

Capital Improvement Expenditures in the CSFRA and other Rent Stabilized Jurisdictions

In November 2016, the voters approved the Community Stabilization and Fair Rent Act (“CSFRA”), which amended the City Charter. The CSFRA regulates the rents of rental properties, with certain exemptions such as single family homes and duplexes. The CSFRA has three primary goals:

1. Stabilize rents
2. Provide eviction protections
3. Ensure a fair and reasonable rate of return on investment

Section 1700 of the CSFRA stipulates that housing providers are entitled to “a fair and reasonable return on their investment”. The CSFRA provides three methods to ensure a fair return is achieved:

1. General Annual General Adjustment of Rent of 100% CPI-U (Bay Area Region)
2. Vacancy Decontrol
3. Individual Petitions for Upward Adjustment of Rent (using a Fair Return Standard)

Although some landlords may anticipate capital improvement costs and set aside reserves from rents received, landlords often recuperate funds expended on capital improvements like soft-story retrofits via vacancy decontrol or individual petitions.

Vacancy Decontrol

The Costa-Hawkins Rental Housing Act (“Costa-Hawkins”; Civil Code, 1954.50 to 1954.535) is a California State law enacted in 1995 that restricts certain aspects of jurisdictional independence over rent control. One aspect of Costa-Hawkins is the requirement that rent control laws allow for vacancy decontrol which grants housing providers the opportunity to set initial rent for new tenancies at market rate, as is the case under the CSFRA. In general, 20 percent of rental units in Mountain View experience tenant turnover annually; in five years, turnover rates could approach 100 percent. Of course there are exceptions to the turnover rate, with some units and buildings that have long-term tenants and minimal, if any, turnover during a five year timeframe.

CSFRA Petitions for Upward Adjustment of Rent (Fair Return Standard)

If a landlord does not believe the permitted annual general rent adjustment provides a fair rate of return, a landlord may petition for an upward adjustment of rent. The CSFRA sets forth the factors a hearing officer must consider when deciding whether to grant the petition. The petition process provides the vehicle for a landlord to effectively “share costs” with tenants by accounting for all of the costs owners are permitted under the CSFRA to ensure that tenant rents compensate for those costs and still provide the landlord with income from the operation of the rental property (i.e. a “fair return”). The “fair return standard” maintains the net operating income (MNOI) received from a property in the years prior to implementation of the CSFRA by increasing the net operating income in accordance with changes to the CPI-Rent of Primary Residence. Any capital improvements that are allowed costs under the CSFRA, must be taken into consideration when a Hearing Officer reviews a fair return petition to determine any amount a landlord can increase the rent with above the annual AGA.

Policy Options for Recovering certain Capital Improvement Costs

1. Use the CSFRA Fair Return Standard – MNOI Petition Process
2. Request RHC to Adopt specific capital improvement petition Regulations
3. March 2020 Ballot Measure to Amend the CSFRA to introduce a specific petition process for certain capital improvements

Option 1: Fair Return Standard – MNOI Petition Process

Option 1 utilizes the current fair return standard petition process for capital improvement related costs to be recovered. This option is currently practiced under CSFRA regulations and City staffing, systems and processes already administer these types of petitions.

Option 2: Request RHC to Adopt Specific Petition Regulations for Certain Capital Improvements

In Option 2, the RHC could develop regulations under the current CSFRA to allow for a specific petition process for certain capital improvements such as soft story retrofits. However, any new petition process would only apply to capital improvements that are allowed in the CSFRA; staff would have to explore whether certain capital improvements would qualify due to the text of the CSFRA. Notably, the CSFRA does not contemplate a petition process specific to the costs of capital improvements, to the exclusion of other operating costs.

Option 3: March 2020 Ballot Measure to Amend the CSFRA

As mentioned above, rent adjustments solely related to capital improvement costs are not specifically authorized in the CSFRA. Accordingly, the CSFRA would need to be amended to create a specific petition process for defined capital improvements. The Council could consider placing a measure on the March 2020 ballot to amend the CSFRA to allow for an increase of rents above the AGA related to certain capital improvement costs.

Please find below a comparison of cost-recovery policies and options in other rent stabilized jurisdictions in California

Policies and options for cost recovery differ among rent stabilized jurisdictions and typically rely on one of two options for cost recovery, a fair return standard or a specific petition process for certain capital improvements. However, regardless of the policy allowed by each city, vacancy decontrol (i.e. adjusting rents to market at the time of unit turnover in order to capture and recuperate costs) appears to be the primary method housing providers are utilizing to recuperate capital improvement costs.

Standards for Adjustment in Rent

Jurisdictions utilize two standards to allow for adjustments in rent greater than the annual general adjustment of rent for capital improvements:

1. Fair Return Standard – Maintenance of Net Operating Income (MNOI) Petition

2 Specific Petitions for certain Capital Improvements without Fair Return Standard

These policies require a petition be filed with the city by the housing provider. In the researched rent stabilized jurisdictions, the majority of cities have stated that few capital improvement-specific petitions of any kind, were filed because housing providers were able to recover costs through vacancy decontrol.

Table X. Types of Standard for Cost-Recovery

	Fair Return Standard	Capital Improvement Cost Recovery Standard	Capital Improvement Cost Recovery Standard (Soft Story Retrofit Specific)
Alameda	✓	✓	
Berkeley	✓	✓	
Los Angeles	✓	✓	✓
Oakland	✓	✓	✓
San Francisco	✓	✓	✓
San Jose	✓	✓	
Santa Monica	✓		
West Hollywood	✓		

Fair Return Standard (MNOI Petitions)

As in Mountain View, all jurisdictions have a fair-return standard/MNOI petition process to ensure housing providers are able to maintain their net operating income on a year-to-year basis adjusted by a percentage increase of a specified consumer price index. In this type of petition, capital improvements are documented as one of a variety of operating costs to be included when calculating a fair return. For the most part, although available, MNOI petitions are generally no longer filed in the researched cities due to the age of the rent stabilization ordinances. Essentially, the further away from the implementation date of the rent stabilization ordinance, the less necessary fair return petitions are for maintaining income. This is due to vacancy decontrol. Santa Monica and West Hollywood strictly utilize the fair return standard.

Capital Improvement Cost Recovery without Fair Return Standard (Expedited Petitions)

Alameda currently utilizes a Capital Improvement Plan Application that must be filed with the City prior to the repairs being conducted. If approved, the plan allows the Program Administrator to determine the Maximum Allowed Rent increase per unit. If the requested increase is above 5%, the applicant may also consider filing an increase petition. Repairs must meet a minimum cost threshold to qualify for the plan as follows: 1 months' rent multiplied by the number of units improved, multiplied by 8 (number determined by Council). Should this threshold be met, an additional calculation is used to determine the allowed maximum increase per unit: $[\text{Total cost of repairs} + \text{interest}] / \text{amortization period} / \text{number of units improved}$. Staff notes that the City of Alameda adopted sweeping changes to its Rent Stabilization Ordinance that have yet to be implemented and may impact the City's current Capital Improvement Plan Application process.

Berkeley allows for a modified process that takes into account capital improvement costs, but not all operating expenses. This method bypasses MNOI calculations to determine a fair return. Capital improvements allowed under this petition are valued at a specific calculation rate. This calculation rate is then used to determine the potential increase per unit via the following equation: [(Out of pocket cost + self-labor cost) x calculation rate] / number of units].

Los Angeles, Oakland, San Jose and San Francisco have regulations that provide for a truncated petition process to recover costs associated with capital improvements. These capital improvement-specific petitions grant housing providers an opportunity to request rent adjustments based solely on costs incurred due to certain capital improvements, instead of reviewing all income and expenses as required under a fair return standard. The petitions require that documentation related to such capital improvement expenses be provided and go through a petition and/or hearing process similar to that of the fair-return petition. Increases granted by these expedited petitions are often capped, amortized and restricted as described below.

Qualifications to Determine Eligible Capital Improvement

	Expense Qualifications - Capital Improvement Cost Recovery Standard
Alameda	Substantial rehabilitation that: <ul style="list-style-type: none"> • Materially adds value to the property • Appreciably prolongs the useful life or adapts the property to a new use • Has a useful life of more than one year and is required to be amortized over the useful life of the improvement • Has a documented cost that is not less than the product of eight times the amount of the rent (as averaged over the past 12 months) multiplied by the number of rental units to be improved
Berkeley	<ul style="list-style-type: none"> • Materially adds to the value of a rental property • Appreciably prolongs its useful life or adapts it to a new use • Has a useful life of more than one year • Direct cost of \$200.00 or more per unit affected, or \$1500.00 per property, whichever is less • Be necessary to bring the unit or property into compliance with applicable new code requirements • Be intended primarily to significantly improve the rental property’s seismic safety or increase its energy efficiency • Be provided by the landlord in good faith to primarily benefit the tenant • Or qualify as a major repair
Los Angeles	<ul style="list-style-type: none"> • Primarily benefit the tenant rather than the landlord • Have a life expectancy of five years or more • Be permanently affixed in place or be relatively immobile • Have been completed within the 12 months preceding the date of application • Not be normal routine maintenance and repair work to the rental unit and/or the building
Oakland	<ul style="list-style-type: none"> • Materially add to the value of the property • Appreciably prolong its useful life or adapt it to new building codes • Primarily benefit the tenant rather than the owner. Do not include: <ul style="list-style-type: none"> • Correction of serious code violations not created by the tenant; • Improvements or repairs required because of deferred maintenance; • Improvements that are greater in character or quality than existing improvements • Improvements that bring the unit up to current building or housing codes (mandatory retrofit excluded) • Cost of a substantially equivalent replacement; or costs for which a landlord is reimbursed
San Francisco	<ul style="list-style-type: none"> • Materially adds to the value of the property

	Expense Qualifications - Capital Improvement Cost Recovery Standard
	<ul style="list-style-type: none"> • Appreciably prolongs its useful life, or adapts it to new uses • Costs may be amortized over the useful life of the improvement of the building <ul style="list-style-type: none"> • Cost of capital improvement work that was required to correct a code violation for which a notice of violation was issued and remained unabated for 90 or more days will not be certified for pass through to the tenants unless the landlord made timely good faith efforts to do the work within that 90-day period
San Jose	<p>Addition or modification to the property, building, or unit, that:</p> <ul style="list-style-type: none"> • Replaces or enhances an existing physical feature of the Rent Stabilized Unit or of a building containing a Rent Stabilized Unit, or • Provides new Housing Services to the Tenants <p>Must do at least one (1) of the following</p> <ul style="list-style-type: none"> • Increase the safety (including ADA accessibility), sustainability (water or energy conservation), or seismic readiness of the Rent Stabilized Unit (or of a building containing a Rent Stabilized Unit); and/or <p>Provide new Housing Services or enhance Housing Service functionality</p>

Examples of Approved Repairs

	Types of Approved Repairs - Capital Improvement Cost Recovery Standard
Alameda	<ul style="list-style-type: none"> • New roof covering all or substantially all of a building or a structurally independent portion of a building • Significant upgrade of the foundation of all or substantially all of a building or a structurally independent portion of a building, including seismic retrofits • New or substantially new plumbing, electrical or heating, ventilation and air conditioning (HVAC) system for all or substantially all of a building • Exterior painting or replacement of siding on all or substantially all of a building <ul style="list-style-type: none"> • Repairs reasonably related to correcting and/or preventing the spread of defects which are noted as findings in a Wood Destroying Pest and Organisms Inspection Report • Installation of water conservation devices intended to reduce the use of water or energy efficient devices, such as solar roof systems • Improvements or upgrades to the Rental Unit or the building/complex that meet or exceed disability/accessibility standards as required by law
Berkeley	<ul style="list-style-type: none"> • New roof covering all or substantially all of a building or a structurally independent portion of a building • Significant upgrade of the foundation of all or substantially all of a building or a structurally independent portion of a building • New or substantially new plumbing, electrical or heating system for all or substantially all of a building <ul style="list-style-type: none"> • Exterior painting or replacement of siding on all or substantially all of a building • Repairs reasonably related to correcting and/or preventing the spread of defects which are noted as findings in a Wood Destroying Pest and Organisms Inspection Report
Los Angeles	<p><i>Capital Improvement Rent Surcharges:</i></p> <ul style="list-style-type: none"> • Roofing • Carpeting • Draperies • Stuccoing the outside of a building • Air conditioning • Security gates • Swimming pool • Sauna or hot tub • Fencing • Garbage disposal <p><i>Capital Improvement Primary Renovation:</i></p> <ul style="list-style-type: none"> • Replacement or substantial modification of any structural, electrical, plumbing or mechanical system that requires a permit under the Los Angeles Municipal Code • Abatement of hazardous materials, such as lead-based paint and asbestos, in accordance with applicable federal, state and local laws

	Types of Approved Repairs - Capital Improvement Cost Recovery Standard	
	<ul style="list-style-type: none"> • Washing machine or clothes dryer • Dishwasher • Children’s play equipment permanently installed on the premises • Complete exterior painting of a building • Smoke detectors • Other similar improvements as determined by the Commission 	
Oakland	<ul style="list-style-type: none"> • Air Conditioning • Appliances • Cabinets • Carpentry • Counters • Doors • Earthquake Expenses • Electrical Wiring • Elevator Repair • Fencing and Security • Fire Alarm and/or Sprinkler Systems • Fire Escapes • Flooring • Fumigation • Furniture (Permanent) Heating • Insulation • Landscaping • Lighting 	<ul style="list-style-type: none"> • Locks • Mailboxes • Meters • Plumbing • Painting • Paving • Plastering • Pumps for Water Intrusion • Railing • Roofing • Security Systems • Stairs • Structural Repairs and Retrofitting • Stucco • Tilework • Wallpaper • Window Coverings
San Francisco	<ul style="list-style-type: none"> • Appliances • Fixtures • Locks • Light fixtures • Water heaters and blankets • Shower heads • Time clocks • Hot water pumps • Carpeting, linoleum, and exterior and interior painting of common areas • New foundation • New floor structure • New ceiling or walls • New sheetrock • New plumbing (new fixtures, or piping) • Weather stripping • Ceiling insulation • Seals and caulking • New furnaces and heaters • Refrigerators 	<ul style="list-style-type: none"> • New electrical wiring • New stairs • New roof structure • New roof cover • New window • Fire escapes • Central smoke detection system • New wood or tile floor cover • New sprinkler system • Boiler replacement • Air conditioning-central system • Exterior siding or stucco • Elevator rebuild • Elevator cables • Additions such as patios or decks • Central security system • New doors • New mail boxes • New kitchen or bathroom cabinets and sinks.
San Jose	<ul style="list-style-type: none"> • ADA Driveway Egress • Insulation • ADA Ramps • Structural Iron or Steel Work • Air Conditioning • Masonry-Chimney Repair • Drought Tolerant Landscape • Security System (including security gates and 	<ul style="list-style-type: none"> • Fire Alarm System • Soft Story Retrofit • Fire Escape • Solar power panels • Fire Sprinklers/Retardant System • Sub metering • Foundation Bolting • Windows

Types of Approved Repairs - Capital Improvement Cost Recovery Standard	
<ul style="list-style-type: none"> fencing) • Elevators • Shear Wall Installation 	<ul style="list-style-type: none"> • Foundation Repair • Foundation Replacement

Share of Costs

Jurisdictions that allow housing providers to file capital improvement-specific petitions place limits on the total costs of capital improvements that can be passed through to tenants through the capital improvement-specific petition process. Restrictions vary by jurisdiction and often include limitations related to amortization (the cost of an improvement spread over its useful lifespan), percent caps of the total amount of the improvement allowed to be passed through or percent caps of an increase related to per unit rent, and sunset provisions related to amortization where the increase is removed after the amortization schedule ends. In most jurisdictions, tenants are also allowed to request hardship relief for capital improvement-specific rent increases. It is worth noting that landlords are prohibited from receiving 100% cost-recovery for capital improvements because property owners retain the value of the improvement (i.e. the improvement increases the value of the unit and the resale value of the property). All jurisdictions eliminate related increases at vacancy decontrol.

	Share of Costs - Capital Improvement Cost Recovery Standard	Share of Costs – Capital Improvement Cost Recovery Standard (Soft Story)
Alameda	[Total cost of repairs + interest] / amortization period / # of units improved	
Berkeley	[(Out of pocket cost + self-labor cost) x calculation rate] / # of units affected	
Los Angeles	<i>Capital Improvement Rent Surcharges:</i> 60% of capital improvement expenditures <i>Capital Improvement Primary Renovation:</i> Permanent 10% increase per unit split over two years plus any regular annual rent increase or Primary Renovation Cost/amortization/number of units (+ interest)	50% of costs; maximum amount of \$38 per month for 120 months
Oakland	70% of actual costs and financing, increase cannot exceed 10% of rent	
San Francisco	<i>Properties with 1 to 5 Units:</i> 100% of actual costs; tenants can apply for hardship; maximum amount of \$30 per year or 5% of tenant's base rent <ul style="list-style-type: none"> • Energy conservation work: 100% of certified costs can be passed through, regardless of number of units; no annual limit <i>Properties with 6 or more units:</i> 50% of actual costs; tenants can apply for hardship; maximum amount of \$30 per year or 10% of tenant's base rent OR 100% of actual costs; tenants can apply for hardship; maximum amount	100% of actual costs; tenants can apply for hardship; maximum amount of \$30 per year or 10% of tenant's base year for 20 years

	Share of Costs - Capital Improvement Cost Recovery Standard	Share of Costs – Capital Improvement Cost Recovery Standard (Soft Story)
	of 5% of tenant’s base rent with limit of 15% of tenant’s base rent <ul style="list-style-type: none"> Energy conservation work: 100% of certified costs can be passed through, regardless of number of units; no annual limit 	
San Jose	Capped at 3% of monthly rent at the time of filing; not considered a rent increase; does not increase with rent increases	

Amortization and Sunset Periods

Capital improvement costs are often amortized, or spread out, over a specified timeframe. Amortization schedules specify the length of time for each type of allowed cost. Once the amortization period is complete, the increases sunset and can no longer be applied to monthly rent charges.

	Amortization Period	Increase Sunset Period	Amortization Period (Soft-Story)	Increase Sunset Period (Soft-Story)
Alameda	15 years	None	Not Applicable	Not Applicable
Berkeley	None	None	Not Applicable	Not Applicable
Los Angeles	<i>Capital Improvement Rent</i> Surcharges: 60 months <i>Capital Improvement Primary Renovation:</i> 180 months	<i>Capital Improvement Rent</i> Surcharges: 60 to 72 months <i>Capital Improvement Primary Renovation:</i> None	Not Applicable	120 months
Oakland	Amortized based on detailed schedule (5 to 20 years)	Determined by amortization period		
San Francisco	<i>Properties with 1 to 5 units:</i> Amortized based on detailed schedule (10 to 20 years) <i>Properties with 6 or more units:</i> Amortized based on detailed schedule (7 to 10 years)	Determined by amortization period; sunset period may be extended to allow all costs to be recovered	Amortized over 20 years	20 years
San Jose	Amortized based on detailed schedule (5 to 20 years)	Determined by amortization period		