Special Meeting of the Richmond Rent Board

February 28, 2018 | City Council Chambers

Item G-1: Application of the proposed draft Maintenance of Net Operating Income Fair Return Regulation (Chapter 9)

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Item G-1: **Background**

- On February 21, 2018, Rent Boardmembers received a draft, proposed Maintenance of Net Operating Income (MNOI) "fair return" regulation (Chapter 9)
- There are a number of policy questions that must be studied and discussed prior to the regulation's adoption

Item G-1: Purpose

- Present an example Maintenance of Net Operating Income calculation to improve understanding
- Solicit direction from members of the Board concerning key policy questions
- These policy questions include:
    1. How much (percentage) of inflation should be applied to the Net Operating Income (NOI)?
    2. What should the Base Year be?
    3. Should rent increases calculated to provide a Fair Return be capped to avoid rent shock, and if so, by how much?
    4. Should amortization of capital improvements be permanent or temporary?

Maintenance of Net Operating Income (MNOI) Fair Return Analysis: Example Calculation

Item G-1:
MNOI Example Calculation

Greetings!
I'm Maria

4 Unit Complex

Item G-1:
MNOI Example

MNOI calculations begin by examining the **Base Year net operating income** and **operating expenses**…

Example of Operating Expenses

Item G-1: **Definition of "Operating Expenses"**

Included in Operating Expenses

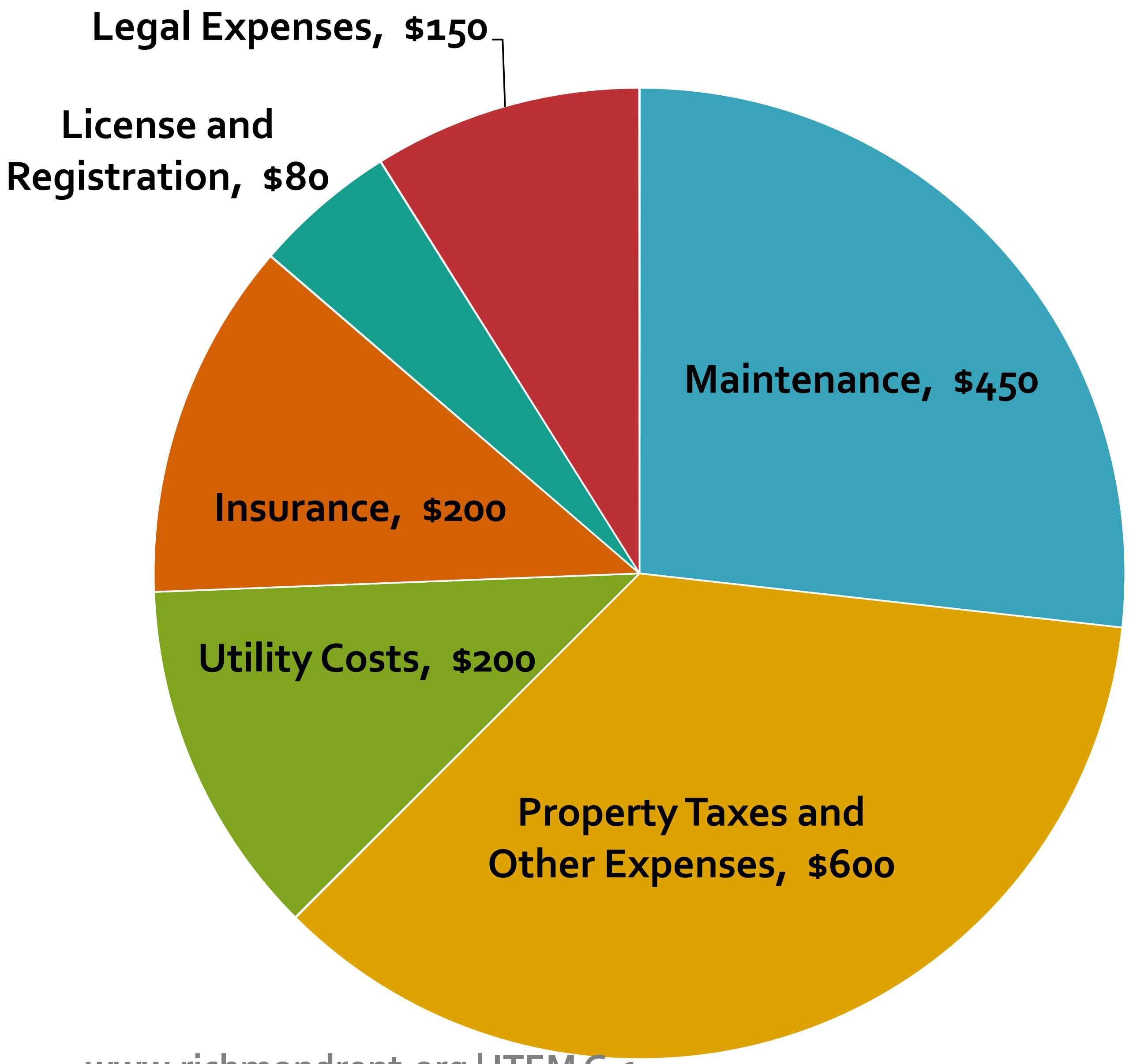
- Reasonable costs of operation and maintenance of the rental unit
- Real property taxes
- Insurance
- Utility costs
- Management expenses
- License, registration, and other public fees
- Landlord-performed labor
- Legal Expenses

NOT Included in Operating Expenses

- Debt service costs and costs for obtaining financing
- Mortgage payments or principal
- Any penalties, fees, or interest assessed for violation of the ordinance or law
- Land lease expenses
- Political contributions
- Depreciation
- Any expenses for which the landlord has already been reimbursed
- Unreasonable increases in expenses since the base year

Maria's Monthly Operating Expenses (Hypothetical)

Item G-1:
MNOI Example Calculation



Total Monthly Operating Expenses = $1,680

What is included in operating income?

Item G-1:
MNOI Example Calculation

Monthly Net Operating Income

=

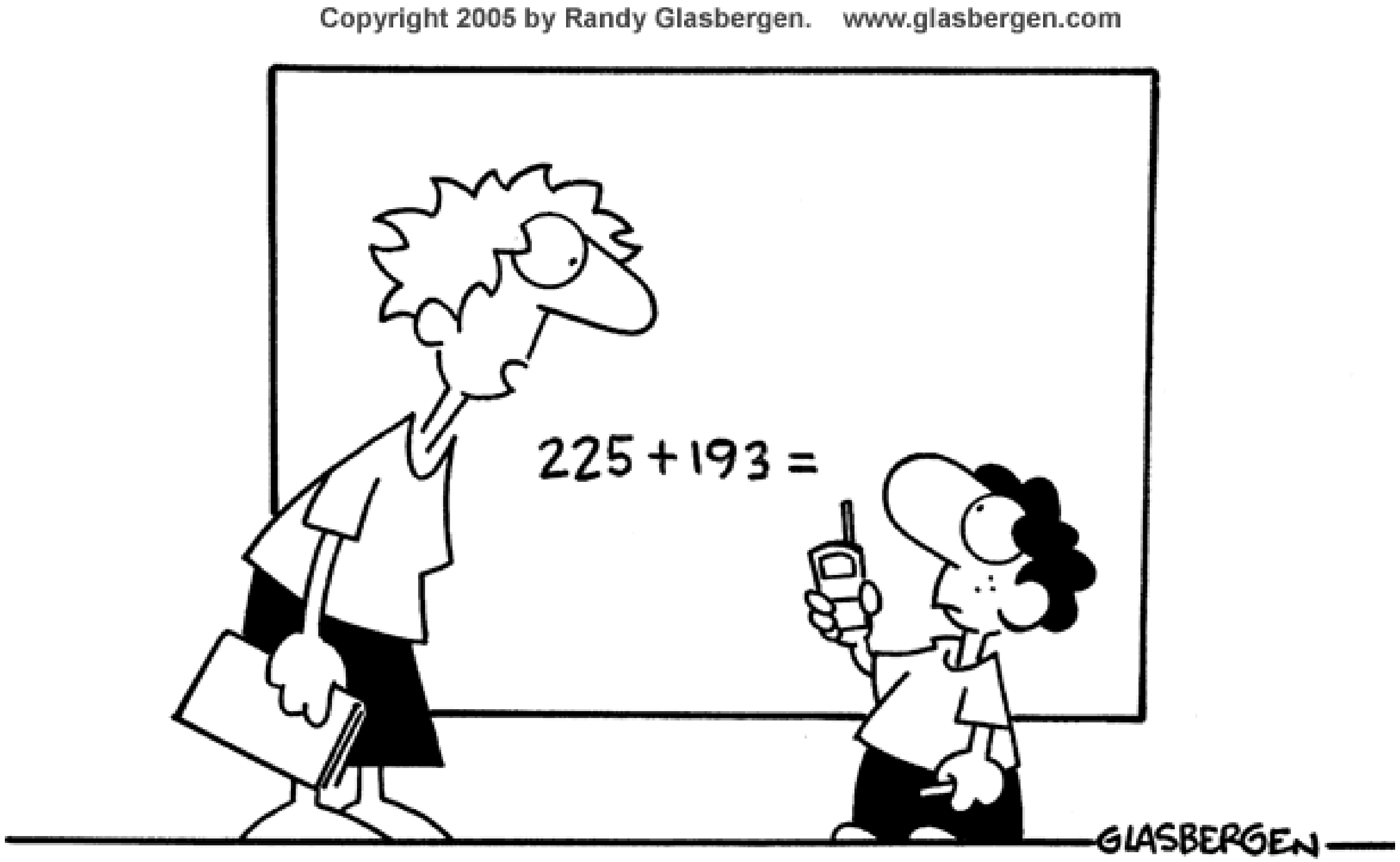
Total Monthly Rent Collected

– Operating Expenses

Operating income is usually the total amount of rent collected minus expenses. For the purpose of the Maintenance of Net Operating Income (MNOI) analysis, we will be using the **monthly** rental income collected.

Let's review a basic Maintenance of net operating Income (MNOI) calculation…..

Item G-1:
MNOI Example Calculation



"You have to solve this problem by yourself. You can't call tech support."

Let's look at a 4-unit complex example with the base year being 2015…

Item G-1: MNOI Example Calculation

$5,600

Monthly revenue is 4 units times $1,400 = $5,600

$1,680

Monthly expenses are 30% of revenue = $1,680

Net Operating Income =

$3,920

Monthly net operating income (NOI) = $3,920

Illustration of Fair Return Using the MNOI Standard

Fast forward to 2020: Rent has increased by **$210 through AGA increases** over the span of five years. The **new Maximum Allowable Rent** for each unit is **$1,610**.

4 Unit Complex

Illustration of Fair Return Using the MNOI Standard

Maria has applied all of the Annual General Adjustment increases, but utility and management costs have also increased.

$6,440

Monthly revenue for 4 units is $1,610 = $6,440

$2,184

Monthly expenses are now 34% of revenue = $2,184

Net Operating Income =

$4,256

Monthly net operating income (NOI) = $4,256

Illustration of Fair Return Using the MNOI Standard

The Hearing Examiner looks at the Net Operating Income in the Base Year (2015) for Maria's case.

\$3,920 2015 NOI + **15% of 2015 NOI (CPI Increase)** = **\$4,508 Fair Return**

- **Fair net operating income is the base year net operating income (NOI) adjusted by the Consumer Price Index (CPI) increase since the base year.**
  - In this hypothetical example, the CPI increased by 15%. Therefore, the fair net operating income is \$3,920 increased by 15% for a total of \$4,508. To receive a Fair Return, the landlord should receive a monthly net operating income of \$4,508.

Illustration of Fair Return Using the MNOI Standard

Item G-1: **MNOI Example Calculation**

- Because expenses have increased by 30 percent (from $1,680 to $2,154) since 2015, Maria's monthly net operating income has increased by less than the percentage increase of the Consumer Price Index (CPI).
  - **The Hearing Examiner has determined the Fair Return Net Operating Income(NOI) is $4,508 (a $252 difference from $4,256).**
  - **To provide the landlord with a Net Operating Income (NOI) that generates a Fair Return, the Hearing Examiner determines each unit may receive up to a $63 increase in the Maximum Allowable Rent (a total of $252 for all 4 units).**
  - **The Hearing Examiner checks to see how much of a percentage the rent increase will result in for each tenant. In this example, the adjustment in the Maximum Allowable Rent would result in a 4 % rent increase for each tenant.**
  - **The board can adopt a cap on the allowed percent rent increase (e.g. 15%), which would phase in on a yearly basis the percentage change to the maximum allowable rent, in order to prevent rent shock for tenants.**

Policy Questions

Policy Question 1:

How much (percentage) of inflation should be applied to the Net Operating Income (NOI)?

- In the previous example, the Hearing Examiner applied 100% of the change in the CPI. This equated to a 15% increase between 2015 and 2020.
- But, what if the Rent Board's policy was to apply 50%, 65% or 75% of the change in CPI?

Policy Question 2:

What should the Base Year be?

- **Staff recommend 2015 for the following reasons:**
  - It is more likely that 2015 rent level information would be available to landlord and tenants.
  - In 2015, there was no adopted rent control policy in the City in effect, therefore 2015 represents the preceding full year without rent regulation.
  - Since the Ordinance was not approved by a majority of Richmond voters until Nov. 2016, using 2014 as a Base Year would account for almost two years prior to the adoption of rent control in Richmond.
- **Why use 2014?**
  - One could argue that some landlords raised rent in early 2015 in anticipation of rent control. If the claim is correct, rent levels in 2015 might be slightly inflated above what they would otherwise have been. The City Council began discussing rent control and just cause for eviction policies in the Spring of 2015.

Policy Question 3:

Should rent increases calculated to provide a Fair Return be capped to avoid rent shock, and if so, by how much?

Policy Question 3: Fair Return (MNOI) Case Study Research

Should rent increases calculated to provide a Fair Return be capped to avoid rent shock, and if so, by how much?

City	% of Inflation for AGA rent increases	% of Inflation applied to NOI calculation (Policy Question #1)	Limitation on a resulting fair return rent increase (if any) (per year)
Berkeley	65%	65%-75% depending on base year	Not more than 15% of the Maximum Allowable Rent on the date the petition is filed, or $50 per month, whichever is greater, with a cap of $75 per month, per year. (Beginning in 1993, the $50 and $75 limitations shall be adjusted upward by 100% of the percentage in the CPI, All Urban Consumers, less its shelter component, for the twelve month period ending on the preceding June 30th.) (Regulation 1274) (applies to all individual adjustments of the Maximum Allowable Rent)
East Palo Alto	80%	100%	None

Policy Question 3: Fair Return (MNOI) Case Study Research (cont.)

Should rent increases calculated to provide a Fair Return be capped to avoid rent shock, and if so, by how much?

City	% of Inflation for AGA rent increases	% of Inflation applied to NOI calculation (Policy Question #1)	Limitation on a resulting fair return rent increase (if any) (per year)
San Francisco	60%	N/A	Landlords may petition for an additional base rent increase of up to an additional 7.0% in excess of the AGA. If payment of the rent increase presents a financial hardship for a tenant, they may seek relief by filing a Tenant Financial Hardship Application with the Rent Board. If the Hardship Application is granted, relief from payment of the O&M rent increase may be for an indefinite period or for a limited period of time, depending on the nature of the tenant's financial hardship. (Topic No. 322)
Santa Monica	75%	40%	Not more than 12% or twice the Employment Cost Index (ECI) or $50 per month, whichever is greater, for any tenant or low or moderate income for whom such a rent increase shall result in severe economic hardship. (Regulation 4107)
Richmond (proposed)	100%	100%	Not more than 15% of the Maximum Allowable Rent on the date the petition is filed may be applied per year.

Policy Question 4:

Should amortization of capital improvements be permanent or temporary?

- **Remember: Capital improvement costs are part of the MNOI standard, however the Board may consider adoption of a separate capital improvement regulation that would allow for cost pass-through for specific types of incentivized improvements (e.g. seismic, energy efficiency, etc.).**
  - **Dr. Kenneth Baar is recommending that interest allowance for capital improvements costs be amortized over a fixed period of time at a rate equal to the "average rate" for thirty-year fixed term rate on home mortgages plus two percent. Under this system, capital improvement rent increases would only last during the term of the amortization period.**
  - **An alternative method would be to create permanent increase (until a new vacancy), that would be based on a fixed percentage (as is done in Berkeley). Therefore, these permanent rent increases would be smaller than if they were amortized over a fixed amortization schedule. This practice would also result in fewer modifications to the rent tracking database, require no amortization schedule for Hearing Examiners to adhere, potentially leading to more streamlined hearings.**

Policy Question 4: Fair Return (MNOI) Case Study Research

Should amortization of capital improvements be permanent or temporary?

City	Amortization of Capital Improvements (does not include routine repair, replacement, or maintenance) – Permanent vs. Temporary Rent Increases
Berkeley	For necessary capital improvement rent increases (included in fair return analysis) the maximum rent is permanently increased by 1.042% of the documented cost of the improvement attributable to that unit or 1.187% for major, long-term repairs. (Regulation 1267)
East Palo Alto	Capital improvement costs are amortized according to a schedule (e.g. 3-27.5 years). The interest allowance is equal to the thirty-year fixed mortgage rate index for single family homes plus 2% as of the date the petition was filed. (Fair Return Petition/Section 12.E.8 of Rent Stabilization Ordinance)
Los Angeles	Capital improvement costs are amortized according to a schedule (e.g. 5-15 years). Interest on money borrowed or otherwise furnished to pay for capital improvement work is not eligible as a cost to be included in calculating the rent increase (Regulation 211.08). (Note: Los Angeles has a separate Capital Improvement Regulation that allows pass-through rent increases for items that benefit the Tenant and will last at least 5 years.)
Oakland	Capital improvement costs are amortized according to a schedule (e.g. 5-20 years). The interest allowance is equal to the average of the 10 year United States treasury bill rate and the 10 year LIBOR swap rate for the quarter prior to the date the permits for the improvements were obtained plus an additional one and one-half percent, to be taken as simple interest. (Regulation 10.6.2 and Regulation 8.22.020) (Note: Oakland has a separate Capital Improvement Regulation that allows pass-through rent increases for specific types of capital improvements that benefit the Tenant rather than the Landlord.)

Policy Question 4: Fair Return (MNOI) Case Study Research (cont.)

Should amortization of capital improvements be permanent or temporary?

City	Amortization of Capital Improvements (does not include routine repair, replacement, or maintenance) – Permanent vs. Temporary Rent Increases
San Francisco	Capital improvement costs are amortized according to a schedule (e.g. 7-20 years). The interest allowance is either the actual interest incurred, or an imputed interest rate equal to the average of the twelve most recent monthly rates (rounded to the nearest tenth) as posted by the Federal Reserve on their Federal Reserve Statistical Release Internet site for Treasury Securities for the number of years the cost is to be amortized. (Note: San Francisco has a separate Capital Improvement Regulation that allows pass-through rent increases for specific types of capital improvements, such as qualified energy efficiency improvements.) (Part 7 of the Rent Board Regulations)
Santa Monica	Capital improvement costs are amortized according to a schedule (e.g. 5-20 years). The interest allowance is 5% per annum plus the rate established by the Federal Reserve Bank of San Francisco on advances to member banks under Section 13 and 13(a) of the Federal Reserve Act prevailing on the date the petition was filed. (Regulation 4101)
Richmond (proposed draft regulation)	Capital improvement costs are amortized according to a schedule (e.g. 5-28 years). The interest allowance is equal to the "average rate" for thirty-year fixed rate on home mortgages plus 2%. The "average rate" shall be the rate Freddie Mac last published in its weekly Primary Mortgage Market Survey (PMMS) as of the date of the initial submission of the petition.
Richmond (staff recommendation)	For necessary capital improvement rent increases (included in fair return analysis) the maximum rent is permanently increased by a calculated percentage (based on a defined amortization schedule and capital improvement financing) of the documented cost of the improvement.

Item G-1: **Recommended Action**

RECEIVE a presentation concerning application of the proposed draft Maintenance of Net Operating Income (MNOI) Fair Return Regulation (Chapter 9) and **PROVIDE** direction to staff.

Item G-1: **Policy Questions**

1. How much (percentage) of inflation should be applied to the Net Operating Income (NOI)?
2. What should the Base Year be?
3. Should rent increases calculated to provide a Fair Return be capped to avoid rent shock, and if so, by how much?
4. Should amortization of capital improvements be permanent or temporary?

Item H-1: Proposed FY 2018-19 Budget, Fee Adoption, and Billing Timeline

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Item H-1: **Purpose**

- Section 11.100.060(n) of the Fair Rent, Just Cause for Eviction, and Homeowner Protection Ordinance requires the Executive Director to submit to the Board the proposed budget for the ensuing fiscal year at least thirty-five (35) days prior to the beginning of the fiscal year (July 1 – June 30).
- The 2018-19 fiscal year begins on July 1, 2018.
- Given the interrelated nature of the Rent Program Budget, Rental Housing Fee, and billing cycle for the Rental Housing Fee, it is prudent to plan accordingly to ensure Rent Program Department operations remain fiscally feasible.

Item H-1: **Background**

- As provided by the Ordinance, the Rent Board exercises its duties and power independent from the City Council, City Manager and City Attorney (except by request of the Board)
- While the City Council and City Manager have no authority to oversee, supervise, or approve the Rent Program budget, the associated Rental Housing Fee must be approved by the City Council.
- Since the Rental Housing Fee is the Rent Program's only source of revenue in the foreseeable future, it is imperative that the Rent Board budget reflects the interests of both the Rent Board and City Council members.

Item H-1: Expense and Revenue Update

Fiscal Year	Budgeted Amount (Excluding Reserves)	Funds Expended (as of 2/28/18)	Revenue Collected (as of 2/28/18)
2016-17	**$920,347**	**$789,592**	**$789,592**
2017-18 (Partial)	**$1,940,271**	**$571,866**	**$850,075**
Total	**$2,860,618**	**$1,361,458**	**$1,639,667**

[1] Note funds expended in Fiscal Year 2017-18 are only as of 2/28/17; this amount does not reflect the projected amount of expended funds for the entire Fiscal Year.
[2] Amount of expended funds and revenue collected reflect 7 months of the 12-month fiscal year.

Proposed Fiscal Year 2018-19 Budget Objectives

Proposed Objective	Possible Anticipated Impact(s)
Increase compliance with the requirements of the Fair Rent, Just Cause for Eviction, and Homeowner Protection Ordinance, including payment of the Rental Housing Fee and all adopted Rent Board regulations, through active enforcement and rent registration	Additional resources should be allocated towards compliance and rent registration. This would require a reduction in other line items or increase in the Rental Housing Fee.
Determine Residential Rental Housing Fee amount(s) for Rental Units partially or fully covered by the Ordinance to ensure the fee recommended by the Rent Board and charged to Landlords is commensurate with the level of services provided by the Rent Program; contemplate a pass-through of the Rental Housing Fee so the cost is shared between Tenants and Landlords	Utilize a tiered-fee approach, such that partially covered units pay a lesser fee than fully-covered Controlled Rental Units; possibly permit a pass-through of a portion of the Rental Housing Fee to be shared between Tenants and Landlords
Incorporate new information and data gathered through the owner-occupancy and exemption verification project performed by Rent Program staff members in September-November 2017 to inform estimates of the total number of Rental Units in the City of Richmond	Since the number of housing units assessed the Rental Housing Fee will likely decrease due to the subtraction of exempt units from the database, the cost of the budget will be allocated among a smaller number of units, resulting in a probable increase in the amount of the Rental Housing Fee for fully covered Controlled Rental Units.
Improve the physical utility of the Rent Program office through the addition of permanent signage and reconfiguration of counseling areas.	Additional resources should be allocated towards office furniture, signage, and construction of counseling stations. This would require a reduction in other line items or increase in the Rental Housing Fee.

Item H-1:
FY 18-19 Proposed Budget Adoption Timeline

#	EVENT	PROPOSED DATE
1	Executive Director submits proposed FY 18-19 Budget to the Rent Board	March 21, 2018, Regular Meeting
2	(Optional) Rent Board discusses FY 18-19 Budget	Possible Special Meeting in late March/early April 2018
3	Public Hearing Notice is posted in Contra Costa Times (newspaper); proposed budgets are available for inspection at Rent Program office	April 6, 2018
4	Rent Board considers adoption of FY 18-19 Budget (Public Hearing)	April 18, 2018, Regular Meeting

Item H-1:
FY 18-19 Proposed Fee Adoption Timeline

#	EVENT	PROPOSED DATE
1	Rent Board receives draft FY 18-19 Fee Study	March 21, 2018, Regular Meeting
2	(Optional) Rent Board discusses FY 18-19 Fee Study	Possible Special Meeting in late March/early April 2018
3	Rent Board approves FY 18-19 Fee Study and recommends to the City Council approval of the FY 18-19 Rental Housing Fee	April 18, 2018, Regular Meeting
4	City Council receives FY 18-19 Fee Study (study session)	May 22, 2018
5	City Council adopts FY 18-19 Fee Study	June 19, 2018

Item H-1:
FY 18-19 Proposed Billing Timeline

#	TASK	PROPOSED SCHEDULE
1	Bills are generated	July 2018
2	Bills mailed	August 2018
3	Rental Housing Fee due	September 2018

Item H-1: Recommended Action

- RECEIVE a proposed timeline for (1) adoption of the Fiscal Year 2018-19 Rent Program Budget; (2) recommendation of approval of the FY 2018-19 Rental Housing Fee to the City Council; and (3) billing of the FY 2018-19 Residential Rental Housing Fee.