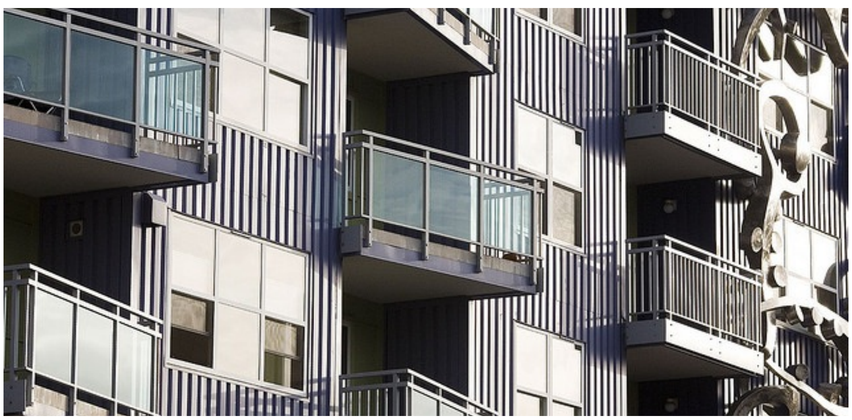
Policy Options for Refining

Seattle's Incentive Zoning Program



July 2014
Final Draft

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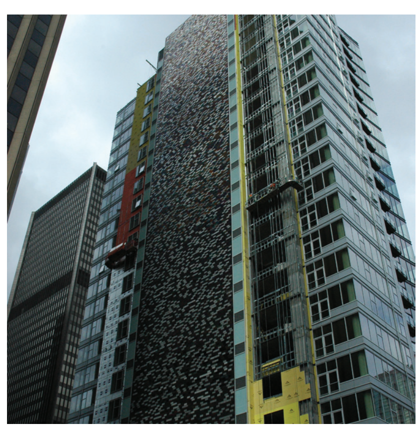

Cornerstone Partnership

Keeping Homes Affordable
& Communities Strong

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Introduction and Summary of Recommendations

There is no right way to create an inclusionary or incentive zoning program. The details of the program should be specific to the specific needs of a city, the ecosystem of other housing and service programs and current market conditions. That said, inclusionary zoning has been used to create affordable housing since the 1970s, and there are best practices and important lessons that have been learned.

In any inclusionary zoning program, policy-makers must decide fundamental questions like

1) What percentages of new units should be affordable?
2) What income level and household size should the program target? and
3) What incentives should be offered?

Beyond that, there are many smaller decisions and challenges. How do you communicate the successes and challenges of the program? Should on site production or revenue be prioritized?

This document is intended to help Seattle build on the successes of its incentive zoning program and address the challenges. This report identifies key questions for Seattle. It provides examples of how other cities answer these big-picture policy questions and design their programs. Where appropriate, this report provides specific recommendations for refinement of Seattle's program.

The recommendations below are based on input obtained through interviews with a limited number of key stakeholders; review of program documents and program performance data; review of research conducted by OTAK and David Rosen and Associates under separate contracts; and a review of current practices in comparable cities. Please note that Cornerstone Partnership did not conduct a comprehensive evaluation of the City of Seattle's Incentive Zoning program. These recommendations are specifically intended to respond to questions raised by local stakeholders and are not intended to provide a comprehensive list of all changes that might be necessary or appropriate.

Two Scenarios for Strengthening Seattle's Program

At a high level, we see two distinct options for refining and strengthening Seattle's IZ program. We have outlined a set of recommendations for improving the Incentive Zoning program under its current policy framework but, taken together, these changes are unlikely to result in dramatic increases in the impact of the program. There are several limitations inherent in the nature of a program that only applies to bonus floor area in projects that voluntary choose to participate and is only available in a handful of recently upzoned areas. An alternative would be to more significantly alter the fundamental policy framework to an Affordable Housing Linkage Fee which could be applied to all floor area in all projects in all areas likely to experience significant development.

Scenario A. Refine Existing Incentive Zoning Program

Seattle's existing Incentive Zoning program is succeeding in generating additional resources to support the development of affordable housing without unduly impacting the feasibility of new residential and commercial development. Many eligible projects have chosen not to take advantage of the bonus density but the economic analysis by David Rosen and Associates suggests that most of these projects would not have chosen to build the additional density even in the absence of affordable housing requirements. While nearly all of the projects receiving the bonus floor area have chosen to pay the fee in lieu rather than provide units onsite, the City has been effective in leveraging these fee revenues to produce new affordable housing units that closely align with local needs. For the most part these units have been in high opportunity locations in relatively close proximity to the projects that received the bonus.

Nonetheless the program could be strengthened. Section I outlines best practices in setting performance requirements and in lieu fee levels among comparable cities and includes a number of recommendations for improving both areas. Among the most significant recommendations are:

> **Maintain the current performance requirement:** While a higher performance requirement appears to be economically supportable, raising the requirement under the current incentive zoning structure would likely mean fewer projects choosing to build the bonus density and could lead to lower overall production. David Rosen and Associates analysis indicates that most project prototypes that are economically feasible without the incentive would still be economically feasible with a performance requirement far above the current requirement, however, in most cases they also found that projects without the incentive were even more profitable, which suggests that increasing the performance requirement under a voluntary incentive zoning framework could be counterproductive.
>
> **Consider a partial waiver for high rise residential projects:** In recognition of the current level of cost and risk associated with high rise development in Seattle, it might be appropriate to establish a performance requirement for high-rise development that was lower than the requirement for other projects.
>
> **Raise the In Lieu Fee:** Currently payment of the fee in lieu is significantly less costly than onsite performance for nearly all project types. As a result most developers have elected to pay the fees rather than build units onsite. The David Rosen and Associates report identifies the 'gap cost' of providing an affordable unit in each of several project types. For highrise residential projects a fee of roughly $300,000 to $350,000 per unit that would be required onsite would provide rough comparability. For non highrise projects a comparable fee would be $100,000 to $150,000 per unit that would be required onsite. While a higher fee would likely result in a greater share of projects providing units on site, it is probable that even when the fee cost roughly as much as an

on site unit costs, many developers would choose the fee option because it is simpler. The analysis by David Rosen and Associates suggests that most projects would likely remain feasible even with this higher fee level.

Authorize the Fee option in Zones with heights less than 85 feet: Currently developers in incentive zones with heights less than 85 feet are required to produce units on site. This has resulted in production of a small number of widely scattered on site units. There does not appear to be a strong policy rational for requiring performance in these areas while allowing fees in other areas. The DRA study suggests that at a higher fee level, many of these projects would nonetheless prefer the performance option.

Require studio and 1 br units to be more affordable: Lower the income targeting for on site residential units to ensure that required affordable units are comfortably below market. Currently, rental units are targeted at people making 80% of AMI and ownership units are targeted at 100% of AMI, regardless of unit size. In particular, the recommendation is to lower the targeting for studio and 1-bedroom units, as summarized below:

	Rental	Ownership
Studio	50% of AMi	60% of AMI
1 bedroom	60% of AMI	80% of AMI
Larger than 1 bedroom	80% of AMI	100% of AMI

Other recommendations in this section include:

- Expand the residential program
- Plan and budget for periodic reviews
- Calculate residential in lieu fees on a per required unit basis
- Consider requiring fees from projects with fewer than 3 affordable units
- Annually update the fee

Scenario B. Replace the IZ program with an Affordable Housing Linkage Fee

While the scenario above would likely result in incremental increases in number of affordable housing units produced through the program, it is unlikely to dramatically change the level of production. Many local stakeholders expressed frustration with the limited impact of Incentive Zoning given the overall strength of Seattle's real estate market. The current program is limited in two fundamental ways:

1) It only applies in a small number of areas that have recently been upzoned. Much of Seattle's development occurs outside of these areas.
2) it only applies to projects that choose to build to the higher allowable density and the economics for many projects don't support denser development.

Together these limitations mean that only a very small portion of Seattle's real estate production is being asked to contribute to mitigating a social problem that all new development is helping to exacerbate. A more widespread program could be more equitable while also producing much more affordable housing.

In place of the current Incentive Zoning program, Seattle could adopt an Affordable Housing Linkage Fee. Under a linkage fee program new residential office or retail development in designated high growth areas (including but not limited to the recently upzoned areas where the IZ program currently operates) would be required to pay money into an affordable housing trust fund or to provide affordable units. The requirements would apply regardless of building height or changes in zoning.

While a linkage fee program could operate in a way that was very similar to the current Incentive Zoning program the underlying legal basis for such a program is quite different. Where the Incentive Zoning program requires affordable housing in exchange for the benefit of additional density, a linkage fee would be structured as a broad based mitigation tied to the impact that new development has on the need for affordable housing.

Target the fee to areas likely to experience development: The linkage fee would not need to be limited to the current incentive zones. The City should carefully evaluate the potential geography where a linkage fee would apply but should consider all Low-rise and higher zones in urban centers and urban villages.

Allow developers in the existing incentive zones to build the bonus density: While a new linkage fee would apply to all projects in designated areas, developers in the existing incentive zones should still be allowed to access the bonus density. Rather than repealing the existing incentive zoning program, the program should be amended to clarify that payment of the linkage fee would satisfy a developer's affordable housing obligation

Base the Fee on the findings of a Nexus Study: Because the linkage fee is intended to mitigate the impact of a given development on the community, it is important that the fee be established based on the measurable contribution of a likely project to the overall need for affordable housing. A Nexus study is the established methodology for making that connection. The Nexus study should focus on likely residential and commercial project types in the targeted higher growth neighborhoods. The study will establish a maximum fee that would be consistent with the housing need created by new development of various types, but Council could choose to set the fee at a lower level if the maximum allowable fee would impact development. It is likely that the fee per square foot particularly for residential projects would be lower than the current Incentive Zoning Fee In Lieu but by applying this fee across a broader area, Seattle might be able to generate more total revenue. While Seattle's fees would be based on conditions in Seattle, in other cities, fees vary dramatically from $1 a square foot to nearly $30 a square foot.

Offer a Performance Option: Even if the program is designed as a Linkage Fee, the city can offer developers the option of providing units onsite in lieu of paying the fee. As with Incentive Zoning, the program can be designed to encourage either units or fees or a combination. But even if the program is designed to encourage fees, an onsite (or offsite) performance option might appeal to certain developers who want to be closely and more publically associated with the provision of the affordable housing that their project generates. To simplify administration, the performance option should only be available to projects that would provide 3 or more affordable units.

Phase the Fee in over time: Any new fee will add to the cost of development. For projects outside of the incentive zoning areas or projects that are not planning to use the bonus density, a sudden increase in costs could be difficult to absorb. Phasing a new fee in stages over a three-year period will allow time for land prices to adjust appropriately without unduly impacting projects that are in the development pipeline today.

Additional Recommendations applicable to either approach:

Whether or not Seattle changes to a Linkage Fee approach, the overall program can and should retain most of the elements of the current Incentive Zoning program. Overall, Seattle's current program is operating in a way that is consistent with the national best practices for Incentive or Inclusionary Housing programs. However Cornerstone Partnership's interviews, data analysis and research into best practices identified a number of issues in the implementation of the current program which could be addressed along with either revisions to the existing program or in the course of implementing a new linkage fee program.

Additional recommendations outlined in detail in section III include the following:

Setting Appropriate Income Targets

P. Continue current income targeting

Q. Continue to use most fee revenue to serve higher need populations

R. Set a portion of fee revenue for 'workforce' housing

S. Continue to allow OH flexibility in investing fees

T. Require studio and 1-br units to be more affordable

Investing Fee Revenue

U. Continue to limit the neighborhoods where fee revenue can be spent

Producing Homeownership Units

V. Develop a more formal program for affordable homeownership

W. Ensure proactive stewardship of homeownership units

Off Site Production

X. Strengthen and clarify requirements for off site production.

Y. Establish an 'additional benefit' standard

Z. Create rules to ensure off site units are built

AA. Create detailed guidelines for preservation projects
BB. Monitor the use of the off site option

Leveraging Other Subsidy Sources

CC. Continue to limit ‘double dipping’
DD. Clarify the standard for approval of exceptions

Preserving Affordability

EE. Extend affordability periods
FF. Renew covenants at resale
GG. Require replacement of demolished IZ units

Monitoring and Refining the Program Over Time

HH. Standardize the code
II. Produce communications materials
JJ. Expand annual reporting requirements
KK. Plan and budget for periodic reviews

I.Refine the Existing IZ Program

In Many ways Seattle's Incentive Zoning Program has been working. Cornerstone Partnership's February 2014 report estimated that the program is responsible for the creation of over 700 units of low and very low-income housing. While very few units have been built onsite within the market rate projects that contribute to the program, most of these units have been located in or adjacent to Seattle's highest growth and highest cost neighborhoods. However, Cornerstone's interviews, and analysis of Seattle's data highlighted a number of challenges. For the most part, these challenges are the same issues that other large city incentive and inclusionary programs struggle with. For each issue identified below, we have attempted to briefly outline some of the strategies that other cities use and, where appropriate, we have made specific recommendations for Seattle.

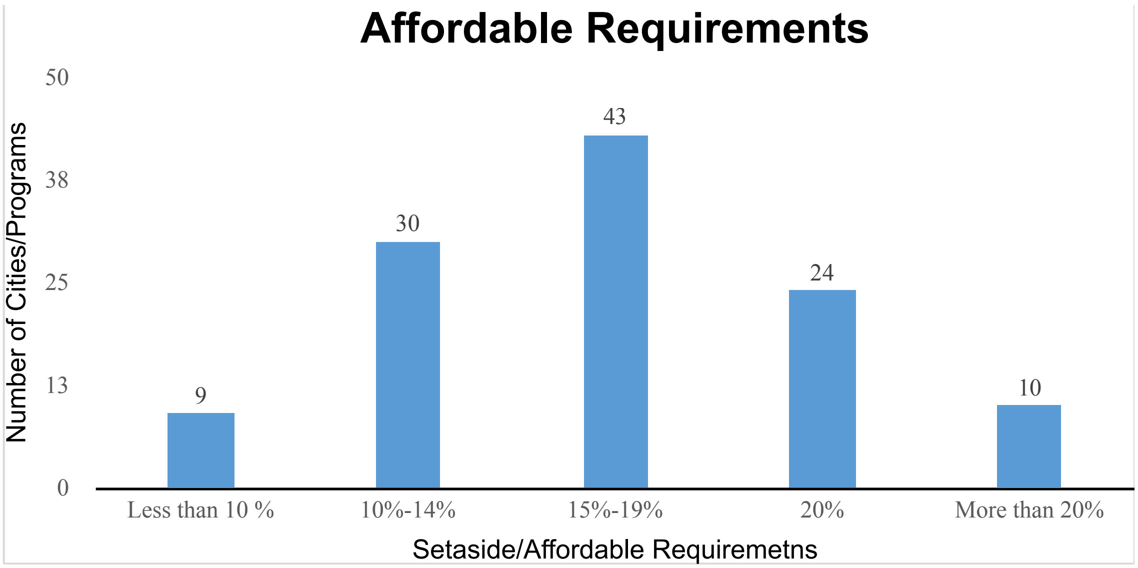
Establishing the Performance Requirement

Background

The key challenge facing every incentive or inclusionary housing program is how much to expect developers to contribute to meeting the City's affordable housing needs. Typically cities establish this basic requirement as a percentage of units that must be rented or sold at affordable prices onsite. Many cities then allow developers to choose among one or more alternative methods of satisfying the requirement (such as payment of a fee or production of units offsite, etc). But the baseline option sets the economic bar against which alternatives are evaluated so it is important that the baseline performance option be appropriate given local market conditions.

There is a wide range of baseline production requirements in practice across the country. Typically, mandatory programs in strong market cities require ten to twenty percent of units to be affordable and weak market cities have no affordable housing requirements.

In 2006, the Nonprofit Housing Association of Northern California did a statewide study of the percentages that various inclusionary housing programs require. The most common requirement was for 15 percent of the units to be affordable.



Source: Nonprofit Housing Association of Northern California

In addition, OTAK's recent study for Seattle found the following points of comparison:

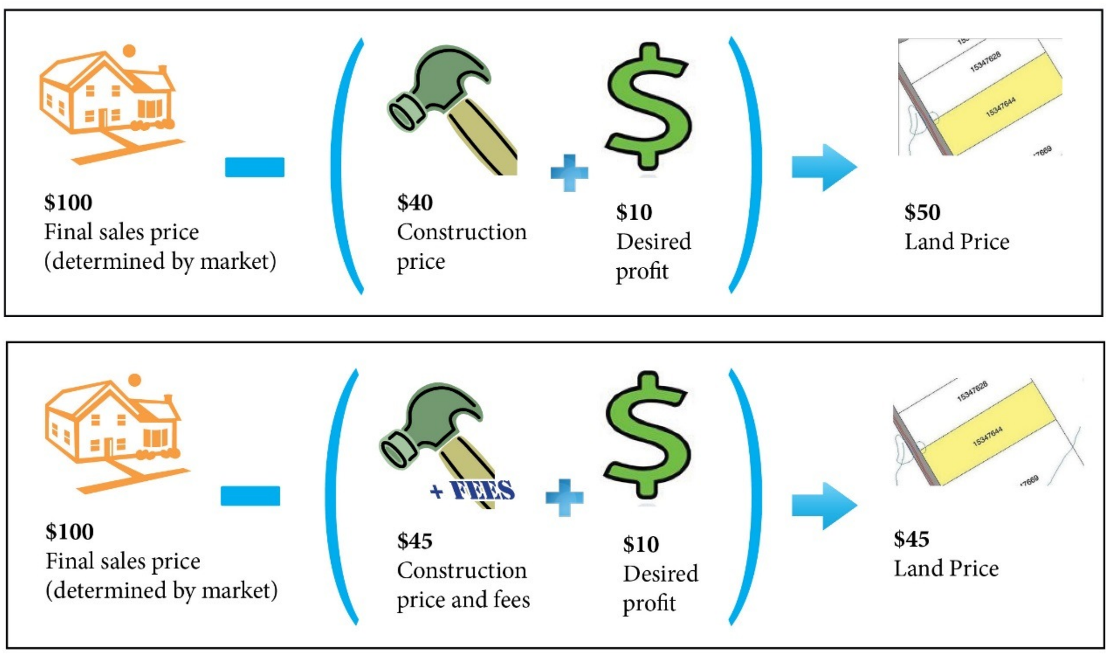
City	Percent units required
Austin	Depends on incentives.
Boston	13% (for onsite)
Denver	10%
Montgomery County, MD	12.5-15%
San Diego	10% city wide for ownership, rental pay fee, 20% in some neighborhoods
San Francisco	10-17%
San Jose	15% for ownership
Washington D.C.	8-10% of residential FAR to be set aside or 50-75% of bonus FAR, whichever is greater

Residual Land Value

It is important to understand how development economics work to understand the question of where to set inclusionary requirements. Generally, when cities impose new requirements (either in the form of an onsite performance requirement or a fee) they decrease the value of redevelopable land. Land value is determined in large part by the amount of profit that can be made if the land is redeveloped. (And generally won't go below the value based on the current use.)

Here is a scenario with simplified numbers. In this case, fees act the same way as inclusionary zoning requirements.

Imagine that a developer can sell a house for $100, but it will cost him $40 to build after accounting for all costs. The developer is only interested in building the house if he can make $10 on the sale. The developer would be willing to pay up to $50 to buy the empty lot. If the city added a $5 linkage fee or inclusionary zoning requirements that cost $5, the value of the lot would drop to $45. The value of the home, once it's built, would still be $100, because the price is determined by the other homes on the market.



Inclusionary zoning requirements can impact development if they are set too high based on local conditions. Requirements that are too high can push developments costs to a point that new projects will not be profitable. In this case, owners of property will decide it is in their interest not to redevelop their land.

For example, changing the numbers above slightly, assume there is a site that currently has a single story restaurant and the property owner could sell the property for $45 based on that use. If a developer could pay $50, development would happen. If fees and market conditions were such that the developer could only pay $40, the land owner would be unlikely to sell.

Voluntary programs add a third theoretical land price to consider. In this case, the three factors are the value of the land under the current use, the value with the density bonus/ affordable housing, and the value with just the base zoning. For this reason, voluntary programs need to make sure that the value of incentives, such as the density bonus, is larger than the costs of providing the units or paying the fee.

Mandatory programs must ensure that their requirements are not so high as to make development infeasible. Voluntary programs must set their requirements lower than this threshold and ensure that it is in the developer's interest to participate in the program.

Responding to differing neighborhood market conditions

It is important for cities to be aware of market conditions when they set their inclusionary housing requirements, both for the entire city and for various neighborhoods.

Most cities do not adjust their inclusionary requirements at a neighborhood level. To some degree, incentive/inclusionary requirements automatically compensate for different market conditions. While it may be more expensive to build in high cost neighborhoods, a density bonus is worth more where the home prices or rents are higher.

However, in some neighborhoods, development may not be feasible even without any inclusionary zoning requirements. Often these neighborhoods have suffered from disinvestment for many years, and these may be areas where cities are particularly interested in encouraging new housing development. If this is the case, cities sometimes reduce requirements and increase incentives.

While the most common neighborhood differences within IZ programs involve higher requirements in the highest cost and generally highest density locations, a few cities have done the opposite and lowered their requirements in the highest density areas in recognition that higher density construction can be significantly more expensive. In some cases, rather than varying the requirements by neighborhood, cities have chosen to vary their IZ requirements based on construction type, which is correlated to neighborhoods because of zoning rules. In most cities, this higher construction cost for high-rise projects is more than offset by generally higher rents and sales prices in these high demand markets but a few cities have found that local market conditions make higher density construction economically marginal enough that affordable housing requirements can become a barrier to development.

In any case, a decision to vary affordable housing requirements by neighborhood or construction type would typically be made based on the findings of an economic feasibility study. If the study were to show that requirements which were supportable in general would likely have an adverse impact on the feasibility of otherwise desirable development types in certain areas, a program might be refined to adjust the requirement in the areas likely to be impacted.

Spotlight

San Francisco graduates their requirements by neighborhood. The overall citywide requirement is 12 percent, but in rezoned areas with strong market potential it ranges from 14.4 – 17.6 percent.

Burlington, Vermont increases affordable requirements for units in their waterfront district up to 25 percent (in other areas, it is typically 15 percent). They also do not allow off-site production or in lieu payments in this one district. Outside of the waterfront area, Burlington adjusts the inclusionary percentage requirements based on the rental or sales price of the market rate development. For developments affordable to people making 180 percent of AMI or more, the set aside requirement can be as high as 25 percent. It can be as low as 15 percent in less expensive developments.

Chapel Hill, North Carolina requires 15 percent of units be affordable in most areas, but reduces the percentage to 10 in downtown. The town explains this requirement as follow, “The requirement is lower in the Town Center because the Town recognizes the challenges of developing housing and affordable housing opportunities in this area where construction costs typically include structured parking and taller buildings.”

Fairfax County, Virginia, takes a slightly different approach. Rather than varying the requirements by neighborhood, they vary them by construction type. The requirements range from five percent in developments with structured parking to 12.5 percent in single family and low-rise multifamily developments. Developers receive a sliding scale density bonus as well.

Local Conditions

Seattle’s current IZ program requires developers to produce affordable units based on the gross square footage of bonus floor area that they receive under the program. The requirements result in roughly 5 percent of units being affordable in residential projects that utilize the full available bonus. David Rosen and Associates Economic Feasibility study evaluated the likely Return on Equity for investors in projects that meet the current performance requirement as well as those same projects under a hypothetical requirement where affordable units would equal roughly 10 percent of all units. Under their baseline alternative (with a 4.25% capitalization rate) they found that all but two of the prototypes that were economically feasible with no affordable housing requirement (ie. With the bonus floor area but without the cost of onsite performance or payment of the in lieu fee) would also be economically feasible with a 10% requirement.

However, they also found that in every case, development without the incentives (ie. With no bonus floor area) was more profitable than development with bonus density and a 10 percent requirement. In other words a 10% requirement appears to be economically feasible but is unlikely to be freely selected by many developers when lower density development is more profitable.

Projected Return on Equity for Rental Projects

		With Incentives			
	Without Incentives	No affordable housing requirements	Current In Lieu Fee	Current Performance	10% Performance
DOWNTOWN	7%	9%	8%	6%	4%
SOUTH LAKE UNION	33%	14%	12%	11%	8%
LOWRISE TO MIDRISE					
Low Scenario	25%	13%	11%	10%	8%
Middle Scenario	18%	18%	16%	15%	13%
High Scenario	13%	16%	14%	13%	12%
4 STORIES TO 6 STORIES					
Low Scenario	26%	17%	16%	15%	11%
Middle Scenario	19%	13%	12%	11%	8%
High Scenario	14%	11%	10%	9%	6%
6 STORIES TO 7 STORIES					
Low Scenario	13%	10%	9%	9%	9%
Middle Scenario	9%	6%	5%	5%	5%
High Scenario	5%	4%	3%	2%	3%

Color Key: Preferred | Feasible | Infeasible

Source: David Rosen and Associates, Seattle Incentive Housing Program Economic Analysis, July 2014. Table 10: Lower Cap Rate Baseline Version - Rental projects only.

Recommendations:

A. **Expand the residential program:** Look for opportunities to expand the residential incentive program through targeted upzoning actions.

B. **Maintain the current performance requirement:** While a higher performance requirement appears to be economically supportable, raising the requirement under the current incentive zoning structure would likely mean fewer projects choosing to build the bonus density and could lead to lower overall production.

C. **Consider a partial waiver for high rise residential projects:** In recognition of the current level of cost and risk associated with high rise development in Seattle, it might be appropriate to establish a performance requirement for high-rise development that was significantly lower than the requirement for other projects.

D. **Plan and budget for periodic reviews:** Every five years, conduct a thorough review of the successes and challenges of the IZ program, including an economic feasibility study including an analysis of relative market conditions in the different neighborhoods included in the IZ or linkage fee program to ensure that the program requirements are not standing in the way of development in any markets

Setting In Lieu Fee Levels

Background

Many communities allow developers to satisfy their inclusionary zoning requirements through payment of an "in lieu" fee, rather than through construction of new affordable homes. Typically, fee revenue is deposited in a housing trust fund and used to facilitate construction of additional units for low- and moderate-income households or to achieve other affordable housing goals.

There are multiple formulas that jurisdictions use to set fee levels. One factor that often shapes those decisions is whether a jurisdiction wants to encourage onsite performance or collect the revenue to leverage other sources of funding. There is no right answer to this question and it depends on the conditions in a city and the community's values.

A properly priced fee will usually lead to more housing, because other sources of funding can be leveraged with the fee to build off site housing. However, the risk of encouraging the fee with little other regulation, is that it can lead to new housing being built in neighborhoods with inexpensive land, which sometimes can lead to increased/continued segregation. Another issue to consider is whether there are (usually nonprofit) developers for the city to work with to ensure that the affordable housing gets built. Some cities have failed to spend their fee revenue in a timely manner because they didn't have the necessary local capacity.

Aside from the question of a city's preference for fee revenue or onsite units, there are methodological differences in how cities calculate the fees and these are summarized below. However, it is important to differentiate the sometimes complicated backend calculations of how a city arrives at a fee, versus the final fee number. Generally, this means that whatever method cities use to arrive at a fee, they then apply a single fee to all projects.

The options for setting in lieu fees include:

1. Affordability Gap: Many cities set the fee based on the difference between the price of a typical market-rate unit, and the price that a lower-income household can afford, adjusted for household size. For example, for a homeownership unit, the affordability gap would be the difference between the typical market rate sales price and the reduced price a developer would receive for an affordable unit. For rental projects, the net present value of the difference between the market and affordable rents generates a fee that is roughly comparable. With this approach paying the fee should have roughly the same economic impact on a project as building the affordable units.

Most commonly, cities calculate this cost based on estimates for the market prices and rents for the kinds of units that are typically being produced by local developers. Because new production units are often quite different from the existing homes, this estimate is generally produced by a consultant hired for this specific purpose rather than a generally published value like the median home value. The City then sets a single fee that applies to all projects citywide for a year or some other defined period of time. A minority of cities base fees on actual prices for the market rate units in the project that is paying the fees. This is significantly more administratively burdensome on both the city and developers but it may provide a more equitable outcome where projects that can afford more pay more.

2. Production Cost: Other cities set the fee based on the expected cost to produce an offsite unit that is affordable to the target income group. Some cities use rough estimates of the cost of construction while others have developed sophisticated pricing models based on the city's actual experience investing in local affordable housing projects.

One point that sometimes causes confusion is that some cities calculate the fee per market rate unit and some per affordable unit. For example, a city could require developers to pay an in lieu fee of $200,000 for every affordable unit they would have been required to build. Another city could require developers to pay $20,000 per market rate unit in their development. Either method is fine, but is important to be clear.

When considering in lieu fees, it is also important to decide if a city wants to always allow developers the option or restrict it. Some cities allow a fee in lieu by right, while others require developers to demonstrate either some net benefit to the city, or a substantial hardship.

Some cities adjust their in lieu fees based on the size of the development (typically by offering a lower fee for small projects). There can be multiple reasons for this, including cities wanting to simplify management of their program by discouraging a pattern where market rate buildings have one or two affordable units. Also, the economics of smaller developments may be more marginal and a lower in lieu fee could help make them feasible.

Responding to changing market conditions

Real estate markets are constantly changing. Incentive and Inclusionary zoning programs are necessarily unable to respond to each and every change in the market. Some communities have increased their inclusionary requirements during housing booms only to reduce them or waive them entirely when their markets crashed but cities can't expect to 'time the market" and adjust requirements as the market changes.

One aspect of many programs that requires more frequent adjustment is the level of In Lieu/ linkage fees. Many cities have written specific dollar amounts into their ordinances for these fees. Over time, a fixed fee will drop relative to inflation and relative to the cost of providing affordable housing. Some communities have managed to keep their fee up to date by having council annually approve a change to the fee calculation but, because this is a controversial issue, these annual approvals can be challenging. In response a number of communities have been indexing their fees to allow for regular increases (and potentially decreases) in response to changing market conditions.

Spotlight

Berkeley, California uses an affordability gap calculation, but scales the fee such that developers are more likely to choose to pay the fee. Specifically, the in-lieu fee is 62.5 percent of the difference between the permitted sale price for inclusionary units and the amounts for which those units are actually sold.

Pacifica, California uses the affordability gap method. They calculate their fees by subtracting the Below Market Rate (BMR) price of a unit from the median cost of a comparable home.

San Francisco contracted with a consulting firm to complete an economic feasibility study for their inclusionary housing program in 2012. Among other things, this study evaluated the average cost to construct new housing units in several different project prototype configurations. The consultant constructed an average construction cost per square foot and used that to estimate the average cost to construct units of each bedroom size. The city revised their ordinance at that point and established their In Lieu fee based on the difference between this cost and the affordable price that would be allowed for each unit size. The ordinance calls for this fee to be adjusted annually based on the Construction Cost Index (CCI) for San Francisco as published by Engineering News-Record.

Somerville, Massachusetts created its inclusionary program at a time when local non-profit developers did not have the capacity to build large quantities of affordable housing. Consequently, it set its fees very high. According to the city's inclusionary zoning administrator, "It was a very punitive formula aimed at discouraging developers from taking this option." As the non-profit development community matured and built capacity, the city decided that it preferred to receive money for the Trust Fund and lowered its fees.

Monterey County, California's, Inclusionary Zoning ordinance requires a detailed evaluation every 5 years. The evaluation involves hiring a consultant to summarize production over the prior 5-year period, identify challenges in implementation and make recommendations for changes to requirements, In Lieu fee levels and other aspects of the ordinance.

Santa Monica, California annually increases their In Lieu fee based on an index consisting of the weighted average of the annual change in the cost of construction and the annual change in land values in the City.

Local Conditions:

David Rosen and Associates Economic Analysis evaluated the economic costs that developers face under three scenarios for program performance: Payment of the current fee in lieu, onsite provision of the affordable units under the current performance option and onsite provision of units under a hypothetical program rule requiring that 10% of all housing units in a building be affordable. They found that for most project types the current in lieu fee levels are significantly below the cost of production. For highrise projects in downtown and South Lake Union the cost of production is roughly double the cost of paying the fee.

	Current Fee Option		Current Production Option	
	Per Bonus Foot	Per Unit	Per Bonus Foot	Per Unit
DOWNTOWN PROTOTYPES				
Rental	$22	$146,044	$50	$334,528
Ownership	$22	$162,258	$35	$259,103
Commercial	$26		$40	
SOUTH LAKE UNION PROTOTYPES				
Rental	$20	$227,331	$36	$409,015
Ownership	$20	$275,361	$25	$345,394
Commercial	$26		$40	
LOWRISE TO MIDRISE				
Residential Rental				
Low Scenario	$15	$98,172	$18	$119,556
Middle Scenario	$15	$98,172	$23	$148,716
High Scenario	$15	$98,172	$28	$181,116
Residential Ownership				
Low Scenario	$15	$122,715	$1	$6,237
Middle Scenario	$15	$122,715	$6	$47,223
High Scenario	$15	$122,715	$11	$92,340
4 STORIES TO 6 STORIES				
Residential Rental				
Low Scenario	$15	$90,900	$23	$138,780
Middle Scenario	$15	$90,900	$29	$171,660
High Scenario	$15	$90,900	$35	$209,100
Residential Ownership				
Low Scenario	$15	$113,625	$3	$22,650
Middle Scenario	$15	$113,625	$9	$66,975
High Scenario	$15	$113,625	$15	$116,175
6 STORIES TO 7 STORIES				
Residential Rental				
Low Scenario	$15	$94,688	$26	$161,875
Middle Scenario	$15	$94,688	$32	$199,250
High Scenario	$15	$94,688	$39	$241,938
Residential Ownership				
Low Scenario	$15	$126,250	$2	$15,250
Middle Scenario	$15	$126,250	$7	$61,167
High Scenario	$15	$126,250	$14	$114,500

Source: David Rosen and Associates, Seattle Incentive Housing Program Economic Analysis, July 2014. Table 9; Cornerstone Partnership analysis.

Cornerstone Partnership's February 2014 report analyzed data provided by Seattle's Office of Housing and found that the average low-income rental unit financed by the City between 2009 and 2013 incurred total development costs of $228,000 per unit. Most of the subsidy for these projects comes from non-local sources. Seattle has been successful in leveraging local resources and Cornerstone's report estimated that, going forward, the City would be able to produce an additional affordable rental unit for each $95,000 in local housing subsidy. This level of leverage is dependent on the continued availability of state and federal affordable housing funding. Potential cuts to state and federal programs would mean that the local investment per unit could be much higher in the future.

Recommendations:

E. **Calculate residential in lieu fees on a per required unit basis:** Currently Seattle's IZ program calculates in lieu fees on a per bonus square foot basis. Because the base zoning allowed without the bonus is different in different zones, there is a large variation in cost of the fee relative to the number of units that would be required onsite. Unless Seattle switches to a widespread linkage fee, the incentive zoning program should be structured to require onsite units at an economically appropriate level (given the bonus square footage allowed) and developers that choose not to build the onsite units should pay a given fee in lieu of each unit that they would otherwise have provided. This approach will allow the City to set a schedule of fees that are economically comparable to onsite production. While it is not practical to set a fee that is exactly comparable to onsite production for every type of project, a schedule with 2 or three tiers applicable to different building types can achieve rough equivalence.

F. **Authorize the fee option in zones with height less than 85 feet:** Currently developers in incentive zones with heights less than 85 feet are required to produce units on site. This has resulted in production of a small number of widely scattered on site units. There does not appear to be a strong policy rational for requiring performance in these areas while allowing fees in other areas. The David Rosen and Associates study suggests that at a higher fee level, many of these projects would nonetheless prefer the performance option but it makes sense to allow payment of fees for projects that might choose that option.

G. **Increase the in lieu fee:** A schedule of fees should be established based on the economic analysis performed by David Rosen and Associates.

   a. For non-highrise projects a fee of $100,000 to $150,000 per unit that would otherwise be required onsite would result in a fee that was roughly comparable to the cost of onsite production for most projects. At this level, we would expect some projects to choose the fee and others to prefer onsite production. A fee of $200,000 per unit would create a fairly strong incentive for developers to choose the production option while still allowing an alternative in cases where the onsite production would otherwise be excessively burdensome.

   b. For highrise projects downtown and in SLU a fee in the range of $300,000 to $350,000 per unit that would otherwise be required would result in a fee that was roughly comparable to the cost of onsite production for most projects. At this level, we would expect most developers to choose the fee but many projects would find that onsite productions was more cost effective. (Note: Above we recommended considering a lower performance requirement for highrise projects. It may seem counterintuitive to also raise the fee on these projects but the goal would be to bring the fee closer in line with the cost of performance while setting performance requirements that are economically feasible.

H. **Consider requiring fees from projects with fewer than 3 affordable units:** Small projects with one to three affordable units are difficult to monitor and administer. Currently most of these small projects are located in zones where onsite performance is required. It might make sense, instead, to require these small projects to pay fees instead simply to reduce the administrative burden on staff.

I. **Annually update the fee.** Index In Lieu fees based on the annual change in the Seattle Construction Cost Index (at ENR.com)

II.Replace the IZ program with an Affordable Housing Linkage Fee

Background:

An increasingly popular alternative to inclusionary zoning programs is to charge linkage fees on new residential or commercial development to pay for affordable housing. The fees are typically placed into an affordable housing trust fund and distributed to qualified affordable housing developers through a Request for Proposal process.

There are a number of advantages to linkage fees. In many states that prohibit mandatory inclusionary housing programs, it is permissible to charge fees. Additionally, linkage fees have the same advantages as in lieu fees, they offer flexibility and can leverage other sources of funding, like Federal Low Income Housing Tax Credits. They also have some of the same challenges, for example it is important to make sure the money is not spent primarily in low income neighborhoods.

The Association of Bay Area Governments recently completed a study of San Francisco and the four surrounding counties and found that 16 cities had residential linkage fees and 13 cities had commercial linkage fees. Most of these cities adopted the fees recently, partly in response to a court case in California that prohibited rental inclusionary housing.

Residential linkage fees can either be a set price for each new home or can be calculated based on the square footage of the new home. On the lower end, **Mountain View, California** charges new residential development $10 a square foot, while Santa Monica charges approximately $28 a square foot. **Berkeley, California** charges $28,000 for each new market rate home to fund affordable housing.

Boston has one of the oldest commercial linkage programs in the country and charges new commercial development over eight dollars a square foot. While recent data is not available, from 1986-2000 Boston generated $45 million in linkage fees, which funded nearly 5000 units. **Arlington County, Virginia** also has a commercial linkage fee of $1.77 a square foot, which is expected to generate almost $14 million in revenue between fiscal year 2013 and 2016. (Arlington allows commercial developers to build units if they prefer.) **San Diego and San Francisco** have commercial linkage fees as well.

Commercial linkage fees often vary depending on the type of development (office, hotel, industrial). For example, **Menlo Park, California** charges almost $15 a square foot for office developments and just over $8 a square for industrial and other uses.

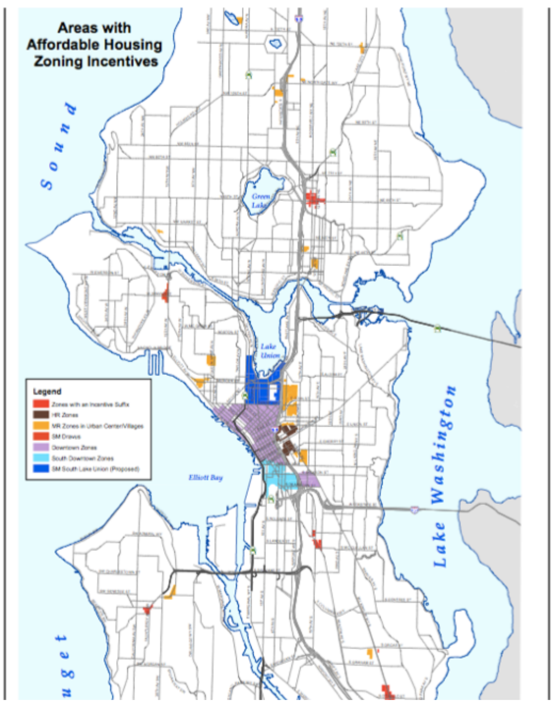
To enact an affordable housing linkage fee, cities must first conduct a study that shows the relationship between new housing or jobs and the need for affordable housing, called a nexus study. While a nexus study documents the maximum legal fee, a second study, called a feasibility study shows what fee levels will not adversely impact development. (A feasibility study was recently completed for Seattle by the consulting firm David Rosen and Associates.)

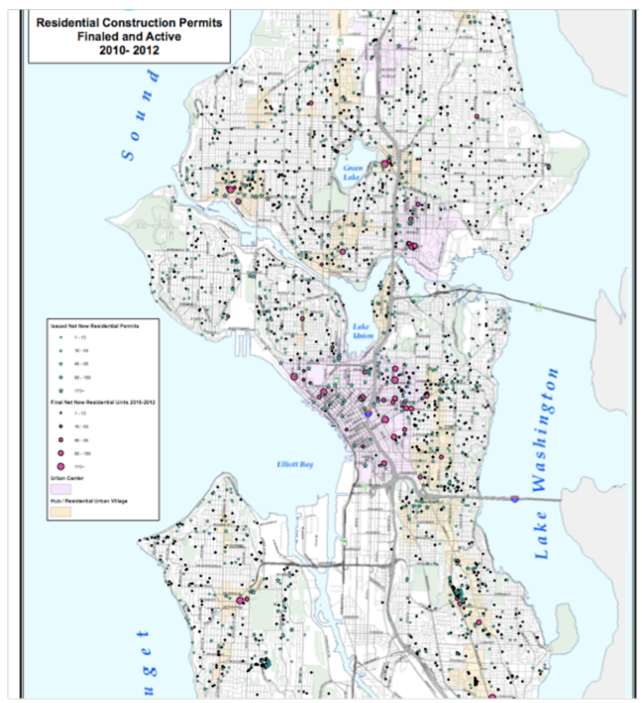
Because the legal environment is different in every state, and changes rapidly, it is important to consult with an attorney to fully understand if linkage fees are permitted in a jurisdiction.

Local Conditions

Incentive Zoning applies to a small geographic area

While Seattle's incentive zoning program is applicable in several of the areas where recent development has been concentrated, only a small share of the overall city falls within the IZ zones and, as a result, only a small share of overall development is eligible for the program.





Source: Seattle Office of Housing

Incentive Zoning applies to a small number of projects in those areas

Cornerstone Partnership's February 2014 report highlighted the fact that the majority of recent projects have chosen to forgo the bonus floor area and build only to the base density.

The David Rosen and Associates feasibility study makes it clear that the majority of these projects would not have taken advantage of bonus density even if it were available without any affordable housing requirements. Of the 24 development prototypes that DRA evaluated only 12 were profitable enough to be considered 'feasible' without the bonus density in DRA's baseline version.[1] DRA evaluated the performance of the same prototypes under the hypothetical situation where developers were allowed to build the bonus density with no affordable housing obligation (ie. They didn't have to build affordable units or pay the in lieu fee). Of the 12 initially feasible prototypes, nine (75%) offered developers lower returns when developed with the bonus density and no housing obligation. In other words the additional cost associated with more expensive construction types was greater then the financial benefit of building higher. For a majority of project types, the incentive, increased height and density, simply does not add value so it should not be surprising that many recent projects have chosen not to build the bonus density.

The extreme case of this situation was South Lake Union Residential Rental projects where DRA estimated that a project that was required to make 10% of units affordable (roughly double the current requirement) would be economically feasible generating an 8% Return on Equity for investors. However, they also found that a project in the same area building to only the base density would generate a staggering 33 percent Return on Equity. The likely explanation for this difference is that the increased density necessitates very significant increases in construction costs while lower density projects in SLU are able to capture the high rents that are generally associated with high rise luxury housing without facing those higher costs.

[1] Using the Return on Equity measure as summarized in Table 10.

Projected Return on Equity for Potential Rental Projects

	Without Incentives	With Incentives			
		No affordable housing requirements	Current In Lieu Fee	Current Performance	10% Performance
DOWNTOWN	7%	9%	8%	6%	4%
SOUTH LAKE UNION	33%	14%	12%	11%	8%
LOWRISE TO MIDRISE					
Low Scenario	25%	13%	11%	10%	8%
Middle Scenario	18%	18%	16%	15%	13%
High Scenario	13%	16%	14%	13%	12%
4 STORIES TO 6 STORIES					
Low Scenario	26%	17%	16%	15%	11%
Middle Scenario	19%	13%	12%	11%	8%
High Scenario	14%	11%	10%	9%	6%
6 STORIES TO 7 STORIES					
Low Scenario	13%	10%	9%	9%	9%
Middle Scenario	9%	6%	5%	5%	5%
High Scenario	5%	4%	3%	2%	3%

Color Key:	Preferred	Feasible	Infeasible

Source: David Rosen and Associates, Seattle Incentive Housing Program Economic Analysis, July 2014. Table 10: Lower Cap Rate Baseline Version - Rental projects only.

Under these economic conditions, voluntary Incentive Zoning simply can't be effective. Even if developers in SLU were offered the bonus density without any affordable housing obligation the project would "only" offer 14% Return on Equity – a fantastic return anywhere else but not nearly enough to induce developers to build higher when they can earn 33% at the lower density.

However predictable, the result of both the small footprint of the IZ program and the relatively small number of projects that benefit from the bonus is that the burden of providing for affordable housing falls on only a very small share of development projects.

Recommendations:

J. **Consider adopting an Affordable Housing Linkage Fee:** In place of the current Incentive Zoning program Seattle could adopt an Affordable Housing Linkage Fee which would be imposed on new residential office or retail development regardless of the level of project density.

K. **Target the fee to areas likely to experience development:** The linkage fee would not need to be limited to the current incentive zones. The City should carefully evaluate the potential geography where a linkage fee would apply but should consider all Low-rise and higher zones in urban centers and urban villages.

L. **Allow developers in the existing incentive zones to build the bonus density:** While a new linkage fee would apply to all projects in designated areas, developers in the existing incentive zones should still be allowed to access the bonus density. Rather than repealing the existing incentive zoning program, the program should be amended to clarify that payment of the linkage fee would satisfy a developer's affordable housing obligation.

M. **Base the Fee on the findings of a Nexus Study:** Because the linkage fee is intended to mitigate the impact of a given development on the community, it is important that the fee be established based on the measurable contribution of a likely project to the overall need for affordable housing. A Nexus study is the established methodology for making that connection. The Nexus study should focus on likely residential and commercial project types in the targeted higher growth neighborhoods. The study will establish a maximum fee that would be consistent with the housing need created by new development of various types but Council could choose to set the fee at a lower level. It is likely that the fee per square foot particularly for residential projects would be lower than the current Incentive Zoning Fee In Lieu but by applying this fee across a much broader area, Seattle might be able to generate significantly more total revenue.

N. **Offer a Performance Option:** Even if the program is designed as a Linkage Fee, the city can offer developers the option of providing units onsite in lieu of paying the fee. As with Incentive Zoning, the program can be designed to encourage either units or fees or a combination. But even if the program is designed to encourage fees, an onsite (or offsite) performance option might appeal to certain developers who want to be closely and more publically associated with the provision of the affordable housing that their project generates. To simplify administration, the performance option should only be available to projects that would provide 3 or more affordable units.

O. **Phase the Fee in over time:** Any new fee will add to the cost of development. For projects outside of the incentive zoning areas or projects that are not planning to use the bonus density, a sudden increase in costs could be difficult to absorb. Phasing a new fee in stages over a three-year period will allow time for land prices to adjust appropriately without unduly impacting projects that are in the development pipeline today.

III. Additional Recommendations Applicable to Either Approach

Whether or not Seattle changes to a Linkage Fee approach, the overall program can and should retain most of the elements of the current Incentive Zoning program. Overall, Seattle's current program is operating in a way that is consistent with the national best practices for Incentive or Inclusionary Housing programs. However Cornerstone Partnership's interviews, data analysis and research into best practices identified a number of issues in the implementation of the current program which could be addressed along with either revisions to the existing program or in the course of implementing a new linkage fee program.

Setting Appropriate Income Targets

Background

Cities should conduct regular research so they understand the needs of the community. Because it is not possible for cities to meet all local needs, it is necessary to prioritize service to certain income groups. Some cities prefer to target one particular need that is not being met by the market (e.g. very low income) while other cities prefer to address some of the need in all categories.

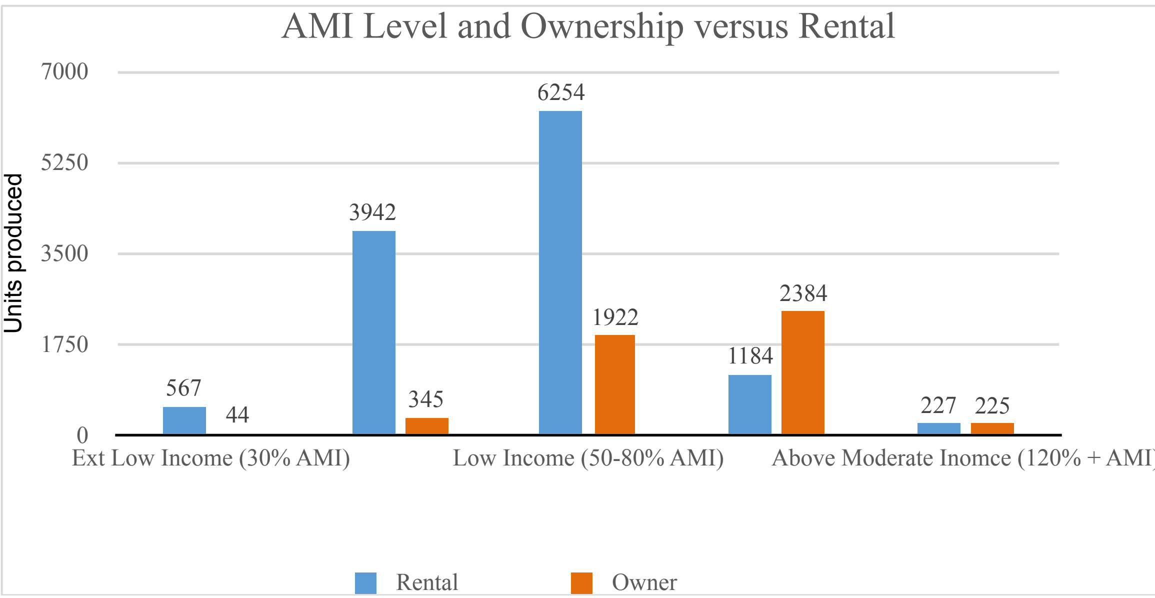
Cities that want to target lower income levels for affordable units have a number of options. Common strategies include:

- Allow developers to provide fewer units with deeper affordability.
- Pay developers or give them incentives to deepen the affordability level.
- Purchase the units and rent or sell them at alternative affordability levels.
- Accept in lieu fee money and partner with nonprofits to ensure that the needed types of housing gets built.

All of these strategies can work well. Cities should choose an option based on needs in their community, market conditions and capacity of the non-profit sector.

Why do Cities have different income targets for Homeownership Units?

Cities often set affordability levels higher for ownership units than for rental units. All ten cities that completed OTAK's survey distributed as part of this project have higher AMI requirements for ownership units. A 2007 study of inclusionary housing programs in California conducted by the Nonprofit Housing Association of Northern California found that most affordable rental units were affordable to low or very low income households and most ownership units were affordable to moderate income households (see below).



This policy is often dictated by market prices. In most cities, Seattle included, rental housing is more affordable than ownership housing. For example, in many areas like the Rainier Valley and West Seattle, a household earning 80 percent of AMI can afford the median priced one bedroom apartment, but cannot comfortably afford to buy a home. Pricing ownership units at 80 or even 120 percent of AMI meets a need in these areas. However, rental units priced at this level would be at or above market value.

On the other hand, ownership units typically cost developers relatively more to produce. While it would be possible to require that ownership units be priced so that they serve the same income group that is being served in rental housing, this would have a greater impact on financial feasibility for ownership projects. So many cities have determined that allowing developers of ownership units to serve a higher income group can reduce the burden of the program on ownership projects while still serving a real affordable housing need.

Another concern that is often raised is that lower-income households might not be financially capable of owning a home (e.g. the owner needs to have enough money to pay for unexpected repairs). However, while there are certainly households whose incomes are not sufficient or stable enough to make homeownership a good option, at the income levels that most IZ programs are serving, this is not likely a significant concern. Especially in high-income cities, most people making sixty or eighty percent of median would have the financial capacity necessary to own a home if affordably priced homes were available.

Ensuring that rents are below market

It is not uncommon for cities to have a problem where their smaller units rent for close to market prices. This is largely due to unrealistic assumptions in Federal income guidelines, which determine affordability levels. For example based on 2013 Federal guidelines for Seattle, an affordable studio (at 80 percent AMI) could rent for up to $1,127. A two bedroom could rent for $1,450. There is relatively little difference in price for very different apartments. Consequently, many more market rate studios would be considered affordable according to Federal rules. Many small Seattle apartments, particularly outside the downtown core, are affordable to small households making 80 percent of AMI.

In response to this challenge, cities can adjust their rental formulas to require lower prices for smaller units. For example, if a two-bedroom unit is priced to be affordable to someone making 80 percent of AMI, a studio could be priced affordable to someone making 60 percent of AMI.

Spotlight

The City of Fairfax, VA, has a voluntary incentive zoning program called a proffer, which is aimed at producing low and moderate income housing. Rather than use a single formula for all unit sizes they opted to make smaller units more affordable. They calculate affordable prices based on HUD's guidelines and this is the price they use for three bedroom apartments. However, to ensure that smaller units are priced below market rates, they multiply the price by 70 percent for studios, 80 percent for one bedrooms and 90 percent for two bedrooms to arrive at the affordable price.

Irvine, California allows some developers to provide fewer units at deeper affordability. Normally, Irvine requires 15 percent of new units to be affordable, with an equal split between very low, low, and moderate income households. For projects in certain areas, the city and developers are allowed to negotiate a reduction in the percentage of affordable units required in exchange for providing units affordable to lower-income people. The ordinance does not give specific guidance, but leaves it to staff to finalize the details.

Montgomery County, Maryland's inclusionary ordinance grants a right to purchase one third of all inclusionary units to the local public housing authority, the Housing Opportunities Commission (HOC). Developers are required to offer the HOC and several other approved nonprofits a 21 day period to opt to purchase any new units before they are offered to homeowners. The HOC has purchased more than 1,500 units in 188 subdivisions (out of more than 10,000 inclusionary units produced in the county) using a range of housing programs including Section 8, Low Income Housing Tax Credits and State rental funds.

In addition, 29 units have been purchased by other nonprofit agencies and rented to low-income residents. As a result of this partnership, Montgomery County has generally served a much higher share of low and very low income residents than is typical of other inclusionary housing programs across the country.

From a developer's perspective, having the county find tenants and manage the rentals can be an advantage. It can speed up the initial sale process and reduce the administrative burden on the developer. However, it is important to note that this strategy achieves deeper affordability only to the extent that additional local affordable housing funds are invested in the Inclusionary units.

Fairfax County,Virginia has a similar relationship which enables their Housing Authority to purchase up to 1/3 of new inclusionary units.

Northern California: In 2006, the Nonprofit Housing Association of Northern California conducted a study that looked at, among other things, the inclusionary programs in California that succeeded in providing housing for extremely low-income households. They found that 68 percent, a disproportionately large number, of inclusionary housing units affordable to ELI households were produced through partnerships with nonprofit developers.

Local Conditions:

Rapidly rising rents and house prices have created hardships for a wide range of Seattle Households. Cornerstone Partnership's earlier report found that in many neighborhoods households earning up to 120 percent of area median income faced significant housing cost burdens. However, it is very clear that the most significant housing affordability challenges face families earning less than 50% of Area Median Income. The majority of Seattle's most rent burdened households earn less than 30% of Area Median income.

A Cornerstone Partnership analysis of Dupre + Scott housing market data found that there were very few units of any size on the market in Seattle that are affordable to households earning 60% or less of Area Median Income (AMI). Above that level there are some market rate units available but only small units. For example the lower end of market rate one bedroom units were affordable to households earning 65% of AMI. However, larger units are much less affordable. The low end of the market rate 4 bedroom units was affordable to households earning 92% of AMI.

	25% rent Level	Approximate Household Income that this rent is affordable to	% of AMI
Studio	$887	$35,480.00	63%
1 bedroom	$981	$39,240.00	65%
2 bedroom	$1,262	$50,480.00	70%
3 bedroom	$1,742	$69,680.00	83%
4 bedroom	$2,148	$85,920.00	92%

Sources: Dupre + Scott Apartment Advisors 2014 and Cornerstone Partnership analysis assuming 30% of income for housing costs and 1.5 persons per bedroom (ie 2br unit = 3 person household, etc).

Recommendations:

P. **Continue current income targeting for onsite units:** Continue the current practice of setting the income limit somewhat higher for ownership units (currently 100% of Area Median Income vs. 80% for rental)

Q. **Continue to use most fee revenue to serve higher need populations:** Seattle has been doing a good job of using resources generated through the IZ program to serve lower-income/higher need populations. While the program could be strengthened by expanding its production of units for households earning 60 to 80% of Area Median Income, the majority of fee revenue (we recommend roughly 2/3) should continue to be invested in highly leveraged nonprofit sponsored projects serving very low and extremely low income households.

R. **Set aside a portion of fee revenue for 'workforce' housing:** Roughly 1/3 of future fee revenue should be set aside to fund new programs designed to serve households earning between 60 and 80% of Area Median Income. This group faces real housing challenges in many parts of Seattle but benefits from few other programs. In addition to serving a slightly higher income group, these programs should prioritize production of larger 'family sized' units with 3 or more bedrooms. It may be difficult to find opportunities to invest in rental properties restricted to this income range but Seattle's current affordable homeownership programs are already successfully serving this income group. (See more under homeownership below).

S. Continue to allow OH flexibility in investing fees: Seattle's Office of Housing has been very effective at leveraging In Lieu fees for maximum public benefit. Council should provide more guidance regarding the goals for the use of these fees but continue to allow significant discretion to the staff. For example, rather than requiring that 50% of fee revenue be spent on 'workforce' projects, council could set a 50% target and require OH to report on the actual results relative to that goal.

T. **Require studio and 1 br units to be more affordable**: Lower the income targeting for on site residential units to ensure that required affordable units are comfortably below market. In particular, lower the targeting for studio and 1-bedroom units.

	Rental	Ownership
Studio	50% of AMi	60% of AMI
1 bedroom	60% of AMI	80% of AMI
Larger than 1 bedroom	80% of AMI	100% of AMI

Investing Fee Revenue

Background

Cities' policies vary widely in terms of how in lieu or linkage fee revenue is spent: some inclusionary or incentive zoning ordinances provide no guidance and some have very specific rules. Guidelines are particularly useful in cities with significant differences in economic conditions between neighborhoods. Thoughtful policies can help cities maximize the value of their investments by guiding spending decisions. Well-written policies can also help address concerns that fees (and offsite units) contribute to segregation.

Often cities develop multiple criteria, including:

- Avoiding further concentration of poverty by not locating affordable housing in low income neighborhoods

- Requiring or prioritizing sites that offer access to transit
- Allowing only sites that conform to local plans
- Allowing only sites that offer proximity to stores or services
- Avoiding undesirable land uses (e.g. not near highways)

Spotlight

Boston requires that half of its In Lieu funds be invested in neighborhoods that have less than the citywide average of affordable housing or have a demonstrated need for producing or preserving affordable housing.

Raleigh, North Carolina wanted to ensure that their new affordable development was located in appropriate areas. They developed a scattered site policy that established multiple criteria and then identified the qualified census tracts. Specifically, they identified three goals:

1. Promoting greater rental housing choice and opportunities for low income households
2. Avoiding overconcentration of assisted rental housing in minority and low income neighborhoods
3. Furthering community revitalization efforts by encouraging the rehabilitation of older housing

They then developed criteria based on those goals. Their policy says that new affordable housing is prioritized in areas that:

- Are continuing to experience growth in population and housing units
- Provide proximity to retail and office development
- Have relatively low percentages of minority populations and low-income residents.
- Are not near existing subsidized housing.
- Have good access to transit.

Assisted housing developments are not permitted in lower income census tracts (where more than 50 percent of residents earn less than 60 percent of AMI) or in areas where the population of people of color exceed 60 percent.

Local Conditions:

Seattle's current rules direct the Department of Housing to attempt to locate housing in the following order of preference:

- 1) Within the originating Urban Center;
- 2) Within an adjacent Urban Center;

- 3) In the City within 0.5 mile of a light rail or bus rapid transit station on a route serving the originating Urban Center;
- 4) In the City within 0.25 mile of a bus or streetcar stop on a route serving the originating Urban Center.

This policy is consistent with the best practice nationally and has successfully ensured that developments funded with fee revenue are developed in relatively close proximity to the projects that receive the bonus density.

Recommendations:

U. **Continue to limit the neighborhoods where fee revenue can be spent:** Maintain the City's current policy of targeting fees to the neighborhoods surrounding the areas where projects paying the fees are being built. This policy is succeeding in achieving economic integration in a way that is cost effective.

Producing Homeownership Units

Background

Incentive or inclusionary housing programs create affordable homeownership opportunities in two distinct ways. First when developers produce for sale projects, most programs require the sale of affordable for sale units on site. In addition, many programs invest some portion of their In Lieu or linkage fees in affordable homeownership programs managed by the City or a local nonprofit agency.

a. **On site Homeownership units**: Most incentive and inclusionary housing programs require developers of market rate ownership projects to meet their affordable housing requirements by providing price restricted 'below market rate' (BMR) for sale homes. The city generally records a deed restriction or covenant which, among other things, requires owner occupancy, limits the allowable price at resale and requires that the home be resold only to an income eligible buyer. Many cities also reserve a right to repurchase units at resale and a right to step in to protect affordability in the case of a foreclosure. Generally cities find monitoring inclusionary homeownership units to be more administratively demanding than monitoring rental units. Rental projects typically have a property management company that can screen residents for eligibility, etc but for homeownership units the city or a nonprofit partner must screen buyers for income eligibility, ensure that they have access to mortgage financing, record the deed restrictions, calculate the affordable price and then, once a buyer is in a unit, someone must periodically monitor to ensure owner occupancy. Each time a family sells, someone must help identify and screen a new buyer and manage the process of resale.

b. **Homebuyer Assistance Loan Programs:** Many cities directly operate purchase assistance loan programs that make gap funding available to income-qualified homebuyers. Generally these programs are structured as 'silent second' loans meaning that buyers make no monthly interest or principal payments as long as they own their homes. These programs are sometimes called 'downpayment' assistance even though the levels of public subsidy often exceed what would be typical for a 'downpayment.' Typically, the program will calculate a maximum loan amount based on the difference between what a family at the target income level can 'afford' and the typical cost of an appropriate unit on the local housing market. Cities vary widely in what they require from homeowners at the time of resale of an assisted unit. Some cities forgive these loans over time so that a family that owned a home for 15 years, for example would not have to repay any of the loan and a family that moved sooner would repay a proportional amount. Other cities require repayment of the original loan amount without any interest while others require sellers to repay these loans together with some amount of deferred interest. Lastly, many cities require repayment of the loan principal together with a share of any appreciation in the market price of the assisted home. Typically, any funds recaptured at resale are made available to additional homebuyers in the future so the more the program recaptures, the more families it will be able to serve with the same investment. When housing prices are rising, however, it is common for even programs that recapture a share of appreciation to recapture substantially less than would be necessary to assist a new family. As a result these loan programs are seen as offering generally less protection of affordability than other options.

c. **Non profit Homeownership projects**: Many incentive and inclusionary housing programs invest a portion of fee revenue in homeownership development projects sponsored by local nonprofit housing developers. These projects might be new construction of affordable homes or renovations of existing housing stock. Typically the city will award funds to these projects through a competitive NOFA and will provide funding in the form of a grant or permanently deferred loan to the project sponsor. The nonprofit sponsor will then typically achieve long-term affordability either through a deed restriction or Community Land Trust Ground Lease. But unlike the typical onsite affordable home, the nonprofit sponsors generally conduct long term monitoring and manage resales. This relieves the city of a potential burden and in some cases the nonprofits are able to fund this service through modest fees.

Experience has shown that cities must actively monitor and enforce their legal documents if homes are to remain affordable over the very long term. For rental IZ units this is a modest task that most cities are effectively able to perform internally. But affordable homeownership units generally require a relatively greater level of ongoing administration and monitoring. In the past, a number of Inclusionary housing programs have run into problems by underinvesting in the stewardship of these homes. The cost of adequately monitoring and supporting ownership units is quite modest relative to the value of the affordable units but it can be difficult for cities to adequately fund and staff this function. Cornerstone Partnership has developed a set of voluntary Stewardship Standards for Homeownership Programs (www.affordableownership.org/standards) which outline a detailed set of proven best practices for communities that are seeking to preserve long term affordability. Many cities with significant portfolios of Homeownership units have turned to third party administrators or other nonprofit partners to assist with the potentially burdensome tasks related to monitoring and enforcing single-family deed restrictions.

Spotlight:

Community Home Trust, a local Community Land Trust plays a key role in the administration of the inclusionary housing program for the Town of Chapel Hill, North Carolina. The town's ordinance requires developers to provide affordable units and the town encourages private developers to work with the land trust to produce their affordable units. The private developers build the units and sell them to the land trust at an affordable price. The land trust then takes on the responsibility for finding eligible buyers. The land trust sells the buyers the homes only, retaining ownership to the land. A 99-year ground lease gives buyers long-term control over the land but allows the land trust to ensure that the homes remain affordable. The market rate developers pay the land trust a marketing fee and homeowners pay a monthly ground rent that supports the organization's ongoing administration and monitoring costs.

A Regional Coalition for Housing (ARCH): is a partnership between East King County Cities who have joined together to assist with preserving and increasing the supply of housing for low– and moderate-income households in the region. ARCH helps local governments to plan for and develop affordable housing. ARCH plays an administrative role in the implementation of several local inclusionary housing programs including ongoing stewardship and monitoring of affordable homeownership units that are created through these programs. ARCH, for example, maintains a regional list of interested lower-income homebuyers and relationships with local lending partners.

Local Conditions:

While the greatest numbers and most acute need for affordable housing is concentrated at the low end of the income spectrum, there are nonetheless many more moderate income Seattle households facing significant housing cost burdens. Much (but not all) of the need for rental housing affordable to households earning 80% of median income is provided for in the market. But homeownership units are far less affordable. Seattle's median home price is $415,000 while a household earning as much as 80% of median could only afford to pay $247,789 for a 3 bedroom house.

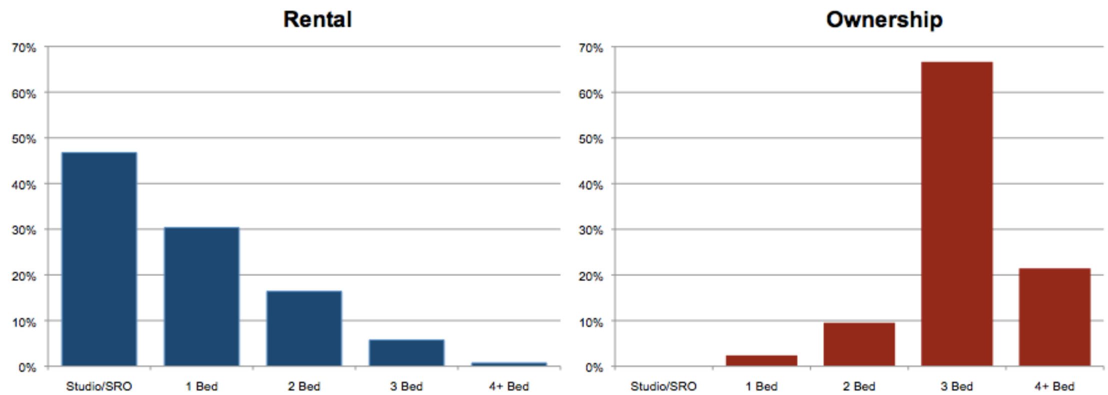
	Ext Low Income	**Very Income**	**Low Income**
	(<30% MFI)	(30-50% MFI)	(50-80% MFI)
0 bedroom	$67,300	$112,100	$166,700
1 bedroom	$72,000	$120,270	$178,704
2 bedroom	$86,541	$144,383	$214,504
3 bedroom	$100,003	$166,722	$247,789
4 bedroom	$111,690	$185,953	$276,341

Notes and sources: Assumptions are 30 year fixed mortgage, property tax 1%, insurance/ PMI/HOA 0.5%, 28% front end ratio, 50% of annual salary as down payment. Cornerstone Partnership Calculation

Nearly all of Seattle's investment of in lieu fee and housing levy funds has been in affordable rental projects serving households below 60% of Area Median Income (AMI). Between 2001 and 2013, the Office of Housing funded affordable rental projects containing over 6,500 units. Ninty-eight percent of these rental units were restricted to households earning less than 60% of AMI. Over the same period, the City funded 42 affordable homeownership units developed by Habitat for Humanity and Homestead Community Land Trust and these projects all served families earning between 60 and 80% of AMI.

In addition, there is a significant shortage of affordable units that are larger than 3 bedrooms. Larger families earning up to 80% of AMI are unlikely to find affordable 3 bedroom or larger rental units in the market. However, less than 10% of the rental units funded by Seattle's Office of Housing have been 3-bedroom or larger units. Among City funded homeownership units, 88% had 3 or 4-bedrooms.

Distribution of affordable units by income category



Source: Office of Housing Data

Recommendations:

V. **Develop a more formal program for affordable homeownership:** We recommended above increasing the use of fee revenue for projects benefiting households earning between 60 and 80% of Area Median Income. Given the current market conditions, homeownership programs would provide the most logical way to invest In Lieu fees to benefit this income group. A more formal program that set aside a predictable share of fee income to fund a growing portfolio of permanently affordable homeownership units would offer a cost effective way to provide both larger units and units affordable at the 60-80% of AMI level. Such a program could also proactively target funding to specific neighborhoods where affordable ownership units could help stabilize the market.

W. **Ensure proactive stewardship of homeownership units:** Contract with a third party nonprofit for active stewardship of all homeownership units produced onsite through the IZ Program. Use Cornerstone's Stewardship Standards to ensure that homes are managed according to national best practices.

Off Site Production

Background

While off site production provides important flexibility for developers, it is common for inclusionary/incentive programs to struggle with how to ensure that off site units are of comparable quality and are built in appropriate locations.

Generally, cities take one of three approaches to off site production:

1. Require or strongly encourage developers to build units on site – This is the best option for cities that do not have the capacity to manage a more complex system, or are strongly committed to mixed-income housing. It is also the simplest to administer.

2. Allow developers to build offsite, but in the vicinity of the market rate project- This option ensures that neighborhoods are integrated, but gives developers more freedom. Some cities use pre-set planning areas, while others use a pre-set distance (e.g. one mile).

3. Allow developers to build affordable housing where they choose – For cities that want to maximize production or where economic differences between neighborhoods are not significant, it is possible to allow the developers to build in alternative neighborhoods. If this is allowed, cities should strongly consider requiring more units or units at lower affordability.

Off-site production can be a valuable tool for cities if it is done right. Offsite units can be constructed by the developer of the market rate project that generates the requirement, by another private developer or by a nonprofit partner. In addition, a number of cities offer developers the option of donating land to the city or an approved partner which facilitates offsite production without requiring the market rate developer to actively participate in the affordable project.

A 2004 survey by the National Housing Conference found that two thirds of programs in California (67 percent) allowed developers to do off-site construction. A smaller, but still significant, number, 43 percent, allowed land dedication. When done well, off-site production can provide flexibility to developers and increase production.

However, to avoid increasing segregation or other problems, it is important to have guidelines for off-site production. Often such guidelines specify where off-site production can occur and add guarantees to ensure that it is built.

Nonprofit Partnerships

Some cities have chosen to encourage off site production particularly when the off site units are developed in partnership with a nonprofit housing developer. Partnerships have good potential to produce more affordable housing if a city has strong nonprofit groups to work with. Nonprofit developers often have considerable expertise in both building and managing affordable housing. They are skilled at combining various funding sources to get the most possible units. A well run nonprofit also is likely to be a good steward of the units, protecting the affordability in perpetuity and potentially reducing the monitoring and enforcement burden on city staff. However, there are limits to the benefits of such partnerships. For example, nonprofits often do not have the seed funding to do pre-development work or to purchase land.

Preservation Projects

Some cities allow developers to purchase, rehabilitate and preserve the affordability of existing housing to meet the affordable housing requirements. While this alternative can help preserve existing affordable housing supply and stabilize existing communities, it can be challenging to regulate the use of this option. There is a risk that developers will find ways to meet their affordable housing obligations without actually increasing the supply or affordable housing, for example, by finding units that are ‘naturally affordable’ in the market and require only modest rehabilitation. For this reason, some cities choose to allow off site satisfaction only through new construction while directing in lieu fees or other resources to meet the need for renovation/preservation. Other cities that have decided that the benefits of allowing off site preservation projects outweigh the increased administrative complexity have created rules that allow preservation projects but limit the circumstances to only projects that provide significant public benefit.

Economic Analysis

Because of the potential complexity of the economics involved in off site projects, many cities reserve the right to review and approve off site satisfaction on a case-by-case basis. Cities that reserve this right, however must ensure that they have adequate capacity either on staff or through outside consultants, to review and assess project financials and determine the level of public benefit inherent in each proposal.

Spotlight

West Hollywood has developed the following criteria for approving off-site production:

- More units are provided off site than would be provided on-site
- The off-site units are comparable in appearance and have the same number of bedrooms as the market-rate units
- The off-site units will be constructed before or concurrently with the market-rate project
- The units will be built in an area zoned for medium to high density residential development
- Management and construction will occur with a nonprofit partner
- Low-income units are not overly concentrated in a specific neighborhood

Boulder, Colorado allows developers to provide up to half of their required units off site, but the percentage can be increased if the developer provides “additional benefit” to the city. Off site units must be owned by the housing authority or a nonprofit and the city must approve any offsite location before issuing a permit for the market rate property. Developers have one year to produce the units and must provide a bond or other financial guarantee to ensure that they will perform. If the affordable units are not produced within one year, the city can collect the original in lieu fee plus a penalty of eight percent.

Santa Monica, California allows developers to build off site projects, but they must provide 25 percent more units than would have been required onsite. Off site projects must be within 1/4 mile, however, if a developer can illustrate that no over-concentration of affordable housing will result, they can locate the units up to one mile away. Developers can also dedicate land to the city with a value equivalent to the onsite requirement.

New York City allows offsite development within a half mile or in the same Community District as the market rate construction. The off-site development must be owned by an independent nonprofit. Each square foot of affordable housing provided off-site allows a developer to build 1.25 more square feet on the market rate site.

Burlington, Vermont allows developers to build off-site, but requires they build 50 percent more units than would be provided on-site.

Irvine, California, provides a menu of options for developers. Developers can build off-site in the same planning area or, depending on the zoning and location, may be eligible to choose one of these alternatives:

- Convert existing market rate housing to affordable housing for a period of at least 30 years.
- Extend the term of affordability for a period of at least 40 years.
- Payment of in-lieu fees.
- Transfer control of units to a nonprofit housing agency.
- Transfer of off-site credits for affordable units not provided on the site.
- Provision of alternative housing.
- Dedication of land for affordable housing.
- Any alternative option acceptable to the City

Petaluma, California, north of San Francisco, has produced over 1,000 inclusionary zoning units. They encourage developers to partner with nonprofits. For example, a developer proposed a large development which would have required approximately 30 affordable units. Instead, the developer dedicated land to the city, which passed it to Eden Housing, a nonprofit developer. Eden Housing was able to secure Low Income Housing Tax Credits and build 74 units. The city had identified a need for larger units and worked with the nonprofit to increase the number of three and four bedroom homes.

West Sacramento, California allowed developers to acquire, rehabilitate existing market-rate units and convert them to deed restricted affordable prices to meet their inclusionary zoning requirements in redevelopment areas. (Redevelopment areas were subsequently eliminated by California.) The developers could either rehabilitate and preserve an equal number of units in the same plan area or twice as many units in another area of the city.

Santa Monica, California employs an economist to use to consult on issues of housing policy when necessary.

Recommendations:

X. **Strengthen and clarify requirements for off site production.** Ensure consistent rules and criteria for approval across all neighborhoods.

Y. **Establish an ‘additional benefit’ standard:** Require that the Director of the Office of Housing review and approve any off-site projects only after making a finding that the proposed alternative will result in greater public benefit than the on-site production that would otherwise be required. Additional benefit should take the form of either a greater number of affordable units or deeper affordability (or both).

Z. **Create rules to ensure off site units are built:** Clarify that offsite units must be completed prior to issuance of a Certificate of Occupancy for the project receiving the bonus unless the developer has provided a bond guaranteeing completion within 12 months.

AA. **Create detailed guidelines for preservation projects:** Develop a set of rules that specifically allow developers to meet their affordable housing requirements through the preservation/rehabilitation of existing housing units but require a careful review and project by project approval by the Office of Housing to ensure that in each case preservation projects provide significantly greater public benefit than would be created through onsite provision of the required affordable units.

BB. **Monitor the use of the off site option:** Require that annual reports to Council outline any approved off-site projects including a comparison between the number of units and affordability levels that would have been produced under the on-site option and the number and level that will result from the off-site alternative that was approved.

Leveraging Other Subsidy Sources

Background

Cities have a variety of policies in regards to allowing developers to use tax credits or other sources of funding to meet inclusionary zoning requirements. If developers are allowed to use scarce Federal, State and local affordable housing funds to provide the same affordable units required by the incentive/inclusionary program, the city runs the risk of ending up with no more affordable housing than they would have received in the absence of the program. For this reason some cities prohibit developers from 'double counting' units (i.e. using other affordable housing programs to subsidize units that are required by the IZ program). A few communities take the opposite position and actively encourage developers to utilize other housing subsidies. This position seems to be more common in communities with a surplus of affordable housing funds.

Many cities adopt policies somewhere in the middle, allowing some affordable housing funds to be utilized but prohibiting others. In general, cities are more cautious about using funds that are highly limited. For example, many cities will allow developers to utilize tax abatements but prohibit the same projects from applying for housing grant funds. A second general guideline is that access to external funding should be balanced against the burdens required or requested of the developer. If cities wish to maintain their inclusionary policies, yet the inclusionary rules make development extremely difficult, they will often err on the side of allowing more external subsidies to be used.

Use of the Federal Low Income Housing Tax Credit program (LIHTC) can be more complicated in part because there are two different types of LIHTC. The so-called 9% credits provide a large share of the cost of eligible projects and as a result they are in very high demand and limited supply. The 4% credits provide relatively less subsidy and require relatively more investment from local sources and private debt, and as a result they are in less high demand. The 9% credits provide deeper subsidies that enable projects to create units that are more deeply affordable. The majority of Seattle's 9% units serve households below 30% of median income, while most of the 4% units are affordable at the 50% to 60% of MFI level. Each state is responsible for allocating access to LIHTC, and like most states, Washington's allocation plan essentially caps the amount of 9% credits that will be awarded for projects in any one community each year. However, there is generally no comparable limit in a city's ability to access 4% credits. In practice, an inclusionary project that accessed nine percent credits might be 'taking them away' from another local affordable housing project while the same project could use the four percent credits without affecting other eligible local projects. For this reason there has been a trend for IZ programs to allow developers to use four percent but not nine percent credits either in onsite or offsite projects.

Spotlight

San Francisco uses its tax credits to achieve deeper affordability. Generally, the city does not allow developments to use any subsidies (local, state or federal). However subsidies can be used, with written permission, to deepen the affordability of a unit beyond the level required by the program. Additionally, if 20 percent of their units are affordable to people making 50 percent of AMI, the four percent tax credit can be used. The percentage increases to 25 percent for offsite production.

Recommendations:

CC. **Continue to limit 'double dipping:'** Continue to specifically prohibit the use of all public affordable housing subsidy programs to finance units required by the IZ program whether on site or offsite with two possible exceptions. The city should consider specifically authorizing use of the 1. The Multi Family Tax Exemption Program and the 4% federal Low Income Housing Tax Credit program in either onsite or offsite projects.

DD. **Clarify the standard for approval of exceptions:** For all projects utilizing the offsite production option, authorize the Director of the Office of Housing to approve the use of other sources of public affordable housing subsidy only when they result in proportionally greater public benefit.

Preserving Affordability

Background

Nothing lasts forever, but many cities attempt to structure their inclusionary/incentive housing programs to preserve the affordable homes for as long a period a possible. Most of the first inclusionary housing programs required only 15 or 20-year affordability periods.

Programs typically record deed restrictions or covenants that limit sale or rental of a regulated unit only to approved low (or moderate) income households. In some communities these covenants are structured to run 'in perpetuity' and in others they have a fixed term generally somewhere between 30 and 99 years.

Many argue that if incentive/inclusionary programs are to create and preserve mixed income communities, long-term restrictions are necessary for the program to have a lasting impact. If homes expire out of the program after a few decades, the program can never really address the need for affordable housing.

It is not entirely clear who benefits from shorter-term restrictions. For homeownership projects, a developer forced to sell units with 15-year restrictions faces the same economic cost as one selling with 99-year restrictions. And since the vast majority of homeowners sell within 15 years, a 30-year restriction benefits whoever happens to own the unit in year 30. For rental properties, the economics are a bit more complex. An investor might pay more for a property with rent restrictions that expire after 15 years than one with 99-year restrictions, but the difference might be slight. In other words the length of affordability makes a big difference to the long-term impact of the program and, at most, a small difference to initial feasibility.

For good reason, it is nearly impossible to construct truly perpetual legal restrictions. Buildings constructed today won't last forever and even the street grids, planning designations and lot lines laid down today will eventually be obsolete. We cannot burden the future with legal restrictions that cannot be reworked but at the same time, we do not know when these changes will be necessary.

The best practice, therefore, is to record restrictions with a fixed-but-long-term (50 years, for example) and then re-record them and 'reset the clock' each time a property is sold or redeveloped so that if a property is sold 20 years after initial development, a new restriction is recorded with a new 50 year term If the restrictions last approximately as long as the useful life of the buildings, there is a high likelihood that affordability will be maintained over time. For homeownership units, the affordability restrictions can be reset each time a unit is resold. Rental properties may not sell as frequently but eventually they will be torn down and rebuilt and the jurisdiction would be in a position to require new affordable units at that point – if that still meets a community need.

Spotlight

Montgomery County's widely copied program created more than 12,000 affordable homes between 1973 and 2005. However, because the affordability of those homes was only regulated for 10 years, by 2005 only 3,000 of those units were still affordable. The overwhelming trend has been for IZ programs to switch to very long-term affordability periods. In 2005, Montgomery County amended their Affordable Dwelling Units program to require 30 years of affordability for new projects, and to reset this clock each time a regulated property was sold.

Recommendations:

EE. **Extend affordability periods:** Set the minimum term of affordability for both rental and ownership units to 99 years.

FF. **Renew covenants at resale:** Require that new covenants be recorded with a new 99-year term each time a restricted property is sold.

GG. **Require replacement of demolished IZ units:** Require a one-to-one replacement of affordable units when deed restricted units are demolished.

Monitoring and Refining the Program Over Time

Background

Incentive or inclusionary zoning programs involve the careful balance of competing goals. These programs have to be adjusted over time, often in response to changing market conditions. And yet, it is difficult for elected officials and other stakeholders to monitor the impact that a program is having. When changes are made to a program, it can take several years before it is clear whether they have had the intended effect. It is important for city departments that are charged with implementing a program to report regularly on the high level results that the program is having and to make an effort to ensure that the information that it shares with elected officials and the public address the specific policy goals established for the program. Most inclusionary or incentive zoning ordinances make no formal provision for annual program reporting but a growing number of programs specifically mandate some form of annual report to help local stakeholders assess the effectiveness of the program and identify conditions that might require changes.

Spotlight

Boulder, Co requires the city manager to “periodically” report to the City Council with enough information to enable the Council to assess the “effectiveness” of their policy, any demographic changes which might impact the policy, and the “integration” of the inclusionary policy with other city tools for increasing affordable housing. The ordinance does not provide further specification on how often this report should be compiled, nor specifics on what should be included.

Sacramento County includes inclusionary reporting in a biennial report on the City and County’s affordable housing program more broadly. This report must include the number of units produced, the amount of land dedicated and purchased, the amount of funds collected, and the levels of affordability satisfied.

Monterey County has both an annual report and a more in-depth five-year report written into their Inclusionary Zoning policy. The annual report is a brief summary of the accomplishments of the program over the previous year. The five-year report includes the number of units produced and households served, the amount of in-lieu fees collected and how those fees are used, and recommendations for policy revisions. This report is presented for public comment.

Recommendations:

HH. **Standardize the code:** Make the program easier to understand by consolidating all the relevant provisions in a single section of code – if there continue to be neighborhood differences deal with them by including tables or neighborhood specific requirements within an overall framework that applies to all neighborhoods.

II. **Produce communications materials:** Hire a consulting firm to develop updated communications materials in order to make program requirements more transparent for developers and other stakeholders.

JJ. **Expand annual reporting requirements:** Provide more specific requirements for annual reporting on the impact of the Incentive zoning program. In addition to the annual production statistics that are currently being reported, the report should include:

- The share of projects that selected the performance, off site development and In Lieu fee options.
- The total dollar amount of fees pledged, collected, committed to a project, and spent in the past year.
- The number of housing units at each relevant affordability level contained in projects receiving commitments of Fee revenue.
- For fee funds expended in a given year, the average number of months that each dollar was held by the city prior to expenditure.
- For all off site projects approved in the past year, the number and affordability level of affordable units in the proposed off site project compared with the number and affordability levels that would have otherwise been required under the on site performance option.

KK. **Plan and budget for periodic reviews:** Every five years, conduct a more comprehensive review of the successes and challenges of the IZ program, including:

- a summary of program production and high level assessment of challenges over the prior period
- an updated analysis of housing needs and demographic trends

- a review of the pricing/rent limit policy to ensure that required rents/prices are below market rate and also affordable to households that are experiencing difficulty accessing housing in the market.
- an economic feasibility study including an analysis of relative market conditions in the different neighborhoods included in the program to ensure that the program requirements are not standing in the way of development in any markets
- an economic analysis as necessary to update the fee based on current market conditions
- A Nexus study (if a linkage fee is implemented)