CITY OF OAKLAND
COUNCIL AGENDA REPORT

TO: Office of the City Manager
ATTN: Robert C. Bobb
FROM: Community and Economic Development Agency
DATE: October 16, 2001
RE: **INFORMATIONAL REPORT REGARDING THE HOUSING NEXUS STUDY AND RECOMMENDATIONS FOR THE ESTABLISHMENT OF A HOUSING LINKAGE FEE**

SUMMARY

This report summarizes the results of a Housing Nexus Study that examines the relationship between new non-residential development and the demand for affordable housing. The study finds that there is a clear relationship between the two, and estimates the cost (per square foot of new building space) of mitigating the affordable housing demand. An economic impact analysis indicates that a modest impact fee would not materially affect the prospects for continued development of non-residential buildings. Staff recommends that the City Council adopt a housing linkage fee policy, with a proposed fee level of $6.00 per square foot on office, hotel, retail and warehouse/distribution uses. Projects of 50,000 square feet or less would be exempted. Due to the current uncertain economic conditions, staff recommends that implementation of the program be deferred for one year. If the City Council adopts the proposed policy, staff will prepare the necessary legislation and return for final approval.

FISCAL IMPACTS

The specific fiscal impacts depend on the fee level, the types of buildings covered, and the extent to which developments that are in the pipeline are constructed. At the proposed fee level of $6.00 per square foot, the linkage fee could generate over $17 million in new funds for affordable housing over the next several years. If implementation is delayed for one year, approximately $2.5 to $5.0 million in revenue could be foregone as a result of planned projects that are expected to apply for building permits within the next 12 months.

BACKGROUND

On December 7, 1999, in response to a request from Councilmember Jane Brunner, chair of the City Council's Community and Economic Development Committee, staff presented to the Committee a report on the formation of a task force to consider policy alternatives for development of housing. The report was presented to the full City Council on December 21, 1999, at which time the City Council approved the report and provided direction to staff on the composition and scope of the new task force.

The Task Force met six times over a five month period. In addition, subcommittees were formed to research issues and frame discussions for the Task Force as a whole. A final report was presented to the City Council and the recommendations were adopted on July 25, 2000.

Among the recommendations was consideration of establishing linkage fees to be assessed on new non-residential development in order to mitigate the impact of increased demand for affordable housing caused by such development. The fees would be deposited into a trust fund dedicated to production of new affordable housing. Similar fees are in place in many other California cities, including San Francisco, Sacramento, and San Diego, and are under consideration in Los Angeles and elsewhere.

Adoption of a linkage fee requires the completion of a "Nexus Study" to demonstrate the relationship between non-residential development and demand for affordable housing. On December 12, 2000, the City Council authorized a professional services contract with David Paul Rosen & Associates (DRA) to complete a nexus study, perform an economic impact analysis, and estimate potential revenues from a housing linkage fee. Funding for the study was appropriated in January 2001, and the contract was initiated in February 2001. The Nexus Study has now been completed. A copy of the full study is attached to this report. The remainder of this staff report summarizes the Nexus Study and presents recommendations for policy actions.

KEY ISSUES AND IMPACTS

Shortage of Affordable Housing

Oakland is experiencing a severe shortage of housing affordable to very low, low and moderate income households. (Very low income households have annual incomes less than $25,000 - $35,000; low income households have incomes less than $37,000 - $53,000, and moderate income households have incomes less than $60,000 - $86,000. Income limits are adjusted depending on family size). According to the City's Consolidated Plan for Housing and Community Development for 2000-2005, over 30,000 low and moderate income renters are paying more than they can afford for housing, or are living in substandard or overcrowded units.

The most recent survey of market rents conducted by CEDA staff indicates that the median rent for an available rental unit is nearly $1,500 for a 2-bedroom apartment. Affordability is defined as housing cost of no more than 30 percent of household income. A household would need an income of $60,000 to afford a $1,500 per month rental unit, which requires a full time hourly wage of $30.00 per hour, or two full-time workers each earning $15.00 per hour.

Development costs throughout the Bay Area are extremely high, due to a shortage of available sites and high costs for labor and materials. It is not unusual for development costs to exceed $200,000 per unit for apartments with modest amenities. The gap between these development costs and the rents that are affordable to lower income households is substantial, and affordable housing cannot be developed without significant public investment. The private market alone will not be able to meet the demand for housing affordable to households with incomes typical of most sales, service and clerical occupations.

The Association of Bay Area Governments (ABAG) is responsible for establishing "fair share" allocations of housing for each jurisdiction in the Bay Area. ABAG estimates that Oakland will need over 3,000 units of housing for very low and low income households, just to meet new demand caused by economic and demographic growth. Continued economic development activities, including the construction of new office, retail, hotel and other non-residential buildings, increase the number of persons working in Oakland. Many of the new workers will seek housing in Oakland as a result of these new jobs. Because the private market is not able to meet this demand, continued development of non-residential buildings will exacerbate the need for public assistance for affordable housing.

What are Linkage Fees?

Housing linkage fees are assessed on new construction of office, retail, hotel, warehouse and other non-residential buildings to mitigate the impact of the additional demand for affordable housing caused by such developments. New construction creates new jobs, some of which are filled by employees who will move to the city. Some of the new jobs will have wage levels that qualify households as low or moderate income. As a result, the demand for affordable housing increases. Due to the gap between development costs and affordable housing costs, new affordable housing must be subsidized if it is to be built. Based on a formula derived from a nexus study that determines how much new affordable housing is needed, developers of new buildings contribute to a dedicated fund to offset at least a portion of the required subsidy.

Linkage fees have been introduced in a number of California cities. The first city to do so was San Francisco, which established an Office Affordable Housing Production Program in 1984. Since that time, San Francisco has generated over $40 million in housing funds. Since 1990, approximately $33 million has been raised for affordable housing in San Diego. Sacramento City and County raised approximately $26 million since their commercial linkage ordinance was passed in 1989.

The Nexus Study includes a detailed description of housing linkage fees in other cities, showing amounts, types of buildings/land uses subject to the fee, revenues, and various implementation details. The chart below provides a summary of the fee structure in those cities.

Housing Linkage Fees in Other California Cities

City	Fee Range	Types of Buildings
Alameda	$0.55 - $3.00 per square foot	Office, retail, hotel, manufacturing, warehouse
Berkeley	$2.50 - $5.00 per square foot (increases may be under consideration)	Office, retail, industrial
Los Angeles	Under consideration	
Menlo Park	$6.00 - $10.00 per square foot	Office, research and development, other commercial uses
Palo Alto	$4.03 per square foot	Commercial uses
Sacramento	$0.27 - $0.99 per square foot (increases are under consideration)	Office, hotel, research and development, commercial, manufacturing, warehouse
San Diego	$0.27 - $1.06 per square foot	Office, hotel, research and development, retail, manufacturing, warehouse
San Francisco	$7.55 - $11.34 per square foot (fees will increase by 32% in January 2002	Office, entertainment, hotel, retail, research and development
Santa Monica	$3.60 - $8.00 per square foot	Office
Sunnyvale	$7.19 per square foot	New industrial development

Legal Issues

The legality of impact or mitigation fees is well established in both statute and case law. In California, the basic requirement is that two tests be met:

1. There must be a "rational nexus" between the impact associated with an action and the use of the fee being collected.
2. There must be a "reasonable relationship" between the development project and the uses to which the fees are put.

In short, in order to impose a housing linkage fee, the City must demonstrate that non-residential development is causing an increase in the need for affordable housing, and the City must set the fee at a level that is no higher than the magnitude of the development's contribution to affordable housing need. Finally, housing linkage fee revenues must be segregated and used only for affordable housing activities.

The purpose of the nexus study is to demonstrate and quantify the relationship between non-residential development and the need for affordable housing, in order to set an upper limit to the amount of fees that can be legally justified. In practice, the actual fee will be far less than the maximum justified fee.

Economic Impact of Linkage Fees

Housing linkage fees rarely are assessed at the maximum level that is justified by the supporting nexus study. In other words, the fees that are established in practice required developers to pay only a portion of the cost of addressing the housing impacts created by their developments.

The actual fee level to be charged must take into account the potential economic impacts of a new fee. Specifically, fees must be set at a level that is not so high that it will discourage development. If fees are set too high, this will result either in rents that cannot be sustained in the market, or returns to the developer that are not competitive with returns that could be gained by building in other cities.

The next section of this report, which provides a thorough description of the nexus study, includes a discussion on the potential impact of a linkage fee on new developments.

Program Design

Finally, the creation of a housing linkage fee entails consideration of a number of factors in the design of the program. These factors include:

- types of buildings affected
- level of fees to be charged
- exemptions for small developments (threshold sizes for assessing fees)
- timing of implementation of the fee

DESCRIPTION OF NEXUS STUDY

The Nexus Study completed by David Rosen and Associates (DRA) identifies and quantifies the nexus between new non-residential development and increased numbers of low and moderate income households that will live in Oakland. It also determines the cost of providing housing units affordable to those households.

Methodology

DRA's analysis uses a methodology similar to that employed in nexus studies prepared in other cities. Data is derived from a variety of sources, including the U.S. Census, ABAG demographic and economic projections, the California Employment Development Department, private developers, and others.

To ensure that the legal requirements are met for demonstrating a nexus, the study consistently uses a very conservative set of assumptions in developing the analysis. When a particular factor can be expressed by a range of values, the study tends to use the end of the range that would underestimate, rather than overestimate, the nexus effect. The final result of DRA's nexus analysis is a conservative estimate of the true relationship between non-residential development and the cost of meeting the increased demand for affordable housing that is caused by such development.

The study examined four types of land use: office, hotel, retail, and warehouse/distribution facilities. It examined the effect of new developments of this type on demand for housing affordable to households at three levels: very low income (less than 50 percent of metropolitan area median income), low income (between 50 and 80 percent of median income), and moderate income (between 80 and 120 percent of median income).

The basic methodology, which is explained in detail in the full study, is as follows. This methodology was employed separately for each of the four land use types:

<u>Nexus Analysis</u>

1. Estimate total number of new employees generated by prototypical new development of 100,000 square feet
2. Estimate percentage of new employees that will reside in Oakland.
3. Reduce estimate of new resident employment to account for previously unemployed Oakland residents filling the new jobs.
4. Estimate the number of <u>households</u> represented by the new employees.
5. Estimate occupational groupings of new resident employees.
6. Based on step 5, estimate household incomes of new resident employees to determine distribution to very low, low and moderate income categories.
7. Adjust number of low and moderate income households to take into account multiple wage-earner households (combined incomes would cause households not to qualify as low or moderate income).

<u>Analysis of Affordable Housing Financing Gap</u>

8. Determine cost of building both rental and ownership housing
9. Determine subsidy gap between development cost and affordable housing expense for very low, low and moderate income households.

<u>Determination of Maximum Justified Fee</u>

10. Multiply number of households in each income category (from step 7) by subsidy gap (from step 9).
11. Adjust results of step 10 to determine amount per square foot of new construction.

Results of Nexus Analysis

Using the methodology described above, DRA estimated the number of additional very low, low and moderate-income households that would result from development of new non-residential uses. Because each land use has a different employment density (workers per 1,000 square feet of space) and a different occupational profile, the results vary by type of development, as shown below:

Affordable Housing Demand Produced by 100,000 Square Foot Development
(number of households, by income level and type of development)

Household Income Level	Office	Hotel	Retail	Warehouse/ Distribution
Very Low Income	17	8	16	6
Low Income	9	2	9	4
Moderate Income	8	1	5	2
Total	**34**	**11**	**30**	**12**

Maximum Legally-Supportable Fee

Based on the foregoing analysis, DRA has developed an estimate of the maximum fee that could be charged and still meet the legal test for a valid impact fee. The results of this analysis are as follows:

Maximum Justified Fee by Land Use

Land Use (Type of Development)	Maximum Legally Justified Fee
Office	\$35.11
Retail	\$32.39
Hotel	\$12.91
Warehouse/Distribution	\$12.85

It should be noted that this is the <u>maximum supportable fee</u> and considerably exceeds the fee levels proposed by staff.

Economic Impact

A key consideration in the development of a linkage fee policy is determination of the effect such a fee would have on the economics and financial feasibility of new non-residential development. DRA's analysis took into account four factors:
- percentage increase in total development costs
- effects on rents for non-residential space
- effects on developers' rate of return
- Oakland's nexus fees for all purposes compared to those of other cities with whom Oakland competes for new business development.

DRA considered a range of possible fees, from a low of \$2.00 per square foot to a high of \$10.00 per square foot. These fees are far below the levels justified by the nexus analysis, and represent a range of policy options that are similar to fee levels charged in other jurisdictions.

Percentage Increase in Development Costs

At these levels, the potential fees represent a relatively small proportion of total development costs. For office buildings, a fee of $2.00 per square foot represents less than 1 percent of total development costs, while a fee of $10.00 per square foot would add just over 4 percent to total development costs. For hotels, the range is from less than 1 percent to less than 3 percent; for retail and warehouse/distribution, the range is between 1.5 percent and just under 8 percent.

Increase in Rents Required to Finance a Linkage Fee

The table below shows the impact of these fee ranges on the rents that would need to be charged in order for developers to maintain a constant rate of return on investment. As can be seen, the effects on rents range between less than 1 percent and 4.5 percent; office and hotel are at the lower end, while retail and warehouse/distribution are at the higher end of that range.

Increase in Annual Gross Rent Required to Finance Linkage Fee
(Increase as Percent of Current Market Rent)

Fee Per SF Building Area	Class A Office	Warehouse/ Distribution	Retail	Luxury Hotel
$2.00	$0.23 (0.63%)	$0.23 (0.89%)	$0.23 (0.90%)	$1.01 (0.81%)
$4.00	$0.45 (1.26%)	$0.45 (1.78%)	$0.45 (1.79%)	$2.01 (1.61%)
$6.00	$0.68 (1.89%)	$0.68 (2.66%)	$0.68 (2.69%)	$3.02 (2.42%)
$8.00	$0.91 (2.53%)	$0.91 (3.55%)	$0.91 (3.59%)	$4.03 (3.22%)
$10.00	$1.14 (3.16%)	$1.14 (4.44%)	$1.14 (4.49%)	$5.03 (4.03%)

For office, warehouse/distribution and retail, figures are for rent per square foot. For hotel, figures are for average nightly room rate.

Effect of Linkage Fee on Rates of Return

The next table shows the impact on developers rates of return if rents remain unchanged. For office and hotel uses, the reductions in rates of return would be anywhere from less than one-tenth of a percentage point to less than one-half a percentage point. For retail and warehouse/distribution, the impact would range from one-quarter of a percentage point to a full percentage point.

Rate of Return on Equity[1] at Different Fee Levels

Fee Per SF Building Area	Class A Office	Warehouse/ Distribution	Retail	Luxury Hotel
None	15.00%	15.00%	15.00%	15.00%
$2.00	14.88%	14.77%	14.77%	14.91%
$4.00	14.75%	14.55%	14.55%	14.83%
$6.00	14.63%	14.34%	14.33%	14.75%
$8.00	14.52%	14.13%	14.12%	14.66%
$10.00	14.40%	13.93%	13.91%	14.58%

[1]Rate of return with no fee is based on interviews with developers

Comparison to Impact Fees in Other Cities

Apart from a fee of $0.33 per square foot assessed for school facilities (the maximum allowed under State law for non-residential buildings), Oakland currently has no impact or linkage fees. By comparison, many neighboring cities, including cities with whom Oakland competes for non-residential development, charge a variety of fees for housing, child care, traffic mitigation, infrastructure, and more.

Total Development Impact Fees Per Square Foot
Based on 100,000 Square Foot Prototype Building

City	Office	Warehouse/ Distribution	Retail	Hotel
Alameda	$3.49	$0.99	$1.98	$2.03
Berkeley	$5.00	None	$5.00	None
Emeryville	$1.45 -$10.65	$0.45	$2.29-$5.43	$1.08
Fairfield	$3.91-$7.81	$0.64-$4.55	$10.97-$14.87	$4.17-$8.01
Fremont	$6.18	$8.08	$5.22-$5.32	$3.23
Oakland	**$0.33**	**$0.33**	**$0.33**	**$0.33**
Pleasanton	$3.50-$3.91	$0.89-$1.17	$1.94-$2.24	$0.81-$1.05
Sacramento[1]	$2.86-$2.95	$1.88-$1.98	$2.87-$3.37	$3.02-$3.52
San Francisco	$17.34	None	$10.57-$13.95	$9.50
San Jose[2]	$0.33	$0.33	$0.33	$0.33
San Ramon[3]	$6.48	Based on trips	$5.51	$4.56
Santa Rosa	$3.96-$6.68	$1.89-$4.61	$5.35-$8.07	$5.35-$8.07
Walnut Creek	$4.55	None	$3.42	None

1 Does not include development fees in special development areas and technology fees, which equal 4% of plan check permit processing fees.
2 Although San Jose does not charge impact fees, it does levy a significant development tax on all new development
3 Does not include additional fees for office and hotel uses which may include beautification/cultural activities, aerial/mapping, Westside Special Plan Recovery and landscape/maintenance fees. For warehouse/distribution uses, fees are based on number of projected trips.

Developer Responses to Linkage Fee

Of critical concern is the effect a linkage fee would have on developers' willingness to invest in Oakland. As seen above, a modest linkage fee would represent a relatively small proportion of development costs, and therefore would not require significant increases in rents or reductions in rates of return.

Other cities that have adopted linkage fees do not appear to have discouraged continued non-residential development. In San Francisco, which has had a linkage fee in place for 15 years, it is clear that development has continued unabated during periods when demand for new non-residential space has been strong.

During the course of the Nexus Study, the consultant and City staff met with a number of major developers involved with Oakland projects. In general, developers indicated that modest fees are not likely to be a key determinant of investment decisions. The most important factor is the market itself. When demand is high, developers will build and will factor fees into their overall development costs. When demand is low, developers are unlikely to build regardless of the presence or absence of linkage fees.

Potential Revenues from a Linkage Fee

DRA also examined the potential revenues that could be generated by a linkage fee. Using data obtained from the City's Major Projects List and from other sources, DRA developed a list that identifies projects at various stages in the pipeline: (1) applications for planning approvals that have not yet been submitted; (2) applications that have been submitted but not yet approved; (3) planning approvals that have been granted but building permits have not yet been issued; and (4) building permits that have been issued.

For purposes of the revenue analysis, projects that have already received building permits were excluded from consideration. In addition, although a number of projects are in the preliminary planning stage, it is uncertain whether those projects will be developed in the near future, particularly given the current economic climate. Accordingly, the analysis of potential revenues has assumed that only 50% of the projects in the pipeline will go forward. This yields a conservative estimate of the potential revenue to be realized from a linkage fee.

The following table identifies the potential revenue at various fee levels for all pipeline projects that have not yet received building permits.

Potential Revenues from Housing Linkage Fee
by status of projects in pipeline and fee level (per square foot)[1]

Project Status	$2.00	$4.00	$6.00	$8.00	$10.00
Pre-application	$2.9m	$5.8m	$8.7m	$11.5m	$14.4m
Planning application submitted	$0.3m	$0.4m	$0.6m	$0.8m	$1.0m
Planning approval	$2.6m	$5.2m	$7.8m	$10.4m	$13.0m
Total	**$5.8m**	**$11.4m**	**$17.1m**	**$22.7m**	**$28.7m**

[1] Excludes projects less than 50,000 square feet, and assumes only 50 percent of pipeline projects are developed.

ENVIRONMENTAL OPPORTUNITIES

Housing linkage fees are intended to mitigate the effects on housing demand that result from new employment-generating development. In the absence of mitigation measures, new employees will be unable to find affordable housing in Oakland, and may be forced to seek housing far from their place of employment. Creation of a linkage fee and development of new affordable housing will address the already serious jobs-housing imbalance that exists throughout the region.

DISABILITY AND SENIOR CITIZEN ACCESS

Because the linkage fee is tied to housing demand that results from new employment, it is unlikely to have much effect on housing for seniors. The linkage fee could result in development of additional housing accessible to persons with disabilities.

RECOMMENDATION(S) AND RATIONALE

The Nexus Study demonstrates that the development of non-residential buildings such as offices, hotels, retail and warehouse/distribution has a clear and significant impact on the demand for affordable housing in the City. The Study also demonstrates that the costs of meeting the increased demand is substantial, and calculates a set of maximum justifiable fees for each of the four building types.

The economic impact analysis shows that the marginal impact of modest fees, set well below the maximum justifiable fee, is relatively small and is not likely to deter continued development. The factors most likely to influence investment decisions for developers are the general strength or weakness of the market, and the level of interest rates. Changes in these factors are more significant than the relatively modest change in costs represented by moderate linkage fees.

Fee Level

The Nexus Study shows that even at levels of $8.00 to $10.00 per square foot, a linkage fee would have relatively small effects on development. However, the City Council has requested that staff examine a possible Open Space Fee, which may or may not apply to nonresidential developments. A Traffic Mitigation Fee is also the subject of a preliminary analysis. To ensure that the cumulative effect of all potential impact fees is not too great, staff recommends that the Housing Linkage Fee be set at $6.00 per square foot.

Exemption for Small Projects

In establishing a linkage fee, it is important to distinguish between major projects and smaller, neighborhood-serving development. Many cities with housing linkage fees provide exemptions for smaller developments. Staff recommends a similar approach for Oakland.

Timing of Implementation

It is important that fees not be imposed in a way that penalizes projects for which substantial work has already been done without the expectation of a new linkage fee. If the City Council adopts a general fee policy on the basis of this report, additional time would be required to draft the necessary implementing legislation and procedures. This would provide some advance notice for projects that are already in the pipeline.

Since the Nexus Study was first initiated, the national and local economies appear to have entered a period of economic downturn. Under these circumstances, it may be prudent to delay implementation of the fee until economic conditions improve. While the Nexus Study shows that a linkage fee itself would have a relatively small effect on rents and/or rates of return, and that investment decisions are driven primarily by market conditions, it is nonetheless possible that establishment of a linkage fee at this time could contribute to delays in new projects or could be perceived by developers as a negative message in these uncertain times. Staff therefore recommends that the fee ordinance not go into effect for another year (January 2003). Because some major projects are expected to secure building permits in the next 12 months, delaying the effective date could cause the City to forego approximately $2.5 to $5.0 million in potential revenue.

Staff Recommendation

Staff proposes that the City Council adopt the following policy guidelines for a housing linkage fee:

1. Housing linkage fees would be established for new construction of office, hotel, retail, and warehouse/distribution land uses. Expansion of existing facilities would be covered to the extent of the net additional space to be built.

2. Projects of 50,000 square feet or less would be exempt from the fee.

3. The fee would be set at $6.00 per square foot for all four covered land use types.

4. The effective date of a new Housing Linkage Fee Ordinance would be delayed until January 1, 2003.

5. Fees would apply to any project that submits a complete application for a building permit after the effective date of the ordinance (January 2003).

6. Funds generated from the linkage fee would be used to support housing for very low, low and moderate income households in the same proportion as justified by the nexus formula.

ALTERNATIVE RECOMMENDATIONS

The City Council may wish to consider alternative approaches to the structure of a linkage fee:

1. Because the economic impacts are greater for retail and warehouse/distribution uses than for office and hotel uses, a two-tier fee structure may be appropriate. In this case, fees could be set at $6.00 per square foot for office and hotel uses, and $4.00 per square foot for retail and warehouse/distribution.

2. Given the City's strong desire to attract new retail developments to Oakland, there is concern that a linkage fee could send the wrong signal to developers. The staff recommendation would exempt neighborhood-serving retail projects (less than 50,000 square feet), but not larger developments. However, as an alternative, the City Council could choose to exempt all retail uses from the linkage fee. When the market for retail development is stronger, the City Council could then re-evaluate whether retail uses should be covered.

ACTION REQUESTED OF THE CITY COUNCIL

Staff requests that the City Council:

1. Adopt a linkage fee policy in accordance with the guidelines listed above.
2. Direct staff to prepare the necessary legislation to implement the policy and establish the program. Staff will return to the Community and Economic Development Committee and the City Council for adoption of the ordinance and a companion resolution to establish a housing trust fund for revenues collected from the fee program..
3. Develop implementing rules and procedures as necessary, consistent with the legislation.

Respectfully submitted,

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Executive Director

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Attachment

APPROVED AND FORWARDED TO THE
COMMUNITY AND ECONOMIC
DEVELOPMENT COMMITTEE

OFFICE OF THE CITY MANAGER