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## TECHNICAL MEMORANDUM

Date: May 29, 2026

To: Jeff Thomas, Alison Van Grop, Adam Zack, City of Mercer Island

From: Michaela Jellicoe, Elliot Weiss, Jo Baldwin, Community Attributes Inc.

Re: City of Mercer Island Affordable Housing In-Lieu Fee Supporting Analysis

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## INTRODUCTION

### Background and Purpose

The Washington State Legislature passed House Bill 1220 (HB 1220) in 2021, introducing additional requirements for how cities plan for growth, specifically requiring that all cities and counties plan for and accommodate housing affordable to all economic segments of the population. The City of Mercer Island adopted its updated Comprehensive Plan in November of 2024, including required updates to the Housing Element. This effort included a Land Capacity Analysis (LCA) in 2023 to identify Mercer Island's capacity for residential growth. However, in February 2025, land use nonprofit Futurewise and two Mercer Island residents filed an appeal of the City's adopted Comprehensive Plan with Washington State's Growth Management Hearings Board (GMHB). The GMHB found that Mercer Island's Comprehensive Plan did not adequately plan to accommodate housing at all affordability levels. Mercer Island retained Community Attributes Inc. (CAI) to prepare an updated Land Capacity Analysis and accompanying policy analyses including an Affordable Housing Nexus Study.

As a part of this effort, the city is evaluating the adoption of an inclusionary zoning program, which would require new residential development to contribute to affordable housing through either on site performance or fee-in-lieu programs. The city is considering a baseline requirement of 10% of new multifamily units priced affordably for households earning 50% of the area median income (AMI). This analysis explores the feasibility of providing affordable units on site compared to paying a fee in-lieu. Findings are used to support policy decision-making to set a fee-in-lieu rate.

This memorandum includes a high-level assessment of the feasibility of ground-up multifamily development under a not-yet-adopted inclusionary zoning program, with an option for developers to pay a fee rather than providing required affordable housing units on-site. The study compares return metrics for a prototypical multifamily development across two scenarios: a scenario where the developer chooses to pay an in-lieu fee, and a scenario in which the developer provides the affordable housing units on-

site. Also included for context is a summary of the in-lieu fee rates and on-site affordable housing requirements among regional competitors.

## Methods

Key findings are summarized from the Draft City of Mercer Island Affordable Housing Nexus Study, dated May 1, 2026. Pro forma financial modeling is used to evaluate the feasibility of a prototypical development project appropriate for zone districts within Mercer Island’s Town Center. The pro forma model estimates costs and revenues and uses two different return metrics to estimate project feasibility. Affordable housing in-lieu fee and on-site performance programs are summarized for a selection of other regional jurisdictions.

## Organization of Report

The remainder of this report is organized as follows:

- **Key Findings** summarizes the overarching findings informing in-lieu fee rates for an inclusionary zoning program.
- **Nexus Study Findings** highlights the maximum allowable affordable housing fee rates established by the Mercer Island Affordable Housing Nexus Study.
- **Inclusionary Zoning Program Comparisons** documents the affordable housing requirements and in-lieu fee rates set in a selection of comparison cities within the region.
- **Feasibility Methodology** provides details on the pro forma analysis inputs and assumptions.
- **Feasibility Findings** summarizes key takeaways from the pro forma analysis.

## KEY FINDINGS

- Cities throughout the region are evaluating new programs and policies to encourage or require the provision of affordable housing in multifamily developments. Some of these programs may also result in a dedicated funding stream for the construction of housing units at very low levels of affordability.
- One such program is called inclusionary zoning with fee-in-lieu. Inclusionary zoning requires that a developer building a multifamily project either provide a specified quantity of affordable housing units within the project, or pay a fee in-lieu of providing them on site, such that the city or its partners can leverage the fee dollars to build affordable units off-site.
- The City of Mercer Island Affordable Housing Nexus Study establishes a maximum supportable fee-in-lieu for an inclusionary zoning program ranging between \$30.90 and \$37.62 per square foot dependent on the zone and anticipated type of development. A fee in-lieu less than \$30 per square foot ensures the fee rate is below the maximum allowable, per the Nexus Study.
- In-lieu fee rates for affordable housing vary widely across nearby jurisdictions, reflecting different policy goals and market conditions. Regional benchmarks

range from about \$8 to \$50 per square foot (Seattle), \$13 per square foot in Bellevue multifamily zones, and up to \$34–\$35 per square foot in Sammamish, with some cities (Kirkland, Redmond) prioritizing on-site performance over fees.

- The maximum supportable on-site affordable housing requirement for an inclusionary zoning program ranges between 13.1% to 16.4% depending on project square footage. An on-site performance requirement recommended by the City of Mercer Island requiring 10% of units affordable to households at or below 50% of AMI falls below the maximum allowable on-site performance requirement.
- Across comparable jurisdictions, on-site performance requirements of approximately 10% of units are standard, with affordability targets typically ranging from 50% to 80% of AMI, sometimes with deeper affordability incentives or tiered structures. While cities like Seattle vary requirements by zoning and unit size (5%–11%), other peer cities, including Bellevue, Kirkland, Redmond, and Sammamish, cluster around a 10% requirement. Several jurisdictions also incentivize deeper affordability (Sammamish’s 2-for-1 credit at 50% AMI) or higher set-asides in denser zones (15% in Kirkland).
- Overall, project feasibility for mid-rise multifamily in the Central Puget Sound region is challenged by current economic conditions.
- This analysis indicates that for a multifamily prototype consistent with the vision for the City of Mercer Island’s Town Center, using assumptions informed by current or expected market conditions, project returns would be slightly higher for the developer that pays the fee-in-lieu than for the developer that chooses to “perform”, or to provide the affordable units on-site, assuming fee rates at or below \$35 per square foot compared to an onsite performance requirement of 10% of units at 50% of AMI.
- An in-lieu fee less than \$35 per square foot would incrementally make payment more financially attractive, and a higher fee would incrementally make performance more financially attractive.

## NEXUS STUDY FINDINGS

The nexus study establishes the maximum feasible affordable housing requirements that development projects can support by linking new growth to the housing needs it generates.

It begins by estimating the affordability gap. This is the difference between what households at various income levels can afford to pay in rent and the actual cost to construct and operate an affordable unit. Next, the analysis evaluates the economic activity generated by each development prototype, including total household income and disposable income. This spending is then translated into the number of jobs supported, which in turn is used to estimate how many new worker households are associated with each project at different income levels. These estimates are combined by multiplying the number of households in each income group by the corresponding affordability gap, producing a total measure of the affordable housing need generated by each development.

From this, two policy metrics are derived:

- The maximum supportable in-lieu fee, calculated by spreading the total affordability gap across the project’s total square footage.
- The maximum on-site performance requirement, calculated as the share of affordable units needed relative to the total number of units in the project.

Together, these outputs define the upper bound of what a development can reasonably contribute toward addressing affordable housing needs, whether through fees or on-site unit provision.

**Exhibit 1** and **Exhibit 2** present the maximum supportable in-lieu fees and on-site affordable housing performance from the City of Mercer Island Affordable Housing Nexus Study. The results are shown at each AMI level and combined for below 80% and below 100% AMI levels. Maximum allowable fee rates range between \$30.90 per square foot to \$37.62, depending on the prototype and zone. Maximum allowable onsite affordable housing requirements range from 13.1% to 16.4% depending on the prototype and zone.

**Exhibit 1. Maximum Supportable In-Lieu Fees per Square Foot by Prototype, City of Mercer Island**

AMI Level	City of Mercer Island		
	Prototype 1 - TC-7	Prototype 2 - TC-5	Prototype 3 - TCMF-4
0-30% AMI	\$3.63	\$4.41	\$4.06
30-50% AMI	\$18.49	\$22.37	\$20.56
50%-60% AMI	\$5.25	\$6.47	\$5.94
60%-80% AMI	\$2.97	\$3.68	\$3.38
Below 80% AMI	\$30.34	\$36.93	\$33.94
80%-100% AMI	\$0.56	\$0.70	\$0.64
Below 100% AMI	\$30.90	\$37.62	\$34.58

*Sources: City of Mercer Island, 2025; U.S. Census Bureau, 2025; Bankrate, 2025; U.S. Department of Housing and Urban Development; King County Assessor, 2025; Community Attributes Inc., 2025.*

**Exhibit 2. Maximum Supportable Onsite Affordable Housing Performance Requirements by Prototype, City of Mercer Island**

AMI Level	Prototype 1 -	Prototype 2 -	Prototype 3 -
	TC-7	TC-5	TCMF-4
0-30% AMI	0.9%	0.9%	1.1%
30-50% AMI	6.3%	6.0%	7.5%
50%-60% AMI	2.2%	2.2%	2.7%
60%-80% AMI	2.5%	2.4%	3.0%
Below 80% AMI	11.9%	11.4%	14.3%
80%-100% AMI	1.7%	1.6%	2.1%
Below 100% AMI	13.6%	13.1%	16.4%

*Sources: City of Mercer Island, 2025; U.S. Census Bureau, 2025; Bankrate, 2025; U.S. Department of Housing and Urban Development; King County Assessor, 2025; Community Attributes Inc., 2025.*

The prototypes, as designed within the Nexus Study, are aligned with the proposed rezoning in Town Center for 8-story and 6-story development. While some development projects may exceed the seven and five stories represented in the prototypes, other development regulations, market factors, and construction cost structures are likely to lead to certain projects building at intensities lower than the maximum allowed by zoning. The prototypes represent balance within this range of outcomes.

**INCLUSIONARY ZONING PROGRAM COMPARISONS**

The Cities of Seattle, Bellevue, Kirkland, Redmond, and Sammamish have each adopted inclusionary zoning programs which have varying requirements for on-site provision of affordable housing (performance) and fee in-lieu of performance (payment).

**On-Site Performance**

A review of other nearby city’s on-site performance requirements reveals that 10% of units is comparable to other inclusionary zoning programs. Required AMI limits range from 50% to 80%.

The City of Seattle’s Mandatory Housing Affordability (MHA) program defines both performance and in-lieu fee requirements by zone and geographic area. Residential performance requirements range between 5% to 11% and require affordability levels of 40% of AMI for units less than 400 square feet and 60% of AMI for units greater than 400 square feet. The City of Seattle’s program has generated just 10% of total units through the performance option.

The City of Bellevue has defined separate requirements for middle housing and mixed-use and multifamily structures. Middle housing, allowing the development of 6 units on any residential land use that would not otherwise allow 6, must provide at least 2

affordable units at 60% of AMI. The City of Bellevue adopted a Mandatory Affordable Housing Program in March of 2026. This program provides a range of compliance options. For rental units a developer may provide 10% of units at 80% of AMI, or 7% of units at 60% of AMI, or 5% of units at 50% of AMI. For ownership units a developer may provide 10% of units at 100% of AMI or 7% of units at 80% of AMI. The City of Bellevue program applies to commercial development as well as residential development.

The City of Kirkland requires 10% of units in low-density residential zones at 80% of AMI for ownership units and 50% of AMI for rental units. For all other applicable zones, except those with height limits of 65 feet or greater, the City requires 10% affordable units at 50% of AMI for rental and 80% of AMI for ownership units. Zones with maximum heights of 65 feet or greater require 15% affordable units.

The City of Redmond has adopted a performance requirement of 10% of units at 80% of AMI. The City of Sammamish also requires 10% of units at 80% of AMI but allows for each unit at 50% of AMI to count for two units at 80% of AMI.

## **Fee In Lieu**

Rates for affordable housing fee in-lieu vary among cities with adopted programs in nearby cities, depending on the impact that new development has on the need for affordable housing and the specific goals of each program. The City of Seattle's MHA program, adopted in 2017, has residential in-lieu fee rates in 2026 between \$8 and \$50 per square foot, depending on the specific zone and geographic location of the development. The City of Seattle has generated more than \$330 million in in-lieu fees across all types of development supporting the production of 4,595 affordable units. During that same period total units provided directly by developers or through performance was 505, or 10% of all units supported by the program.

The City of Bellevue has several programs designed to support affordable housing. For middle housing development the in-lieu fee option is \$150,000. The newly adopted Mandatory Affordable Housing Program sets in-fee rates between \$10 and \$12 per square foot of new nonexempt residential and mixed-use gross floor area depending on the land use district. The rate is \$16.50 per square foot of new nonexempt nonresidential gross floor area.

The City of Kirkland and City of Redmond's programs are both designed to incentivize on-site performance. The City of Kirkland allows an in-lieu fee as a compliance option at \$15 per square foot above 2,000 square feet for low-density residential zones but only allows in-lieu fees for fractional units in other zones. Redmond Municipal Code (RMZ) 21.20.050 specifically states a preference for on-site performance and defines provisions for alternative compliance but does not specify the rate. RMZ 21.20.050 rather states that the payment in lieu must exceed the cost of on-site performance by 10%. The City of Sammamish also prefers performance but has defined an in-lieu fee rate of \$34.45 per square foot.

## FEASIBILITY METHODOLOGY

A pro forma financial model is used to evaluate the feasibility of a prototypical development appropriate for zone districts within Mercer Island’s Town Center. The purpose of this model is to compare return metrics between a scenario in which the developer provides affordable housing on-site to a scenario where the developer chooses to pay an in-lieu fee. Additionally, scenarios compare these metrics at different levels of fee-in-lieu rates to understand potential developer preference between an in-lieu fee compared to providing affordable housing on-site.

### Prototype Inputs and Assumptions

The prototype studied in this analysis is a seven-story multifamily project with 390,595 built square feet on a 1.9-acre parcel. The prototype includes 368 total housing units. Across all unit types, the average net unit size is about 850 square feet. Overall, 47% of all units are assumed to be one-bedroom units, followed by two-bedroom units at 25%, and studios at 21%. The remaining units are three bedrooms. Because the City of Mercer Island will be implementing the requirements of HB 1491<sup>1</sup> by December 31, 2029, which prohibits the city from maintaining minimum parking requirements within the light rail station area, no additional off-street parking is assumed.

### Lease Rates

Assumed lease rates are based on an analysis of 65 comparable housing units in recently built mid-rise multifamily buildings located in ARCH<sup>2</sup> cities of east King County. Observed rents for these units range from \$2.96 to \$5.30 per square foot. Model inputs reflect the average cost of units in the sample, controlled for unit size (number of bedrooms). Lease rate data were collected during Q2 and Q3 2025.

### Development Costs

The assumed development costs are informed by both the Rider Levett Bucknall (RLB) Q1 2026 Quarterly Construction Cost Report and contextual data from ARCH. RLB gives the current range of hard costs for multifamily in the Seattle region at \$290 to \$495 per square foot. This analysis assumes a hard construction cost at the midpoint of this range, \$392.50 per square foot. To account for soft costs, such as administrative,

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<sup>1</sup> HB 1491 (2024) introduced transit-oriented development (TOD) requirements, establishing minimum density and allowable use standards within defined station area walksheds served by high-capacity transit. These TOD requirements prohibit the City of Mercer Island from maintaining minimum parking requirements within the light rail station area.

<sup>2</sup> ARCH (A Regional Coalition for Housing) is a partnership of King County and East King County cities working to preserve and increase housing for low- and moderate-income households in the region. ARCH is comprised of member jurisdictions Beaux Arts Village, Bellevue, Bothell, Clyde Hill, Hunts Point, Issaquah, Kenmore, King County, Kirkland, Medina, Mercer Island, Newcastle, Redmond, Sammamish, Woodinville and Yarrow Point.

legal, and design-related fees, 30% of hard costs are added, resulting in a total development cost of \$510 per square foot before land acquisition costs are added.

The analysis uses comparable, for-sale properties to determine an assumed land cost. Comparable properties include on-market land zoned for multifamily uses at similar densities as reflected in the prototype. The model assumes land will cost \$190 per square foot, or about \$8.3 million per acre. These assumptions result in a modeled total development cost (TDC) of \$550 per square foot (assuming the developer provides affordable housing on-site) to \$575 per square foot (assuming the developer pays the in-lieu fee).

## Financing Assumptions

The analysis assumes the prototype would be built using a combination of debt and equity. Specifically, the model assumes a commercial mortgage at 60% loan-to-cost (LTC) with a 30-year amortization and a 6.00% interest rate. As with other assumptions in the model, financing terms vary and should be updated regularly if the model is to remain applicable to current conditions.

## Policy Scenarios

The pro forma model analyzes four levels of fee-in-lieu rates: \$20, \$25, \$30, and \$35 per gross square foot of building area compared against a requirement that the developer provide 10% of units affordable to households at 50% of AMI (on-site performance). The in-lieu fee rates at or below the maximum allowable level determined in the Mercer Island Affordable Housing Nexus Study. The fee and on-site performance requirement have not been adopted by the City of Mercer Island. The range of fees is informed by both the Nexus Study and the range of fees charged in other jurisdictions. The comparison is used to demonstrate the relative impacts between the fee in-lieu and on-site performance on hypothetical project feasibility.

## Return Metrics

The pro forma model estimates costs and revenues and employs two different return metrics to summarize project feasibility. The return metrics used in the model are cash-on-cash (COC) and yield-on-cost (YOC). Each can be useful for analyzing the development prototypes.

### Cash-on-Cash Return (COC)

Cash-on-cash measures the annual pre-tax cash flow generated by a property relative to the actual equity invested. The formula is:

$$\text{Annual Cash Flow} \div \text{Total Equity Invested}$$

For example, if an investor put in \$2 million of equity and the property generates \$160,000 in net cash flow after debt service, the COC return would be 8%. COC is a

levered metric, meaning it reflects the impact of financing, and it only captures actual cash received, not appreciation or principal paydown.

COC is most appropriate for:

- Equity investors focused on actual cash distributions who want to understand the return on their out-of-pocket capital;
- Stabilized deals where the financing structure is known and fixed; or
- Comparison of investment alternatives where the equity requirements and leverage profile are similar across options.

### Yield-on-Cost (YOC)

Yield-on-cost measures the stabilized net operating income (NOI) a project will generate relative to the total all-in development or acquisition cost. The formula is:

$$\text{Stabilized NOI} \div \text{Total Project Cost}$$

For example, if the total project cost is \$10 million and stabilized NOI is \$700,000, YOC would be 7%. YOC is an unlevered metric, meaning it doesn't account for financing or leverage, and it is forward-looking in the sense that it uses a projected stabilized NOI, not current cash flow.

YOC is most appropriate for:

- Evaluating a development or value-add project and understanding whether the economics of building/repositioning make sense before layering in financing assumptions;
- Comparing development spread against prevailing market capitalization rates; and
- Comparing projects on an apples-to-apples basis, independent of how each might be capitalized

Both return metrics can be used together in feasibility analyses. YOC indicates whether the deal makes economic sense at the asset level; COC indicates whether the equity return justifies the risk given a specific capital structure.

## Identifying and Understanding Hurdle Rates

The hurdle rate is the rate of return that a project needs to exceed for a developer or investor to deem it feasible. Hurdle rates vary by return metric and based on market conditions. Rather than identifying a single, published, widely-accepted hurdle rate, developers set them internally based on their cost of capital, risk tolerance, and product type.

### Cash-on-Cash Hurdle Rate

COC returns generally need to exceed the interest rate on the developer's permanent financing, or the loan taken to repay or "take out" the construction loan. At

underwriting, COC yields that are 150-200 basis points above the interest rate may be preferred, but this range can vary. Seattle area commercial mortgage rates begin around 5.4% at the time of writing. Because this rate is a best-case scenario, and rates vary based on loan term, loan-to-value, debt service coverage, asset quality, and other factors, this analysis assumes permanent financing at 6.0%. At the assumed rate, and accounting for the developer spread, COC returns would need to reach at least 7.5 to 8% under stabilized operations.

### **Yield-on-Cost Hurdle Rate**

This analysis attempts to reasonably estimate hurdle rate benchmarks by anchoring to current Seattle market capitalization rates, then building in an appropriate development spread. The development spread is the difference (in basis points) between the YOC and the market capitalization rate. Development spread typically ranges from 75 to 150 basis points but can vary more widely.

CBRE's most recent capitalization rate survey, published February of 2026, indicates that the current rates for stabilized Class A multifamily in an urban setting within the Seattle market range from 4.75% to 5.25%. After accounting for the development spread, an appropriate estimate of the YOC hurdle rate for the Mercer Island Town Center would range from 5.5% to 6.75%.

## **FEASIBILITY FINDINGS**

In recent years, cost increases and relatively high financing costs have made ground-up multifamily development challenging. Given this economic context, modeled feasibility results would not be expected to show most projects as feasible. Nonetheless, over a longer term, costs and revenues are expected to better align to improve conditions for housing development.

Depending on the scenario, the prototype generates between 0.7% to 1.1% COC return and 4.6% to 4.8% YOC return. Fee in-lieu COC return rates are slightly greater compared to on-site performance at all fee rates tested, up to \$35 per square foot. YOC metrics at all fee rates are 0.1 to 0.2% greater than for on-site performance (**Exhibit 3**). This indicates that returns would potentially be slightly higher when choosing to pay the fee in-lieu, when the fee rate is set at \$35 per gross square foot or less. However, the prototype does not clear the hurdle rate in any of the above scenarios, reflecting more broadly challenging economic conditions. As these conditions change over time, project feasibility may improve.

### Exhibit 3. Modeled Returns for Multifamily Prototype

Scenario	Cash-on-Cash (COC)	Yield-on-Cost (YOC)
Fee In-Lieu at \$20 psf	1.1%	4.8%
Fee In-Lieu at \$25 psf	1.0%	4.7%
Fee In-Lieu at \$30 psf	0.8%	4.7%
Fee In-Lieu at \$35 psf	0.7%	4.7%
<b>Performance (10% of Units at 50% of AMI)</b>	<b>0.7%</b>	<b>4.6%</b>

Source: Community Attributes, Inc., 2026

At \$25 per gross square foot of building area, the prototype used in this analysis would pay approximately \$9.7 million in fees in lieu of providing affordable units on-site. The estimated fees for the range of rates explored with these scenarios range between \$7.8 million at a fee rate of \$20 per square foot to \$13.7 million at \$35 per square foot.

The size of future projects will vary, and fees paid will also vary with project size. At \$25 per gross square foot, the inclusionary zoning program would generate \$2.5 million in fees for every 100,000 square feet of multifamily housing built, assuming that developers choose to pay rather than perform. Fee generation per 100,000 square feet ranges from \$2 million at \$20 per square foot to \$3.5 million at \$35 per square foot. Because some developers may choose to perform, rather than to pay a fee in-lieu, or choose a combination of payment and performance, the fees generated in the aggregate and at scale may fall short of that ratio.

Feasibility analysis suggests that at approximately \$35 per square foot the return metrics between an in-lieu fee compared to a 10% of units at 50% of AMI performance option are roughly comparable. At \$25 per square foot, the in-lieu fee option results in more positive return metrics. An inclusionary zoning in-lieu fee for the City of Mercer Island between \$25 and \$30 per square foot falls below the maximum supportable fee, is comparable with other programs, and creates an in-lieu fee program that may generate a dedicated stream of revenue to support the construction of housing units at deeper levels of affordability.

## CONCLUSION

The City of Mercer Island is analyzing an inclusionary zoning program. The Mercer Island Affordable Housing Nexus Study calculates the maximum allowable in-lieu fee rates and performance requirements. The maximum allowable rate ranges from \$30.90 to \$37.62 per square foot and maximum allowable performance requirements range from 13.1% to 16.4% of all units, depending on the zone and project size. Comparable cities have adopted fee rates between \$8 to \$50 per square foot with performance requirements typically at 10% of units to serve households at or below 50% to 80% of AMI. A program with in-lieu fee rates between \$25 to \$35 per square foot and a

performance requirement at 10% of units affordable to households at or below 50% of AMI falls below the maximum allowable rates and within ranges adopted by other comparable cities.

Overall, project feasibility for mid-rise multifamily in the Central Puget Sound region is challenged by current economic conditions. This analysis indicates that for a multifamily prototype consistent with the vision for the City of Mercer Island’s Town Center, using assumptions informed by current or expected market conditions, project returns would be slightly higher for the developer that pays the fee-in-lieu than for the developer that chooses to “perform”, or to provide the affordable units on-site, assuming fee rates at or below \$35 per square foot compared to an on-site performance requirement of 10% of units at 50% of AMI. An in-lieu fee less than \$35 per square foot would incrementally make payment more financially attractive, and a higher fee would incrementally make performance more financially attractive.