

SUBJECT: **COST SHARING OPTIONS FOR MANDATORY SEISMIC
RETROFITTING AND POSSIBLE RECOMMENDATIONS ON
GUIDING POLICIES FOR FURTHER ANALYSIS**

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

The Rent Stabilization Commission will receive additional information on the City's upward rent adjustment approach, cost sharing approaches used by other rent stabilized jurisdictions, and a summary of public input received at recent community events, and consider formulating recommendations for the City Council to consider when setting initial guiding policies for further analysis of potential revisions to the current rent adjustment application or creation of a pass-through option.

RECOMMENDATION:

Receive the report and attachments and discuss. If appropriate, form initial recommendations for the City Council to consider when setting guiding policy for further analysis of a cost sharing approach for mandatory seismic retrofitting in West Hollywood.

BACKGROUND ANALYSIS:

On January 25, 2018, the Rent Stabilization Commission reviewed the upward rent adjustment application in the RSO, which allows a property owner to request a rent increase when total certain costs at a property exceed rents.

The Commission's review was prompted by the City's mandatory seismic retrofitting requirements which will take effect on April 1, 2018 for soft-story buildings, and August 7, 2018 for non-ductile concrete and steel moment frame buildings. Although the requirements become effective on these dates, property owners will not be required to act until receiving notice from the City. Once notified, a property owner must complete an engineering report and then complete all needed retrofitting within five years for soft-story buildings, 20 years for non-ductile concrete and steel moment frame buildings.

Currently, through the RSO upward rent adjustment application a property owner of rent stabilized property may request essentially to pass on seismic retrofitting costs to tenants when all costs associated with the property plus the seismic retrofitting costs (spread out over 30 years, e.g. amortized to 30 years) exceed the income at the building (e.g. total rents). The rent adjustment is applied to each tenant's base rent and therefore is a permanent increase. This is the approach used by the City of Santa Monica. In contrast San Francisco and Los Angeles have established a cost pass through allowing property owners to pass through a specific dollar amount to each tenant for a specific period of time, 10 years in Los Angeles and 20 years in San Francisco.

Although, the Rent Stabilization Commission's review of the upward rent adjustment was not focused only on cost sharing for mandatory seismic retrofitting, it could be worthwhile to consider possible options for property owner to pass through costs incurred differently when satisfying the City's mandatory seismic retrofitting requirements, in contrast to costs incurred from standard operation and maintenance of a property.

On January 25, 2018, the Rent Stabilization Commission requested additional information on the upward rent adjustment and approaches used in other jurisdictions. Additional information is provided in this report. Also, in 2016, BAE Urban Economics reviewed the various cost sharing approaches used in the rent stabilized cities of Berkeley, Los Angeles, San Francisco, and Santa Monica. The BAE report is provided at Attachment A. Although BAE focused specifically on rehabilitation and upgrades of major building systems (roofing, windows, electrical, plumbing, and mechanical) and did not include seismic retrofitting projects, the analysis and outcomes in the report are meaningful when reviewing and comparing the various approaches used by other rent stabilized cities to determine if a landlord can share costs with tenants, and if so how much of the costs can be shared.

Recommendations the Rent Stabilization Commission may wish to consider

After reviewing the information provided in this report and the attachment, the Rent Stabilization Commission may wish to consider forming initial recommendations for the City Council to consider when establishing guiding policy for further analysis of cost sharing options for mandatory seismic retrofitting in West Hollywood. The Commission's recommendations would then be shared with the City Council at an upcoming meeting along with a recommendation that the further analysis be directed back to the Rent Stabilization Commission. The Commission would then consider various options within the City Council's guiding policies, and if appropriate, create a draft approach to cost sharing for mandatory seismic retrofitting for the City Council to consider.

Initial recommendations to the City Council related to guiding policies the Rent Stabilization Commission may wish to form could relate to the following questions:

- *Should mandatory seismic retrofitting be considered different than other capital improvements anticipated over the life of a property?*

Seismic retrofitting may not have been anticipated by some property owners at purchase, further seismic requirements could have changed over the period of ownership for longer term property owners.

- *Is the City's current upward rent adjustment application the appropriate means to determine if a property owner can share costs of mandatory seismic retrofitting?*
- *If the upward rent adjustment is the appropriate means, should the calculations used be reviewed and possibly modified?*

Draft cost estimates based on City of Los Angeles seismic retrofit projects are provided in Attachment A. These estimations suggest property owners may not be able to substantiate the need for a rent increase using the current upward rent adjustment application approach. Further, feedback from property owners suggests the application

requirements are difficult to meet and, therefore, there is little interest in pursuing an adjustment. A risk in not providing a form of cost share property owners are willing to use is that some owners may opt to leave the rental business rather than complete the mandatory retrofitting.

- *Should the City establish a hardship exemption?*

Some households may not be able to afford a rent increase or other form of cost sharing pass-through. Importantly, if a hardship exemption is desired it may not be possible to establish for the upward rent adjustment process. This is because an upward rent adjustment is ordered only when the property owner has established that income generated at the property is not sufficient. Therefore, it may not be possible to exempt some tenants from rent increases, since this could prevent the property owner from earning the Net Operating Income determined through the upward rent adjustment.

A hardship exemption is most likely possible under a pass-through, since the pass-through is not based on ensuring a minimum income is achieved at the property.

- *Should a separate pass-through approach be explored in place of the upward rent adjustment application?*

A pass-through can be set at a specific amount, which is either considered part of the rent or a separate charge. A hardship exemption can most likely be established by which a household may petition for an exemption based on financial means. Los Angeles and San Francisco both use direct pass-through approaches, however each is different. Case studies for each City are presented in Attachment B.

- *If a pass-through is created for mandatory seismic retrofitting, should costs be spread out over a number of years and a monthly payment cap set?*

The Los Angeles and San Francisco direct pass-through programs have maximum amounts that can be pass-through to tenants. Los Angeles allows 50% of costs to be passed through over a 10 year period, but capped at \$34 per month, per tenancy. San Francisco allows 100% of costs to be pass-through but over a 20 year period.

- *If a pass-through is created for mandatory seismic retrofitting, should it be considered part of the rent, or separate?*

Los Angeles considers the pass-through as part of the rent; this applies the Annual General Adjustment to the pass-through and results in slightly higher rent increases. Keeping the pass-through separate would ensure the pass-through does not factor into the annual rent adjustment and so the pass-through would remain set at the established amount while the pass-through is in effect.

Community Engagement

The City recently held two community meetings on cost sharing for mandatory seismic retrofitting. Both meetings had a collaborative tenor with landlords and tenants seeming to acknowledge a role in paying for the work. However, staff also heard from tenants much opposed to any form of cost sharing. All participants seemed to agree with creating a hardship exemption for tenants unable to pay. Attendance at both meetings was low. Saturday had 11 participants, Tuesday evening had 36. Staff is developing an online survey and will continue polling stakeholders, while exploring other means of engaging with landlords and tenants.

ATTACHMENTS:

Attachment A – Additional Information on Upward Rent Adjustments

Attachment B – West Hollywood Rehabilitation Study: Background Trends & Case Study Research

Additional Information on Upward Rent Adjustments

The following information is being provided in response to questions posed by the Rent Stabilization Commission on January 25, 2018.

What is a non-ductile concrete building?

Non-ductile concrete buildings are concrete buildings that were built before the 1976 building code standard requiring reinforced concrete. The detailing and construction of the reinforcing steel in these buildings may be inadequate to safely resist large seismic forces caused by earthquakes. The buildings tend to be large, multi-story structures, and the expected cost of retrofitting is substantial.

What is the NOI process in the RSO?

The NOI process guarantees the landlord a fair return on the property. It is not designed to be a cost sharing or cost pass-through mechanism, even though applicants sometimes use it for that purpose. Instead, it guarantees the landlord an annual increase in the property's NOI that is tethered to the rise in the Consumer Price Index.

The process uses a property's 1983 NOI as representing the typical return on the building. If the NOI has not increased by 60% of the rise in the CPI since 1983, the landlord can file for a hearing which would order rent increases to make up the shortfall. While capital improvement expenditures are part of the calculation used to determine the NOI, those expenditures do not necessarily result in rent increases. The rent is increased only when the current year's NOI is less than the NOI guaranteed by the RSO. There is no direct pass-through of expenditures.

Why is the ordered increase an ongoing increase in rent?

Because the RSO guarantees the landlord a certain return on the property, rent increases must be ordered when the return is not met. They must be ongoing to maintain the return.

Is there a hardship exemption?

There can be no hardship exemption because the RSO guarantees the landlord a certain level of return. Acknowledging that large rent increases may be difficult for some tenants to pay, the process requires increases to be phased-in. The increases are limited to 12% for the first two years, with any remaining balance going into effect at year three. In the pre-Costa Hawkins rental environment, it was felt that the additional time would give a tenant the ability to move to another rent stabilized unit in the area.

How many NOI applications have been filed?

Since the passage of the Rent Stabilization Ordinance, landlords filed 151 applications for rent increases alleging a failure to receive a fair return. The number of applications filed after vacancy decontrol went into effect on January 1, 1999 is twenty, the most recent being in 2014. The reduction can be attributed to the impact that establishing market rate rents has on the process. The new rent levels typically mean that the current year NOI exceeds the guaranteed fair return on the property.

What are some of the issues involved if the current seismic NOI process is used for the purpose of sharing the cost of the mandated retrofitting?

As mentioned before, the NOI process is not designed to be a cost sharing or cost pass-through program. By definition, it will result in rent increases to bring a building's NOI to the guaranteed level. It will not order the sharing of a specific cost.

In addition, the process is cumbersome. It requires extensive documentation of a building's income and expenses for two 12-month periods and substantial staff time evaluating the documentation.

While the Division has records of the 1983 base year NOI for approximately 100 properties whose owners previously filed for a NOI hearing, records for other properties may not be available. Landlords are allowed to propose an alternate base year if records for 1983 no longer exist, but the alternate base year must be between 1984 and 2002. Those records may also be unavailable.

Will the current seismic NOI process result in a cost sharing of the expense?

While it is impossible to say with 100% certainty, based on the above analysis cost sharing is doubtful. The current NOI will exceed the guaranteed NOI due to the rent levels collected after vacancies occur. Under the RSO, the landlord is receiving a fair return even with the retrofitting expense.

Will tenants be entitled to rent decreases for loss of services such as parking and storage during retrofitting?

WHMC §17.48.060 states that when the loss of housing services is due to seismic retrofitting, a rent reduction can be postponed until after the completion of the work. This provision in the RSO was enacted in response to the Court of Appeal ruling in *Golden Gateway Center v. San Francisco Rent Stabilization and Arbitration Board* which limited a rent control board's ability to grant a rent decrease for disruptions caused by construction if the construction is necessary and is being completed in a reasonable and timely manner. It may be possible to address the loss of services in a tenant habitability plan by providing a replacement service, or "compensation" for the loss.

Calculating Net Operating Income

The City's upward rent adjustment application uses net operating income (NOI) as the basis for determining whether the property owner is entitled to a rent increase. To determine NOI, the current application uses 1983 financial records at the base year. The base year is then adjusted by 60% of increase in the Consumer Price Index (CPI) from 1983 to present. Sixty-percent of the change in CPI from 1983 to 2017 is 94.2%. Therefore a property owner would multiple the NOI received in 1983 by 1.942 to determine the minimum income they would be entitled to (Adjusted Base Year NOI, or "Just and Reasonable Return"). The Adjusted Base Year NOI is then compared to the actual NOI received in 2017. If the property is currently earning an NOI higher than the Adjusted Base Year NOI, then no rent increase can be ordered. If the property is currently not earning an NOI higher than the Adjusted Base Year NOI, then rent increases can be ordered to increase the current NOI to match the Adjusted Base Year.

Below we calculate NOI for four properties. The 1983 data was taken from the hearing decision for each property. The current year income for each property represents rental income only. The rent roll was determined by looking at the Division’s registration and re-registration records. Available general adjustments were applied as appropriate. Note: there are approximately 100 properties with established 1983 base year NOI, out of approximately 1,900 properties. Properties without an established 1983 base year NOI could petition to use a different year, say for instance, if the property was purchased at a later date, it is possible for the property owner to request the purchase date be used.

Two approaches were taken to estimate current year expenses. The first followed the methodology used in the “Economic Study of the Rent Stabilization Ordinance and the Los Angeles Housing Market,” a 2009 study commissioned by the City of Los Angeles to evaluate its Rent Stabilization Ordinance. Using various industry sources, the study concluded that expenses in the Los Angeles housing market typically amount to 25% to 40% of the rent roll, so 40% of the current rent roll was calculated. The second approach, listed in parenthesis, took the base year expenses for each property and increased them by 157%, the total rise in the CPI since 1983. Because the current year expenses all came out less using this approach, it was discarded. The calculations were not completed.

| | Property A 20 units | | Property B 10 units | | Property C 9 units | | Property D 19 units | |
|----------|------------------------|---------------------------------------|------------------------|--------------------------------------|-----------------------|--------------------------------------|------------------------|---------------------------------------|
| | 1983 | Current | 1983 | Current | 1983 | Current | 1983 | Current |
| Income | \$90,555 | \$313,044 | \$38,402 | \$167,760 | \$47,050 | \$220,800 | \$84,058 | \$354,336 |
| Expenses | \$30,632 | \$125,218 (\$78,724) (\$82,486) | \$7,868 | \$67,104 (\$20,221) (\$27,818) | \$10,265 | \$88,320 (\$26,381) (\$36,682) | \$20,566 | \$141,734 (\$52,854) (\$53,683) |
| NOI | \$59,923 | \$187,826 | \$30,534 | \$100,656 | \$36,785 | \$132,480 | \$63,492 | \$212,602 |

The cost of the seismic work was estimated using data from 150 properties in the City of Los Angeles that have undergone retrofitting. Buildings with 4 to 6 units averaged \$8,600 per unit, buildings with 7 to 15 units averaged \$6,600 per unit and buildings with more than 15 units averaged \$4,400 per unit. Because retrofitting can be different from property to property, the estimated cost was doubled to account for problems. It was then amortized over 30 years, creating the current year NOI after the retrofitting.

| | | | | |
|--|------------|------------|------------|------------|
| | Property A | Property B | Property C | Property D |
|--|------------|------------|------------|------------|

| | | | | |
|-----------------------|-----------|-----------|-----------|-----------|
| Est. Seismic Cost | \$88,000 | \$66,000 | \$59,400 | \$83,600 |
| Adjusted for Problems | \$176,000 | \$132,000 | \$118,800 | \$167,200 |
| Amortized 30 yrs. | \$5,867 | \$4,400 | \$3,960 | \$5,573 |
| Post-Seismic NOI | \$181,959 | \$96,256 | \$128,520 | \$207,209 |

The NOI process guarantees the landlord an increase in the NOI equal to 60% of the rise in the CPI from the base date. The Los Angeles area CPI stood at 100.8 as of December 1983. It was 259.22 as of December 2017. The CPI increase is 157%, so the guaranteed increase in the NOI is 94.2%.

| | Property A | Property B | Property C | Property D |
|-------------------------|------------|------------|------------|------------|
| 1983 NOI | \$59,923 | \$30,534 | \$36,785 | \$63,492 |
| 60% of 157% CPI Rise | 94.2% | 94.2% | 94.2% | 94.2% |
| Guaranteed NOI | \$116,370 | \$59,297 | \$71,436 | \$123,301 |

This last chart compares the guaranteed NOI with the estimated actual NOI. All properties are generating more than a fair return under the RSO. No rent increases would be ordered.

| | Property A | Property B | Property C | Property D |
|----------------|------------|------------|------------|------------|
| Guaranteed NOI | \$116,370 | \$59,297 | \$71,436 | \$123,301 |
| Actual NOI | \$181,959 | \$96,256 | \$128,520 | \$207,209 |