nblc
N. Barry Lyon Consultants Ltd.

Memorandum

To:	City of Ottawa Hemson Consulting
From:	N. Barry Lyon Consultants Limited
Date:	October, 2021
RE:	Discussion in support of Ottawa's ongoing Community Benefits Charge Analysis: Effects of Increasing Development Related Costs on Real Estate Economics

1.0 Introduction

N. Barry Lyon Consultants Limited ("NBLC") with Hemson Consulting has been retained by the City of Ottawa, to prepare a discussion paper examining the relationship between development related charges and housing affordability. The term *development related charge* refers to government imposed charges that are assumed by the private sector when developing real estate. Development related charges can therefore include building permit fees, Development Charges, development application fees, cash-in-lieu of parkland, Community Benefits Charges (formerly Section 37 contributions), property taxes, land transfer tax, HST, and others (e.g. Inclusionary Zoning).

This memo summarizes the economics of home building in Ontario, with a view to assessing how new home pricing is established and the relationship between the delivery costs of home building, pricing, affordability and housing supply. We note that the word "affordability" in this memo is used as a relative term, and does not refer to any formal definition of affordable housing as defined by the Province or City of Ottawa.

2.0 Summary

NBLC has relied on its more than 45 years of experience in housing market research in Canada in developing this paper. The majority of our experience has been helping developers pinpoint residential product types, positioning, pricing and anticipated sales or leasing rates for new home construction. This experience provides us with the insight that home pricing is related to market supply and demand considerations. These market characteristics ultimately establish how much a purchaser or renter is willing to spend given the features and location of the home and the competitive choices in the marketplace.

Understanding this, developers and/ or owners will charge the maximum rent or sale value for a home that the market can bear at any given time, irrespective of the cost of constructing the home in the first place. If the maximum price supported by the market does not produce enough revenue to cover all development costs (including the purchase of land and an attractive profit), the developer will not build the project. They cannot simply increase the price of homes beyond what is supported by the market when faced with rising costs.

Ultimately, supply and demand conditions in the market determine how much a developer can charge a purchaser for a home. This is further illustrated by the fact that the trajectory of housing prices in urban markets across Southern Ontario have typically increased at a higher pace than increases in development related charges or construction costs themselves.

If development costs increase – due increases in development related charges imposed by a municipality, or a number of other factors – developers will discount the amount they pay for a development site. Land value is negatively impacted because other elements of the equation (**Figure 1**) are generally fixed: construction costs are relatively fixed, the sale price of homes cannot exceed what the market of willing buyers are willing to pay, and a developer is generally unwilling to reduce their required profit expectation.

The impact of rising development related fees and charges therefore reduces the *residual land value (RLV)* of a project, which is simply the amount that a developer can afford to pay for a development site.

Figure 1

Understanding Residual Land Value	
Project Revenue	A
Project Costs	- B
Developer Profit	- C
Land Value	= D

Generally, in communities where market pricing supports land values that well exceed the value of other competing uses (retail, gas stations, low-density residential, etc.), there should be no impact to the viability, pricing, and supply of residential development. In these situations, developers will continue to purchase developable land in the market and charge purchasers an amount that is supported by local supply and demand conditions.

With respect to Community Benefits Charges (CBC) specifically, Provincial regulation caps a municipality's CBC to a maximum of four percent of land value. While this is may be a meaningful charge to projects in some weaker market locations, given the scope of other fees and charges that a developer is exposed to, CBC in isolation is unlikely to represent a major impact to development viability or housing supply. To expand on this, we have discussed undertaking further review to examine typical/ historical Section 37 contributions collected throughout the City in comparison to what a new CBC at 4% of land value might mean to a typical development in Ottawa. This point of comparison could be useful in future consultation with stakeholders.

However, when considered cumulatively with other emerging changes to municipal fees and policy (i.e. Inclusionary Zoning), increasing fees can impact a developer's ability to pay for land or proceed with a development project. If the land value of a residential development site is reduced below the value of other competing uses or below the expectation of a land owner, a developer will not be able to purchase the property and would not be able to build the project.

Further, if the viability of residential development is impacted on a large scale, the supply of housing will be reduced as developers will be unable to build new housing. More broadly, if supply does not meet demand, the price of both new and existing homes will increase, which is a function of basic housing economics (i.e. a large pool of buyers competing for a comparatively shallow supply of homes).

It is noted that the City of Ottawa's refreshed 10-year housing plan identifies an urgent need to increase the supply of housing for low and middle income households. This gap in the market is not addressed by the development industry because the market either supports higher pricing, or the market does not support revenue sufficient to cover all development costs and an attractive profit. To encourage a greater supply of housing targeted to low and middle-income households, municipalities can consider a range of tools including incentives (e.g. increasing density permissions, waiving, reducing, or deferring development costs in exchange for housing supply at a defined affordability level), or through a market interventions like Inclusionary Zoning (IZ) at Protected Major Transit Station Areas. In either strategy, it is imperative that the City's policies are aligned with development economics so that the tools achieve their intended outcomes. For instance, that offsets are valuable enough to offset economic gaps, or that IZ policies do not depress land values to the point that development activity stalls.

Finally, we note that NBLC has not assessed the impact of proposed changes to development related charges in Ottawa on project viability. However, as is common across other urban markets, it is likely that impacts will vary across the City's varying submarket areas; a reflection of underlying land market conditions (existing entitlements and the value of existing uses) and revenue potential for new development (achievable sales/ rental pricing, absorption velocity, etc.).

3.0 Background

3.1 Factors That Influence the Cost of Housing

The costs of building housing generally fall into one of four discrete categories:

- Hard Construction Costs
- Soft Development Costs (including development related charges and fees which are expanded upon within Section 3.1.1)
- Developer Profit
- Land Costs

Hard construction costs encompass all the materials and labour required to physically construct a building. Hard construction costs will vary from project to project. Factors such as topography and grading, geotechnical issues, site contamination, building materials (e.g., concrete vs wood), the height of a building, surface vs. underground parking, and other similar considerations will all impact construction costs.

Hard construction costs are dictated by the market, albeit a different market than house prices. Developers will purchase building materials like any other commodity, which are subject to fluctuations in price. Macro-economic trade impacts (e.g., tariffs on steel or lumber) can also impact the price of materials and other commodities. Labour demand and supply conditions also affect hard costs. Overall, once the specifics of a development project are defined, hard costs become relatively fixed.

Soft development costs include all the other costs that a developer will encounter when developing real estate. These items include government-imposed development related charges and fees, as well as a host of other costs including, consultants, financing costs, marketing costs and taxes. Like hard costs, soft development costs can also vary depending on the specifics of a development project. For example, factors such as project scale and absorption rates can affect the time it takes to develop a project, which in turn can affect financing and other carrying costs.

Changes to the Section 37 of the Planning Act through the implementation of a Community Benefits Charge (CBC) framework will further impact the way soft costs are calculated in a developer's proforma. Provincial regulation caps CBCs at a maximum of four percent of land value.

Developers and their investors require a certain profit threshold to undertake a development project. They are investing their skills and equity, as well as taking on significant risk in order to make a profit that is superior to the rate of return that might be achievable through another investment vehicle. If an acceptable profit margin cannot be achieved, developers will seek development opportunities in other markets, invest in other real estate asset classes, or choose another investment vehicle altogether.

Moreover, a developer's lender will look to see adequate profit in a project to ensure that risk factors are accounted for to finance a project. If profit margins are inadequate, lenders will not advance funds to the project.

3.1.1 Development Related Charges

Expanding on the above, development related charges that are imposed on the building industry when undertaking a real estate development can include the following items:

Local and Regional Municipal Charges:

- **Development Charges:** Municipalities collect Development Charges on development to pay for capital costs associated with expanding infrastructure to meet the increased servicing needs of development. Not all municipal services and capital costs are eligible for Development Charge funding. In most Ontario municipalities, residential charges are calculated on a per capita basis and differentiated by housing types (e.g. single-detached, apartments, etc.) based on average occupancy patterns.
- **Cash-in-Lieu of Parkland:** The City of Ottawa typically requires on-site parkland dedication when a development is proposed in order to accommodate a new park and/or open space. In situations where a development cannot accommodate on-site parkland or where the City does not require a conveyance of land, a cash-in-lieu (CIL) payment can be made. New apartment or other higher intensity uses often will pay a cash-in-lieu payment to the municipality, which is required to be paid prior to building permit issuance. Currently, CIL payments are capped to not exceed 10% of the value of the land area of the site being developed. Without this cap in place, the Planning Act permits

municipalities to charge a value equivalent to 1 hectare per 500 units, which in many urban instances can be a significant charge.

- **Development Application Review Fees:** Local and Regional municipalities will charge fees for the review of development applications, such as Official Plan Amendments, Rezoning applications, site plan control, and committee of adjustment applications. Municipalities are permitted to charge fees to offset the cost of providing land use planning and building code services in accordance with Provincial legislation. As per Section 69 the Planning Act, these fee rates are designed to meet only the anticipated cost to the City in respect of the processing of each type of application. This ensures that such costs are not borne by tax payers.

- **Building Permit Fees:** Similar to the above, building permit fees are also charged to offset the costs to the municipality of administering and enforcing the building code. This process typically involves one or more inspections of the building site as well as processing and administration of the building permits. As per the Building Code Act, municipal building permit fee rates are designed to not exceed the anticipated costs of administration and enforcement of the Building Code.

- **Section 37 / Community Benefits Charges:** Prior to 2020, Section 37 of the Planning Act allowed municipalities to request community benefits in exchange for heights/densities above the existing zoning permissions. Section 37 contributions could include on-site community benefits such as a community facility or streetscape/park improvements. Section 37 contributions could also include a cash payment that would be used by the municipality to address various City-wide needs, however there was not standard calculation within the legislation, meaning the cost was regularly negotiated as part of the development entitlements process.

  Section 37 has subsequently been revised to now permit municipalities to implement a by-law to impose Community Benefits Charges (CBC) against land (where development is five storeys and 10 units or greater) to pay for the capital costs of "facilities, services, or matters required because of development or redevelopment in the area to which the by-law applies". The CBC can include in-kind or cash contributions. Ontario Regulation 509/20 caps the calculation of CBCs to four percent of land value at time of permit.

- **Public Art (or similar) Contribution:** Some municipalities require a contribution from developers for the implementation of public art or other similar initiatives. Developers are typically encouraged to include public art as part of their development and/or contribute an agreed upon amount of the construction costs to a public art program. Where applicable, this cost typically ranges between about 0.5% to 1.0% of construction costs.

- **Property Taxes:** Developers will pay property taxes on a development site as soon as the property is acquired. Taxes will also be paid during application review and construction, ceasing once the new homes are transferred to the purchaser, at which time purchasers begin paying property taxes on their individual unit.

Provincial and Other Development Related Charges:

- **Land Transfer Tax:** Developers pay the provincial land transfer tax when acquiring a development site. Additionally, the land transfer tax is also paid by purchasers when closing on their home. First time home-buyers are however eligible for a rebate on all or part of the land transfer tax, to a maximum rebate of $4,000.

- **Tarion Enrolment Fee:** Tarion requires developers of new homes in Ontario to pay an enrollment fee, which varies depending on the value of the home as per the Enrolment Fee Calculation Table. The purpose of Tarion is to protect consumers of new homes by ensuring that builders comply with provincial legislation and building codes.
- **HST:** New home sales in Ontario are subject to the Harmonized Sales Tax of 13%. A rebate on this tax is provided, which varies depending on the sale value of the home. The advertised price of new homes typically include the HST amount in the purchase price.

3.2 Factors That Influence the Price of Housing

In determining the highest and best use of a residential development site, a developer will evaluate the most marketable housing types, pricing, product positioning (e.g., mid-market or luxury), sales absorption rates or lease-up rates, target purchasers and marketable suite mix, and other similar items. Often, these inputs feed into a financial analysis to evaluate overall project viability, including land value and profit. When deciding how to price housing, it is important to consider both demand and supply conditions in the local market area.

Ultimately, developers are seeking to determine the maximum they can charge purchasers or renters and still sell or lease-up their project within a reasonable time frame (or, absorption period). If a developer sells or leases homes slowly, this is may be a sign that pricing was too high for the project. Conversely, if the entire project sells out over a weekend, the developer may have been able to charge more for the product. Developers carefully examine supply and demand to ensure this does not happen.

Developers will also monitor supply and demand conditions throughout a sales campaign, often increasing pricing throughout the process at specific thresholds (e.g., at the beginning of construction). Some developers also may not release all units to the market at the same time, later adjusting pricing or other elements based on the market's response to an initial release. This is an important consideration, as developers can – and often do – increase pricing if the market supports such an increase. This adjustment to pricing is independent of any shift in development costs.

Given this, changes in municipal fees or charges (CBCs, or otherwise) do not directly affect the price of housing, the supply and demand conditions considered above do not change after a municipal fee is increased. Rather, if municipal fees or charges do increase, project costs increase as a proportionate share of revenue. This dynamic affects land value, as will be discussed in section 3.3. It is of course possible that if new policies affect costs significantly, that projects could become unfeasible. In some instances, this could restrict the supply of housing and potentially drive demand and pricing for available homes upwards.

3.3 Understanding Land Values for High Density Projects

Accurately assessing the land value for high density residential development involves an assessment of the probable revenues and costs, as well as desired profit. Project revenues are driven by the sale or rental value of homes as well as other sources or revenue such as parking spaces, storage lockers, and ground-floor commercial space or other revenue-generating uses. As illustrated by **Figure 1**, developers will then subtract all development hard and soft costs, as well as their required profit from the estimated revenue of the project. The remaining amount, or residual amount, is referred to as the Residual Land Value (RLV). The RLV represents the theoretical maximum price a developer could pay to acquire land to construct the housing project and achieve their required profit margin.

When a developer conducts an RLV analysis, the result will guide whether to proceed with the land acquisition and undertake the project. This results in one of the two scenarios:

- **RLV is equal to or higher than the asking price of land in the market:** If the RLV of a proposed development is greater than the asking price of the land in the market, a developer can, in theory, purchase the land and build the project while satisfying their profit expectation.
- **RLV is below the asking price of land in the market:** In this situation, the housing development would not be considered viable because a developer could not pay the asking price of land and still maintain their required profit margin.

When municipal policy changes result in costs increases, land value becomes the key fluctuating variable given the following:

- **Project Revenue:** With the exception of Inclusionary Zoning policies (which imposes a price ceiling on some portion of revenue) the introduction of new or higher municipal fees and charges do not impact project revenue. As discussed earlier, developers work to set project revenues at the maximum the market will bear within a desired project absorption timeline.
- **Developer Profit:** Developers will seek a return on the equity they invest that reflects the project risk and range of other matters. If they cannot achieve this return, developers may shift to invest in other sectors. In practical terms, lending institutions will need to see a healthy forecasted profit – as a hedge against their risk – prior to advancing financing. The margin for profit is therefore generally considered fixed. In our work for example, we assume a target profit of 15% of gross revenue in condominium scenarios. For these reasons, a developer is not able to adjust their profit margin to offset the cost of an inclusionary zoning policy.
- **Land**: Given that development revenue is established by market demand and a developer's profit margin is relatively fixed, increases to development costs as a result of changing municipal fees will have the primary effect of reducing the amount a developer can pay for land.

Of course, the introduction of higher municipal fees and charges will translate to higher delivery costs for housing. It is common to hear that if costs increase developers will simply apply these costs to the price of a new home. However, developers cannot simply increase the price of homes beyond what the market will support. If the market can support an increase, developers will increase pricing regardless of costs. Certainly, if costs are reduced in a strong market, home prices do not typically decline.

If a developer has purchased land without being aware of forthcoming changes to project costs, it could have – depending on the magnitude of the rate or policy change – a significant impact the feasibility of the project.

For developers, increasing municipal fees and charges should be treated no differently than a developer discovering soil contamination issues at a property they are considering for purchase. A developer would not pay full market value for a site with soil contamination issues and then later attempt to recapture the increased cost of remediating the site by increasing the sale value of homes at pricing beyond what is supported in the market. Rather, if soil remediation works were to require $2.0M in added project costs, the developer should seek to pay $2.0M less for the property. In same way, if new municipal fees increase costs by $2.0M. the site's land value should be reduced accordingly.

The discussion in this section therefore concludes that increased municipal fees and charges will reduce a developer's budget to acquire development sites. This will place downward pressure on land values for properties which may be suitable for redevelopment. The only exception to this is where a developer has already acquired land, as a developer cannot pay less for land to account for rising costs if they have already purchased land without accounting for this impact. In this situation, a developer must either: accept a lower return; delay the project until pricing increases / costs decrease; or, cancel the project. For this reason, it is common and appropriate that significant changes to policy or municipal fees are accompanied with transition or phase-in policies in order to allow markets time to adjust.

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