LIVABLE BERKELEY

JUNE 2017

BERKELEY CITY COUNCIL HOUSING PROPOSALS WHITEPAPER

Introduction

Berkeley and the Bay Area continue to experience an unprecedented housing crisis. In recent years, Berkeley has done more than most Bay Area cities (though still not enough) to address this crisis. Certain areas of Berkeley are building substantial amounts of new housing; and these new projects have been an important source of on-site affordable housing units and funding for affordable housing. Although recent homebuilding in Berkeley and the Bay Area at large appears to have ameliorated the crisis slightly, housing remains expensive and scarce. To fully address the housing crisis, we must build upon recent successes by creating more housing at all income levels.

DOCUMENT SECTIONS

Consistent with our commitment to greater housing choice and affordability in Berkeley, Livable Berkeley has authored this whitepaper to analyze and respond to recent City Council housing proposals. Although well-intended, we are deeply concerned that these proposals will negatively impact Berkeley's ability to continue creating housing and affordable housing. We hope that this whitepaper will help increase public awareness and understanding of these issues, and help the City Council refine its proposals to better serve the goals of ensuring greater housing choice and affordability.

This document contains the following sections:

- Introduction *(this section)* – Provides background, and explains the purpose and organization of this whitepaper.
- Executive Summary – A brief overview of the upcoming proposals and the whitepaper's findings and recommendations.
- Upcoming Proposals – A detailed description of the specific elements of the most impactful items being considered by the City Council.
- Our Analysis – An in-depth discussion of what Livable Berkeley views as the potential consequences of the upcoming proposals.
- Recommendations – A bulleted list of suggestions for how the City could address, amend, and expand upon the upcoming proposals.

Executive Summary

On May 16, 2017, the Berkeley City Council considered multiple items relating to housing and affordable housing in Berkeley. These items were subsequently referred to a June 13th public hearing and were also subject to discussion at the May 30th Council meeting. These proposals include major changes Berkeley's fees, policies, and requirements related to the creation of both market-rate and affordable housing, and they would generally serve to increase the level of fees and regulation applied to new housing in Berkeley.

After reading and analyzing these Items, Livable Berkeley has identified multiple concerns about the potential impacts of these proposals. Taken both individually and together, the proposals before the City Council have the potential to: severely curtail housing creation citywide; decrease production of affordable housing units; reduce the total amount of affordable housing fees paid to the City; discourage production of medium-density housing; and violate State Law.

Livable Berkeley believes that the City Council should direct City staff to engage in a comprehensive economic and legal review of all upcoming proposals. As part of this, the City should initiate a new Economic Feasibility Study that updates and expands upon the work of the prior, outdated study. We believe that these proposals should not be enacted until their impact can be more fully assessed. Finally, we believe the City should consider restricting future changes to a set schedule that ensures such changes are adequately analyzed; and that the Council should also explore options to consolidate and simplify City fees, policies, and requirements for new housing.

Note on rapidly evolving proposals:

Proposals being considered by the City Council at the June 13th hearing are rapidly evolving. Entire items may yet be added to or removed from the agenda, and items are subject to revisions proposed by City staff and/or councilmembers. Some of the information in this whitepaper may therefore be out of date upon its publication. Additionally, in the interest of timely release, there are some new items this whitepaper does not address.

Nevertheless, we believe this whitepaper offers an important perspective on how these various items may impact Berkeley's ability to address the housing crisis. The rapidity of revisions to these proposals makes a thorough analysis even more important. Even if some proposals we discuss are withdrawn or reworked, cumulative effects may still negatively impact housing production. We have therefore chosen to publish this whitepaper irrespective of the likelihood that it will be rendered outdated by changes in these proposals.

Upcoming Proposals

Below is a summary of the key changes being proposed to the City of Berkeley's Inclusionary Zoning (IZ) requirements, Affordable Housing Mitigation Fee (or "in-lieu" fee), and other related policies.[1] The items are referred to by their item numbers from the May 16th City Council meeting (at which these items were referred to a June 13th public hearing). Following this discussion of potential changes, the whitepaper dives more deeply into Livable Berkeley's concerns regarding the consequences of these proposals.

Item 29: Changes in the Affordable Housing Mitigation Fee

1. Changes the timing of fee payment and eliminates discount for early payment of the fee.

Currently, homebuilders are required to pay any Affordable Housing Mitigation Fees to the City no later than when a project's Certificate of Occupancy is issued (i.e., immediately before people can move into the new housing). Under current law, homebuilders may alternatively elect to pay the fee when a project's Building Permit is issued (i.e., before the project begins construction). This earlier fee payment is currently incentivized with a $4,000 per unit discount. That is, earlier payment results in a fee of $30,000 per new market-rate unit, while later payment results in a fee of $34,000 per market rate unit.

Item 29 would change the Municipal Code to require homebuilders to make the full payment at the earlier time—issuance of Building Permit. (See Item 30 below for additional, related changes.)

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[1] Inclusionary Zoning (IZ) refers to the practice of requiring new housing projects to dedicate a portion of the units built to serve as Below Market-Rate (BMR) units (also sometimes referred more colloquially as "affordable units"). Per State law, as interpreted by the courts, cities must also offer homebuilders the option of paying a fee per new market-rate unit instead of including BMR units on site. In Berkeley, this fee option is referred to the as the Affordable Housing Mitigation Fee. A full discussion of these concepts and applicable statutes is beyond the scope of this whitepaper. For additional background on Inclusionary Zoning, see:
https://www.huduser.gov/portal/periodicals/em/spring13/highlight3.html
For additional background on Berkeley's Affordable Housing Mitigation fee, see:
http://www.ci.berkeley.ca.us/ContentDisplay.aspx?id=74682
For additional information on the Palmer Decision, which is key to how California approaches both Inclusionary Zoning and Affordable Housing Fees, see:
http://www.cp-dr.com/articles/node-2401

2. Requires projects contain a minimum number of units to qualify for provision of on-site Below Market Rate (BMR) housing:

Currently, housing projects of any size in Berkeley may elect to meet the City's affordable housing requirements by providing on-site BMR units. (Rental housing projects with four or fewer units are currently exempt from the City's affordable housing requirements.)

Item 29 would preempt housing projects with 10 or fewer units from including on-site BMR housing to satisfy City requirements, and would instead mandate payment of the Affordable Housing Mitigation Fee.

3. Changes how the City calculates the proportion of BMR units in a new housing project:

Currently, the City of Berkeley calculates the proportion of BMR units in new developments using what is called the "base project." The base project does not include additional units that are granted under the State Density Bonus. (See the Our Analysis section, below, for a more complete explanation of this calculation and the proposed change.)

Item 29 would change the calculation method so that the proportion of BMR units in a new housing project is based on the full project (including any density bonus units) rather than the base project.

4. Allows the City to adopt zoning- or geographic-based inclusionary requirements or Affordable Housing Mitigation Fee levels:

Currently, Berkeley's inclusionary housing requirements and Affordable Housing Mitigation Fee are set for the entire city, with no geographical or zoning-based variation.

Item 29 would allow the City to vary inclusionary requirements (different BMR unit proportions and/or affordability levels) and/or vary Affordable Housing Mitigation Fee levels across different zoning designations and/or areas of the city.

Item 30: Changes in the Affordable Housing Mitigation Fee

1. Reaffirms Item 29's changes to fee payment timing and eliminates early payment discount:

   As discussed above, homebuilders may currently elect to pay Affordable Housing Mitigation Fees earlier (at Building Permit rather than Certificate of Occupancy) in exchange for a discount of $4,000 per market-rate unit.

   Item 30 would change prior Council resolutions to be consistent with Item 29's requirement that Affordable Housing Mitigation Fees be paid at issuance of Building Permit rather than at issuance of Certificate of Occupancy. The proposal would also eliminate the current $4,000 per market-rate unit discount for making early fee payment.

2. Indexes Berkeley's Affordable Housing Mitigation Fee to construction costs:

   Currently, the City's Affordable Housing Mitigation Fee does not automatically change and is instead periodically revisited by the City Council. Changes to the fee have usually been based on changes in the local/regional housing market and/or the broader economy.

   The proposal would adjust the amount of Berkeley's Affordable Housing Mitigation fee "by the Construction Cost Index every other year."

Item 46: One-Time/Annual Monitoring Fees for Multi-Family Housing Developments Providing Below Market Rate Units

1. Establishes one-time and recurring fees charged to housing projects that include BMR units:

   Currently, existing and new housing projects that fully meet requirements for on-site BMR units are not required to pay ongoing affordable housing fees to the City. (Projects that provide only a portion of required BMR units on-site must make up the remainder by paying a pro-rated Affordable Housing Mitigation fee in lieu of these units.)

   This proposal would require all new projects that include BMR units to pay an additional, one-time $10,000 fee and an annual fee of $450 per BMR unit thereafter. Existing projects that include BMR units would be required to begin annual payment of the $450 per BMR unit fee.

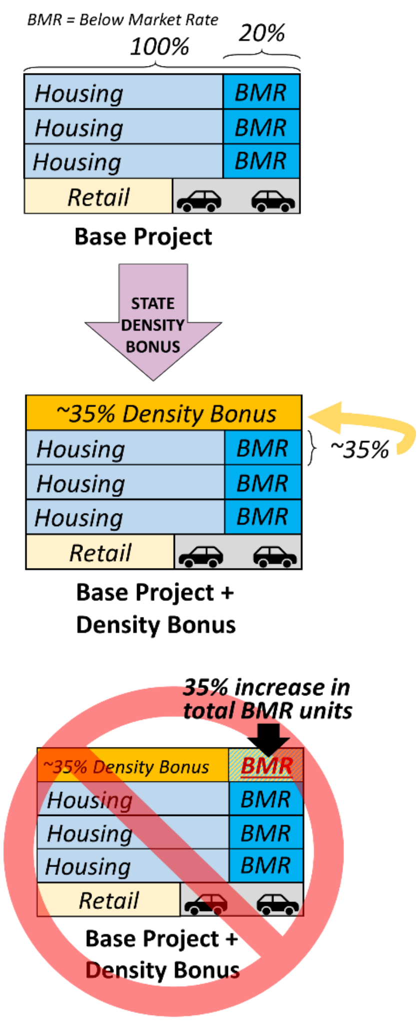
Our Analysis

Livable Berkeley believes that both individually and in combination, these proposals could have a negative impact on Berkeley's production of both market-rate and below-market rate (BMR) housing. As such, they may also negatively impact the City's ability to generate funding to build and maintain 100-percent affordable housing projects. Additionally, we believe that certain aspects of these proposals may be contrary to State Law. In the text that follows, we have endeavored to catalogue and discuss these concerns one by one. At the end to this whitepaper, we offer recommendations for how we believe these issues may be avoided and/or addressed.

Changes to inclusionary calculations may violate State law

Item 29 would significantly change how the City of Berkeley calculates the number of BMR units required for new housing projects that elect to provide on-site affordable housing. Currently, the City determines the percentage of BMR units based on the total number of units in what is referred to as the "base project." The base project does not include any additional units that might be awarded under the State Density Bonus. Although it may seem counterintuitive, the City of Berkeley's existing approach is necessary to maintain consistency with State Density Bonus law. Berkeley's current approach to calculating inclusionary requirements and density bonuses is illustrated in a simplified form, at left.

State Density Bonus
Graphic Example



The State Density Bonus is governed by Section 65915 of the California Government Code. The relevant subsection is 65915(b)(3), which states:

> *For the purposes of this section, "total units" or "total dwelling units" does not include units added by a density bonus awarded pursuant to this section or any local law granting a greater density bonus.*

By requiring that the City of Berkeley's inclusionary percentage be calculated based on a full project, including any density bonus units, this proposal would violate subsection (b)(3) of the State Density Bonus statute. Put another way, requiring that a portion of density bonus units be set aside for additional BMR units effectively reduces the size of any density bonus. This is especially true because each additional BMR unit typically results in a marginal loss for the homebuilder. The figure at left graphically illustrates the consequences of these changes that would be illegal under State Law. In addition to recognizing the inherent benefits of providing more housing, the purpose of the Density Bonus is to provide incentive to include on-site BMR units. This proposed change to Berkeley's calculation method would dramatically reduce this incentive—undermining both the letter and spirit of State law.

The proposals give inadequate consideration to economic feasibility

Economic feasibility is critical

The amount of BMR housing produced across Berkeley is arguably just as, if not more important than the proportion of any individual project that is set aside as BMR units.[2] Furthermore, higher inclusionary requirements will not necessarily result in increased creation of BMR units citywide. If City requirements and fees are such that housing projects are cancelled or never even proposed due to economic infeasibility, then Berkeley will lose out on opportunities for both BMR and market-rate housing. Put bluntly, even 100 percent of zero would still be zero.

Although it is possible that recent rent increases may be sufficient to offset the various impacts to economic feasibility discussed below, it is not possible to be certain without a revised Economic Feasibility Study.

Increased Inclusionary Zoning (IZ) requirements threaten economic feasibility of on-site BMR units

The proposed changes to BMR calculations would serve to increase the inclusionary zoning requirements for projects by up to 35 percent above current levels. To be precise, the amount of this increase over current BMR requirements would be one-to-one proportional to the amount of any density bonus being applied to a project.

For example, a project requesting a 20 percent density bonus would face an inclusionary requirement 20 percent higher than what is currently expected; a project seeking the maximum 35 percent density bonus would face a 35 percent increase over current inclusionary requirements.

This creates an enormous disincentive for homebuilders to include higher amounts of BMR housing and receive density bonuses. This would reduce Berkeley's overall housing production and undercut Berkeley's goal of placing more housing near jobs and along transit and commercial corridors.

[2] See below for a discussion of why (contrary to the methods of the Nexus Study) market-rate units do not necessarily generate a large need for BMR units.

Economic feasibility is not an all-or-nothing consideration

Although increases to Berkeley's inclusionary requirements may not end all privately-led housing creation in Berkeley, housing production may nevertheless be severely curtailed since a larger proportion of potential projects would be rendered economically infeasible.

Except in cases of extremely stringent or extremely lax requirements, project feasibility is not typically an all-or-nothing prospect at the city level. Projects in extremely high-demand areas, such as Berkeley's Southside neighborhood, may remain feasible under a set of requirements that would render projects in West Berkeley infeasible.

Inclusionary requirements and the Affordable Housing Mitigation Fee are currently applied citywide. Moving toward differential fees based on neighborhood or zoning type could help to address this issue, and we are pleased that Item 29 includes a provision that would allow this. Nevertheless, project feasibility often rests upon site-level constraints that may vary within a single neighborhood or zoning category. Even if fees are adjusted by neighborhood or zoning category, creation of housing and affordable housing in those areas may still be reduced if the fees remain too high.

The City may wish to attempt to project the level at which fees and requirements would encourage the production of an "optimal" amount of new housing.[3] Such a complex analysis may prove unnecessary or beyond the scope of the City's resources. Nevertheless, we believe it is important to consider (at least in concept) both citywide and neighborhood-level impacts that fee levels may have on housing production.

Project certainty is also key to economic feasibility

In addition to basic economic feasibility, another important factor in determining whether housing projects are proposed and built is that of certainty. A project that appears to be economically feasible on paper may nevertheless go unpursued if a homebuilder or lender perceives a risk that the project may fail and/or that the requirements applicable to the project may change mid-way through the approvals process. Whether such "mid-way" changes result in cancellation of a project depends heavily on project specifics. But the overall impact of such unpredictability is diminished housing creation, since a larger proportion of projects are likely to be deemed too risky.

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[3] Determining what level is optimal is inherently subjective, but attempting to ensure attainment of Regional Housing Needs Allocations goals for Low- and Middle-Income housing may represent a good starting point.

For the recent case of 2902 Adeline Street, mid-way changes to affordable housing requirements do not appear to have scuttled the project. However, it remains to be seen whether the project will ultimately prove economically viable and be built. Perhaps more importantly, other homebuilders observing the process surrounding 2902 Adeline now have strong indications that in the end the City Council may abrogate whatever requirements and fees were in place at the time a project was proposed.

Broader changes to affordable housing requirements and fees are arguably less harmful to project certainty than project-level negotiations or retroactive application of changes. Nevertheless, the frequency with which Berkeley changes its affordable housing fees and requirements undermines the sort of predictability that could encourage greater housing creation.

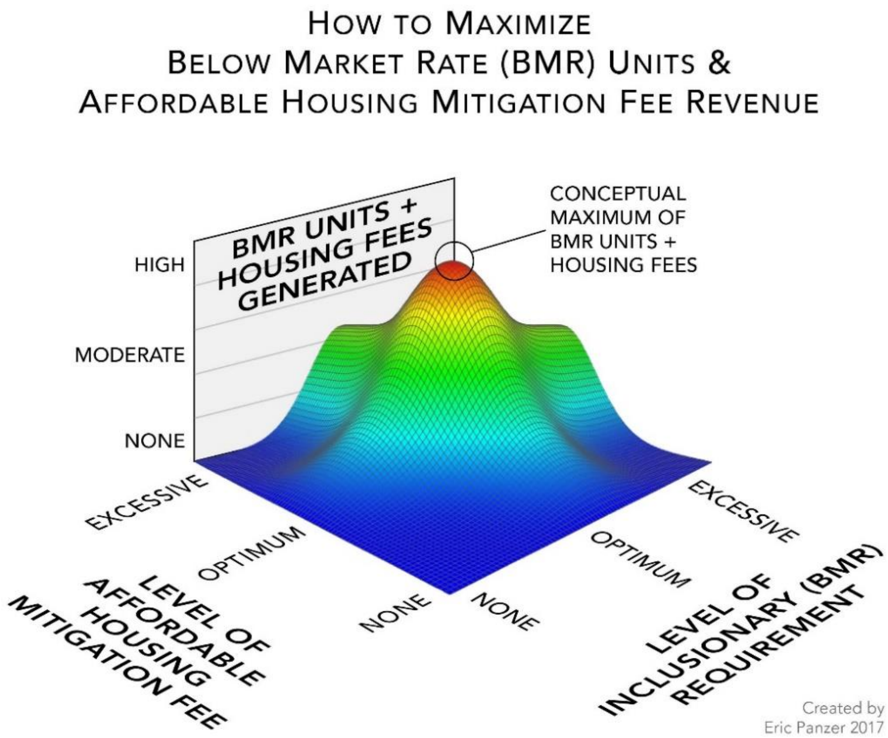
Reliance on 2015 Nexus / 2016 Economic Feasibility Studies

Items 29 and 30 draw unsupported conclusions from the 2016 Economic Feasibility Study

Items 29 and 30 reference both the 2015 Nexus Study and the 2016 Economic Feasibility study. Item 30 asserts that the latter “found that a fee of $44,000 was supportable without unduly impacting the economic feasibility of for-profit housing projects.” But this statement is misleading. The 2016 Economic Feasibility Study did not consider a $44,000 fee; rather, it analyzed a $45,000 fee and found that a model project would only be “marginally feasible,” with a yield on cost (YOC) of 6.5 percent.

It is important to note that the Economic Feasibility Study indicated that 6.5 to 7.5 percent YOC represented the “threshold for feasibility in Berkeley.” This does not mean that 6.5 to 7.5 percent YOC represents an “ideal” range for Berkeley housing creation. Rather, it means that the feasibility “breaking point” for a typical Berkeley project likely lies somewhere within this range. Projects with YOC levels above 6.5 percent are not guaranteed to be feasible; and this level could also vary between projects, or neighborhoods. It is even conceivable that certain projects on the higher end of the threshold range could be infeasible, if sufficient market uncertainties exist. Given that a $45,000 fee would be at the bare edge of “marginal feasibility,” it is not reasonable to conclude that $44,000 would be a feasible fee level

This ties in with the point made above that project feasibility at the city level is not “all or nothing.” Even if project requirements and fee levels are set such that the estimated YOC for a “typical” project is in the middle of the feasible range, it remains possible that achieving a higher citywide YOC could increase overall production of housing, BMR units, and mitigation fees. The figure below illustrates a conceptual version of this concept.



The 2016 Economic Feasibility Study uses outdated cost assumptions

Despite having been completed in early 2016, the existing Economic Feasibility Study bases its inputs on those used for the 2015 Nexus Study. Some of the key assumptions/quantitative inputs made by the 2016 Economic Feasibility Study are therefore out of date.

For example, the study used an estimated land cost of $110 per square foot; but land costs are currently more than 50 percent higher than this number. Earlier this year, the City Council voted to acquire the former Premier Cru site at a cost of $6.65 million for 0.864 acres. This equates to a cost of $176.69 per square foot, which is dramatically higher than the land value assumed by the 2015 Nexus Study and 2016 Economic Feasibility Study.

Construction costs in the Bay Area have also risen dramatically, which could further impact feasibility considerations. Although it is possible that recent rent increases may be sufficient to offset these various impacts to economic feasibility, it is not possible to be certain without a revised analysis.

Given the degree to which the various quantitative inputs of the 2016 Economic Feasibility Study deviate from current land values, construction costs, etc., it is imperative that City staff, commissions, and the City Council revisit these feasibility analyses before adopting significant changes to affordable housing requirements or fees.

The 2016 Economic Feasibility Study does not account for upcoming and/or proposed City fees

The Berkeley Unified School District (BUSD) is anticipated to soon begin assessing a fee of $3.48 per square foot for new residential construction. This proposal alone would add thousands of dollars to the per-unit cost of constructing both market-rate and BMR housing in Berkeley. Additionally, (per Item 46 described above) the City is considering assessing a new $450 per unit annual fee on all BMR units in mixed-income buildings, as well as a one-time $10,000 fee on all new housing projects that include BMR units.

None of these proposed fees are accounted for in the 2016 Economic Feasibility Study, but either could have a significant impact on project feasibility. Even without the significant changes being proposed by Items 29, 30, and 46, the adoption of the new BUSD development fees alone would arguably justify reexamining the 2016 Economic Feasibility Study.

Additionally, at its May 30th meeting, the City Council considered increasing the City's "1 Percent for Art" requirement from 1 percent of total project costs to 2 percent of total project costs (or 1 percent of project costs if the fee is paid directly to the City).[4] This imposes yet another cost on new housing that could affect project feasibility. This change in requirements/fees should also be incorporated into a revised economic feasibility study.

2016 Economic Feasibility Study rent assumptions may not be ideal

The 2016 Economic Feasibility Study assumes a market rent of $3,400 for a two bedroom, 900 square foot unit. In many areas of Berkeley, this may now be a radical underestimate, while in others it may still hold true.

Either way, $3,400 for a two-bedroom apartment remains above a level that would generally be considered "affordable." For perspective, a household spending 30 of its income on housing would need a total annual income of $136,000 per year to afford this rent. Even if a household were to spend 50 percent of its income on housing alone, such a unit would require an annual household income of $81,600. Clearly, such an apartment would be out of reach for much of Berkeley's current population and workforce.

[4] The City of Berkeley currently requires that 1 percent of construction costs for any new private project be spent on on-site public art or that the homebuilder directly pay the City a fee equivalent to 0.8 percent of project construction costs. Homebuilders may also elect to do a pro-rated combination of the two.

Although it is unlikely that market rents will fall to a level that could be considered "affordable" in the near term, it remains worth considering that Berkeley's relatively high Affordable Housing Mitigation Fee is only tenable because market rents are currently so high. If housing production, public policies, and/or economic changes result in decreased rents, the City may need to consider commensurate decreases in affordable housing fees.

Although presently unrealistic, it may nevertheless be instructive to have any new study estimate feasible fee/inclusionary levels in the purely theoretical event that rents fell to the point where housing was being provided "at cost." This would offer some perspective on where the City's Affordable Housing Mitigation Fee stands relative to what might possible under what could be considered a more "preferable" state for the housing market.

Berkeley's Requirements May Already Be Too High

In 2016, the San Francisco Controller's Office convened a Technical Advisory Committee (TAC) and drafted a report that analyzed San Francisco's affordable housing requirements. The final report was completed and released in February 2017. The report found that in San Francisco, 18 percent was the maximum inclusionary requirement that could be imposed without undesirable decreases to housing production and negative impacts to overall housing affordability. This finding was overwhelmingly endorsed by the TAC and has gone on to form the basis of new affordability requirements that are anticipated to be adopted in the very near future by the San Francisco Board of Supervisors.

Given that San Francisco continues to command higher rents than Berkeley, and given that San Francisco's recently proposed inclusionary requirements are less stringent than Berkeley's, it is possible that Berkeley's existing 20 percent inclusionary requirement is already too high and is negatively impacting local housing creation. In addition to being two percentage points lower than Berkeley's current requirement, San Francisco's proposed inclusionary requirement allows a significant proportion of BMR units to be dedicated to moderate-income households. Berkeley currently requires that all BMR units go to a combination of very-low- and low-income households.[5]

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[5] The City of Berkeley sets the thresholds for various income levels using standards from the U.S. Department of Housing and Urban Development (HUD) and regional economic data in the form of Area Median Income (AMI). The income level at which a BMR unit is targeted is often referred to as the "depth of affordability." I.e., BMR units reserved for low- and very-low-income households require a much steeper discount from market rents than units reserved for moderate-income households. Deeper levels of affordability therefore reduce project revenues by a greater amount, resulting in decreased economic feasibility.

It is currently unclear whether San Francisco's inclusionary requirements will apply to full projects rather than base projects. It also remains to be determined how the City's new requirements will interact with the existing State Density Bonus and a proposed San Francisco Density Bonus.

Before adopting significant changes to its inclusionary requirements and affordable housing fees, San Francisco embarked on thorough examination of potential impacts to housing production, creation of affordable housing, and overall affordability. Given that Berkeley is poised to make equally significant changes to its affordable housing requirements, revising the existing Economic Feasibility Study represents the bare minimum effort the City should undertake to evaluate impacts. Ideally, the City would convene a similar Technical Advisory Committee under the auspices of the City Manager's Office, the Department of Planning and Development, and the Office of Economic Development.

Misunderstanding the 2015 Nexus Study

Nexus studies are not designed to serve as policy documents

The need for Berkeley and other cities to conduct nexus studies for affordable housing mitigation fees arose primarily out of what has become known as the Palmer decision. The Palmer decision resulted in California municipalities being prohibited from mandating inclusionary BMR units in new for-rent housing. However, cities were not precluded from charging affordable housing mitigation fees and offering homebuilders the option to "voluntarily" provide on-site inclusionary housing units instead of paying the fees. To establish these fees, however, cities are required perform studies to establish a "nexus" or connection between the "impact" of new market-rate housing and the fees being charged.[6]

The purpose of these studies is therefore to provide a legal basis for cities to charge affordable housing mitigation fees. In many cases, cities seek to ensure that their nexus studies are formulated to justify the highest possible maximum fee. While such an approach is helpful in that it offers localities maximum flexibility to set their fees, this approach does not represent a sound basis for determining the real-world need for BMR housing that is generated by new market-rate housing. Nor should Nexus studies alone be used to justify a particular fee level or inclusionary requirement.

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[6] This requirement is based on Supreme Court decisions regarding the Constitutionality of city-imposed fees on new development.
Additional background: http://bit.ly/2s4St5E

San Francisco's 2016 Residential Affordable Housing Nexus Analysis even contains the following passage:

> "This analysis has not been prepared as a document to guide policy design in the broader context. We caution against the use of this study, or any impact study for that matter, for purposes beyond the intended use. All nexus studies are limited and imperfect but can be helpful for addressing narrow concerns. The findings presented in this report represent the results of an impact analysis only and are not policy recommendations for changes to the San Francisco Program. [Emphasis in original.]"

The following paragraphs briefly describe some of the limitations and unrealistic assumptions inherent to nexus studies. Although these limitations and assumptions are essential to ensuring the legal utility of nexus studies, they undermine their validity as policy documents.[7]

Nexus studies make generous use of theoretical assumptions

Berkeley's 2015 Nexus Study rests on multiple assumptions that detract from its fidelity to "real-word" circumstances.[8] But most important is the assumption that each new unit of market-rate housing inevitably results in the addition of a household with the income level necessary to afford that unit. This assumption ignores the fact that higher-income households are likely to move to Berkeley even if new market-rate units are not built.[9]

This unrealistic assumption means that the 2015 Nexus Study completely ignores the ability of new market-rate housing to absorb higher-income households that might otherwise displace or outbid lower-income households for existing housing units. In the event a new unit of market-rate housing prevents the displacement of a lower-income household, any economic impact would be based on the spending of the lower-income household that was retained, not the spending of the higher-income household that would have come to Berkeley anyway.

[7] We would like to acknowledge Yonathan's Blog, which provided the incisive and clearheaded analysis that formed the basis of this section of the whitepaper. The blog entry which discusses the limitations of nexus studies may be found here: https://blog.yonathan.org/posts/2017-04-stop-quoting-the-residential-nexus-analysis.html

[8] For a more complete explanation of its methodology and inputs, see the City of Berkeley 2015 Nexus Study: http://www.berkeleyside.com/wp-content/uploads/2015/11/2015-07-14-WS-Item-01-Affordable-Housing.pdf

[9] We know this is happening and will continue because rents and home prices have increased dramatically for existing units. Even areas that have seen little to no recent homebuilding have seen housing costs skyrocket over the past five years.

If the 2015 Nexus study were to account for the ability of market-rate units to absorb these higher-income households that would have moved to Berkeley anyway, then the estimated impact on local spending would be considerably lower. This means that the estimated need for BMR units generated by market-rate housing would subsequently be lower.

Nexus studies also leave out the ability of increased market-rate development to relieve overall market pressure and reduce prices—especially at the regional level and over the long-term. The ability of market-rate housing to have this effect serves to counteract (at least partially) the need for new BMR units that it may generate.

One might argue that the 2015 Nexus Study was intended only to look at direct impacts of new housing, rather than indirect impacts such as those related to broader supply and demand effects. But this would be inconsistent with the study's own methodology, which *does* consider indirect impacts.

The 2015 Nexus Study specifically accounts for "economic multiplier" effects from the estimated additional spending generated by residents of new housing. Rather than merely looking at the jobs generated directly by that new spending, the Nexus Study bases its calculations on broader impacts to employment as increased spending circulates and recirculates through the economy. The Nexus Study therefore considers the indirect employment impacts generated by new housing, but completely ignores the indirect impacts of those new units on the housing market itself. Nexus studies are therefore internally inconsistent (albeit purposely) in how they compute the economic impacts of new housing.

Proper Use of the Nexus Study

Given the narrow purpose of the 2015 Nexus Study (i.e., legally justifying Berkeley's Affordable Housing Mitigation Fee), the study's seemingly unrealistic assumptions are perfectly justified. Nexus studies are intended to project the maximum theoretical need (rather than the real-world need) for BMR units that could be generated by new market-rate housing.

Therefore, while the findings of the 2015 Nexus Study are wholly appropriate for their intended purpose (establishing a legal maximum), it is *inappropriate* to set real-world Affordable Housing Mitigation Fee levels and/or inclusionary requirements in a manner that rests primarily on nexus study findings relating to the maximum theoretical need for BMR housing.

Negative consequences of disallowing BMR housing in small projects and requiring early payment of Affordable Housing Mitigation Fees

Increased income segregation

Prohibiting small projects from including BMR units and instead requiring them to pay the Affordable Housing Mitigation Fee would reinforce income segregation in Berkeley. Since only large projects would be permitted to include on-site BMR units, most BMR housing would end up concentrated Downtown, on Southside, and immediately abutting commercial corridors.

"Missing-middle" housing types, such as bungalow courts, small apartment homes, and clusters of townhomes (which could be allowable away from major thoroughfares), would be prohibited from meeting City requirements by providing onsite BMR units. Focusing housing development near jobs and transit remains an important goal. But to the extent other, lower-density housing is constructed elsewhere in Berkeley, it should be allowed to elect the option of including BMR housing. This flexibility is essential to offering low-income households a greater degree of housing choice, so that large apartment buildings are not the only option available to them.

Preclusion of missing-middle housing

For certain types of missing-middle housing, up-front payment of Affordable Housing Mitigation Fee may not be feasible. Because smaller projects tend to be built by smaller developers, or even just individual families, securing financing tends to be more difficult. Many lenders already perceive loans to smaller projects as carrying greater risk. Adding the additional expense of the Affordable Housing Mitigation Fee to a construction loan could imperil most, if not all smaller projects. Continuing to allow these projects to include BMR housing would avoid this problem because the effective "cost" of the BMR unit (in the form of reduced revenue) would not actually be incurred until after a project was completed and occupied.[10]

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[10] Reduced revenue potential from including BMR units in smaller projects may, in some cases, also cause lenders to perceive such projects as less lucrative and credit-worthy. This issue is related to the questions of project feasibility addressed above. The City may wish to more closely examine the feasibility impacts of various fee levels and inclusionary requirements on smaller, "missing-middle" projects.

Possible impacts to larger projects

Even among larger projects, requiring that Affordable Housing Mitigation Fees be paid prior to issuance of the Building Permit could result in economic infeasibility.

As an example, the recently completed Varsity housing project paid a total of $1.58 million in Affordable Housing Mitigation Fees. Even for larger projects, such sums would represent a significant addition to a construction loan. Similar to what could occur for smaller projects, lenders may be less willing to extend the larger construction loans necessary to cover these fees up front. Additionally, servicing this larger debt could add tens or even over a hundred thousand dollars to project costs (depending on project size and the duration of construction). For some large projects, these may not prove to be insurmountable challenges; but for others, especially more marginal projects, this could be the factor that tips the project into economic infeasibility.

Additionally, Berkeley currently has no mechanism for refunding Affordable Housing Mitigation Fees if a project's construction is interrupted or cancelled unexpectedly. Thankfully, no large, recent projects in Berkeley have been cancelled after starting construction. Nevertheless, certain risks (e.g. fire, natural disaster, or the discovery of artifacts or environmental contaminants) have the potential to lead to project cancellation. If the City chooses to move forward with requiring payment of the Affordable Housing Mitigation Fee prior to project construction, the City should create a mechanism whereby a project that is cancelled may have these fees fully or partially refunded.

Changes in construction costs are an inappropriate index for affordable housing mitigation fees

The optimum level for Affordable Housing Mitigation Fees is determined by many diverse factors. Beyond construction costs, these factors include: economic feasibility, market-rate rent levels, local income levels, federal and State subsidies, economic multipliers, socioeconomic indicators for new tenants, land costs, and many others.

Not only are construction costs merely a small portion of what determines an appropriate fee level, but increased construction costs themselves negatively impact project feasibility—making it even more difficult to pay impact fees. If the City were to index the Affordable Housing Mitigation Fee to construction costs, negative impacts to project feasibility from construction cost increases would be amplified by the commensurate increases in the indexed fee.

Given that determining an appropriate Affordable Housing Mitigation Fee requires complex computation based on diverse factors, the City should refrain from indexing the fee to any one indicator; and instead establish a regular, frequent schedule for revisiting the Economic Feasibility Study.

New fees on BMR units would be counter-productive

Item 46 proposed levying a one-time $10,000 fee on each new project that includes BMR units, as well as establishing a $450 annual fee per BMR unit for all new and existing projects that include them.

This approach would serve to discourage homebuilders from including on-site BMR housing and would further exacerbate project feasibility issues. It is understood that the City expends considerable resources to administer BMR housing programs and ensure ongoing compliance; however, effectively taxing a public good the City wishes to provide more of (i.e., affordable housing) seems a suboptimal approach to funding these efforts.

Before imposing additional costs on new housing (and by extension Berkeley's newest and youngest residents), the City should explore additional options for cost savings within the BMR program, as well as other sources of revenue. The recently passed Measure U1 is expected to generate at least $2.1 million in new funding for affordable housing; setting aside a portion of these revenues could cover much of the administrative cost for the BMR program. Using U1 proceeds for this purpose would be fairer, because the revenues are generated by Berkeley's overall rental market, while the $10,000 and $450 fees would exclusively target new and recent housing.

Recommendations:

- The City Council should refrain from any changes to housing-related fees, policies, and requirements until all proposed changes can be evaluated comprehensively and subjected to an updated Economic Feasibility Study.
- The City should initiate a new Economic Feasibility Study that considers all existing and proposed fees, policies, and requirements that would apply to new/existing housing in Berkeley.
- Preparation of the Economic Feasibility Study should be informed by the creation of a Technical Advisory Committee that offers guidance for the study's inputs and methodology.
- The Economic Feasibility study should attempt to quantify the impact of various fee levels and inclusionary requirements on city-wide housing creation, BMR housing production, and overall housing affordability.
- The Economic Feasibility Study should evaluate how both the level and payment-timing of fees could impact project feasibility.
- The City Attorney should perform a thorough review of proposed changes to housing-related fees, policies, requirements, and calculation methods, and provide guidance on how to ensure compliance with State law.
- The City should establish a regular schedule for revisions to the City's housing-related fees, policies, and requirements, and should consider requiring that future changes be accompanied by an updated Economic Feasibility Study.
- The City should consider adopting a policy of not changing housing-related requirements, policies, and fees outside of any established schedule; exceptions could be made for specific economic triggers and/or emergencies.
- The City should refrain from indexing housing-related fees to any single metric, unless a fee correlates exclusively to its assigned metric.
- The City should refrain from restricting on-site BMR units to larger projects.
- The City should consider adopting standardized differential inclusionary requirements and/or Affordable Housing Mitigation Fees based upon project size and geographic location.
- The City should explore establishing a citywide points-based system (or similar) to comprehensively address housing requirements and fees, and potentially density bonuses.