Council Meeting Date: July 24, 2017 **Agenda Item:** 9(a)

CITY COUNCIL AGENDA ITEM

CITY OF SHORELINE, WASHINGTON

AGENDA TITLE:	Implementing Affordable Housing Provisions of Station Subarea Plans: Fee-In-Lieu
DEPARTMENT:	Community Services Division Planning & Community Development Department
PRESENTED BY:	Rob Beem, Community Services Division Manager Rachael Markle, AICP, Planning & Community Development Director Miranda Redinger, AICP, Senior Planner
ACTION:	____ Ordinance ____ Resolution ____ Motion _X__ Discussion ____ Public Hearing

PROBLEM/ISSUE STATEMENT:

The Puget Sound region, along with many other areas of the country, lacks an adequate stock of housing that is affordable to a significant percentage of the population. As the region becomes more affluent through growth within the technology industry, this problem continues to get worse.

Shoreline began examining this problem and potential solutions in 2006 when it convened a Citizen Advisory Committee and adopted a Comprehensive Housing Strategy in 2008. As well, as part of the 2012 update to the City's Comprehensive Plan, City staff worked with the Housing Development Consortium and other affordable housing advocates to craft policy language that supports preservation and creation of more affordable housing.

Through the 185th and 145th Street Station Subarea Plans, Shoreline adopted inclusionary zoning, which requires a given share of new rental-market construction to be affordable for people with low to moderate incomes in Mixed-Use Residential (MUR) -45' and -70' zoning designations. These provisions are designed to increase the housing that is available to households with annual incomes between 60% and 80% of the King County Area Median Income, or $57,600 and $76,820 for a four person household. In April of this year, the City also extended the applicability of the Multi Family Property Tax Exemption (PTE) to portions of the Station Areas to further support affordable housing development.

Currently, developers are required to meet the City's affordable housing requirement with housing units that are constructed as a part of their developments. The Development Code allows for, but does not require, that a "Fee-in-Lieu" (FIL) option for this affordable housing be developed, wherein a developer may request permission to pay a fee rather than to construct the affordable housing.

City staff is in the process of developing the administrative guidelines and processes to administer these provisions. As a part of this work, staff is seeking Council guidance on the provision of a FIL for affordable housing. While this work is largely administrative, to establish a FIL and the Housing Trust Fund to manage the fees collected requires Council direction and action.

The purpose of this staff report and discussion is for Council to provide direction on whether or when to offer a fee-in-lieu option; and if so, to determine the appropriate formula to capture the value of the affordable units.

RESOURCE/FINANCIAL IMPACT:

Tonight's discussion will not have a direct financial impact, but decisions about whether to offer a FIL alternative to constructing required affordable units on-site, and how to administer this fee and resultant Housing Trust Fund, could have resource and financial impacts.

RECOMMENDATION

While this item is for discussion purposes only, staff is seeking direction from Council regarding the use of a Fee-In-Lieu as a method to support the development of affordable housing in the Station Areas. Staff recommends that Council establish a Fee-In-Lieu formula, that the Development Code be amended to explicitly state that PTE in the Stations Areas may not be used in combination with the Fee-In-Lieu, that the affordability gap method be used to calculate the Fee-In-Lieu, that the Fee-In-Lieu only be available for partial units of affordable housing, and that a Housing Trust Fund be established.

Approved By: City Manager *DT* City Attorney *MK*

INTRODUCTION

The Puget Sound region, along with many other areas of the country, lacks an adequate stock of housing that is affordable to a significant percentage of the population. As the region becomes more affluent through growth within the technology industry, this problem continues to get worse.

Shoreline began examining this problem and potential solutions in 2006 when it convened a Citizen Advisory Committee and adopted a Comprehensive Housing Strategy in 2008 (http://www.shorelinewa.gov/home/showdocument?id=2611). As well, as part of the 2012 update to the City's Comprehensive Plan, City staff worked with the Housing Development Consortium and other affordable housing advocates to craft policy language that supports preservation and creation of more affordable housing.

Attachment A to this staff report provides a graphic that was originally included in the 2008 Comprehensive Housing Strategy which has been updated with figures that reflect current market conditions. It defines various thresholds such as the current Median Home Price in Shoreline ($530,000 as of May 2017), and the percent of Area Median Income (AMI) that a household would need to make in order to be able to afford it (136% of AMI or $130,000). It further identifies the types of interventions and support that is most useful at the various points along the spectrum. For example, inclusionary zoning, the subject of this discussion, is most effective for requiring market rate developers to provide "workforce housing" (for households earning from 60% to 80% of the AMI). Deeper levels of affordability require subsidies like grants provided to non-profit affordable housing developers.

BACKGROUND

The Housing Element of the 2012 Comprehensive Plan contains policy direction to fulfill the State Growth Management Act goal to "Encourage the availability of affordable housing to all economic segments of the population of this state, promote a variety of residential densities and housing types, and encourage preservation of existing housing stock." Comprehensive Plan policies H7-H20 articulate ways to "Promote Affordable Housing Opportunities", but the most relevant policies are below:

- **Policy H9** - Explore the feasibility of creating a City housing trust fund for development of low income housing.
- **Policy H18** - Consider mandating an affordability component in Light Rail Station Areas or other Transit-Oriented Communities.

Policy H18 was implemented in March 2015 through adoption of the 185th Street Station Subarea Plan, specifically Ordinance No. 706, which codified affordable housing requirements for the MUR-45' and MUR-70' zoning designations (and the MUR-70'+ option that would require a development agreement and deeper levels of affordability in addition to other criteria) under SMC 20.40.235.

At the time of adoption, it was envisioned that the City would ultimately establish the administrative framework to implement these inclusionary housing provisions. This includes the process for a developer to go through during permit review and the internal process and procedures to monitor and ensure that units continue to meet affordability requirements in future years. The Code speaks to methods of alternative compliance for meeting the affordable housing requirements including the establishment of a Fee-in-Lieu (FIL) option as well as establishing the framework for a Housing Trust Fund to receive such payments.

This year, the City has worked with Michael Stanger of *Social Impact Workshop* to develop the administrative procedures and to assist with any additional policy development that may be required. Mr. Stanger has experience with A Regional Coalition for Housing (ARCH) developing and implementing similar programs in cities on the eastside of Lake Washington. This work is scheduled to be completed by the end of 2017. The City will then have the capability to take in and process development applications which contain housing affordability requirements. In addition, the City will have the framework established to monitor these agreements over time. While this work is largely administrative, to establish a fee in lieu and the Housing Trust Fund requires Council direction and action.

Station Area Inclusionary Housing/Fee-In- Lieu Provisions

Both Station Areas contain inclusionary housing provisions to support the development of “workforce” housing. This is largely considered housing available to households with incomes between 60% and 80% of AMI. The policy direction from the City Council is clear that the City’s priority for workforce housing is that it be developed “on site”. This means that developers would build these affordable units into their development projects, as opposed to using a FIL option. SMC 20.40.235(E) states:

> *“The City’s priority is for residential and mixed-use developments to provide the affordable housing on site.”*

While this is the City’s stated priority, the Code does allow for a developer to meet these affordable housing requirements by paying a FIL rather than constructing qualifying units as a part of their project if the City Council establishes a FIL formula. SMC 20.40.235(B)(2) states:

> *“Payment in lieu of constructing mandatory units is available upon City Council’s establishment of a fee in lieu formula. See subsection (E)(1) of this section.”*

If the Council decides to establish the formula, then the “alternative compliance” must achieve a result equal to or better than providing affordable housing on site. This is identified in SMC 20.40.235(E):

> *“The Director, at his/her discretion, may approve a request for satisfying all or part of a project’s on-site affordable housing with alternative compliance methods proposed by the applicant. Any request for alternative compliance shall be submitted at the time of building permit application and must be approved prior to issuance of any building permit. Any alternative compliance must achieve a result equal to or better than providing affordable housing on site.”*

The thinking at the time was that there could be circumstances where it would be advantageous to a developer to seek this alternative. The City would then retain the FIL in a "Housing Trust Fund." Proceeds in this fund would then be made available to affordable housing developers through a process much the same as is used to allocate housing capital in the Community Development Block Grant.

The Code is also specific as to the conditions under which a FIL would be acceptable. SMC 20.40.235(E)(1) states the following:

> *"Payments in lieu of constructing mandatory affordable housing units is subject to the following requirements:*
> *a. The in-lieu fee is set forth in Chapter 3.01 SMC, Fee Schedules. Fees shall be determined at the time the complete application for a building permit is submitted using the fee then in effect.*
> *b. The fee shall be due and payable prior to issuance of any certificate of occupancy for the project.*
> *c. The City shall establish a housing program trust fund and all collected payments shall be deposited in that fund."*

DISCUSSION

Property Tax Exemption (PTE) in the Station Areas

In April 2017, PTE was extended to the Station Areas through adoption of Ordinance No. 776. The staff report for this Council action can be found at the following link: http://cosweb.ci.shoreline.wa.us/uploads/attachments/cck/council/staffreports/2017/staffreport041017-7c.pdf.

Prior to this, when the Station Area zoning and development regulations (including inclusion of the FIL alternative option) were initially adopted, the PTE program was considered but not offered in these areas. In the process of staff's analysis of the FIL, staff has concluded that the value of PTE outweighs any potential value of a FIL in most foreseeable cases.

The State's requirements for PTE call for 20% of a development project's units to be affordable. For instance, if a 162 unit multi-family apartment project was developed in one of the station areas, to make use of the PTE, a developer would need to make 32.4 affordable units available. To meet this requirement, the developer would need to construct 33 units of affordable housing (rounding up from 32.4 units, as it is impossible to construct two fifths of a unit). Paying a FIL for the 0.4 unit would result in only 32 affordable units being constructed, which would not meet the PTE requirements that 20% of the units be constructed. Should a developer not opt to use the PTE there would be an option to allow them to meet their affordable housing requirement for a partial unit through the FIL.

Should the FIL Formula be Established?

Based on the newly available PTE incentive in the Station Areas, staff does not see the use of the FIL as an option developers will likely exercise. While this further strengthens the City's priority that affordable units be constructed on site, maintaining the FIL option in the Development Code does increase the tools available to the development community. It is also possible that a developer may still choose to use the FIL option instead of build on site for various reasons that are difficult to discern now.

Staff therefore recommends that the Council continue to proceed with setting the FIL in the City's Fee Schedule so that the option exists as currently identified in SMC 20.40.235(E). Staff also recommends that the Development Code be amended to clearly and explicitly articulate that a FIL cannot be used in conjunction with PTE.

What Method Should be Used to Calculate the FIL?

If Council agrees that the FIL Formula should be established, there are two general approaches to computing a FIL for affordable housing: the Affordability Gap Method and the Production Cost Method.

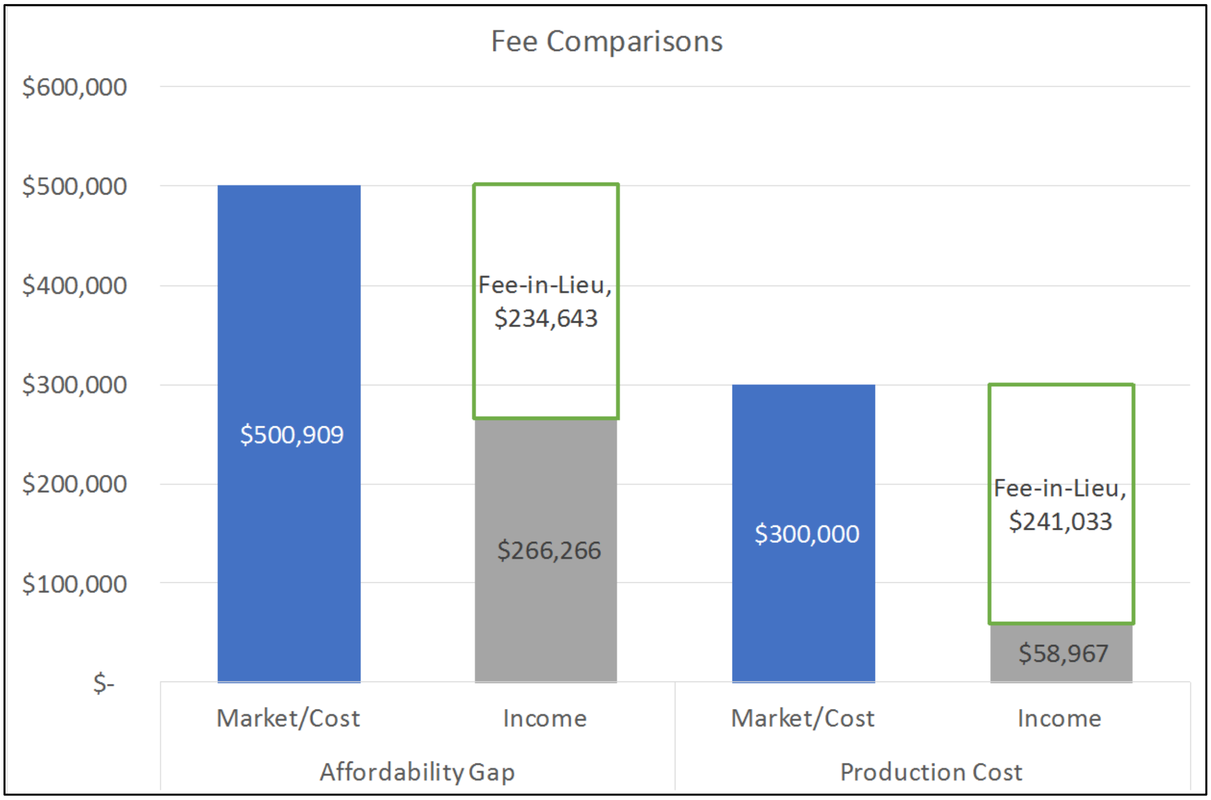
Affordability Gap Method

The "affordability gap method" is intended to recover the value (or "public benefit") of the affordable units; i.e., the gap between what a low- or moderate-income household can afford and what they would have to pay on the open market. To calculate the fee using this approach, one subtracts the affordable rent from the present market rent for comparable new multifamily housing and divides the difference by the current market capitalization rate (the "cap rate"). The result is a lump sum fee per unit. This approach has roughly the same economic impact on the average project as building the affordable units. See Attachment B for a more detailed discussion of this approach.

Production Cost Method

The "production cost method" is designed to calculate the amount needed to produce the units off site for the units the developer wants to "buy out." Whereas the affordability gap approach represents the market-rate developer's perspective, the production cost approach corresponds to the non-profit developer's view. The fee aims to fill the gap between what residents will pay and the cost of creating the affordable housing. The fee is calculated by dividing the net operating income of an affordable unit by the cap rate, and subtracting that result from the per-unit cost of a typical affordable housing project. See Attachment C for a more detailed discussion of this approach.

Applying these approaches to development in Shoreline results in the following for a two to three bedroom unit affordable at 60% AMI. The source of the costs were based on market rents in the spring of 2017 and the development costs experienced in building the Ronald Commons project.



Both formulas are capable of producing fee revenue equal to or better than the value of on-site construction of units, as required in SMC 20.40.235(E). The production cost method will calculate the fee needed for creating affordable units off-site if the land, development, and construction costs for non-profit developers are accurately gauged. Typically these costs are calculated using data on cost generated by looking at similar projects in a given city or market area. Those can be difficult to pin down, particularly because few affordable housing projects have been developed recently in Shoreline. The affordability gap method is somewhat simpler and more reliable in that (unlike production costs) market rents can be obtained from survey data which is updated annually.

Given that both formulas generate roughly equivalent figures, staff recommends that the City use the affordability gap method to calculate the FIL. This method is easier to calculate, update and to explain to developers and the community.

<u>Should the FIL be Applicable to all Required Units or only Partial Units?</u>

As noted earlier, in some developments, there may be a situation where a developer must produce a partial (or fractional) affordable housing unit. In this event, SMC 20.40.235(C)(6) states the following:

> *"In the event of a fractional affordable housing unit, payment in lieu in accordance with subsection (E)(1) of this section is allowed for the fractional unit"*.

This means that fractional affordable units cannot be rounded down by the developer, but satisfied either by the construction of a whole affordable unit (rounded up) or through a FIL if established by the City. As staff is recommending that the Council establish a FIL formula, Council also needs to provide direction on whether the FIL should be available for all units (applicable to an entire project) or just applicable to fractional units if they exist in a project.

As noted earlier, there is policy direction to have the required affordable units built on site. By limiting the use of FIL to only partial units, nearly all affordable units will be constructed on-site and the affordable units will be equal to the market rate units in the same project. Staff therefore feels that the FIL should only be allowed to be used for partial units, with the understanding that the practical application of the Code and the PTE incentive means that there will likely be very little use of the FIL at all. Staff also recommends that the Development Code be amended to clarify that FIL is available only for partial units.

Housing Trust Fund

As noted above, while staff does not anticipate much (if any) usage of the FIL for partial units, in order to receive any FIL payments, the City will need to receive these funds into a specific fund. Monies in this fund would clearly be dedicated to the provision of affordable housing. For now it is sufficient to simply establish a fund. At a later date the City can set up the specific guidelines and timelines for use of these funds. These guidelines would address things such as income targets, whether funds could be used for capital or operating expenses, how often the funds would be made available and through what process.

Given the current rate of development, the fact that FIL would be just for partial units (if Council provides this policy direction), and the fact that developers would likely not use the FIL at all because of the PTE incentive, work to determine the parameters of the Housing Trust Fund can follow the enactment of the FIL and can be scheduled for the 2018 work plan.

Administration of Inclusionary Housing and PTE

Staff anticipates that there will be one to three projects annually that will require review for compliance with the City's affordable housing provisions and/or Property Tax Exemption program. Using experience at ARCH, Mr. Stanger calculated that it takes about 50-60 hours of staff time to administer the affordable housing provisions of the City's codes per development per project. These projects, once constructed, will also require ongoing monitoring to ensure continued compliance. Staff anticipates that the City Manager's 2018 Budget will include resource to retain consulting services to assist City staff with the necessary reviews of development proposals and to assist with the ongoing compliance monitoring. New fees may be established to support all or some of this work.

Income Verification for Tenants

As staff develops the administrative requirements for this program they will be evaluating approaches to income verification. Currently participants in the City's PTE program provide the City with an annual certification that indicates they and their tenants are in compliance with the income requirement of the program.

Different agencies validate household income eligibility in various ways. ARCH has a process whereby landlords include eligibility qualification as part of their usual screening process for tenants. ARCH administers land use and tax incentive housing programs for eight Eastside cities; none of those cities base eligibility on household assets. They require a two-page certification form filled out by the applicant and the applicant's income tax return (or other wage statements). The King County Housing Authority (KCHA) requires applicants to submit longer forms which KCHA uses to obtain income and asset documentation directly from their sources (including employers and the federal government). The City of Seattle relies on landlords to check for income verification, but expects them to get documentation directly from employers (instead of relying on tax returns or pay stubs). Applicants must disclose their assets, although assets themselves are not part of the qualification. Unlike ARCH cities, Seattle does not require affordable housing tenants to recertify their eligibility after initial occupancy.

Based on this review of others' practices, Shoreline's current policy of requiring annual certification for compliance appears to be at the low end in terms of complexity and cost to administer. Staff is seeking additional direction as to whether to retain Shoreline's current practice or to adjust it to include additional steps to verify tenants' incomes. If so, and the adjustment becomes more complex to administer, staff will include this cost in the next review of the program and in the 2018 Budget.

NEXT STEPS

With the guidance received from this meeting, staff will include the Development Code amendments noted here with the batch amendments that will be reviewed by the Planning Commission later in 2017. When these come before Council in late 2017 or early 2018, staff will also bring forward the necessary amendments to the City's Fee Schedule (SMC Section 3.01) and legislation to create a Housing Trust Fund. Staff will also continue to work on the administrative processes for the inclusionary housing program and the development of guidelines for a Housing Trust Fund.

COUNCIL GOALS ADDRESSED

This item addresses the following Council Goals and Action Steps:

Council Goal 3: Continue preparation for regional mass transit in Shoreline

- Action Step 8- Implement the Affordable Housing Program as identified in light rail station subarea plans.

Council Goal 4: Expand the City's focus on equity and inclusion to enhance opportunities for community engagement.

- Action Step 2- Facilitate the development of affordable housing projects in Shoreline and engage in regional efforts focused on addressing homelessness.

RESOURCE/FINANCIAL IMPACT

Tonight's discussion will not have a direct financial impact, but decisions about whether to offer a fee-in-lieu alternative to constructing required affordable units on-site, and how to administer this fee and resultant Housing Trust Fund could have resource and financial impacts as discussed in this staff report.

RECOMMENDATION

While this item is for discussion purposes only, staff is seeking direction from Council regarding the use of a Fee-In-Lieu as a method to support the development of affordable housing in the Station Areas. Staff recommends that Council establish a Fee-In-Lieu formula, that the Development Code be amended to explicitly state that PTE in the Stations Areas may not be used in combination with the Fee-In-Lieu, that the affordability gap method be used to calculate the Fee-In-Lieu, that the Fee-In-Lieu only be available for partial units of affordable housing, and that a Housing Trust Fund be established.

ATTACHMENTS

Attachment A: Housing Options Based on Income Graphic
Attachment B: Affordability Gap Method
Attachment C: Production Cost Method

Housing Options Based on Income

CITY OF SHORELINE

INCOME
(% OF MEDIAN)

$130,000
136%

MARKET
Able to afford the median priced home; $530,000, May 2017.

$96,000
Median

MEDIAN
Can purchase the lowest priced single-family house or have a choice in condo/townhouse market.

- *Afford up to $2400/month for housing; 21% of owner-occupied homes*

$76,800
80%

ENTRY TO MARKET
Predominantly rental housing. May be able to puchase if they have savings or gifts for a down payment or are willing to pay more than 30% of income for housing. Limited First Time Home Buyer assistance available.

- *Afford up to $1920/month; 13% of owner-occupied homes. 44% of renter-occupied homes, 24% of all housing units.*

$48,000
50%

WORKFORCE HOUSING
Exclusively rental housing. Construction requires subsidy usually from federal, state and/or local governments.

- *Afford up to $1200/month; 4% of owner-occupied homes. 24% of renter-occupied homes. 11% of all housing units.*

$28,000
30%

VERY LOW INCOME
Exclusively multi-family rental operated by non-profits or housing authorities. Needs subsidy for capital and operating costs. Construction subsidized through federal low-income tax credits, WA State Housing Trust Funds, other state and local programs. Operating costs subsidized by Section 8 Vouchers, other public resources or private foundations/organization.

- *Afford $720/month; no owner-occupied homes. 14% of renter-occupied homes; 5% of all housing stock.*

Source: ARCH 2017

Attachment B
Affordability Gap Example
On Fees in Lieu of Affordable Housing

The “affordability gap” method to setting a fee in lieu of affordable housing is to have the owner/developer pay the amount they see themselves “losing” if they provided the affordable units themselves. In the case of a rental housing project, the idea is to calculate the value of a negative income stream over time from the difference between market-rate and affordable rents.

The formula is not very complicated. The fee-in-lieu is derived by subtracting the maximum housing expense of an affordable unit, including utilities, from the market rent of an equivalent unit, and dividing the result by the current market capitalization rate. (See box.) The property owner’s long-term income loss is now converted to a current value in the same basic way that an investor would calculate how much he or she might pay for a rental property based on the property’s net operating income.

For “market rent,” the city can choose a survey average (from the American Community Survey or a survey research firm, such as Dupre+Scott Apartment Advisors) or another basis believed to represent the current market rate of new apartments in Shoreline. To the extent possible, the market rent and capitalization rate should each adhere to consistent sources year to year. Utility allowances come from the King County Housing Authority.

What is the “capitalization rate?”

The capitalization rate, or “cap rate,” is the rate of return on a real estate investment property based on the income that the property is expected to generate. The capitalization rate is used to estimate the investor's potential return on his or her investment.

The capitalization rate of an investment may be calculated by dividing the investment’s net operating income (NOI) by the current market value of the property, where NOI is the annual return on the property minus all operating costs. The formula for calculating the capitalization rate can be expressed in the following way:

Capitalization Rate = Net Operating Income / Current Market Value

Some consider the capitalization rate to be, in essence, the discount rate of a perpetuity, though the use of perpetuity in this case may be slightly misleading as it implies cash flows will be steady on an annual basis.

Direct capitalization is a method used for valuing a real estate investment that incorporates the capitalization rate. With this method, one can divide NOI by the cap rate in order to determine the investment’s capital cost.

http://www.investopedia.com/terms/c/capitalizationrate.asp#ixzz4RAzkCLkL

Here's an example taken from the accompanying spreadsheet: A studio unit has a market rent of $1,580, and a 50 AMI affordable rent (less utility allowance) of $682. The difference (affordability gap) between the two is $898 per month. Dividing by the cap rate yields $215,550, which would be the fee in lieu of an affordable studio apartment.

	Studio Apartment	
Monthly Rent, 100 AMI		$1,580
Maximum Housing Expense, 50 AMI	$790	
Utility Allowance	$108	
Affordable Monthly Rent		$682
Rent Loss per Unit per Month		$898
Capitalized Value (5.0%)		$215,550

Utilities are deducted from the affordable rent, and not the market rent, assuming that all tenants pay their own utility bills, and utility expenses must be included in the maximum monthly cost of affordable housing (i.e., 30% of household income).

Attachment C
Production Costs Example
On Fees in Lieu of Affordable Housing

The "production costs" method to setting a fee in lieu of affordable housing is to have the owner/developer pay the amount it would take someone to develop equivalent affordable housing off-site, less the income generated by the unit. The fee is calculated by subtracting the capitalized value of the net operating income per unit from the cost to produce a unit of affordable housing, including land and site development (see box in Attachment A).

The production cost can be derived either from a survey of recent affordable housing projects, where land prices are similar to those of Shoreline, or by a custom calculation using standardized sources for land, construction, and related costs. We estimate the net income by subtracting a utility allowance, vacancy and credit losses, and operating costs from the maximum affordable housing expense. Utility allowances come from the King County Housing Authority. Average vacancy and credit losses and operating costs can be obtained from survey research firms.

Here's an example taken from the accompanying spreadsheet: A studio unit has a 50 AMI affordable housing expense of $790. Deducting the utility allowance, vacancy and credit losses, and general operating expenses leaves net operating income of $254 per month. Dividing the annual NOI of $3,050 by the cap rate equals $61,001. The difference between this and the production cost is the fee-in-lieu, equal to $238,999.

	Affordable Unit (50 AMI)	
Cost to Produce One Unit		$300,000
Maximum Housing Expense, 50 AMI	$790	
Utility Allowance	$108	
Vacancy & Credit Loss (2.3%)	$25	
Operating Expense	$403	
Net Operating Income (NOI)	$254	
NOI per Year	$3,050	
Capitalized Value (5.0%)		$61,001
Fee-in-Lieu		$238,999