

**SUBJECT: STUDY SESSION ON THE RSO UPWARD RENT ADJUSTMENT
APPLICATION FOR SEISMIC RETROFITTING AND OTHER
CAPITOL IMPROVEMENT COSTS**

INITIATED BY: HUMAN SERVICES AND RENT STABILIZATION DEPARTMENT
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STATEMENT ON THE SUBJECT:

The RSO currently allows landlords to submit an Upward Rent Adjustment application when seismic retrofitting or other capital improvement costs exceed rents. Information on the Upward Rent Adjustment application is included in this report in a manner intended to elucidate comments, suggestions and feedback from the Commission. Staff is reviewing the current process and plans to return to the Rent Stabilization Commission in March for a full discussion of possible changes to the application process the Commission may wish to recommend the City Council adopt.

RECOMMENDATION:

Receive the report, discuss and provide feedback.

BACKGROUND ANALYSIS:

Information is provided in this report on the current RSO Upward Rent Adjustment application process. On December 18, 2017, staff provided an update to the City Council on the application and initiated a review of the process to ensure tenants are well protected from possible rent increases which they may not be able to afford, while also ensuring property owners receive a fair return on investment. Information on the Upward Rent Adjustment application is being provided to elucidate comments, suggestions, and feedback from the Commission on aspects of the current process which staff should focus on for potential modifications. After the Commission has provided feedback, staff will engage the community; gather input, and then return to the Commission in March, 2018 for a full discussion of possible options to consider in a recommendation to the City Council.

Mandatory Seismic Retrofitting and Financing Costs

On April 17, 2017 the City Council adopted an ordinance establishing a mandatory seismic retrofitting requirement for existing buildings with soft, weak or open-front walls (soft story buildings), effective April 1, 2018. On August 7, 2017, the City Council adopted a second ordinance establishing a mandatory seismic retrofit requirement for existing non-ductile concrete and pre-Northridge steel moment frame buildings, effective

August 7, 2018. Many of the buildings subject to these Ordinances are rent stabilized apartment buildings, and compliance will first require evaluation by an engineer to determine if seismic retrofitting is necessary. If retrofitting is required for soft story buildings, the work must be completed within five years of receiving notice from the City. Retrofitting for non-ductile concrete and pre-Northridge steel moment frame buildings is more complicated and therefore additional time is allowed to complete the work, which must be completed within 20 years.

The City's Rent Stabilization and Housing Division and Building and Safety Division are coordinating efforts to ensure information is provided to the community in an effective and timely manner. To begin, two information sessions are planned in the month of February, the first on Saturday, February 24 from 11:00am to 2:00pm at the West Hollywood Park Auditorium. The second will be held on February 27, from 6:30pm to 9:00pm at Fiesta Hall in Plummer Park. The events are an opportunity to learn about the RSO Upward Rent Adjustment application and how landlords may apply. The events will also provide an opportunity for participants to provide input on possible revisions to the current application, including a direct cost pass-through. In addition, staff will be available to answer questions about the seismic retrofit ordinance and the state's Property Assessed Clean Energy (PACE) program, which can provide financing for retrofitting. The events will be open to the general public and all are encouraged to attend. Interested participants need not attend both meetings as the sessions will cover the same information.

Beginning April 1, 2018, RSO property owners of soft-story buildings could begin receiving notices from the City that they are required to have an engineer review the building, and if identified by the engineer, complete any seismic retrofitting necessary within 5 years to ensure the building is secure (20 years for non-ductile concrete and pre-Northridge steel moment frame buildings). Some property owners will need to finance the upfront costs of completing the mandatory seismic retrofitting. The most readily available source is the Property Assessed Clean Energy (PACE) program, which provides financing based on unencumbered value of the property, not the property owner's credit. PACE financing remains with the property and the debt service payments are added to the property tax obligation for the property. Current interest rates range from 5% to 8.25%, depending on the loan term. Additionally, a form of credit enhancement is potentially available through the California Seismic Capital Access Loan Program (CalCAP/Seismic Safety Financing Program). Grant funds are potentially available from the California Residential Mitigation Program (CRMP) and the Federal Emergency Management Agency (FEMA). Staff and the City's technical consultant, Keyser Marston Associates, is currently reviewing the various finance programs. Information on qualifying and funding requirements will be made available to property owners before the soft story building mandatory requirement takes effect April 1, 2018.

Increased Customer Service and Tenant Habitability Requirements

In addition to financing, property owners will need additional customer service support to understand and be able to meet the mandatory requirements. Anticipating an increase in seismic retrofitting plan review activity, the Building and Safety Division has a contract

with an engineering firm to help process any increase in permit requests. There may also be a need for enhanced customer support in the Rent Stabilization and Housing Division to assist property owners and tenants understand their responsibilities and rights. The Legal Services Division may require additional support for processing upward rent adjustment applications, although the extent of the impact is unknown at this point. Additional customer service needs are currently being assessed and, if necessary, staff will ask the City Council to approve an additional contract for support services. Added customer service capacity will ensure property owners are well informed of mandatory requirements, available financing and the upward rent adjustment application, while tenants are supported in understanding their rights and protections under the RSO.

Importantly, staff is also developing requirements for tenant habitability during seismic retrofitting and other renovations. It is anticipated most property owners will be able to follow standard practices ensuring tenants retain expected levels of habitability while construction is underway. In order to ensure tenant habitability during construction, property owners may need to develop and submit a Tenant Habitability Plan. Additionally, since landlords may use renovation as an opportunity to offer buy-outs to tenants. Both the habitability requirements and buy-out offer monitoring program will be presented to the Rent Stabilization Commission in February, 2018.

Existing Upward Rent Adjustments for Seismic Retrofitting

Currently a landlord may apply for an Upward Rent Adjustment if Net Operating Income (NOI) for their building exceeds rents collected. The financing previously presented will cover upfront costs incurred by property owners to complete seismic retrofitting. Upfront costs and costs related to financing could increase overall annual expenses. For rent stabilized properties,¹ if the costs to complete seismic retrofitting work exceed income generated (exceeds rents collected), the Rent Stabilization Ordinance and Rent Stabilization Regulations currently allow landlords to apply for an upward rent adjustment. The upward rent adjustment process was established in order to ensure landlords receive a just and reasonable return when making capital improvements, including seismic retrofitting. The process is based on the landlord establishing that they are falling below the fair "Net Operating Income" (NOI). With respect to applications based on seismic retrofitting, there is an evidentiary presumption in the landlord's favor regarding expenses incurred in performing work relating to the reduction of earthquake hazards in unreinforced masonry buildings. (Municipal Code Section 17.48.040)

Presently, the City has little data and cannot accurately estimate what possible upward rent adjustments (rent increases) could result from mandatory seismic retrofitting. In part this is because, although the application is available, property owners are not using it. The last time a property owner applied for an upward rent adjustment associated with seismic retrofitting was before 1992, which was prior to the Costa-Hawkins Act (vacancy decontrol). At that time, when rent increases were ordered, the amount was capped for the first and second years at 12-percent each year, and in year 3 any remaining amount

¹ Rent Stabilized Properties are residential rental properties subject to the City's annual limitation on rent increases. Generally, a residential property is rent stabilized if built and first rented on or before July 1, 1979, this includes condominiums and single-family homes where the current tenant moved in before 1996.

of increase was applied to the rent. Prior to Costa-Hawkins, if a tenant received a rent increase that he or she could not afford, the tenant had the ability to move to another apartment since city-wide, rents remained controlled when a vacancy occurred. As such, upward rent adjustments implicitly did not need to safeguard against over-burdening in-place tenants. After Costa-Hawkins and rent de-control, in-place tenants, especially long-term, lower income tenants, will most likely not find other apartments in West Hollywood renting at or near the same rent they are currently paying. Therefore, anticipating the upward rent adjustment application may now be utilized by property owners completing mandatory retrofitting, the process will be reviewed to ensure adequate safeguards are in place to protect vulnerable tenants from rent increases they cannot pay. Additionally, the process will be reviewed to ensure property owners are aware of the program and are able to successfully complete the application and provide supporting documentation.

Aspects of the Upward Rent Adjustment Application to be Reviewed:

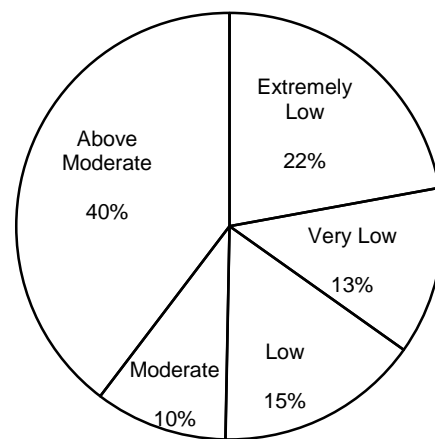
- *Currently, an upward rent adjustment becomes part of Maximum Allowable Rent (MAR)*

Currently, an upward rent adjustment is added to, and becomes part of, the MAR. Thus, the rent increase is permanent and included in the calculation for future rent increases. Tenants struggling now to pay rent could become more cost burdened, which may result in the tenant having to move.

- *Currently, there is no hardship exemption for tenants*

The ability for a tenant to afford higher rent is currently not considered in the upward rent adjustment application. There are no exemptions and all tenants receive the rent increase ordered regardless of ability to pay. Post Costa-Hawkins vacancy decontrol there is now a need to protect tenants from added cost burdens.² In West Hollywood, 50 percent of renters are already cost burdened.³ Cost burden affects lower income tenants, especially extremely low income tenants at a greater rate than higher income households. For instance, an estimated 65 percent of extremely low income tenants (earning approximately \$18,000 or less a year) are currently paying more than half their monthly income for housing. This high rate of cost burden among West Hollywood renter households

Renter Income in West Hollywood



² Housing affordability is generally defined by the relationship between household income and payment for housing (including rent and utilities if a renter household). If a household pays more than 30 percent of rent and utilities, the household is considered to be experiencing a housing “cost burden,” and in need of lower cost housing.

³ Based on HUD Area Median Family Income (HAMFI) from the Comprehensive Housing Affordability Strategy (CHAS), which provides cross-tabulations of ACS data. The most recent CHAS data currently available are based on ACS data collected between 2010 and 2014.

could be a result of households living on fixed incomes, and because incomes for many middle and lower income households in California and the US have not been keeping pace with inflation.

Housing costs also have a greater impact on renter households. In West Hollywood, as in most other cities, rent households have a lower median income than owner households.³ In 2013, West Hollywood median renter household income was \$46,174, approximately half of the median income of \$93,357 from owner households. Without a hardship exemption, upward rent increases could have the potential to displace vulnerable extremely low and lower income households who are unable to pay the additional rent cost.

The upward rent adjustment process will also be reviewed to better understand why property owners are not currently utilizing it when completing seismic retrofits and other capital improvements. Lack of participation in the Upward Rent Adjustment Process could be for various reasons, including:

- *Costa-Hawkins vacancy decontrol could be allowing rents to exceed costs*

One of the justifications for Costa-Hawkins vacancy decontrol was to incentivize investment in rent stabilized properties. Landlords have been taking advantage of the Costa-Hawkins vacancy decontrol provisions, and have increased rents up to market rates following vacancies. From January 1, 1999 to January 1, 2015, rents charged when a new tenant moves in have led to a 92 percent increase in average new rents (market rate rents), from \$944 to \$1,810, which is equivalent to a growth rate in rents of 4.4 percent annually. This turnover has allowed owners to improve their revenue and increase NOI beyond levels allowed when the allowable rents remained controlled after vacancies. Revenue increases might be rising faster than operating expenses, which means owners could have extra cash flow available to pay for capital improvements without raising rent.

- *Upward rent adjustment application requirements are difficult to meet*

The current cost share formula requires substantial financial information on the NOI for the property. NOI testing in past cases has been cumbersome and labor-intensive for City staff and the property owner. The formula is based on the following:

1. The Base Year NOI is set at 1983.⁴
2. The Base Year NOI is then escalated at an amount equal to 60% of the increase in the Consumer Price Index (CPI) between the base year and the year the capital expense is incurred (Adjusted Base Year NOI).
3. The property owner is allowed to treat the annual amortized cost of the capital improvement as an operating expense.

⁴ In the event that an owner for good cause cannot produce base year income and expense information, a different period for estimating may be utilized. The burden, however, rests on the landlord to provide adequate documentation and demonstrate a basis for deviating from the base year.

4. If the NOI for the year in which the capital cost is incurred, including the annual amortized cost of any financing required, is less than the Adjusted Base Year NOI, the hearing examiner may order increases in rent.
5. Rent increases are limited to 12% per year for the first two years, with any remaining balance going into effect as of year three. Annual interest at a rate of 10% is added to all deferred rent increases.

To recover the cost of improvements, the current formula permits NOI to increase by 60 percent of CPI between the Base Year and the current year. In a unit where a vacancy occurred and then the unit was rented anew at market rate, the increase in rent could cause the current year NOI to exceed the allowed 60 percent of the CPI difference. Given the rates of apartment turnover and the amount of rent increases since Costa-Hawkins, there may in fact be few instances where the current formula would allow rent increases. However, a scenario where rent increases could be ordered would be when there are several long-term tenancies, especially in smaller buildings, duplexes, triplexes and quadplexes, with low turnover (leading to a low NOI) and substantial improvement costs. Means for supporting tenants and safeguarding against large rent increases potentially leading to displacement will be developed through this review process.

Prior Upward Rent Adjustment Application Hearings

In April of 1990, the City ordered seismic retrofitting for unreinforced masonry buildings, seven of which were subject to the Rent Stabilization Ordinance. Three rent increase applications were received. The hearing examiner's decisions ordered rent increases for two properties. Increases for the third property were denied:

- Attachment A - Rent increase application I-092 dealt with a four unit property. The hearing determined that the 1983 NOI was \$14,709.29 and the current year was \$12,930.62. The NOI decreased \$1,778.65. The CPI rose 44.3% during the applicable time period, so an increase of 27.7% to the NOI, or \$18,783.74 was guaranteed by the RSO.
- Attachment B - Rent increase application I-094 dealt with a five unit property. The hearing determined that the 1983 NOI was \$27,159 and the current year was \$24,541. The NOI decreased \$2,618. The CPI rose 46.3% during the applicable period, so an increase of 27.8% to the NOI, or \$34,709 was guaranteed by the RSO.
- Attachment C - Rent increase application I-108 dealt with a 25 unit property. The hearing determined that the 1983 NOI was \$98,988.06 and the current year was \$148,857.03. The NOI increased \$49,868.97. The CPI rose 45.5% during the applicable period, so an increase of 27.3% to the NOI, or \$126,011.80 was guaranteed by the RSO.

Net Operating Income vs. Cost Recovery

West Hollywood has long sought to ensure quality housing and an inventory of rental units affordable to a diverse population, while also ensuring landlords a fair return on

investment. Currently the NOI based upward rent adjustments is the mechanism a rent stabilized property owner subject to the mandatory seismic retrofit requirement will have to increase revenue at his or her property, if they are not receiving a just and reasonable return. The process had been developed for seismic retrofitting unreinforced masonry buildings, and the evidentiary presumption regarding expenses incurred in performing seismic retrofitting should be extended to soft story, non-ductile concrete, and pre-Northridge steel moment frame buildings. In addition to this, the staff reports accompanying the two seismic ordinances, also alluded to cost recovery (pass through) repayment options currently available in other jurisdictions. If through the upcoming review, the City Council wanted to entertain the possibility of developing a new process for property owners to recapture seismic retrofitting costs there are two typical approaches: Net Operating Income, and cost recovery.

- *Net Operating Income*

The NOI approach permits the amortized cost of capital improvements to be counted as an expense, and compares the NOI in the current year to a specified base year. NOI is permitted to increase over the base year amount by an increase tethered to CPI. The approach is intended to conform to a municipal jurisdiction's authority to regulate rents, provided a landlord is not deprived a just and reasonable return. Whether the NOI provides a just and reasonable return is measured by comparing the current year NOI to the base year NOI to determine if a certain increase tethered to the CPI has been achieved. If the evidence received during the rent increase application proceeding shows that the landlord is earning a just and reasonable return, no rent increase will be authorized. The NOI approach is used in West Hollywood. The City of Santa Monica also uses NOI for capital improvements, but a separate approach is currently being created for use in its recently adopted mandatory seismic retrofit program.

- *Cost Recovery*

The cost recovery method takes the actual improvement cost and permits the landlord to recapture some or all of the costs over a specified period of time. This method presumes that the landlord needs the rent increase in order to complete the mandatory seismic retrofitting. Under a pass-through structure, a property owner is allowed to share retrofitting costs with tenants as a separate fee that terminates after the approved cost share amount is received. The amount passed through to tenants is not escalated from year-to-year. If crafted carefully, based on the percentage of costs eligible and length of amortization, and balanced with rent caps and other tenant protections a cost pass-through program can provide an incentive for landlords to reinvest in aging rental properties while ensuring tenants are not overly burdened with costs. This approach is used by San Francisco and Los Angeles.

Approaches Used by Other Rent Stabilized Jurisdictions

The seismic programs for Berkeley, Los Angeles, San Francisco and Santa Monica, were reviewed by Keyser Marston Associates and by BAE Urban Economics and the following summaries for each program were developed to showcase how other jurisdictions have approached costs associated with mandatory seismic retrofitting rent

stabilized buildings. Each of the four cities has established, or is in the process of establishing, a separate pass-through structure for completing mandatory seismic improvements. Although each program is different, each takes into account the tradeoffs between the percentage of reinvested costs eligible for pass-through, and the amortization period during which the property owner can pass the cost through to tenants. In addition, other considerations include what types of improvements qualify as capital improvements, caps on per year and overall rent increases, allowances for hardship exemptions and relocation assistance, the last two items being especially important for tenants in lower income categories.

The characteristics of each existing program can be summarized as follows:

- *City of Berkeley*

Berkeley's formula prohibits property owners from passing through any seismic retrofitting costs to tenants. The Berkeley program, however, does allow property owners to apply for permission to pass through costs if the majority of the tenants have resided in the project since before 1999. When this is the case, Berkeley "means-tests" cost recovery using an NOI formula. Berkeley does not allow the landlord to pass-through costs if the landlord is deemed to be already earning a fair return.

In projects where a property-owner's request for a pass-through is granted, very-low income tenants can apply for a hardship exemption. A very-low income household can obtain an exemption if the increase causes the rent to exceed thirty percent of their income, and no subsidy is available to reduce the rent to below that threshold.

- *City of San Francisco*

San Francisco's formula allows property owners to recoup up to 100 percent of the seismic retrofitting costs over a 20-year amortization period. The amount borne by the tenant cannot exceed the greater of 10 percent of the tenant's base rent or \$30 per month. The pass-through is not included in the base rent, and cannot be included in annual rent increases.

Tenants can apply for a hardship exemption if they receive means-tested public assistance, or their income is less than 80 percent of the area median income (Lower Income). Tenants can also apply for relief if they can demonstrate exceptional financial circumstances exist.

- *City of Los Angeles*

The Los Angeles formula allows property owners to recoup up to 50 percent of the seismic retrofitting costs over a 10-year amortization period. The amount borne by the tenant cannot exceed \$38 per month. The pass-through is included as base rent, and is also included in the calculation of annual rent increases.

Summary

Importantly, each city has tailored its capital improvement program to meet its policy goals. It is important to strike a policy balance between owners and tenants. San

Francisco, for instance, aims to encourage landlords to invest in improvements and permits a pass-through according to a simple cost recovery formula. Berkeley’s program aims to balance impact to tenants and allows a pass-through only under extenuating circumstances.

Although there were few capital improvement cases reported in the case studies, the number of cases increased when improvement costs were high. Data from Berkeley showed that the number of landlord petitions, which included capital improvement pass-through requests, declined significantly after Costa-Hawkins was fully implemented. In the same time period average Berkeley rents increased at a faster rate. Cities that have recently passed seismic ordinances, however, are seeing a slight increase in the number of petitions because costs related to seismic improvements can be high, potentially \$60,000 to \$90,000 or more for an entire building.

Next Steps

Community engagement events aimed at sharing information on financing and the City’s current Upward Rent Adjustment Process will be held beginning in late January and February to receive input from the community at large, and from potentially affected property owners and tenants.

The Rent Stabilization Commission will receive summaries of all input and review the upward rent adjustment process at one of its scheduled meetings in March. Once the Rent Stabilization Commission has reviewed the Upward Rent Adjustment application process and formulated its recommendation, a report, including any program revisions will be presented to the City Council for consideration, along with summaries of community input received.

Upward Rent Adjustment Process Review Timeline

	January	February	March	April
Community Engagement				
Rent Stabilization Commission				
City Council				

Community engagement will include information and opportunities to provide input at the following events:

Targeted Meetings (landlords / tenants)	February 24	February 27
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Additional community engagement opportunities:

RSO Newsletter	January 5	July 5
RSO Classes (Tenants)	January 23	January 30
RSO Classes (Landlords)	February 6	February 13
Annual Housing Meetings	February 1	February 15

In preparation for the upcoming community discussions, a technical expert and a meeting facilitator have been contracted to provide support:

- Technical Assistance – Keyser Marston Associates
- Meeting facilitator – Center for Non-Profit Management

Further updates will be provided to the Rent Stabilization Commission as the review process gets underway and as added customer service and other preparations are put in place prior to the April 1, 2018 effective date of the soft story mandatory seismic retrofit requirement.

ATTACHMENTS:

- A. Rent increase application I-092
- B. Rent increase application I-094
- C. Rent increase application I-108