



Jeremy N Rubenstein
jr@mpcompanies.com

TO: District of Columbia Zoning Commission

FROM: Jeremy N Rubenstein, President, Metro Properties, Inc.

DATE: July 25, 2005

RE: Case No. 04-33 (Text Amendments to Require the Provision of Affordable Housing – Inclusionary Zoning)

On behalf of Metro Properties, Inc , I would like to thank the members of the Zoning Commission for providing me with the opportunity to testify concerning the proposed inclusionary zoning text amendments. I also would like to commend the staff of the Office of Planning for all of their hard work, and for seeking to obtain the input of so many diverse members of the advocacy and business communities.

Unfortunately, I am unable to support the proposal in its current form. Many other parties will be commenting on the specifics of the proposal. I would like, however, to focus on the basic limitations of a mandatory program.

Metro Properties, Inc. strongly supports the concept of inclusionary zoning as a means of providing some, albeit limited, relief to the many residents of the District of Columbia who cannot afford to purchase a home under current market conditions. However, it is imperative that such an approach be incentive-based rather than mandatory. *Incentive-based inclusionary zoning would reap much of the benefit of a mandatory program without incurring the significant economic risks or the bureaucratic costs and delays of a mandatory program.*

I am proud that Metro Properties, Inc. is the first developer to utilize the incentive based bonus density provisions for affordable housing provided for the Uptown Arts District, as I will discuss later in my testimony.

I now would like to submit the following seven points to support the use of incentives rather than mandates to achieve the goals of inclusionary zoning.

1. Multi-Family Development is a Driving Force for the DC Economy.

It is matter of public record that the District of Columbia has recently emerged from a long period of fiscal difficulties. While there are many factors that have led to the current period of strong fiscal health, one of the key reasons that the District of Columbia

Metro Properties, Inc
www.mpccompanies.com

4550 Montgomery Avenue
Suite 305 North
Bethesda, MD 20814

Tel (301) 907-7100
Fax (301) 907-7105

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currently has the economic strength to address many of its pressing fiscal needs is the real estate market, particularly the multi-family market. According to the June 15, 2005 testimony of Natwar M. Gandhi, Chief Financial Officer of the District of Columbia, before the US Senate Appropriations Subcommittee on the District of Columbia concerning the District's Budget Request for Fiscal 2006:

In FY 2006, the District's certified general fund revenue is forecasted to be \$4.81 billion, an increase of 13.8 percent over the FY 2005 approved budget after tax policy changes. Underlying the District's robust revenue growth is continued strength in the District's real estate market and strong growth in personal income. Substantial increases in prices and the number of transactions in both residential and commercial real estate markets were major sources of revenue gains in FY 2003 and FY 2004, and are expected to contribute significantly to FY 2005 and FY 2006 revenues. (<http://app.cfo.dc.gov/CFORUI/news/testimonies.asp>)

While the robust market has its downsides – particularly affordability – it is important to remember that almost every market rate condominium built results in a substantial tax benefit to the District, and typically demands far less in services than it generates. For this reason, I urge the Zoning Commission to tread carefully in its review of policy options.

2. Real Estate is Highly Cyclical.

The United States housing market in general, and the District of Columbia market in particular, are booming at present. Under the conditions of the past few years, fueled by historically low interest rates and purchase prices that exceed construction costs, it may seem hard to imagine a scenario in which development would be substantially discouraged. It is possible that the current environment will continue for a while. However, the current market is considerably riskier for developers than that of even a year or two ago due, among other things, to:

- a. Sharply higher construction costs,
- b. The risk of changing to a rising interest rate environment,
- c. The large number of speculative condominium purchases who cannot cover their carrying costs with rental payments;
- d. The extremely high percentage of unconventional mortgage loans used to purchase condominiums, which can lead to large changes in required monthly payments,
- e. Higher interest rates for construction financing;
- f. Expectations of owners of developable land and buildings that appreciation will continue at recent rates, and
- g. More limited supply of easily developed sites

Please note, I am by no means predicting that the currently favorable real estate environment is about to end, rather I simply note that no one really knows when development activity is going to slow and or stop and that, given its importance to the District of Columbia, extreme care should be taken to avoid discouraging development

3. A Mandatory Program Would Discourage Housing Development under Many Scenarios.

First, I would like to acknowledge and commend the fine work that the Office of Planning has done in preparing the financial analyses underlying their submission to the Zoning Commission, and their willingness to meet with and listen to all interested parties. Unfortunately, the assumptions made by the Office of Planning do not hold true under a number of both macroeconomic and site specific scenarios.

- a. **Macroeconomic Considerations.** In preparation for its report to the Zoning Commission, OP analyzed a range of types of zoning and construction scenarios. Although the models that they have used appear to be reasonable summaries of the effect of the changes under the assumptions used, they all are based on a single set of costs and market conditions. OP did, in part, acknowledge that their model is sensitive to what they call "input changes." See pp 25-26 of the July 15, 2005 memo from Ellen McCarthy, Director, Office of Planning, to the District of Columbia Zoning Commission, hereafter cited as the "OP Memo." However the discussion does not, in our view, give sufficient consideration to the effect of these "input changes," which we would instead call real world considerations.

For example, construction costs are escalating rapidly in the DC area – according to the OP Memo rising as much as 1% a month. *Id* While OP acknowledges this fact, their response is that this would occur with or without inclusionary zoning and that "no development will get built unless land starts to absorb the impact." *Id* Economic activity generally does not act as if it is connected to an on/off switch, however; rather there is a continuum. It is a simple fact that, unless *all* residential development is stopped, if inclusionary zoning causes projects to be come less profitable, fewer projects will get built

As construction costs rise, the value of any bonus density will, by definition, decrease unless sales prices increase or land prices decrease. Increased costs will make the profit per market rate unit decrease and the loss per affordable unit increase. In other words, the rate of return to the developer will be less, and at times substantially less, than it would be without the provision of affordable housing. Since land prices are unlikely to decrease as quickly as construction costs rise – once sellers become accustomed to a valuation, they generally are reluctant to sell for less – some projects will become marginal or unprofitable. Although many projects in the past few years have been "saved"

from increasing construction costs by increasing sales prices, the conditions that have fueled such sales price increases are unlikely to continue indefinitely.

Our conclusions are supported by independent research. As is modeled and analyzed in detail in Chapter 11 (Inclusionary Zoning) of an extensive report issued by the Furman Center for Real Estate and Urban Policy of the New York University School of Law, Reducing the Cost of New Housing Construction in New York City: 2005 Update, Jerry J. Salama, Michael H. Schill and Jonathan D. Springer (hereafter cited as the "Furman Report") (http://www.law.nyu.edu/realestatecenter/CREUP_Papers/cost_study_2005/CostStudy_intro.html):

The financial model shows that financial feasibility under IZ mandates is very much a function of market conditions (including hard costs, sales/rent levels and interest rates) and the particular IZ affordability regime considered. . . A mandatory regime that is financially feasible today may become infeasible in the future give a change in market conditions, and vice versa. *Furman Report* at 110

Although OP assumes that land prices will absorb any change in costs, land costs are far less likely to move down quickly than to move up. As the Furman Report further noted, although an IZ regime "should theoretically reduce the value of land and thus prices," it is not clear that landowners always will reduce their price to the extent necessary to make development feasible. *Id*

- b. **Site Specific Considerations.** One of the key economic assumptions made by OP in its analysis of mandatory inclusionary zoning was that "there is no change per square foot hard costs created by adding additional density." *OP Memo* at page 2 of the attachments. Yet construction is frequently not so simple, particularly in areas such as the District of Columbia where many projects must deal with small lot size, existing neighborhood conditions, and governmental restrictions such as historic preservation which may require very specific and expensive steps that result in very uneven construction costs. Many sites in the District of Columbia that are available for multi-family construction require significant environmental remediation, which exponentially increases the cost of excavating additional soil. Moreover, the smaller the lot the more costly it is to provide parking spaces, and the more difficult it is to dig deeper to provide them.

This is the area that OP's report is probably the most dismissive of the real world considerations faced by developers. When discussing the fact that additional parking for the increased number of market rate units may be more

costly, OP states that “[f]rom a policy standpoint, the problem is that developers chose to provide significantly more parking than is required by the District’s zoning regulations. This is the developer’s market decision ” *Id* Yet the fact remains that purchasers of market rate condominiums tend to expect that they will have a place to park a car (regardless of whether they use it frequently), and the sales price of units without parking available often is adversely affected Yes this is a market decision. So is the decision to build in the first place. If a developer must choose between higher costs and lower sales prices, then the expected rate of return is affected and marginal projects will not get built.

4. Administration

One of the key costs of any system of inclusionary zoning is the additional regulatory bureaucracy required to administer the program While OP is to be commended for listening to the concerns of developers in trying to devise an administrative regime that is more flexible than some of the original proponents of mandatory inclusionary zoning would provide, it remains a fact that an entire system of relief – including in many instances a full variance process – would be needed to administer the system. Moreover, none of these systems would be capable of addressing substantial economic changes, since there is *no provision for economic hardship that leads to a reduction in more than a small percentage of units and any affordable offsite housing would have to be substantially greater than required onsite.*

Such programs rarely are administered perfectly even with the best of personnel and intentions. Personnel change, backlogs grow, and delays will accrue. Any variance sought is likely to be hotly contested by one of many DC advocacy groups, adding greater time, uncertainty, and cost to the system In contrast, voluntary programs are largely self-administered

5. Limited Impact of Inclusionary Zoning.

One of the great unsung accomplishments of the DC government is the current success in providing affordable housing According to the Office of the Deputy Mayor for Planning and Economic Development, since 1999 DC has financed nearly 11,000 units of affordable housing According to the Deputy Mayor:

- In FY 1999, 1,558 units were financed
- In FY 2000, 1,902 units were financed
- In FY 2001, 3,353 units were financed
- In FY 2002, 2,418 units were financed
- In FY 2003, 2,740 units were financed
- In FY 2004, 2,183 units were financed
- To date in FY 2005, nearly 3,493 units are in the pipeline

In total, between the city's project and the private ones, there are more than 37,000 units of housing that are either complete, in production, or in the citywide pipeline. In addition to new housing, the District's Housing Authority (DCHA) operates 8,997 units of public housing, with 99% Housing Choice Voucher Program utilization rate, 98% public housing occupancy rate, 11,555 Section 8 voucher residents, 9,355 HCV tenant-based residents and 2,200 Project based residents.
(<http://dcbiz.dc.gov/dmped/cwp/view,a,1366,q,572638.asp>)

In contrast to the above, only a limited number of affordable units will be constructed under OP's proposal. According to Delta Associates, in the boom year of 2004, 3,076 new condominium units were sold in the District of Columbia. See Delta Associates, Year-End 2004 Report: Mid-Atlantic Class A Apartment & Washington Area Condominium Market, at 31, Table 1.1 (hereafter cited as the "Delta Report"). The "bonus" FAR under the OP proposal generally is 20%, of which half to three quarters is required to be devoted to affordable housing. Thus, somewhere between 10% and 15% of the "base" (pre-bonus) new units would be required to be affordable housing.

I believe that more bonus units would be built under the 50/50 ratio, which would mean that the affordable units would be closer to 10% of the base units. For the sake of simplicity, however, let us assume that the affordable units would equal 12.5% of the base. Under the "perfect" assumption that every single project in 2004 used the full bonus available, 384 units (12.5% of 3,076) of affordable housing would have been provided by condominium developers – or approximately 17.6% of the affordable units that the Deputy Mayor states were financed by the District of Columbia. The "perfect" assumption is, of course, not true – many of the projects were in areas, such as the Downtown Development District or in historic districts, in which no or reduced bonus density would be available due to limitations on building height or other constraints. Thus, the true number of affordable units would have been well below 300. Although this number does not include rental apartments, there are, as OP has acknowledged, few new rental projects expected in the DC area.

I do not mean to imply that 300 affordable units would not be significant, or that these calculations are more than a rough estimate. However, it is also important to remember that inclusionary zoning is not going to be the primary solution to DC's affordable housing crisis under any scenario, and that any reduction in units delivered by using an incentive based program is, in the greater context of things, relatively small. The best way to address long term affordability issues is to remove the many impediments to new construction (many of them caused by unnecessary zoning restrictions) so that supply can be increased.

6. Incentive Based Zoning Boosts Affordable Housing without Dampening Development

As noted above, the effect of mandatory inclusionary zoning on development activity is highly variable depending on macroeconomic and site specific circumstances. By providing incentives, however, developers will naturally provide affordable housing whenever it makes economic sense. Admittedly, the ratio may need to be slightly greater than under a mandatory system, but the relatively small number of units affected must be compared to the large risks and administrative costs of a mandatory program. No hearings are needed, since developers will automatically build affordable units when and where it makes sense. Of course, DC can continue to produce a relatively large number of affordable units in connection with land that it currently owns and releases for development.

Many of the advocates for inclusionary zoning will cite other municipalities that have mandatory programs as evidence that such a program will work. Yet it is impossible to know to what extent development that otherwise would have occurred has been suppressed by such programs. We do know, however, that Montgomery County has long had what is, in effect, a mandatory inclusionary zoning requirement that is a substantial impediment to new construction. During the recent boom, the pace of new condominium sales in suburban Maryland has been vastly lower than that of either the District of Columbia or Northern Virginia. *According to the Delta Report, in 2004 new condominium sales in all of suburban Maryland totaled 952 units, or less than one third than that of the District of Columbia (3,076) and less than one fifth of that of Northern Virginia (5,080). Delta Report at 31, Table 1.1.*

7. DC Should Try Incentive Based Zoning First.

Finally, I would like to end with the strong suggestion that the Zoning Commission make a good faith attempt at using voluntary incentive based zoning before taking the risks entailed in a mandatory program. It is a political reality that, once introduced, it would be exceptionally difficult to adjust zoning requirements downward to reflect changing circumstances and, even if a desire to do so existed, would take substantial time.

As I stated initially, Metro Properties, Inc. is proud to have made use of the affordable housing bonus in the Uptown Arts District. Of course, the bonus provided was relatively small, and we would have been pleased to have provided more such housing if there was an incentive that did not require us to take the risk and delay that a PUD application would have entailed.

I would also like to note that the existing programs that provide incentives for affordable housing simply do not work as planned in most cases. Limited attempts have been made to provide incentives for affordable housing, such as those provided by the Uptown Arts District regulations that we have used. Such incentives, however, have provided

relatively little bonus FAR (the Uptown Arts District effectively permits a less than 12% increase from 4.0 to 4.5 FAR for buildings that are primarily residential) and affordable housing is only one of many ways that a developer can obtain the bonus

At the same time, developers often are subject to other requirements, such as having ground floor retail, that provide bonus FAR. Given the limit on the overall FAR bonus available, and the failure to distinguish between affordable housing and other uses, there often is no incentive left. In our case, ground floor retail was not required, thus permitting us to achieve a bonus for the affordable units. A better designed system would break out incentives for affordable housing and provide a sufficient amount of extra FAR to make the development worthwhile.

As the members of the Zoning Commission are well aware, prior to the submission of the petition from the Campaign for Mandatory Inclusionary Zoning (CMIZ), OP was working on its own proposal that would have been incentive based. We respectfully submit that OP should continue to work on its voluntary program, and that mandates should be reserved for a last resort.