LOS ANGELES DEPARTMENT OF CITY PLANNING
RECOMMENDATION REPORT

CITY PLANNING COMMISSION

DATE: January 11, 2007*
TIME: After 8:30 AM*
PLACE: 200 N. Spring St.
City Hall, Room 1010
Los Angeles, CA 90012

PUBLIC HEARING REQUIRED

CASE NO.: CPC-2005-8252-CA
CEQA: ENV-2005-8253-ND
LOCATION: Coastal Zone
COUNCIL DISTRICTS: 3, 5, 11 and 15
PLAN AREAS: Brentwood-Pacific Palisades; Canoga Park-Winnetka-Woodland Hills-West Hills; Encino-Tarzana; Palms-Mar Vista-Del Rey; Los Angeles International Airport; Port of Los Angeles; San Pedro; Venice; Wilmington-Harbor City; Westchester-Playa Del Rey; and West Los Angeles
RELATED FILE: C.F. NO. 98-0255

*** MATTER CONTINUED FROM MEETING OF NOVEMBER 9, 2006**

SUMMARY: On November 9, 2006, the City Planning Commission considered a staff report and draft ordinance amending the Los Angeles Municipal Code to implement the Mello Act, a state law that requires local governments to comply with various regulations concerning affordable housing in the Coastal Zone. The Commission also considered draft administrative procedures and proposed revisions to the Citywide Affordable Housing Incentives Guidelines. The Commission took testimony at the public hearing but continued the matter until January 11, 2007. In addition, a subcommittee was established to consider the matter in more depth and report back when the full Commission reconvened on January 11th.

RECOMMENDED ACTIONS:

1. **Consider** the report of the Mello Act subcommittee and take further testimony on the matter; and
2. **Direct** staff to prepare a revised ordinance in accordance with direction provided by the Commission.

S. GAIL GOLDBERG, AICP
Director of Planning

JANE BLUMENFELD, Principal City Planner
(213) 978-1372

ALAN BELL, AICP, City Planning Associate
(213) 978-1322

ADVICE TO PUBLIC: *The exact time this report will be considered during the meeting is uncertain since there may be several other items on the agenda. Written communications may be mailed to the *Commission Secretariat, 200 North Spring Street, Room 532, Los Angeles, CA 90012* (Phone No. 213/978-1300). While all written communications are given to the Commission for consideration, the initial packets are sent the week prior to the Commission's meeting date. If you challenge these agenda items in court, you may be limited to raising only those issues you or someone else raised at the public hearing agendized herein, or in written correspondence on these matters delivered to this agency at or prior to the public hearing. As a covered entity under Title II of the Americans with Disabilities Act, the City of Los Angeles does not discriminate on the basis of disability, and upon request, will provide reasonable accommodation to ensure equal access to its programs, services and activities. Sign language interpreters, assistive listening devices, or other auxiliary aids and/or other services may be provided upon request. To ensure availability of services, please make your request not later than three working days (72 hours) prior to the meeting by calling the Commission Secretariat at 213/978-1300.

TABLE OF CONTENTS

SUPPLEMENTAL STAFF REPORT

EXHIBITS

SUPPLEMENTAL STAFF REPORT

The Mello Act is a state law that went into effect in January, 1982 to help protect and increase the supply of affordable housing in California's Coastal Zone. In the City of Los Angeles, the Mello Act applies to the Pacific Palisades, Venice-Playa Del Rey and San Pedro-Harbor, areas that collectively have a population of around 100,000. (See map attached as Exhibit 1.)

The Mello Act consists of two primary rules. One, if existing housing units occupied by low or moderate income households are converted or demolished, they must be replaced one-for-one with new affordable units. Exceptions based on feasibility[1] are provided. Two, a new housing development must provide affordable units, if feasible.

The City's compliance with the Mello Act is governed by a settlement agreement that went into effect in January, 2001 that resolved a lawsuit filed against the City in 1993. Until a permanent ordinance implementing the Mello Act is adopted, the settlement requires the City to abide by an interim policy set forth in a document called the "interim administrative procedures." These procedures include detailed standards and processes governing every aspect of the City's compliance with the Mello Act. To support development of the permanent ordinance the settlement agreement additionally required the City to hire a consultant to prepare a technical study that would, among other tasks, analyze the financial capacity of residential projects typically proposed in the Coastal Zone to provide affordable housing.

On November 9, 2006 the City Planning Commission considered a staff report and draft of the required permanent ordinance. The Commission also considered the report prepared by Hamilton, Rabinovitz & Alschuler, Inc., (HR&A), the policy, financial and management consulting firm selected to prepare the technical study. Numerous speakers testified at the public hearing. After receiving this testimony and also written comments the Commission continued the matter until its meeting on January 11, 2007. Staff indicated that Mr. Paul Silvern, a partner with HR&A and the principal author of the technical study, and Mr. Kenneth Fong, the attorney in the City Attorney's office assigned to the Mello Act, would both attend the Commission's meeting on January 11th. The Commission then established a subcommittee to meet twice before then to review in more depth the issues raised at the public hearing.

---

[1] The Mello Act defines "feasible" as "capable of being accomplished in a successful manner within a reasonable period of time taking into account economic, environmental, social and technical factors."

Staff's proposed permanent ordinance included compliance standards as well as recommended in-lieu fees based on HR&A's analysis. New for-sale housing developments and condominium conversions of ten or more units would be required to either pay an in-lieu fee or make at least ten percent of all units on-site affordable to very low income households. Ownership projects of between five and nine units would be required to pay an in-lieu fee but not required to directly provide any affordable units. Rental projects of any size would not be required to provide either affordable units or pay an in-lieu fee. All converted or demolished existing affordable units would have to be replaced one-for-one with new affordable units or an in-lieu fee paid. As set forth in the staff report attached as Exhibit 5, the proposed ordinance included numerous other provisions intended to comply with the settlement agreement and improve the City's ability to provide affordable housing in the Coastal Zone—the ultimate goal of the Mello Act.

Summary of Issues

A summary of the main issues discussed by the Mello Act subcommittee and presented in oral and written testimony before the City Planning Commission on November 9, 2006 is set forth below:

1. <u>Rental housing requirements</u>. In 2004, HR&A found that typical rental projects in the Coastal Zone were financially infeasible even if comprised 100 percent of market-rate units. In a preliminary study completed in 2000, however, HR&A found that such projects could support some affordable housing. Market conditions over the intervening four-year period explain the difference between these two conclusions.

   Almost all inclusionary zoning ordinances in California require rental as well as ownership projects to make an affordable housing contribution, either through direct provision of units or by paying an in-lieu fee. Before adoption of the settlement agreement, the City had always exempted rental projects for the same reason that the Coastal Commission had exempted them from its affordable housing requirements prior to enactment of the Mello Act: due to the extreme shortage of rental units in the Coastal Zone, any new bona fide rental projects would add to the community's stock of affordable housing. Since the City's Mello Act regulations cannot quickly be changed every time the market changes, the question is whether the draft permanent ordinance should take the long view and be revised to also apply to new rental housing developments so that these projects also make an affordable housing contribution in the Coastal Zone.

2. <u>On-site requirement</u>. The majority of California communities with inclusionary zoning ordinances require new projects above a certain threshold to provide affordable units on-site. No on-site requirement is included in the draft permanent ordinance. The argument for an on-site requirement is that affordable housing is provided directly in the Coastal Zone. The argument for allowing provision of units off-site or payment of a fee is that on-site provision is often infeasible. In-lieu fees are seen as particularly advantageous because they can be leveraged to obtain additional state

and federal affordable housing dollars at a 3:1 ratio. The question is whether the draft permanent ordinance should include an on-site requirement, and if so, what the project size should be that triggers that requirement. The interim Mello Act policy includes an on-site requirement for both rental and new for-sale housing developments of ten or more units.

3. Off-site options. If the Commission requires affordable units to be provided on-site, a decision must then be made concerning the menu of allowable off-site options when provision on-site is shown to be infeasible. Specifically, the question is whether the developer should be restricted to directly providing affordable units off-site, or whether payment of an in-lieu should also be allowed. A related question is whether payment of an in-lieu should be allowed when affordable replacement units must be provided. Both the Mello Act and the settlement agreement specifically allow payment of in-lieu fees for providing replacement units.

4. In-lieu fees. The following issues relating to in-lieu fees have been raised:

   a. Small project threshold. The interim policy exempts small projects of nine or fewer units from providing either affordable units or paying an in-lieu fee. The draft permanent ordinance, however, requires small ownership projects of five to nine units, including condominium conversions, to pay reduced in-lieu fees. Given that most new projects in the Coastal Zone are smaller, and because there are few development sites remaining in the Coastal Zone that can accommodate larger projects, the Commission could consider lowering the threshold to even one- or two-unit projects so that all, or nearly all, new market-rate residential developments in the Coastal Zone make an affordable housing contribution.

   b. Small project fees. Comments were made that the recommended small project fees, which the draft permanent ordinance set at 40 percent of the large project fees, are "artificial." Specifically, it was recommended that the ordinance impose the same fees regardless of project size. HR&A's study generally found that larger projects have a greater capacity to make an affordable housing contribution than smaller ones. The interim policy includes a blanket exemption for all small projects of nine or fewer units. Since projects in the Coastal Zone tend to be on the smaller side, staff recommended lowering this threshold and imposing reduced fees consistent with HR&A's report. To do otherwise could create an undue burden that discourages the most typical small housing projects from being built in the first place.

   c. Fractional units. Under both the interim policy and the draft permanent ordinance any fractional units of 0.5 and above are rounded up to result in one more required affordable unit. Any fractional units below 0.5, however, are rounded down and thus are "lost" to the City. One proposal discussed was to "capture" fractional units of less than 0.5 by requiring payment of an in-lieu fee for projects required to provide at least one inclusionary unit. For example, if a project is required to provide 2.3 inclusionary units the developer would be required to provide two units and also pay a fee equal to 30 percent of the fee required to provide one inclusionary unit. This approach is used in some inclusionary housing programs around the state.

d. Land price assumptions. HR&A based its recommended in-lieu fees on land prices inside the extended Coastal Zone. Comments were made that the fees should instead be based on the higher land prices inside the Coastal Zone. HR&A's per square foot land price assumptions are as follows:

Coastal Zone Subarea	Land Prices in Extended Coastal Zone	Land Prices in Coastal Zone
Pacific Palisades	$95 per SF	$175 per SF
Venice-Playa Del Rey	$85 per SF	$150 per SF
San Pedro-Harbor	$40 per SF	$50 per SF

For comparison purposes, staff directed the consultant to prepare alternative in-lieu fees based on land prices inside the Coastal Zone. The results are summarized below. Exhibit 3 contains a financial feasibility analysis of the new fees prepared by HR&A.

Coastal Zone Subarea	Fees Based on Land Prices in Extended Coastal Zone	Fees Based on Land Prices in Coastal Zone
Pacific Palisades	$220,061	$278,653
Venice-Playa Del Rey	$209,075	$260,343
San Pedro-Harbor	$178,835	$186,159

The in-lieu fees presented above represent the cost of providing one unit of housing affordable to a very low income household in a prototypical affordable housing project, minus the amount of debt that can be amortized by the project's net operating income (primarily rents). Since HR&A's fees are based on year 2004 data, before they are adopted they should be adjusted upwards to account for land price and construction cost inflation over the last two years.

5. Geographic targeting. A key issue in setting the City's Mello Act policy is geographic targeting. The draft permanent ordinance allows units to be located anywhere in the Coastal Zone or extended Coastal Zone, but also provides a mechanism for more refined siting. Specifically, the draft ordinance allows Council to establish specific geographic targets for units subsidized with in-lieu fees. The initial decision-maker may do the same for units that a developer will directly provide. The question is whether this mechanism goes far enough toward ensuring a balanced distribution of affordable units, and if not, whether the ordinance should call out specific geographic targets. For example, the ordinance could require that in-lieu fees collected in the Venice-Playa Del Rey Coastal Zone subarea only be spent there. Likewise, if a developer building a project in San Pedro-Harbor is allowed to provide units off-site then the ordinance could require that these units only be located there and not in the Venice-Playa Del Rey or the Pacific Palisades subareas. If

geographic targets are included staff recommends that an administrative "relief valve" also be developed to allow siting outside the target area if provision inside it is infeasible.

6. Income targeting.[2] The draft permanent ordinance allows in-lieu fees to be spent on any mix of units affordable to very low, low or moderate income households, subject to Council policy. Similar to the geographic targeting issue discussed above, the question is whether a tighter standard should be adopted that only allows these fees, for example, to be spent on very low or low income households. Under the Mello Act affordable units may be targeted to either low or moderate income households.

7. Reduced unit sizes. Staff has proposed that affordable units provided without benefit of a density bonus be allowed to comply with the following Low-Income Housing Tax Credit Program standards: 500 square feet for one-bedroom units; 800 square feet for two-bedroom units; 1,000 square feet for three-bedroom units; and 1,200 square feet for four-bedroom units. In the technical study HR&A found that these unit sizes enabled the residential prototypes analyzed to provide more affordable units than if larger sizes had been assumed.

   The purpose of the City's "comparability" policy is to avoid stigmatizing affordable units by ensuring that they are publicly perceived as comparable to all other units in the same building. Comparability in multi-family developments is achieved by ensuring equal access to amenities and randomly distributing the affordable units in the project. Unlike in subdivisions of single-family homes, size comparability has virtually no meaning in multi-family developments since all residents will use the same stairways and elevators, lobby, and other common areas. No one will have any knowledge or perception of what exists in the private space behind any resident's front door. The question is whether the City's permanent Mello Act policy should allow reduced unit sizes or whether stricter comparability should always be required. While square footage comparability is a laudable goal, given the magnitude of the City's housing crisis it should be balanced against the need to provide as many affordable units as possible.

8. Methods to provide affordable units. The interim policy allows two methods to build off-site affordable units: new construction and adaptive reuse. The draft permanent ordinance adds two new methods to the menu: conversion of existing market-rate

---

[2] The draft permanent ordinance requires replacement units to have the same level of affordability as the converted or demolished units they are intended to replace. For example, an existing unit affordable to a very low income household may only be replaced with a new unit also affordable to a very low income household. Since the settlement grants displaced households a right of first refusal, a "like-for-like" policy is needed to make sure these households are not offered new units they cannot afford.

Comments submitted on November 9, 2006 suggest that the draft ordinance's "like-for-like" policy is confusing and should be clarified. Staff will provide clarifying language in the next iteration of the ordinance.

units (including units under construction) and rehabilitation of vacant residential buildings. Both options would require the Housing Department's approval before they could be utilized. Comments made at the November 9th public hearing argued against both options based on the thesis that only construction from the ground up and adaptive reuse increases the City's housing stock. Given the Coastal Zone's limited supply of vacant land and limited number of underperforming commercial or industrial buildings suitable for conversion, restricting the City's options to new construction and adaptive reuse only could ultimately be self-defeating, and is also unnecessary since nothing in the Mello Act prohibits the new methods staff is proposing.

9. Converting residential units to non-residential uses. The Mello Act, adopted in 1982, prohibits the conversion of market-rate units into non-residential uses, while the Ellis Act, adopted in 1986, allows it, at least with respect to the conversion of market-rate rental units. The draft permanent ordinance takes its cue from the Ellis Act, and allows the conversion of market-rate housing into non-residential uses. Consistent with the rest of the draft ordinance any existing affordable units that are removed would have to be replaced one-for-one with new affordable units. The question is which law takes precedence, the Mello Act or the Ellis Act, a legal issue that should be addressed by the City Attorney's office.

10. Double-counting. The settlement agreement requires that any required replacement units be subtracted before a project's inclusionary obligation is determined. For example, if a 20-unit project must provide three replacement units, the inclusionary obligation only applies to 17 units. Comments have been made that the Mello Act prohibits this provision and so therefore is unlawful. Again, the question is a legal issue that should be addressed by the City Attorney's office. The draft permanent ordinance complies with the settlement agreement's prohibition against double-counting.

HR&A's Supplemental Report and Response to Comments

In early 2005 staff provided the Legal Aid Foundation of Los Angeles and Western Center on Law and Poverty with a copy of HR&A's preliminary technical study. Over a period of several months, Legal Aid and Western Center analyzed this preliminary report, engaging the services of two experts, Dr. Neil Mayer of Neil Mayer and Associates and Joan Ling, Executive Director of the Community Corporation of Santa Monica. On October 7, 2005 Legal Aid and Western Center submitted detailed written comments, which were also included in the package submitted to the Commission on November 9, 2006.

Both Planning and Housing Department staff reviewed these comments. Meetings were subsequently held with Dr. Mayer, Ms. Ling, attorneys with Legal Aid and Western Center, and Mr. Paul Silvern, the City's Mello Act consultant employed by HR&A. Based on these meetings, City Planning and Housing staff were satisfied with HR&A's preliminary report and believed that the consultant had adequately responded to Legal Aid and Western Center's comments. Accordingly, staff did not direct HR&A to make any substantive revisions to the preliminary report and authorized preparation of the final report. After the Commission's meeting on November 9, 2006, staff directed HR&A to prepare a formal written response to Legal Aid and Western Center's comments. HR&A's response is attached as Exhibit 2.

Third Party Review

In 2004 the City Council authorized the Director of Planning to extend the term of HR&A's contract for an additional three years. As part of that action the Council also instructed the City Planning Department and the City Attorney to "explore what avenue is available [for] ... third party review of the work product that will have been done by HR&A, in the most timely manner once the consultant's report is completed."

This instruction came about in the context of preliminary work that HR&A had performed on the City's behalf relative to a large residential project proposed in 2003 in the Coastal Zone. Since the interim policy had taken effect in 2000, staff had been faced with the difficult task of reviewing appeals based on claims that complying with the interim standards were financially infeasible. Simply put, staff did not and do not now have the expertise to adequately review appeals based on such claims. Since this particular project was so large, at 298 units, and so therefore would have a high profile, staff asked HR&A to undertake the requisite financial analysis. HR&A did not solicit this work on its own.

Similar to the procedure used to prepare environmental impact reports, the agreement was that the developer would pay HR&A to prepare the analysis, subject to staff's oversight, review and approval. Since HR&A was under contract to the City staff believed that its analysis would be more objective and reliable than any analysis prepared by a consultant selected by the developer. Based on this arrangement Legal Aid and Western Center have alleged that HR&A had a conflict of interest and so therefore any work that it performed on the Mello Act technical study for the City would be tainted. In light of the facts presented above staff strongly disagrees. As it turned out, due to the ensuing controversy, HR&A did not complete a final report and so the Housing Department agreed to prepare a financial review.

Since then, staff has continued to struggle with the issue of evaluating Mello Act appeals based on claims of financial infeasibility. As a long-term solution staff proposes to require developers filing appeals based on economics to pay a fee into a City-managed trust fund, which would then be used to compensate a specialized consultant selected and overseen by the Housing Department to examine the data and prepare a report for the appellate body's consideration.

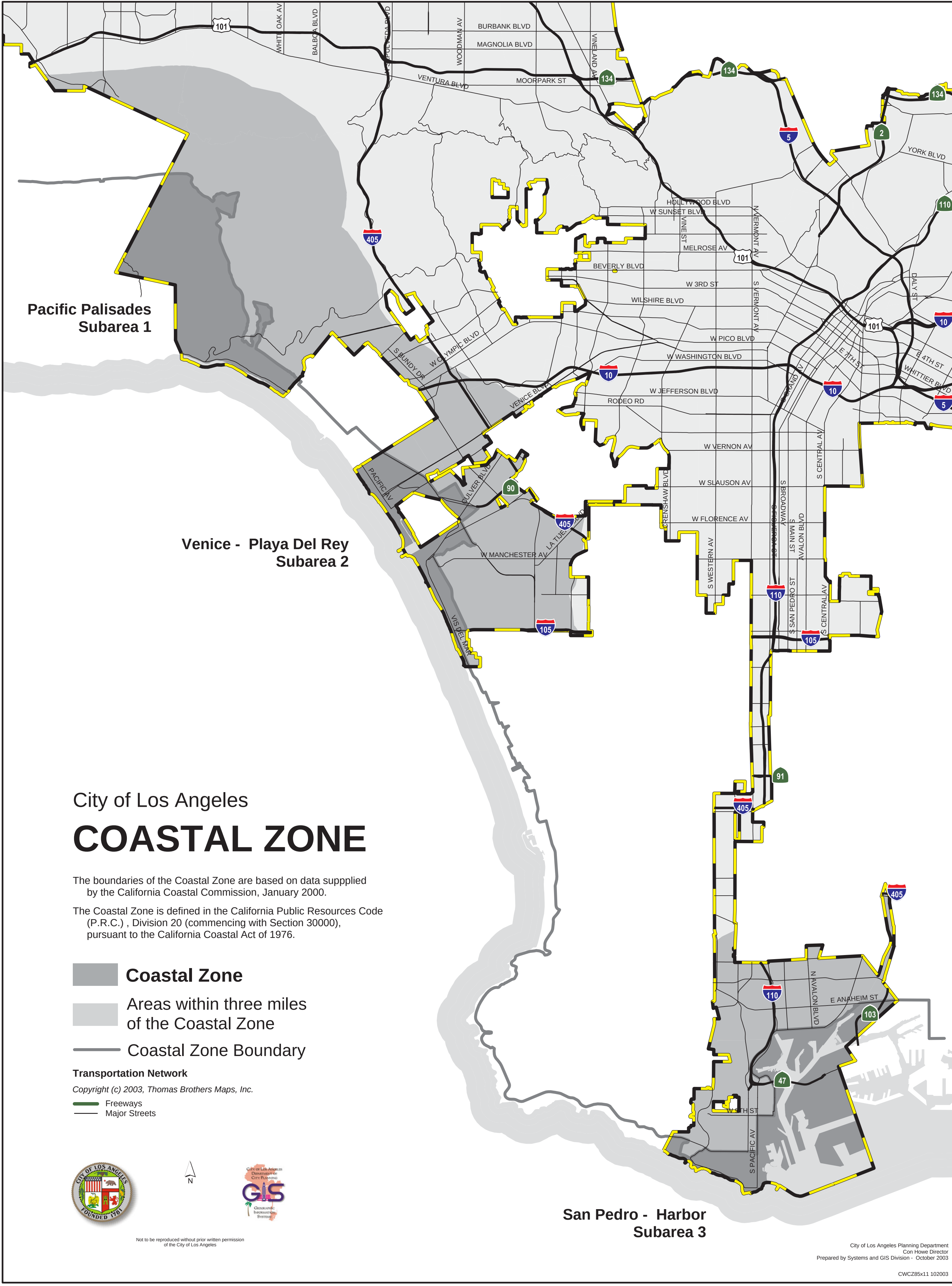
To comply with Council's specific instruction regarding independent review of HR&A's technical study, the Planning Department asked one of its newer employees, Ms. Claire Bowin, to perform an analysis. Ms. Bowin has not had any role in preparing the draft permanent ordinance, supervising HR&A, or been involved in any other aspect of the City's compliance with the Mello Act. Having worked as the Director of Real Estate Development for Livable Places, a non-profit affordable housing developer, Ms. Bowin is well qualified to complete the required review. Her analysis and qualifications are attached as Exhibit 4.

Conclusion

The issues presented in this supplemental report reflect staff's synthesis and analysis of the comments that have been made concerning the first draft of the City's permanent Mello Act ordinance that was presented to the Planning Commission on November 9, 2006. Based on direction provided by the Commission, staff is ready to prepare a revised ordinance for public review and subsequent action.

EXHIBIT 1

MAP OF THE COASTAL ZONE IN THE CITY OF LOS ANGELES



City of Los Angeles

COASTAL ZONE

The boundaries of the Coastal Zone are based on data suppplied by the California Coastal Commission, January 2000.

The Coastal Zone is defined in the California Public Resources Code (P.R.C.) , Division 20 (commencing with Section 30000), pursuant to the California Coastal Act of 1976.

Coastal Zone

Areas within three miles of the Coastal Zone

Coastal Zone Boundary

Transportation Network

Copyright (c) 2003, Thomas Brothers Maps, Inc.

Freeways

Major Streets

City of Los Angeles Planning Department
Con Howe Director
Prepared by Systems and GIS Division - October 2003

CWCZ85x11 102003

EXHIBIT 2

SUPPLEMENTAL REPORT AND RESPONSE TO COMMENTS PREPARED BY HAMILTON, RABINOVITZ AND ALSCHULER, INC.

HAMILTON, RABINOVITZ & ALSCHULER, INC.
Policy, Financial & Management Consultants

MEMORANDUM FOR: Alan Bell, Department of City Planning
City of Los Angeles

MEMORANDUM FROM: Paul J. Silvern

SUBJECT: Responses to Comments on the HR&A Technical Study

DATE: January 2, 2007

The following are responses to comments received from the Legal Aid Foundation of Los Angeles (LAFLA) on HR&A's Technical Study that was prepared for the Department of City Planning to assist in drafting a permanent ordinance to implement the Mello Act. LAFLA provided written comments in a letter to you dated October 7, 2005,[1] which reflects analysis by two consultants working on LAFLA's behalf. These comments were on a preliminary draft of the Technical Study dated May 9, 2005, not the Final Draft Technical Study dated May 9, 2006 which is now before the City Planning Commission. More recently, LAFLA provided additional written comments in a letter to the City Planning Commission dated November 9, 2006. Although we have previously discussed and responded to the comments in LAFLA's October 2005 letter during meetings attended by members of your Department and the Los Angeles Housing Department, we summarize these responses below. Where relevant we also include comments on certain related issues that were raised in LAFLA's November 2006 comment letter.

LAFLA's October 2005 comment letter addresses six categories of technical issues, as follows:

- The measures of return used in the Technical Study;
- The specific thresholds for each measure of return that were used to determine feasibility;
- The condominium prices and apartment rents used in the Technical Study;
- The gross-to-net floor area assumption used in the larger Venice prototypes;

[1] The October 7, 2005 letter is actually a slightly revised version of a comment letter dated August 25, 2005, which also addressed the May 2005 preliminary draft of the Technical Study.

- Issues related to certain other topics including analysis of the off-site option; the analysis of replacement units; the duration of affordability covenants; comparability of market rate and affordable units; and use of external financing; and

- Various issues related to in-lieu fees.

For clarity of presentation, we begin with the second item first and then address each of the other categories as they are presented in the October 2005 comment letter. It should be noted at the outset that in many cases, the issues raised by LAFLA result from disagreements about analytic approaches that were specified in the Study Methodology, which was reviewed and approved by the Department of City Planning with input from LAHD prior to preparation of the Technical Study (see Technical Study Appendix A).

1. The Technical Study's Measures of Financial Return

LAFLA objects to the Technical Study's use of "gross margin" as the measure of developer financial feasibility for condominiums and "return on total development cost" as the measure for apartment projects. It cites Internal Rate of Return (IRR) and profit divided by total development cost, among others, as preferable measures.

As explained at some length in the Technical Study (pp. 50-52), careful consideration was given to selection of these feasibility measures from among several that are used to one degree or another in the real estate development industry, including IRR. Private multi-family real estate developers use a range of financial feasibility calculation approaches, and often a mix of approaches for the same project. Each approach involves different measurement concepts and minimum acceptable benchmarks, which are established through individual experience and consultations with lenders, investors, industry peers and information available from periodic surveys and other professional publications. These benchmarks, or feasibility thresholds, differ among development products and market location, and change over time in response to changes in market conditions, interest rates, price inflation and associated yields available from less risky investments (e.g., US Treasury bills). These thresholds establish the point at which a reasonably well-informed and experienced property owner or developer with a typical multi-family housing development project would decide whether to pursue a project. A Mello Act affordable housing requirement that causes an otherwise feasible project's financial return to fall below these thresholds can be used as a reasonable indicator that the requirement causes a project to become financially infeasible.

The Technical Study utilizes two feasibility thresholds from among several that could be used: "return on total development cost" for apartments (net operating income divided by total development cost) and "gross margin" for condominium projects (profit divided gross sales). These measures are frequently used by the real estate industry as initial project feasibility screening criteria. They were also chosen because their calculation and comparison across the kinds of conceptual prototypes used in this analysis do not depend on individual developer financial circumstances and borrowing capacity. The Technical Study cites numerous examples where these measures have been used in analyzing the feasibility of inclusionary housing proposals.

Alternative methods that were considered for the analysis included cash-on-cash return on equity and Internal Rate of Return (IRR) on equity. These two equity return measures are best suited to analysis where borrower or investor circumstances are known and the project and market conditions have been detailed. Calculation of IRR, in particular, involves a form of discounted cash flow analysis that requires many calculation assumptions beyond those used in the Technical Study, including long-term inflation rates, specification of a holding period, rates of absorption, a terminal capitalization rate, and selection of a discount rate, none of which are appropriate for the very general specification of the prototypes used in the Technical Study. The fact that LAHD utilized an IRR approach in analyzing one specific contested project proposed for the Venice Coastal Zone does not suggest that it is appropriate for the kind of analysis contained in the Technical Study, and does not, as claimed in LAFLA's November 2006 comment letter, represent a new City standard measure of feasibility.

As also noted in the Technical Study, few developers, in HR&A's experience, use IRR analysis at the early stage of project formulation, when basic decisions are made about whether to pursue project entitlements, including an assessment of the effects that local government regulations may have on project feasibility. Many developers, including some of the most experienced, use much more abbreviated analysis metrics, such as return on cost and gross margin, at this early assessment stage. IRR analysis, to the extent that it is used, is generally performed at later stages in the development process, but only after a prospective project has passed successfully through the initial feasibility screening. It is used primarily by equity investors, not developers.

2. <u>The Technical Study's Gross Margin and Return on Cost Feasibility Thresholds</u>

LAFLA comments that the thresholds utilized in the Technical Study for each of the feasibility measures – i.e., 18 percent for gross margin and nine percent for return on cost -- are too high. Based on analysis by its consultants, the comment letter compares alternative thresholds derived from review of the Technical Study with those for two specific development projects proposed for the Venice Coastal Zone subarea, and with inclusionary housing studies prepared by Bay Area Economics (BAE).

As explained in the Technical Study (see p. 52), condominium and townhome projects of the scale used for the Coastal Zone prototypes should yield a gross margin within a range of 15-20 percent to render a project feasible. The Study utilizes 18 percent as the minimum threshold for gross margin as a compromise between long-term average conditions, and prospects for rising interest rates, in which a 20 percent gross margin would apply, and the atypical market conditions at the time the Study was prepared in which a 15 percent gross margin may be acceptable. This selection also accounted for the fact that the Technical Study assumes near-ideal entitlement circumstances and associated risk reduction, which is not particularly common in the Coastal Zone.

For apartment projects, the Technical Study states that a developer in a market that must be reasonably certain of achieving at least a 10 percent return on the amount spent to develop the project (i.e., purchase of land and all other development costs) by the time the project reaches stabilized occupancy (i.e., 95 percent occupied), before committing to undertake the project, assuming long-term average interest rates and capitalization rates. The Study notes that this is a generally accepted benchmark, but also one to which, like all such general rules in the real estate industry, there are undoubtedly exceptions due to project or market particulars. More specifically, it states that in the low interest rate and low capitalization rate environment that characterized the 2004 market, and intense competition for development and investment opportunities in the Coastal Zone, an acceptable return on cost may be as low as eight percent. The Technical Study utilizes a nine percent return on cost threshold for analysis of apartment project feasibility, as a compromise between long-term trends and current market conditions.

The LAFLA comment letter converts the Technical Study's gross margin and return on cost thresholds to other return thresholds sometimes used by the real estate development industry and then presents comparisons between the resulting return thresholds and those used in certain other studies. On the basis of these comparisons the comment letter concludes that the Technical Study's return thresholds are too high.

First, the assumptions basis for each of these conversions is not included in the comment letter and so it is not possible to verify their accuracy.[2] We also note, for example, that the comment letter defines gross margin as profit divided by net sales, not profit divided by <u>gross</u> sales. For the condominium return comparisons, the comment letter includes levels of return for two large projects proposed for the Venice Coastal Zone subarea, which are not typical for the Coastal Zone as a whole — i.e., a 298-unit project and a 30-unit project. Even if they were appropriate benchmarks, they produce significantly different levels of return from one another on every category of return comparison, according to the comment letter, which renders the comparison of little value.

Although the Technical Study mentions (see page 50) inclusionary housing studies prepared by Bay Area Economics (BAE) for the cities of San José and Salinas, as mentioned in the LAFLA comment letter, it did so only for the purpose of illustrating that return on development cost is an appropriate measure of financial feasibility, but not for the specific thresholds used in the two BAE studies. Both of those studies were conducted for areas with completely different market and entitlement circumstances that are not applicable to the City of Los Angeles Coastal Zone. In addition, the development prototypes tested in the two BAE studies are very different and much larger prototypes[3] than are appropriate for the Los Angeles Coastal Zone. Thus, the 10-15 percent return on cost threshold applicable to volume builders of large subdivision, townhouse and apartment developments, as used in the BAE studies, are not suitable for relatively small, custom-built projects in a very expensive market and contentious entitlement environment that is more typical of the Los Angeles Coastal Zone.

The apartment return comparisons also omit the calculation details that would aid in verifying their accuracy, and also include the initial apartment version (later changed to a condominium project) of the atypical proposed Alexan Marina project, the BAE studies whose

---

[2] For example, the IRR conclusions do not identify the discount rate, holding period, absorption rate or interest rate used in deriving the stated results.

[3] The Salinas study's prototypes include 200-unit single-family subdivisions, 200-unit condo projects, 200-unit apartment projects and a 45-unit townhome project in a market environment with $13 per square foot land costs. The San José study's prototypes included 60-70 unit single-family subdivisions, a 150-unit condo project, 70-unit townhome project and 150-unit apartment project in a market environment with $40-$45 land costs.

prototypes are inappropriate references for the Los Angeles Coastal Zone, and an uncited reference to a real estate investment trust.

3. Condominium Prices and Apartment Rents

LAFLA objects to HR&A's selection of average condominium sale prices per square foot and monthly rental rates per square foot, as used in the feasibility analysis. LAFLA's consultants selected alternative prices and rents from the data included in the Technical Study to perform alternative feasibility calculations which lead to different results from those in the Technical Study.

As explained in the Technical Study, which is supported by a detailed appendix, all of the market rate condominium prices and apartment rent data were derived from available secondary data sources for calendar year 2004, the time period applicable to the study. The Technical Study's choices of overall median condo sale prices reflects consideration for notable price differences among neighborhoods within each Coastal Zone subarea, as evident from the address-specific 2004 sale data contained in Technical Appendices C and D. For example, the Technical Study utilized an average sale price of $487 per square foot for the Venice-Playa Del Rey subarea to account for significant price variation for units in close proximity to the ocean as opposed to those sites closer to Lincoln Boulevard.

For its alternative analysis of apartment feasibility in the Venice-Playa Del Rey subarea, LAFLA's consultants utilized the rents for a proposed 298-unit apartment project. It is inappropriate to use that project as a rent indicator because: (a) the scale and amenity level available in such a large development is not representative of the prototypes analyzed in the Technical Study; and (b) rents are only estimated not actual for a project that was subsequently changed to condominiums.

While condo prices and rents in the Coastal Zone have continued to increase since 2004, so have construction costs, land costs, cost of professional services and other "soft" development costs. Thus, it would be inappropriate to utilize alternative, higher condo price and rent values in light of changing market conditions, as suggested in LAFLA's November 2006 comment letter, without also accounting for changes in development costs.

4. The Physical Specification of the Large Venice Prototype

The LAFLA comment letter states that the Technical Study's analysis of the large Venice prototype errs in its assumption about net floor area, because that value as a percentage of gross floor area is less than in other prototypes used in the analysis.

There is no error in the analysis. As explained in the Technical Study (p. 42), the 22-unit prototype in that subarea is located on underdeveloped Lincoln Boulevard commercial land within the Oxford Triangle Specific Plan, where lot assembly is permitted, and that it is developed at R3 density, per that Specific Plan, but subject to the 25-foot height limit due to proximity of R1 across an alley. The narrow (113 feet deep) lot dimensions along Lincoln Boulevard, combined with other zoning regulations (e.g., setbacks and private open space per unit), result in a relatively inefficient layout for the 22-unit prototype. This is simply a reflection of the challenges a developer would face in trying build a project of this scale on Lincoln, which is one of the only locations in the Venice subarea where a project of this scale could be developed. This combination of site limitations does not apply to sites in the other Coastal Zone subareas that are suitable for the larger prototypes analyzed in the Technical Study.

5. Comments on Other Topics

A. Use of the State Density Bonus

LAFLA objects to the fact that the Technical Study did not include consideration of the State density bonus when affordable units are included in a development.

The reasons that the State density bonus was not included in the analysis is discussed in the Technical Report (see page 53). Briefly, these reasons included the fact that the City had not yet (and still has not) adopted regulations to implement the latest version of the density bonus law, and thus its applicability and practicality for use in all Coastal Zone developments could not be assured. The Technical Study also notes that the City's own 35 percent density bonus that is available when a project is located near a transit center, regional center, major economic activity center, or major college or university was not included in the analysis, because these conditions do not apply uniformly across the Coastal Zone. Further, the Venice Coastal Zone Specific Plan, the San Pedro Specific Plan, and various "Q" conditions on property in the Coastal Zone include height limits, limits on shadows cast on adjacent property and other property development regulations which, as a practical matter, may limit a developer's ability to expand a project's physical envelope sufficiently to accommodate the density bonus. City staff's interpretation is that these specific plans take priority, at least for the time being.

B. Analysis of the Off-site Option

LAFLA objects to the assumption in the Technical Study that affordable units that may be provided at an off-site location would be rental units rather than ownership units. LAFLA cites no provision of the Mello Act or other authority to support its position that off-site units provided to meet the affordable housing requirements of a market rate for-sale project must also be for-sale and not rental units. This appears to be a LAFLA policy preference, not a statutory requirement.

C. Analysis of Replacement Units

LAFLA comments that: (a) additional feasibility analysis of replacement requirements should be added to the Technical Study for developments with less than three market rate units; (b) recommends a three-tiered locational preference hierarchy for replacement units; and (c) it disagrees with the Technical Study's recommendations for targeting the income of households in replacement units.

As to the first issue, the Technical Study did not include analysis of affordable housing requirements associated with single-family homes and duplexes, because your Department determined that it would recommend that the Permanent Ordinance require replacement units in all such cases.

The second LAFLA comment concerns a three-tiered locational preference hierarchy for replacement units. This was not an issue addressed by the Technical Study.

The third LAFLA comment concerns another Mello Act policy issue about whether affordable replacement units provided by market rate developers should feature the same affordability characteristics as the affordable units removed. The Technical Study observes (pp. 79-80) that the Mello Act does not require adherence to any particular replacement unit requirement, but rather that demolished or converted units that were occupied by low or moderate-income persons be replaced, one way or another. The Technical Study also notes that the income targeting question should be considered in conjunction with City housing policy priorities for the Coastal Zone. For example, since nearly all of the City, State and Federal housing programs target very low- and low-income households, it would seem consistent for the City's Coastal Zone policies to do likewise. Considering further that any Coastal Zone in-lieu fees are intended for use in developing units for very low-income households, the so-called "intermediate targeting standard" would allow developers to rent or sell those units at prices affordable to either very low- or low-income households, regardless of where in the spectrum of low- to moderate-income the households in the demolished or converted units were situated. This would also facilitate use of the City's density bonus and related incentives for affordable housing production, which are linked to the provision of units for very low- and low-income households.

LAFLA advocates for a stricter "like-for-like" approach so that a displaced very low-income unit is replaced by a unit affordable to another very low-income household, not a low-income household. The draft Permanent Ordinance before the City Planning Commission is consistent with LAFLA's position.

D. Duration of Affordability Covenants

LAFLA supports the Technical Study's recommendation to maintain affordability of replacement and inclusionary units for a 55-year term. LAFLA further recommends a "life of the development" term be considered by the City. This is an issue that may require input from the City Attorney.

E. Comparability of Market Rate and Affordable Units

LAFLA objects to the Technical Study's recommendation that required affordable units be of sizes that are used in most public financing programs, because doing so would be inconsistent with a provision of the Settlement Agreement, which requires that unit sizes conform to the same-size requirements contained in the City Planning Commission's Affordable Housing Incentives Guidelines.

The Technical Study notes that it is customary in inclusionary housing regulations throughout California to permit developers to provide affordable units with unit sizes that are smaller than market rate units, provided they are otherwise indistinguishable in external appearance. Doing so is consistent with the fact that public agencies that sponsor affordable housing development, and the public programs that help fund them, permit smaller unit sizes, such as the standards used in the State's administration of the federal Low-Income Housing Tax

Credit program. The Technical Study also demonstrated that allowing smaller affordable unit sizes produced an affordable housing benefit by making it feasible to include more affordable units within the prototypes tested if the unit sizes were consistent with public financing standards, thereby leaving more floor area available for market rate units. The staff recommendation to the City Planning Commission includes a recommendation to amend the Affordable Housing Guidelines to address the inconsistency noted by LAFLA.

F. Use of External Financing

LAFLA comments that the Technical Study should have assumed the availability of public subsidies or external financial assistance, as required by the Settlement Agreement.

The use of such subsidies and financial assistance were considered in developing the Study Methodology. The Technical Study notes, first, that the scale of the prototypes tested in the analysis (i.e., 4-24 market rate units), and the tested number of affordable housing units that might be required (i.e., 1-5 units) are not of a scale that would be competitive for most public subsidy programs. Second, even if such funds were available (e.g., down payment assistance or below market rate second mortgages for affordable home purchasers) it cannot be assumed that all developers, or households occupying their affordable units, would be equally successful in receiving such assistance. For this reason, the Technical Study also did not assume that households occupying affordable rental units will qualify for Section 8 rental certificates, though this may occur in some cases. It would be inappropriate for the City to enact an ordinance requiring certain percentages of affordable housing or amounts of in-lieu fees if the feasibility determination underlying those requirements assumes that such financial assistance is available and used in each and every development project when all available evidence suggests otherwise.

6. <u>In-Lieu Fees</u>

The LAFLA comment letter (a) objects to the availability of in-lieu fees for new construction projects; (b) objects to taking financial feasibility into account in setting the fee amounts; and (c) objects to using land values in the Extended Coastal Zone in calculating the in-lieu fees.

As noted in the Technical Study (pp. 63-64), the Settlement Agreement explicitly states that an in-lieu fee approach may be considered in the Permanent Ordinance for meeting the Mello Act's affordable housing requirements, both for replacement of existing affordable housing and new housing developments, provided the fees are set at levels high enough to result, in aggregate, in the number of replacement units or new units that would otherwise be required.[4] More specifically, the Settlement Agreement provides that if the City determines that a requirement for on-site or off-site affordable units is infeasible, the City will permit a project applicant to pay in-lieu fees.[5] It further states that if the City determines that on-site or off-site affordable housing requirements are infeasible, but that payment of some amount of in-lieu fees

[4] Settlement Agreement, Section H 2.

[5] *Id*., Section H 2.3.1

is feasible, the City may charge such in-lieu fees.[6] In January 2001, the City Council established a Coastal Zone Affordable Housing Trust Fund into which any subsequently collected in lieu fees would be deposited and reserved for construction of affordable housing in the Coastal Zone.

LAFLA now states in its comment letter that despite the plain language in the Settlement Agreement permitting consideration of in-lieu fees, that because the Mello Act does not specifically allow such fees for new construction, they should not be allowed by the City. This statutory interpretation is clearly at odds with the Settlement Agreement, with which LAFLA in other cases demands strict compliance.

The issue of whether the City should consider the financial feasibility in setting the in-lieu fees was a based on specific direction to HR&A by the City Attorney, as reflected in the Study Methodology.

The issue of whether the in-lieu fee calculation approach should utilize Extended Coastal Zone or Coastal Zone land prices, and the difference this choice makes in the fee amounts, are addressed in a separate memorandum.

---

[6] *Id.*, Section H 2.3.2

LEGAL AID FOUNDATION OF LOS ANGELES

ATTORNEYS AT LAW
110 Pine Avenue, Suite 420
Long Beach, California 90802-4421
Telephone: (562) 435-3501
Fax: (562) 435-7118

Central Office
1550 W. Eighth Street
Los Angeles, CA 90017-4316
(213) 640-3881

East Office
5228 E. Whittier Boulevard
Los Angeles, CA 90022-4013
(213) 640-3883

Santa Monica Office
1640 Fifth Street, Suite 124
Santa Monica, CA 90401-3343
(310) 899-6200

South Central Office
8601 S. Broadway
Los Angeles, CA 90003-3319
(213) 640-3884

West Office
1102 Crenshaw Boulevard
Los Angeles, CA 90019-3111
(323) 801-7989

Writer's Direct Dial Number (213) 640-3897

sbrowne@lafla.org

October 7, 2005

Mr. Alan Bell
L.A. Planning Department
200 North Spring Street, 7th Floor
L.A., CA 90012

RE: REVISED COMMENTS ON HR&A'S MELLO ORDINANCE STUDY

Dear Mr. Bell:

The Legal Aid Foundation of Los Angeles and Western Center on Law & Poverty submit this letter in response to Hamilton, Rabinovitz & Alschuler's preliminary report (the "Report") regarding the City's Mello Act Ordinance. As you know, our two organizations represented the plaintiffs in Venice Town Council v. City of Los Angeles, which resulted in our December 5, 2000 Settlement Agreement and adoption of the Interim Administrative Procedures for Complying with the Mello Act. Two experts in the real estate development field, Dr. Neil Mayer of Neil Mayer and Associates and Joan Ling, Executive Director of the Community Corporation of Santa Monica, have reviewed HR&A's report. Their independent analysis concludes that HR&A's report should be revised using corrected assumptions and alternative methodologies and thresholds. This letter discusses their findings and conclusions.

I. Summary and Overview of Key Conclusions

HR&A's analysis understates the ability of both condominium and rental apartment projects to provide affordable housing in the Los Angeles coastal zone.

- The Report uses feasibility thresholds for its prototype projects that are far too high.
- The Report's choice of measures of return on developers' investments is inappropriately limited,
- The Report relies on inadequate data for condominium prices and apartment rents.
- The Report contains a serious technical error in its definition of two of its 12 prototypes.

- The Report fails to include the impacts of density bonuses in evaluating feasibility.

An analysis that corrects for these errors reveals that both condominium and apartment projects have substantially greater ability to provide affordable housing.

A. Results with Corrected Method and Threshold – Condos

Correcting just the measurement method and threshold level problems for condominiums (and the technical error),[1] we find that projects can support the inclusionary provisions in Table 1. In cases where less than one unit is feasible, the approximate amount of an in-lieu fee that could be paid by the project is indicated. Please note that we use two threshold levels for discussion and comparison. We used a 10% return on TDC threshold because it has recently been used because Bay Area Economics (BAE) for several inclusionary studies in northern California cities. The 15% return is provided as the high end range based on discussions with local developers and their consultants.

As the Table indicates, for the three larger buildings, the number of feasible on-site inclusionary units nearly triples in our analysis. For the three smaller buildings, substantial in lieu fees become feasible in each case—two of them in cases in which HR&A found that not even the baseline projects themselves, with no provision for inclusion, were feasible.

Table 1
Financial Feasibility for **Condominiums**
Very Low Income Units on Site or **In Lieu** Fee
Different Feasibility Measures and Thresholds

Project Type	HRA	@10 Return on TDC	@15% Return on TDC
Pacific Palisdades			
5 units	0 units	0 units	0 units
	$0 in lieu fee	$125,000 in lieu fee	$0 in lieu fee
18 units	1 unit	3 units	2 units
Venice-Playa Del Rey			
5 units	0 units	0 units	0 units
	$44,000 in lieu fee	$425,000 in lieu fee	$275,000 in lieu fee
22 units	2 units	6 units	5 units
San Pedro-Harbor			
7 units	0 units	0 units	0 units
	$0 in lieu fee	$50,000 in lieu fee	$0 in lieu fee
24 units	2 units	5 units	4 units

[1] HR&A inexplicably uses a far lower ratio of saleable or rentable spaee to total building size in the condominium and apartment 22-unit prototypes for Venice-Playa Del Rey than for the others. We corrected this number, as detailed in Section II.C. below.

B. Results with Corrected Method, Threshold and Prices -- Condos

Correcting condominium prices, in addition to feasibility measure and threshold, produces the results in Table 2. Now almost every prototype can supply at least one very low-income inclusionary unit on site, with inclusionary percentages of 20% or more.[2] The one remaining case falls just short of permitting an inclusionary unit and can supply a large in lieu fee to support an off-site unit.

Please note that we used the lower of (a) top quartile of condo sales prices per square foot or (b) the sales price of condos built since 1990 to conservatively adjust for the fact that new for sale condominiums more closely match their newer counterparts and are generally built for the luxury market. Even with these adjustments, we are still likely understating the value of new luxury condominiums. See Section II.B. below for additional detail on the price data alternatives.

Table 2
Financial Feasibility for **Condominiums**
Very Low Income Units on Site or **In Lieu** Fee
Different Feasibility Measures, Thresholds, **and Prices**

Project Type	HRA	@10 Return on TDC	@15% Return on TDC
Pacific Palisdades			
5 units	0 units	1 unit	0 units
	$0 in lieu fee	n.a.	$525,000 in lieu fee
18 units	1 unit	5 units	5 units
Venice-Playa Del Rey			
5 units	0 units	1 unit	1 unit
	$44,000 in lieu fee	n.a.	n.a.
22 units	2 units	9 units	8 units
San Pedro-Harbor			
7 units	0 units	0 units	0 units
	$0 in lieu fee	$350,000 in lieu fee	$200,000 in lieu fee
24 units	2 units	7 units	6 units

C. Results with Corrected Method and Threshold – Apartments

For apartments, the impacts of corrections in the analysis are also substantial, though less uniform. HR&A projected that none of the rental prototypes were feasible, even without

[2] At a 10% threshold ratio of profit to total development cost. Using a 15% ratio yields one more case of 0 inclusionary units (very low income on site) and only slightly reduces the number of inclusionary units feasible in the other cases. See Table 2 for the complete figures.

inclusionary units. In the corrected analysis, inclusionary units are feasible for two of the three larger prototypes.

The market data supplied by HR&A regarding rent levels is inadequate. A satisfactory apartment analysis cannot be provided without the collection of new data. For the Venice sub-area, we supplemented HR&A's information with rent data from a recently proposed project.[3] For Pacific Palisades and San Pedro, HR&A's data includes only one project built since 2000 and needs to be supplemented. The Pacific Palisades and San Pedro areas should be reanalyzed once adequate data is obtained.

Please note that we used the same thresholds for apartments as we did for condominiums for the sake of comparability. We believe, however, that the actual threshold for apartments is in the low teens range.

Table 3 shows the results of correcting the measure of return, threshold level, and rents, to the extent possible, (plus the technical error) for the apartment prototypes.

Table 3
Financial Feasibility for **Apartments**
Very Low Ineome Units on Site or **In Lieu** Fee
Different Feasibility Measures, Thresholds, and Rents

Project Type	HRA	@10 Return on TDC	@15% Return on TDC
Pacific Palisdades			
5 units	0 units $0 in lieu fee	0 units $0 in lieu fee	0 units $0 in lieu fee
18 units	0 units	1 unit	0 units $400,000 in lieu fee
Venice-Playa Del Rey			
5 units	0 units $0 in lieu fee	0 units $0 in lieu fee	0 units $0 in lieu fee
22 units	0 units	3 units	2 units
San Pedro-Harbor*			
7 units	0 units $0 in lieu fee	0 units $0 in lieu fee	0 units $0 in lieu fee
24 units	0 units	0 units	0 units

*No good data are currently available to correct San Pedro sub-zone rents.

Sections II and III below explain the basis for our corrected condominium and apartment analysis above. Section IV discusses the impacts of density bonuses and examines off-site options.

[3] Alexan Marina development, apartment version.

II. The Condominium Analysis

This section describes the basis for our conclusions regarding condominiums reported in the Summary above.

A. Measuring Returns and Choosing Thresholds for Condominiums

HR&A uses gross margin, defined as profit/total net sales, as its measure of feasibility for condominium projects, where profit is total net sales less total development cost (TDC). This method does not address the amount of investment on the part of the developer. In addition, this method does not account for the amount of total cost of the project against which to compare profits. Even if a simple measure of this type is to be used, a preferred measure would be profit/total development cost, so that gain is compared to outlay.

We believe, as did LAHD in its Trammell Crow condominium analysis, that internal rate of return (IRR) and return on equity are preferred measures of feasibility. Both of these methodologies show the return a developer receives on its investment—the actual basis for its decision whether to build. While HR&A argues against those choices because they require an assumption about the amount of equity the developer chooses to put in and the amount of the construction loan, HR & A's own analysis makes exactly such an assumption. HR&A assumes a construction loan of 75% of TDC in its own analysis in order to determine the interest to be paid on the loan. Such an estimate is well based in the typical practice of lenders and borrowers in actual development projects. The developers of the 1046 Princeton condominiums and the Alexan Marina/Princeton condominiums, for example, used assumptions of construction loans at 75% of total development cost. HR&A should use this information and compute IRR levels and return on equity to determine a project's economic viability.

Suppose, nonetheless, that we accept the HR&A use of gross margin. HR&A chooses 18% as a threshold level. For several reasons, it is clear that this threshold is far too high. The two most important reasons are:

1. When converted to an IRR model, it produces an IRR that far exceeds accepted threshold levels; and
2. It is far higher than the figure used by other similar studies that do have an empirical basis for their choice of threshold

Consider the IRR issue first. If we start with the gross margin threshold of 18%, accept HR&A's assumption that investor equity is 25% of TDC, and make simple assumptions about a project's timing,[4] we can compute IRR for any of HR&A's prototypes. The result is an IRR threshold of 37.1%. That is, if we use 18% gross margin as a feasibility

[4] The assumptions are that the project takes two years to develop once the equity goes in, and that—for simplieity and to make the estimate very conservative-- equity goes in all at once at the start of the project, and that all sales revenue comes out only at the very end.

threshold, then we are effectively using over 37% IRR as the threshold.[5] This plainly far exceeds the levels that reasonable developers and investors would anticipate. Returns in the 15-20% range are in fact the threshold level for IRR, based on data and estimates from a wide variety of sources.[6] That means gross margin threshold level should be in the range of 9%, which corresponds mathematically to IRR levels around 19%.

Looking at the second issue, similar studies cited in the Report[7] conflict sharply with the 18% gross margin threshold. When we convert 18% gross margin—using simple algebra—to a corresponding profit/TDC measure, the profit/TDC threshold is 22%. The studies by Bay Area Economics (BAE), which HR&A cites, employ profit/TDC as its feasibility measure. But BAE uses a threshold level of 10%, not 22%. The actual BAE reports describe the process by which it reached its 10% threshold conclusion. BAE included extensive meetings and signoffs by members of the development and lending communities in several cities and also refers to gross margin data from the National Association of home builders that showed typical levels of return on projects of well below 10%, as measured by gross margin. Real estate consultants, brokers, and lenders with whom our consultant Neil Mayer has spoken also cited the 10% figure.

In our analysis, we therefore use a feasibility measure of profit/TDC and a threshold level of 10% (or 0.10) for that measure.[8] We included a threshold level of 15% for discussion purposes as well. These changes alone make provision of inclusionary units in condominium projects much more feasible than HR&A estimates, as Table 1 above demonstrates.

Table 4
Comparison of Feasibility Thresholds for Condominiums as Indicated by Recent Studies

Study:	HRA	LAHD	Wald Realty	Bay Area Economics
Date:	5/05	early 05	8/05	various – 2/3/04
Project:	n/a	Trammell Crow Alexan	Princeton lofts	n/a
Description:		large/new	small/adaptive	
Profit/Net Sales	**18.0%**	7-8.0%	**15.0%**	**8.0%**
Profit/TDC	22.0%	9-10.0%	17.0%	**10.0%**
Profit/Equity	88.0%	36-40.0%	68.0%	40.0%
Leveraged Annual IRR*	37.0%	**15-20.0%**	**20.0%**	15.0%

[5] The 37% is in addition to the developer fee, overhead, and in some cases general contractor fees and sales commissions that the developer will earn and that are included in the HR&A costs of development.
[6] CB Richard Ellis, writing for Trammell Crow regarding Alexan Marina/Princeton condos, argued for a 20% threshold. The consultant on inclusionary feasibility to the developers of 1046 Princeton stated that 15 to 20% is the range for similar projects, making 15% the threshold for IRR. The 15% to 20% range is also consistent with the real estate market participants with whom Neil Mayer and Joan Ling consulted in the course of consideration of these projects.
[7] See footnotes 9 and 10, p.50.
[8] While we continue to believe that IRR provides a better measure, for comparison we deliberately chose an approach which more closely matches HR&A's except for their grossly high threshold level.

Notes:
* Assumed 25% equity, 75% debt, reasonable condo pre-sales and sales timing.
Bolded #s indicate the analyst's specified thresholds.
Unbolded #s are calculated based on 25/75 equity/debt ration and certain margin between TDC and Net Sales.

B. Condominium Sales Prices

HR&A underestimates the expected sales prices for condominiums to be developed in the coastal zones. It uses overall median sales price per square foot based on 2004 sales as its estimate. But, newly built condominiums will sell for higher prices per square foot than the average of all existing units. Alternative measures that would provide better measurement of prices of new condos include the highest quartile of sales by price per square foot and the price per square foot of condos that have been recently built. Indeed, HR&A itself calculates the highest quartile (see HR&A Table 6) but does not use the results in its feasibility analysis; and it defines the highest quartile in terms of those condos with the highest total prices, which means it emphasizes large condos rather than those with high per square foot prices. In addition, HR&A inexplicably uses $487/s.f. sales prices in the Venice/Playa Del Rey area when its own median figure for this zone is $543/s.f. (see HR&A Appendix C). The median data for each sub-zone is as follows. We used the lowest of the appropriate alternative-to-HR&A prices in each zone.

Pacific Palisades

- HR&A's top quartile by total price: $517/s.f.
- Preferred top quartile by price/s.f.: 532
- Sales of condos built since 1990: 516
- HR&A's overall median 438

We therefore substituted $516/s.f. for HR&A's overall median $438.

Venice/Playa Del Rey

- HR&A's top quartile by total price $571/s.f.
- Preferred top quartile by price/s.f. 591
- Built since 1990 (one observation) 746
- HR&A's overall median 543

We therefore substituted $591 for HR&A's unexplained $487.

San Pedro-Harbor

- HR&A's top quartile by total price $318/s.f.
- Preferred top quartile by price/s.f. 359
- Built since 1990 (one observation) 352
- HR&A's overall median 319

We therefore substituted $352/s.f. for HR&A's overall median of $319.

The adoption of prices more appropriate to the sale of newly developed condominiums provides for further increase in feasible inclusionary units, as detailed in Table 2.

C. Building Efficiency

Building efficiency is the percentage of a building's gross area that is used for living by residents in their individual units after deducting space for common hallways, utility infrastructure and other such uses. Without explanation, HR&A uses a building efficiency level for the Venice/Playa Del Rey 22 unit structure that is only 0.82, instead of in the range of 0.92 that it applies in the smaller Venice prototype and all prototypes in the other two sub-zones. This means that HR&A substantially underestimates the amount of space that can be sold to condo buyers and thus the revenue and profits the developer can obtain. We adjusted the building efficiency of that Venice structure, in both condo and apartment cases, to match the efficiency of the other prototypes. (This is the technical error referred to earlier in the Summary).

III. The Apartment Analysis

This section provides the basis for our conclusions regarding apartments reported in the Summary and discusses further impacts of additional adjustments.

A. Measuring Returns and Choosing Thresholds for Apartments

HR&A measures feasibility of apartment projects using net operating income divided by total development cost (NOI/TDC). This measure provides only a partial picture of the developer's return—a picture of the current operating return. In fact, investors also rely in part on returns to be gained by the increasing value of their projects above the cost of developing them—value received whether at actual sale or as an asset onto which they hold. The conventional way of assessing return on an apartment development is to do a two step analysis:

- to value the structure as if it were being sold, based on its current income and the capitalization rate that reflects the market's assessment of the value of the income stream it will produce over time, or
  Value= NOI/Cap Rate
- to assess profitability in terms of that Value relative to the costs of development

The best mechanism for taking the second step is to evaluate IRR, in order to measure the return on what the developer actually invests (equity) as distinct from the construction loan—again as LAHD did in the Trammell Crow case. An alternative, again closer to the HR&A analysis for comparison purposes, is to evaluate:
(Value – TDC)/TDC, which is the profit above costs received at a (potential or actual) sale, divided by the total costs of the development. It is this measure, Profit/TDC—the same measure as in the condominium analysis above— that we use in our apartment analysis.

For any measure, the threshold level employed is, again, key. HR&A's threshold level is far too high for the measure it uses, producing much higher return thresholds than we know developers are seeking. HR&A uses a 0.09 or 9% threshold level for its NOI/TDC measure. Applying a reasonable capitalization rate of 0.07[9] and some algebra, it produces:

Profit/TDC = 0.286, or a profit rate of 28.6%.

This is nearly three times the 0.1 level we saw was appropriate in the condominium case and which BAE applied in its apartment analysis. It would produce an IRR nearly three times as high as the 18% level that is in the middle of the consensus range of 15% - 20% for the threshold for that measure. We therefore use 0.1 as the threshold level for Profit/TDC in our feasibility analysis, in place of HR&A's implicit use of 0.286.

Table 5
Comparison of Feasibility Thresholds for Apartments as Indicated by Recent Studies

Study:	HRA	LAHD	Bay Area Economics	BRE REIT verbal
Date:	5/05	early 05	various - 2/3/04	9/05
Project:	n/a	Trammell Crow Alexan	n/a	n/a
Description:		large/new		
NOI/TCD	**9.0%**	n/a	0.0%	**6.5%**
Profit/TDC**	28.6%	n/a	**10.0%**	n/a
Profit/Equity	>100.0%	**15.0%**	40.0%	n/a
Leveraged Annual IRR*	>50.0%	**15.0%**	n/a	n/a

Notes:
* Assumed 25 equity, 75% debt, and apartment building sales after stabilized occupancy.
** Assumed 7% capitalization rate in calculating capitalized value, and then profit is equal to capitalized value less total development cost (TDC).
Bolded #s indicate the analyst's specified thresholds.
Unbolded #s are calculated based on 25/75 equity/debt ration and certain margin between TDC and Net Sales.

B. Rents for Apartments

The data HR&A uses to estimate rents for prototype developments are simply inadequate for so crucial a task. The data are presented in Table 8 of its report. The two-bedroom unit data is the data on which HRA relies. For Pacific Palisades, there are three such observations; for Venice/Playa, five, and in San Pedro, three. For most of the buildings, there is no information provided about when they were built, despite the importance of age in rental value. HR&A uses the averages from these very limited sets of apartments in each sub-zone in its feasibility analysis.

Given the limitations of these data, especially with regard to future new units, we used the rent per square foot of a recently proposed development (Alexan Marina) located near the Venice/Marina Del Rey border for the rent in that area: $2.49 per s.f., replacing HR&A's $1.89. For Pacific Palisades, we drew on the inadequate HR&A data but used only the two of three data points from relatively recently built projects (rents for buildings

[9] Capitalization rates in West Los Angeles, according to HR&A appendices and other sources, currently range from under 0.05 to 0.064.

constructed in 1992 and 2003, but not 1973). The two bedroom units in those projects average \$2.36/sf, which we substitute for HR&A's \$2.24. We have not had the opportunity to research recent developments that might provide data for San Pedro and therefore adopted the highest of HR&A's three observations: \$1.62. Additional research on rents is absolutely necessary in at least 2 and perhaps in all three of the sub-zones.

C. Capitalization Rates

As a highly conservative assumption, our feasibility analysis reported in Table 3 used a capitalization rate of 0.07 in computing apartment sales values and thence profits. Recent rates especially in San Pedro are well below that level, according to HR&A's own data cited in their Table 10, at 0.049. Adjusting the cap rate for San Pedro prototypes to 0.06, still well above observed levels in that area, makes a major difference for the 24 unit prototype. Three very low-income on-site units are feasible, rather than no inclusionary provisions as currently in Table 3 for that structure. Once adequate data for San Pedro rents has been obtained and the apartment prototypes are reanalyzed, consideration should be given to pursuing the lower cap rate's implications.

IV. Other Issues

A. Density Bonus Analysis

State law and the Settlement Agreement[10] require the City Council to award a developer a density bonus. The California Government Code provides that a city *must*[11] grant a density bonus when a developer agrees to construct either at least 10% of the total units for very low or low income households or 5% of the total units for very low income households.[12] A "density bonus" means "a density increase of at least 20 percent … *over the otherwise maximum allowable residential density under the applicable zoning ordinance*."[13] The density bonus can be increased up to a maximum of 35 percent.[14] Although State law allows a developer to obtain a density bonus and developers reserving affordable units on-site are likely to seek the bonus, HRA's report ignores the impacts a density bonus will have on a feasibility determination.

A density bonus makes a large difference in feasibility analysis for inclusionary units because it allows affordable units to be added to structures with zero or reduced impact on the number of profit-producing market-rate units and because additional units impose

---

[10] Section V.E. of the Mello Act Settlement provides as follows: "City policies shall apply the incentives set forth in the Affordable Housing Incentives Guidelines, including a Density Bonus, to the provision of Affordable Replacement Units or Inclusionary Units."

[11] The California Government Code supersedes any city or county development standard. The Code states: "In no case may a city…apply any development standard that will have the effect of precluding the construction of a development meeting the criteria of subdivision (b) at the densities or with the concessions or incentives permitted by this section." CAL. GOVT. CODE § 65915(e).

[12] CAL. GOVT. CODE § 65915(b)(1-2).

[13] *Id.* § 65915(g)(1).

[14] *Id.* Under the statutory formula, providing 11% of the units for very low-income households increases the density bonus to the maximum of 35 percent.

no additional land cost. Assume that the provisions of the bonus follow state law. Table 4 shows the effects on feasibility for inclusionary units, compared to Tables 1 and 3.[15] The impacts are substantial for the larger buildings with one exception, but most of the smaller buildings remain unable to support one inclusionary unit on site.

Table 6
Impact of Density Bonus
On Very Low-Income Units Feasible On Site

Project	**Affordable Units With Density Bonus (@10% return on TDC)**	**Affordable Units Without Density Bonus (@ 10% return on TDC)**
Condominiums		
PP 5 units	None feasible	In lieu fee
PP 18 units	6	3
VP 5 units	1	In lieu fee
VP 22 units	7	6
SP 7 units	None feasible	In lieu fee
SP 24 units	8	5
Apartments		
PP 5 units	None feasible	In lieu fee
PP 18 units	4	1
VP 5 units	None feasible	In lieu fee
VP 22 units	7	3
SP 7 units	None feasible	None feasible
SP 24 units	None feasible	None feasible

B. Off-site Options

HR&A improperly limits the off-site analysis to rental units.[16] If a developer of ownership units is permitted to provide off-site affordable units, those units must be ownership units.
The Mello Act allows on-site units to be located off-site under certain circumstances. The nature of those units (as ownership versus rental) does not change by changing the location. Therefore, HR&A must analyze off-site ownership units.

---

[15] Table 4 shows the impact of the density bonus using HR&A's condominium prices and the revision to rents that we were able to make given the inadequate H$&A rent data. A final density bonus analysis should adopt revised condominium prices (as in Table 2) and incorporate improved information on rents once it is obtaincd.

[16] See HR&A Study, p. 73.

The provision of affordable units off-site could be a cheaper option than on site for the developer because the off-site units (like density bonus units) do not reduce the number of profitable market-rate units that can be developed. The impacts of that option are however quite limited.

Using HR&A's data for project costs and off-site units, and the corrected measures of return and threshold levels, we find the following:

- All the larger condo buildings (18, 22, and 24 units) already can feasibly provide 10% or more inclusionary units on site for people of very low-income. Unless there is a preference for larger percentages of off-site units over those on-site units, off-site feasibility analysis makes no difference for those cases.
- Using HR&A condo prices (as in Table 1), the one usable off-site option is for the 5 unit condominium in Venice/Playa. One off-site unit is feasible though one on-site was not.
- Using revised condo prices (as in Table 2), for the 7 unit condominium in San Pedro, one off-site unit is feasible though one on-site is not.
- Apartment projects are not affected by providing an off-site option, at least pending further analysis of rents. Those that cannot afford on-site inclusionary units cannot afford off-site units either.

C. Replacement Units

1. Single Family Dwellings and Duplexes

Pursuant to the Mello Act, if a developer converts or demolishes a residential structure with less than three dwelling units, the developer must replace affordable units demolished or converted only if it is feasible to do so.[17] HR&A's study does not include any analysis regarding the feasibility of replacing affordable units in residential structures with less than three dwelling units. The study should be supplemented to include such an analysis. The City cannot reply upon HR&A's inclusionary analysis for replacement units because there are no land costs if the replacement units are located on-site. This distinguishes replacement feasibility analysis from inclusionary analysis.

2. Buildings with Three or More Units

Pursuant to the Mello Act, if a developer converts or demolishes affordable units in a building with three or more units, the developer must replace the affordable units.[18] With respect to the location of such replacement affordable units, the Mello Act provides:

> Replacement dwelling units shall be located within the same city or county as the dwelling units proposed to be converted or demolished. *The replacement dwelling units shall be located on the site of the converted or demolished*

[17] CA Gov't Code Sec. 65590(b)(1)
[18] CA Gov't Code Sec. 65590(b)

> *structure or elsewhere within the coastal zone if feasible, or, if location on the site or elsewhere in the coastal zone is not feasible, they shall be located within three miles of the coastal zone.*

CA Gov't Code Sec. 65590(b) (emphasis added).

The Mello Act states a clear preference that replacement units be located on-site or elsewhere within the coastal zone. Replacement units should only be located within three miles of the coastal zone if location on-site or elsewhere in the coastal zone is not feasible.

As a matter of sound policy, the City's Mello Ordinance should adopt a three tiered preference regarding location of replacement affordable units. Developers should be instructed to locate replacement affordable units: (1) on-site; (2) if not feasible on-site, then elsewhere within the coastal zone within the same council district; (3) if not feasible elsewhere in the coastal zone within the same council district, then within three miles of the coastal zone within the same council district. This three tiered approach will ensure that replacement affordable units are located as close to the demolished or converted units as possible. This approach will best preserve affordable housing in each sub-area of the coastal zone. This approach will also prevent developers from placing all replacement units in the least expensive parts of the coastal zone.[19]

3. Affordability Level Considerations

HR&A misstates the Mello Act's affordability requirements for replacement units. HR&A states that the Mello Act does not require adherence to any particular replacement unit requirement. HR&A alleges that the Mello Act "requires only that demolished or converted units that were occupied by low or moderate-income persons be replaced, one way or another. (See Study, p. 76). HR&A's interpretation is at odds with the plain language of the Mello Act, which provides:

> The conversion or demolition of existing residential dwelling units occupied by persons and families of low or moderate income . . . shall not be authorized unless provision has been made for the replacement *of those dwelling units for persons and families of low or moderate income.*

CA Gov't Code Sec. 65590(b) (emphasis added).

This code section supports a "like for like" requirement for replacement of affordable units. In other words, replacement units must be maintained at the same affordability level as the demolished or converted units.

HR&A recommends that the City adopt an intermediate targeting standard for replacement units, which would allow developers to replace very low-income units with either low or very low-income units. We strongly disagree with HR&A's

[19] The Mello Act uses this three tiered approach for its inclusionary requirement. CA Gov't Code Sec. 65590(d).

recommendation. The plain language of the Mello Act supports "like for like" replacement. Policy considerations, moreover, weigh in favor of "like for like" replacement. Developers will always opt to build low-income units instead of very low-income units if given the choice. Without a "like for like replacement" requirement, the city will continually lose very low-income units that will never be replaced. A "like for like" replacement standard ensures that very low-income families will not be entirely priced out of the housing market in the coastal zone and extended coastal zone. A "like for like" replacement standard, therefore, is in the best interest of the City and its residents.

4. Project Options

Project options should be considered in determining the feasibility of replacing demolished or converted affordable units. If, for example, a double-sized lot allows a subdivision, this should be considered in the feasibility analysis of on-site replacement. Similarly, if zoning regulations allow multiple units where only one on-site unit is proposed, a multi-unit option should be considered in determining feasibility.

D. Duration of Affordability Covenants

We support HR&A's recommendation to maintain the affordability of replacement and inclusionary units for a period of 55 years.

The City should nonetheless consider adopting a policy requiring that affordable units be maintained as affordable for the life of a development project. The Coastal Commission recently modified the Pioneer Bakery development to require that the affordable units be maintained as affordable for the life of the project.

E. Comparability of Market Rate and Affordable Units

On pages 54 and 59 of its Study, HR&A recommends that affordable units not be the same size as market rate units. HR&A recommends that, despite the size of market rate units, affordable units should be sized as follows: 500 square feet for a one bedroom unit, 800 square feet for a two bedroom unit, 1,000 square feet for a three bedroom unit and 1,200 square feet for a four bedroom unit.

HR&A's recommendation violates the terms of our Settlement Agreement. The Settlement provides that "City Policies[20] shall require compliance with the following

---

[20] The Settlement defines "City Policies" to include the Permanent Mello Ordinance. The Settlement defines City Policies as follows: "'City Policies' means all interim and permanent policies, ordinances and resolutions the City adopts to implement the Mello Act and the terms of this Agreement." (Settlement, Section III.) The Settlement further provides that "All City Policies and City Procedures, and all other ordinances, programs, plans, and policies in the Coastal Zone, shall be consistent with the Mello Act and this Agreement. All future zoning, land use, development and planning regulations, ordinances, resolutions and policies adopted by the City shall be consistent with the Mello Act and this Agreement." (Settlement, Section IV.B.)

portions of the Performance Standards set forth in the Affordable Housing Incentives Guidelines (Exhibit C): 7.5.1 Project Design; and 7.5.2 Equal distribution of amenities." (Settlement, Sec. V.G.4.)

The Project Design portion of the Performance Standards requires that affordable units:

> shall be comparable in every manner to market rate dwelling units, *including total square footage*, bedrooms size, closet space amenities, number of bathrooms, etc., except in the quality of interior "finish" materials (e.g., floor and wall coverings). The design of the restricted dwelling units should generally reflect the average number of bedrooms per dwelling units in the development. Restricted dwelling units shall not be confined to one type of dwelling unit within a development. (emphasis added).

HR&A's recommendation to limit the size of affordable units must be rejected by the City, as it violates the terms of our Settlement Agreement.

F. External Financing Assistance

On p. 55 of its Study, HR&A explains that it did not include consideration of any public subsidies or external financial assistance in its Study. HR&A's failure to consider public subsidies and external financial assistance violates the terms of our Settlement Agreement. Section VII.C.2.1. of our Settlement provides:

> The City shall enter into a contract with a qualified consultant to complete the Longer-Term Study. Among other provisions, the contract scope of work shall require the consultant to:
>
> To take into *consideration the public subsidies and other incentives* the City typically utilizes to encourage affordable housing in evaluating proposed City Policies regarding the feasibility of Affordable Replacement Units and Inclusionary Residential Units, as required by the Mello Act. (emphasis added).

HR&A, accordingly, must be instructed to consider public subsidies and other incentives in his Study, as this is required by our Settlement.

G. In Lieu Fees

1. In Lieu Fee Options for Replacement and Inclusionary Units

An in lieu fee option should not be offered for replacement or inclusionary units unless it is infeasible for a developer to provide even one replacement or inclusionary unit. If it is infeasible for a developer to provide one inclusionary or replacement unit, then the developer should be allowed to pay an in lieu fee for a partial unit. Such a policy will ensure that replacement and inclusionary units are actually built. In lieu fees are almost always insufficient to provide the same number of replacement and inclusionary units off-site due to rising construction costs and land prices, as well as a shortage of land in the coastal zone.

It is our understanding that City staff has recommended against an in lieu fee option for required replacement units. (Study, p. 64). We agree with this recommendation.

We do not agree with HR&A's recommendation to offer an in lieu fee option where inclusionary units are feasible. HR&A's recommendation conflicts with the plain language of the Mello Act. The Mello Act provides: "New housing developments constructed within the coastal zone *shall*, where feasible, provide housing units for persons and families of low or moderate income . . . . " CA Gov't Code Sec. 65590(d) (emphasis added). If it is feasible for a developer to provide inclusionary units, either on or off-site, the developer must do so. An in lieu fee option should not be made available if it is feasible to provide inclusionary units on or off-site.

Moreover, while the Mello Act specifically contemplates in lieu fees for replacement units, it does not do so for inclusionary units. With respect to replacement units, the Mello Act provides:

> The requirements of this subdivision for replacement dwelling units shall not apply to the following types of conversion or demolition unless the local government determines that replacement of all or any portion of the converted or demolished units is feasible, in which event replacement dwelling units shall be required:
>
> The conversion or demolition of a residential structure located within the jurisdiction of a local government which has established a procedure under which an applicant for conversion or demolition will pay an in lieu fee into a program, the various provisions of which, in aggregate, will result in the replacement of the number of dwelling units which would otherwise have been required by this subsection.

CA Gov't Code Sec. 65590(b) and (b)(4).

The Mello Act does not contain a similar provision regarding in lieu fees for inclusionary units. The Mello Act, therefore, does not allow in lieu fees for inclusionary units. The Mello Ordinance, accordingly, should not offer an in lieu fee option for inclusionary units.

2. Feasibility of Paying In Lieu Fees

On page 70 of its study, HR&A asserts that the in lieu fee amounts it has calculated for inclusionary units need to be tested for feasibility. HR&A concludes that the in lieu fees should be reduced to prevent projects from becoming infeasible. This proposal to reduce in lieu fees directly conflicts with the terms of the Settlement which require that in lieu fees be "sufficient to provide, in aggregate, the same number and type of inclusionary residential units which would otherwise be required by City Policies, the Mello Act and this Agreement." (Settlement, Sec. V.H.2.3.1). HR&A's proposal to reduce in lieu fees violates the terms of the Settlement.[21]

H. HR&A's In Lieu Fee Analysis

As explained above, the Mello Act does not allow in lieu fees for inclusionary units. Nevertheless, we want to explain why HR&A's proposed in lieu fees are too low since the in lieu fee option may be applied where less than one whole inclusionary unit is feasible.[22]

First, HR&A computes the in lieu subsidy necessary to support one very low income unit in the **extended** coastal zone, not the coastal zone itself. The impact of this decision affects land costs - HR&A's figures indicate lower costs per square foot of land in the Extended Zone compared to the Coastal Zone of $80 (out of $175) in Pacific Palisades, $65 (out of $150) in Venice-Playa Del Rey, and $10 (out of $50) in San Pedro-Harbor (HR&A's Table 15). With total true coastal land costs per unit of housing ranging to nearly $250,000 in smaller buildings and over $200,000 in the larger prototypes, the difference in computed in lieu fee subsidy per unit as a result of this choice is very large, especially in the first two sub-areas, ranging to as much as $100,000 per housing unit in some prototypes. HR&A's focus on the extended coastal zone is inappropriate. As noted above, the Mello Act favors development in the coastal zone. HR&A explain their choice of the lower Extended Zone land costs on the basis that less expensive land would be a requirement for such projects to be competitive for financing both from the City trust funds and external sources. However, the task at hand is specifically to estimate the in lieu subsidy cost without the use of those other subsidies because they are in such short supply. If the fee is properly set by that standard, the other sources would not need to be drawn upon. The in lieu cost per unit should be recalculated using coastal zone land costs, in order that the fees could in fact potentially be used to provide housing in that area.

A second smaller item is that HR&A determines subsidy per unit by dividing the total subsidy needed for its all-affordable unit prototype by 36. But the number of affordable units by HR&A's description is in fact 35. The 36th unit reserved for an on-site manager. The appropriate figure would thus be about 3 percent higher than HR&A's from that

---

[21] Although the Mello Act does not permit in lieu fees for inclusionary units, we nonetheless felt it was important to point out that Silvern's policy to reduce in lieu fees violates the Settlement. While the Mello Act allows in lieu fees for replacement units, the Mello Act specifically requires that the in lieu fees "will result in the replacement of the number of dwelling units which would otherwise have been required by this subdivision." CA Gov't Code Sec. 65590 (b)(4). The Mello Act, accordingly, does not allow in lieu fees for replacement units to be tested and reduced for feasibility.

[22] It is important to note in this context that our experts' analysis indicates that one or more whole inclusionary units are feasible in all condominium prototypes except the small San Pedro project and in 2 of the 3 larger apartment prototypes. Use of improved rental data may add to that list of apartment projects.

factor alone. Finally, a mechanism is needed to adjust in lieu subsidy costs as costs of development continue to rise past the time of HR&A's calculations.

V. Table Summarizing our Analysis and Conclusions

Table 7, on the following page, summarizes our analysis and conclusions in this letter.

TABLE 7

Feasibility of Inclusionary Units with Alternative Methods and Assumptions **(Number of very low-income units on site)**

PROJECT PROTOTYPE	HR&A	Corrected Feasibility Measures And Thresholds P/TDC=0.10*	P/TDC=0.15**	Corrected Feasibility Measures, Thresholds And Prices P/TDC=0.10	P/TDC=0.15	Corrected Feasibility Measures, Thresholds And Rents***** P/TDC=0.10	P/TDC=0.15	With Density Bonus*** P/TDC=0.10	Off-site Units P/TDC=0.10
CONDOMINIUMS									
Pacific Palisades									
5 units	0	0	0	1	0			0	0
18 units	1	3	2	5	5			8	n.a.
Venice/Playa Del Rey									
5 units	0	0	0	1	1			1	1
22 units****	2	6	5	9	8			7	n.a.
San Pedro/Harbor									
7 units	0	0	0	0	0			0	1******
24 units	2	5	4	7	6			8	n.a.
APARTMENTS									
Pacific Palisades									
5 units	0					0	0	0	0
18 units	0					1	0	4	n.a
Venice/Playa Del Rey									
5 units	0					0	0	0	0
22 units****	0					3	2	7	n.a
San Pedro/Harbor									
7 units	0					0	0	0	0
24 units	0					0	0	0	0

Notes:
*P is profit, TDC is total development cost, and the analysis uses a feasibility threshold level of 0.10 for P/TDC.
**P is profit, TDC is total development cost, and the analysis uses a feasibility threshold level of 0.15 for P/TDC.
***The density bonus analysis uses, for condominiums, the same revised feasibility measures and thresholds as the second column of numbers in the table (not adjusting for condo prices). It uses, for apartments, the same revised feasibility measures, thresholds, and rents as the sixth column of numbers.
****All the columns in this row except HR&A assume normal building efficiency, correcting an apparent HR&A error.
*****HR&A rent data are inadequate for all 3 regions. We use improved data for Venice, Slightly improved data for Pacific Palisades, but lack an adequate substitute in San Pedro.
******Only if adjusted condo prices are used.

VI. Conclusion

For the foregoing reasons, HR&A's report needs to be revised to properly analyze the feasibility of inclusionary and replacement units in the coastal zone. The City should not adopt an ordinance based upon the flawed thresholds, measures of returns and assumptions in the HR&A study. The City should also reject HR&A's policy recommendations, as they violate the terms of our Settlement Agreement. We are available to work with the City and HR&A to correct the analysis and policy recommendations. Thank you for your consideration of our comments.

Sincerely,

Susanne Browne
Staff Attorney

Attachments (We have attached 33 Spreadsheets that include the data supporting the findings in the 7 Tables in our analysis).

cc: Gerald Gubatan, Office of Councilmember Reyes
Aaron Gross, Office of Councilmember Rosendahl
Lynn Hansen , LAHD
Mercedes Marquez, LAHD
Jane Blumenfeld, Planning Dept.

EXHIBIT 3

ALTERNATIVE IN-LIEU FEES
PREPARED BY HR&A

HAMILTON, RABINOVITZ & ALSCHULER, INC.
Policy, Financial & Management Consultants

MEMORANDUM FOR: Alan Bell, Department of City Planning
City of Los Angeles

MEMORANDUM FROM: Paul J. Silvern

SUBJECT: Alternative Mello Act In-Lieu Fee Calculation

DATE: January 2, 2007

At your request, we have prepared an alternative calculation of in-lieu fees for the proposed Mello Act permanent ordinance, and tested it for financial feasibility. This alternative utilizes higher land prices directly within the City's three Coastal Zone subareas as of 2004, rather than land prices in each subarea's Extended Coastal Zone. We conclude that the resulting higher fees would still be feasible for the larger prototypes utilized in our May 2006 Technical Study in all three of the City's Coastal Zone subareas.

The Technical Study In-Lieu Fee Amounts

In our May 2006 Technical Study we presented a method for calculating a fee that could be charged to new developers of market rate multi-family residential developments planned for the City's Coastal Zone in lieu of providing 10 percent of the units in those developments at prices affordable to very low-income households.

As we noted in the Technical Study, although the City and Plaintiffs apparently agreed that a formal "nexus" study is not required to support in-lieu fees for the implementation of the Mello Act in Los Angeles, the lack of a controlling judicial decision about whether the Mitigation Fee Act[1] applies to in-lieu fees for similar inclusionary housing programs suggests that caution should be exercised in the derivation of a Mello Act in-lieu fee. Accordingly, the method proposed for deriving the an in-lieu fee was based on the principle in the Mitigation Fee Act that the amount of a development fee must be reasonably related to the City's cost of delivering the public infrastructure for which the fee is assessed. Thus, the City's direct cost to construct affordable units, or to facilitate such construction by a third party, was used as the basis for the fee.

Accordingly, we estimated the cost that the City would incur to produce a unit of housing affordable to a very low-income household in the vicinity of the Coastal Zone, based on an

[1] Govt. Code § 66000, *et seq*.

affordable development prototype which would qualify for funding with tax-exempt bonds, Low-Income Housing Tax Credits and the State Multifamily Housing Program, although proceeds from such external financing were not included in deriving the fee. The development prototype was a 36-unit project on an R3 lot developed with a 35 percent density bonus, which is typical of such projects. It is targeted at households with a mix of very low incomes between 30 and 60 percent of Area Median Income.

The costs to develop this prototype were estimated from certified construction costs for a bond-funded project constructed in another part of the City, as provided to HR&A by LAHD, with certain adjustments for coastal land costs, more current construction costs and HR&A's experience assisting affordable housing developers. Three development budgets were prepared, assuming the prototype would be developed within the three-mile Extended Coastal Zone adjacent to each subarea, where land cost is less than directly inside the Coastal Zone. This assumption reflected the fact that less expensive land would be a requirement for such projects to be competitive for financing both from the City's trust funds and external sources.

After subtracting from these costs the amount of construction loan that could be supported by the prototype's Net Operating Income (NOI), we concluded that the resulting fee per required unit would be $178,835 in the San Pedro-Harbor subarea; $209,075 in the Venice-Playa Del Rey subarea; and $220,061 in the Pacific Palisades subarea. We then calculated the in-lieu fee that would apply to each of the six condominium prototypes used in our Technical Study and tested the financial feasibility implications using the study's feasibility methods and thresholds. We concluded that a fee amount that allows the City to directly offset a 10 percent on-site affordable very low-income housing requirement is feasible for the three larger condominium prototypes, but this scale of fee would be feasible for the five-unit Venice-Playa Del Rey prototype only under then-current, but historically atypical, market conditions in which a 15 percent gross margin might apply. The maximum fee that could be charged to the smaller Venice-Playa Del Rey prototype and still maintain the long-term average minimum 18 percent gross margin is $83,630, or about 40 percent of the otherwise applicable in-lieu fee.

<u>Alternative Fee Amounts</u>

Comments received on the Technical Study questioned the use of the land prices in the Extended Coastal Zone in calculating the in-lieu fee, rather than the land cost directly inside the Coastal Zone. Although using the Coastal Zone land price could be inconsistent with the way the fees might actually be used by the City to develop affordable housing using fee proceeds, we tested the implications of using the higher land costs. Doing so changes total development cost for the 36-unit affordable housing prototype in each Coastal Zone subarea, as shown in Appendix A. After deducting supportable construction debt from these revised costs the resulting fees per required affordable unit are $186,159 in the San Pedro-Harbor subarea; $260,343 in the Venice-Playa Del Rey subarea; and $278,653 in the Pacific Palisades subarea (see Appendix B).

These results, along with the fee amounts expressed per market rate unit and per square foot, based on the characteristics of the six condominium prototypes used in the Technical Study are shown below, along with the results of testing them for financial feasibility. The pattern of these feasibility results is identical to the pattern using fees based on Extended Coastal Zone land prices — i.e., the fees are still feasible for the larger condominium prototypes in each subarea, but infeasible for the smaller prototypes.

HR&A Technical Study Table 28 -- Revised
Financial Feasibility Results for In-Lieu Fees for Condominium Prototypes with a 10% Very Low-Income Affordable Housing Requirment, Assuming Coastal Zone Land Prices and Extended Coastal Zone Prices

Coastal Zone Subarea and Prototype	Fee/ Req'd. Unit	Fee Amount	Fee/ GBA SF	Fee/ Mkt. Unit	Feas.?[1]
WITH COASTAL ZONE SUBAREA LAND PRICES					
Palisades	**$278,653**				
5 units		$139,327	$15.26	$27,865	NO
18 units		$ 501,575	$16.50	$27,865	**YES**
Venice-Playa Del Rey	**$260,343**				
5 units		$ 130,172	$14.16	$26,034	NO
22 units		$ 572,755	$19.00	$26,034	**YES**
San Pedro-Harbor	**$186,159**				
7 units		$ 130,311	$11.91	$18,616	NO
24 units		$ 446,782	$14.43	$18,616	**YES**
WITH EXTENDED COASTAL ZONE SUBAREA LAND PRICES					
Palisades	**$ 220,061**				
5 units		$110,031	$12.05	$22,006	NO
18 units		$ 396,110	$13.03	$22,006	**YES**
Venice-Playa Del Rey	**$ 209,075**				
5 units		$ 104,537	$11.37	$20,907	NO
22 units		$ 459,965	$15.26	$20,907	**YES**
San Pedro-Harbor	**$ 178,835**				
7 units		$ 125,184	$11.44	$17,883	NO
24 units		$ 429,204	$13.86	$17,883	**YES**

[1] Feasibility Threshold = 18% Gross Margin

Source: HR&A, Inc.

APPENDIX A

Development Costs for the 36-Unit Affordable Housing Prototype,
by Coastal Zone Subarea, Using Coastal Zone Subarea Land Prices
Rather than Extended Coastal Zone Subarea Land Prices

HR&A Technical Study Table 23 -- Revised
Development Budget for a Prototypical Coastal Zone Affordable Housing Development[1]
Pacific Palisades Subarea, Using Coastal Zone Land Price

Development Cost Line Items	Calc. Factors		Extension	Per Unit	Per GBA
Site Acquisition					
Land Cost	$175	per SF	$ 4,032,000	$ 112,000	$ 117.89
Closing Cost	4.0%	x Land Cost	$ 161,280	$ 4,480	$ 4.72
Subtotal: Acquisition			$ 4,193,280	$ 116,480	$ 123
Hard Costs					
Off-site Improvements	$1,500	per unit	$ 54,000	$ 1,500	$ 1.58
On-Site Improvements	$5,500	per unit	$ 198,000	$ 5,500	$ 5.79
Demolition/Site Work	Allowance		$ 20,000	$ 556	$ 0.58
Construction (structure)	$80	per GBA	$ 2,736,000	$ 76,000	$ 80.00
Construction (semi-subt. parking)	$12,000	per space	$ 648,000	$ 18,000	$ 18.95
GC Profit, Overhead & General Conditions	14%	x subtotal	$ 511,840	$ 14,218	$ 14.97
Construction Contingency	7%	Subtotal	$ 291,749	$ 8,104	$ 8.53
Subtotal Hard Costs			$ 4,459,589	$ 123,877	$ 130.40
Soft Costs					
Technical Consultants					
Environmental Consultants	Allowance		$ 2,500	$ 69	$ 0.07
Architect	6%	x Hard Costs	$ 267,575	$ 7,433	$ 7.82
Landscape Architect	Allowance		$ 2,500	$ 69	$ 0.07
Engineers and Surveyor	Allowance		$ 80,000	$ 2,222	$ 2.34
Construction Manager	Allowance		$ 65,000	$ 1,806	$ 1.90
Subtotal Technical Consultants			$ 417,575	$ 11,599	$ 12.21
Other Soft Costs				$ -	$ -
Developer Fee	$ 15,000	x Units	$ 540,000	$ 15,000	$ 15.79
Local Permits and Fees	$ 6,500	per unit	$ 234,000	$ 6,500	$ 6.84
Marketing & Lease-up	500	per unit	$ 18,000	$ 500	$ 0.53
Furnishings	$ 1,000	per unit	$ 36,000	$ 1,000	$ 1.05
Accounting/Audit	250	per unit	$ 9,000	$ 250	$ 0.26
Administrative and Organizational	Allowance		$ 10,000	$ 278	$ 0.29
Market Study	Allowance		$ 10,000	$ 278	$ 0.29
Real Estate Taxes	1.2%	x Land (x2) + Hard (x1)	$ 308,308	$ 8,564	$ 9.01
Insurance - Liability & All Risk	$ 1,400	per unit	$ 50,400	$ 1,400	$ 1.47
Subtotal Other Soft Costs			$ 1,215,708	$ 33,770	$ 35.55
Subtotal Soft Costs			$ 1,633,283	$ 45,369	$ 47.76
Soft Cost Contingency	2%	x Subtotal	$ 32,666	$ 907	$ 0.96
Subtotal Soft Costs			$ 1,665,949	$ 46,276	$ 48.71
Legal Fees					
Lender Legal Costs paid by Applicant	$ 900	per unit	$ 32,400	$ 900	$ 0.95
Real Estate Legal	$ 2,000	per unit	$ 72,000	$ 2,000	$ 2.11
Subtotal Legal Fees			$ 104,400	$ 2,900	$ 3.05
Reserves				$ -	$ -
Capitalized Operating Reserve	6 mos ops expenses		$ 64,800	$ 1,800	$ 1.89
Subtotal Reserves			$ 64,800	$ 1,800	$ 1.89
Financing Interest and Fees					
Construction Interest	Subtotal x 6% x 12 mos x 65% out		$ 432,371	$ 12,010	$ 12.64
Construction Lender Fees	1%	x loan	$ 110,864	$ 3,080	$ 3.24
Permanent Loan Origination Fee	$ 350	per unit	$ 12,600	$ 350	$ 0.37
Permanent Lender Fees	Allowance		$ 25,000	$ 694	$ 0.73
TCAC Application/Monitoring Fees	Allowance		$ 40,000	$ 1,111	$ 1.17
Bond Issuance & Premium	$ 2,000	per unit	$ 72,000	$ 2,000	$ 2.11
Bank Construction Monitoring	$ 150	per unit	$ 5,400	$ 150	$ 0.16
Title & Recording	$ 500	per unit	$ 18,000	$ 500	$ 0.53
Appraisal (bank)	Allowance		$ 7,850	$ 218	$ 0.23
Subtotal: Financing Interest and Fees			$ 724,086	$ 20,113	$ 21.17
TOTAL DEVELOPMENT COST			$ 11,212,103	$ 311,447	$ 327.84

[1] Based on project program in Technical Study Table 22.

Source: HR&A, Inc.

HR&A Technical Study Table 24 -- Revised
Development Budget for a Prototypical Coastal Zone Affordable Housing Development[1]
Venice-Playa Del Rey Subarea, Using Coastal Zone Land Price

Development Cost Line Items	Calc. Factors		Extension	Per Unit	Per GBA
Site Acquisition					
Land Cost	$150	per SF	$ 3,456,000	$ 96,000	$ 101.05
Closing Cost	4.0%	x Land Cost	$ 138,240	$ 3,840	$ 4.04
Subtotal: Acquisition			$ 3,594,240	$ 99,840	$ 105
Hard Costs					
Off-site Improvements	$1,500	per unit	$ 54,000	$ 1,500	$ 1.58
On-Site Improvements	$5,500	per unit	$ 198,000	$ 5,500	$ 5.79
Demolition/Site Work	Allowance		$ 20,000	$ 556	$ 0.58
Construction (structure)	$80	per GBA	$ 2,736,000	$ 76,000	$ 80.00
Construction (semi-subt. parking)	$12,000	per space	$ 648,000	$ 18,000	$ 18.95
GC Profit, Overhead & General Conditions	14%	x subtotal	$ 511,840	$ 14,218	$ 14.97
Construction Contingency	7%	Subtotal	$ 291,749	$ 8,104	$ 8.53
Subtotal Hard Costs			$ 4,459,589	$ 123,877	$ 130.40
Soft Costs					
Technical Consultants					
Environmental Consultants	Allowance		$ 2,500	$ 69	$ 0.07
Architect	6%	x Hard Costs	$ 267,575	$ 7,433	$ 7.82
Landscape Architect	Allowance		$ 2,500	$ 69	$ 0.07
Engineers and Surveyor	Allowance		$ 80,000	$ 2,222	$ 2.34
Construction Manager	Allowance		$ 65,000	$ 1,806	$ 1.90
Subtotal Technical Consultants			$ 417,575	$ 11,599	$ 12.21
Other Soft Costs				$ -	$ -
Developer Fee	$ 15,000	x Units	$ 540,000	$ 15,000	$ 15.79
Local Permits and Fees	$ 6,500	per unit	$ 234,000	$ 6,500	$ 6.84
Marketing & Lease-up	500	per unit	$ 18,000	$ 500	$ 0.53
Furnishings	$ 1,000	per unit	$ 36,000	$ 1,000	$ 1.05
Accounting/Audit	250	per unit	$ 9,000	$ 250	$ 0.26
Administrative and Organizational	Allowance		$ 10,000	$ 278	$ 0.29
Market Study	Allowance		$ 10,000	$ 278	$ 0.29
Real Estate Taxes	1.2%	x Land (x2) + I	$ 279,554	$ 7,765	$ 8.17
Insurance - Liability & All Risk	$ 1,400	per unit	$ 50,400	$ 1,400	$ 1.47
Subtotal Other Soft Costs			$ 1,186,954	$ 32,971	$ 34.71
Subtotal Soft Costs			$ 1,604,529	$ 44,570	$ 46.92
Soft Cost Contingency	2%	x Subtotal	$ 32,091	$ 891	$ 0.94
Subtotal Soft Costs			$ 1,636,620	$ 45,462	$ 47.85
Legal Fees					
Lender Legal Costs paid by Applicant	$ 900	per unit	$ 32,400	$ 900	$ 0.95
Real Estate Legal	$ 2,000	per unit	$ 72,000	$ 2,000	$ 2.11
Subtotal Legal Fees			$ 104,400	$ 2,900	$ 3.05
Reserves				$ -	$ -
Capitalized Operating Reserve	6 mos ops expenses		$ 64,800	$ 1,800	$ 1.89
Subtotal Reserves			$ 64,800	$ 1,800	$ 1.89
Financing Interest and Fees					
Construction Interest	Subtotal x	6% x 12 mos x (	$ 407,865	$ 11,330	$ 11.93
Construction Lender Fees	1%	x loan	$ 104,581	$ 2,905	$ 3.06
Permanent Loan Origination Fee	$ 350	per unit	$ 12,600	$ 350	$ 0.37
Permanent Lender Fees	Allowance		$ 25,000	$ 694	$ 0.73
TCAC Application/Monitoring Fees	Allowance		$ 40,000	$ 1,111	$ 1.17
Bond Issuance & Premium	$ 2,000	per unit	$ 72,000	$ 2,000	$ 2.11
Bank Construction Monitoring	$ 150	per unit	$ 5,400	$ 150	$ 0.16
Title & Recording	$ 500	per unit	$ 18,000	$ 500	$ 0.53
Appraisal (bank)	Allowance		$ 7,850	$ 218	$ 0.23
Subtotal: Financing Interest and Fees			$ 693,296	$ 19,258	$ 20.27
TOTAL DEVELOPMENT COST			$ 10,552,944	$ 293,137	$ 308.57

[1] Based on project program in Technical Study Table 22.

Source: HR&A, Inc.

HR&A Technical Study Table 25 -- Revised
Development Budget for a Prototypical Coastal Zone Affordable Housing Development[1]
San Pedro-Harbor Subarea, Using Coastal Zone Land Price

Development Cost Line Items	Calc. Factors		Extension	Per Unit	Per GBA
Site Acquisition					
Land Cost	$50	per SF	$ 1,152,000	$ 32,000	$ 33.68
Closing Cost	4.0%	x Land Cost	$ 46,080	$ 1,280	$ 1.35
Subtotal: Acquisition			$ 1,198,080	$ 33,280	$ 35
Hard Costs					
Off-site Improvements	$1,500	per unit	$ 54,000	$ 1,500	$ 1.58
On-Site Improvements	$5,500	per unit	$ 198,000	$ 5,500	$ 5.79
Demolition/Site Work	Allowance		$ 20,000	$ 556	$ 0.58
Construction (structure)	$80	per GBA	$ 2,736,000	$ 76,000	$ 80.00
Construction (semi-subt. parking)	$12,000	per space	$ 648,000	$ 18,000	$ 18.95
GC Profit, Overhead & General Conditions	14%	x subtotal	$ 511,840	$ 14,218	$ 14.97
Construction Contingency	7%	Subtotal	$ 291,749	$ 8,104	$ 8.53
Subtotal Hard Costs			$ 4,459,589	$ 123,877	$ 130.40
Soft Costs					
Technical Consultants					
Environmental Consultants	Allowance		$ 2,500	$ 69	$ 0.07
Architect	6%	x Hard Costs	$ 267,575	$ 7,433	$ 7.82
Landscape Architect	Allowance		$ 2,500	$ 69	$ 0.07
Engineers and Surveyor	Allowance		$ 80,000	$ 2,222	$ 2.34
Construction Manager	Allowance		$ 65,000	$ 1,806	$ 1.90
Subtotal Technical Consultants			$ 417,575	$ 11,599	$ 12.21
Other Soft Costs				$ -	$ -
Developer Fee	$ 15,000	x Units	$ 540,000	$ 15,000	$ 15.79
Local Permits and Fees	$ 6,500	per unit	$ 234,000	$ 6,500	$ 6.84
Marketing & Lease-up	500	per unit	$ 18,000	$ 500	$ 0.53
Furnishings	$ 1,000	per unit	$ 36,000	$ 1,000	$ 1.05
Accounting/Audit	250	per unit	$ 9,000	$ 250	$ 0.26
Administrative and Organizational	Allowance		$ 10,000	$ 278	$ 0.29
Market Study	Allowance		$ 10,000	$ 278	$ 0.29
Real Estate Taxes	1.2%	x Land (x2) +	$ 164,538	$ 4,570	$ 4.81
Insurance - Liability & All Risk	$ 1,400	per unit	$ 50,400	$ 1,400	$ 1.47
Subtotal Other Soft Costs			$ 1,071,938	$ 29,776	$ 31.34
Subtotal Soft Costs			$ 1,489,513	$ 41,375	$ 43.55
Soft Cost Contingency	2%	x Subtotal	$ 29,790	$ 828	$ 0.87
Subtotal Soft Costs			$ 1,519,304	$ 42,203	$ 44.42
Legal Fees					
Lender Legal Costs paid by Applicant	$ 900	per unit	$ 32,400	$ 900	$ 0.95
Real Estate Legal	$ 2,000	per unit	$ 72,000	$ 2,000	$ 2.11
Subtotal Legal Fees			$ 104,400	$ 2,900	$ 3.05
Reserves				$ -	$ -
Capitalized Operating Reserve	6 mos ops expenses		$ 32,400	$ 900	$ 0.95
Subtotal Reserves			$ 32,400	$ 900	$ 0.95
Financing Interest and Fees					
Construction Interest	Subtotal x	6% x 12 mos x	$ 308,576	$ 8,572	$ 9.02
Construction Lender Fees	1%	x loan	$ 79,122	$ 2,198	$ 2.31
Permanent Loan Origination Fee	$ 350	per unit	$ 12,600	$ 350	$ 0.37
Permanent Lender Fees	Allowance		$ 25,000	$ 694	$ 0.73
TCAC Application/Monitoring Fees	Allowance		$ 40,000	$ 1,111	$ 1.17
Bond Issuance & Premium	$ 2,000	per unit	$ 72,000	$ 2,000	$ 2.11
Bank Construction Monitoring	$ 150	per unit	$ 5,400	$ 150	$ 0.16
Title & Recording	$ 500	per unit	$ 18,000	$ 500	$ 0.53
Appraisal (bank)	Allowance		$ 7,850	$ 218	$ 0.23
Subtotal: Financing Interest and Fees			$ 568,548	$ 15,793	$ 16.62
TOTAL DEVELOPMENT COST			$ 7,882,320	$ 218,953	$ 230.48

[1] Based on project program in Technical Study Table 22.

Source: HR&A, Inc.

Appendix B

HR&A Technical Study Table 27 -- Revised
Derivation of Affordable Housing In-Lieu Fee,
by Coastal Zone Subarea, Using Coastal Zone Land Prices

Pacific Palisades Subarea		
Total Development Cost	$ 11,212,103	(from Table 23 Revised)
Less Supportable Debt	($1,180,600)	(from Table 26, Technical Study)
Net Capital Subsidy Required		
Total	$10,031,503	
Per Affordable Unit Required	**$278,653**	
Venice-Playa Del Rey Subarea		
Total Development Cost	$ 10,552,944	(from Table 24 Revised)
Less Supportable Debt	($1,180,600)	(from Table 26, Technical Study)
Net Capital Subsidy Required		
Total	$9,372,344	
Per Affordable Unit Required	**$260,343**	
San Pedro-Harbor Subarea		
Total Development Cost	$ 7,882,320	(from Table 25 Revised)
Less Supportable Debt	($1,180,600)	(from Table 26, Technical Study)
Net Capital Subsidy Required		
Total	$6,701,720	
Per Affordable Unit Required	**$186,159**	

Source: HR&A, Inc.

EXHIBIT 4

THIRD PARTY REVIEW OF HR&A'S MAY, 2006 TECHNICAL STUDY

City Hall • 200 N. Spring Street, Room 721
• Los Angeles, CA 90012

January 2, 2007

TO: Jane Usher
President
City Planning Commission

FROM: Claire Bowin
Planning Assistant
Citywide Planning Division

SUBJECT: **REVIEW OF THE TECHNICAL STUDY IN SUPPORT OF A PERMANENT MELLO ACT IMPLEMENTATION ORDINANCE FOR THE CITY OF LOS ANGELES COASTAL ZONE.**

Pursuant to the Settlement Agreement reached on December 5, 2000 between the City of Los Angeles and the Venice Town Council, Inc, The Barton Hill Neighborhood Organization, and Carol Berman concerning the "Implementation of the Mello Act in the Coastal Zone Portions of the City of Los Angeles" I have reviewed the "Technical Study in Support of a Permanent Mello Act Implementation Ordinance for the City of Los Angeles Coastal Zone" (Technical Study) completed by Hamilton, Rabinovitz and Alschuler (HR&A) in May of 2006. After careful review of this Technical Study I can assert that I find the assumptions and conclusions to be based upon customary and standard practices and assumptions typically utilized to analyze and evaluate the financial feasibility of real estate projects. It is my opinion that HR&A has accurately and thoroughly reflected the individual market conditions, zoning, construction costs, and sales prices of the three separate sub-areas, which comprise the City's Coastal Zone.

A graduate of the University of Virginia with a Bachelor in Architecture and the University of California, Los Angeles with a Certificate in Executive Management I worked for six years, prior to joining the Department of City Planning in March of 2006, primarily as a Project Manager for several construction and real estate development firms. The majority of that time was spent at Livable Places, Inc. first as a Project Manager and ultimately as their Director of Real Estate Development. In these capacities I was responsible for managing all aspects of real estate development from acquisition, financing, entitlements, design, and construction to marketing and sales. Livable Places is a non-profit development corporation focused on both policy and development activities that advocates for smart growth and affordable housing within Los Angeles County. As a result of my experience at Livable Places, my prior construction experience which was focused exclusively on the Westside of Los Angeles and my education in Architecture and Management I am extremely familiar with the Coastal Zone residential market, its demographics, area construction costs, development costs, its opportunities, challenges, and constraints, financing models, as well as marketing strategies and sales prices.

The type of study conducted by HR&A is inherently difficult in that it requires the consultant to establish a methodology that will yield fair and consistent results while recognizing market fluctuations as to rates, sales prices, market demand, lending and financing. HR&A has done a very credible job in balancing this information. Perhaps most controversial is HR&A's criteria for establishing financial feasibility and yet their conclusion that a 9% return on development cost for apartments and an 18% minimum threshold for gross margin for condominium development is reasonable and representative of current industry standards. It is important to keep in mind that these profit thresholds are meant to represent an average across three separate geographical markets with individual development conditions and differing levels of risk. In addition the 9% return and 18% gross margin represent an average, over a period of time, of what has been and what is likely to be in the future, an acceptable profit level given unknown future costs of borrowing (and other factors). The real estate development market in general is fraught with risk and most developers pursuing urban infill projects within the City of Los Angeles must compete with traditional financial markets in securing investors. Due to the volatility of the urban infill market every project pursued may not result in a completed or even profitable project which compounds the difficulty in satisfying financial sources with competitive margins.

Nationwide, highly capitalized development companies, such as KB Homes, have financing sources that, due to the volume of development, reduced susceptibility to fluctuating materials prices, green field locations and the wide distribution of their sales markets have much reduced risk in comparison to the typical Los Angeles developer and therefore are not necessarily a suitable comparison on which to judge parallel thresholds for return. Los Angeles developers traditionally pay for land based upon a projection of the property's value after entitlements have been received. The property may not ultimately be accepted for the entitlements for which the property was purchased which may require the developer to sell the property, potentially at a loss, and/or to develop the property at a lower density than the purchase price calculated. The Los Angeles real estate market provides little certainty, especially in areas such as the coastal zone, where almost every project requires some type of discretionary action. From market uncertainty to escalating construction and insurance costs to delays resulting from an unexpected soils condition housing developers assume tremendous risks and as a result their financial backers expect compensatory returns.

HR&A employs a methodical and thorough approach to their research. It is clear from the study that the information derived from the research and qualitative analysis provided the basis for the results and that predetermined conclusions had not been assumed. HR&A recognized that each of the three sub areas discussed in this Technical Report (Brentwood/Pacific Palisades, Venice/Playa Del Rey, and San Pedro/Harbor) are unique in multiple respects and therefore allocates substantial effort to accumulating specific demographic, housing, zoning, building permits, unit sizes, construction cost, market and sales and rental price information about each. The information is obtained from a variety of secondary sources and interviews with real estate professionals. The data that HR&A accumulated is consistent with my knowledge and awareness of the market during the same time period.

An important conclusion of the data research is the selection of prototypes for each sub-area that realistically represent the market conditions and thus consider what project size would prototypically be developed. After reviewing the Technical Report I conclude the methodology used to select a prototype for each sub area is consistent with prototypical lot and project sizes currently found in each area. In recognition of the higher development costs per unit borne by smaller projects, and thus their reduced ability to subsidize a percentage of affordable units HR&A suggests that prototypes towards the larger end of each sub-area's spectrum be utilized to establish a higher threshold of affordability. This decision results in slightly higher affordable requirements than might otherwise have been concluded. An argument could be made that the study could have been expanded to allow for HR&A to consider alternative zoning options such as higher density, smaller unit sizes and reduced parking all of which would have positively contributed to greater affordability and financial feasibility. Furthermore, given the assertion of an 18% gross margin for condominium projects, which reflects a certain level of entitlement uncertainty, the study could also have considered broader assumptions.

The decision to limit the prototypes to all 2-bedroom/2-bath units is of necessity a generalization, but it does accurately reflect the existing market predominance for this unit type and therefore it is hard to argue against this decision.

The assumptions that HR&A uses for its proformas and development budgets are consistent, overall, with the then current development costs for land acquisition, construction, soft costs and financing. In conclusion I find the study to be credible and reasonable with regard to the assumptions, the analysis, the approach and the conclusions.

EXHIBIT 5

STAFF RECOMMENDATION REPORT AND ATTACHMENTS DATED NOVEMBER 9, 2006

The staff recommendation report and attachments dated November 9, 2006 are available online at www.lacity.org/PLN under "Plans and Ordinances in Progress."