



**ECONOMIC IMPACT ANALYSIS OF
INCLUSIONARY HOUSING PROGRAM
IN OAKLAND**

EXECUTIVE SUMMARY

Prepared for the
CITY OF OAKLAND

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INTRODUCTION

Purpose

To assist the City of Oakland in its consideration of an inclusionary housing program, an economic study was undertaken to analyze the impacts of potential inclusionary housing requirements on the feasibility of developing housing in Oakland.

Evaluation of City's Proposed Ordinance Requirements

The economic analysis tested the impacts of the proposed inclusionary requirements as set forth in the City's draft ordinance of October 2006. Key aspects of those requirements include the following:

- ◆ Three options for compliance:
 - On-site: 15% of units affordable.
 - Off-site: 20% of units affordable.
 - In-lieu fee: Equivalent to amount required if City were to subsidize production of off-site affordable units.

- ◆ Affordability levels for inclusionary units:
 - For-sale units affordable at an average of 100% Area Median Income (AMI).
 - Rental units affordable at an average of 60% AMI.
 - Affordable sales prices and rents to be determined consistent with California Redevelopment Law.

- ◆ Inclusionary units to be at least proportional to market-rate units in terms of number of bedrooms.

Sensitivity Analysis of Alternative Requirements

Once the economic impacts of inclusionary requirements in the proposed ordinance were evaluated, additional sensitivity analysis was done to test the impacts of alternative ordinance parameters, focusing on differences in the percentages of inclusionary units required, and differences in the affordable sales prices for the inclusionary units.

Approach for the Analysis

The first step in the analysis was to assemble current data and information on prototypical development projects that cover the range of types of market-rate housing projects being developed throughout Oakland. Pro forma financial analysis summaries were then prepared for

the development prototypes to understand the economics of feasible development. Separately, the costs of potential inclusionary requirements were estimated for each of the compliance options: on-site units, off-site development, or in-lieu fee payment. With these inputs, the costs of inclusionary requirements were added to the housing prototype pro formas to assess potential impacts on project feasibility and to consider possible implications for residential development in Oakland if the inclusionary requirements were adopted.

OAKLAND HOUSING DEVELOPMENT PROTOTYPES

Seven market-rate housing development prototypes were identified for use in the analysis. The prototypes were chosen to be representative of the range of types of housing development occurring in Oakland. They also were chosen to represent developments with different costs and revenues. In this way, it is possible to demonstrate how the economics of development vary among prototypes in order to test the possible market effects of inclusionary requirements throughout the city.

The seven housing development prototypes are defined based on a combination of factors that determine the costs and revenues of development:

- *Building types and densities:* including wood-frame, and concrete and steel construction, from low-rise townhomes/lofts/row houses, to lower-rise and mid-rise condos, to higher-rise development.
- *Locations within the city serving different markets:* including locations in the neighborhoods of North Oakland, West Oakland, and East Oakland, locations along the Estuary waterfront, and locations in downtown Oakland.

The prototypes are all for-sale developments, as new market-rate housing occurring in Oakland has been for-sale housing. Consultations with developers and feasibility testing undertaken as a part of this effort, indicated that rental housing is generally not feasible to develop under current market conditions. The few market-rate rental projects that have been proposed or developed recently, are rented on an interim basis and then sold as condominiums.

Certain housing types were not included as prototypes for this analysis. They include: single family detached homes (typically developed on individual lots or in small projects not covered by inclusionary requirements); conversions of non-residential buildings to residential use (costs are specific to individual projects and not easily generalized); and luxury, high-rise development in tall towers (only limited examples in Oakland, which tend to be relatively unique and are not generally feasible in most parts of the city).

BASE CASE FEASIBILITY WITHOUT INCLUSIONARY HOUSING IN OAKLAND

Financial pro formas were developed for the housing prototypes based largely on data and information for actual Oakland projects. The objective was to develop an understanding of the

economics of housing development by establishing a base case for each prototype, without an inclusionary housing program in Oakland.

Market Context and Feasibility Thresholds

The pro formas for the prototype projects reflect *costs* for construction and land, as of late 2006/early 2007 when data was collected for the analysis. They also include *revenues* based on housing sales prices estimated for the time when the new units would be completed and ready for sale. Depending on the prototype, the sales prices would apply about one to two years later than the costs. For the analysis, market-rate housing prices assume future prices at levels that have been achieved in Oakland, although prices in late 2006/early 2007 were somewhat below those levels for some prototypes. Generally, prices are anticipated to return to prior levels and then increase again thereafter.

There is uncertainty about housing prices in the near future. The assumptions for this analysis are reasonable, and not particularly optimistic or conservative. They also tend to even out the effects of the recent housing market downturn for purposes of assessing economic impacts. For economic impact analyses, assumptions about market conditions should reflect overall trends, and not be based at either the low point or the high point of market cycles.

The pro formas calculate the return from development and evaluate project feasibility by comparing this return to the minimum return levels or feasibility thresholds typically required by developers for the types of development projects analyzed. The required return measures set firm thresholds for project feasibility, and are used in the development industry by developers, lenders, and investors. The minimum returns identify what must be achieved for developers to earn acceptable compensation for their efforts and risk and for financing and equity investment to be attracted to the project.

Base Case Feasibility for Development Prototypes

The results of the base case pro forma analyses without an inclusionary housing program in Oakland, show that project feasibility varies among development prototypes throughout the city.

Most Feasible Projects

Wood-frame prototypes in the stronger market areas show returns that are above the minimum feasibility thresholds. These prototypes include the following:

- Prototype B: Low-rise lofts/townhomes in North Oakland/West Oakland, typically in the vicinity of the Oakland/Emeryville/Berkeley borders.
- Prototype D: Mid-rise condos (4-5 floors) in North Oakland and along the eastern parts of the Estuary waterfront.

- Prototype E: Mid-rise condos (4-6 floors) in Downtown Oakland including the Jack London District.

These results are confirmed by recent development activity in these areas and including these product types.

Marginally Feasible Projects

Lower-cost, wood-frame prototypes that provide lower-priced, often entry-level housing in Oakland neighborhoods show returns at or close to the minimum feasibility thresholds. These prototypes include the following:

- Prototype A: Low-rise townhomes and row houses in East Oakland and West Oakland, including larger projects on former industrial sites and smaller projects on infill locations.
- Prototype C: Lower-rise condos (3 floors) in East Oakland and West Oakland, often along the major streets/corridors.

In general, market-rate development of these prototypes has become feasible only recently in Oakland. Developer interest has not been as strong as for other prototypes, due to lower potentials for return and fewer successful project examples. Although identified for East and West Oakland, Prototype C is also applicable in nearby parts of North Oakland as well.

Infeasible or Marginally Feasible Projects

The more costly prototypes with *concrete/steel construction* show returns below the minimum feasibility thresholds. These prototypes include:

- Prototype F: Higher-density, mid-rise condos (6-8 floors) in larger projects in Downtown Oakland.
- Prototype G: High-rise condos (9-16 floors) in Downtown Oakland.

For these prototypes, construction costs are high and have been increasing, while sales prices have not kept pace with costs or have not reached high enough levels in Oakland.

This group includes project types that have been recently built downtown. However, the costs for these recent developments were below current costs as the projects were built under construction contracts signed several years earlier. There also are numerous projects of these prototypes that are approved or proposed in downtown Oakland. The financial analysis suggests that many of those proposals will not be built right away, and that construction is likely to be postponed until housing prices increase.

While the results for Prototypes F and G are generally applicable, some projects of these types in particularly strong locations may command higher sales prices and generate higher returns that could fall within or above feasibility thresholds. Examples include downtown projects with waterfront sites on Lake Merritt or the Estuary and, possibly, particularly strong locations in Chinatown or the Jack London District.

COSTS OF PROPOSED INCLUSIONARY REQUIREMENTS

The inclusionary housing requirements proposed in the City's draft ordinance of October 2006 were analyzed to estimate the costs of compliance from the perspective of the market-rate projects that would be subject to the requirements. Costs were identified for each of the compliance options: on-site development, off-site development, or payment of an in-lieu fee that reflects the full subsidy required to build the inclusionary units as part of a separate affordable development. The costs of compliance are based on inputs from actual developments in Oakland, State Redevelopment Law definitions for affordable sales prices, and other City of Oakland requirements.

- ◆ *Affordable Sales Prices.* Based on the City's proposed ordinance, on average, inclusionary units are to be affordable to households with incomes up to 100% AMI. Consistent with State Redevelopment Law and City of Oakland definitions, the calculations of affordable sales prices are based on 35% of 90% AMI. The State formula includes a number of costs and lending assumptions that are different from what is typically used by the lending industry. Under conventional underwriting standards, households with incomes as low as 70% AMI could be able to purchase units at these affordable prices.
- ◆ *On-Site Compliance.* The cost of on-site compliance is represented by the difference between the market-rate sales price and the affordable sales price for inclusionary units required in a residential development. From the perspective of the market-rate project subject to the requirements, the "cost" is the reduction in revenues from selling a unit at the affordable price instead of the market-rate price. It is assumed that the development costs for the affordable units (15 percent of units in the project) would be essentially the same as the costs of developing the market-rate units in the project (85 percent of units).
- ◆ *Off-Site Compliance.* To provide inclusionary units off-site, the developer could build the units directly or could contribute funds to another developer who would build the affordable units. The cost of off-site compliance is defined as the difference between affordable sales prices and the development costs of the off-site units. The analysis assumes that the off-site affordable units are constructed without public funds. As calculated, the costs may understate the true costs of off-site compliance, as there could be additional risks and difficulties of developing two projects in the same timeframe, which cannot be easily quantified. In most cases, the development costs of off-site units are less than the costs of on-site units, as it is assumed that developers of relatively more expensive, market-

rate projects could develop affordable units on less valuable sites and with lower construction costs.

- ◆ *In-Lieu Fee.* The proposed ordinance provides the option of paying a fee in-lieu of providing units either on-site or off-site. The fee is to cover the costs for a developer, generally a non-profit, to provide the required inclusionary units as part of an affordable housing development. The amount of the in-lieu fee is calculated as the difference between affordable sales prices and development costs to build the affordable units with receipt of City funds (including payment of prevailing wages and meeting other City contracting requirements).

The costs of compliance were estimated for each of the market-rate housing development prototypes. The results show that the costs of compliance would vary among prototypes and among compliance options. In most cases, the costs of compliance through payment of the in-lieu fee or with off-site development would be lower than the costs of compliance on-site.

In general, on-site compliance could reduce sales revenues by an average of \$27,000 to \$59,000 per unit in the project, depending on the development prototype. By comparison, the in-lieu fee payments range from \$25,000 to \$40,000 per market-rate unit, and the off-site compliance costs are estimated to range from \$23,000 to \$29,000 per market-rate unit (without accounting for the additional risks and hassles involved in developing two projects in the same timeframe).

IMPACTS OF PROPOSED INCLUSIONARY REQUIREMENTS

The costs of proposed inclusionary housing requirements were integrated into the base case housing prototype pro formas to test potential impacts on development feasibility. Analysis was also done to assess effects on residual land values, and to identify how much housing prices would need to increase to offset inclusionary costs. Consideration was then given to overall implications for housing development in Oakland.

Effects on Housing Project Feasibility

Overall, the impact analysis identifies that the costs of inclusionary requirements in the City's proposed ordinance are high relative to returns from housing development in Oakland. The proposed inclusionary requirements could cause returns from development to fall below feasibility thresholds in almost all cases. The pro forma analyses show that, for the five prototypes that are feasible in the base case, there is only one prototype under one compliance option where development might be marginally feasible. The two prototypes that are already not feasible in the base case, would have returns that fall further below feasibility thresholds with the additional costs of the proposed inclusionary requirements. The proposed requirements are anticipated to have the greatest impact on the feasibility of developing lower-priced housing in the neighborhoods and developing the more costly building prototypes downtown.

Among compliance options, payment of an in-lieu fee or off-site development would have less impact on project feasibility than on-site compliance in most cases. This is consistent with the differences in costs among the compliance options.

Market Adjustments and Implications for Housing Development

Over time, a combination of market adjustments are likely to be required to offset the costs of the proposed inclusionary housing requirements. Given the magnitude of effects on project feasibility, these adjustments could take time. In the process, there are likely to be implications for housing development in Oakland. The following summarizes anticipated adjustments and their implications.

- ◆ If the October 2006 ordinance proposal was implemented immediately, some development may slow or stop until the market adjusts to incorporate the costs of inclusionary requirements. It also could take longer for development not currently feasible to reach minimum feasibility thresholds, with inclusionary requirements.
- ◆ Land prices are likely to stabilize initially and then decline over time, as a result of the inclusionary requirements. Changes in land prices could eventually offset some of the additional costs of inclusionary requirements.
 - For the prototypes with stronger financial feasibility in the base case (three of the seven prototypes), a combination of land price adjustments and development returns at minimum threshold levels, could make a difference in project feasibility.
 - Land price adjustments (in combination with development returns at minimum threshold levels) are unlikely to make enough difference where development is marginally feasible or infeasible in the base case (four of the seven prototypes). With the inclusionary requirements, residual land values are very low or negative for these projects.
- ◆ Over time, market increases in housing prices may help restore feasibility, depending on broader housing market trends. Price increases would first need to exceed increases in development costs. Then, price increases would likely go to offsetting inclusionary costs before increasing development returns and/or land values.
 - Housing price increases could help in offsetting inclusionary costs. Depending on the prototype, housing price increases of two percent to eight percent above prices assumed for the analysis and above any increases in development costs, could be sufficient to offset compliance costs and restore feasibility for the five prototypes that are feasible to develop in the base case.
 - Given the current market context, it is unlikely that housing prices will increase this much in the short term, suggesting that it could take a number

of years for prices to increase sufficiently to offset the costs of complying with the proposed inclusionary requirements.

- ◆ Feasibility is likely to be restored sooner for the wood-frame building types in the strongest market areas, as exemplified by Prototypes B, D, and E.
 - These are the projects with stronger feasibility in the base case. A combination of adjustments in land prices, housing prices, and development return could occur more quickly than for the other prototypes.
- ◆ Effects of the inclusionary requirements could encourage wood-frame construction over steel/concrete construction since the requirements would increase the already high costs of developing the larger building types, as exemplified by Prototypes F and G. To some extent, this is already happening in the current market context under the base case.
 - For the higher-cost building types, the housing prices required for a feasible project with an inclusionary program would need to be at levels above those achieved in Oakland thus far, and therefore could take time to achieve. In addition, possible land price adjustments could make relatively small contributions to restoring feasibility for these projects.
- ◆ Lower-priced housing projects, as exemplified by Prototypes A and C, could require significant adjustments to offset inclusionary costs.
 - The ability of land price adjustments to offset inclusionary costs is limited. Similarly, lower development return is unlikely to help offset inclusionary costs, since these projects already have returns at or just above the feasibility thresholds in the base case.
 - Higher housing prices may not be obtainable in some of the locations where these projects could be built, unless there is a general increase in housing prices throughout the broader market.

SENSITIVITY ANALYSIS OF ALTERNATIVE ORDINANCE PARAMETERS

Additional analyses were undertaken to test the impacts of alternative ordinance parameters, focusing on differences in the percentages of inclusionary units required, and differences in the affordable sales prices for the inclusionary units. The alternatives tested assumed lesser requirements that would have lower costs of compliance than the inclusionary requirements in the October 2006 ordinance proposal.

The findings of the sensitivity analyses show that changes in ordinance parameters could make a difference in lessening impacts on housing project feasibility in Oakland. With less stringent requirements resulting in lower costs of compliance, an inclusionary program could be more successful in producing inclusionary housing units sooner and with fewer market impacts.

While each of the several alternatives evaluated has the effect of reducing impacts and the market adjustments needed to offset inclusionary costs, the results are not substantially different from those for the proposed requirements until fairly large changes in requirements are assumed. Housing development throughout Oakland is not so profitable that it can easily absorb the additional costs of an inclusionary housing program. Of the many alternatives tested, the following options achieved financial feasibility for the greatest range of prototypes and compliance options.

◆ *Lower Percentages of Inclusionary Units Required:
5% On-Site and 10% Off-Site/In-Lieu Fee*

With these lower requirements, three of the prototypes could be feasible to develop under all three compliance options compared to only one prototype under one compliance option with the proposed ordinance requirements. Returns would still fall below feasibility thresholds for the other four prototypes, including the higher-cost building types and the lower-priced prototypes. As the inclusionary costs would be lower than under the ordinance proposal, fewer market adjustments would be needed to offset inclusionary costs.

As noted above, and assuming the ordinance parameters from the October 2006 proposal, the costs of compliance for off-site development and payment of an in-lieu fee are lower than the costs for on-site compliance for most prototypes. This could result in few affordable units being incorporated into market-rate projects. The sensitivity testing of alternative percentage requirements identified that as the inclusionary requirements are reduced, the differential between the on-site and off-site/in-lieu fee requirements is also reduced. If the percentage requirements were reduced to 5% on-site and 10% off-site/in-lieu fee, there is a higher probability that developers would choose to build affordable units on-site.

◆ *Higher Affordable Sales Prices for Inclusionary Units: Up to 120% AMI*

Affordable sales prices based on a higher nominal target income level of up to 120% AMI (setting prices so that State-defined housing costs equal 35% of 110% AMI), would lower the costs of compliance and reduce impacts compared to the ordinance proposal. Under conventional underwriting standards, housing priced at the alternative sales prices could actually be affordable at incomes as low as 87% AMI. As a result, the City could set the affordable sales prices at a higher level than specified in the proposed ordinance and still maintain affordability to households at incomes at or below 100% AMI.

With the higher affordable sales prices, two to three of the prototypes could be feasible to develop (three reach the feasibility threshold under one compliance option and two do so under two of the options), compared to only one prototype under one option under the ordinance proposal. Returns may still fall below feasibility thresholds for the other development prototypes (four to five prototypes), including the high-cost building types and the lower-priced prototypes. As inclusionary costs would be lower than under the ordinance proposal, fewer market adjustments would be needed to offset inclusionary costs.

Under this alternative, the higher affordable sales prices make the most difference in project feasibility for off-site and in-lieu fee compliance. Higher sales prices alone are not sufficient to make any of the prototypes feasible with on-site compliance.

- ◆ *Combination of Lower Percentage Requirements and Higher Affordable Sales Prices:*
 - *5% On-Site and 10% Off-Site/In-Lieu Fee*
 - *Housing Priced at 120% AMI*

The feasibility testing of this combined alternative shows at least one feasible compliance option for four of the housing prototypes, including Prototypes A, B, D, and E. The results for a fifth prototype, Prototype C, are just below the feasibility threshold. The results for Prototypes F and G are still below feasibility thresholds, since they are already not feasible in the base case.

Among all of the alternatives tested, this combined option could be the most successful in producing inclusionary housing units sooner because the required adjustments to development return and/or land prices would be relatively smaller and more easily absorbed.

Comments Regarding Possible Phasing-In of Inclusionary Program

If an ordinance were to include requirements at the mid-level or higher end of the range of costs for an inclusionary program, “phasing in” such a program over time could help accommodate the necessary market adjustments. “Phasing-in” could include implementation of lower-cost requirements for a period of time followed by the more costly requirements at a later time. The effect of “phasing-in” inclusionary requirements would be to allow more time for market adjustments. It also could allow time for overall market conditions to improve.

The benefits of this approach, however, would depend on trends in the broader housing market context during the phasing-in period. Improving market conditions for new housing development would help accommodate the costs of inclusionary requirements, while stable or declining conditions would not.

The phasing-in of an inclusionary housing program may not in itself eliminate or substantially reduce impacts, particularly for the higher cost alternatives. However, the benefits of phasing-in inclusionary requirements would allow more time for market adjustments to occur and would give the market an early signal regarding future compliance costs, which could be especially important when developers are negotiating land purchase prices.