City of Seattle
Edward B. Murray, Mayor

MEMORANDUM

To: Councilmember Sally Clark, Chair, Housing Affordability, Human Services and Economic Resiliency Committee
Councilmember Tom Rasmussen
Councilmember Kshama Sawant
Councilmember Mike O'Brien

From: Ben Noble, Director, City Budget Office
Steve Walker, Director, Office of Housing
Robert Feldstein, Director, Office of Policy & Innovation

Date: April 1, 2015

Subject: Statement of Legislative Intent response: Investigate a capital project and bond sale to build housing (130-1-A-2)

Statement of Legislative Intent 130-1-A-2, adopted with the 2015 Adopted Budget, required the Mayor's Office, Office of Policy and Innovation and the Office of Housing to investigate a proposal under which the City would issue up to $1 billion in bonds to build publicly owned affordable housing; in addition, the proposal envisioned that the housing could be sited on excess City property. The SLI further proposed rent revenues as the primary source of the publicly owned properties' operating expense and debt service, with other revenues from progressive taxes serving as a secondary source.

This response is divided into four parts:

- The first provides an analysis of debt financing for affordable housing, including examination of the City's legal and practical debt capacity and use of debt.
- The second reviews the availability of City land upon which to site City-financed affordable housing.
- The next part models a housing project based on assumptions specified by the SLI. The model provides the foundation for analysis of the degree to which rent revenues can cover bond repayment and operating costs, and how much additional revenue would be needed from a new tax source.
- The final section provides a summary of our conclusion.

I. Debt Financing for Affordable Housing

Legal Debt Capacity

The City's ability to debt finance projects is primarily constrained by the availability of future revenues to repay the debt with interest. "Legal debt capacity" is simply a statutory limitation imposed by the State on the total general obligation debt a city could have outstanding at any given time. This limitation is a function of the total assessed value of all real estate within the City, and existing outstanding obligations. State law limits the amount of limited tax general obligation (LTGO, or "Councilmanic") bonds – bonds that the City may issue without a vote of the people – to 1.5% of the City's assessed value. As of February 2015, the City's assessed value totals $145 billion. The amount of outstanding debt, including City guarantees and required accounting adjustments, stands at $884 million. Additionally, the City of Seattle adheres to a set of debt management policies, adopted by Council, that require a portion of the total legal debt capacity to be kept available for emergencies such as major natural disasters or other significant threats to public health and safety. Based on these numbers, the current available debt capacity for LTGO bonds – bonds that the City may issue without a vote of the people – is $1.031 billion.

Managing Debt Capacity

Regardless of the amount of available LTGO debt capacity, in the end bonds are merely a tool to enable the City to spread out the costs of a big capital project over time. Capital investments in other public goods – such as transportation infrastructure, parks and recreation, information technology projects and public safety – are civic needs that must also be considered for the City at large. The proposed use of all available debt capacity for public housing now would preclude all other uses.

Furthermore, issuing debt equal to the City's full legal capacity would have additional adverse financial impacts. To date, the City's prudent policies and practices regarding the issuance and management of debt have minimized the City's debt service and issuance costs and retained the highest practical credit rating. If the City's entire available LTGO debt capacity were used, the City's current AAA rating would be negatively affected. Such a downgrade would result in an increase in the cost of borrowing for the City, and a detrimental ripple effect felt across all lines of City business, including the utilities. This would increase the share of General Fund resources needed to support major capital projects, reducing the funding available for other services, and would also increase utility bills for City Light and Seattle Public Utility customers. Thus, the scale of any program to involve the City directly in the funding and construction of affordable housing would need to consider the competing needs for debt capacity and the potential impacts on overall City finances.

Debt Repayment

If a share of available debt capacity were to be directed toward direct housing investment, it would be essential to identify and dedicate a significant new revenue source. The model project analysis presented below shows that revenues other than rent would need to cover 66 percent of the annual debt service and operating costs for a City-funded housing investment. Given the structural deficit of the current City of Seattle budget, a new tax would be needed to address these funding needs, unless the City's elected leadership was prepared to significantly reduce funding for existing services. From the perspective of managing the City's debt and maintaining the City's access to low cost borrowing, such a new revenue source would need to be both predictable and reliable.

Through a separate Statement of Legislation Intent, the Council has requested a legal analysis of a City income tax. We presume that this is the type of "progressive tax" cited by Council as a potential source of repaying a housing-related debt issuance. In general, the City's taxing authority is granted by the state and any new revenue source would need to conform to this authority.

II. Availability of City Land

Each year the City's Department of Finance and Administrative Services produces a list of City-owned properties and provides it to City Council. The 2014 list is used for this analysis. That list includes a total of 1,194 properties. Not all are suitable for housing, so as requested during follow-up meetings with Councilmember Sawant and her staff, we screened the properties by the following criteria:

- Within City limits (1,040 remaining)
- Not fully utilized for an existing municipal purpose (210 remaining)
- Not utility-owned (177 remaining)
- Greater than 15,000 square feet (33 remaining).

These criteria allow us to identify in-city parcels that could be available without cost (utility owned parcels must be purchased from the utility at fair market value) and that are large enough (greater than 15,000 square feet) to efficiently build new housing. Given returns to scale in development and construction costs, projects with fewer than 100 units have significantly higher per-unit costs.

These criteria left a total of 33 potential parcels. However, it is worth noting many of these parcels are in a location or of a configuration that limits the site's development potential or suitability for housing production. Further, not all of the properties are suited to residential use, lacking access to transportation and favorable educational and employment opportunities. In addition, some parcels not owned by the utilities may not be available for zero cost. Properties acquired for other purposes may have other constraints that limit the City's ability to discount the sale price, either legal (e.g., source of funds by which the property was acquired) or programmatic (e.g., disposition proceeds reserved for a specific use).

The financial analysis presented below shows that new revenues would be needed to cover 66 percent of the total annual costs (debt service plus operating expenses) for City-funded housing projects. This percentage is based on an analysis that uses the first year of stabilized rent as the level amount, which is the real estate industry standard. It is important to recognize that this analysis assumes that the projects would not require funding for the purchase of land. Thus, under the financial terms described here, the scope of a City-funded housing program would also be limited by the availability and suitability of existing no-costs sites. If land purchases would be required, the amount of additional revenue needed to support the projects would obviously increase.

III. Model Project

The following sections examine a prototype project based on assumptions that reflect conditions in the local housing market and input from Councilmember Sawant's office regarding the basic affordability parameters of interest. For the sake of this analysis we assumed a 4.5% interest rate (which includes the cost of issuance and a slightly higher rate than City currently achieves due to greater uncertainty in repayment revenues), a 20 year term, and level debt service (i.e., annual payments of principal and interest are level for the term of the debt). These terms match the City's current approach to financing assets of this type and recognize that a capital infusion for system upgrades and repairs would likely be needed after 20 years.

Costs to Construct and Operate

The cost to construct and operate multifamily rental projects can vary widely.

Construction Cost

Depending on a project's location, land cost accounts for about 15 percent of the total development cost. The remainder of the total development cost includes soft costs, such as those for architectural, engineering, and other professional services, and hard costs, such as those for materials and labor. For purposes of this analysis we started with separate per-unit total development costs (excluding land costs) for studios, 1-bedrooms, 2-bedrooms, and 3-bedrooms, consistent with the limits established by the Washington State Housing Finance Commission. Commission-issued cost limits coupled with recent experience with projects receiving OH awards provide a good proxy for the projects envisioned under the SLI, as they assume prevailing wages for workers, 50-year construction standards, and a commitment to cost-effective sustainability features.

Operating Expense

Over and above debt service, operating expense comprises items such as property management, utilities, insurance, maintenance and repair, property and other taxes, and replacement reserves, which is a fund for future capital needs. In 2013, the average annual operating expense for OH-funded rental housing that serves a general (rather than special needs) population amounted to about $6,365 per unit, including both operating and replacement reserves. For the purposes of this analysis we assumed that the properties would be permitted to participate in the multifamily property tax exemption (MFTE) program or otherwise be exempted from property tax, reducing annual operating expense to $5,000 per unit. For purposes of this simple analysis, property tax is excluded, although MFTE exempts property taxes for only 12 years; the MFTE expiration would increase operating expenses beginning in year 13.

It should be noted that the City of Seattle does not own or operate affordable housing. Currently, OH-funded projects are owned by partner agency LLCs and managed by the owner and/or a property management company, which is often a nonprofit entity. The Seattle Housing Authority is the only public owner and operator of affordable housing in the city, and it has extensive staff to manage this function. If the City were to become directly involved in the ownership, management, and operation of affordable housing, additional staffing would be needed. Given the salary scale and benefits available to City employees, average per unit operating costs would likely exceed those of the existing providers. While this analysis does not factor in the cost of City staff to manage and maintain the property, it could be a significant expense.

Revenues: Approach to Determining Capacity of Affordable Rent to Cover Costs

Calculating rental income for affordable multifamily properties factors in assumptions about unit (and household) sizes, rents geared to different levels of area median income, and vacancy rates. For the sake of this analysis we employed a base case of rents split evenly between units restricted to 50% of area median income, 60% of area median income and 80% of area median income. State law restricts the City's ability to fund housing at higher income thresholds. With the understanding that larger family-sized units (2 and 3 bedrooms) are desired, we assumed a mix of unit sizes as follows: studios (20% of total units), one-bedrooms (30%), two-bedrooms (30%), and three-bedrooms (20%).

Given the costs described above and using a 100-unit prototype described below, rent revenues geared to 50%, 60% and 80% of area median income cover operating expense and about 34 percent of the debt service. Other sources of capital would be necessary to cover the remaining 66 percent of annual debt service. This approach is based on a level net operating income (NOI) using the first year of stabilized income as the level amount, which is the real estate industry standard. An alternative way to look at income is to increase expenses by 3.5% per year and rents by 2.5% per year for 20 years. Under this analysis, rental income in excess of operating expenses cover 41% of the debt service, and 59% of annual debt service must be covered by other revenue sources.

Sample Property Sources and Uses

In order to better understand the costs and revenues associated with owning and operating affordable multifamily housing, a sample 100-unit property is described below. For a prototype project of 100 units, rents annually provide an estimated $728,829 after expenses, and the annual gap between what rents can cover and debt service payments needed would be $1,386,378 with no allowance for error. As a practical matter, the City would need to maintain a revenue reserve sufficient to ensure that debt service could be paid even in the event of lower-than-expected net operating income. In effect, using an industry standard coverage of 1.2x, the amount needed annually for 20 years to cover the gap between rental income generated by 100 units and amount needed to pay debt service is $1,809,420.

Capital Sources and Uses - Sample 100-unit Project				
Uses			**Sources**	
Land	$0		Bond Proceeds	$27,861,760
Development	$27,861,760			
Total	$27,861,760		Total	$27,861,760
Annual Operating Revenue and Expense				
Expense			**Revenue**	
Operations	$500,000		Rent	$1,228,829
Debt Service	$2,115,207		Annual gap	$1,386,378
Total	$2,615,207		Total	$2,615,207
Notes: Annual debt service of $2.1 million derives from applying an interest rate of 4.5% and a 20-year amortization period (level debt service) to a total borrowed total of $27.9 million. The annual gap of would grow to $1.8 million with the inclusion of a 1.2x revenue reserve.				

A summary of the key assumptions underlying this analysis follows:

- 100 units (20 studios, 30 1-bedrooms, 30 2-bedrooms, 20 3-bedrooms)
- 34 units restricted at 80% AMI; 33 units restricted at 60% AMI; 33 units restricted at 50% AMI (distributed proportionally by size)
- Vacancy rate: 5%
- Annual Operating expense: $5,000 per unit (assumes property tax exemption)
- Per unit development cost: $231,400 to $330,750 depending on unit size
- Land cost: $0

While all these assumptions are important, this last is critical. Depending on location, land costs typically represent 15% of total costs for a project of the scale described here. With the addition of land costs, the unfunded annual gap would increase to $1,759,650, with no allowance for coverage to guard against risk, or $2,182,692 with 1.2x coverage.

IV. Conclusion

In summary, a portion of the City's debt capacity could potentially be made available to support investments in low-income housing, but only if funding can be identified to address the subsidy needed to maintain and operate such housing into the future. The scale of any such investment would need to be gauged carefully to avoid the City taking on imprudent risks that could jeopardize the City's bond rating, and result in higher borrowing costs for other critical capital projects such as transportation improvements and public safety facilities.

A secondary consideration is the strategic capacity to leverage additional resources. A large City bond issue to fully finance City-owned affordable housing as contemplated by the SLI request would sacrifice other sources – notably low income housing tax credit equity – that could otherwise cover a substantial portion of the project cost; with typical leverage achieved by current OH projects, each City dollar is matched at a 3:1 ratio. Because the proposed strategy does not utilize tax credit equity or other leveraging sources, the total project cost would be borne wholly by the City. If, instead of debt financing the entire 100-unit project, the City chose instead to substitute an upfront equity investment as opposed to an ongoing commitment to pay the debt service gap, it would need to supplement $18.3 million in cash on top of a $10 million bond in order to achieve just 100 units of housing.

The Mayor's Housing Affordability and Livability Agenda (HALA) efforts will be reviewing many options to increase the supply of affordable housing in Seattle, including but not limited to the investigation of potential City properties, new revenue sources, regulatory options to incentivize housing, and creative financing approaches. The HALA Advisory Committee is a twenty-eight member stakeholder group that includes renters and homeowners, for-profit and non-profit developers and other local housing experts. Recommendations from the Advisory Committee will come out by the end of May and will be shared with the City Council and general public.