Housing Element Update Advisory Committee

Report of Subcommittee on Affordable Housing
Subcommittee Members Bloom, Fruchbom and Tucker
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I Introduction

The Southern California Association of Governments ("SCAG") has assigned the City of Newport Beach (sometimes, the "City") a Regional Housing Needs Allocation ("RHNA") of 4,834 housing units for its 6th Cycle Housing Element. Accordingly, under State law the City must adopt an updated Housing Element that plans for at least 4,834 units to be built over the 8-year planning period ending in October 2029. Each agency's RHNA must segment its allocated units into four different income categories: Very-Low (affordable to those earning less than 50% of the area median income ("AMI")), Low (earning less than 80% of AMI, but 50% or more of AMI), Moderate (earning less than 120% of AMI, but 80% or more of AMI) and Above Moderate (earning 120% or more of AMI).

The City's RHNA for units affordable to those in the Very-Low income category is 1,453 units and is 928 units for those in the Low-income category. While State law does not require the City to ensure any housing is built, the City's update to its Housing Element is required to identify the specific locations where its RHNA is to be planned. Those locations are required to be listed in a Sites Inventory Form ("Form") promulgated by the State Department of Housing and Community Development ("HCD"). The Form also requires the City to identify for each location listed (each a "Site" or collectively, the "Sites") the income categories that Site is anticipated to help accommodate. The information about each location from the Form will be included in a Table in the updated Housing Element called the Sites Analysis and Inventory Summary (the "Sites Inventory").

II Executive Summary

The Affordable Housing Subcommittee ("Subcommittee") is comprised of members of the Housing Element Update Advisory Committee ("Committee") with experience in, and knowledge about, developing and financing affordable housing. The Subcommittee believes that the Committee and the City Council decision making process would benefit from general information about the methods used to incentivize the production of affordable housing units and the complexities involved.

As noted above, housing affordability is determined based upon AMI which for Orange County cities is the countywide median income of $103,000 in 2020 for a family of four. Of course, the greater the average rents in a city, the less affordable its housing generally will be. Rents would have to be materially discounted in coastal cities such as Newport Beach to fit the definition of being affordable to the Very-Low and Low income earners. A property owner cannot be expected to voluntarily discount rent without the effects of such discount being offset by a direct subsidy and/or other incentives and/or through beneficial provisions included in any mandate for affordable housing.

Such subsidies, incentives and beneficial mandates exist in Federal and State law today and could also be created by local laws at the discretion of the City Council. Simply put, affordable housing production is almost entirely dependent upon making use of the benefits found in a complex web of laws and regulation adopted by Federal, State and local governments, primarily in the Internal Revenue Code, the State Government Code and city Municipal Codes. The greater the value of land in a jurisdiction, the greater the subsidies, incentives and/or beneficial mandates that become necessary to prompt

production of affordable housing units. An example of the magnitude of the reduction of value that would result from discounting rent in Newport Beach is set forth in Schedule 1 attached to this Report.

There are four primary governmental programs/mandates (the "Programs") intended to provide enough incentive alone, or in connection with other Programs, to trigger development of affordable housing:

(1) Federal Low Income Housing Tax Credit Program that uses 9% tax credits ("9% LIHTC");

(2) Federal Tax-Exempt Bond financing with 4% Low Income Housing Tax Credits ("4% LIHTC");

(3) State Density Bonus Law; and

(4) Local inclusionary housing ordinances which require (i) affordable units to be built in new projects, (ii) contribution of Sites for affordable housing projects as part of project entitlement exactions and/or (iii) fees to be paid by project developers in lieu of providing affordable housing units.

Users of 9% LIHTCs develop new projects that are 100% affordable units while those who make use of the other Programs described above develop market rate housing that also includes some affordable housing units in their projects. Because of the size of the subsidies that can be necessary, projects which use 9% LIHTCs or 4% LIHTCs may also need to avail themselves of the Density Bonus Law and/or local inclusionary zoning ordinances. The market and demand for LIHTCs is very well defined and orderly in large measure because another Federal law, the Community Reinvestment Act, provides incentives for banking institutions to be buyers of LIHTCs and otherwise provide credit facilities for affordable housing projects or projects that include affordable housing units.

Since the benefits of the 9% LIHTCs, 4% LIHTCs and Density Bonus Law already exist in Federal and State law, no action is required by the City Council for such programs to be used. At the local level, additional policies and strategies described in Paragraph VII below could also be implemented by the City Council to further encourage affordable housing development in the City.

Due to the high value of land in the City, the Subcommittee believes that affordable housing in the City will need to be planned as rental housing rather than for sale housing. And because candidate Sites for larger scale, or even moderately sized, rehabilitation projects do not appear to exist in the City to any meaningful extent, the various approaches to planning for affordable housing described below can be expected to generate newly constructed affordable units rather than rehabilitation of existing units.

III Limited Scope of Report

The summary information below is not intended to be comprehensive since that would require a level of detail well beyond what the Committee and the City Council need to consider in making their recommendations and decisions, respectively. Accordingly, nuances and exceptions that are inherent in any statutory framework may not have been covered in this Report. Nonetheless the summary information should be sufficient for the reader to understand the basics of each Program and to gain an appreciation of some of the complications, limitations and restrictions involved in using one or more of the Programs to create affordable housing units.

IV Availability of Sites to Meet Lower-Income RHNA

The first step in planning for an affordable housing project or units is of course, to identify a Site. Each potential Site will be owned by someone or some entity. Broadly speaking, Sites will be owned by the City, by other governmental agencies or by private interests (whether for profit or not for profit). Vacant sites that are under the control of a public entity are the most ideal candidates to be explored for affordable housing potential. Unfortunately, the City owns very little property that is not already developed and being used under ground lease agreements (e.g., Balboa Bay Resort, Beacon Bay, Lido House Hotel), or being used by the City itself as part of its operation (e.g., Utilities Department, Police Headquarters, Fire Stations, a Corporate Yard, Oasis Senior Center, City Hall and many parks and some open space).

While some affordable units could be planned on what little property is owned by the City that is not already in use (or underutilized), and perhaps on property within the City owned by other public agencies (e.g. County of Orange), most of the City's lower-income affordable units will have to be planned on private property. And most of that property will not be owned by non-profit entities. Accordingly, most of the opportunities for affordable units will have to be planned as infill projects on existing developed properties. HCD refers to such property as "non-vacant" Sites in its Housing Element Sites Inventory Guidebook published in June 2020 (the "Guidebook"). However, it should be noted that the Guidebook (at Page 27) states that the existing use of a non-vacant Site will be presumed to impede new or additional residential development on the Site unless the Housing Element describes findings based upon "substantial evidence" that the current use of the Site will likely be discontinued during the planning period. Examples of substantial evidence are set forth in the Guidebook.

The Subcommittee believes that Sites where units affordable to lower income residents may be most feasible will be locations where moderate and market rate housing can also be developed in so-called "mixed income" developments. But private property owners are under no duty to plan for or build housing, and in particular housing affordable to those in the lower income categories. Accordingly, the City and HCD should anticipate that virtually all private property owners can be expected to act in their economic self-interest, and therefore cannot be expected to plan for, redevelop or sell their properties for a housing use unless there is a clear financial benefit for the owner that more than offsets the burden (time, effort and money) and risk (construction, marketplace, future rent control and even "rent strikes") of planning for housing, including affordable housing, in place of, or in addition to, the current use of the property.

V Details of Programs

A. Availability of 9% LIHTC:

In considering policies and strategies to address the City's lower income RHNA it will be helpful to generally understand the workings of the Programs. The Program most utilized in financing affordable housing projects is the 9% LIHTC Program, but the financing of such projects is the most complex. Under the 9% LIHTC Program, chosen projects are awarded Federal income tax credits equal to 9% of the eligible costs of that project each year for 10 years. The tax credits are made available to each State every year pursuant to Federal law. The amount of the tax credits available to projects in each State is based upon a per capita amount set by Federal law, multiplied by the number of people in the State. A housing authority in each State is empowered to decide which projects are awarded those tax credits. In California, the California Tax Credit Allocation Committee ("TCAC") awards the tax credits pursuant to a competition conducted twice per year. Each State has a Qualified Allocation Plan whereby the State publishes factors that the State finds important in allocating its tax credits. Affordable housing

developers submit their projects to TCAC which selects the "winners" based upon a point scoring criteria. The tax credits are allocated to various regions in the State (Orange County is one such region) and then projects in those regions compete for the tax credits which are allocated to as few as 1-2 projects in each competition period. The 9% LIHTCs are almost always allocated only to 100% affordable housing projects since market rate units are not entitled to claim the credits, and of course the point of the tax credit program is to generate affordable units. The developer must make an election as to which of three alternative rent affordability levels its project will be bound and those restrictions on rent must stay in place for 55 years. Each 100% affordable housing project involves a non-profit entity as the developer or co-developer in order to qualify for a property tax exemption that is crucial to keeping operating costs as low as practicable.

The competition for 9% LIHTCs is intense with the number of projects competing for the 9% LIHTCs far exceeding the tax credits that become available each year. It is not unusual for a project to have to apply for tax credits twice or more before succeeding, and some projects never succeed. The credits can be "sold" to investors and the money paid for the credits is used to pay a significant portion, but not nearly all, of the costs of a 100% affordable housing project. So, in addition to the proceeds from selling the tax credits, the winning developers must also arrange for one or more other sources of funding to cover the costs to develop the project not covered by the 9% LIHTCs. Traditional financing is one source but when combined with tax credits proceeds, additional financing is generally still required. Those other sources of funds can be from Community Development Block Grants, other Block Grants, State Housing Trust Funds, County or Federal Affordable Housing Programs, National Housing Trust Fund or even charitable contributions from Foundations.

Typically, a 100% affordable housing project has at least 4 sources of funding, which means time, effort and money has to be spent to secure each layer of the "stack" of financing necessary to move forward with a 100% affordable housing project. If the additional money comes from certain government sources, such as State Affordable Housing Bonds approved by the electorate and sold by the State, the project labor must be paid prevailing wage which in turn means significant added labor costs which has the perverse effect of causing construction of affordable housing to be more expensive to build than other housing where paying prevailing wage is not required by law.

Projects financed in part by 9% LIHTCs are typically no larger than 150 units and most are much smaller. TCAC has placed a funding cap on the amount that can be allocated to any one project. And since a goal of affordable housing is to locate residents near jobs and services, units affordable to lower income residents are not concentrated in one area. A March 2020 study by the Terner Center for Housing Innovation at UC Berkley found that of the 653 9% LIHTC projects built in California from 2008 to 2019, only 50 (7.7%) were larger than 100 units, while 155 (23.7%) were less than 40 units and 448 (68.6%) were between 40 and 100 units. According to the Terner study the average project size was 55 units mostly in buildings under 3 stories. Because of the small size of the typical 9% LIHTC project, they do not achieve economies of scale, so they are less economically efficient to build. And due to the rent structure of the units, the units do not financially work with more expensive construction techniques used to achieve higher density such as a "wrap" product where a parking structure is built in the center of a project and the housing units then wrap around the parking structure, or a "podium" product where a concrete parking structure is built below ground and/or one or two stories starting at grade with the housing units above. Because 100% affordable housing projects are generally lower density, they occupy more land per unit. In costly land locations, that can materially increase the per square foot cost of the overall project compared to locations with less costly land.

Due to the competition for 9% LIHTC, and the nature of geographical competition in the State for the tax credits, the tax credits are distributed broadly across the State by TCAC, thereby ensuring that no geographical area is materially over-represented. So even if Newport Beach had an abundance of land available for 100% affordable housing projects, it would not necessarily receive enough 9% LIHTCs to help finance all or most of its 100% affordable housing Sites. Although it should be noted that if Newport Beach is deemed a so-called "high resource area" (in general, high resource areas have a lower poverty rate, are more suburban and have a greater share of non-Hispanic White households), it may be more favorably considered for 9% LIHTC if project proponents with land in Newport Beach applied.

Given the economic realities of 100% affordable housing projects, as a general rule, 100% affordable housing projects need free or very low-cost land, whether in fee or via a long-term ground lease at minimal rent, so that adds to the challenge of finding Sites for such projects. Land for 100% affordable projects more often becomes available due to unique circumstances within a jurisdiction than happens with larger scale market rate or mixed income projects. Agencies, advocates and developers actively seeking to find 100% affordable housing sites look for unusual situations where land that is not being used, or is being inefficiently used, could become an affordable housing site. Some examples would be a parking lot on public property, or excess church land where serving lower income individuals is part of a Church's mission, or abandonment of a use on public land, or as part of a master development plan where perhaps there is a street abandonment or realignment that might create an available land area that could be used for affordable housing units. In other words, with 100% affordable housing projects there is more frequently an atypical source of land, and often these sites are small. Of course, the costlier the land, the more money that has to be raised to effectively reduce the land costs enough to enable a 100% affordable housing project to proceed.

Lastly, because of the number of financing sources involved in putting together a stand-alone 100% affordable housing project as described above, it takes quite a bit of time to find a Site, design and entitle a project, compete for the 9% LIHTCs, assemble the remainder of the financing stack and complete a project from start to finish which means that the volume of 100% affordable housing projects that can be expected over the 6th Cycle RHNA could be somewhat limited even for agencies that make every effort to assist in the development of such projects. Given the constraints on what can be paid for land and the competition for tax credits that cannot be expected to be concentrated in one community, the Subcommittee believes it would be optimistic to plan for 100% affordable housing projects to satisfy more than a modest portion of the sizable lower-income RHNA of the City.

B. <u>Availability of Tax-Exempt Bond Financing with 4% LIHTCs:</u>

Another Federal program allows the use of tax-exempt bond financing for certain "private activities" such as affordable housing if at least 50% of the eligible project costs come from such bond financing. A project that includes a stipulated amount of affordable housing and uses tax-exempt bond financing is automatically eligible for 4% LIHTCs. An important feature of bond financing arises because the interest paid on the bonds is tax exempt and therefore the interest rate that lenders are willing to accept is lower than the market rate for financing where the interest paid is taxable. The lower the interest rate on project debt, the lower the debt service payments will be. The lower the debt service, the more project debt the same net operating income of a project will be able to pay - - thus increasing financing proceeds available to cover project costs.

In housing projects that use tax-exempt bond financing, the trade-off is that at least 20% of the units in the project must be affordable based upon a specified income criteria. But since most of the units in such projects would be market rate housing, the tax credit only applies to the "applicable fraction" of the eligible costs that can be allocated to the cost of developing the affordable units in a project. The

applicable fraction is the lesser of the affordable units as a percentage of total units, or the affordable unit square footage as a percentage of total project square footage (so as to ensure the average square footage of affordable units will be roughly equivalent to the average square footage of other units in the project). And instead of 9% of eligible costs being the credit amount that can be taken each year for ten years, it is only 4% per annum and only then equal to the applicable fraction of the eligible costs allocable to the affordable units. However, because of the keen competition for 9% LIHTCs, 100% affordable housing projects are sometimes financed using 4% LIHTCs and tax-exempt bonds even though at 4% of eligible costs, the maximum tax credit amount for such a project would be less than half of the value of the tax credits in a project which is awarded 9% LIHTCs. 100% affordable housing projects using 4% LIHTCs would require additional grant type funds to cover much of the difference between the value of 9% credits and 4% credits.

Each State has a limit on how much private activity tax-exempt bond financing can be issued by it each year since that type of financing has an effect on the Federal budget. Other private activities that are authorized to use tax-exempt bond financing and thus compete for the finite amount of such financing that is available are: certain infrastructure financing, financing of certain types of industrial facilities, funding of student loans and funding of home mortgage loans. In recent years the demand for private activity tax-exempt bond financing has also greatly exceeded supply. Since tax-exempt bonds must be issued by a governmental agency (with the permission of the State), the agencies get to decide which types of activities they prefer to see funded. Because an agency has no financial risk in issuing the bonds, the State or other agencies is at liberty to allocate the limited supply of tax-exempt bonds to uses other than affordable housing for reasons peculiar to each State (even though affordable housing is the only such use that also receives the benefit of the 4% LIHTCs).

An additional important factor inherent in the use of tax-exempt bond financing is that significant additional costs are involved in the issuance of bonds. The bond buyers in many cases are retail investors so such projects will usually be burdened by an underwriter, a credit enhancer (to qualify the bond issuance for an appropriate bond rating so as to assure the bond buyers of the creditworthiness of the investment) and a trustee to hold and disburse the bond proceeds as the project work proceeds. Each of those functions has its own legal counsel and each function that must be performed represents an added cost. The benefits of a lower interest rate and a higher loan amount has to more than offset the added costs of a bond issuance and an extended period of credit enhancement costs to make tax exempt bond financing worthwhile. If the buyer for the entire bond issuance is a bank, the costs can be somewhat less than if the buyers are retail investors.

The benefit of the spread in interest rates between tax-exempt financing and taxable financing available for multi-family projects has decreased rather precipitously in 2020 due to very low interest rates. So, tax-exempt bond financing for housing is not as beneficial at the moment, although the duration of that circumstance is anybody's guess. Since tax-exempt bond financing has been an important source of financing for affordable housing units, a reduction in the economic incentive for using this Program could be expected to adversely impact the number of affordable housing units that will be developed until interest rate spreads normalize.

C. Density Bonus Law:

A State law requires each jurisdiction in California to grant a density bonus of a statutorily specified percentage above and beyond the base zoning for a property in exchange for a covenant by the property owner that a statutorily specified percentage of the project will be rented at a level of affordability stipulated in the law. The Density Bonus Law allows for density bonuses generally from 20% to 35% of the base number of units allowed by the zoning of a Site, depending on the number of

units to which the project developer covenants to provide at specified affordability levels. For instance, if the base zoning of land would allow a 260-unit project, a developer would be entitled to a 20% density bonus, or 52 units (for a total of 312 units) in exchange for a covenant to develop the site with 5% of the base units (i.e. 13 units) being affordable to "very-low income" residents. If the same developer for the same project instead decided to raise the affordability level to "low-income" residents, then the density bonus law specifies that the number of affordable units would have to be 10% of the base density (i.e., 26 units). Developers can only be expected to take advantage of the Density Bonus Law if the value of the density bonus exceeds the cost of the subsidy burden of developing the affordable units.

In addition to a density bonus, the Density Bonus Law also requires an agency to provide certain projects which qualify for a density bonus with one or more other "incentives" or "concessions" depending on the percentage of affordable units to which the project formally commits. An incentive or concession could be a reduction in site development standards or a modification of zoning code or architectural design requirements, such as a reduction in setbacks or minimum square footage requirements or other regulatory adjustments that result in identifiable and actual cost reductions.

D. Inclusionary Housing Ordinance:

Another source of affordable units in many jurisdictions is a local inclusionary housing ordinance ("IHO"). Newport Beach no longer has an IHO since it rescinded its IHO when the 5th Cycle RHNA was a total of 5 units. The provisions of an IHO can vary materially from jurisdiction to jurisdiction but the most effective IHOs are structured to generate as much affordable housing as is feasible, while not rendering projects financially infeasible due to an excessive affordable housing mandate. In other words, affordable housing mandates should be understood as a cost of development and if those costs are too high, a project may be impeded from coming to fruition.

Agencies that have IHOs generally require affordable housing in every new housing project of a minimum size. While Newport Beach does not have such a requirement citywide today, it does have an affordable housing overlay that encumbers certain land in the airport area. That land may be used for residential uses but in order to do so the overlay requires that a minimum of 30% of the project units must be affordable to lower-income households in certain instances. Most of Newport Beach has no such requirement.

E. Administrative Burden of Using Programs:

Use of any of the Programs in connection with development of affordable housing units will also include the administrative burden of detailed tenant related record keeping and income verification as well as filing of periodic reports to document compliance with Program requirements, which reports are subject to regulatory compliance audits.

VI Planning Considerations Due to No Net Loss Law

In 2017, a material new concept was added to State law dealing with differences between what is shown for a Site in the Sites Inventory and how that Site is actually developed. Senate Bill 166 (the "No Net Loss Law") includes provisions that limit the loss of Sites that would include housing units affordable to lower income households, or the reduction of units at stipulated affordability levels throughout the planning period. For this reason, there may be instances where rezones may be required during the planning period to accommodate the implications of this law. For example, if a Site listed on the Sites

Inventory ("Subject Site") is developed but not with the unit count at the affordability levels listed in the Sites Inventory, the City must demonstrate it has the capacity to accommodate in other locations the units not so developed at Subject Site by affordability level. If the units not so developed by affordability level are not able to be provided at other Sites listed in the Sites Inventory, the City would then be required to identify and make available Sites not on the Sites Inventory to accommodate the units by affordability level that were supposed to have been, but were not, developed at Subject Site. Therefore, in order to avoid the potential need to compensate for Sites which are not developed in the number, and at the affordability levels identified in the Sites Inventory as required by SB 166, the City may want to consider planning for more units in its Sites Inventory than is required in its RHNA for 2021-2029. In other words, the City may want to create a buffer if actual development of Sites is not consistent with the breakdown by income category set forth in the Sites Inventory.

VII Potential Policies and Strategies to Achieve Lower-Income RHNA

Due to the No Net Loss Law, the City may want to consider policies that not only plan for Lower-Income units, but encourage Lower-Income units to be built. Based upon the above, there are several policy options that the City could consider that would enhance the number of affordable units likely to be built in the 6th Cycle planning period. However, since the alternatives are policy choices, the Subcommittee recommends that this Report be forwarded to the City Council for consideration since the Committee is not the body that makes policy decisions. In evaluating policy choices, the City Council may want to be mindful that in a built-out city, encouraging Sites to be rezoned for housing means that a current use will be discontinued. Prior policy goals of the City included having a jobs/housing balance. The 6th Cycle RHNA, in effect, prioritizes housing uses in the City to a greater degree than has previously been the case.

Potential policy and strategy alternatives available to the City to foster more affordable housing would be:

1. For publicly owned properties, encourage the owner to make some of the land available to an affordable housing developer at little or no cost. Some examples would be: (a) The airspace above the parking lot at the Courthouse owned by the County of Orange at the Northwest corner of Jamboree and Birch; (b) City property that might be able to accommodate housing while continuing to accommodate its current use; (c) City parking lots that could have housing built over the parking area; and (d) the vacant site at the Dunes that is owned by the County of Orange and zoned for a family inn might be able to also accommodate a site for affordable units to offset the demand for workforce housing that a family inn use will generate.

Additionally, Newport-Mesa School District owns land adjacent to Banning Ranch, although that land is not currently located in the City. Because the NMUSD land is in the City's Sphere of Influence, that legal status has its own set of rules as to which jurisdiction gets RHNA credits for any units that are planned for the property under HCD guidelines. The City should ask NMUSD to plan for housing on this Site and further the City and NMUSD should ask the City to be given the RHNA credit for those units to the extent NMUSD plans the Site for housing due to the impetus of the City.

2. Non-profit users that might be able to accommodate housing in a portion of their parking lots - - such as churches if affordable housing were part of their missions.

3. For larger parcels that are not presently zoned for housing, enter into a development agreement to grant housing entitlements in exchange for an obligation by the owner of the Site to convey a portion of the Site to an affordable housing developer at little to no cost (or address in # 8 below).

4. For land in parts of town where land is very valuable due to ocean views, enter into a development agreement to grant entitlement for housing in exchange for an obligation by the owner to pay an affordable housing in lieu fee that could be used to help offset the cost of building affordable housing in areas of town where land is less expensive (or address in #8 below).

5. Grant entitlement density for housing that is somewhat less than optimal to encourage property owners to utilize the Density Bonus Law which requires that an amount of affordable housing specified in the Government Code will be built.

6. Consider modifying the existing overlay in the airport area (which requires a minimum of 30% affordable housing units) if it is found to discourage the development of projects in that overlay area that could otherwise contribute to affordable housing production in the City.

7. As suggested by the Guidebook, create one or more new Affordable Housing Overlays that grant a housing use or higher density with relaxed development standards for projects that voluntarily include some level of affordable housing within those projects.

8. Adopt an IHO that could require (i) a realistic and feasible portion of a proposed housing project to be affordable housing; (ii) payment of an affordable housing in lieu fee on proposed housing projects that are not required by the IHO to provide affordable housing units so money can be pooled to help subsidize an affordable housing project elsewhere in the City; and/or (iii) for proposed projects with a larger land area, require contribution of free and clear land for use as a 100% affordable housing project.

9. Encourage (without regulatorily requiring) larger employers based in Newport Beach to develop or help finance affordable housing for their lower income workers.

10. Expedite processing and plan review for projects that provide a stipulated amount of affordable housing to enable projects to move through the process at an accelerated pace. This could also include adoption of objective design standards and elimination of the currently existing discretionary review process.

11. Consider waiver or reduction of development related fees for projects that provide a stipulated amount of affordable housing in order to reduce project costs.

12. Apply for public and private grants to assist with funding of affordable housing units.

13. Consider adoption of policies or programs that incentivize and promote the creation Accessory Dwelling Units ("ADU") beyond the minimum State housing law requirements. HCD permits cities to apply expected new ADU development toward RHNA based upon a three-part approach: (i) development trends (considering ADUs permitted in the prior planning period or more recent trends); (ii) anticipated affordability; and (iii) providing resources and/or incentives. Regarding affordability, HCD and SCAG have formally adopted an assumed affordability that would treat 25% of new ADUs as being affordable to the Very-Low income category and 43% of new ADUs as being affordable to the Low income category. To encourage and accelerate ADU construction, the City could also consider several measures such as permit and development fee waivers, permit-ready standard plans to minimize design and construction costs, an amnesty program for owners of illegal units to bring them into compliance, and/or creation of a public information/outreach program to encourage ADU development.

14. If implementation of the policies and strategies listed above or in the Guidebook do not generate the necessary subsidies and incentives for the City to be able to create an "adequate sites program" (i.e., to identify a sufficient number of suitable and available Sites that can be planned by the City to meet its Lower-Income RHNA), then the City may need to request a financial commitment from the State or other governmental sources to fund the remaining subsidies necessary for the City to implement an adequate sites program that will enable the City to plan for its Lower-Income RHNA.

VIII Potential Limiting Factors on Effectiveness of Strategies to Achieve Affordable Housing

A. Motivations of Private Property Owners:

In considering which policies to implement to enable planning for the lower income RHNA on private property, the City will be constrained by the financial expectations of private property owners. Private property owners are usually in business to make a profit, so to the extent affordable housing incentives are not clearly a net positive for a private property owner, private property owners may be reluctant to allow a housing use to be planned on their property.

B. Financial Constraints to Development Intensification of Sites:

The Guidebook suggests that if there is not sufficient land upon which affordable housing may be located that the agency consider enacting policies that will generate enough additional benefit to property owners to offset the costs associated with providing housing affordable to lower-income residents. In effect, the Guidebook suggests that allowing more density and easing development standards, such as height, setbacks, private open space to allow more housing on a Site should be coupled with a mandate that a portion of those additional units be affordable to lower income residents. The premise is that such intensification will allow the project to be financially feasible even with the burden of affordable units. While the Subcommittee agrees that enabling more units on a site can increase the value of the Site, the Subcommittee notes that at some point, adding more density in certain locations will not necessarily make a site more valuable. For example, the more densely a project is developed, generally the greater the height of the structures. But if the height of structures causes them to move into a different construction class under the building code, the more expensive per square foot the Site will become to build. Relaxing development standards could also mean a Site will feel more crowded, making the project less appealing to market rate renters who have more choices as to where to live. The less appealing a project is, the lower the rent per square foot that such a project can command. In other words, at some point, adding units/square footage to a site, or relaxing development standards will cease to generate additional economic benefit.

C. Coastal Zone Properties

Some of the sites that otherwise look to be feasible locations for housing are in the Coastal Zone. The City has found that seeking development approvals of property within the coastal zone is time-consuming, expensive and somewhat unpredictable (e.g. Banning Ranch). Given the timeframe in which HCD expects the update to the Housing Element to be achieved, the Subcommittee believes it will be challenging to identify affordable housing opportunities in the Coastal Zone within the 6th Cycle approval timeframe. Accordingly, most of the City's 6th Cycle (sizable) RHNA will have to be planned on private property outside the Coastal Zone. However, the Subcommittee suggests that City Staff nonetheless discuss Coastal Zone alternatives with HCD and Coastal Commission Staffs to ascertain if there may be opportunities for housing projects that could include affordable housing in the Coastal Zone that could be approved by the Coastal Commission in a timely fashion.

IX Conclusion

Public agencies such as the City are not developers, lenders or directly engaged in project-level feasibility of development projects. For affordable housing, a city may take a more active role in providing entitlements, perhaps some land, infrastructure and/or other components of a project, but the overall planning and arranging financing and other funding sources of a project is primarily that of an entity external to the City. Therefore, the City should focus on using its authority to adopt policies, programs and regulatory considerations to directly and indirectly influence the feasibility of development of affordable housing units in the City, and otherwise follow the recommendations in the Guidebook to the extent practicable.

Schedule 1
Loss of Value due to Discounted Rent

The cost of the subsidy to lower the rent of a unit from market rent to an affordable rent is the loss of value that such rent discount causes to a project. Since affordable housing rent restrictions are long term, the value reduction should be viewed as permanent. Income producing assets such as an apartment project are valued based upon their annual cash flow generated from operations.

The cost of the subsidy would be computed by a landowner/developer in roughly the following manner: Suppose a cursory inspection of available one-bedroom apartments in Newport Beach shows rents averaging about $3,200-$3,500 per month for new luxury apartments, down to $1,700-$1,900 per month for older projects. A developer of affordable housing has to choose one of two affordability ranges, or a combination of the two: At least 20% of the units have to be affordable to those earning 50% or less of AMI, or at least 40% of the units have to be affordable to those earning 60% or less of AMI. In Orange County, one-bedroom affordable rents are $1,149 for 50% of AMI income levels and $1,387 for 60% of AMI income levels. These rents are subject to adjustment for family size and utilities, but those adjustments will be ignored for the purposes of this example which is just to demonstrate the order of magnitude of the potential loss of value due to discounting rent. Apartments projects today are selling for 4%-5% yields tending to the lower yields as the community becomes more desirable as would be the case with projects in Newport Beach.

Assuming a 4.5% yield and that market rents are only $1,900 per month (in reality a new or remodeled project could command much more), then the loss of value, or subsidy, for an apartment rent discounted to be affordable to an occupant with AMI of less than 50% of median income, would be approximately $200,000 {($1900-$1149)x12/.045)} and would be approximately $137,000 for an apartment affordable to an occupant with AMI of less than 60% of median income {($1900-$1387)x12/.045)} and these are conservative estimates. If the estimate were more aggressive, as much as $500 might be added to market monthly rents which a selling owner might expect, and the gap would widen by an additional $133,000 per unit. A new luxury unit renting at market for $3,000 per month discounted to be affordable to the 50% AMI renter at $1,149 month would mean a subsidy of approximately $494,000 {$3,000-$1,149x12/.045} per unit.