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TITLE:

JOINT STUDY SESSION REGARDING INCLUSIONARY HOUSING PROGRAM OVERVIEW AND POLICY DISCUSSION

DEPARTMENT: ECONOMIC AND DEVELOPMENT SERVICES DEPARTMENT/PLANNING DIVISION

PRESENTED BY: JENNIFER LE, ECONOMIC AND DEVELOPMENT SERVICES DIRECTOR AND NANCY HUYNH, SENIOR PLANNER

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RECOMMENDATION:

Staff recommends the City Council and Planning Commission receive the staff presentation, provide feedback, and provide direction regarding a potential inclusionary housing ordinance for Planning Commission and City Council consideration.

BACKGROUND:

Housing Element and Regional Housing Needs Assessment (RHNA)

The Housing Element is a chapter of the City's General Plan required by State law to be updated every eight years. The purpose of the Housing Element is to evaluate community housing needs and identify a high-level strategy for addressing the City's needs over the eight-year planning cycle. Each eight-year planning cycle, the City is allocated a specific number of housing units including affordable units called the Regional Housing Needs Allocation (RHNA) that the City needs to plan for which is determined by the State and the Southern California Associations of Governments (SCAG). The City's RHNA allocation, which is intended to reflect the City's "fair share" of the regional housing need, is 11,760 units. The allocated housing units are divided into household income categories, i.e., very low income, low income, moderate income, and above moderate income, which are based on the most current Area Median Income (AMI) for Orange County; refer to Table 1 below for the City's 2021-2029 RHNA.

Table 1 - City of Costa Mesa 2021-2029 RHNA

Very Low (0-50% AMI)	2,919 Units
Low Income (51-80% AMI)	1,794 Units
Moderate Income (81-120% AMI)	2,088 Units
Above Moderate Income (120% or more AMI)	4,959 Units
Total RHNA	**11,760 Units**

Although the City is not required to construct these units, the City is required per State law to plan, zone and otherwise create the policy framework to accommodate the RHNA allocation. In addition, the City is required to report annually to the State as to its progress in implementing its Housing Element programs and progress toward achieving the RHNA allocation. As such, the Housing Element includes the City's housing goals, policies, and implementation actions (referred to as Housing Element "programs").

The City began preparation of its Housing Element in October 2020 and held its first community outreach meeting in November 2020. Following several community meetings, Planning Commission and City Council study sessions, and public review of the Draft Housing Element, the Housing Element was submitted to the State for certification and subsequently adopted by the City Council on February 1, 2022. Following revisions that were required in order to respond to State comments and requests, the City Council re-adopted the 2021-2029 6th Cycle Housing Element on November 15, 2022. On May 9, 2023, the State issued a letter accepting and approving the City's Housing Element as being in compliance with State Housing Element law (see Attachment 1).

The Housing Element includes over 40 programs that work together to form a cohesive and comprehensive housing strategy to address housing needs. For example, the City's housing programs call for re-zoning certain housing opportunity sites and updating the City's local urban plans and specific plans for the areas of the City located north of the I-405 and along other major City commercial and industrial corridors. The required rezoning and updates are for the purpose of creating new housing opportunities and increasing housing supply in the City. Other programs call for the City to evaluate and remove regulatory constraints that increase housing development costs or otherwise discourage housing projects from moving forward. Examples of potential housing constraints for cities include higher than typical development fees, residential parking requirements, or procedural requirements that contribute to longer processing times or approval uncertainty for housing projects. Lastly, programs call for City actions that focus on regulations, incentives, or funding programs that directly preserve or create housing that is affordable to all segments of the Costa Mesa community.

One of the Housing Element goals (Housing Goal #2) is to "facilitate the creation and availability of housing for residents at all income levels and for those with special housing needs." In order to accomplish this goal, the Housing Element identifies Program 2A which calls for the City to consider adoption of an inclusionary housing ordinance. An inclusionary housing ordinance would generally require new housing projects in the City to provide a certain percentage of its housing units as affordable units to moderate, low, and/or very low-income households. The City must make efforts to implement this program within one year of Housing Element adoption in order to maintain compliance with State law. Adopting such an Ordinance would meet this requirement.

Community Demographics and Need for Affordable Housing

In planning for and addressing the City's housing needs, staff considered the City's existing housing stock and community demographics (e.g., population, employment, economics, and household characteristics) as well as projected future growth trends. The demographic analysis was included in Chapter 2 of the City's Housing Element, referred to as the Community Profile. The findings of the Community Profile identify demographic trends, segments of the community most vulnerable to housing instability, and should inform policy decisions related to inclusionary housing.

- **Lower Income Households:** Approximately 47-percent of the Costa Mesa community earn a lower income and approximately 29-percent of the community qualify for very low or extremely low-income housing. Lower income households cannot afford to own or rent in Costa Mesa without experiencing overpayment. This indicates that the production of and access to affordable housing options for lower income households should be a priority for housing policy.

- **Housing Cost Burdens/Overpayment:** Affordable housing is defined in State law as not paying more than 30-percent of a household's gross income on housing costs including utilities. Yet nearly half of renters in Costa Mesa experience housing cost burdens that exceed 30-percent of gross income and over a quarter of renters experience severe housing cost burdens that exceed 50-percent of gross income. Overpayment is an indicator of the lack of affordable housing options and high housing costs compared to household incomes.

  For context on what is considered an affordable rent or purchase price, please refer to the tables in Attachment 2. These tables show the household income limit for the various income categories (very low, low, moderate income) and what would be considered an affordable rent or purchase price for housing for each household income level.

  As shown in the tables, a household of four with an income of $108,400 would be considered "low-income". An affordable rental price for a two-bedroom apartment for a low-income household is $2,003. However, the average rent in Costa Mesa for a two-bedroom unit is $2,649 (2020).

  For ownership housing, a household of four with an income of $142,900 is considered moderate income. An affordable sales price for a for sale two-bedroom unit is $439,900. Yet, the median home price for ownership housing in Costa Mesa is $1.3 million (2022).

- **Low Vacancy Rates:** Costa Mesa has a low housing vacancy rate which indicates that there is a high demand for housing but low supply to fulfill the community's housing needs. With high demand and low supply, rental and ownership housing prices tend to be higher and thus is one of the factors contributing to the lack of affordable housing options in Costa Mesa. Costa Mesa's housing stock was primarily built prior to 1990 with almost a quarter of the stock built around the time the City was incorporated in the 1950's. A little over two-percent of the housing stock in the City was built after 2010. The lack of newer housing stock has contributed to the low supply and high rental and housing costs.

- **Age Characteristics:** Housing needs are influenced by the unique requirements and preferences of certain age groups. Costa Mesa's population is showing aging trends. The population aged 65 and over experienced the most growth in Costa Mesa between 2010 and 2018. An aging population could result in changing needs and demand for different housing types. Seniors tend to have less flexible or fixed incomes. Therefore, with the rising prices in rental and ownership housing costs, affordable housing options for seniors should be a priority.

  While the population has been aging in recent years, young adults 20 to 34 years represent the largest age group in Costa Mesa at over a quarter of the City's population. Like the senior age group, young adults tend to also have comparatively lower incomes and therefore tend to favor apartments, or where feasible smaller, more affordable, single-family units, townhomes, or condominiums.

City Council Housing Goals

Concurrently with the Housing Element efforts, the City Council adopted a Strategic Plan in 2021, identifying five key goals to address specific community issues and needs. One of the Council's Strategic Plan goals is to ***"diversify, stabilize, and increase housing to reflect community needs."*** To address this goal, the City Council also identified several strategic objectives and priorities. One of the Council's identified priorities included considering a draft inclusionary housing ordinance.

As such, staff retained an expert consultant, Keyser Marston Associates Inc. (KMA), to evaluate and make policy recommendations for a potential inclusionary housing ordinance, including the affordability percentage requirement, the potential for an in-lieu fee option, and other factors described in greater detail in this report.

Study Session

This study session is intended to provide an overview of inclusionary housing policy, including a summary of the major components of an inclusionary ordinance, legal requirements, compliance options, and a discussion of policy considerations and industry best practices including inclusionary requirements adopted by other local cities.

In addition, at the study session we will discuss the scope of KMA's financial evaluation which is currently underway, KMA's initial findings based on its base zoning prototype analysis for both rental and ownership products, and pending analysis scenarios that are being based on the re-zoning scenarios described in the City's adopted Housing Element.

Staff is seeking the Planning Commission and City Council's initial feedback and will ultimately prepare a draft ordinance for Planning Commission recommendation to the City Council, if so directed.

ANALYSIS:

Inclusionary Housing Overview

For over thirty years, local California jurisdictions have implemented inclusionary housing programs to increase the supply of affordable housing for low- and moderate-income households. Presently, over 170 California cities have adopted inclusionary housing programs including eight in Orange County. Inclusionary housing policies require developers to reserve a percentage of new housing units for low- or moderate-income households within new residential developments. Residents of the reserved units are subject to income eligibility requirements. Inclusionary housing requirements can be applied to new residential for-sale (ownership) projects as well as rental projects.

Inclusionary housing programs offer multiple benefits for communities seeking to increase housing affordability and develop diverse neighborhoods which include increased housing options for lower income households, helping cities achieve RHNA goals, and reducing vehicle miles traveled and greenhouse gas emissions by locating affordable housing options closer to places of employment. Inclusionary programs are one tool among many that cities can utilize to increase the supply of affordable housing units.

Legal Requirements

During the past decade, inclusionary housing programs have been subject to review by both the California Supreme Court and State legislature. In 2015, the California Supreme Court ruled that inclusionary housing programs are a “valid exercise of a jurisdictions zoning powers” (California Building Industry v. City of San Jose). Furthermore, Assembly Bill (AB) 1505, which was adopted in 2017, reaffirmed the authority of local jurisdictions to include rental units within inclusionary ordinance requirements and added the requirement for the State’s Housing and Community Development Department (HCD) to review an inclusionary ordinance for “economic feasibility”. HCD’s review is required in order to confirm that the requirements of an inclusionary housing ordinance would not “unduly constrain the production of housing”.

Since the adoption of AB 1505, local jurisdictions now routinely complete comprehensive financial evaluations to ensure that inclusionary programs consider the strength of the local real estate market and are not “confiscatory”, meaning that the requirements do not deprive a property owner/developer of a reasonable return on investment, or otherwise constitute a “taking” of property by the government.

KMA has been retained to complete this financial evaluation analysis for Costa Mesa which is in progress and would be completed prior to a draft ordinance being prepared and presented to the Planning Commission.

Inclusionary Housing Program Components

There are key provisions that are commonly found in most inclusionary housing programs which include the following:

- **Project Size Threshold:** Inclusionary housing requirements are not usually applicable to all housing development projects. Most programs have a threshold project size standard that would trigger the requirement and this number can vary greatly.

- **Minimum "Set-Aside" Requirement:** The "set-aside" requirements refers to the number of dwelling units in a new housing project required to be set-aside for affordable units.

- **Affordability Level:** The affordability level refers to the targeted household income level, e.g., very-low, low, or moderate-income households, for which the units are required to be affordable.

- **Covenant Period:** Inclusionary housing programs typically require a covenant to ensure the units remain affordable for many years in the future.

- **Alternative Compliance Options:** In California, State law requires that alternative methods of compliance be provided for projects that cannot include affordable housing units onsite. There are four common alternatives to the onsite production of affordable units: in-lieu fees, off-site production, land dedication, and the acquisition and substantial rehabilitation of existing offsite apartment units.

Each of these program components are discussed in greater detail under the "Inclusionary Housing Policy Considerations" heading below.

Density Bonus Programs

Density bonuses are commonly used by housing developers to reduce the financial impacts associated with providing affordable housing. State Government Code section 65915 requires jurisdictions to provide density bonuses based on a sliding scale ranging from five-percent to 50-percent, depending on the proposed affordability level of the proposed units. For example, if a project proposes 15-percent of its units be affordable at the very-low income level, the project could receive a 50-percent density bonus (calculated on the base number of units) under State law. Refer to the table in Attachment 3 of this report which shows the State's density bonus sliding scale.

The City is required to grant a developer's request for the density bonus along with a required number of concessions and/or incentives (unless the City finds that the proposed concession and/or incentive does not result in identifiable and actual cost reductions. The City has the burden of proof in the event the City does not grant a requested concession and/or incentive.) The number of required concessions and/or incentives, as outlined in Government Code Section 65915, is based on a project's percentage of affordable units and the affordability level of each unit; refer to Table 2 below. A concession or incentive under State density bonus law includes: a reduction in development standards or a modification of zoning code requirements such as a reduction in setbacks and/or required parking, waiver or reduction in development fees, or other regulatory incentives or concessions which actually result in identifiable and actual development cost reductions.

Table 2 - Required Number of Concessions/Incentives

Number of Concessions/ Incentives	Very Low Income	Low Income	Moderate Income
1	5%	10%	10%
2	10%	17%	20%
3	15%	24%	30%
4	100%	100%	100%

Although density bonus laws have existed for decades, Costa Mesa has not had a density bonus project since the 1990’s, with the exception of the LUX housing project at 2277 Harbor Boulevard (the former Costa Mesa Motor Inn site), which utilized State density bonus law and included 200 units (of which nine were deed-restricted to be affordable to very low-income households).

Although density bonus requests have not been common in recent decades, density bonuses are discussed in this report because, with the adoption of an inclusionary housing ordinance, it is likely density bonus requests will increase. The reason for the likely increase is that requiring affordable housing units as part of an inclusionary program will automatically make a housing project eligible for a density bonus under State density bonus law.

For example, if the City requires a 10-percent affordable housing set aside as part of its inclusionary policy, a housing project complying with that requirement will automatically be eligible for concessions/incentives and a 32.5-percent density bonus under State law (if the affordable units are provided at the very-low income level; the density bonus percentage applied is lower if the affordable units are provided at a higher income level).

Inclusionary Housing Programs in Orange County Cities

Eight Orange County cities have adopted inclusionary housing ordinances. These cities include: Brea, Huntington Beach, Irvine, Laguna Woods, La Habra, San Clemente, San Juan Capistrano, and Santa Ana. Each city’s program is summarized in Attachment 4 to this Agenda Report.

Generally, each Orange County city adopted the following in their inclusionary housing ordinances:

- Project threshold size ranges between two and 50 units (for both rental and ownership housing) with the average threshold size being approximately 12 units;
- Set-aside percentage between 10 and 15-percent with 15-percent being the most common;
- Affordability level varies and there does not appear to be a common level as affordability level is tailored to each specific jurisdiction and its housing goals and market conditions. However, most set the level differently for rental versus ownership units and require the units to be allocated across multiple income levels with a mix of very low, low, or moderate-income;

- Different covenant periods for rental versus ownership housing including 45 years for ownership and 55 years for rental (20 years is the shortest term as adopted by San Clemente; Irvine adopted 30 years for both housing types);
- Variety of alternative compliance methods including offsite production of units, in-lieu fees, land dedication, or preservation/rehab of existing apartment units; and
- In-lieu fee amounts typically differ for rental versus ownership housing projects and the fee is either a flat rate per square foot or per unit or a formula calculation based on certain variables such as estimated construction cost, land value, and/or cost to produce an affordable unit.

Inclusionary Policy Considerations

There is no one “model” inclusionary housing policy but rather a number of best practices and a range of policy options to consider. Inclusionary housing programs should offer flexibility and be tailored to the unique needs of each community.

A Balanced Policy

Inclusionary requirements should balance the interest of property owners/developers with the public benefit created by the production of affordable housing units. The requirements should not be so burdensome that they would make new housing development infeasible and deprive an owner/developer of a reasonable return on their investment. A requirement that is too stringent given the market conditions in a City could deter and disincentivize housing in that City altogether.

Furthermore, market rate construction is necessary to help drive production of affordable housing. For example, the development of an exclusively affordable project usually requires a combination of tax credits and public agency funding or other subsidies to be feasible or “pencil out”. With the dissolution of the redevelopment agencies in California, funding for housing projects is more limited and opportunities are scarce for such projects. However, affordable housing as a component of a market rate housing development, especially when coupled with a density bonus and/or other zoning changes, helps balance the cost of providing affordable units and makes affordable housing development feasible for private developers to build as part of market rate projects.

In addition, most inclusionary housing programs apply the requirement to housing projects regardless of location in the City to ensure that the policy is implemented equitably and to ensure the affordable units are provided throughout the community and not concentrated in one geographic area. Such a policy creates diverse neighborhoods and incorporates housing options at a range of income levels. However, some cities have adopted different inclusionary requirements for different areas of the City if market conditions are different enough in this areas to warrant that approach.

Inclusionary units are also typically required to be dispersed throughout a housing project, be designed no differently than the market rate units, be constructed concurrently, and have access to the same community amenities. It is typical for inclusionary housing ordinances to include these development standards to ensure the units are equivalent regardless of household income level. In some circumstances, housing developers have asked for flexibility in these requirements to allow for affordable units that meet city-required standards but are not the same as onsite market rate units when this difference supports project feasibility.

Local Context and Financial Feasibility

The key requirements of an inclusionary housing ordinance have been summarized above. However, each of the components must be considered in the local development context for Costa Mesa.

Prior to 2017 and following the enactment of AB 1505 and the ruling in the *California Building Industry Association v. City of San Jose, 61 Cal 4th 435*, some California cities adopted inclusionary housing ordinances based on templates approved by neighboring cities and desired outcomes. However, this “one size fits all” approach led to inconsistencies in the level of success each city could achieve based on its own particular demographics, zoning and opportunities for land use changes. The legislation and court ruling made it an industry best practice and in some cases a mandate that each city conduct a detailed City-specific financial evaluation to drive its own specific policy recommendations to ensure that mandated affordable housing development was economically feasible for both housing developers and the community.

For the City of Costa Mesa, the in-depth financial evaluation performed by KMA is currently underway. The study is evaluating the financial feasibility of imposing Inclusionary Housing requirements on certain housing types and under market conditions experienced in Costa Mesa. To accomplish this, KMA is developing pro forma analyses of prototype residential projects reflective of the Costa Mesa market. (Pro forma is a method of calculating financial results using certain projections and market assumptions). The prototype projects are based on local past or pending residential projects and the residential projects in KMA’s local market surveys. The evaluation analyzes both rental and ownership product types and at varying density levels. The evaluation includes housing development scenarios under both existing base zoning and density provisions allowed by the Costa Mesa General Plan and Municipal Code, as well as under future zoning and density provisions envisioned in the City’s adopted Housing Element. The analysis considers that developers could utilize the density bonus for additional dwelling units (beyond the zone’s established density) and concessions which reduce and offset the cost of constructing inclusionary units and make a higher inclusionary housing requirement more feasible.

Attachment 5 lists the analysis scenarios underway and in summary includes an analysis of a rental unit project developed at the City’s base zoning density of 20 dwelling units per acre and a scenario for the same project under a density bonus scenario of 30 dwelling units per acre. Base scenarios also include an evaluation of ownership housing projects including townhomes, live/work, and condominium projects with varying site size and at base densities ranging from 16 to 25 dwelling units per acre. Scenarios will also be run at densities reflecting State density bonus law.

These scenarios are starting points for the analysis and function as “sensitivity analyses” which are modified and re-run to determine the level of affordable housing requirements that can be supported under existing zoning and current market conditions.

KMA has provided a preliminary executive summary of the outcomes of the base zoning scenarios, see Attachment 6. In summary, it shows that a 10% inclusionary housing requirement for low income units (without a density bonus) may be able to be supported in Costa Mesa under base zoning conditions for rental product types and an eight percent inclusionary housing requirement for moderate income units (without a density bonus) for ownership units. A higher inclusionary set aside and deeper affordability will likely be able to be required under the pending analysis scenarios based on the Housing Element's zoning proposals which is intended to promote and encourage housing.

The analysis scenarios which are pending completion include re-zoning scenarios based on projects which range between 30, 35, 40, 50 and 90 dwelling units per acre. Lower density housing projects are envisioned along the City's major commercial and industrial corridors, with the 90 dwelling unit per acre scenarios envisioned for the areas north of the I-405 where housing projects at higher densities already exist.

This study session will provide an opportunity to share these very preliminary initial findings and recommendations that can help the Planning Commission, City Council, housing advocates, housing developers and the community better understand the factors that can influence a successful inclusionary housing program, and the data required to make those critical decisions. It is also our hope that the study session will provide an opportunity for staff and KMA to receive important feedback regarding any other data, financial pro formas, or housing development scenarios that should be included in the report to help inform future policy decisions.

Project Size Thresholds

Although many inclusionary program components are heavily informed by the financial evaluation, outcomes also respond to local priorities and policy preferences. For example, many cities do not apply their inclusionary requirements to all housing development projects. Most programs have a project threshold size standard that would trigger the inclusionary requirement and this number can vary greatly among city. Some programs do not specify a threshold size and require compliance with the inclusionary program regardless of project size and some do not require onsite production but do require in lieu fees for smaller projects.

The threshold size requirement is important because if it is too high then fewer development projects could trigger the inclusionary housing requirement and therefore not produce affordable units. However, the requirement should not be set at a size that would then encourage projects to develop just under that threshold which would frustrate the goal of inclusionary housing. If the threshold is too low, it could discourage housing projects in the City altogether because it may become financially infeasible to construct a profitable smaller project along with the inclusionary requirements.

Staff recommends that the Council consider establishing a minimum project size to apply the inclusionary housing requirement. The minimum size could be based on a project's proposed number of units or based on land area of the proposed lot. The most common threshold size in California cities is five to ten dwelling units. For projects with fewer than five to ten units, it may become economically infeasible to apply inclusionary requirements and discourage smaller developments and "missing middle" housing types. In addition, smaller projects tend to be developed by smaller local developers who are less familiar and operationalized to appropriately apply and report on affordability requirements over time.

As such, staff recommends the Council apply an exemption for smaller projects 10 units or less in order to continue encouraging smaller scale housing projects. Staff is seeking Council feedback whether to study a sliding scale in lieu fee for smaller projects rather than requiring onsite production.

Minimum "Set-Aside" and Affordability Level

The set-aside requirement should be set at a percentage amount that is supportable by the pending KMA financial evaluation. The financial evaluation will test different prototype projects (ownership and rental) to determine at which percentage and income level the requirement is feasible while providing a fair return on investment.

In California, most adopted inclusionary policies are based on a percentage and have fallen within the ten to 20-percent range - 15-percent being the most common. For example, if a new development project proposes 100 dwelling units and the requirement is 10-percent then 10 of the 100 units must be deed restricted as affordable to moderate or lower-income households. The preliminary findings of the KMA analysis for the base zoning scenario indicates a 10% set aside for low income units for a rental project and an 8% set aside for moderate income units for an ownership project is potentially supportable in Costa Mesa. However these findings may be modified and updated pending the completion of the final financial evaluation.

The set-aside requirement could apply to any income level. For example, a 10-percent requirement could be applied but the developer could choose which affordability level to provide, as long as they provide the minimum number of units. However, it is likely the moderate-income level would be pursued since the return on investment is more beneficial for developers at the higher income level. As another option, the set-aside requirement could be based on a combination of income levels, for example, a 10-percent requirement with 7-percent required to be at the very low and 3-percent at the low- or moderate-income level. This combination approach could produce more lower-income units compared to moderate-income units, more directly addressing the segments of the Costa Mesa community that experience the greatest housing instability. A combination approach is also more consistent with the City's 2021-2029 RHNA allocation.

The set-aside percentage requirement can be the same for rental and ownership housing but the affordability level should be considered differently for each housing type. Inclusionary policies typically require ownership housing projects to provide units at the moderate-income levels. Rental projects most often are required to provide units at the low, very-low income, and in some programs, extremely-low level. Extremely-low income units are not built as often due to the limited and often negative return on investment for developers. Extremely low-income units are typically built by affordable housing developers and are supported by public funding sources which subsidize housing for individuals and families that fall within this category.

Requiring the inclusionary units (especially for rentals) to be allocated across multiple income levels could provide deeper affordability. Other Orange County cities have included this approach in their programs. The City of Santa Ana's set-aside requirement is a tiered system with the highest percentage at 15-percent for low-income units and the percentage is lowered if deeper affordability is provided e.g., 10-percent for very low-income, 5-percent for extremely-low units, etc. The Council could consider a similar tiered set-aside and affordability level requirement (if supported by the financial evaluation).

Staff recommends that ownership housing affordability be focused on the moderate income level and rental housing affordability levels be focused on low income and very low income in cases where a density bonus is used.

Covenant Period

It is standard for inclusionary housing programs to require a specific length of time the units must remain affordable. Covenants for ownership units usually range from 30 to 45 years and those for rental housing are most often 55 years. Projects that utilize the State's density bonus are already subject to rental or ownership term restrictions but should the City require more stringent terms, the higher requirement would prevail. The State density bonus law requires 55 years for rental units which could explain why many programs adopt the same terms. For ownership, State density bonus law requires no minimum covenant period. When a unit is resold, it is sold at the market rate and the seller must pay to the City the difference in the market rate price compared to the affordable price at the time of original purchase and a proportionate share of the equity appreciation.

Staff recommends a 55-year covenant for rental units and is seeking Council feedback regarding applying the same re-sale procedures as provided by State density bonus law for ownership units or establish a set covenant period which will require long term re-sale oversight to ensure ownership units are sold at the affordable price and occupied by eligible household over the duration of the covenant period.

Alternative Compliance Options

While there should be a heavy emphasis and encouragement to provide inclusionary units onsite, it is required under State law that the City provide an alternative option to comply with the inclusionary housing requirement if a project cannot satisfy it with onsite units. Alternatives should only be available when onsite units are less feasible and under specific circumstances and not as a default option for developers to choose at their sole discretion.

As described in the above section of this Agenda Report, there are four main alternative compliance options. The City should consider including a menu of options to provide developers with reasonable flexibility, but also ensure production of as many or more affordable units as would have been required onsite in order to accomplish the goal of an inclusionary housing program.

In-Lieu Fees

In-lieu fees is a payment option if units cannot be provided onsite. In-lieu fees are established as either a fixed amount per unit or are applied on a square foot basis. Fees are updated from time to time to reflect current market conditions. In-lieu fees are collected by the City as a revenue source to support, fund and/or subsidize affordable housing within the City.

Payment of in-lieu fees is a typical option in many inclusionary housing programs and the fees collected are allocated to a housing fund to benefit housing related programs in the City. The fee amount should be set at an amount supportable by the pending KMA financial evaluation. The pending financial evaluation will analyze the appropriate in-lieu fee amount for both rental and ownership housing types. The fee amount should not be set too low such that it would not achieve the goals or benefits of the inclusionary housing program. It should also not be too high where it could result in an impact on feasible development and could deter housing. The fee amount may also need to change over time to reflect the changes in construction costs and other market forces. As such, staff recommends fees be adopted by Resolution so fees can be adjusted on a regular basis without the need to amend the ordinance.

KMA preliminary findings supports an in-lieu fee of approximately $25 per square foot of floor area for both rental and ownership projects under the base zoning (no density bonus) scenario. These fee estimates will be refined and expanded upon completion of the pending analyses.

In-lieu fees can be allowed to be paid by right for all projects or for certain project types (ownership or rental), sizes (smaller projects), or affordability levels in order to incentivize specific Council priorities. They can also be allowed to be paid only under a certain specific set of circumstances on order to incentivize onsite production. Staff is seeking Council feedback regarding the possibility of using a sliding scale of in lieu fees to incentivize certain housing types and characteristics.

Offsite Production

The affordable units may be constructed at another location within the same jurisdiction. Offsite units are required to meet the same affordability level and covenant period that would have applied to onsite units.

Allowing offsite production (within City boundaries) of inclusionary units is also another common alternative option. A developer may choose this option if it is not feasible to develop the units onsite but they have the ability to construct and provide them offsite elsewhere in the City on a property they own or have access and ability to develop. However, offsite units should still be produced nearby the original project to foster mixed income neighborhoods or at least dispersed equitably throughout the community and not clustered in one area. Offsite units should be constructed concurrently with the project that required the inclusionary units. Requiring the offsite units be built at the same time or before the original project would ensure the affordable units are actually provided and not just an option to avoid complying with the inclusionary requirements. Other inclusionary programs that have included offsite units as a compliance option tend to require more units to be built offsite than would have been required onsite. Offsite production usually involves cost savings, so the City should require more units to ensure an equal value. In doing so, it ensures onsite and offsite construction have similar costs.

Staff recommends Council include offsite production as an option subject to requirements generally described above, understanding it may only be applicable in limited cases due to the limited availability of developable land.

Land Dedication

Developers could be allowed to dedicate property in-lieu of constructing affordable units onsite or offsite. Dedicated land must be located within the jurisdiction's boundaries.

The benefit of including land dedication or donation as another compliance option is the land could be used to develop other needed types of housing that an inclusionary housing ordinance may not typically produce such as permanent supportive housing or housing for special needs populations. Donated land should also be equivalent or greater in value than onsite units. Because cities do not typically develop and construct housing units, the City could consider partnering with a reputable affordable housing developer to construct and manage an affordable housing project on the donated land. In such case, the land dedication should be conveyed to the City who could then lease it to an affordable housing developer. The donated land should be suitable for a housing development so the inclusionary ordinance should include criteria for what is suitable land for dedication. For example, the size and physical characteristics should be reasonable to develop units at a certain density; if the dedicated land is too small, then it may not be economically viable.

Staff recommends Council include land dedication as an option subject to specific requirements generally described above, understanding it may only be applicable in limited cases due to the limited availability of developable sites without major constraints.

Acquisition and Substantial Rehabilitation

Developers could be allowed to acquire and rehabilitate existing offsite market rate rental units within the jurisdiction's boundaries and applying affordable covenants to those units. The same affordability level and covenant period that would apply to onsite units also apply to these rehabilitated units.

Though this option is not as common, some Orange County cities also include it in their inclusionary housing program. This option would allow a developer to rehabilitate an existing housing project in the City. Although rehabilitation may be a good policy, it is not as desirable as an inclusionary housing requirement alternative because it is not producing additional new affordable units and therefore the units cannot be counted toward the City's RHNA allocation. The other concern with this option is potential impacts to existing tenants while the property is undergoing renovations. The benefit of this option is potentially extending the life of existing housing and improving aging properties.

Staff is seeking feedback as to whether to include rehabilitation as an option.

Credits

Although not as common as other alternative compliance options, some cities (such as Irvine) allow developers who construct a greater number of inclusionary units than required to gain "credits". These credits may be used in future projects or can be transferred to another housing developer. Oftentimes, credits must be equivalent to the units in the originating project and have expiration dates from year of issuance.

Although uncommon in other inclusionary programs, the City could also consider a credit system for developers who construct affordable units beyond the minimum requirement. For example, if 10 units are required to be affordable and the developer constructs 15 units - five of the units could be "credited" towards the developer's future housing project in the City. Alternatively, the developer could transfer their credit to another housing developer that could be applied to their project in the City. The credits could be given for other reasons that could also be considered "above and beyond" the inclusionary requirements besides providing more affordable units than required. For example, credits could be given for providing deeper affordability than required such as extremely-low income level or providing affordable units with smaller (studios) or higher bedroom (3-bedrooms) count. As part of its next steps, staff could evaluate further whether credits could work well in Costa Mesa.

Concessions and Incentives

In addition to the minimum requirements included in most inclusionary housing programs, some cities offer incentives to developers to offset costs associated with providing affordable units to further incentivize housing development or in exchange for more affordable units or deeper affordability. These may include greater density than allowed in the underlying zone, flexible development standards, expedited processing, or financial subsidies including but not limited to a reduction/waiver of certain fees. As part of its next steps, staff could evaluate further whether these types of incentives could work well in Costa Mesa.

Unit Mix

Unit mix could also be considered in the inclusionary ordinance. For example, the City could require or incentivize the production of a certain number or percentage of housing units to be studios, one, two, or three-bedrooms. By requiring a certain unit mix, it could ensure housing units are available for a range of household sizes. The City could consider which unit mix would be the most beneficial given the community's profile and incentivize specific unit types. For example, the City may want to incentivize the provision of studio units for seniors who live independently or two and three-bedroom units for large families or multi-generational households. As part of its next steps, staff could evaluate further whether requirements or incentives for these types of housing or housing characteristics could work well in Costa Mesa.

Program Implementation and Compliance

If an inclusionary ordinance is adopted, it would create a new housing program that would require additional resources to implement, manage, monitor, and enforce inclusionary requirements for the duration of the program. Such tasks would include but are not limited to the collection and management of in-lieu fees, preparation of requests for proposals, agreements, and staff reports for the allocation of in-lieu housing funds, development of community development partnerships, preparation and monitoring of affordable housing agreements for each inclusionary project, annual rent certifications to ensure required units are rented to households at the appropriate income levels, and appropriate tracking and reporting of units to the State annually.

The Council should also consider identifying and articulating in the inclusionary ordinance the potential uses of collected in-lieu fees. For example, in-lieu fees could be used as additional funding to leverage State and federal funds to fund an affordable housing project, to produce needed units that the inclusionary requirement is not producing such as extremely-low income units, funding to preserve existing affordable units with expiring covenant periods, subsidizing the production of ownership units in places where the inclusionary requirement is primarily creating for-rent units (or vice versa), and/or funds the development of affordable units in parts of the City where development is not occurring and thus the inclusionary requirement is having no impact. The Council should also consider using in-lieu fees to fund existing housing support programs that could benefit from the flexibility afforded by using a local funding source (as opposed to State or federal funds) and using in-lieu fees to ensure adequate City resources are allocated to manage the inclusionary housing program in the long-term.

Stakeholders Feedback

As part of staff's analysis and research regarding the potential impacts and opportunities of an inclusionary housing ordinance in Costa Mesa, staff met with both local affordable housing advocate groups and local housing developers with expertise in land development. In all, staff conducted six separate meetings. All stakeholders were generally accepting or supportive of an inclusionary housing program in Costa Mesa and understood the need for one; however, as with any local ordinance the detailed components and how they all come together will ultimately determine the overall effectiveness and feasibility of the program in Costa Mesa. Below is a summary of feedback from these initial meetings:

- **In-Lieu Fees:** The stakeholders were supportive of providing in-lieu fees as an alternative compliance option. It was discussed that the fee should be an appropriate amount because if too high, it could deter housing projects. It was also discussed that the in-lieu fee is more beneficial for and should be applied to smaller housing projects;

- **Land Costs:** Housing developers indicated that an inclusionary housing program will impact land value in that the cost of producing affordable units will be factored into the price a housing developer is willing to pay to acquire property for a project. This was a particular concern for commercially- or industrially-zoned properties where housing could be allowed through modified zoning, but if a developer's offer to purchase the property is lower than a land owner is willing to take (due to development costs), and if the land owner has a viable and profitable commercial or industrial property, a land owner could prefer to keep the property as is rather than sell the land for housing. Because the market changes often, the ability to modify the ordinance flexibly is also important;

- **Incentives:** Stakeholders concurred that the density bonus will be utilized more with an inclusionary housing requirement and understood that the City is required to grant concessions/incentives. The concessions under the density bonus provisions sought by developers most often included lower parking requirements, building height and setbacks. Some suggested including additional incentives such as expediting processing by identifying a staff team responsible only for housing entitlement projects in the City, streamlining processes by using by right development and objective design standards (as opposed to discretionary processes), offering flexibility in key provisions of the ordinance (for example, longer covenants) in exchange for a lower percentage, or fee waivers were also mentioned; and

- **Workforce Housing and First-time Home Buyers:** Housing advocates emphasized the need for workforce housing, which is housing for Costa Mesa residents at the low to moderate-income level, so that people can live where they work and in turn, improve their quality of life and be part of the community they work in. Focusing policy on the very low- and low-income categories is critical for rental units. In addition, it was discussed that the inclusionary program should incentivize affordable ownership units especially for first time home buyers and not just affordable rental units. It was mentioned that younger individuals and families are leaving Orange County due to unattainable housing prices. It was also suggested that the City should consider a more aggressive affordable housing requirement for the Fairview Developmental Center, since the land is State-owned.

Next Steps

Following the joint study session, KMA will complete its draft financial evaluation working with staff to incorporate additional and modified sensitivity analyses and scenarios and will prepare policy recommendations, incorporating community feedback and the direction received from the City Council and Planning Commission.

Staff in coordination with the City Attorney's Office would then prepare a draft Costa Mesa specific ordinance, followed by implementing guidelines. A draft ordinance framework is provided as Attachment 7 to provide the Council with the general understanding of the layout and components of the future ordinance. The Ordinance would be completed incorporating the entire comprehensive inclusionary program, upon Council direction.

The draft Costa Mesa specific ordinance based on the KMA financial evaluation could be presented to the Planning Commission this summer for review and recommendation to City Council. Following Planning Commission's recommendation, the first reading of the draft ordinance would be presented to City Council for consideration. If the first reading is approved, the second reading would be scheduled for the next meeting. If the second reading is approved, then the ordinance becomes effective 30 days thereafter.

Subsequent evaluation of fees and staff/consultant resources necessary to implement the new inclusionary housing program would be presented at a later date.

ALTERNATIVES:

The City Council could request an additional study session following the completion of the financial evaluation and draft policy recommendations. An additional study session could provide additional opportunities for feedback and direction, if necessary, prior to staff finalizing a draft ordinance.

FISCAL REVIEW:

There is no impact to the City's General Fund from a policy discussion pertaining to inclusionary housing. However, if the Council directs staff to move forward with preparation of a draft ordinance, staff will evaluate the fiscal impacts of such an ordinance, including the potential for revenue in the form of housing in-lieu fees and the potential for additional staff or consultant resources necessary to manage an affordable housing program over time.

LEGAL REVIEW:

The City Attorney's Office has reviewed and approved this report as to form.

CITY COUNCIL GOALS AND PRIORITIES:

This item supports the following City Council Goal:

- Diversify, Stabilize and Increase Housing to Reflect Community Needs

CONCLUSION:

Consideration of an inclusionary housing ordinance has been included in the City's Housing Element as part of an overall strategy to promote the creation of additional housing supply that is affordable to all segments of the Costa Mesa community. Furthermore, the inclusionary housing ordinance is included as a strategic plan objective and priority to accomplish the City Council's goal to "*diversify, stabilize and increase housing to reflect the community needs".* Staff is seeking feedback from the City Council and Planning Commission regarding the various components of an inclusionary housing ordinance including project threshold size, target affordability levels, covenant periods, compliance options, and any other policy initiatives the Planning Commission or City Council would like to consider.