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MEMORANDUM

Highlands TDR Program Allocation Methods
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An essential component of any TDR program is the method by which transferrable development rights¹ will be allocated to sending zone property owners. Allocation consists of defining what these rights are and how many rights should be given to a particular lot. For purposes of the Highlands TDR Program, staff is recommending two allocation methods: one for residentially zoned properties and another for non-residentially zoned parcels. **Appendix A** sets forth the formulas for these allocation methods. This memorandum discusses the bases for these recommended allocation methods.

Residential Allocation Method

How TDR credits are allocated to residentially zoned property varies among TDR programs. Some programs allocate on the basis of gross acres of a given land type. For example, one transferrable development right is allocated for every five acres of non-environmentally constrained land. Other programs look solely to the lost development potential of a sending zone parcel. Thus, if ten homes could have been developed on a sending zone parcel consistent with local development regulations prior to establishment of the TDR program, and after program implementation only one home could be built, then the property is allocated nine credits reflecting the nine homes that cannot be built.

In the context of establishing a Highlands TDR Program allocation method, the distinct and uneven real estate markets that exist within the Highlands Region present a challenge to uniformly allocating credits. From north to south and from east to west in the Highlands Region, land values and real estate development markets vary significantly. Whereas New Jersey based TDR programs in the Pinelands and in Chesterfield Township assigned credits uniformly, based primarily on the land based development potential of a given parcel, such an approach is problematic in the Highlands. The Highlands Region does not enjoy the relatively uniform land values that existed in the Pinelands

¹ Under the Highlands TDR Program, transferrable development rights are called Highlands Development Credits ("HDCs").

Preservation Area in the 1980's or the generally similar values that can exist within a single municipality.

Within the vast Highlands Region, a development right in one county may vary significantly from the value of a development right in another. So, while assigning credits on a uniform basis, tied to the development potential of the land (soils, building constraints, underlying pre-Highlands zoning, etc.) is attractive for its simplicity, such an approach does not provide a means to reflect the influence of varied markets on the value of credits. This creates a level of inequity and it also creates a real market imbalance. In a TDR market where the value of a credit to a developer is the same wherever it is used, credit buyers will tend to seek out sending zone credits in lower land-value markets.

In light of this challenge, staff proposes that the allocation of Highlands Development Credits ("HDCs") for residentially zoned property use a hybrid approach. Specifically, staff recommends that HDCs be allocated on the basis of lost development potential but adjusted for relative differences in land value occasioned by property location and the type of development that could have been constructed onsite prior to enactment of the Highlands Act. Consequently, the formula for allocating HDCs to residentially zoned eligible parcels is expressed as: **(Net Yield) x (Zoning Factor) x (Location Factor) = HDC Allocation**. Each element of this method is discussed below.

Net Yield

The starting point for allocating HDCs to eligible parcels begins with a determination of a parcel's lost development potential (Net Yield). Lost development potential is determined by first examining the land use and environmental regulations applicable to the subject parcel in light of the size of the parcel and what development may already exist there (pre-Highlands Act development yield). Then, the determination of lost development potential must also account for what development potential remains after applying the provisions of the Highlands Act, the Department of Environmental Protection's Preservation Area rules, and the standards of the Highlands Regional Master Plan.

An example illustrates this determination. Assume prior to passage of the Highlands Act, an undeveloped five-acre lot in the Preservation Area is residentially zoned at one single family house per acre. Assume further that, due to wetlands present on the lot, one acre cannot be developed. This results in four acres being available for development prior to enactment of the Highlands Act. After passage of the Highlands Act, only one single family house may be built on the lot under the exemption for construction of a single family house on a lawfully existing lot that was in existence on August 10, 2004. In this example, the lot would have lost 3 single family housing opportunities as a result of the Highlands Act (4 acres at 1 unit/acre minus 1 unit under exemption = 3 lost units).

Net Yield Bonus

An important consideration in allocating HDCs to an eligible sending zone parcel is determining whether the parcel will receive a bonus. Under the Highlands TDR Program policies, a sending zone parcel is eligible to receive a bonus where a landowner chooses not to exercise an applicable Highlands Act exemption. The purpose of providing a bonus to the allocation is to encourage property owners not to exercise an applicable exemption.

Staff recommends that parcels located in a High Value conservation priority area or agricultural priority area receive a 25% bonus to their net yield when not exercising an exemption. Thus, if a parcel has a net yield of 10 lots, and is located in a High Value conservation priority area, the resulting net yield increases to 12.5 lots. For parcels located in a Moderate Value conservation priority area or agricultural priority area, staff recommends that they receive a 15% bonus to their net yield where the landowner chooses not to exercise an applicable exemption.

Zoning Factors and Location Factors

Next, to account for the Highlands Region's real estate market variability and differences in value of unit types, staff developed two market adjustment factors for use in HDC allocations to residential properties: Zoning Factors and Location Factors. The Zoning Factors (ZF) serve as regional adjustment factors recognizing that the value of the land varies according to the type of residential development that could have been constructed on the property prior to the Highlands Act consistent with municipal zoning. The Location Factors (LF) recognize that the per unit value of land varies by location within the Highlands Region.

Staff developed the Zoning Factors by first calculating the average equalized assessed lot value for seven of the residential composite zones for each municipality in the Highlands Region.² These municipal values are reflected on the county worksheets listed in **Appendix B** titled "**Regional Zoning Factors.**" Next, using these municipal values, staff then determined the average lot value for each county. From this data, staff then calculated a regional lot value for a given residential composite zone. The regional lot values per residential composite zone are reflected on the first worksheet of Appendix A. To establish the regional Zoning Factors based upon the regional composite zone lot values, staff identified the most prevalent residential zoning type in the Highlands Region, which is the Low Density Residential Composite Zone.³ The average density within this composite zone is 0.76 units per acre representing minimum lot sizes that range between 1 to 2 acres. Staff set the Zoning Factor for this composite zone at 1.00. Staff then determined the relative differences in regional lot value for each of the other six residential composite zones by dividing the regional lot value for a given composite zone by the regional lot value of the Low Density Residential Composite Zone, which is \$200,129.34. The resulting regional Zoning Factors are shown on the first worksheet of **Appendix B**.

Staff developed the Location Factors by first calculating the average equalized assessed land value per acre for residentially developed parcels in the Highlands Region.⁴ To start this process, staff

² For purposes of establishing the Zoning Factors, Highlands Council staff used 2005 MOD-IV tax assessment data for Class 2 parcels (residentially developed parcels) received from the New Jersey Treasury Department, Division of Taxation. The data is derived from real property tax assessment information submitted by municipal tax assessors to the Division of Taxation. Information contained in the 2005 MOD-IV data is for the period January 10, 2004 through January 9, 2005.

³ The average density within this composite zone is 0.76 units per acre representing minimum lot sizes that range between 1 to 2 acres.

⁴ For purposes of establishing the Location Factors, Highlands Council staff also used 2005 MOD-IV tax assessment data for Class 2 parcels (residentially developed parcels) received from the New Jersey Treasury Department, Division of Taxation.

separated the residential parcels into seven distinct density types based upon observed lot size ranges consistent with the residential composite zones developed by Highlands Council staff. The lot size categories are as follows:

<u>Category</u>	<u>Lot Size Range</u>
Category A	> 10 Acres
Category B	> 5 to 10 Acres
Category C	> 2 to 5 Acres
Category D	1 to 2 Acres
Category E	0.5 to < 1 Acres
Category F	0.33 to < 0.5 Acres
Category G	0.125 to < 0.33 Acres

Using these categories, staff then segmented the parcels by county, municipality, and ultimately equalized assessed land value per acre. From this data, representing over 200,00 records, staff excluded the top 5% and bottom 5% of all parcel records for each category for purposes of ensuring data confidence. Additionally, each municipality with less than 3 parcels records for a given category was excluded to ensure sufficient sample size.

Working from these data sets, the Average Equalized Assessed Land Value per Acre (Average ELV/Acre) per municipality was calculated for each of the seven residential categories. To divide each class into tiers, deviations of 50% of the Average ELV/Acre per municipality was then calculated. This was done by multiplying the lowest Average ELV/Acre by 1.5. This established the ranges for each tier. Once the ranges were determined, the municipalities were then assigned a tier number based upon where that municipality's Average ELV/Acre fell within the ranges established. Tier No. 1 is the tier with the lowest range of Average ELV/Acre. Once each municipality was assigned to the appropriate tier, the Weighted Average ELV/Acre for that tier was then calculated.

After establishing the Weighted Average ELV/Acre for each tier within a residential category, staff calculated the Location Factor by dividing the Weighted Average ELV/Acre for each tier by the Weighted Average ELV/Acre for the lowest tier in that class. The data and calculations performed to derive the LFs are set forth in **Appendix C** titled "**Location Factors.**"

Appendix D titled "**Sample Residential Allocation Calculations**" provides examples of how the above allocation formula is applied, including an example applying a 25% bonus to net yield.

Non-Residential Allocation Method

The Highlands TDR Program permits the allocation of HDCs to eligible, non-residentially zoned parcels. The basis for allowing such allocation is that non-residentially zoned parcels have fewer options than residentially zoned property for extracting equity out of these lands. Additionally, staff has envisioned since program inception that HDCs could be used for residential and non-residential development in designated receiving zones.

Very few TDR programs allocate transferrable development rights to non-residentially zoned property. The few examples found by the Highlands Council staff were not appropriate given the types of non-residential property that are to be included in the Highlands TDR Program. Moreover,

in the programs where such allocation occurs, transfers may only occur between non-residentially zoned sending and receiving zones.

Working in conjunction with the Highlands Council's consultant Integra Realty Resources ("Integra"), staff set out to develop a non-residential allocation method that incorporates the same elements developed for the residential allocation method, namely lost development potential adjusted for market conditions. In developing this method staff considered several important circumstances. First, there are less than 3,500 disreect acres of undeveloped non-residentially zoned land in the Highlands Preservation Area. Second, consolidation of non-residential parcels further reduces the number of disreect property owners affected, and relative to the overall scale of the residential impacts, the non-residential formula is likely to be applied in far less instances, and is unlikely to be immediately required for hardship. Third, staff specifically acknowledges that non-residential properties not currently developed do not have an applicable Highlands Act exemption, and therefore, the allocation method must be broadly applicable, even though a specific non-residential property may not be considered "prime" in terms of location and physical characteristics.

In light of these considerations, staff recommends an allocation method for non-residentially zoned property that considers lost development potential and unit values for different types of non-residential uses. This allocation method is expressed in the following formula: **(Permitted Square Footage) ÷ (Non-Residential SF for Specified Use) x (30% Discount) = HDC Allocation.** Each element of this method is discussed below.

Permitted Square Footage

Based upon the assistance of Integra, staff recognizes that the functional variables typically used to value non-residential property is the potential building square footage that a specific property can yield. This is generally calculable within the context of local zoning requirements, adjusted for all ordinary physical constraints, and specifically with parking ratios and lot coverage requirements considered. Consequently, in determining a non-residentially zoned parcel's development yield, staff must consider parcel size, the applicable Floor Area Ratio ("FAR"), parking requirements and whether the parcel is subject to environmental constraints.

Non-Residential SF for Specified Use⁵

Similar to the Zoning Factors developed for the residential HDC allocation, staff recommends the use of a factor that recognizes different types of non-residential development have different underlying land values.

⁵ Unlike the residential uses that typically have a high degree of variation in the underlying land values because of the disparity in end unit housing prices (driven by schools, taxes, existing development patterns, etc.), non-residential uses are primarily affected by demand for non-residential space. Consequently, across the Highlands Region, non-residential unit values expressed on a dollar per FAR (buildable square foot) basis tend to bracket a relatively tight range. As such, location factors are not inherently required when one considers that general non-residential rent levels will be a function of demand, and that relative demand should be considered a constant given the limited number of non-residential property owner's affected.

Integra undertook a study of their existing non-residential land database, land records within CoStar and other subscription comps services, and considered the broad non-residential experience of the Integra professionals who specialize in non-residential valuation. Based upon this information, Integra recommended that the non-residential allocation method adopt an understanding of the land values on a dollar per square foot FAR (“\$/SF FAR”) basis generally in accordance with the following matrix:

<u>Use</u>	<u>\$/SF FAR Range</u>	<u>Average \$/SF</u>	<u>Ratio</u>
Industrial	\$10 - \$20 FAR	\$15/SF	1.0
Office	\$20 - \$40 FAR	\$30/SF	2.0
Retail	\$25 - \$60 FAR	\$42.50/SF	2.83

A “conversion factor” should then be applied based on the type of non-residential use. Industrial uses tend to support employees at a ratio of 1 per 1,500 SF. This becomes the basis for establishing the conversion factors to account for value/price variations in non-residential end use. Consequently, HDCs are allocated to the above uses at the following square foot intervals:

$$\text{Industrial Use} = (1,500/1 = 1,500) = 1,500 \text{ SF}$$

$$\text{Office Use} = (1,500/2 = 750) = 750 \text{ SF}$$

$$\text{Retail Use} = (1,500/2.83 = 530) = 530 \text{ SF}$$

Thirty Percent Discount

Importantly, because the non-residentially zoned parcels to be allocated HDCs are undeveloped, a discount must be applied that recognizes that the above conversion ratios are based on typical prices of approved non-residential development, or development subject to approvals. Therefore, a 30% discount is applied to adjust for lack of approvals.

The examples below illustrate how the non-residential allocation formula is applied in the case of a building that is 10,000 square feet in size.

$$10,000 \text{ SF industrial building} \div 1,500 \text{ SF} \times 0.70 = 4.66 \text{ HDCs}$$

$$10,000 \text{ SF office building} \div 750 \text{ SF} \times 0.70 = 9.33 \text{ HDCs}$$

$$10,000 \text{ SF retail building} \div 530 \text{ SF} \times 0.70 = 13.2 \text{ HDCs}$$