# MEMORANDUM

To: City of South Pasadena

From: Julie Cooper, Thomas Gonzales, and Darin Smith

Subject: South Pasadena Inclusionary Housing In-Lieu Fee Calculation; EPS #214034

Date: April 4, 2024

# Introduction

The City of South Pasadena (City) adopted an inclusionary housing policy in May 2021 and subsequently updated the policy in November 2023. The policy requires that a minimum of 15 percent of the total number of dwelling units in a residential or mixed-use development consisting of ten (10) or more units be provided at below-market-rate prices affordable to Extremely Low, Very Low, Low, and/or Moderate Income households, based on income standards established by the State of California's Department of Housing and Community Development (HCD).

The City's code allows, under certain circumstances, for development projects to pay an in-lieu fee as an alternative to providing required units. For-sale projects can pay an in-lieu fee instead of building any on-site affordable units. Rental projects must build their required affordable units on-site, but have the option to pay an in-lieu fee for any fractional affordable units required as an alternative to rounding up to the next whole number of units that must be provided on-site.

The City hired Economic & Planning Systems, Inc. (EPS) to calculate an appropriate inclusionary housing in-lieu fee rate to charge in such instances. The City's code specifies that the in-lieu fee be established in an amount that is equivalent to the cost of providing a comparable unit for each unit that would have been provided in the project. As detailed in this memorandum, EPS has calculated proposed fee amounts by estimating the subsidy necessary to support construction of an affordable housing unit, so that the cost of the fee is equivalent to the financial burden on a developer to provide an on-site unit.

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EPS additionally analyzed the impact of paying the in-lieu payment on development feasibility relative to the financial impacts of building affordable units on-site, to inform the City whether a developer would be more likely to choose to provide affordable units on-site or pay the in-lieu fee (in the cases where they have such a choice). The analysis indicated that for an average hypothetical rental project, a developer could receive a comparable financial return whether building an additional affordable unit or paying the fractional fee. Therefore, a given developer may reasonably choose either option. Meanwhile, a developer of an average hypothetical for-sale project is more likely to achieve a higher return by providing units on-site to meet their inclusionary requirement rather than paying the in-lieu fee, primarily due to the benefits of utilizing the State Density Bonus Law.

## Proposed In-Lieu Fee

Based on close discussion with City staff and stakeholders since early 2022, EPS has developed a set of proposed in-lieu fees for projects that choose an alternative to building on-site units, when allowed. The proposed fees per square foot of affordable unit required are summarized in **Table 1** below. For rental projects, there are two fee options: a single blended fee or a split fee. The split fee option includes two different fee levels, which would be applied to a project depending on the required level of affordability for the "next affordable unit" required on a given project. Details of how each fee is calculated are described in further in this memorandum. This memorandum also includes an **Appendix** with fee calculation formulas and examples.

**Table 1 Proposed In-Lieu Fee Per Required Affordable Unit Square Feet**

| Item | Fee Per Square Foot [1] |
|---|---|
| **Rental Projects - Proposed In-Lieu Fee Options** | |
| ***Single Fee Option*** | |
| Blended Fee (avg. of Very Low Income and Low Income) | $418 |
| ***Split Fee Option*** | |
| Fee at Very Low Income (50% AMI) | $538 |
| Fee at Low Income (80% AMI) | $297 |
| **For-Sale Projects - Proposed In-Lieu Fee** | |
| Fee at Moderate Income (120% AMI) | $371 |

[1] Fee is charged on a project's total square feet of affordable units required under the IHO that are to be satisfied by fee payment in-lieu of building the units on-site.

### Recommended Implementation Measures

EPS recommends that the fee be officially adopted by resolution by City Council and referenced in the City's Zoning Code. In addition, EPS recommends that the resolution establish an automatic annual escalation of the fee using a construction cost or inflation index,[1] in order to ensure the fee scales with changes in costs over time.

## Fee Approach

This report estimates the subsidy needed to produce housing units that are affordable to households at the City's specified income levels using an affordability gap analysis, which compares the costs of building the affordable units to their value at affordable levels. EPS calculated this gap for three inclusionary requirement scenarios, as reflected in the City's ordinance:

1) A rental project's inclusionary requirement includes a fractional unit, and the next unit built must be affordable to Very Low Income households.[2]
2) A rental project's inclusionary requirement includes a fractional unit, and the next unit built must be affordable to Low Income households.
3) A for-sale project's inclusionary requirement includes units affordable to Moderate Income households.

**Table 2** details when a particular scenario would be applied to a given development project.

[1] Potential indices include the Bureau of Labor Statistic's Consumer Price Index (https://www.bls.gov/cpi/) or Engineering News-Record's Construction Cost Index or Building Cost Index (https://www.enr.com/economics)

[2] The City's policy allows rental project developers to meet a portion of their requirement by providing units affordable to Extremely Low Income households. However, given the higher level of subsidy required to provide units at that income level, and lack of additional incentives for doing so, it is EPS' professional opinion that a typical developer would opt to provide units at the Very Low Income rather than the Extremely Low Income level.

**Table 2 Affordable Housing Requirements in South Pasadena by Development Type**

| Development Project Type | Projects with Fewer than 10 Units | Rental Project with 10 or More Units [1] [2] | For-Sale Project with 10 or More Units [2] |
|---|---|---|---|
| *Affordability Requirement* | None | 7.5% of Units Must Be Affordable to Extremely Low Income or Very Low Income Households<br>and 7.5% of Units Must be Affordable to Low Income Housholds | 15% of Units Must Be Affordable to Moderate Income Households |
| *In-Lieu Fee Option* | N/A | Fee Payment Accepted for Fractional Units Only | Fee Payment Accepted for All Required Units |
| *Required Type of Units* | N/A | Rental | Either For-Sale or Rental |

[1] The number of units affordable to Very Low Income households must be equal to or greater than the number of units affordable to Low Income households.
[2] Fractional units, if any, must be rounded up or paid via in-lieu fee.
*Source : South Pasadena City Code*

## Product Prototypes

The following analysis uses prototype affordable residential products, which were informed by the City's Housing Element Update and reflect the most common allowable building types at sites inventoried in the Housing Element as potential locations for the construction of affordable housing. The prototypes were reviewed and approved by City staff to utilize in this analysis.

The assumptions for the prototype products are summarized in **Table 2**. As shown, both the for-sale and the rental product prototypes are a two-bedroom unit within a four-story, wood frame building, developed at a density of 70 units per acre. The for-sale prototype is a 1,200 square feet condominium, while the rental prototype is a 1,000 square feet apartment. The analysis also assumes both prototypes are served by structured parking, at a ratio of one space per two-bedroom unit. This ratio represents the typical parking ratio that an affordable housing developer would look to achieve for a two-bedroom unit, and also reflects new State legislation that allows a developer to provide fewer parking spaces than required by the City standards if the development is constructed within ½-mile of a major transit hub, which applies to several of the sites identified for lower income units in the Housing Element.

**Table 3 Unit Prototype Characteristics**

| Product Type | Construction Type | Density | Unit Size | Unit Sq. Ft. | Parking Type |
|---|---|---|---|---|---|
| For-Sale | 4-Story Wood Frame Condo Building | 70 units/acre | 2 Bedroom | 1,200 sq. ft. | 1 space per unit (structured) |
| Rental | 4-Story Wood Frame Apartment Building | 70 units/acre | 2 Bedroom | 1,000 sq. ft. | 1 space per unit (structured) |

## Maximum Affordable Housing Rents and Prices

Income levels for affordable housing units are set for the County of Los Angeles by the California Department of Housing and Community Development (HCD) on an annual basis. **Table 4** shows the income limits for 2023 for a three-person household, as this analysis assumes the two-bedroom prototype units are occupied by three-person households.[3]

The Area Median Income (AMI) for a family of three in Los Angeles County is $88,400 in 2023. For the Low and Very Low Income categories, the maximum incomes do not correspond mathematically to the defined 50 and 80 percent of AMI, respectively, due to HCD adjustment factors for Los Angeles County. For example, the Low Income group would definitionally represent households earning up to 80 percent of AMI, but due to the HCD adjustment factor, the resulting Low Income maximum is slightly *above* the AMI. HCD makes these adjustments to Low and Very Low Income levels in counties with relatively high housing costs and/or relatively high or low household incomes. HCD does not apply these adjustment factors to the Moderate Income levels.

**Table 4 2023 Household Income Limits for Los Angeles County**

| Income Group and Definition | | **2023 Maximum Income** 3-Person Household |
|---|---|---|
| Very Low | >30% to ≤50% AMI + *HUD adjustment [1]* | $56,750 |
| Low | >50% to ≤80% AMI + *HUD adjustment [1]* | $90,850 |
| Median (Base) | >80% to ≤100% AMI | $88,400 |
| Moderate | >100% AMI to ≤120% AMI | $106,050 |
| HUD Adjustment Factor for Very Low & Low Income Groups | | 128.5% |

[1] HUD applies adjustments to the amounts based on unusually high or low family income, uneven housing-cost-to income relationship, or other reasons.
*Source: Los Angeles County, California Housing and Community Development (HCD).*

[3] Based on California Health and Safety Code Section 50052.5.

Consistent with the City ordinance, the analysis assumes that households spend 30 percent of their gross annual income on total housing costs. For rental units, this includes rent and utilities.[4] Spending on utilities is subtracted from spending on total housing costs to determine the maximum rent that a household can pay in a year. For for-sale units, the 30 percent includes mortgage principal and interest, property taxes, and private mortgage insurance payments (collectively, "PITI"), plus estimates of annual Homeowners Association (HOA) fees. After subtracting taxes, insurance, and HOA fees from the spending on total housing costs, the remainder was used to calculate a maximum affordable house purchase price, based on average mortgage term assumptions.[5]

For the purposes of the affordability gap analysis, EPS used the County's maximum income levels for Very Low Income and Low Income households for rental units, and the levels for Moderate Income for for-sale units. As summarized on **Table 5**, a three-person, Very Low Income household can pay up to $1,188 per month for a two-bedroom rental unit, and a Low Income household can pay $2,040 per month. These affordable rents are far below the market-rate rent for a newly constructed unit of the same size in South Pasadena, which EPS estimates at $4,200 based on market data.[6] For for-sale units, a three-person Moderate Income household can pay up to $2,438 on monthly housing costs, which translates into a maximum purchase price of $333,000 for a two-bedroom condominium unit.[7] EPS estimates that a newly constructed market-rate unit of the same size could achieve a sale price of $990,000 in South Pasadena, based on recent market transactions.[8] It is important to note that the market-rate rents and prices reflect newer units (i.e., those built within the past 10 years for rental projects and within the past 25 years for for-sale projects), since it is only new development that would be subject to the inclusionary requirements.

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[4] The utility allowance for a two-bedroom unit is based on a schedule published by the Los Angeles County Development Authority (LACDA)

[5] Assumes a 30-year fixed mortgage with a 5.5 percent effective interest rate, plus a 10 percent down payment from the homebuyer.

[6] Rent estimated based on average per square foot rents reported by CoStar for market-rate, two-bedroom apartments built since 2014 and located within South Pasadena and Pasadena, with a 3% "new construction" premium.

[7] This calculation is further detailed in Table 7 below.

[8] Price estimate based on transaction data obtained from Redfin for two-bedroom condominiums built since 1999 and located within South Pasadena and Pasadena. No "new construction" premium was added due to current interest rate trends that have slowed growth in home sale prices.

**Table 5 Maximum Affordable Monthly Housing Costs for Three-Person Household in Los Angeles County**

| Income Category | % of AMI | Adjusted Annual 3-Person HH Income [1] | Annual Spending on Housing [2] | Annual Spending on Utilities [3] | Maximum Rent or Housing Payment Assumptions [4] | |
|---|---|---|---|---|---|---|
| | | | | | *Annual* | *Monthly* |
| Very Low (Rental) | 50% | $56,750 | $17,025 | $2,772 | $14,253 | $1,188 |
| Low (Rental) | 80% | $90,850 | $27,255 | $2,772 | $24,483 | $2,040 |
| Moderate (For-Sale) | 120% | $106,050 | $31,815 | N/A | $31,815 | $2,651 |

[1] Assumes adjustment factor of 128.5% in calculating the maximum income for Very Low Income and Low Income groups. See Table 4.
[2] Assumes a housing cost to income ratio of 30 percent.
[3] For rental units, other housing costs include utility expenditures consistent w ith the Los Angeles County Community Development Authority limits for a 2-bedroom unit (assumes use of electricity for heating and cooking). Utility costs effective July 2023. Utility costs are
[4] Maximum income available to pay for rent or mortgage and interest after allow ance for utilities.
[5] Affordable sale price is based on a 30-year mortgage w ith 10% dow npayment and 5.5% annual interest rate.
*Sources: Los Angeles County Community Development Authority; California HCD; Economic & Planning Systems, Inc.*

## Development Cost Assumptions

Residential development costs include land costs, direct or "hard" costs (e.g., labor and materials), and indirect or "soft" costs (e.g., architecture, entitlement, fees, marketing, etc.). Development cost estimates used in the analysis are based on data from recent land transactions in South Pasadena as well as from EPS interviews with housing developers both within South Pasadena and the larger Los Angeles region. A developer fee is also estimated and represents a typical level of compensation to an affordable housing developer for their time investment in developing the project. These assumptions are shown in **Table 6** and **Table 7** and indicate that the total development cost per unit is about $709,000 for rental apartments and $822,000 for for-sale condominiums. Again, these figures represent "prototypical" projects; the actual costs for a given project will vary by location and project design characteristics.

## Revenue Assumptions

To calculate the value of the affordable units, several revenue-related assumptions were made regarding applicable income levels and the percentage of household income that can be put towards housing costs, including rent. In addition, translating a revenue estimate into an estimate of total value (i.e., sale price per unit) required assumptions for operating expenses and capitalization rates. The following assumptions were used:

- *Percentage of Gross Household Income Available for Housing Costs*—The City's inclusionary housing ordinance indicates that lower-income households should pay no more than 30 percent of their gross income on housing costs. EPS calculated the rents and sale prices that three-person Very Low and Low Income households would be able to pay for rental units and three-person Moderate Income households would be able to pay for for-sale units, net of other housing-related costs (e.g. utilities, insurance and taxes, HOA fees) as shown above in **Table 5**.

- *Operating Costs for Rental Units*—The analysis assumes that affordable rental apartment operators incur annual operating costs of $7,000 per unit, which include the cost of management, maintenance, and common utilities (those not paid by tenants). These operating costs assume that all affordable rental apartments constructed for Very Low and Low Income households would be exempt from property taxes because they are income-restricted and constructed by non-profit developers. No operating costs were estimated for for-sale units, as these costs would be paid directly by the condominium occupant via HOA fees.

- *Capitalization Rate*—A capitalization rate represents the rate of return that an investor in a real estate project expects to receive, and generally indicates the project's relative risk (e.g., a lower capitalization rate suggests that a project is less risky, and therefore an investor is willing to accept a lower rate of return because the return is more guaranteed). The value of a rental project is calculated by dividing the net operating income (NOI) by the capitalization rate. For the rental prototypes, EPS utilized a capitalization rate of 4.25 percent.[9] For the for-sale prototypes, the estimated value of the unit is equivalent to their affordable sale price.

## Affordability Gap Analysis

**Table 6** shows the subsidies required for construction of rental apartments for three-person households at Very Low and Low Income levels. As shown, such units are estimated to cost approximately $709,000 to develop. The estimated net operating income from those units at affordable rents would translate to values between $171,000 to $412,000, using the aforementioned capitalization rates. Based on this analysis, building a prototypical rental apartment unit affordable to a Very Low Income household would require a subsidy of approximately $538,000, while a unit affordable to a Low Income household would require a subsidy of approximately $297,000.

**Table 7** shows the subsidies required for construction of for-sale condominium units affordable to three-person households earning Moderate Income levels. As shown, these households could afford to pay up to roughly $376,000 for a unit, while such units are estimated to cost approximately $822,000 to build. Based on this analysis, building a prototypical affordable for-sale condominium unit would require a subsidy of $446,000.

[9] Based on H1 2023 cap rate surveys for infill multifamily development in the Los Angeles region, published by CBRE, a real estate services firm

**Table 6 Affordability Gap Pro Forma Analysis for Prototype Rental Unit Affordable to Very Low and Low Income Households**

| | Input Assumptions | 4-Story Wood Frame Apartment Building with Structured Parking: Very Low Income (50% AMI) | Low Income (80% AMI) |
|---|---|---|---|
| **Prototype Unit Assumptions** | | | |
| Density/Acre | | 70 | 70 |
| Gross Unit Size | | 1,176 | 1,176 |
| Net Unit Size [1] | 85% efficiency | 1,000 | 1,000 |
| Number of Bedrooms | | 2 | 2 |
| Number of Persons per Unit [2] | | 3 | 3 |
| Parking Spaces/Unit [3] | | 1.00 | 1.00 |
| **Cost Assumptions** | | | |
| Land/Unit [4] | $4,750,000 /Acre | $67,857 | $67,857 |
| Direct Costs | | | |
| Direct Construction Costs/Unit [5] | $350 /Gross Sq. Ft. | $411,800 | $411,800 |
| Parking Construction Costs/Unit | $50,000 /Space | $50,000 | $50,000 |
| Subtotal, Direct Costs/Unit | | $461,800 | $461,800 |
| Indirect Costs/Unit [6] | 20% of direct costs | $92,400 | $92,400 |
| *Land + Direct + Indirect Cost Subtotal (before Developer Fee)* | | *$622,057* | *$622,057* |
| Developer Fee (rounded) | 14% of all costs | $87,000 | $87,000 |
| *Total Cost/Unit (rounded)* | | *$709,000* | *$709,000* |
| **Maximum Supported Unit Value** | | | |
| Maximum Annual Rent Payment [7] | | $14,253 | $24,483 |
| (less) Operating Expenses per Unit/Year [8] | | ($7,000) | ($7,000) |
| Net Operating Income | | $7,253 | $17,483 |
| Capitalization Rate [9] | | 4.25% | 4.25% |
| *Total Unit Value [10]* | | *$171,000* | *$412,000* |
| **Affordability Gap** | | **($538,000)** | **($297,000)** |

[1] Assumes that approx. 85% of gross building space can be rented, excluding common areas, circulation space, etc.
[2] Assumes an average unit for income-qualified worker households would be two bedrooms. State law (Health and Safety Code Section 50052.5) indicates that a two-bedroom unit should be assumed to be occupied by a three-person
[3] Assumption of 1.0 parking spaces/unit is consistent with the City's streamlined density bonus requirements for projects including affordable housing units.
[4] Estimate based on recent sales data from CoStar and conversations with local developers for projects of similar
[5] Cost assumptions include both labor and materials and are based on estimates from private developers active in South Pasadena and other parts of the region. EPS experience is that costs to develop affordable housing units are typically the same or higher than to develop market rate units.
[6] Includes estimated costs for architecture and engineering; entitlement and fees; project management; appraisal and market study; marketing, commissions, and general administration; financing and charges; insurance; developer
[7] See Table 5.
[8] Estimated operating expenses for affordable rental units is based on EPS discussions with affordable housing developers and operators working in Southern California. Excludes property tax; assumed to be built and managed by
[9] The capitalization rate is used to determine the current value of a property based on estimated future operating income, and is typically a measure of estimated operating risk. The capitalization rate used in this analysis is based on CBRE U.S. Cap Rate Study, First Half 2023 for Los Angeles market.
[10] The total supportable unit value is determined by dividing the net operating income by the capitalization rate.

*Sources: Los Angeles County; California HCD; CBRE; Rider Levett Bucknall; and Economic & Planning Systems*

**Table 7 Affordability Gap Pro Forma Analysis for Prototype For-Sale Unit Affordable to Moderate Income Households**

| | Input Assumptions | | 4-Story Wood Frame Condo Building with Structured Parking<br>Moderate Income (120% AMI) |
|---|---|---|---|
| **Prototype Unit Assumptions** | | | |
| Density/Acre | | | 70 |
| Gross Unit Size | | | 1,412 |
| Net Unit Size [1] | 85% | efficiency | 1,200 |
| Number of Bedrooms | | | 2 |
| Number of Persons per Unit [2] | | | 3 |
| Parking Spaces/Unit [3] | | | 1.00 |
| **Cost Assumptions** | | | |
| Land/Unit [4] | $4,750,000 | /acre | $67,857 |
| Direct Construction Costs/Unit [5] | $350 | /net sq. ft. | $494,118 |
| Parking Costs/Unit | $50,000 | /space | $50,000 |
| Subtotal, Direct Costs/Unit | | | $544,118 |
| Indirect Costs/Unit [6] | 20% | of direct costs | $108,824 |
| *Land + Direct + Indirect Cost Subtotal (before Developer Fee)* | | | *$720,798* |
| Developer Fee (rounded) | 14% | of all costs | $101,000 |
| *Total Cost/Unit (rounded)* | | | *$821,798* |
| **Maximum Supported Home Price** | | | |
| Maximum Monthly Housing Payment [7] | | | $2,651 |
| Other Monthly Housing Costs | | | |
| Insurance | | | ($125) |
| Taxes [8] | | | ($305) |
| HOA Fee | | | ($300) |
| Maximum Monthly Mortgage Payment (after Other Housing Costs) | | | $1,921 |
| Mortgage Assumptions | | | |
| Down Payment | | | 10% |
| Interest Rate (annual) | | | 5.50% |
| Loan Term (months) | | | 360 |
| Total Supportable Unit Value [9] | | | $376,000 |
| **Affordability Gap** | | | **($445,798)** |

[1] Assumes that approx. 85% of gross building space can be rented, excluding common areas, circulation space, etc.
[2] Assumes an average unit for income-qualified worker households would be two bedrooms. State law (Health and Safety Code Section 50052.5) indicates that a two-bedroom unit should be assumed to be occupied by a three-person
[3] Assumption of 1.0 parking spaces/unit is consistent with the City's streamlined density bonus requirements for projects including affordable housing units.
[4] Estimate based on recent sales data from CoStar and conversations with local developers for projects of similar
[5] Cost assumptions include both labor and materials and are based on estimates from private developers active in South Pasadena and other parts of the region. EPS experience is that costs to develop affordable housing units are typically the same or higher than to develop market rate units.
[6] Includes estimated costs for architecture and engineering; entitlement and fees; project management; appraisal and market study; marketing, commissions, and general administration; financing and charges; insurance; developer fee and
[7] See Table 5.
[8] Taxes equal to approximately 1.1% of sale price.
[9] The total supportable unit value is equivalent to the down payment plus total mortgage amount, assuming a mortgage with terms for interest rate, term, and payment as shown in table.

*Sources: Los Angeles County; California HCD; Zillow; Rider Levett Bucknall; and Economic & Planning Systems*

# In-Lieu Fee Calculations and Application

## Rental Development In-Lieu Fee

As described above, a new rental development can only pay the in-lieu fee for a fractional or partial required affordable unit. For example, a project with 14 dwelling units would be required to provide 2.1 affordable units (14 units*15% = 2.1 units). The developer in this case can either (a) build two affordable units and pay a fee equivalent to 0.1 affordable units, or (b) round up and build three affordable units on site. Per the requirements of the City's inclusionary ordinance, the number of units affordable to Very Low Income households provided by a rental project must be equal to or greater than the number of units affordable to Low Income households. In other words, if an odd number of affordable units is required, the number of units affordable to Very Low Income households must be one more than the number affordable to Low Income households.

**Table 8** shows two sets of proposed in-lieu fee options for rental projects in South Pasadena: a single blended fee or a split fee. The split fee option includes two different fee levels, one for units affordable to Low Income households and one for units affordable to Very Low Income households.

With a single, blended fee, developers would pay the same fee for any fractional unit, regardless of the project's unit count. The fee is set at the midpoint between the financing subsidy gap needed to support rental units affordable at the Very Low Income and Low Income levels.

With a split fee, developers would pay one of the fees for a fractional unit, according to the specific inclusionary scenario relevant to their project (as described on page 4). The fee would differ based on unit count of the project, as follows: if the fractional unit would have to be affordable to Very Low Income households (if it was rounded up to a full unit), the developer must pay the fee at the Very Low Income level. If, however, the fractional unit may be affordable to Low Income households if rounded up to a full unit, the developer may pay the fee at the Low Income level (see **Appendix** for examples of applying the fee calculations). Each fee is set based on the financing subsidy gap needed to support rental units affordable at the corresponding income level.

**Table 8** shows the fees on both a per affordable unit and per affordable square foot basis, based on a prototypical affordable rental unit of 1,000 square feet (see **Table 3**). Fee amounts are rounded to the nearest dollar per square foot, or $1,000 per unit.

Given that new rental developments are required to build affordable units similar to the project's market-rate units, the required fee for a given project should be calculated using the average size of its market-rate units. In the example 14-unit development project, assuming an average market-rate unit size of 1,000 square feet, if the project needs to pay a fee on 0.1 units, the fee would be calculated as the subsidy needed to support 150 square feet of an affordable unit (1,000 sq. ft.*15%=150 sq. ft.). Alternatively, if the project had an average unit size of 800 square feet, the fee would be calculated as the subsidy to support 120 square feet of an affordable unit (800 sq. ft. *15%=120 sq. ft.).

**Table 8 Proposed In-Lieu Fee Options for Rental Projects**

| Item | Amount |
|---|---|
| **Financing Gap at Very Low Income (50% AMI)** | |
| Value/Unit | $171,000 |
| Costs/Unit | $709,000 |
| Subsidy per Affordable Unit | $538,000 |
| Subsidy per Affordable Sq. Ft. [1] | $538 |
| **Financing Gap at Low Income (80% AMI)** | |
| Value/Unit | $412,000 |
| Costs/Unit | $709,000 |
| Subsidy per Affordable Unit | $297,000 |
| Subsidy per Affordable Sq. Ft. [1] | $297 |
| **Proposed Rental In-Lieu Fee Options** | |
| ***Single Fee Option*** | |
| Blended Avg Fee [2] | $418 per sq. ft. |
| ***Split Fee Option*** | |
| Fee at Very Low Income [2] | $538 per sq. ft. |
| Fee at Low Income [2] | $297 per sq. ft. |

[1] Based on a 1,000 square foot unit.
[2] Fee is charged on a project's total square feet of required affordable units that a developer wishes to pay a fee for (instead of building on-site).
*Source: Economic & Planning Systems*

## For-Sale Development In-Lieu Fee

For-sale developments have the option to pay an in-lieu fee for the entirety of their affordable unit requirement, or to provide on-site units affordable to Moderate Income households and pay an in-lieu fee on any fractional required units. **Table 9** summarizes the calculation of in-lieu fees needed to support the development of for-sale units affordable to Moderate Income households in South Pasadena. The table shows the fee on both a per unit and a per square foot basis, based on a prototype affordable for-sale condominium unit of 1,200 square feet (see **Table 3**). As with rental developments, for-sale developments are required to build affordable units similar to the project's market-rate units. Thus, the required fee for a given project should be calculated using the average size of its market-rate units. For example, if the average market-rate unit size in an 14-unit for-sale project is 1,500 square feet, the project needs to pay an in-lieu fee equivalent to the 2.1 required affordable units (14 units x 15%=2.1 units), and the fee would be calculated as the subsidy needed to support 3,150 square feet worth of units affordable to a Moderate Income household (1,500 sq. ft.*2.1=3,150 sq. ft.).

**Table 9 Proposed In-Lieu Fee for For-Sale Projects**

| **Item** | ***Total*** |
|---|---|
| **Financing Gap at Moderate Income (120% AMI)** | |
| Value/Unit | $376,000 |
| Costs/Unit | $821,798 |
| Subsidy per Affordable Unit | $445,798 |
| Subsidy per Affordable Sq. Ft. [1] | $371 |
| **Proposed Rental In-Lieu Fee Options** | |
| Fee at Moderate Income [2] | $371 per sq. ft. |

[1] Based on a 1,200 square foot unit.
[2] Fee is charged on a project's total square feet of required affordable units that a developer wishes to pay a fee for (instead of building on-site).
*Source: Economic & Planning Systems, Inc.*

Besides the difference in affordability level, a critical difference in the fee program for for-sale projects is that a developer may choose to pay the in-lieu fee for *all* required affordable units, not just for fractional or partial units.[10]

# Feasibility Analysis

Given the City's preference for the development of on-site affordable units, there is a desire to understand the relative impact on development economics of constructing affordable units on-site versus paying the in-lieu fee.

In the case of rental projects, developers have a choice between paying an in-lieu fee on a required fractional affordable unit or rounding up to provide that additional affordable unit on-site. In the case of for-sale projects, developers may choose between building the required affordable units on-site or paying the corresponding in-lieu fee for the whole affordable requirement. If the cost of the in-lieu fee is lower than the financial burden represented by building the on-site affordable units, developers will likely opt into paying

[10] If a for-sale project includes affordable units on-site, an in-lieu fee can be paid on any required fractional units, or the developer can round-up to provide an additional affordable unit, as with rental projects.

the fee; conversely, if the fee is equal to or higher than the financial burden represented by building on-site units, developers become more likely to provide the units directly.

To assess the development feasibility impact of these trade-offs on new market-rate development, EPS modeled two market rate development scenarios using the same product prototypes used in the affordability gap analysis and summarized in **Table 3**.

### Impact of In-Lieu Fees on Rental Development Feasibility

To provide an illustrative analysis of feasibility trade-offs associated with new rental projects, EPS formulated a hypothetical market-rate rental project for the analysis. The project included the following assumptions:

- *Lot Size* – EPS assumed that the project would be developed on a 0.8-acre lot. This lot size is similar to new residential development projects being proposed in the City.
- *Density and Unit Count* – EPS assumed that the base density for the lot is 70 units/acre, which would allow for 56 units on the 0.8-acre site. However, given the project's affordability requirements, it would automatically qualify for a density bonus under California's State Density Bonus law. Specifically, if project includes four Very Low Income units and four Low Income units on-site, it qualifies for a bonus of 25 percent over the base density (allowing for a total unit count of 70); if the project includes five Very Low Income units and four Low Income unit on-site, it qualifies for a bonus of 27.5 percent over the base density (allowing for a total unit count of 72).[11] The additional bonus units allowed over the base density would be rented at market rates.
- *Affordable Units* – Both projects are required to provide 8.4 affordable units – four units for Very Low Income households, four units for Low Income households, and either an additional unit for a Very Low Income household or an in-lieu fee paid to subsidize 0.4 units affordable to Very Low Income households.
- *Market Rate Rents* – The rent for the market-rate units is set at $4,200 per month, based on EPS research of recent market rents for newer constructed units in the South Pasadena market.

**Table 10** shows the results of the feasibility analysis for the example rental project. For the project that rounds up and builds an additional on-site affordable unit, total returns are slightly less than if the in-lieu fee is paid for the fractional required unit. The additional bonus density that can be achieved when the developer rounds up the number of affordable units does not offset the additional cost of that unit.

[11] The density bonus is based on the percentage of affordable units relative to total unit count at the base density. Providing a higher percentage of units as affordable entitles a project to a higher density bonus. A detailed table of density bonuses by percentage of affordable units can be found at the following link: https://www.meyersnave.com/wp-content/uploads/California-Density-Bonus-Law_2023.pdf

**Table 10 Feasibility Impact of Proposed In-Lieu Fee on a Rental Development Project**

| | | | |
|---|---|---|---|
| | | *For Rent Property* | |
| | | **4-Story Wood Frame Apartment Building with Structured Parking** | |
| | | Round Up Fractional Unit (Build on Site) | Pay In-Lieu Fee on Fractional Unit |
| **Development Program Assumptions** | | | |
| Base Unit Count | | 56 | 56 |
| Required Affordable Units | | 8.4 | 8.4 |
| Very Low Income Units | | 5 | 4 |
| Low Income Units | | 4 | 4 |
| On-Site Affordable Units Built | | 9 | 8 |
| % Units Very Low Income | | 8.9% | 7.1% |
| State Density Bonus [1] | | 27.5% | 25.0% |
| Density Bonus Units | | 16 | 14 |
| **Total Built Units** | | **72** | **70** |
| Acreage | | 1 | 1 |
| Density/Acre after Bonus | | 90 | 88 |
| Gross Unit Size | | 1,176 | 1,176 |
| Net Unit Size [2] | 85% efficiency | 1,000 | 1,000 |
| Number of Bedrooms | | 2 | 2 |
| Parking Spaces/Unit [3] | | 1.0 | 1.0 |
| **Cost Assumptions** | | | |
| Land/Unit [4] | $4,750,000 /Acre | $52,778 | $54,286 |
| Direct Construction Costs/Unit [5] | | $461,800 | $461,800 |
| Indirect Costs/Unit [6] | 20% of direct costs | $92,360 | $92,360 |
| Fractional Affordable Units | | | 0.4 |
| Square Feet of Affordable Units | | | 400 |
| Total In-Lieu Fee | $418 per affordable sq. ft. | | $167,200 |
| In-Lieu Fee per Unit Built | | | $2,389 |
| Total Cost/Unit (rounded) | | $607,000 | $611,000 |
| *Total Development Cost* | | $43,704,000 | $42,770,000 |
| **Project Value** | | | |
| Revenue per Year per VLI Unit [7] | $1,188 per month | $14,253 | $14,253 |
| Revenue per Year per LI Unit [7] | $2,040 per month | $24,483 | $24,483 |
| Affordable Revenue per Year | | $169,197 | $154,944 |
| MR Revenue per Year [8] | $4,200 /mo per unit | $3,175,200 | $3,124,800 |
| Operating Costs [9] | 30% OpEx Ratio | ($1,003,319) | ($983,923) |
| Total NOI | | $2,341,078 | $2,295,821 |
| **Yield on Cost [10]** | | **5.36%** | **5.37%** |

[1] Per State Density Bonus Law (California Government Code Sections 65915 – 65918).
[2] Assumes that approx. 85% of gross building space can be rented, excluding common areas, circulation space, etc.
[3] Assumption of 1.0 parking spaces/unit, consistent with the City's density bonus requirements for projects including affordable housing
[4] Estimate based on recent sales data from CoStar and conversations with local developers for projects of similar density.
[5] See cost assumptions on Table 6.
[6] Includes estimated costs for architecture and engineering; entitlement and fees; project management; appraisal and market study; marketing, commissions, and general administration; financing and charges; insurance; developer fee and contingency.
[7] See affordable rents assumptions on Table 5.
[8] Based on CoStar data for similar 2BR apartments located in South Pasadena.
[9] Reflective of properties in Los Angeles County. Inclusive of management, maintenance, common utility, and property tax costs.
[10] Yield on cost is calculated as NOI divided by total development costs, and is a typical return metric used for rental real estate projects.
*Sources: Los Angeles County; California Housing and Community Development; CoStar; CBRE; and Economic & Planning Systems, Inc.*

Based on this analysis, the returns are comparable under either option: the difference is negligible in that the yield is around 0.01 percentage points higher when paying the fractional fee on 0.4 Very Low Income units rather than rounding up and build an additional affordable unit on-site. Other project-specific factors are more likely to guide the developer's choice to build on-site or pay the in-lieu fee on fractional units.

For example, the developer may be less likely to build on-site if the fraction of a required unit is small versus large (say, 0.2 versus 0.8) or if the unit is a Low Income unit instead of a Very Low Income unit. This analysis also assumes that a developer takes full advantage of the State Density Bonus, which may not always be possible due to site constraints or other limitations. EPS anticipates that each developer will make a choice based on the economics of their own individual project.

### *Fee Waiver Incentive for On-Site Affordable Units*

Based on direction from the City, EPS considered whether the use of an additional fee waiver could help incentivize developers to build affordable units on-site rather than pay the in-lieu fee. The City currently waives the Public Arts Fee on affordable units, which is equal to 1% of the unit costs. EPS analyzed whether further waiving the City's Growth Capital Impact Fee ($1.64 per gross foot square foot) for affordable units could further incentivize a developer to build units on-site instead of paying an in-lieu fee.

EPS found that waiving the Growth Capital Requirement Fee would have a very small impact that is likely to negligibly impact a developer's choice to pay the in-lieu fee versus. The total impact of waiving this fee on affordable units is less than 0.05% of total development cost in all scenarios.

## Impact of In-Lieu Fees on For-Sale Development Feasibility

To provide an illustrative analysis for feasibility trade-offs associated with the options for new for-sale housing projects to comply with the City's affordability requirements, EPS formulated a hypothetical market-rate for-sale project for the analysis. The project included the following assumptions:

- *Lot Size* – Similar to the rental project example, EPS assumed that the for-sale project would be developed on a 0.8-acre lot.
- *Density and Unit Count* – EPS again assumed that the density for the lot is 70 units/acre, which would allow for 56 units on the 0.8-acre site. EPS assumed that the project that builds eight Moderate Income units would achieve a density bonus of 11 percent, for a total unit count of 63.
- *Affordable Units* – The project is required to provide nine units for Moderate Income households on-site, or to pay an in-lieu fee for Moderate Income units.
- *Market Rate Prices* – The sale price for the market-rate units is set at $990,000, which is based on EPS research of recent condo sales for newer constructed units in the South Pasadena market.

**Table 11** shows the results of the feasibility analysis for the example for-sale project. Total profit margin returns for a project that builds on-site affordable units (and utilizes the State Density Bonus) are higher than for a project that pays the in-lieu fee. Therefore, a developer would be more likely to build on-site units rather than pay the fee. However, some developers may choose to pay the fee rather than build on-site due to project-specific factors.

It is worth noting that the fee waiver amounts considered are sufficiently small that they are unlikely to have a strong impact on a developer’s decision to build on-site or not. However, they are slightly larger and could be more influential for the example for-sale project than for the example rental project.

**Table 11 Feasibility Impact of Proposed In-Lieu Fee on a For-Sale Development Project**

| | Input Assumptions | | *For Sale Property* 4-Story Wood Frame Condo Building with Structured Parking: Build Affordable Units On Site | Pay In-Lieu Fee |
|---|---|---|---|---|
| **Development Program Assumptions** | | | | |
| Total Project Units | | | 56 | 56 |
| Required Affordable Units | | | 8.4 | 8.4 |
| On-Site Affordable (Moderate Income) | | | 9 | 0 |
| % Moderate | | | 16.1% | 0.0% |
| State Density Bonus [1] | | | 11.0% | 0.0% |
| Density Bonus Units | | | 7 | 0 |
| **Total Built Units** | | | **63** | **56** |
| Total Project Acreage | | | 0.80 | 0.80 |
| Density/Acre after Bonus | | | 79 | 70 |
| Gross Unit Size | | | 1,412 | 1,412 |
| Net Unit Size [2] | 85% | efficiency | 1,200 | 1,200 |
| Number of Bedrooms | | | 2 | 2 |
| Parking Spaces/Unit | | | 1.00 | 1.00 |
| **Cost Assumptions** | | | | |
| Land/Unit [3] | $4,750,000 | /acre | $60,317 | $67,857 |
| Direct Construction Costs/Unit [4] | | | $544,118 | $544,118 |
| Indirect Costs/Unit [5] | 20% | of direct costs | $108,824 | $108,824 |
| Total Affordable Units | | | | 8 |
| Square Feet of Affordable Units | | | | 10,080 |
| Total In-Lieu Fee [6] | $371 | per square foot | | $3,739,680 |
| In-Lieu Fee per Unit Built | | | | $66,780 |
| Total Cost/Unit (rounded) | | | $713,259 | $787,578 |
| *Total Development Cost* | | | $44,935,294 | $44,104,386 |
| Affordable For Sale Value [7] | | | $395,000 | |
| Market Rate For Sale Value [8] | | | $990,000 | $990,000 |
| *Total Project Value* | | | $57,015,000 | $55,440,000 |
| **Profit Margin [9]** | | | **26.9%** | **25.7%** |

[1] Per State Density Bonus Law (California Government Code Sections 65915 – 65918).
[2] Assumes that approx. 85% of gross building space can be rented, excluding common areas, circulation space, etc.
[3] Estimate based on recent sales data from CoStar and conversations with local developers for projects of similar density.
[4] See cost assumptions on Table 7.
[5] Includes estimated costs for architecture and engineering; entitlement and fees; project management; appraisal and market study; marketing, commissions, and general administration; financing and charges; insurance; developer fee and contingency.
[6] In-lieu fee is based on required Moderate income units. See Table 10.
[7] See affordable value assumptions on Table 7.
[8] Profit margin is calculated as project value minus project costs, divided by project costs, and is a typical return metric used for for-sale residential development projects.
*Sources: Los Angeles County; California Housing and Community Development; Economic & Planning Systems, Inc.*

# Appendix: Fee Calculation Formulas and Examples

## Rental Project Fee Formulas and Example Calculations

### *Fee Option 1: Single, Blended Fee*

**Figure 1** provides a formula that developers would use to calculate the fee owed for a rental project under the single, blended fee option. It also provides an example calculation of the number of affordable units required and the fee amount owed.

**Figure 1 In-Lieu Fee Formula and Calculation Example under a Single, Blended Fee Option for New Rental Projects in South Pasadena**

**Rental Project In-Lieu Fee Formula**

For Projects Requiring a Partial unit:
*Fractional Unit Required x Average Sq.Ft. of Market-Rate Units x $418.00*

**Example Calculation**

**Example Project** is a 23-unit development with an average unit size of 900 sq. ft.

Affordable units required = 23 units*15% = 3.45 units

Inclusionary requirement is at least 2 Very Low Income units, 1 Low Income units, and either a fee paid on 0.45 units or an additional Low Income unit.

***Fee Owed = 0.45 units x 900 sq. ft. x $418 = $169,290***

### *Fee Option 2: Split Fees*

**Table 12** provides a useful table for understanding the number of units required at each affordability level for a new rental project at various project sizes. Specifically, it also shows the affordability level required for next unit, which is the basis for selecting the correct in-lieu fee (under the split fee option) to apply to any partial or fractional affordable unit. **Figure 2** below it details the formula that applies for a developer that chooses to pay the in-lieu fee for a fractional unit rather than build an additional unit on-site, followed by example fee calculations in **Figure 3**.

**Table 12 Example Calculations of Full and Fractional Affordable Units Required and Associated Fee Basis for Typical Rental Projects by Size**

| Number of Units | Total Affordable Units Required | Min. Number of On-Site Very-Low Income Units | Typical Number of Low-Income Units | Fractional Affordable Units Required | Affordability Level Required for Next Unit [1] |
|---|---|---|---|---|---|
| 9 or fewer | 0 | 0 | 0 | 0 | N/A |
| 10 | 1.5 | 1 | 0 | 0.5 | Low-Income |
| 11 | 1.65 | 1 | 0 | 0.65 | |
| 12 | 1.8 | 1 | 0 | 0.8 | |
| 13 | 1.95 | 1 | 0 | 0.95 | |
| 14 | 2.1 | 1 | 1 | 0.1 | Very-Low Income |
| 15 | 2.25 | 1 | 1 | 0.25 | |
| 16 | 2.4 | 1 | 1 | 0.4 | |
| 17 | 2.55 | 1 | 1 | 0.55 | |
| 18 | 2.7 | 1 | 1 | 0.7 | |
| 19 | 2.85 | 1 | 1 | 0.85 | |
| 20 | 3 | 2 | 1 | 0 | N/A |
| 21 | 3.15 | 2 | 1 | 0.15 | Low-Income |
| 22 | 3.3 | 2 | 1 | 0.3 | |
| 23 | 3.45 | 2 | 1 | 0.45 | |
| 24 | 3.6 | 2 | 1 | 0.6 | |
| 25 | 3.75 | 2 | 1 | 0.75 | |
| 26 | 3.9 | 2 | 1 | 0.9 | |
| 27 | 4.05 | 2 | 2 | 0.05 | Very-Low Income |
| 28 | 4.2 | 2 | 2 | 0.2 | |
| 29 | 4.35 | 2 | 2 | 0.35 | |
| 30 | 4.5 | 2 | 2 | 0.5 | |

[1] Per the City's inclusionary ordinance, the number of Very Low income units must be equal to or greater than the number of Low Income units. The table shows the minimum number of Very Low income units that must be built on-site for a rental project of a given size. The table also shows the number of Low Income units that a typical developer would choose to build in order to maximize project returns. When the number of Very Low Income units is equal to the number of low-income units, then the next unit built must be affordable at the Very Low Income households; accordingly, the (higher) Very Low Income In-Lieu Fee amount must be paid on any fractional or partial units.

**Figure 2 In-Lieu Fee Formula under a Split Fee Option for New Rental Projects in South Pasadena**

**Rental Project In-Lieu Fee Formula**

For Projects Requiring a Partial Very Low Income Unit:
*Fractional Unit Required x Average Sq.Ft. of Market-Rate Units x $538.00*

For Projects Requiring a Partial Low Income Unit:
*Fractional Unit Required x Average Sq.Ft. of Market-Rate Units x $297.00*

**Figure 3 Example Calculations of In-Lieu Fees Owed under a Split Fee Option for New Rental Projects**

**Example Calculations**

**Example Project 1** is a 23-unit development with an average unit size of 900 sq. ft.

Affordable units required = 23 units*15% = 3.45 units

Inclusionary requirement is at least 2 Very Low Income units, 1 Low Income units, and either a fee paid on 0.45 Low Income units or an additional Low Income unit.

***Fee Owed = 0.45 units x 900 sq. ft. x $297 = $120,285***

**Example Project 2** is a 58-unit development with an average unit size of 1,200 sq. ft.

Affordable units required = 58 units*15% = 8.7 units

Inclusionary requirement is 4 Very Low Income units, 4 Low Income units, and either a fee paid on 0.7 Very Low Income units or an additional Very Low Income unit.

***Fee Owed = 0.7 units x 1,200 sq. ft. x $538 = $451,920***

## For-Sale Project Fee Formula and Example Calculation

The formula for determining a for-sale project's in-lieu fee requirement is presented in below in **Figure 4**, followed by an example.

**Figure 4 In-Lieu Fee Formula and Calculation Example for New For-Sale Projects in South Pasadena**

**For-Sale Project In-Lieu Fee Formula**

For Projects Building Affordable Units On-Site:
*Fractional Unit Required (if applicable) x Average Sq.Ft. of Market-Rate Units x $371.00*

For Projects Not Building Affordable Units On-Site:
*Total Affordable Units Required x Average Sq.Ft. of Market-Rate Units x $371.00*

**Example Calculation**

**Example Project** is a 18-unit for-sale development. Each unit is 1,500 square feet, for a total project size of 21,000 square feet.

Affordable units required = 18 units*15% = 2.7 Moderate Income units

Inclusionary requirement is 2 Moderate Income units, and a fee paid on 0.8 Moderate Income units; or a fee paid on 2.7 Moderate Income units

***Fee for Fractional Unit = 0.7 units x 1,500 sq. ft. x $371 = $389,550***

***Fee for All Req. Units = 2.7 units x 1,500 sq. ft. x $371 = $1,502,550***