Ruthanne Fuller
Mayor

City of Newton, Massachusetts
Department of Planning and Development
1000 Commonwealth Avenue Newton, Massachusetts 02459

Telephone
(617) 796-1120
Telefax
(617) 796-1142
TDD/TTY
(617) 796-1089
www.newtonma.gov

Barney S. Heath
Director

M E M O R A N D U M

DATE: July 13, 2018

TO: Councilor Albright, Chairman
Members of the Zoning and Planning Committee

FROM: Barney S. Heath, Director of Planning and Development
James Freas, Deputy Director of Planning and Development
Amanda Berman, Housing Development Planner
Jennifer Caira, Chief Planner

RE: **#187-18** DIRECTOR OF PLANNING requesting amendments to the Inclusionary Housing provisions of Chapter 30, Newton Zoning Ordinance, to increase the required percentage of affordable units; to require that some affordable units be designated
for middle income households; to create a new formula for calculating payments in lieu of affordable units; and to clarify and improve the ordinance with other changes as necessary.

MEETING DATE: July 16, 2018

CC: Ouida Young, Acting City Solicitor
Planning & Development Board
City Council

The availability of a diverse array of affordable housing options is a critical issue for the City of Newton, affecting the City's long-standing value as a welcoming community for people of all backgrounds, preventing City employees from being able to live in the community they serve, and hindering the ability of businesses of all types in the City to compete for employees.

In an effort to design a new Inclusionary Zoning ordinance that would ensure that new housing development in Newton includes units for households of various income levels across the city, while not restraining development altogether, staff contracted with RKG Associates to determine the financial impact resulting from the proposed changes to the City's existing Inclusionary Zoning ordinance. The Financial Feasibility Analysis developed by RKG (attached) details the approach the consultants used to test the City's proposed ordinance changes, the results of their analysis, and their recommended modifications to the proposed ordinance to reduce the financial impacts of the ordinance on housing development so as to maintain financial feasibility.

To perform the analysis, RKG created a financial feasibility model based on traditional pro forma analysis standards for real estate development. The model focuses on Internal Rate of Return (IRR) calculations to determine financial feasibility. This measure is a standard approach to understanding the potential performance of a real estate investment. ***Boston area development industry minimum standards for a desired IRR are currently 20% for new construction ownership residential and 12% for rental residential projects.*** Generally, projects that do not achieve this IRR are not able to get financing.

Pro forma development modeling requires substantial market data to generate the model assumptions needed to calculate financial performance. The three primary data categories include: construction/development data; revenue/expenditure data; and finance/investment data. RKG used several tools to gather both local and regional data, including interviews with several for-profit and non-profit residential developers and commercial lending bank professionals, the City Assessors database, current rent rates and sales prices throughout Newton, and nationally-recognized secondary data sources, such as Marshall & Swift Valuation Services.

RKG's modeling efforts compared the financial performance of seven distinct residential development scenarios under the City's existing Inclusionary Zoning ordinance against the financial performance of those same scenarios under the proposed IZ ordinance. The results were compared to understand the impact of the proposed ordinance on the financial feasibility of each scenario. The seven development scenarios reflected various small, medium and large-scale ownership and rental development projects that may occur in Newton. The financial model calculated the basic go/no-go decision a developer must make about a potential project, which usually comes down to overall financial return and risk exposure. If there is confidence that the desired returns will be reached, then the project will be pursued, otherwise the project will not be undertaken.

While the full report provides greater detail around the results generated by each of the seven model scenarios, the following is a summary of the key findings from the financial analysis:

- **Project size (number of units in a project) matters.** The addition of an affordable unit or a required payment-in-lieu can have an outsized impact on the overall financial return of a project and can quickly render a project infeasible. Small-scale developers have greater sensitivity to changes in their development program due to their inability to spread the cost of an affordable unit or a payment-in-lieu of a unit across several market-rate units.

- **The proposed IZ percentage requirements for medium size projects (7-20 units) appear to be calibrated correctly.** For projects with 10-20 new units, the proposed percentage requirements result in more affordable units for the City, while returning an acceptable financial outcome to the developer. The increase in affordable unit requirements is offset by the introduction of Tier 3, middle-income units (81%-110% AMI). *(It is important to note, however, that RKG was only asked to test one scenario in the 10-20 new units category: a 20-unit rental project. While the financial return for this scenario under the proposed ordinance comes out positive, the majority of scenarios in this category do not. Staff tested multiple scenarios for this project size category and found that the proposed IZ requirements were too great for most of the projects to be financially acceptable. Had more scenarios been run in this project size category as part of the RKG analysis, it is likely that the consultants would not have come to the same conclusion about the proposed ordinance for this category of projects).*

- **The proposed IZ percentage requirements for large size projects (20+ units) have a negative impact on the overall financial return of a prototypical development and are financially infeasible for the developer.** The key issues for these large size projects are the 25% IZ requirement (10% higher than the existing IZ ordinance) and the introduction of Tier 1 units (at or below 50% AMI).

- **The proposed density bonus of 2 additional market-rate units for every 1 additional inclusionary unit is not sufficient enough to offset the requirement that each additional inclusionary unit be designated at Tier 1 (50% AMI), nor does it help to make these larger projects financially viable.** Even applying a hypothetical three-to-one ratio does not yield a positive result for these projects.

After thorough review and consideration of the Financial Feasibility Analysis developed by RKG, staff reworked its Inclusionary Zoning Ordinance proposal from 2017 to reflect findings from this report. We sought to create an updated ordinance that does not stifle residential development, but rather, strikes a careful balance between the City's vast need for affordable housing and the nuanced economics of housing development. This updated proposal works to realize the greatest public benefit from private residential development occurring throughout Newton.

Also attached to this memo is the December 8, 2017 staff memo to the ZAP Committee for the Public Hearing that took place at the committee's December 11, 2017 meeting. This memo summarizes staff's proposed changes to the Inclusionary Zoning Ordinance at that time and includes a clean and red-lined version of the proposed ordinance text.

Proposed Changes to the 2017 Inclusionary Zoning Proposal:

1. **Amend the proposed "Number of Inclusionary Units Required" table to reflect the findings from the Financial Feasibility Analysis and staff research**
   - Introduce IZ requirement at 7 new units, rather than 4 new units
   - Overall, reduce the IZ requirement across all project size categories to better balance the financial feasibility of a project with the desired public benefit
   - Create new project size categories between 21 new units and 100 new units to account for surface parking versus underground parking thresholds (per RKG's Financial Analysis, projects with >35 units tend to see 100% underground parking, which is most often very costly and done in space scarce developments)
   - De-couple Rental and Ownership IZ requirements to account for the differing financial impact the ordinance could have on these types of projects
   - Continue to utilize a rising IZ percentage requirement to project size given that smaller scale projects have a greater sensitivity to changes in their development program than larger projects, which are able to spread the risk across more units
   - Lock in IZ requirement at point of application (Special Permit or Building Permit application, whichever comes first)

2018 Proposal:

Number of Inclusionary Units Required: 2018 Proposal												
Tier Level	7-9 new units		10-20 new units		21-34 new units		35-64 new units		65-100 new units		101+ new units	
	Rental	Owner	Rental	Owner	Rental	Owner	Rental	Owner	Rental	Owner	Rental	Owner
Tier 1, up to 50% AMI	0.0%	0.0%	0.0%	0.0%	5.0%	0.0%	0.0%	0.0%	2.5%	0.0%	2.5%	0.0%
Tier 2, 51%-80% AMI	15.0%	15.0%	17.5%	5.0%	7.5%	10.0%	2.5%	7.5%	10.0%	10.0%	12.5%	12.5%
Tier 3, 81%-110% AMI	0.0%	0.0%	0.0%	10.0%	5.0%	7.5%	15.0%	10.0%	5.0%	7.5%	2.5%	5.0%
Total	*15.0%*	*15.0%*	*17.5%*	*15.0%*	*17.5%*	*17.5%*	*17.5%*	*17.5%*	*17.5%*	*17.5%*	*17.5%*	*17.5%*

2018 Proposal, Project Size Examples:

Number of Inclusionary Units Required: 2018 Proposal Examples												
Tier Level	7 new units		16 new units		24 new units		47 new units		78 new units		225 new units	
	Rental	Owner	Rental	Owner	Rental	Owner	Rental	Owner	Rental	Owner	Rental	Owner
Tier 1, up to 50% AMI	0	0	0	0	1	0	0	0	2	0	6	0
Tier 2, 51%-80% AMI	1	1	3	1	2	2	1	4	8	8	28	28
Tier 3, 81%-110% AMI	0	0	0	2	1	2	7	5	4	6	6	11
Total	***1***	***1***	***3***	***2***	***4***	***4***	***8***	***8***	***14***	***14***	***39***	***39***

2017 Proposal:

Number of Inclusionary Units Required: 2017 Proposal												
Tier Level	4-6 new units		7-9 new units		10-20 new units		21-50 new units		51-100 new units		101+ new units	
	Rental	Owner	Rental	Owner	Rental	Owner	Rental	Owner	Rental	Owner	Rental	Owner
Tier 1, up to 50% AMI	-	-	-	-	-	-	5.0%	-	7.5%	-	10.0%	-
Tier 2, 51%-80% AMI	15.0%	15.0%	15.0%	-	10.0%	10.0%	10.0%	10.0%	10.0%	15.0%	10.0%	15.0%
Tier 3, 81%-110% AMI	-	-	-	15.0%	10.0%	10.0%	10.0%	15.0%	7.5%	10.0%	5.0%	10.0%
Total	***15.0%***	***15.0%***	***15.0%***	***15.0%***	***20.0%***	***20.0%***	***25.0%***	***25.0%***	***25.0%***	***25.0%***	***25.0%***	***25.0%***

Staff notes:

As described above, our recommended changes to the 2017 proposed IZ ordinance are in direct response to the findings from RKG's Financial Feasibility Analysis, as well as staff's additional testing of the financial model, research and learnings over the past six months. The updated percentage requirements still include three tiers of income eligibility, as well as a tiered structure linking affordability to project size and project type; however, staff's updated proposal introduces the IZ requirement at a higher "new units "number and reduces the IZ requirement across the board to better balance the financial feasibility of a project with the desired public benefit.

Additionally, the updated proposal further considers the nuances of housing development and more closely accounts for the differing costs and financials associated with different project sizes and types. As detailed in the RKG report, ownership projects require a much higher Internal Rate of Return (20%) than rental projects (12%) and therefore, are more sensitive to the inclusion of affordable units. Because the sales value of an affordable unit is capped at a level that is affordable to a household at 80% of the area median income, a value gap exists between delivering a market-rate unit and an affordable unit. From the developer's standpoint, the inability to realize full value from an affordable unit, which has a similar cost to that of a market-rate unit, results in a financial loss if the IZ requirement is too great.

While the 2018 proposed "Number of Inclusionary Units Required" table appears to favor ownership projects over rental, the difference in percentage requirements is merely accounting for the differing financial characteristics of these project, and the much higher expected rate of return for ownership developments.

2. **Institute the "Round Up and Build Units" methodology rather than the "Fractional Payments" proposal**
    - Where the IZ requirement results in a fraction of a unit greater than or equal to 0.5, require the developer to build one inclusionary unit to capture that fraction (Newton's current IZ policy)
    - Do not require a cash payment for a fractional amount, even if the IZ requirement results in a fraction of a unit less than 0.5

Staff notes:
While the fractional payment methodology proposed by staff in 2017 may result in a project delivering both inclusionary units and a cash payment to the City, many of the scenarios run utilizing RKG's model result in a financially infeasible project due to the large fractional payment required per the proposed calculation. As discussed in the RKG report, the fractional cash payment is added to the initial cost of the development, which ultimately influences the project's overall financial return. The fractional cash payment, coupled with the value loss from providing affordable units on site, erodes the developers financial return to the point of not moving forward with a project.

In an effort to put forth an ordinance that carefully balances the need for greater affordable units, while not stifling residential development altogether, staff recommends streamlining the proposal to favor the building of units, rather than the receipt of fractional cash payments. We believe the "round up and build units" methodology will not only provide more certainty for the development community as they consider potential projects, it will ultimately result in the creation of more affordable units throughout Newton.

3. **Allow for cash payments in lieu of providing inclusionary units for projects with 7-9 new units**
    - Utilize DHCD's current Qualified Allocation Plan (QAP) "Total Residential Development Cost Limits" Index, [1] (2018-2019 QAP = $389,000, the average of the

[1] From the Commonwealth of Massachusetts Department of Housing and Community Development's Low Income Housing Tax Credit Program 2018-2019 Qualified Allocation Plan, Appendix C, https://www.mass.gov/files/documents/2018/04/26/20182019QAP.pdf

"Small Units" index and "Large Units" index), at a decreasing percentage adjusted for the number of units:
    - Ex. 7-unit project: 70% of $389,000 = $272,300
    - Ex. 8-unit project: 80% of $389,000 = $311,200
    - Ex. 9-unit project: 90% of $389,000 = $350,100
- Continue to distribute IZ funds equally to the Newton Housing Authority and the City of Newton's Planning & Development Department
- Target the City's portion of these funds for the creation and preservation of deed-restricted units at or below 50% AMI

Staff notes:

While this updated proposal does away with the fractional payments requirement, it still provides the *option* for a developer to request a cash payment in lieu of building the actual inclusionary units as part of the proposed project. With a preference for the inclusionary units over the cash payments, this new proposal only allows projects with 7-9 new units to choose to make such a payment without receiving permission from the City Council through the Special Permit process. As referenced in RKG's Financial Analysis, smaller-scale projects are more sensitive to the inclusion of affordable units, and therefore, may benefit from the ability to pay a fee-in-lieu, rather than build the affordable units on site.

By offering the payment-in-lieu option at a decreasing percentage requirement for small projects with 7-9 new units, a concept also utilized by the Town of Watertown, staff believes we are expanding the opportunity for projects of this size to succeed, even with the inclusionary requirement. In addition, the cash payment option offers the City the potential to receive funds for its Inclusionary Zoning Fund, which will be targeted for the creation and preservation of deed-restricted units affordable to households at or below 50% AMI.

Staff continues to recommend utilizing DHCD's Qualified Allocation Plan (QAP) Index as the basis for these fee-in-lieu payments. These cost limits, published annually, provide a defensible number that is grounded in industry-wide research by a respected third party, the Massachusetts Housing Partnership (MHP). As stated in the QAP, to develop these cost limits, MHP researched the costs of hundreds of rental projects over a four-year timeframe in DHCD's and MHP's portfolio, and assessed multiple variables, including the cost of production versus preservation; family housing versus senior housing or special needs housing; regional variations in cost; and variations based on construction type.[2]

4. **For projects subject to IZ requirements, other than those that fall in the 7-9 new units category, allow for payments-in-lieu through the Special Permit Process, only where the City Council makes specific findings to unusual net benefit to allowing a fee rather than inclusionary units**
    - For projects that receive approval from the City Council for a payment-in-lieu, utilize DHCD's QAP index of $389,000 per unit to calculate the total required payment.
        - Example, 18-unit rental project: 17.5% requirement X 18 units = 3.15; 3.15 X $389,000 = *$1,225,350 total payment*

Staff notes:
As discussed above, while this updated proposal does away with the fractional payments requirement, it still provides the *option* for a developer to request a cash payment in lieu of building the actual inclusionary units as part of the proposed project; however, only projects with 7-9 new units may choose to make such a payment without receiving permission from the City Council through the Special Permit process.

5. **Include a provision where projects consisting of 100% deed-restricted, affordable units (at Tier 1, Tier 2, Tier 3, or any combination thereof) are not required to comply with the proposed Section 5.11.4.B. "Number of Inclusionary Units Required"**
    - Such projects would still be subject to all other sections of the proposed ordinance, but would not be required to comply with prescribed percentage requirements per income level, as detailed in the proposed Section 5.11.4.B.
        - Example: 35-unit rental project at 100% Tier 3 (81%-110% AMI) would not be required to provide any units at Tier 1 or Tier 2
        - Example: 75-unit rental project at 85% Tier 3 and 15% Tier 2 would not be required to provide any units at Tier 1

Staff notes:
While the need for affordable housing in Newton exists across all low to middle-income levels, the introduction of such a provision may help to encourage the development community to consider projects that serve Newton's shrinking middle-income population,

[2] From the Commonwealth of Massachusetts Department of Housing and Community Development's Low Income Housing Tax Credit Program 2018-2019 Qualified Allocation Plan, Appendix C, https://www.mass.gov/files/documents/2018/04/26/20182019QAP.pdf

helping to diversify the array of housing options present throughout the City. Such a provision could be particularly beneficial to Newton's senior population, many of whom fall in this middle-income category. Housing options for this group are particularly constrained as their annual income is too high to qualify for the majority of subsidized housing (reserved for households at or below 80% AMI), but too low to afford the limited supply of senior-friendly apartments and condominiums throughout Newton that are priced at market-rate and above. Additionally, the introduction of greater middle-income units throughout the City could also help to slow the rapid pace of escalating rents at all income levels.

This provision, however, does not simply favor 100% middle-income projects. Any project that includes 100% affordable units, regardless of tier, would not be required to comply with the prescribed percentage requirements of the proposed IZ ordinance. Staff believes that such a provision provides additional incentive for developers to propose and build housing in Newton at a diversity of income levels, a need that exists across the City.

6. **Require that "Elder Housing with Services" projects make a cash payment to the City's Inclusionary Zoning Fund rather than provide the inclusionary beds on site**
   - Utilize 5% of the total number of beds provided in the project as the basis for determining the payment-in-lieu, coupled with DHCD's Qualified Allocation Plan QAP Index for "Single Room Occupancy / Group Homes / Assisted Living / Small Unit Supportive Housing" of $259,000 to calculate the total required payment
     - Example, 115-bed assisted living project: 5% requirement X 115 beds = 5.75; 5.75 X $259,000 = *$1,489,250 total payment*
   - Continue to distribute IZ funds equally to the Newton Housing Authority and the City of Newton's Planning & Development Department
   - Target the City's portion of these funds for the creation and preservation of deed-restricted units at or below 50% AMI

Staff notes:

As written, Newton's existing IZ policy for Elder Housing with Services lacks clarity and guidance for determining the inclusionary requirements for this type of project. However, Newton is not alone in struggling to design an inclusionary policy that successfully considers the complicated nature of the pricing strategy for projects of this type. The "housing" costs are only part of the equation; the real challenge comes in trying to define how the medical costs for a household offered an inclusionary bed would be determined. No clear best practices exist to assist staff in crafting a proposal that works for both the developer and the households eligible for the inclusionary beds.

This proposed change seeks to simplify and clarify the ordinance language, while providing developers and the City with greater certainty around the expectations for an Elder Housing with Services project. By requiring a payment-in-lieu rather than on-site beds, the proposed ordinance carefully balances the need to receive a critical contribution from projects of this type with the ability for the City to fund housing projects that provide a greater level of subsidy for more income-eligible households.

Once again, by utilizing DHCD's QAP Index for these payments, the proposed ordinance provides a defensible number that is grounded in industry-wide research by a respected third party, Massachusetts Housing Partnership.

7. Remove the Density Bonus provision from the Inclusionary Zoning ordinance altogether

Staff notes:

As specified in the Financial Feasibility Analysis, the Density Bonus provision as proposed in 2017 (two additional market-rate units for every one additional inclusionary unit at 50% AMI) does not provide enough of an incentive to the developer to render the project financially feasible. Due to the deep affordability level of the additional inclusionary unit, the value loss that results is too great for the developer to overcome. Even applying a hypothetical three-to-one ratio does not yield a positive result for these projects.

In its current form, the "Incentives" section of the existing IZ ordinance (1 unit granted for each additional inclusionary unit provided above the number required per the ordinance) is vastly underutilized. While the current "incentive" bonus may be beneficial to a project's financial feasibility, the request for increased density may present more issues than solutions for a proposed project in the development review process.

Given that this incentive is neither successful in its current form, nor financially feasible in its proposed state, staff recommends removing this provision altogether.

Attachments:

- Attachment A: City of Newton Inclusionary Zoning: Financial Feasibility Analysis, March 15, 2018, prepared by RKG Associates, Inc.
- Attachment B: Public Hearing Memo to ZAP, December 8, 2017, including a red-lined version of 2017 proposed IZ Ordinance language and a clean version of 2017 proposed IZ Ordinance language