MEMORANDUM

TO: District of Columbia Zoning Commission

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SUBJECT: ZC Case 20-02 Supplemental Report: Stakeholder Feedback & Economic Modeling on Expanded Inclusionary Zoning[1]

I. RECOMMENDATION – AMENDED

The Office of Planning ("OP") continued to analyze the comments provided by DCBIA and others. Based on this feedback, analysis and the goal to maximize the productivity of Expanded IZ (aka IZ Plus), OP has amended the proposal from the initial approach of using an escalating Floor-Area-Ratio (FAR) in increments of 0.5 proposed in the public hearing report (Exhibit 12) to a system that instead use a sliding scale of percent-increase in density as shown in Figure 1.A below. The percent increase will be calculated as the difference between the existing zone and the requested zone.

Figure 1.A Revised Recommended Expanded IZ Set-Aside Requirements

IZ Inclusionary Developments that do not employ Type I construction (non-steel) and are located in a zone with a by-right height limit of 85 feet or less:

TABLE C § 1003.3 SET-ASIDE FOR INCLUSIONARY UNITS

Percent Increase in FAR	**20%-40%**	**40.1%-60%**	**60.1%-80%**	**80.1% or Above**
Set-Aside Requirement	**14%**	**16%**	**18%**	**20%**

IZ Inclusionary Developments that employ Type I construction (steel) or are located in a zone with a by-right height limit that is greater than 85 feet:

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[1] Also known as "IZ Plus."

TABLE C § 1003.4 SET-ASIDE FOR INCLUSIONARY UNITS

Increase in FAR	**20%-50%**	**50.1%-75%**	**75.1-100%**	**100.1%-125%**	**125% or Above**
Set-Aside Requirement	**10%**	**12%**	**14%**	**16%**	**18%**

Figure 1.A replaces the initial approach of using an escalating Floor-Area-Ratio (FAR) in increments of 0.5 with a percentage gain in FAR found in Table C of 1003.3 and 1003.4 of the public hearing report shown below in Figure 1.B.

A map amendment that rezones a property from either a PDR zone or unzoned land to any R, RF, RA, MU, D, CG, or ARTS is still proposed to have a 20 percent set aside requirement. A map amendment from a zone with a prescribed residential FAR to a D zone without a prescribed residential FAR is also still proposed to have a 20 percent set aside requirement.

OP will provide updated zoning text in a future filing to incorporate the revised set-aside requirements at Subtitle C §§ 1003.3 and 1003.4 in the public hearing report and the revised increase in FAR calculation at Subtitle X §§ 502.3 and 502.4 in the public hearing report.

Figure 1.B Expanded IZ Set-Aside Requirements in OP Public Hearing Report

IZ Inclusionary Developments that do not employ Type I construction (non-steel) and are located in a zone with a by-right height limits of 85 feet or less:

TABLE C § 1003.3 SET-ASIDE FOR INCLUSIONARY UNITS

Increase in FAR	**0.25-0.50**	**0.51-1.00**	**1.01-1.50**	**1.51 or Above**
Set-Aside Requirement	**14%**	**16%**	**18%**	**20%**

IZ Inclusionary Developments that employ Type I construction (steel) or are located in a zone with a by-right height limit that is greater than 85 feet:

TABLE C § 1003.4 SET-ASIDE FOR INCLUSIONARY UNITS

Increase in FAR	**0.25-0.50**	**0.51-1.00**	**1.01-1.50**	**1.51-2.00**	**2.01-2.50**	**2.51 or Above**
Set-Aside Requirement	**10%**	**12%**	**14%**	**16%**	**18%**	**20%**

The tables in Figure 1.A are based on OP's economic modeling of Expanded IZ completed after careful consideration and research conducted as a result of stakeholder feedback. The sliding scale requirements based on a change in FAR (Figure 1.B) proposed in OP's set down and public hearing reports did not accurately consider the value of the percent change in density. For instance, Figure 3.A and Figure 4 discussed within Section III - Economic Modeling result in very different outcomes even though they had the same 20 percent IZ requirement. Figure 3.A shows a slight decline in land value of 1.5 percent with a 1.7 FAR increase, or a 68 percent increase in density.

As proposed, it does not present an incentive to apply for an Expanded IZ map amendment. Figure 4 on the other showed a 37.7 percent increase in land value with a 1.8 FAR increase, but which represented a 100 percent increase in density.

II. STAKEHOLDER FEEDBACK

As stated in OP's public hearing report, OP received feedback on the economic modeling primarily through two avenues: 1) OP hosted online public forums held October 6, and 13; 2) A video meeting requested by DCBIA was held on October 30. This supplemental report provides a summary of the feedback and focuses on OP's research and analysis conducted on the feedback and how inputs to the model were ultimately changed.

Feedback received during the OP's forums characterized the model as strong and there was agreement that two inputs should be modified.

1. Hard construction costs made up of materials and labor were eight to nine percent too low; and
2. Soft development costs at 30 percent of hard costs were too high and should be changed to 25 percent.

OP accepted these suggestions and applied them to the model.

DCBIA participants provided the following comments:

1. The model is overparking the Regular IZ base scenario; Parking for the Regular IZ scenario should be reduced to one-half level below grade.
2. The Expanded IZ scenario does not include a longer pre-development period due to the map amendment process and a longer period to lease units within a larger building upon completion. Twelve months (one full year) should be added to the predevelopment period extending it from 15 months to 27 months.
3. Required annual rate of return to equity is too low at 11 percent and should be changed to annual rate of 20 percent.
4. Expanded IZ does not work when a map amendment shifts from medium to high-rise construction.
5. Pre-existing uses impede land sales for redevelopment.
6. Some site conditions limit the ability to achieve full buildout of the new zone.
7. Expressing the requirements based on base zone with IZ bonus to new zone with IZ bonus has greater logic for landowners.
8. Consider geographic variations in markets as Expanded IZ appears to work better in higher cost markets.

OP provided a review and response to most of these comments in the public hearing report. This supplemental report will focus on comments #2 and #3. Cumulatively, this feedback has significant implications on the viability of Expanded IZ. OP's first step was to test the validity of the feedback by testing them under a text amendment scenario with the current IZ requirements and without any Expanded IZ requirements. OP used DCBIA's adapted version of the economic model and applied it to a scenario under the current IZ rules.

Figure 2 below presents the results of DCBIA's feedback applied to a map amendment from the MU-4 to the MU-5A. Under the current IZ rules this would actually reduce the percent of residential Gross Floor Area (GSF) required for IZ units from 12.5 percent to 8.3 percent.[2] The figure shows that the combination of a longer investment period and an almost doubling of the required annual rate of return from 11.0 percent to 20.0 percent per year changes the required total return from 18.7 percent used in OP's set down report to 34.4 percent in the Regular IZ matter-of-right scenario and 44.0 percent in the Expanded IZ map amendment scenario. This results in a reduction of land value of almost $6.0 million or 35 percent decline when combined with DCBIA participants' other feedback. If the capital equity markets had required comparable rates over the past several years then there would have been no map amendment applications, yet there have been 32 map amendment cases since 2016. All have been approved except three that are still under review. Clearly economic conditions prior to the economic side effects of COVID-19 public health emergency enabled map amendments.

Figure 2. Residual Land Value Economic Feasibility Model: DCBIA Rental Scenario MU4 – MU5A

[2] These assume the full 20 percent bonus density is achieved under each scenario.

		MIZ Scenario 12.5% GSF @ 60% MFI 20% Bonus Density	IZ+ Scenario 8.3% GSF @ 60% MFI 68% Density Increase
Monthly Rent	$3.09 Market	$ 430,453	$ 614,691
Parking Revenue	$190 / Space	$ 14,250	$ 23,940
Annual Income		$ 5,336,431	$ 7,663,568
- Vacancy/Economic Loss	5%	$ 266,822	$ 383,178
- Operating Expenses	30%	$ 1,600,929	$ 2,299,070
RE Taxes (Included in OE)		$ 685,669	$ 984,679
Net Operating Income		$ 3,468,680	$ 4,981,319
Cap Rate	4.30%		
Estimated Value		$ 80,666,980	$ 115,844,627
- Hard Costs		$ 28,800,000	$ 46,200,000
- Parking		$ 2,992,500	$ 5,027,400
- Soft Costs	30%	$ 9,537,750	$ 15,368,220
- Contingency	5%	$ 1,589,625	$ 2,561,370
- Hurdle Rate		34.1%	44.0%
- Developer Return		$ 20,523,261	$ 35,419,159
Residual Land Value		$ 17,223,845	$ 11,268,478
			IZ+ Scenario
Change in Residual Land Value			$ (5,955,367)
Percent Change in Land Value			-35%
Expanded Inclusionary Zoning Evaluation Metrics			
FAR Increase (Base Zone without Bonus to New Zone with Bonus)			1.7
Percent FAR Increase			68%
IZ+ Percent of Increased Density Required			29%
Percent Affordable Change			-7%
		MIZ Scenario	IZ+ Senario
Market Rate Units		180	264
Affordable Units		25	23
Total Units		205	290

Source: DCBIA Participant, DC Office of Planning, November 2020.

OP acknowledges the annual rates of return to equity required by external capital markets are an important part of the economic analysis, but a report published in the second quarter of this year in the middle of the COVID crisis may reflect the required rate of return needed to begin construction during a period of record vacancy, dropping asking rents and tremendous uncertainty. Land use policy should take into account a longer-term point of view. In addition, it should consider local market conditions when using national level data.

OP's research into the DCBIA comments suggested several appropriate adjustments to the testing scenarios.

- First, a map amendment process does add time to the development time frame. A map amendment process is typically eight months and it is unlikely that a developer would halt all other pre-development work on the project. Other pre-development activities would overlap during the map amendment process. Therefore, OP added five months to the predevelopment time frame. A larger building might take longer to lease up as well. There are options to maintain a comparable lease up period such as concessions and marketing that do not interfere with longer term value. However, OP added months as a result of larger project.

- Second, a map amendment does increase risk of the added time without any benefit if the application is denied. Out of the 23 map amendment cases that were applied for, zero were denied. This suggests the risk is relatively low risk when map amendment reflect land use permitted by the Future Land Use Map. After adding a range of months to the development time frame, OP tested how much return increased as a result of a map amendment with OP's proposed Expanded IZ. DCBIA participants said that under current competitive conditions property owners are unlikely to wait and properties need to be acquired prior to attaining entitlements. OP held land value constant at the matter-of-right acquisition price and tested the increase in return. The model suggests that under OP's Expanded IZ requirements proposed at set down, return varied the same way land value changed.

III. ECONOMIC MODELING

The major difference between OP's analysis below and that within OP's set down report is the addition of five months to the predevelopment process. A key assumption is when the property is purchased. OP's analysis assumes the property is purchased early in the development period. DCBIA participants stated that competitive pressures require this, but in many cases, developers do not close a contract of sale until very close to the start of construction. Early in Regular IZ's administration DCRA had to adjust when IZ covenants are required from before to after issuance of the building permit because the sale of the property had often not yet occurred. OP's assumption that the property is purchased early is therefore a very conservative assumption that affects the potential increase in affordability.

Other changes include adjusting both hard and soft construction costs, increasing the annual rate of return to equity from 11.0 to 12.0 percent, adjusting the rate of unit absorption and fixing broken links and errors.

<u>Analysis of Set Down Requirements:</u>

Figures 3, 4, and 5 below provide the two OP scenarios from set down evaluated with the revised model and a third figure illustrating a shift within high-density construction.

The revised numbers in Figure 3.A and 3.B, show a potential project in the Rock Creek West Planning Area going from MU-4 to MU5A with and without the 3-bedroom IZ unit requirements, The figure documents that Expanded IZ as an estimated negative impact to land of 1.5 percent. This means by itself Expanded IZ would be unlikely to act as an incentive. The 20 percent reduction in IZ square footage if 50% of IZ units are 3-bedrooms shown in Figure 3.B illustrates a modest improvement to land value of $0.64 million, 1.8 percent increase.

OP notes that when a project uses Tax Exempt Bonds and 4.0 percent Low Income Housing Tax Credits (LIHTC) are applied to Figure 3.A (analysis not shown) the land value increases by $2.4 million, or a 6.9 percent increase in land value. Not included is the new tax abatement for affordable housing in high-cost areas of the District. OP may revisit analysis of the tax abatement when the District publishes administrative regulations. However, limited abatement authority suggests few projects would receive it and it should therefore not be relied on.

Figure 3.A Sample Economic Feasibility Model and Evaluation Metrics: MU-4 to MU-5A

		MIZ Scenario 12.5% GSF @ 60% MFI 20% Bonus Density		IZ+ Scenario 20% GSF @ 60% MFI 68% Density Increase	
Monthly Rent	$3.57 Market	$	492,445	$	660,453
Parking Revenue	$190 / Space	$	23,940	$	23,940
Annual Income		$	6,196,615	$	8,212,716
- Vacancy/Economic Loss	5%	$	309,831	$	410,636
- Operating Expenses	30%	$	1,858,985	$	2,463,815
RE Taxes (Included in OE)		$	823,472	$	1,091,393
Net Operating Income		$	4,027,800	$	5,338,265
Cap Rate	4.16%				
Estimated Value		$	96,879,036	$	128,399,133
- Hard Costs		$	31,500,000	$	50,190,000
- Parking		$	5,027,400	$	5,027,400
- Soft Costs	25%	$	9,131,850	$	13,804,350
- Contingency	5%	$	1,826,370	$	2,760,870
- Hurdle Rate			18.0%		21.3%
- Return		$	14,783,820	$	22,530,006
Residual Land Value		$	34,609,596	$	34,086,507

		IZ+ Scenario
Change in Residual Land Value	$	(523,089)
Percent Change in Land Value		-1.5%

Expanded Inclusionary Zoning Evaluation Metrics		
FAR Increase (Base Zone without Bonus to New Zone with Bonus)		1.7
Percent FAR Increase		68%
IZ+ Percent of Increased Density Required		70%
Percent Affordable Increase		124%
	MIZ Scenario	IZ+ Senario
Market Rate Units	180	230
Affordable Units	25	57
Total Units	205	291

Source: DC Office of Planning.

Figure 3.B Sample Economic Feasibility Model and Evaluation Metrics: MU-4 to MU-5A - 20% Reduction for 50% IZ 3-Bedrooms

		MIZ Scenario 12.5% GSF @ 60% MFI 20% Bonus Density		IZ+ Scenario 20% GSF @ 60% MFI 68% Density Increase	
Monthly Rent	$3.57 Market	$	492,445	$	667,954
Parking Revenue	$190 / Space	$	23,940	$	23,940
Annual Income		$	6,196,615	$	8,302,722
- Vacancy/Economic Loss	5%	$	309,831	$	415,136
- Operating Expenses	30%	$	1,858,985	$	2,490,817
RE Taxes (Included in OE)		$	823,472	$	1,103,354
Net Operating Income		$	4,027,800	$	5,396,769
Cap Rate	4.16%				
Estimated Value		$	96,879,036	$	129,806,311
- Hard Costs		$	31,500,000	$	50,190,000
- Parking		$	5,027,400	$	5,027,400
- Soft Costs	25%	$	9,131,850	$	13,804,350
- Contingency	5%	$	1,826,370	$	2,760,870
- Hurdle Rate			18.0%		21.3%
- Return		$	14,783,820	$	22,776,922
Residual Land Value		$	34,609,596	$	35,246,769

		IZ+ Scenario
Change in Residual Land Value	$	637,174
Percent Change in Land Value		1.8%

Expanded Inclusionary Zoning Evaluation Metrics

FAR Increase (Base Zone without Bonus to New Zone with Bonus)		1.7
Percent FAR Increase		68%
IZ+ Percent of Increased Density Required		56%
Percent Affordable Increase		79%
	MIZ Scenario	IZ+ Senario
Market Rate Units	180	242
Affordable Units	25	45
Total Units	205	291

Source: DC Office of Planning.

Figure 4 illustrates the impact of updates to the model on land value when the zone changes from the RA-2 to the RA-3 in the Upper NE Planning Area. The figure shows that land values increased by $6.7 million or a 37.7 percent increase indicating that the 20 percent requirement works very well when there is a 100% increase in density. This analysis caused OP to shift the recommendation to a sliding scale based in the percent increase in density.

Figure 4. Sample Economic Feasibility Model and Evaluation Metrics: RA-2 to RA-3

		MIZ Scenario 12.5% GSF @ 60% MFI 20% Bonus Density	IZ+ Scenario 20% GSF @ 60% MFI 100% Density Increase
Monthly Rent	$3.16 Market	$ 316,487	$ 508,086
Parking Revenue	$190 / Space	$ 18,430	$ 23,940
Annual Income		$ 4,019,000	$ 6,384,311
- Vacancy/Economic Loss	5%	$ 200,950	$ 319,216
- Operating Expenses	30%	$ 1,205,700	$ 1,915,293
RE Taxes (Included in OE)		$ 535,712	$ 850,996
Net Operating Income		$ 2,612,350	$ 4,149,802
Cap Rate	4.14%		
Estimated Value		$ 63,024,973	$ 100,117,197
- Hard Costs		$ 22,680,000	$ 39,960,000
- Parking		$ 5,027,400	$ 5,027,400
- Soft Costs	25%	$ 6,926,850	$ 11,246,850
- Contingency	5%	$ 1,385,370	$ 2,249,370
- Hurdle Rate		16.9%	20.4%
- Return		$ 9,103,376	$ 16,979,995
Residual Land Value		$ 17,901,976	$ 24,653,582
			IZ+ Scenario
Change in Residual Land Value			$ 6,751,605
Percent Change in Land Value			37.7%
Expanded Inclusionary Zoning Evaluation Metrics			
FAR Increase (Base Zone without Bonus to New Zone with Bonus)			1.8
Percent FAR Increase			100%
IZ+ Percent of Increased Density Required			50%
Percent Affordable Increase			167%
		MIZ Scenario	IZ+ Senario
Market Rate Units		129	197
Affordable Units		18	49
Total Units		147	251

Source: DC Office of Planning.

Figure 5 presents the results of OP proposed requirement in the set down report that starts with a base zone of MU-10 with an FAR of 6.0 (6.5 w/IZ) and height of 90 feet (100 feet w/IZ) to the MU-9 with an FAR of 6.5 (7.8 w/IZ) and a height of 90 feet (100 feet w/IZ). The project rents and cap rates reflect market conditions of the Lower Anacostia Waterfront Near SW Planning Area. The table shows the analysis of Expanded IZ as proposed during the set down. This scenario saw a decline in land value of $9.3 million or 42 percent decline.

Figure 5. Sample Economic Feasibility Model and Evaluation Metrics: MU-10 to MU-9

		MIZ Scenario 8.3% GSF @ 60% MFI 20% Bonus Density		IZ+ Scenario 16% GSF @ 60% MFI 30% Density Increase	
Monthly Rent	$3.30 Market	$	1,120,889	$	1,167,138
Parking Revenue	$190 / Space	$	23,940	$	23,940
Annual Income		$	13,737,943	$	14,292,933
- Vacancy/Economic Loss	5%	$	686,897	$	714,647
- Operating Expenses	30%	$	4,121,383	$	4,287,880
RE Taxes (Included in OE)		$	1,893,057	$	1,969,534
Net Operating Income		$	8,929,663	$	9,290,407
Cap Rate	4.01%				
Estimated Value		$	222,712,630	$	231,709,857
- Hard Costs		$	116,640,000	$	126,360,000
- Parking		$	5,027,400	$	5,027,400
- Soft Costs	25%	$	30,416,850	$	32,846,850
- Contingency	5%	$	6,083,370	$	6,569,370
- Hurdle Rate			23.6%		26.2%
- Return		$	42,491,659	$	48,116,587
Residual Land Value		$	22,053,351	$	12,789,650

	IZ+ Scenario	
Change in Residual Land Value	$	(9,263,701)
Percent Change in Land Value		-42.0%

Expanded Inclusionary Zoning Evaluation Metrics

FAR Increase (Base Zone without Bonus to New Zone with Bonus)	1.8
Percent FAR Increase	30%
IZ+ Percent of Increased Density Required	208%
Percent Affordable Increase	109%

	MIZ Scenario	IZ+ Senario
Market Rate Units	452	448
Affordable Units	40	85
Total Units	492	538

Source: DC Office of Planning.

As stated in OP's public hearing report, there are no cases of map amendments that cross from a zone below 85 feet to a zone greater than 85 feet. In addition, most if not all the cases that started above 85 feet represented special conditions such as: publicly owned or unzoned land, a conversion from PDR to mixed-use high, a hotel request from RA-5 to MU- to expand use permissions or others. The lack of map amendment cases indicate the cost of construction becomes a major impediment. This is another reason for OP's shift in recommendation to a sliding scale based on the percent change in density as opposed to one based on the absolute FAR change.

IV. NEXT STEPS & FURTHER ANALYSIS

<u>Public Lead Map Amendments</u>

OP noticed through the economic modeling that a delay to a project caused by an owner-led map amendment case could be a significant obstacle to maximizing affordability of the Expanded IZ requirements. This is supported by several comments OP has received during both the Comprehensive Plan and Expanded IZ process. The modeling suggested it was particularly true in the high-rise construction scenario.

- This presents an opportunity when OP undertakes a map amendment case as part of a neighborhood rezoning that stems from a Small Area Plan (SAP) or other planning effort. As part of the SAP, OP would conduct economic modeling specific to that neighborhood to maximize the percent of affordable units achieved. The resulting rezoning would enable a matter-of-right process for new development under the new zones.

<u>Greater Integration with Other Affordable Housing Tools</u>

OP's approach was Expanded IZ should stand on its own without integration of other affordable housing tools. The two main tools that do not require a competitive process are Tax Exempt Bond and accompanying 4 percent LIHTC, and the new Tax Abatement for Affordable Housing in High Cost Areas. OP's review and analysis showed that there are limitations on these tools:

- The Fiscal Year 2021 Budget Support Act included a tax abatement for mixed-income housing in high cost areas. The provision requires 33 percent of units be affordable to households earning an average of 80 percent of the MFI and not to exceed 100 percent. The tax abatement provides significant incentive and support to projects pursuing Expanded IZ. However, the abatement is capped and is estimated to help two to maybe four projects a year.
- Tax Exempt Bonds have a modest beneficial impact when integrated with Expanded IZ. The total dollar amount of bond authority is capped by federal government and the District splits this cap housing and industrial revenue bonds. Most housing related bonds are used in conjunction with the District's Housing Production Trust Fund, which is a competitive process. Bonds are be more readily available than the abatement, but only provide a modest amount of help.

Sliding Scale of Requirements Based on Percent Change in Density

OP's recommendation contained in this supplemental report is a significant shift in the approach to Expanded IZ. OP looks forward to receiving testimony from the public hearing on this approach and is ready to conduct additional research requested by the Zoning Commission if needed.