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COUNCIL TRANSMITTAL: LOS ANGELES HOUSING DEPARTMENT REPORT ON THE ECONOMIC STUDY FINDINGS AND RECOMMENDATIONS TO AMEND THE FORMULA TO SET THE RENT STABILIZATION ORDINANCE ANNUAL ALLOWABLE RENT INCREASE

SUMMARY

The General Manager of the Los Angeles Housing Department (LAHD) respectfully requests approval of the recommendations in this report to amend the provisions that govern the setting of the annual allowable rent increase for rental units subject to the City's Rent Stabilization Ordinance (RSO).

RECOMMENDATIONS

That the City Council, subject to the approval of the Mayor:

1. REQUEST the City Attorney, with the assistance of LAHD, to draft an amendment of the Rent Stabilization Ordinance, Article 1 of Chapter XV of the Los Angeles Municipal Code (LAMC), to revise the methodology to establish the annual allowable rent increase for RSO rental units as follows:
    a. Replace *Consumer Price Index All-Items for All Urban Consumers* with the *All-Items Less Shelter Index* in the methodology to establish the RSO annual allowable rent increase (LAMC 151.06.D and 151.07. A6);
    b. Establish a floor of 2% for annual RSO rent increases;
    c. Establish a ceiling of 5% for annual RSO rent increases;
    d. Provide that in years when the otherwise permissible rent increase calculated by the formula above exceeds the 5% ceiling, the calculated percent above 5% shall be added (rolled over) to the subsequent years' allowable rent increase, with the total annual increase not to exceed 5%, and provide that LAHD shall publish the allowable rent increase annually by December 1st of each year; and
    e. Delete the provision that allows an additional 1% or 2% increase for gas and/or electricity.

2. INSTRUCT LAHD to work with the Rent Adjustment Commission (RAC) to update the existing Rent Adjustment Commission Guidelines governing the Just and Reasonable rent increase program and conduct an outreach campaign to inform landlords on how to utilize the program and other cost reimbursement provisions of the RSO in order to ensure a fair return on their rental units.

BACKGROUND

In 2020, the City of Los Angeles adopted some of the strongest tenant protections in the country in order to avert widespread renter displacement and homelessness otherwise expected as a result of the economic impact of the public safety orders issued in response to the COVID-19 pandemic. Eviction protections for nonpayment of rent were maintained from March 2020 until February 1, 2024. Unless amended by the City Council, the annual allowable rent increase for RSO units of four percent (4%) commenced on February 1, 2024, and is in effect through June 30, 2025. Based on the existing formula, the annual allowable rent increase for RSO units beginning on July 1, 2025, through June 30, 2026, will be three percent (3%).

On October 31, 2023, as the City was preparing to lift the COVID-19 Tenant Protections, the City Council approved a motion (C.F. No. 23-1134), authorizing the Los Angeles Housing Department to negotiate and execute a sole-source contract with the Economic Roundtable, a non-profit, public benefit corporation, to conduct an economic study of the formula to set the RSO annual allowable rent increase, to include:

- Analysis of allowable rent increases in the California cities that have recently adopted or amended their formula for the annual allowable rent increase, including but not limited to Oakland, Bell Gardens, Antioch, Pomona, Santa Ana, and Oxnard

- The financial impact of the RSO rent freeze imposed during the COVID-19 pandemic

- A review of mandated City fees (i.e. RSO, SCEP, LASAN, RecycLA, DWP, etc.) impacting operating expenses in rental properties, including:
    - trash-hauling fees
    - water rates
    - electricity
    - insurance
    - property taxes
    - increasing labor and material costs

- Analysis of the impacts on homelessness in the City of Los Angeles, including the analysis from the 2020 U.S. Government Accountability Office study around median rent increases, for any recommended allowable rent increase caps and formulas.

This report provides the findings of the Economic Roundtable's published study "Equitable Rent - Rent Stabilization Standards in the City of Los Angeles" dated September 2024 and proposed recommendations to amend the provisions regulating the RSO annual allowable rent increase.

The City's Rent Stabilization Ordinance generally applies to rental properties built on or before October 1, 1978, and regulates approximately 651,000 rental units, representing nearly 74% of the City's multi-family housing stock. The RSO limits annual rent increases and allows landlords to increase rents in accordance with the Consumer Price Index, with a floor of 3% and a ceiling of 8%.

According to the U.S. Census Bureau, 63% of Angelenos are renters. Fifty percent (50%) of renters are rent burdened, paying more than 30% of household income for rent, and 30% of renters are severely rent burdened, paying over 50% of household income for rent. Los Angeles consistently ranks as one of the most rent-burdened cities in the nation.

As summarized on page 83 of the Equitable Rent Study, when the RSO was adopted in 1979, the annual allowable rent increase was set at a flat 7%. Since then, the RSO formula to set the maximum annual allowable rent increase was amended twice: in 1980, to allow an additional 1% for each utility (gas and electricity, only) and in 1985 to allow an annual increase based on the Consumer Price Index (CPI), with a ceiling of 8% and a floor of 3%.

The current RSO provisions utilize the Consumer Price Index All-Items for All Urban Consumers for the greater Los Angeles area, based on data from the Bureau of Labor Statistics from the US Department of Labor. The RSO allows a maximum annual rent increase of 100% of the change in the CPI, with a maximum 8% percent ceiling and a floor of 3%. Landlords who pay 100% of the cost of gas and/or electricity (but not water) are allowed to add an additional 1% annual rent increase for each utility, for a maximum annual increase of 10% if a landlord provides both gas and electricity.

Since the inception of the RSO in 1979, the City has undertaken four prior studies (1984, 1988, 1994, and 2009) that included an analysis of the methodology utilized to set the annual allowable rent increases. Both the 2009 study and the current study were conducted by the Economic Roundtable, a non-profit research organization based in Los Angeles.

SUMMARY OF THE MAJOR FINDINGS OF THE STUDY

The following is a summary of the major findings of the 2024 Study "Equitable Rents –Rent Stabilization Standards in the City of Los Angeles". The full report is provided as an attachment to this report and available online at https://economicrt.org/publication/equitable-rent/

Los Angeles Housing Inventory

- Los Angeles has an estimated 1,549,889 total housing units for a total population of 3,822,224 residents, or 2.47 residents per unit.
- Almost two-thirds of Los Angeles residents rent the housing units in which they reside – 64 percent.
- Forty-two percent of the City's residents live in rent-stabilized housing.
- Half of RSO properties were constructed before 1950, while another 29 percent were built from 1950 to 1970. The remainder were built in the 1970s.
- The preponderance of RSO-dominant neighborhoods is located in the Los Angeles basin, plus the Southeast San Fernando Valley.
- Rent stabilized units are older and concentrated in the urban core of Los Angeles. Non-RSO units are newer and concentrated in areas of Los Angeles that have been built-out more recently.

Los Angeles Renters

- RSO and non-RSO renters have similar demographic characteristics, including frequency of disabilities, ethnicity, level of education, age, sources of income, and English fluency.
- RSO and non-RSO renters differ in that RSO households are more frequently made up of a single person, and are more often overcrowded.
- Non-RSO households are slightly more likely to have moved recently.
- The average income of non-RSO households is 22 percent higher than the income of RSO households. However, both groups of renters have similar levels of rent burden because the average rent for non-RSO units is higher.
- Over the past three decades, rent has increased in the same ratio for RSO and non-RSO renters. However, given the higher average income of non-RSO renters, the same percent spent on housing is less likely to divert funds from other basic necessities.
- One-fifth (20%) of Los Angeles renters live in poverty based on the federal standard. More than half of these households (14% of Los Angeles renters) pay 90 percent or more of their income for rent. These highly vulnerable renters are likely to be younger, live alone, be unemployed or have annual incomes below $20,000, and are more likely to receive public benefits. Additional findings regarding the demographics of vulnerable renter households are discussed in Chapter 4, pages 33 through 36 of the Study.

Rent Savings for RSO Tenants

- Citywide, the average rent for non-RSO units has been an average of 25 percent higher than for RSO units from 1990 through 2022. This is based on comparing all RSO units with all non-RSO units without accounting for where units are located or their size.
- There are differences in the size of RSO and non-RSO units, the shares of the RSO and non-RSO rental inventories located in different districts of the City, the income levels of renters in different districts of the City, and the average rent for RSO and non-RSO units in different districts of the City.
- Non-RSO units in the City of Los Angeles have an average of 2.1 bedrooms, whereas RSO units have an average of 1.5 bedrooms. Non-RSO units are typically bigger. This difference should be considered in estimating rent savings for RSO units.
- While it is feasible to control for the size of units in estimating the difference in rent for RSO and non-RSO units, it is not feasible to control for geographic differences.
- The rent differential between RSO and non-RSO units is the average of multiple different rental markets within the City.
- Based on comparing the rent for RSO and non-RSO units using both the number of bedrooms and total number of rooms as benchmarks, the average rent paid by RSO renters is **19 percent less** than the rent paid by non-RSO renters for units of comparable size.

Rent Increases and Homelessness

- The most frequent explanation that homeless adults in Los Angeles provide for their lack of housing is unemployment and lack of money.
- There is a direct connection between loss of income and loss of shelter, but these losses do not occur simultaneously. Disconnection from work is a degenerative dynamic - less work, less earnings, less stable living conditions, and further disconnection from work.
- One-quarter of renters in the Los Angeles region have household incomes under $25,000. Eighteen percent of these households say it is extremely likely that they will be evicted in the next two months.
- Rent costs that exceed what tenants can pay is a primary cause of homelessness.
- Increases in income inequality lead to increases in homelessness because they simultaneously drive up the cost of housing and the percent of low-income renters who cannot afford that housing.
- There is a high rate of homelessness in Los Angeles primarily because of the interaction between the housing market and the labor market—namely, the high cost of housing and the high rate of working poverty.
- Los Angeles has relatively high local income inequality—and therefore, high homelessness—compared to the rest of the country.
- An increase in evictions is a driver of an increase in homelessness.
- The primary driver of evictions is the rising cost of housing.
- ***The eviction moratorium, rental assistance and fiscal stimulus programs were successful in preventing the rise of homelessness from being as severe as it would have been otherwise.***

2020 U.S. Government Accountability Office Study

The discussion of the study by the 2020 U.S. Government Accountability Office (GAO) is found on pages 48 – 50 in Chapter 6 of the Equitable Rent Study that discusses Rent Increases and Homelessness.

Financial Stress of Landlords by Size

- Small landlords with two to four units account for the plurality of the RSO housing inventory, 30 percent.
- The typical (median) RSO unit is in a building with 17 units.
- The buildings owned by small landlords with one to four units typically have more bedrooms than all other size classes of ownership. They provide an average of 46 percent more bedroom space than the overall average for the RSO inventory.
- Seventy-five percent of units in buildings with two to four units have two or more bedrooms, compared to 34 percent of units in buildings with five or more units.
- The average rent for units owned by small landlords is higher than the average rent for any other building size group and 20 percent higher than for the overall RSO inventory.
- When rents are compared on the basis of rent per bedroom, small landlords receive 16 percent less rent per bedroom than the overall average for RSO units.
- Fifty-seven percent of tenants in units owned by small landlords are reported by the Census Bureau to have been in their units five or more years. This compares to only 47 percent of tenants in all RSO units reaching the five-year mark, and is longer occupancy than any other ownership group. Less tenant turnover reduces lost revenue from empty units. However, it also reduces the frequency with which rents can be vacancy decontrolled and re-rented at market rates.
- Based on vacancy data from the Census Bureau, vacancy rates increase with ownership size; small landlords have the lowest vacancy rate. The person-to-person relationship between tenants in small buildings and their mom-and-pop landlords appears to make tenants more inclined to stay where they are.
- Vacancy rate data indicates small landlords have vacancy rates that closely match, or are lower than, other ownership groups.
- RSO landlords have less tenant turnover than non-RSO landlords, which reduces lost rent when units are vacant as well as costs to refurbish units for new tenants.
- Operating expenses for smaller buildings may be offset by self-management, which reduces cash outlays for managing small RSO buildings.
- Smaller RSO landlords appear to receive higher rent per unit, although lower rent per bedroom, and have lower vacancy rates than larger RSO landlords. The Study did not find evidence that they have greater financial stress than larger landlords.

Impact of the COVID Pandemic on Landlords

- Nationwide:
    - Landlords experienced a sharp increase in non-payment of rent during the COVID pandemic, which they addressed by granting more rent extensions, charging less rent fees, deferring maintenance, and listing their properties for sale.
    - Smaller landlords were more likely to experience non-payment of rent, and larger landlords were more flexible in managing this problem, for instance, by granting rental extensions or forgiving late rent fees.
    - Landlords were least likely to offer accommodations to renters of color for the same level of non-payment of rent.
- Rental assistance programs throughout the U.S. provided significant help to tenants, but did not reach as many tenants as administrators hoped due to strong resistance from landlords. However, in the City of Los Angeles, rental assistance was paid directly to tenants whose landlords declined to participate.
- In Los Angeles and Orange Counties, rental non-payment declined from 2020 to the end of 2023.
- Based on the Census Bureau's household surveys, approximately 13 percent of renter households in Los Angeles and Orange Counties are estimated to be currently behind on rent, with an average of 3.1 months unpaid.

- Since 2014, RSO properties have been far more successful in filling the average unit than non-RSO properties. This low turnover is likely due to the value that tenants find in rent-restricted units as rents and property values have risen in recent years.
- Despite earning lower rents for comparable units, on average, RSO landlords receive the compensating benefit of lower turnover costs, more stable revenue, and proportionally more revenue-generating units.
- The pandemic has had a more lasting negative effect on occupancy in non-RSO properties, where vacancy rates remain elevated.

Market Rate Rents, Restricted Rents, and Inflation

- From 2000 to 2023, the Los Angeles region had a higher rate of inflation than the rest of the United States, due entirely to housing costs. For all goods other than housing, the Los Angeles region actually became slightly more affordable than the rest of the country.
- From 2000 to 2023, housing added 0.3 percentage points to the annual national inflation rate and 0.6 percentage points to the annual Los Angeles inflation rate, accounting for 12 percent of inflation nationally and 21 percent of inflation in Los Angeles.
- From 2015 to 2024, average effective asking rents grew faster for RSO properties than for non-RSO properties (24.1 percent, compared to 15.6 percent), likely reflecting strong demand for protection against high rent hikes in an increasingly expensive market, as reflected in low vacancy rates.
- Los Angeles rents decreased significantly in the early months of the pandemic, erasing the outsized gains they had made relative to the rest of the country. From 2020 to 2023, rents grew more slowly in Los Angeles than in the rest of the United States.

Rent Regulation

- According to the Study consultants, increases in rents for RSO units are the result of the combination of increases in market rents at the commencement of a tenancy and annual allowable rent increases during tenancy.
- Annual general adjustments of rents were not permitted from May 2020 through January 2024. However, substantial rent increases, averaging 30 to 50 percent above the 2020 level, could be obtained from units with a turnover in tenants.
- Because of substantial turnover rates of about 50 percent within a four-year period, market rents are a central determinant of allowable rent levels and increases in rent under the RSO.
- From 2010 to 2020, the RSO annual allowable rent increases totaled 35.6 percent compared to a 20.9 percent increase in the CPI. In the five-year period from 2015 to 2020, the annual allowable rent increases totaled 17 percent, compared with a 12.5 percent increase in the CPI.
- Overall, due to substantial increases in market rents, move-in year is a central determinant of the current allowable rent of RSO units.

Operating Expenses and Other Costs for Low-Income Housing

- The largest expenses and losses for most Los Angeles landlords are capital expenditures, followed by vacancy, salaries and personnel, taxes, and contract services.
- The fastest growing expense from 2010 to 2022 for rent-stabilized properties has been property insurance, though it still comprises a small portion of total operating costs (4.6 percent to 8.6 percent).
- Operating expenses outpaced inflation in the Western region of the United States from 2010 to 2022, increasing 67 percent compared to 38 percent increase in the Consumer Price Index.
- Until 2019, increases in RSO rents mostly kept pace with increases in operating expenses, but have lagged inflation since the onset of the COVID pandemic.

- According to the consultants, for equity investors who have owned their properties for a long time, paid off their loans, and are now free-and-clear of debt, the average apartment unit in Los Angeles appears to be highly profitable.

<u>Increases in Apartment Operating Costs</u>

- In Los Angeles, operating expenses for apartments average about 35 percent of rental income.
- Assuming an average monthly rent of $1,600 and an average operating expense ratio of 35 percent, monthly operating costs per rental unit average $560.
- Property taxes average $146 per unit per month for properties with five or more units and $191 for properties with three or four units.
- Total utility costs for water, sewer, gas, and electricity generally amount to less than 10 percent of the rent. Therefore, the increases in utility rates that have exceeded the rate of inflation in recent years have not had a substantial impact on the net operating income obtained from rental properties.
- The Study authors project management expenses of four percent for offsite management expenses.
- Insurance costs formerly amounted to only about two or three percent of the rents but may have doubled within the past few years and continue to increase.
- The balance of rental income net of operating expenses - net operating income - is the return on the investment in the property, which is available to cover debt service and provide cash flow.

<u>Returns from Rental Properties</u>

- Average market values of RSO units have doubled over the last ten years from about $150,000 to $300,000 per unit and are nearly five times above their 2000 level.
- Historically, investors' expectation is that the cash flow will increase as rents and net operating income increase above their levels at the time of purchase, while mortgage payments will decline relative to overall income. This expectation and the leveraged nature of investment in rental property has made investments in rental properties attractive, notwithstanding low cash returns at the outset.
- Seventy-four percent of RSO units were purchased before 2015; thirty-eight percent were purchased before 2000. The average length of ownership is virtually the same for different size properties.
- Net operating income from rental housing investments has grown at faster rates than the CPI (3.9 percent versus 2.6 percent).
- The Study consultants conclude that there has been substantial growth in the net operating income of rental units covered by the RSO, although operating expenses have outpaced increases in the CPI.

<u>California Rent Stabilization Laws</u>

- In the 1980s, rent legislation was adopted by Los Angeles, San Francisco, Oakland, San Jose, Santa Monica, Berkeley, and West Hollywood and a few other cities.
- In the last eight years, the tightening of the rental market has led to the adoption of local rent legislation in fifteen other jurisdictions, including Los Angeles County, Culver City, Inglewood, and Pasadena and to the adoption of a state ceiling on increases in apartment rents of units that are not regulated by local ordinances. Eight of those ordinances were adopted between 2020 and 2022.
- Most rent ordinances tie annual allowable rent increases to all or a portion of the percentage increase in the CPI and place a ceiling on the allowable increase pursuant to the CPI standard.
- Fifteen of the ordinances limit the annual rent increase to less than 100 percent of the increase in the CPI.
- Twenty-two of the ordinances now in effect place a ceiling of either three, four, or five percent on allowable rent increases based on a CPI standard, or fix the annual increase amount at four or five percent.

- Under Los Angeles's RSO in effect prior to the pandemic, the allowable annual increases were greater than those permitted under a majority of the ordinances now in effect in other cities.
- In the decade before the pandemic, from 2010 to 2020, the result of the RSO standard in effect compounded move-in rents set under shortage conditions with allowable rent increases during tenancies that exceeded the CPI increase in years with low inflation.

Impacts of Alternative Policies Related to the Efficacy of the RSO Annual Adjustment

- The RSO provides security of tenure by limiting the rent increases after a tenant takes possession of the rental unit.
- Because of vacancy decontrol, initial rents are not regulated, so the RSO does not preserve the affordability of housing, except for long-term tenants, who constitute a minority of the tenant population. This limitation on rent control is mandated by state law, the Costa Hawkins Act. The City of Los Angeles, along with all rent-control jurisdictions in California, is required to have vacancy decontrol.
- The impact of the RSO on properties differs based on the frequency of tenant turnovers.
- Historically, questions and criticisms have been raised about the use of the *CPI All-Items Index* to determine annual increases on the basis that this index is based on the increases in the costs of a market basket of goods purchased by an average household, which differ substantially from basket of expenses associated with the operating of an apartment building.
- Apartment operating costs only constitute about 35 percent of rental income, while the annual general adjustment applies to all of rental income including the other 65 percent which is net operating income.
- In the past, some jurisdictions have conducted annual operating cost studies of the types of expenses incurred by apartment owners in order to tie allowable annual rent increases to trends in apartment operating costs. However, jurisdictions that used this methodology subsequently switched to a CPI standard.
- There are a number of CPI indexes that are based on the prices of particular commodities or types of services.
- Most discussion and consideration of the Consumer Price Index is centered on *CPI All-Items Index.*
- The ***All-Items Less Shelter Index*** is the CPI index recommended for use in determining the annual allowable rent increase. This would remove the circularity associated with using trends in market rents, which are heavily based on shortage conditions that motivated the adoption of the RSO.
- Annual rent increases should cover increases in apartment operating costs. An annual increase in the range of 35 percent of the percentage in the CPI would cover those cost increases in years in which operating costs increased at the same rate as the CPI, but would not allow for any growth in net operating income.
- An alternative to setting a fixed ceiling on allowable annual rent adjustments is to use a descending percentage of CPI increases above a specified amount. This type of standard recognizes the differences between different amounts of increase in the CPI.
- A disadvantage of allowing greater rent increases for small properties is that tenants in those properties would experience larger rent increases than the balance of the tenant population, although the rent levels of their units and the rate of increase in their rents may not differ from the average for other units.

Allowable Additional Rent Increases for Apartment Owners Who Pay for Gas &/or Electricity

- Under the RSO, apartment owners who cover either gas or electricity costs are permitted additional annual rent increases of one percent for each of these services. This impacts the rents of about 20 percent of all RSO units. In about eight percent of all units, an additional two percent is permitted based on the provision of both services. In 11 percent of all units, landlords pay for gas, but not electricity. In 1.4 percent of all units, landlords pay for electricity but not gas.
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Service	Percent of Units
Gas & Electricity	7%
Gas, But Not Electricity	11%
Electricity, But Not Gas	1.4%

Source: Economic Roundtable team analysis; City of Los Angeles Housing Department Rent Registry 2024.

- The RSO provisions allowing a fixed annual adjustment for these services is unique among California rent stabilization ordinances
- In tenancies of five years, the additional rent increase could be in the range of $150 to $240 for each service provided. This amount exceeds the total cost of the utility service.
- In other jurisdictions, the permitted amounts are based on the average amounts of the rent increases that would be required to cover the actual increases in costs of providing electricity and/or gas, rather than being a permanently fixed annual amount.
- Los Angeles's allowance of a one percent annual increase for each of these costs is disproportionate to actual increases in the costs of master-metered electricity and gas. ***The Economic Roundtable recommends that the increases in utility costs that are passed through to renters should not exceed the average actual amount of increases in those costs rather than a permanently fixed amount and should be limited to years in which there are significant increases in these costs.***

Accessory Dwelling Units

- ADUs represent an opportunity to expand the City's inventory of affordable housing with modest capital investments.
- The number of "legal" ADU's has grown since 2017, with a total of 19,760 in the city.
- The consultants project that 6,123 ADUs will be produced in 2024, the City's highest single-year total yet.
- Over 11,800 building permits have been issued for unbuilt ADUs.
- The average ADU in the City of Los Angeles is 816 square feet.
- The average valuation is $61,000 each, or $92 per square foot.
- Legal ADUs provide 2.1 percent of the City's rental housing stock. ADUs alone cannot fix the City's affordable housing shortage.
- The consultants recommend that the Planning Department completes its studies of potential modifications in the building and zoning codes that would encourage construction of more ADUs.
- It is recommended that the City consider providing economic incentives that will stimulate more ADU production.

Recommendations for Additional Data

In addition to the findings above, the Economic Roundtable submitted a number of additional recommendations for additional studies and data:

- The Los Angeles Housing Department should be provided with data from the Los Angeles Department of Water and Power on average utility costs for buildings covered by the RSO on an annual basis. The information should include average water and electricity costs for master-metered buildings.
- The Sanitation and Environment Department should provide data on average costs for solid waste collection, both for RSO buildings with four or less units and buildings with five or more units.
- The consultants also noted that about 69 percent of all RSO units are properly registered in the LAHD Rent Registry and that LAHD should have increased funding in order to enforce the registration requirement. Requests for additional positions for the Rent Registry will be submitted in the Department's 2025-26 budget request.

POLICY OPTIONS FOR COUNCIL CONSIDERATION

In order to understand the analysis in the Study and conclusions, it is important to understand how the RSO operates in the Los Angeles rental market. While the RSO limits the maximum annual allowable rent increase that landlords are permitted to impose, landlords make economic and business decisions about how much to raise the rent each year and for which units. The RSO sets an upper maximum limit on how much a landlord may legally raise the monthly rent for each RSO rental unit. A landlord may raise the rent by any amount up to the maximum percentage, may elect to not to raise the rent for a new tenancy that is already at market rent, or may take individual tenants' personal situation into consideration. Thus, it is not accurate to assume that rents for all RSO rents are raised by the maximum allowable amount each year. Rather, landlords make these decisions on a case-by-case basis.

The Los Angeles RSO, as all jurisdictions in California, must adhere to state law (the Costa Hawkins Act) that mandates vacancy decontrol when rental units turn over, with limited exceptions. The Rent Stabilization Ordinance is not strict rent control, rather it is a rent *stabilization* law that protects tenants from excessive rent increases during their tenancies. It is not designed to and cannot ensure housing affordability. As noted on page 143 of the Study: "The RSO provides security of tenure by limiting the rent increases of a tenant after taking possession." This is true in all rent-regulated jurisdictions in California, because vacancy decontrol is mandated under state law.

In setting the methodology for setting the maximum annual allowable rent increase for RSO units, City policy makers must determine the following criteria:

1. The most appropriate CPI Index;
2. The percentage of the CPI Index on which to base the calculation;
3. The maximum percent by which rents may be increased (the "ceiling") and the minimum percent by which rents may be increased (the "floor");
4. Whether to allow an additional adjustment for landlord paid utilities and, if so, how much.

Chapter 15 of the Study provides information on the rent increase formulas for 33 rent stabilized jurisdictions plus the statewide Tenant Protections Act of 2019 (for a total of 34 jurisdictions).

The Study consultants conclude that apartment operating costs constitute only about 35 percent of rental income. However, this excludes mortgage costs as well as capital expenditures, replacement of major building systems, deposits into reserves, and debt service payments, all of which are real expenses that must be taken into account in order to calculate fair and reasonable returns on investments in rental property. These costs are partially addressed through the RSO provisions that allow an annual allowable rent increase based on 100% of the CPI and maintain a minimum percentage as the floor for the annual allowable rent increase. LAHD further notes that while leveraged investments in rental property may be attractive notwithstanding low cash returns at the outset, this could change as operating costs increase relative to income. The RSO features several cost recovery programs that provide landlords with the opportunity to offset investments in their rental properties, further discussed in the section on outreach and education.

<u>CPI Index</u> – The Study recommends utilizing the ***All-Items Less Shelter Index*** rather than the Consumer All Items index in the formula to determine the annual allowable rent increase. This would remove the redundancy of utilizing housing costs and market rents in determining future RSO rents. LAHD concurs with this recommendation.

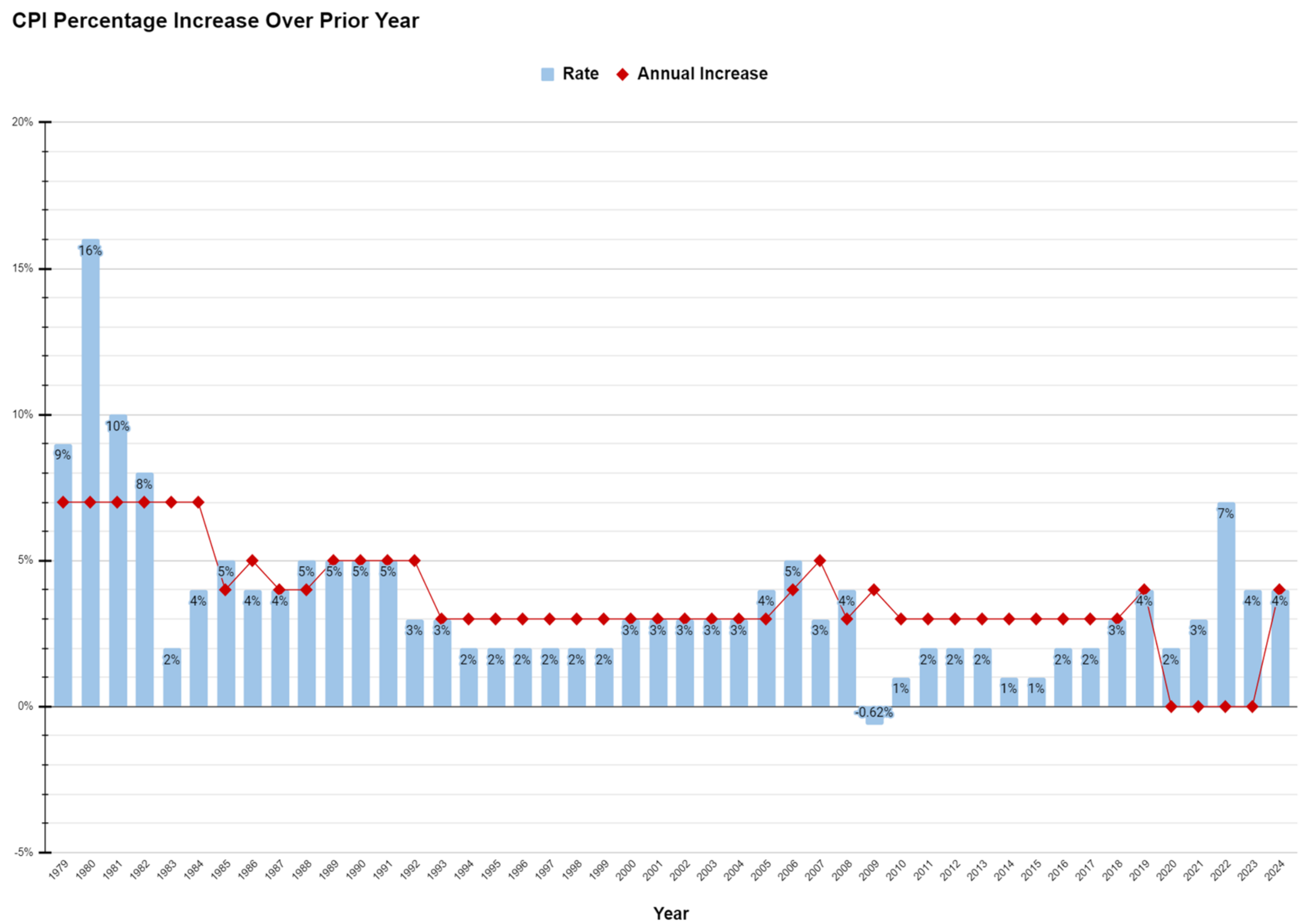
<u>Percentage of CPI</u> – The current City of Los Angeles RSO sets the annual rent increase at 100% of the CPI. In 2009, the Economic Roundtable reported that: "An important finding is that the current method of determining the annual allowable rent increase utilizing the CPI is the best available economic benchmark for setting rent

increases and the best available measure of an allowance for increases in operating costs. The CPI annual increase standard fairly balances the interests of renters and owners." (https://economicrt.org/publication/economic-study-of-the-rent-stabilization-ordinance-rso-and-the-los-angeles-housing-market/ C.F. No. 04-0777).

As reported on page 126 of the current Study, 15 of 33 jurisdictions (45%) allow a rent increase based on *less* than 100% of the CPI, with percentages ranging from 60% to 80% of the CPI. Fourteen (14) jurisdictions (42%) including Los Angeles calculate the annual rent increase based on 100% of the CPI, including 4 jurisdictions that allow the full CPI *plus* 5%. Four (4) jurisdictions (12%) set a fixed annual percentage of either 4% or 5%, regardless of changes in the CPI. **When jurisdictions that set a fixed percentage are included, the majority (53%) of California rent control programs, including the City of Los Angeles, employ a formula that allows annual rent increases based on 100% of the CPI except in years when the CPI is higher than 4% or 5%.** (Note: for this analysis, the city of Bell Gardens which utilizes a unique methodology is excluded.)

<u>Ceiling and Floor</u> – The data on the maximum ceiling and minimum floor for annual allowable rent increases is detailed on pages 126-127 of the Study. While all rent-regulated jurisdictions place a ceiling on annual allowable rent increases ranging from 3% to 10%, only 13 of 34 rent regulation programs (38%) have a minimum annual allowable rent increase (floor), ranging from 1% to 5%. For reference, the City's current floor is 3%. The Study notes that 22 jurisdictions (65%) currently place a maximum of 3%, 4% or 5% on the percentage allowed for an annual increase for regulated rental units.

One of the major findings of the Study is that due to the 3% floor on annual allowable rent increases, the Los Angeles RSO has permitted higher increases than other jurisdictions in years when the CPI rate is under 3%. The following chart compiled by LAHD indicates the CPI index and RSO annual allowable rent increases since the adoption of the RSO in 1979:



Note: In the table above, the CPI increase is reflected in the annual allowable increase for the following year.

<u>Utilities</u> – The City's current maximum is 8%, but if a landlord pays the full cost of gas and/or electricity, the landlord may charge an additional 1% for each utility for a maximum total annual adjustment of 10%. About 20% of RSO rental units are master-metered and, therefore, subject to the additional annual rent increase for gas and/or electricity. Chapter 16 of the Study provides an analysis of the additional allowable rent increase for utility costs. The Study notes that this provision of the RSO is unique among all of the rent regulated jurisdictions and that the cumulative effect of this allowance exceeds the actual cost of the utility service. Furthermore, Los Angeles's allowance of a 1% annual increase for each of these costs is disproportionate to actual increases in the costs of master-metered electricity and gas. The Economic Roundtable recommended that the increases in utility costs that are passed through to renters should not exceed the average actual amount of increases in those costs.

<u>Small Landlords</u> – LAHD was asked to report back on the financial impact of the COVID emergency measures and whether there should be special consideration for property owners considered "mom and pop" landlords. The RSO defines small landlords as those who own four or less rental units. Chapter seven of the Study reviews the financial condition of landlords by building size and notes that landlords with four units or less make up thirty percent of the RSO inventory, the biggest share of the by building size. Key findings include:

- The average rent for units owned by small landlords is higher than the average rent for any other building size group and 20 percent higher than for the overall RSO inventory.
- Fifty-seven percent (57%) of tenants in units owned by small landlords are reported by the Census Bureau to have been in their units for five or more years, compared to only 47 percent of tenants in all RSO units,

longer occupancy than any other ownership group. Less tenant turnover reduces lost revenue from empty units, but also reduces the frequency with which rents can be vacancy decontrolled and re-rented at market rates.

- Small landlords have the lowest vacancy rate. The person-to-person relationship between tenants in small buildings and their mom-and-pop landlords appears to make tenants more inclined to stay where they are.
- Operating expenses for smaller buildings may be offset by self-management, which would reduce cash outlays for managing small buildings.
- Smaller RSO landlords appear to receive higher rent per unit and have lower vacancy rates than larger RSO landlords. The Study did not find evidence that they have greater financial stress than larger landlords.
- A disadvantage of allowing larger rent increases for small property owners is that their tenants would be subject to larger rent increases than other tenants, simply because of where they rent.

With regard to the consideration of creating a different regulation for allowable rent increases for small landlords, the Study noted that traditionally rent regulations have provided for uniform annual allowable increases for all properties covered by the regulation. “The paradigm has been that rent increases should be stabilized and exceptions to the across-the- board rule would be based on operating cost factors, service levels, and history of rent increases for the particular property, rather than the personal circumstances or purchase financing arrangements of the owner or the size of the property. In fact, in fair return cases under rent regulations, appellate courts in California and other states have ruled that differences in allowable rents based on differences in financing arrangements have no rational basis.”

The Study goes on to explain that “a flip side of the view that ‘mom-and-pops’ have been squeezed is that, apart from the freeze period, they have been the beneficiaries of the rapidly increasing rent levels prior to the freeze, and during the freeze have been able to obtain large increases in rents as units have turned over. Consequently, they have realized large increases in cash flows and benefited from large appreciation of investments that were substantially leveraged at the outset. The data from the LAHD registration database indicates that the average rents in properties with four units or less increased from $1,502 in 2017 to $1,876 by January 2023, an increase of 25 percent, compared to the 24.3 percent increase in the CPI.”

The Study consultants further note that “a common view has been that if mom-and-pops are not permitted higher rent increases, they will be replaced by out of town investors. An alternative view is that if higher rent increases are permitted for smaller properties - out of town investors will pay even more per unit for those properties than for larger properties and that the increased values of smaller properties, which are already approaching $400,000 per unit for three and four unit properties, will provide even greater incentives for the mom-and-pops to sell.”

LAHD RECOMMENDATIONS

Los Angeles is a majority renter city, with the majority of tenants rent-burdened. The Study describes the continued vulnerability of renters, with 20% of Los Angeles renters in poverty and 10% paying over 90% of income for rent (page 30), as well as the findings of the GAO Study that the primary driver of evictions is the rising cost of housing (pages 48-50). The City Council may consider the following amendments to the RSO to lessen the impact of annual allowable rent increases on renters of RSO units and provide a more sustainable rate of annual rent increases for RSO tenants:

1. CPI Index - Retain the methodology to calculate the annual increase based on 100% of the Consumer Price Index (CPI), but replace the All-Items Index with the CPI All Items-Less Shelter Index, in order to remove the redundancy of including the cost of housing in the formula that sets rent increases for RSO rental units.

While it has been suggested to utilize a lesser percentage of the CPI, such as 60%, this may not account for mortgage costs, capital expenditures, replacement of major building systems, deposits into reserves, and debt service payments. It also does not factor in the impact of 4 years of zero percent annual allowable rent increases from 2020 until 2024 during which the City's COVID-19 emergency measures were in effect. During this time, landlords had to forego cumulative rent increases of 16% which would have otherwise been allowed under the RSO, as well as increased fees and operating costs discussed in Chapters 11 and 12 of the Study. Permitting 100% of the CPI also provides landlords with the cash flow and operating income to be able to afford to invest in upgrades and improvements in aging RSO properties, which by definition are more than 46 years old, with some buildings built 100 years ago. The City must promote landlords' ability to maintain and upgrade rental properties in order to prevent the disastrous deterioration in the quality of the rental housing stock recently demonstrated in several portfolios of the City's aging housing inventory.

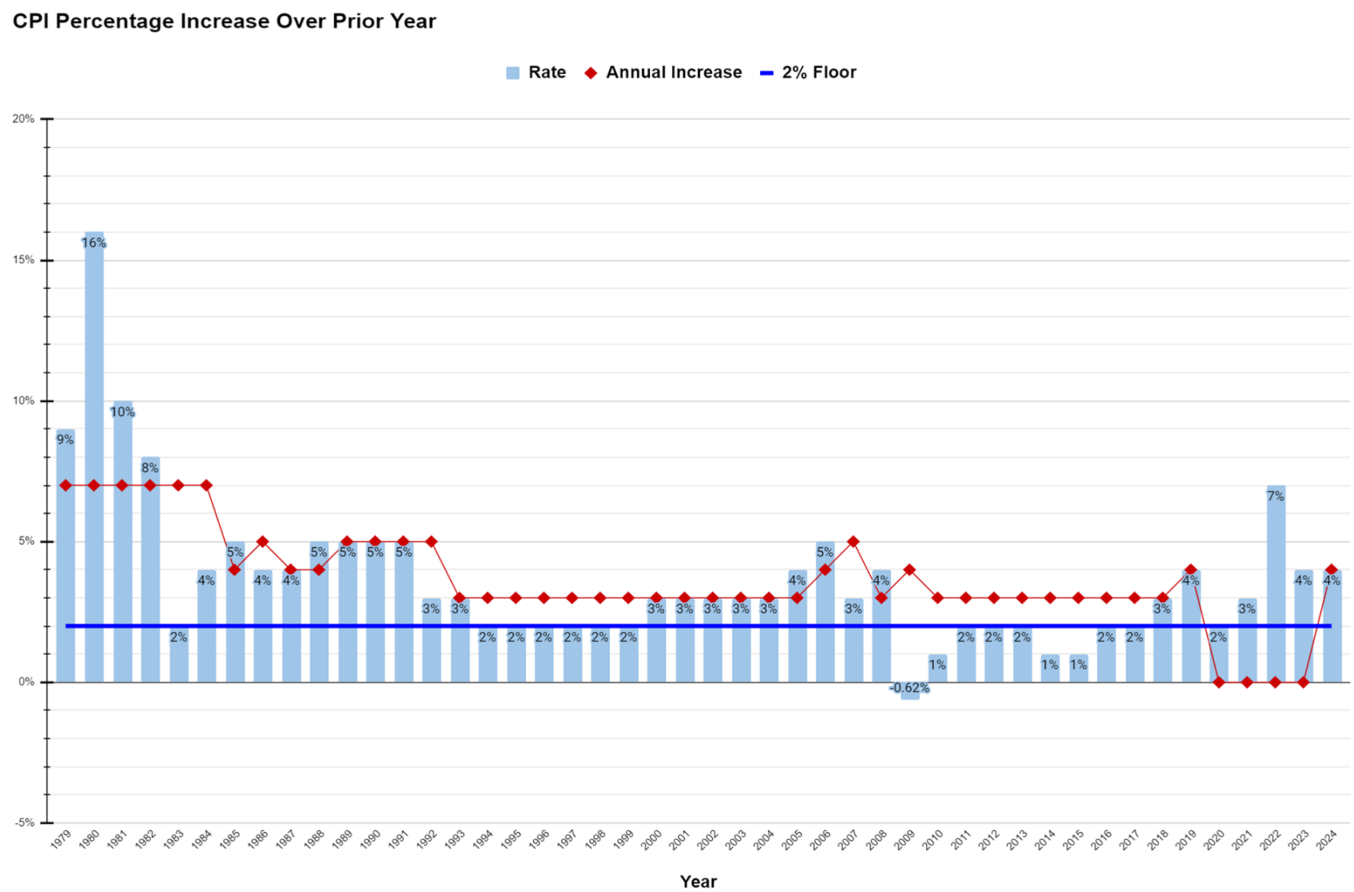
Chapter 12 of the Study notes that operating expenses have outpaced increases in the CPI. Owners of RSO units were subject to the financial impacts of the pandemic rent freeze and escalating operating costs, including trash-hauling fees, water rates, electricity, insurance, property taxes, labor and material costs. These increases are normally partially offset by the annual allowable RSO rent adjustment, as well as by higher rents upon turnover (vacancy decontrol). Owners of RSO units need sufficient income to reinvest in their rental properties and prevent the deterioration of the aging RSO housing stock with old infrastructure and building systems that require upkeep.

2. RSO Ceiling - Revise the maximum annual allowable rent increase to 5%, in line with the majority (65%) of rent regulated jurisdictions in California. In order to allow landlords to keep up with inflation and invest in their rental properties in future years, the 5% annual cap should be adopted with a provision to allow "banking" of CPI rates higher than 5% to future years, while maintaining the 5% cap every year. LAHD must track and publish the allowable rate every year.

3. RSO Floor - Modify the floor for the annual RSO rent increase to 2%, rather than the current 3%. As illustrated in the next chart, a 2% floor would conform with the CPI for all but 4 years (**91%**) of the 46-year history of the RSO from 1979 – 2024. LAHD made a similar recommendation in 2009 at the time of consideration of the last major Study of the RSO; however, the recommendation was not adopted at that time.

   Substitution of the CPI All Items-Less Shelter Index for the All-Items Index, as recommended in this report, and utilizing a 2% floor still results in an annual rent increase reflecting the actual change in the CPI in the vast majority of years - **76%** (35 of 46 years).

In the outlier years when inflation is less than 2%, the 2% floor is a useful tool to provide landlords with long-term RSO tenants with stability in their financial return from their investment in rental properties and allow for sufficient income to cover City-mandated fees and rising operating costs. In addition, a 2% floor may permit landlords with long-term tenants to gradually recover from limits on any rent increases for long-term tenants imposed during the pandemic years (2020-2023), when they were required to forego 16% rent increases per the existing RSO provisions. The following table illustrates the effect adoption of a 2% floor for the annual allowable rent increase.



Note: In the table above, the CPI increase is reflected in the annual allowable increase for the following year.

4. <u>Allowable Rent Increase for Utilities</u> - As discussed in Chapter 16 of the Study, Los Angeles is the only jurisdiction that permits an allowance of an additional 1% - 2% for gas and electricity. In the case of long-term tenancies, the additional rent increase exceeds the total cost of the utility service. LAHD additionally notes that the cost of increased utility costs is already built into the 100% of the CPI which is the basis of the annual allowable rent increase. Therefore, allowing an additional 1% - 2% "double counts" those increased operating costs for utilities. LAHD recommends that the City Council repeal the provision that permits an additional 1% - 2% increase for gas and electricity.

<u>Outreach and Education on the Just and Reasonable and RSO Cost Recovery Programs</u>

In the findings on small landlords, the Study authors note that "in the context of vacancy decontrols, the annual general adjustment standard does not have a significant impact on ownership patterns of smaller properties" and recommend that if higher rent increases are allowed for smaller properties, other conditions should be attached relating to the overall income of the property compared to prior years and that a standard of this type should be as objective and easy as possible for applicants to document for applications purposes.

The RSO allows landlords to apply for "Just and Reasonable" rent increases (LAMC 151.07.B), based on landlords' operating income and expenses including property taxes, operating and maintenance costs, capital improvements, and other factors, in comparison to increases in the CPI. This program is particularly useful for landlords with historically low rents. However, that program is not often accessed by landlords. LAHD will work with the Rent Adjustment Commission to update the existing regulations for this program and develop an education and outreach plan, with a focus on small landlords in order to promote awareness and utilization of this program, which can serve as a safeguard for "mom and pop" and other landlords who are not able to obtain sufficient revenue from their rental units to maintain their operating income in line with the CPI. LAHD will expand outreach and education on the Just and Reasonable program as well as other existing programs that allow landlords to partially recover costs of upgrades to their rental properties including:

- Capital Improvement
- Seismic Retrofit
- Primary Renovation
- Rehabilitation

The table below compares the current provisions and the proposed amendments to the RSO annual allowable rent increase formula.

RSO ANNUAL ALLOWABLE RENT INCREASE FORMULA COMPARISON CURRENT RSO PROVISIONS – PROPOSED AMENDMENTS		
Formula Indicators	**Current RSO Provisions**	**Proposed RSO Provisions**
CPI Index	Consumer All-Items	Consumer All-Items Less Shelter
% CPI Allowed	100%	100%
Ceiling	8% - 10%	5%
Floor	3%	2%
Rent Banking	"Use It, or Lose It"	Allowed per LAHD Authorization/Publication
Utilities	+ 1% - 2%	0
FY 2025-26 Projected %	3%	2%

CONCLUSION

The RSO statement of purpose states that "it is necessary and reasonable to regulate rents, so as to safeguard tenants from excessive rent increases, while at the same time providing landlords with just and reasonable returns from their rental units." RSO rental units house the majority of City residents. The recommendations presented above build on the Study findings and recommendations, and represent a careful balance of protecting tenants from destabilizing rent increases while providing landlords with a fair return on their investment in order to prevent deterioration of the City's valuable RSO housing stock and incentivize landlords' to upgrade and improve their rental properties, in order to preserve safe and decent rental units for the majority of City residents.

FISCAL IMPACT

There is no fiscal impact to the General Fund resulting from the recommendations included in this report.

Approved By:

Keane

TRICIA KEANE
Interim General Manager
Los Angeles Housing Department

ATTACHMENT:

Equitable Rent Rent Stabilization Standards in the City of Los Angeles September 2024