$337</td><td>$180</td></tr>
<tr><td>McFarland</td><td>15%</td><td>20%</td><td colspan="2">15</td><td>Very Low or Low</td><td>Very Low, Low, or Mod</td><td colspan="5">No In-Lieu Fee allowed as an alternative means of fulfillment to the Affordable Housing Requirement</td></tr>
</table>

[1] Fee per Unit and Fee per Sq Ft calculated based on applying each jurisdiction's fee schedule to a prototypical development in Merced.

SECTION 5: ANALYSIS OF PLAN AFFORDABLE UNIT PRODUCTION OPTIONS AND IN-LIEU FEE LEVELS FOR THE CITY OF MERCED

This section discusses the potential cost of compliance under a range of options for Plan design requirements, concluding with RSG's recommendations for Merced's Plan and in-lieu fee amounts. RSG evaluated several permutations of program design options that Merced might consider for its Plan and applicable fee, including those shown in Table 5-1 below.

Table 5-1: Range of Program Design Options Evaluated

<table>
<tr><td>Affordable Unit Production Percentage:</td><td>15%</td><td colspan="2">12.5%</td><td>10%</td></tr>
<tr><td>Income-level Targeting:</td><td colspan="4">RHNA allocation based</td></tr>
<tr><td>Variable or Fixed Fee:</td><td colspan="2">Variable by tenure (ownership vs. rental);</td><td colspan="2">Fixed fee for all types and tenure</td></tr>
</table>

RSG used the affordable development funding gap amounts from Table 3-6 to calculate equivalent in-lieu fees for each of the program design options noted in Table 5-1. RSG calculated the in-lieu fees on both a per-square-foot and per-market-rate-unit basis for the prototypical housing development types.

RSG then evaluated the impact of the range of options on the feasibility of development. This is an essential step in setting a Plan production requirement and associated in-lieu fee because setting the requirement and fee level too high may deter residential development altogether, thereby raising housing costs and negating the purpose of the Plan. To avoid this unintended consequence, the City should modulate program requirements and/or reduce the in-lieu fee to mitigate the cost impacts on development.

As a measure of feasibility, RSG used a common rule of thumb in real estate development that return on cost ("ROC") should exceed market cap rates by 1.5 to 2.5%. ROC is calculated as developer profit divided by development cost and, with current cap rates for multi-family residential projects ranging from 5.4 to 6.3%, should range from 7.0 to 8.75% for each prototype to be deemed feasible after applying the in-lieu fee. For the purpose of this analysis, RSG evaluated each housing prototype using an 8.0% minimum return on cost.

Among the program options RSG presented in Table 5-1, the 15% production percentage, RHNA allocation-based income-level targeting, and variable fee by tenure (ownership vs rental) had the greatest negative impact on development feasibility. RSG's analysis indicates that a program with this combination of options would result in an in-lieu fee ranging from $27,701 to 38,035 per new residential unit. At this level, development would be infeasible in Merced with an ROC of 3.6% to 4.6% as shown in Table 5-2 (Design Option 1).

Our analysis indicates that development may be approaching feasibility under the set of options in the right column of Table 5-1 (10% production percentage, RHNA allocation-based income-level targeting, and variable fee for all types and tenures), and that developers of most of the prototypes could achieve a reasonable ROC with fee levels of $18,467 to 25,357 per new residential unit, as indicated in Table 5-2 (Design Option 3) below. At this level, development would be infeasible in Merced with an ROC of 7.1% to 7.3% as shown in Table 5-2. As previously discussed, the acceptable ROC ranged from 7.0% to 8.75%, and while Design Option 3 has not exceeded a ROC of 8.0%, it is within the acceptable range of returns.

RSG then considered an adjustment of the in-lieu fee to a level that would allow development of all prototypes to be feasible and attain an 8.0% ROC. RSG estimated market value based on current single-family home sale prices and estimated net operating income based on current multi-family rental rates, vacancy rates, operating expenses, and real estate taxes. The market value for both prototypes exceeded the development cost, meaning that both prototypes are feasible in the current market. The ROC ranged from 12.2 to 14.8% for the single-family and multi-family prototypes, respectively. The difference between the feasibility ROC (12.2 to 14.8%) and the minimum ROC (8.0%) represents the maximum feasible in-lieu fee. This results in an in-lieu fee of $15,187 per unit for ownership units and $23,045 per unit for rental projects, as demonstrated in Table 5-2 as Design Option 4.

Table 5-2: Projected Impact on Prototype Feasibility

	Single-Family	Multi-Family
Prototype Unit Square Feet	1,700	906
Unit Market Value	$407,003	$387,598
Development Cost per Unit	$362,792	$337,549
Developer Return per Unit	$44,210	$50,049
Return on Cost	**12.2%**	**14.8%**
Design Option 1: 15%, RHNA, Variable by Prototype		
In-Lieu Fee per Square Foot	$16	$42
Total In-Lieu Fee per Unit	27,701	38,035
Total Unit Cost with Fee	390,493	375,585
Developer Return per Unit with Fee	16,510	12,013
Return on Cost with Fee	**4.6%**	**3.6%**
Design Option 2: 12.5%, RHNA, Variable by Prototype		
In-Lieu Fee per Square Foot	$14	$35
Total In-Lieu Fee per Unit	23,084	31,696
Total Unit Cost with Fee	385,876	369,245
Developer Return per Unit with Fee	21,127	18,353
Return on Cost with Fee	**5.8%**	**5.4%**
Design Option 3: 10%, RHNA, Variable by Prototype		
In-Lieu Fee per Square Foot	$11	$28
Total In-Lieu Fee per Unit	18,467	25,357
Total Unit Cost with Fee	381,259	362,906
Developer Return per Unit with Fee	25,743	24,692
Return on Cost with Fee	**7.1%**	**7.3%**
Design Option 4: Max Feasible, RHNA, Variable by Prototype		
In-Lieu Fee per Square Foot	$9	$25
Total In-Lieu Fee per Unit	15,187	23,045
Total Unit Cost with Fee	377,979	360,594
Developer Return per Unit with Fee	29,023	27,004
Return on Cost with Fee	**8.0%**	**8.0%**

To summarize, this Analysis finds that an affordable unit production requirement of 12.5% (Design Option 2) results in a supportable in-lieu fee of $23,084 per unit for single-family and $31,696 per unit for multi-family residential, however this is not financially feasible to develop because the ROC is less than 8.0%. The maximum feasible fee that results in an 8.0% ROC would be $15,187 per unit for single-family and $23,045 per unit for multi-family residential (Design Option 4).

A production requirement of 12.5% is not financially feasible for a prototypical development if all required units were produced on-site. However, developers could opt to pay the maximum feasible fee as an alternative. If the City would like to incentivize producing affordable units on-site rather than payment of the in-lieu fee, the production requirement could be reduced from 12.5% to 10%.

The City may also offer developers the option of providing a portion of the affordable units on site, while the remainder of the developer's obligation is fulfilled by paying the in-lieu fee. A developer may choose, for example, to develop moderate income units on site and pay the proportional in-lieu fee for the very low- and low-income unit obligations.

One methodology to approach this is to break down: (1) the multi-family in-lieu fee proportional to the City's RHNA allocations for each income level, and (2) the single-family in-lieu fee proportional the City's RHNA allocation for low- and moderate-income units (omitting the very low-income unit RHNA allocation). Typically, it is substantially infeasible to provide very low-income units as single-family households, whereas multi-family developments may qualify for several different subsidy programs that enable the feasibility of very low-income units mixed with low- and moderate-income units.

Accordingly, Table 5-3 breaks down the maximum supportable and maximum feasible in-lieu fees into the component income levels. RSG recommends rounding these to the nearest $100 to make the fee more straightforward.

Table 5-3: Maximum Supportable and Maximum Feasible In-Lieu Fee per Unit by Income Level

	Single Family	**Multi-Family**
Maximum Supportable In-Lieu Fee	$23,100	$31,700
Very Low-Income	9,600	13,200
Low-Income	6,600	9,000
Moderate-Income	6,900	9,500
Maximum Feasible In-Lieu Fee	$15,200	$23,000
Very Low-Income	6,300	9,600
Low-Income	4,300	6,500
Moderate-Income	4,600	6,900

SECTION 6: CONCLUSION AND POLICY OPTIONS

The following presents policy options for the City to consider in setting an in-lieu fee, negotiating development agreements subject to the Plan, and making modifications to its Plan from time-to-time.

Policy	Current Plan	Alternative Options
On-site affordable unit production requirement	12.5%	RSG's analysis found that a production requirement of 12.5% is not financially feasible for a prototypical development if all required units were produced on-site. However, developers could opt to pay the in-lieu fee as an alternative. If the City would like to incentivize producing affordable units on-site rather than payment of the in-lieu fee, the production requirement could be reduced from 12.5 to 10%.
In-Lieu Fee	To be determined	The in-lieu fee amount may be set or changed at any time by a resolution of the City Council. The maximum *supportable* in-lieu fee (rounded to the nearest $100) for a 12.5% production requirement is: • $23,100 per unit for single-family residential • $31,700 per unit for multi-family residential This based on the financing gap per affordable unit in a prototypical development subject to the plan. However, this fee is not financially feasible for developers because it results in c low return on cost as detailed in Section 5. The maximum *feasible* fee (rounded to the nearest $100) is: • <u>$15,200 per unit</u> for single-family residential • <u>$23,000 per unit</u> for multi-family residential

In-lieu Fees by Income Level		The City could opt to set a universal fee for all income levels by housing type, or set a different fee for different income levels. Fees set by income level allow developers to include a portion of the affordable units in proposed projects, while paying the in-lieu fee for the remainder of the obligation. The proportional fees for the maximum supportable and maximum feasible in-lieu fees are presented in Table 5-3.
In-lieu Fee Annual Adjustments		In the case of a project that satisfies the requirement with a mix of on-site affordable units and an in-lieu fee, or for a fractional unit obligation, the fee per unit would be multiplied by the market-rate units for which the on-site inclusionary requirement has not otherwise been met. The in-lieu fee amount shall increase based on the annual percent increase in the Construction Cost Index as published by Engineering News Record for San Francisco.
In-Lieu Fee Administration		At the applicant's option, all or a portion of whole units required may be satisfied by payment of an in-lieu fee. The City Council, by resolution, shall establish the amounts and calculation to determine the housing in-lieu fee. The fee for a for-rent unit shall be paid no later than prior to the final inspection for each unit in a residential project; for a for-sale unit, the fee shall be paid no later than the close of escrow or one year following the final inspection, whichever is sooner. All housing in-lieu fees paid to the City shall be deposited into the City's Housing Trust Fund for use by the City to fund the development or preservation of housing situated within the City limits that is affordable to households of Extremely Low- to Moderate-incomes, including, but not limited to, the acquisition of property, costs of construction or rehabilitation, including costs associated with

		planning, administration and design, as well as actual building or installation costs and program administration.
Affordability Mix	Spread across Extremely Low-, Very Low-, Low-, and Moderate-Income Levels at the discretion of City staff	Leaving this to City staff's discretion as it negotiates agreements on a project-by-project basis permits the most flexibility to align with changing City needs and mandates. As a general guideline: *Ownership development*: Typically, it is substantially infeasible to provide very low-income units as single-family households. Instead, the City could consider requiring at least 50% of the affordable units to be Low-income with the remainder designated as Moderate-income. *Rental development*: Units could align with the City's RHNA production requirements of 42% Very Low-, 28% Low- and 30% Moderate-income.
Development standards:	n/a	The City may consider the following requirements when negotiating agreements under the Plan. Affordable units shall be: • Reasonably dispersed throughout the residential project; • Proportional, in number of bedrooms and location, to the market rate units; • Comparable to the market rate units included in the residential project in terms of size, design, materials, finished quality, and appearance; and • Permitted the same access to project amenities and recreational facilities as the market rate units. All affordable units in a project shall be constructed concurrent with, or before the construction of the market rate units. If the City approves a phased project, a proportional share of the required inclusionary units shall be provided within each phase of the residential project.

Waiver or reduction in requirements:	Exclusions include any proposed project wherein the City Council at their sole discretion determines that meeting the production requirements is infeasible due to costs or other factors such as health and safety issues	Require the developer to show economic hardship (the inability to achieve a profit) which can be verified through an independent third-party review at the developer's cost.
Density bonus:	n/a	Affordable housing provided on-site may qualify the project for any density bonus granted under State law.
Review period:	n/a	Consider reviewing the Plan within three years of adoption and thereafter in conjunction with preparation of the City's Housing Element. The in-lieu fee amount may be amended at any time by the City Council based on an analysis of current market conditions and housing needs.
Enforcement:	n/a	Revoke building permits or certificate of occupancy for failure to comply. Renting/selling above income requirement is a misdemeanor. Include these clauses in negotiated agreements.