

Testimony Regarding Inclusionary Zoning

By

Jim Campbell
Somerset Development Company

Presented to

The District of Columbia Zoning Commission
July 25, 2005

My name is Jim Campbell, Principal of Somerset Development Company. Somerset is a private, for-profit developer specializing in multifamily housing. In particular, we specialize in the preservation of affordable housing and in the development of market rate and mixed-income housing in urban in-fill locations. I bring over 27 years experience in the development and financing of multifamily housing and commercial real estate. Prior to starting Somerset, I worked for several years as the Chief Investment Officer for the AFL-CIO Investment Trusts. The Trusts are probably the largest investor of pension funds in the new construction of multifamily housing in the country. Annually we invested over \$500 million in new development projects in cities throughout the U.S.

I have two key points that I would like to address today.

One, Inclusionary Zoning can work. And if properly crafted with certain incentives such as the density bonus proposed, can produce affordable housing without impairing market incentives for development to go forward. This has been demonstrated in a number of cities.

Two, a thorough analysis of the actual marginal costs of adding units under a density bonus, and of the actual appropriate cost of capital or return on capital attributable to the increased costs, will demonstrate that the Campaign's proposed affordability requirements are achievable and will not impair a market decision to proceed with a project.

Inclusionary Zoning Can Work. I have worked on inclusionary housing developments as a city planner, as a private developer, as a lender and as an institutional investor partner I've participated in inclusionary projects in Boston and Cambridge, Massachusetts, in NYC, in San Francisco, in Baltimore and other locations In most cases, the inclusion of affordable units in an otherwise market development was the result of a negotiated process, building in appropriate incentives in various zoning approvals or other entitlements to off-set the "loss" associated with renting or selling the affordable units below market. These projects all moved forward, were built and achieved market results In many locations, those cities moved to formalize an inclusionary zoning program.

Measuring the Financial Impact of Inclusionary Zoning on a Project: Having gone through several deal by deal analysis of including affordable units in an otherwise market transaction, I have been able to gain a strong understanding of the actual financial impacts. There are real soft cost and hard cost impacts, potential land cost impacts, opportunity cost impacts, potential profitability impacts, and financability impacts Each of these needs to be understood when formulating the appropriate requirement for the number or percentage of affordable units and the level of income targeting

I want to commend the Office of Planning for its very diligent and exceptionally professional work in this regard, and for putting forward a very viable inclusionary zoning program However, the assumptions regarding the marginal costs and adjusted return on capital used in their model for determining the appropriate level of affordability are overly cautious or conservative – resulting in overly restrictive requirements for the inclusionary affordability levels.

OP's model does not change construction costs at all; and does not reduce the ratio of soft costs. A sharper pencil would reveal significantly lower real marginal costs of adding the additional 20% of buildable area A developer's total project budget includes literally dozens of line-items, and the construction budget includes maybe two dozen divisions each with numerous line-items A line by line review shows that the cost of adding the

additional 20% of space is in fact significantly below that of the base 100%. Costs associated with land acquisition, civil and geotechnical engineering, environmental analysis and remediation, schematic design, most entitlements, and roofing are barely increased, if at all. There are then very real economies-of-scale in design development, structural and mechanical design, foundations, vertical transportation, utilities, electrical service, general conditions and contractor overhead, and many other construction items. The added space will typically result in improvements in the building's overall efficiency related to gross square footage to net square footage – meaning that the added space is typically more efficient than the base space (you don't have to add additional proportionately bigger lobbies, business centers, exercise rooms, etc., and in many cases no additional stairwells or elevators). Also, the lower cost of finishes for the affordable units (which can be as much as \$30,000 lower per affordable unit in a high-end condo project) is left out of the OP model, but is in fact a very significant savings.

I would caution that one exception to this rule is the rare and unlikely case where the additional square footage would require a change in construction type, that is a required change from stick-built to steel and concrete or from low-rise to high-rise. The relief proposed to be granted under this circumstance is appropriate. In addition, situations might arise where other construction thresholds are crossed – e.g., an additional elevator bank is required or an additional level of below grade parking is necessary – which offset some or all of the marginal cost savings. However, these are very likely to be the rare and unusual exceptions, not the rule, administrative relief could be considered in these instances.

There is some increase in the time required to complete the project. But I believe that it is less than may have been used in the Office of Planning model. And in any case, that time related to the initial processing happens before any significant capital has been expended, so that the added capital costs of carry are minimal.

Also, it is very important in measuring the financial impacts to consider the costs of capital for the added space and the return on capital to be expected for the capital used for

the added space. Cost of capital is related to the return on capital expected by the investing entity, which is related to the risk profile of that investment. Obviously, for real estate development there are a number of risk factors that drive the cost of capital. zoning and entitlements risk; then construction risk, then market risk, along with on-going interest rate risk. It is not necessarily the case that the return required for the additional 20% inclusionary space has to be the same as that for the base project. Two of the risk factors have been eliminated or substantially mitigated. There is no additional zoning or entitlement risk associated with that additional 20% of space; and the market risk – probably the most significant risk factor – is dramatically reduced for that square footage because a substantial share of the space is being rented or sold below market into great demand.

I would like to conclude by re-stating that I believe the Office of Planning Inclusionary Zoning proposal is workable. It achieves a certain level of included affordability without hindering market forces. However, I believe that the Campaign's Inclusionary Zoning proposal is both, equally workable, and represents stronger, more effective policy to address the severe affordability and work-force housing crisis in the District. The Campaign's proposal achieves even more affordability, while not hindering market forces. The Campaign's proposal more than adequately compensates a developer for including the prescribed level of affordability.

Thank you