

AGENDA ITEM REQUEST FORM

Department: Rent Program

Department Head: Nicolas Traylor

Phone: 620-6564

Meeting Date: February 28, 2018

Final Decision Date Deadline: February 28, 2018

STATEMENT OF THE ISSUE: At their February 21, 2018, Regular Meeting, Rent Boardmembers received a draft proposed Maintenance of Net Operating Income Fair Return Regulation (Chapter 9). Given the complexity and impact of this regulation, and considering feedback received from members of the Rent Board and community groups, staff members recommend that Boardmembers continue to discuss and consider the application of a Maintenance of Net Operating Income Fair Return Regulation to ensure there is adequate understanding of the proposed regulation prior to its adoption and the Board's consideration of Historically Low Rent and Capital Improvement regulations.

INDICATE APPROPRIATE BODY

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|---|---|--|--|---|
| <input type="checkbox"/> City Council | <input type="checkbox"/> Redevelopment Agency | <input type="checkbox"/> Housing Authority | <input type="checkbox"/> Surplus Property Authority | <input type="checkbox"/> Joint Powers Financing Authority |
| <input type="checkbox"/> Finance Standing Committee | <input type="checkbox"/> Public Safety Public Services Standing Committee | <input type="checkbox"/> Local Reuse Authority | <input checked="" type="checkbox"/> Other: <u>Rent Board</u> | |

ITEM

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| <input type="checkbox"/> Presentation/Proclamation/Commendation (3-Minute Time Limit) | | |
| <input type="checkbox"/> Public Hearing | <input type="checkbox"/> Regulation | <input checked="" type="checkbox"/> Other: <u>STUDY AND ACTION SESSION</u> |
| <input type="checkbox"/> Contract/Agreement | <input type="checkbox"/> Rent Board As Whole | |
| <input type="checkbox"/> Grant Application/Acceptance | <input type="checkbox"/> Claims Filed Against City of Richmond | |
| <input type="checkbox"/> Resolution | <input type="checkbox"/> Video/PowerPoint Presentation (contact KCRT @ 620.6759) | |

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 - Rent Program (Nicolas Traylor/Michael Roush 620-6564).

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AGENDA REPORT

DATE: February 28, 2018

TO: Chair Gray and Members of the Rent Board

FROM: Nicolas Traylor, Executive Director
Michael Roush, Legal Counsel

SUBJECT: PRESENTATION REGARDING APPLICATION OF A PROPOSED MAINTENANCE OF NET OPERATING INCOME (MNOI) FAIR RETURN REGULATION (Chapter 9)

STATEMENT OF THE ISSUE:

At their February 21, 2018, Regular Meeting, Rent Boardmembers received a draft proposed Maintenance of Net Operating Income Fair Return Regulation (Chapter 9). Given the complexity and impact of this regulation, and considering feedback received from members of the Rent Board and community groups, staff members recommend that Boardmembers continue to discuss and consider the application of a Maintenance of Net Operating Income Fair Return Regulation to ensure there is adequate understanding of the proposed regulation prior to its adoption and the Board's consideration of Historically Low Rent and Capital Improvement regulations.

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 (Nicolas Traylor/Michael Roush 620-6564).

FISCAL IMPACT:

There is no fiscal impact related to this item.

DISCUSSION:

Background

For most multi-family rental properties in the City of Richmond, rent increases are limited to the annual change in the Consumer Price Index (a measure of inflation). The Richmond Fair Rent, Just Cause for Eviction and Homeowner Protection Ordinance

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provides Landlords with the right to a reasonable return on their rental property investment and tasks the Rent Board with promulgating “Fair Return” standards and regulations.

At their meeting on December 20, 2017, the Rent Board received a memorandum from Kenneth Baar regarding the Maintenance of Net Operating Income (MNOI) fair return standard and directed staff to prepare implementing regulations utilizing the MNOI standard (Attachment 1). Accordingly, at their meeting on February 21, 2018, Boardmembers received and considered a subsequent memorandum and draft proposed regulation for allowing adjustments in the Maximum Allowable Rent to ensure Landlords are able to receive a fair return on their rental property investment (Attachment 2). In the proposed regulation, “Fair Return” is defined as the right to obtain a net operating income equal to the base year net operating income adjusted by a set percentage increase in the Consumer Price Index (CPI), since the base year (Attachment 3).

Recommended Approach

Due to the complexity and impact of a Fair Return Regulation, staff members believe it is prudent for the Rent Board to continue to discuss and consider the proposed regulation prior to adoption. In addition, staff members intend to provide the Board and members of the community with an opportunity to achieve a thorough understanding of the Maintenance of Net Operating Income regulation prior to consideration of Historically Low Rent or Capital Improvement regulations.

Community Engagement

On December 4 and December 9, 2017, Rent Program staff members hosted two well-attended community workshops regarding setting standards in the Maximum Allowable Rent. Relevant portions of the community workshop presentation and community feedback summaries are contained in Attachment 4 of this item.

A proposed draft Fair Return Regulation (Chapter 9) was posted on the Rent Program website on February 14, 2018, and a listserv message was sent with instructions for submitting comments prior to the February 28, 2018 Board meeting.

Updates regarding the process of developing Rent Adjustment Regulations will be posted at <http://www.ci.richmond.ca.us/3521/Rent-Adjustment-Regulations> and disseminated via the Rent Program listserv.

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Proposed Timeline and Next Steps

Proposed Date	Event
February 28, 2018- Special Rent Board Meeting	Rent Board continues discussion regarding MNOI Fair Return regulation (Chapter 9)
March 21, 2018 – Regular Rent Board Meeting	Rent Board considers adoption of Fair Return regulation (Chapter 9) and receives Historically Low Rent and Capital Improvement regulations
Late March/Early April 2018	First Rent Adjustment Petition hearings are scheduled
April 18, 2018 – Regular Rent Board Meeting	Rent Board considers adoption of Historically Low Rent and Capital Improvement regulations

DOCUMENTS ATTACHED:

Attachment 1 – December 20, 2017, Memorandum from Ken Baar concerning Fair Return Rent Adjustment Standards

Attachment 2 – February 21, 2018, Memorandum from Ken Baar concerning the proposed Maintenance of Net Operating Income

Attachment 3 – Proposed Draft Fair Return (MNOI) Regulations (Chapter 9)

Attachment 4 – Community Workshop presentation and community feedback concerning fair return standards



MEMORANDUM

TO: Chair Gray and Members of the Rent Board
FROM: Kenneth Baar, Consultant¹
DATE: December 20, 2017
SUBJECT: FAIR RETURN METHODOLOGIES

Executive Summary

This memo discusses fair return concepts and makes recommendations to the Rent Board for the selection of a fair return standard.

Richmond's "Fair Rent, Just Cause for Eviction and Homeowner Protection Ordinance" provides for a right to a fair return ("a Reasonable Return on ... Investment") and includes a list of factors to be considered in individual rent adjustment cases. However, it does not provide a methodology or standard for or calculating fair return.

The State Supreme Court has held that an ordinance with a list of factors, but without a specific fair return standard is constitutional. Also, the Courts have held that no single type of fair return formula is required. Instead, "a governmental entity may choose to regulate pursuant to any fairly constructed formula. While the selection of a fair return standard is a legislative task, the Courts are the ultimate arbiters of whether a particular standard or the application of the standard in a rent adjustment case permits a fair return. It is strongly recommended that the Rent Board adopt a specific standard to provide guidance to tenants, landlords and hearing officers and ensure consistency in decisions. In the absence of specific standards, fair return hearings commonly turn into legislative type hearings over what standard shall be used as well determinations of what rent increase is justified under the standard.

Maintenance of Net Operating Income (MNOI) Standard

Most jurisdictions with apartment rent controls (including Los Angeles and San Jose) have adopted a maintenance of net operating income (MNOI) fair return standard. "Net operating income" is rental income net of operating expenses. Mortgage interest is not considered an operating expense. In the apartment rental business typically 30 to 50% of rental income covers operating expenses and the balance is net operating income, which covers mortgage payments and provides cash flow.

¹ Baar's publications and testimony on fair return issues have been cited frequently in published California appellate courts opinions. He has prepared fair return reports for 18 California jurisdictions in fair return cases.

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Under the MNOI standard, current year net operating income is compared with base year net operating income. "Fair return" is defined as base year net operating income adjusted by the percentage increase in the Consumer Price Index (CPI) since the base year or a portion of the percentage increase in the CPI since the base year. The amortized costs of capital improvement expenses are included as operating expenses. To the extent that reasonable increases in maintenance costs are not covered and growth in net operating income is not provided by annual allowable increases, the MNOI provides for the recovery of these increases.

For example, under a standard which provides for indexing the net operating income at 100% of the rate of increase in the CPI, if the net operating income was \$100,000 in the base year and the CPI has increased by 70% since the base year, the current fair net operating income would be \$170,000.

Fair Rate of Return on Investment Standard

A second type of fair return standard is a "rate of return on investment" (ROI) standard. Under that standard, a fair return is a net operating income equal to a designated percentage of the investment.

$$\text{FAIR RENT} = \text{OPERATING EXPENSES} + X\% \text{ of INVESTMENT}$$

From an intuitive perspective a rate of return of investment standard is often viewed as very logical. Richmond's ordinance includes a provision stating that one of its purposes is to provide a fair "return on investment." (Sec. 11.100.070 (g)(8)). This type of provision is common among rent stabilization ordinances. However, none of the jurisdictions with apartment rent controls use a rate of return on investment standard.

Rate of return on investment is commonly used as a measure of return by real estate analysts in evaluating real estate investments and is based on the commonly accepted concept that investors should always be permitted a fair rate of return on their investments. However, in the context of a fair return determination under a rent regulation, the use of a fair rate of return on investment standard in rent regulation works in a **circular** manner.

In the market place, investment is determined by the expected returns. If the allowable returns in a rent-regulated environment are set at designated percentage of the amount invested in a property, the process of determining what is a fair return becomes circular. Under this type of standard, the investment (and, therefore, the investor) determines what return and, therefore, what rents will be fair. Apart from this conceptual defect, rates of return vary substantially among properties and experts have widely diverging opinions about what rate is fair.

A Standard Providing for Rent Adjustments Based on Increases in Operating Expenses over the Prior Year

A third methodology for setting allowable rents pursuant to individual rent adjustments provides for rent increases to cover operating cost increases since the prior year, which are not covered by the allowable annual rent increase. This type of standard is in effect under San

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Francisco rent regulations. San Jose had this type of standard until it was replaced by an MNOI standard in 2017.

A concern about this type of standard is that substantial variations in annual maintenance expenses can be typical. This type of standard enables apartment owners to obtain increases due to unusually high operating expenses in a particular year or may reward intentional bunching of maintenance expenses which do not recur annually into a particular year.

The Exclusion of Debt Service Costs in Fair Return Standards

The Richmond ordinance is silent on whether or not debt service costs should be considered.

Eight of the eleven apartment rent control ordinances in California (Los Angeles, San Jose, Oakland, Berkeley, Santa Monica, West Hollywood, East Palo Alto, and Mountain View) specifically **exclude** consideration of debt service in setting allowable rent levels, (except when the debt service is associated with capital improvements).

In three cases, the California Court of Appeal has ruled that a regulation which takes into account debt service and provides for varying allowing rents based on mortgage payments has no rational basis.

Recommendation

It is recommended that the Rent Board adopt regulations that include a specific fair return standard. A fair return standard provides guidance not only to the hearing officer but also to the parties impacted by the Ordinance and provides an objective methodology for consistent decisions.

Furthermore, the adoption of a maintenance of net operating income (MNOI) standard is recommended. The standard guarantees a right to rent increases which cover operating cost increases and provide for growth in net operating income over a base year. The standard has been approved by the courts and in challenges to individual decisions applying the standard, its use has been consistently upheld.

I. Introduction

This memo discusses fair return concepts and makes recommendations to the Rent Board for the selection of a fair return standard.

Under price regulation, including rent control, constitutional property rights include the right to a "fair return." The courts have held legislatures have the power to establish fair return standards. However, the Courts are the ultimate arbiters of what constitutes a fair return. As a consequence, the drafting of fair return standards is strongly guided by judicial precedent.

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Within this framework, rent stabilization ordinances provide for a petition process for adjudicating petitions based on claims that additional rent increases above the allowable annual rent increases and vacancy increases are needed in order to permit a fair return.

Cities with rent stabilization laws (except for a few cities with a small number of units) have adopted a specific method for calculating fair return and allowable rent increases pursuant to individual rent adjustment petitions. These methods are either set forth in the ordinance or in regulations that have been promulgated pursuant to more general fair return requirements in the ordinance.

Richmond's "Fair Rent, Just Cause for Eviction and Homeowner Protection Ordinance" provides for a right to a fair return ("a Reasonable Return on ... Investment") and includes a list of factors to be considered in individual rent adjustment cases. However, it does not provide a method for calculating fair return.

The applicable section states:

Landlords Have the Right to a Reasonable Return on Their Investment.

In making individual adjustments of the rent ceiling, the Board or hearing examiner shall consider the purposes of this chapter and shall specifically consider all relevant factors, including (but not limited to):

- (1) Increases or decreases in property taxes;**
- (2) Unavoidable increases or any decreases in maintenance and operating expenses;**
- (3) The cost of planned or completed capital improvements to the rental unit (as distinguished from ordinary repair, replacement and maintenance) where such capital improvements are necessary to bring the property into compliance or maintain compliance with applicable local code requirements affecting health and safety, and where such capital improvement costs are properly amortized over the life of the improvement;**
- (4) Increases or decreases in the number of tenants occupying the rental unit, living space, furniture, furnishings; equipment, or other housing services provided, or occupancy rules;**
- (5) Substantial deterioration of the controlled rental unit other than as a result of normal wear and tear;**
- (6) Failure on the part of the Landlord to provide adequate housing services, or to comply substantially with applicable state rental housing laws, local housing, health and safety codes, or the rental agreement;**
- (7) The pattern of recent rent increases or decreases;**
- (8) It is the intent of this chapter that individual upward adjustments in the rent ceilings on units be made only when the Landlord demonstrates that such adjustments are necessary to provide the landlord with a fair return on investment. (Sec. 11.100.070)**

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While Richmond's ordinance does not set forth a methodology for calculating fair return or allowable rent increases pursuant to individual rent increase petitions, it states that: "The Board shall issue and follow such rules and regulations, including those which are contained in this Chapter, as will further the purposes of the Chapter." (Sec. 11.100.060 (f)).

Although a list of factors without a specific fair return standard may be constitutional, it is strongly recommended that the Rent Board adopt a specific standard to provide guidance to tenants, landlords and hearing officers and ensure consistency in decisions. In the absence of specific standards, fair return hearings commonly turn into legislative type hearings over what standard shall be used as well determinations of what rent increase is justified under a particular standard.

II. Alternate Fair Return Methodologies

A. *Judicial Guidance - General Directions Regarding Fair Return*

Since rent regulations became widespread in California at the end of the 1970's and early 1980's fair return has been extensively litigated. Some of the cases have involved facial challenges to ordinances or regulations; however, most have involved challenges to individual rent board decisions in fair return cases. While most of the challenges have been to individual decisions commonly they have raised general issues about what methodologies are valid in making fair return determinations.

Since the mid-1980's, most of the cases have involved regulations of mobilehome park space rents. However, apartment and mobilehome park space rent regulations are guided by the same judicial doctrines and precedents regarding fair return.

The Courts have held that no single type of fair return formula is required.² Instead, "a governmental entity may choose to regulate pursuant to any fairly constructed formula."³ The California Supreme Court has also held that a rent regulation does not have to include a specific method for calculating fair return.⁴

Some of the judicial guidance has been very general. In one case a court explained that fair return involves a "balancing...of investor and...consumer interests" and allowing for rents adequate to "maintain financial integrity."

² *Carson Mobilehome Park Owners' Assn. v. City of Carson*, 35 Cal.3d 184, 191 (1983)

³ *Carson Harbor Village, Ltd. Carson Mobilehome Park Rent Review Board* (1999) 70 Cal. App. 4th 281, 290.

⁴ In 1983, in *Carson Mobilehome Park Owners' Assn. v. City of Carson*, the California Supreme Court rejected a claim that a fair return standard in a rent control ordinance which left the selection of a fair return standard open ended and did not prescribe the use of a particular formula was overly vague. The Court stated: That the ordinance does not articulate a formula for determining just what constitutes a just and reasonable return does not make it unconstitutional.

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“Determining prices that will provide a fair return “involves a balancing of the investor and the consumer interests” [cite omitted]. ... One of these investor interests is a “return ... commensurate with returns on investments in other enterprises having corresponding risks. That return, moreover should be sufficient to ... attract capital.” ... a “court must determine whether the [regulation] may reasonably be expected to maintain financial integrity, attract necessary capital, and fairly compensate investors for the risks they have assumed, and yet provide appropriate protection for the relevant public interests, both existing and foreseeable.”⁵

The California Supreme Court has held that fair return is a “constitutional minimum” and the fact that a regulation reduces the value of a property does not render it unconstitutional.⁶

In *Galland v. Clovis*, the California Supreme Court stated:

“Although the term “fair rate of return” borrows from the terminology of economics and finance, it is as used in this context a legal, constitutional term. It refers to a constitutional minimum within a broad zone of reasonableness. As explained above, within this broad zone, the rate regulator is balancing the interests of investors, i.e. landlords, with the interests of consumers, i.e. mobilehome owners, in order to achieve a rent level that will on the one hand maintain the affordability of the mobilehome park and on the other hand allow the landlord to continue to operate successfully. [cite omitted]. For those price-regulated investments that fall above the constitutional minimum, but are nonetheless disappointing to investor expectations, the solution is not constitutional litigation but, as with nonregulated investments, the liquidation of the investments and the transfer of capital to more lucrative enterprises.”⁷

Another California Supreme Court opinion notes:

“[a]ny price-setting regulation, like most other police power regulations of property rights, has the inevitable effect of reducing the value of regulated properties. But it has long been held that such reduction in property value does not by itself rend a regulation unconstitutional.”⁸

The Courts have repeatedly reiterated the principle that a “range” of rents may be considered reasonable. One court explained:

⁵ *Galland v. City of Clovis*, 24 Cal. 4th 1003 (2001), *Kavanau v. Santa Monica Rent Control Board*, 16 Cal.4th 761, 771-772 (1997).

⁶ Other types of land use regulations such as zoning amendments commonly reduce property values.

⁷ *Galland v. City of Clovis*, 24 Cal.4th 1003, 1026 (2001)

⁸ *Fisher v City of Berkeley*, 37 Cal.3d. at 686.

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There is a range of rents which can be charged, all of which could be characterized as allowing a "just and reasonable" return. [cite omitted] [the terms "just and reasonable" and "confiscatory" are not precise formulations]; [cite omitted] [there is a zone of reasonableness which is higher than a confiscatory rate].) Thus, many decisions by rent control boards will focus on the issue of where the requested increases fall within the range of possible rents -- all of which rents would allow the owner a return sufficiently "just and reasonable" as to not be constitutionally confiscatory.⁹

The debate over what constitutes a fair return has been complicated by the fact the Courts have reached conflicting conclusions on fair return issues at times and the decisions contain some very general statements open to multiple interpretations.

One California Court of Appeal commented about the complexity of fair return issues and the lack of precision and sometimes conflicting nature of judicial guidance on the issues.

"What appears at first blush to be a simple question of substantial evidence turns out to be something considerably more complex when one realizes that the formula for determining a 'fair return' is hotly debated in economic circles and has been the subject of sparse, scattered, and sometimes conflicting comment by appellate courts. In particular, only the broad outlines have been discussed in California decisions."¹⁰

B. "Specific" Judicial Guidance

Apart from setting forth general principles about what constitutes a fair return, in the past few decades, there has been substantial precedent in regard to particular types of fair return concepts and standards that have either been commonly advocated and/or adopted.

The Courts Have Held that Return on "Value" Standards are Not Required and Are Circular in the Context of Rent Regulation

In response to fair return claims made in the early 1980s, the Courts rejected the view that a fair *rate* of return on the *value* of a regulated property must be permitted in order to provide a fair return. The Courts have concluded that this type of standard is "circular" in the context of a rent regulation. In 1984, the State Supreme Court explained:

"The fatal flaw in the return on value standard is that income property most commonly is valued through capitalization of its income. Thus, the

⁹ *San Marcos Mobilehome Park Owners' Ass'n v. City of San Marcos*, 192 Cal.App.3d. 1492, 1502-1503 (1987)

¹⁰ *Palomar Mobilehome Park Assn. v. Mobile Home Rent Review Com.* 16 Cal.App.4th 481, 484 (1993).

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process of making individual rent adjustments on the basis of a return on value standard is meaningless because it is inevitably circular: value is determined by rental income, the amount of which is in turn set according to value. Use of a return on value standard would thoroughly undermine rent control, since the use of uncontrolled income potential to determine value would result in the same rents as those which would be charged in the absence of regulation. Value (and hence rents) would increase in a never-ending spiral."¹¹

The Right to an Increasing Net Operating Income

Other guidance from the court has come to play a central role in fair return doctrine. One guiding principal is that growth in net operating income (NOI) must be permitted. In *Fisher v. Berkeley* (1984), the State Supreme Court held that a regulatory scheme "may not indefinitely freeze the dollar amount...profits without eventually causing confiscatory results. ...If the net operating profit of a landlord continues to be the *identical* number of dollars, there is in time a real diminution to the landlord which eventually becomes confiscatory."¹² In other words, allowable rent increases must be adequate to cover increases in operating costs and permit growth in net operating income.

In the apartment rental business typically 30 to 50% of rental income covers operating expenses and the balance is net operating income, which covers mortgage payments and provides cash flow.

Comment on Alternate Standards: The following discussion addresses conceptual issues and judicial precedent associated with three types of fair return standards. – 1) maintenance of net operating income (MNOI), 2) rate of return on investment (ROI) , and 3) a pass-through of increases in operating costs over the level of the prior year. This section also includes a discussion of judicial precedent regarding consideration of debt service, which indicates that debt service may not be considered in setting allowable rents.

C. Maintenance of Net Operating Income "MNOI" Standard

a. The MNOI Standard Is the Most Widely Used Standard

The most widely adopted fair return standard has been the maintenance of net operating income (MNOI) standard. This standard has been adopted by the following jurisdictions with apartment rent controls: Los Angeles, San Jose, Oakland, Berkeley, Santa Monica, West Hollywood, East Palo Alto and Mountain View. Also, a substantial

¹¹ . *Id.* 37 Cal.3d.at 680, fn 33.

¹² *Id.* 37.Cal.3d. at 683.

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number of the mobilehome park rent stabilization ordinances in California include an MNOI standard and this standard is commonly used to make fair return determinations pursuant to mobilehome park space rent stabilization ordinances which list factors to be considered in determining what is a fair return, without setting forth a formula.

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Jurisdiction	Type of Fair Return Standard (MNOI = maintenance of net operating income)
Berkeley	MNOI, adopted by regulation
East Palo Alto	MNOI, in ordinance
Santa Monica	MNOI, adopted by regulation
Los Angeles	MNOI adopted by regulation
West Hollywood	MNOI in ordinance
Alameda	list of factors, no specific standard
Oakland	MNOI and pass-through of cost increases over prior year
San Jose	MNOI, in ordinance
San Francisco	increase in costs over prior year
Beverly Hills	MNOI, in ordinance
Mountain View	MNOI, adopted by regulation
Los Gatos	consider increases in operating costs and debt service, no specific standard
Hayward	list of factors, no specific standard, limited pass-through increases in debt service

b. Description of the Maintenance of Net Operating Income Standard

This method is not an “intuitive” measure because it is not the measure that investors or laypersons commonly use to measure rate of return. Under the MNOI standard, current year net operating income is compared with base year net operating income. “Fair return” is defined as base year net operating income adjusted by the percentage increase in the Consumer Price Index (CPI) since the base year or a portion of the percentage increase in the CPI since the base year.

For example, under a standard which provides for indexing the net operating income at 100% of the rate of increase in the CPI, if the net operating income was \$100,000 in the base year and the CPI has increased by 70% since the base year, the current fair net operating income would be \$170,000. Under most MNOI standards, the year specified as the base year precedes the adoption of rent regulation.

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The hypothetical example below illustrates how an MNOI standard works, under a standard which defines a fair return as the base period net operating income adjusted by 100% of the percentage increase in the NOI since the base year

In this example, the gross income increased by \$50,000. The net operating income increased from \$60,000 in the base year to \$80,000 in the current year, a 33% increase, compared to a 50% increase in the CPI during this period. This amount would be adequate to cover operating cost increases, but would not provide adequate growth in net operating income. Through an individual rent adjustment petition (with adequate documentation of income and operating expenses) the owner would be able to obtain an additional rent increase. The allowable increase would be \$10,000 in order to raise the net operating income to a level that is 50% above the base year net operating income.

**(Table 1)
Illustration of MNOI Standard**

	CPI	Gross Income	Operating Expenses	Net Operating Income	Fair Return Allowable Rent Increase
Base Year	100	\$100,000	\$40,000	\$60,000	
Current Year	150	\$150,000	\$70,000	\$80,000	
Pct. Increase Base Year to Current Year	50%	50%	75%	33%	
Fair NOI (Base Year NOI Adjusted by the 50% increase in CPI)				\$90,000	
Allowable Fair Return Rent Adjustment (= Fair NOI - Current NOI) (\$90,000 - \$80,000)					\$10,000

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Jurisdictions with MNOI standards provide for adjusting (“indexing”) base period of net operating income by varying percentages of the percentage increase in the Consumer Price Index, ranging from 40% to 100%. Berkeley and Santa Monica provide for 40% indexing. A majority of mobilehome ordinances provide for indexing by less than 100%. All of these indexing standards have been upheld by the Courts, which have consistently rejected the contention that indexing the net operating income by less than 100% of the percentage increase in the CPI is confiscatory¹³

c. Rationale for Using the MNOI Standard

To the extent that reasonable increases in maintenance costs are not covered by annual allowable increases, the MNOI provides for the recovery of these increases.

By providing for growth in net operating income, the MNOI standard allows for growth in the portion of rental income (the net operating income) that is available to pay for increases in debt service, to fund capital improvements, and/or to provide additional cash flow (net income). Therefore, the growth in net operating income also provides for appreciation in the value of a property.

The standard provides all owners with the right to an equal rate of growth in NOI regardless of their particular purchase and financing arrangements. By measuring reasonable growth in net operating income by the rate of increase in the CPI, this approach meets the twin objectives of protecting tenants from excessive rent increases that are not justified by operating cost increases and increases in the CPI, and of providing regulated owners with a “fair return on investment.”

¹³ See *Berger v. City of Escondido*, 127 Cal.App.4th 1, 13-15 (2007); *Stardust v. City of Ventura*, 147 Cal.App. 4th 1170, 1181-1182 (2007); *Colony Cove Properties v. City of Carson*, 220 Cal. App.4th 840, 876 (2013) The rationale for less than 100% indexing has been that the rate of increase in equity may exceed 100% of the rate of increase in the CPI even if the rate of increase in the overall value of a property is lower. For example, the value of an apartment building may increase by 20% from \$1,000,000 to \$1,200,000, but the increase in the equity of an owner who purchased with a 70% loan may increase from \$300,000 to \$500,000.

In the Colony Cove opinion, the Court stated:

In *H.N. & Frances C. Berger Foundation v. City of Escondido*, the court explained why 100 percent indexing was not required for a rent controlled mobilehome park to achieve a fair return: "A mobilehome park's operating expenses do not necessarily increase from year to year at the rate of inflation, and . . . a 'general increase at 100% of CPI . . . would be too much if expenses have increased at a lower rate.'" (*H.N. & Frances C. Berger Foundation v. City of Escondido* [cite omitted].) Moreover, "the use of indexing ratios may satisfy the fair return criterion because park owners typically derive a return on their investment not only from income the park produces, but also from an increase in the property's value or equity over time." (*Ibid.*; accord [cite omitted] [explaining that "one reason for indexing NOI at less than 100 percent of the change in the CPI" is that "real estate is often a leveraged investment" in which "[t]he investor invests a small amount of cash, but gets appreciation on 100 percent of the value"]. *Id.*876-877.

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Under the MNOI standard, it becomes the investor's task to determine what investment and financing arrangements make sense in light of the growth in net operating income permitted under the fair return standard.

d. Judicial Acceptance of the MNOI Standard

California appellate Courts have repeatedly upheld the use of an MNOI standard.¹⁴ For example, one court found the MNOI standard was reasonable because it allowed an owner to maintain prior levels of profit¹⁵, and another concluded the MNOI formula is a "fairly constructed formula" which provides a "just and reasonable" return on ... investment," even if an alternative fair return standard – such as the rate of return on investment standard (discussed further below) – would provide for a higher rent.¹⁶

Several California courts have approved the MNOI fair return standard (*Oceanside Mobilehome Park Owners' Ass'n v. City Oceanside*, 157 Cal. App. 3d. 887 (1984). See also *Baker v. City of Santa Monica*, 181 Cal. App. 3d. 972 (1986). California appellate courts upheld maintenance of net operating income fair return standards. In *Oceanside* the Court found that the standard was reasonable because it allowed an owner to maintain prior levels of profit. See 157 Cal. App. 3d. 887, 902-905 (1984). "The maintenance-NOI approach has been praised by commentators for both its fairness and ease of administration." See *Palomar Mobilehome Park Assn. v. Mobile Home Rent Review Com.*, 16 Cal.App.4th 481, 486 (1993)

In *Rainbow Disposal v. Mobilehome Park Rental Review Board*, 64 Cal. App. 4th 1159, 1172 (1998), the Court of Appeal stated: [the] MNOI approach adopted by the Board is a "fairly constructed formula" which provided Rainbow a sufficiently "just and reasonable" return on its investment. The Board was not obliged to reject [an] MNOI analysis just because an historical cost/book value formula using Rainbow's actual cost of acquisition and a 10 percent rate of return would have yielded a higher rent increase.

In 2013, in *Colony Cove v. City of Carson*, the Court explained the rationale for an MNOI standard.

¹⁴ Most of the published appellate court opinions regarding fair return under rent regulation have involved mobilehome park rent regulations. This is a consequence of the facts that: 1) the mobilehome rent regulations are stricter – not allowing for increases upon vacancies, 2) some of the mobilehome rent ordinances have not allowed for annual across-the-board rent increases, thereby compelling owners to submit fair return petitions each time they desire to obtain a rent increase, 3) the stakes in mobilehome park cases are substantial due to the size of mobilehome parks, typically involving from one to several hundred spaces. However, in regards to fair return issues the fair return concepts are interchangeable with the courts relying on fair return opinions from apartment cases in mobilehome park cases and vice versa.

¹⁵ *Oceanside Mobilehome Park Owners' Ass'n v. City Oceanside*, 157 Cal.App.3d.887 (1984); Also see *Baker v. City of Santa Monica*, 181 Cal.App.3d. 972 (1986)

¹⁶

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The MNOI approach does not focus on how much the owner chose to pay for a rent-controlled property or how the purchase was financed. That fact does not render it constitutionally invalid. In *Donohue v. Santa Paula West Mobile Home Park*, where the rent control ordinance permitted adjustments to " 'maintain net operating income' " and specifically excluded from consideration " '[m]ortgage principal [and] interest payments,' " the court rejected the owner's facial challenge to the ordinance: "Numerous courts ... have acknowledged that the [MNOI] approach is constitutionally valid ... ," even though it ignores "certain expenses incurred by landlords" in determining NOI, including "land acquisition costs" (*Donohue v. Santa Paula West Mobile Home Park*, supra, 47 Cal.App.4th at p. 1178; see *Rainbow Disposal Co. v. Escondido Mobilehome Rent Review Bd.*, supra, 64 Cal.App.4th at p. 1172 [rent board need not reject MNOI merely because formula using owner's actual cost of acquisition yielded higher rent increase].) Indeed, the MNOI standard has been praised by courts and commentators for "its fairness and ease of administration" (*Palomar Mobilehome Park Assn. v. Mobile Home Rent Review Com.*, supra, 16 Cal.App.4th at p. 486), because it " 'recognizes that in the rental housing market, ratios of rental income to value, equity, and gross income vary substantially among buildings. Therefore, rather than designating a particular rate of return as fair, [MNOI] standards pursue the best available option, which is to preserve prior [net operating income] levels' " (*H.N. & Frances C. Berger Foundation v. City of Escondido* (2005) 127 Cal.App.4th 1, 9 [25 Cal. Rptr. 3d 19]). The advantage of the MNOI approach over other methods of determining fair rent was further explained in *Oceanside Mobilehome Park Owners' Assn. v. City of Oceanside*, where the court stated: " 'Use of a return on value standard would thoroughly undermine 220 Cal. App. 4th 840, *868; ...rent control, since the use of uncontrolled income potential to determine value would result in the same rents as ... would be charged in the absence of regulation. Value (and hence rents) would increase in a never-ending spiral.' " [cites omitted]

Use of the MNOI formula " ' "avoids the necessity of having to undertake the administratively difficult (if not impossible) task of calculating equity and/or fair market value.["] ' " [cite omitted] ... Instead, it "permits park owners to obtain a just and [***60] reasonable return under general marketing conditions in any given year" and "reflect[s] the tenant's interest by giving the park owner an incentive to incur all reasonable expenses for maintenance and services." [cite omitted].¹⁷

¹⁷ 220 Cal. App. 4th 849, 869-870 (2013)

e. Adjustment of Low Base Year Rents (“Vega” Adjustments) under the MNOI Standard

If an MNOI standard only permitted consideration of actual base year net operating levels, owners with very low base period rents may be locked into rents that do not reflect market conditions. This would occur because the current fair net operating income under the MNOI standard would be based on a CPI adjustment of a low base period net operating income.

However, this issue has been addressed by authorizing adjustments of base period rent which do not reflect market conditions in order to provide a level that reflects market conditions and provides a reasonable base period net operating income. Such adjustments are known as “Vega” adjustments, because the right to such adjustments was established in the case of *Vega v. West Hollywood*.¹⁸

The *Vega* case involved an apartment owner who charged rents that ranged from \$70 to \$180 per month, compared to a city average which was three times higher. The rents of several units had not been raised in 15 to 20 years and the tenants had taken over responsibility for maintaining the property, from the 84 year old owner. The Court held the peculiar circumstances in this case, in addition to low base period rents, justified a base period rent adjustment.

The entitlement to an increase in the base rent depends on the existence of circumstances that prevented the base rent from reflecting market conditions.”¹⁹ Subsequent to *Vega*, an appellate court rejected the view that owners had a general entitlement to adjust base date rents which were below market rents and ruled that:

Respondents' position that "Birkenfeld and Vega establish a constitutional standard of general application to all historically low rent properties without exception" is not supported by the opinions in those cases, and we hold that there is no general entitlement to an increase in base date rents predicated on market conditions.²⁰

In the context of mobilehome park space rent controls the historically low rent issue was considered in *Concord Communities v. City of Concord*,²¹ in 2001. In that case the Court found a recent purchaser of the park met the “unique and extraordinary circumstances” test set forth in *Vega* based on the following facts:

¹⁸ 223 Cal.App.3d 1342 (1990); also, see *Concord Communities v. City of Concord*, 91 Cal. App.4th 1407 (2001)

¹⁹ 24 Cal. App.4th 1730, 1737

²⁰ *Apartment Association of Greater Los Angeles v. Santa Monica Rent Control Board* [AGLA] 24 Cal. App.4th 1730, 1737.(1994)

²¹ 91 Cal. App.4th 1407 (2001)

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- 1) the applicant was locked into below market rents set by the prior owner, who had “not raised rents in a consequential manner since 1985”,
- 2) the current owner entered into a purchase contract just before the city adopted a rent regulation and
- 3) the current owner was not favored by particularly low property taxes of the previous owner.²²

D. Fair Rate of Return on Investment Standard

A second type of fair return standard is a rate of return on investment (ROI) standard. From an intuitive perspective a rate of return of investment standard is often viewed as very logical. Furthermore, Richmond’s ordinance includes a provision stating that one of its purposes is to provide a fair “return on investment.” (Sec. 11.100.070 (g)(8)). This type of provision is common among rent stabilization ordinances. Sometimes it has sometimes been viewed as commanding the use of a rate of return on investment formula; however, usually this view has not been adopted.

a. Description of Standard

In the context of rent regulations, the most common rate of return on investment formula has been:

FAIR RENT = OPERATING EXPENSES + X% of INVESTMENT

The allowable rent depends on what rate of return is considered fair. The following examples illustrate the outcomes under a 6% and a 9% rate of return on investment standard.

(Table 2)

**Variations in Outcomes under Rate of Return on Investment Standard
Depending on What Rate is Deemed Fair
(Hypothetical Investment - \$1.2 million)**

OPERATING EXPENSES		X% OF INVESTMENT (fair net operating income)		FAIR RENT
\$70,000	+	\$72,000 (6% of \$1,200,000)	=	\$142,000
Or				
\$70,000	+	\$108,000 (9% of \$1,200,000)	=	\$178,000

²² *Id.*, 91 Cal. App.4th at 1417-1419.

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Investment is defined as the total investment (purchase price + improvements) rather than only as the cash investment (total investment minus mortgage borrowing). The return is the net operating income (income before mortgage payments), rather than only the cash flow (net operating income left after mortgage payments).²³ The fair net operating income is a net operating income which is a designated percentage of the total investment.

b. Use of Fair Rate of Return Standard in other jurisdictions

None of the California jurisdictions with apartment rent regulations use the “rate of return on investment” standard. However, this type of standard has been used in making fair return determinations in some mobilehome park rent stabilization fair return cases.

c. Comment on the Fair Rate of Return on Investment Standard

i. Circularity Issues

Rate of return on investment is commonly used as a measure of return by real estate analysts in evaluating real estate investments. and is based on the commonly accepted concept that investors should always be permitted a fair rate of return on their investments. However, in the context of a fair return determination under a rent regulation, the use of a fair rate of return on investment standard in rent regulation works in a **circular** manner.

In the market place, investment is determined by the expected returns. However, if the allowable returns in a rent-regulated environment are set at designated percentage of the amount invested in a property, the process of determining what is a fair return becomes circular. Under this type of standard, the investment (and, therefore, the investor) determines what return and, therefore, what rents will be fair.

A leading utility text identifies potential drawbacks using the investment (purchase price or “transfer cost”) as the measure of investment in order to calculate fair return, in the context of a rent regulation.

Transfer cost does not represent a contribution of capital to public service. Instead, it represents a mere purchase by the present company of

²³ In some jurisdictions a fair return on cash investment (as opposed to total investment) standard has been used. However, such standards discriminate among owners based on their financing arrangements. In three cases, a California Court of Appeal has ruled that consideration of debt service in a rent setting standard has no rational basis. *Palomar Mobilehome Park Ass’n v. Mobile Home Rent Review Commission* [San Marcos], 16 Cal.App.4th 481, 488 (1993) and *Westwinds Mobilehome Park v. Mobilehome Park Rental Review Board* [Escondido], 30 Cal.App.4th 84, 94 (1994), *Colony Cove v. City of Carson*, 220 Cal.App.4th 840, 871 (2013).

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whatever legal interests in the properties were possessed by the vendor. Even under an original-cost standard of rate control, investors are not compensated for buying utility enterprises from their previous owners any more than they are compensated for the prices at which they may have bought public utility securities on the stock market. Instead, they are compensated for devoting capital to public service. ...

The unfairness, not to say the absurdity, of a uniform rule permitting a transferee of a utility plant to claim his purchase price was noted by Judge Learned Hand ...

The builder who does not sell is confined for his base to his original cost; he who sells can assure the buyer that he may use as a base whatever he pays in good faith. If the builder can persuade the buyer to pay more than the original cost the difference becomes part of the base and the public must pay rates computed upon the excess. Surely this is a most undesirable distinction. (*Niagara Falls Power Company v. Federal Power Commission*, 1943 ...) ²⁴

This reasoning has not been generally applied in rent control cases. However, federal courts in New York have concluded the return on investment approach does not make sense in the context of land use controls and rent regulation, noting how, the "regulated" investor can, in fact, regulate the allowable return under the rate of return on investment approach by determining the size of the investment. In a zoning case, the Court held:

In addition to being inconsistent with the case law, appellants' [return on investment] approach could lead to unfair results. For example, a focus on reasonable return would distinguish between property owners on the amount of their investments in similar properties (assuming an equal restriction upon the properties under the regulations) favoring those who paid more over those who paid less for their investments. Moreover in certain circumstances, appellants theory "would merely encourage property owners to transfer their property each time its value rose, in order to secure ... that appreciation which could otherwise be taken by the government without compensation..." [cites omitted] ²⁵

While the California courts have not held that a rate of return on investment standard may not be used they have noted the practical limitations of the rate of return on investment approach In the *Fisher* case, the California Supreme Court

²⁴ Bonbright, Danielson, and Kamerschen, *Principles of Public Utility Rates*, 240-241 (1988, Arlington, Virginia, Public Utilities Reports, Inc.)

²⁵ *Park Avenue Tower Associates v. City of New York*, 746 F.2d. 135, 140 (1984).

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noted that the “mechanical” application of a return on investment standard could produce “confiscatory results in some ...cases” and alternatively in other cases could provide for “windfall” returns for recent investors, who paid high prices:

At the same time that mechanical application of the fair return on investment standard may have the potential to produce confiscatory results in some individual cases [cites omitted] it is also recognized that the that standard has the potential for awarding windfall returns to recent investors whose purchase prices and interest rates are high. If the latter aspect were unregulated, use of the investment standard might defeat the purpose of rent price regulation.²⁶

Sometimes a “prudent” investor standard is used to try to rectify the shortcomings of a rate of return on investment standard by limiting what size investments will be considered in measuring what net operating income would be fair. However, under this the results become circular, especially if the investment may be considered “prudent” only if the current rents are already adequate to generate a return that would be considered fair.

Subsequent to the *Fisher* opinion, one Court of Appeal concluded that evaluation of a claim that a purchase cost may be viewed as high (imprudent) presents a “Catch-22.” situation. The Court explained:

... it is a “Catch-22” argument. It posits that a prudent investor will purchase only rent-controlled property for a price which provides a fair rate of return at the then-current (i.e. frozen) rental rates. Having done so, however, the fair market value is frozen ad infinitum because no one should pay more than the frozen rental rate permits; and existing rental rates are likewise frozen, since the investor is already realizing a “fair rate of return”.²⁷

The foregoing judicial responses to the issues associated with rate of return on investment standards reflect the outcomes of two sides of a circular concept. On the one hand, there is the view that rate of return on investment standards should not provide windfall returns to recent investors who paid high prices. On the other hand, if a “prudent” investment concept is adopted, an investment may be considered imprudent if the current rents do not yield a fair return on that investment.

ii. Subjectivity in Measuring Fair Rate of Return under a Rate of Return on Investment Standard

²⁶ 37 Cal.3d. 644, 691 (1984)

²⁷ *Westwinds Mobile Home Park v. City of Escondido*, (1994), 30 Cal.App.4th. 84, 93-94.

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Apart from the circularity issues associated with the use of a rate of return on investment standard, the determination of an appropriate rate presents substantial problems.

In fact, rates of return vary substantially among properties, especially in times of significant inflation in property values. Therefore, the net operating income (and, consequently the rent) that will yield a fair return on an investment made decades ago might be a fraction of the rent required to provide the same rate of return on the investment of a recent purchaser.

Varying theories and/or statistical constructions” about how to compute what is a “fair rate” can lead to widely differing outcomes. One commentary, in a textbook on utility rate regulation, even characterizes expert presentations on which particular rate is as “witches brews of statistical elaboration and manipulation”:

“... as we begin sheer disgust to move away from the debacle of valuation, we will probably substitute a new form of Roman holiday – long-drawn-out, costly, confusing, expert contrived presentations, in which the simple directions of the *Hope* and *Bluefield* cases are turned into veritable witches’ brews of statistical elaboration and manipulation.²⁸

In mobilehome park rent stabilization fair return cases, expert witness’ projections of a fair rate of return have ranged from 4% to 12% (and even higher). Typically, in recent years, experts on behalf of mobilehome park owners have testified that a rate of return of about 9% is fair, while experts on behalf of cities and/or residents have contended that a fair rate is equal to the prevailing capitalization rate, now about 5 to 6%.²⁹ Adjudicators’ (retired judges acting as arbitrators, rent commissions, trial courts, and appellate courts) conclusions about what rate is fair have ranged from 5% to 9%.

When rate of return on investment standards are used, a host of options appear for measuring the investment and for the determination of a reasonable rate of return. In an adjudicatory process the fair return determination can turn into a mix and match process, in which alternate measures of investment and of a fair rate are “juggled” in order to obtain a desired result.

²⁸ Shepard and Gies, *Utility Regulation, New Directions in Theory and Policy*, 242-243 (1966, New York, Random House)

²⁹ The prevailing capitalization rate is the net operating income/purchase price rate that new purchasers are obtaining at the outset of their investments. When the purchase price is inflation adjusted in the fair return analysis the fair return also becomes inflation adjusted.

iii. Issues Associated Measuring the Investment (The Rate Base)

The selection of a rate base raises another set of issues. Large variations in the outcome of a fair return calculation result from alternate choices in regard to the measure of the investment (rate base). Whether the original investment should be used as a rate base or whether that investment costs should be adjusted for inflation has been debated. Typically, long-term owners have investments that are low by current standards, while recent purchase prices have low rates of return relative to their investment. In periods of inflation in the prices of real property, the fair return becomes a function of the length of ownership. As a result, the rate of return on investments in apartment buildings with comparable rents and operating costs will vary substantially based on the purchase date of the building.

Some courts have held the investment should be inflation adjusted to reflect the real amount of the investment in current dollars. In *Cotati Alliance for Better Housing v. City of Cotati*, the court concluded that Cotati's return on investment standard was not confiscatory because "[t]he landlord who purchased property years ago with pre-inflation dollars is not limited to a return on the actual dollars invested; the Board may equate the original investment with current dollar values and assure a fair return accordingly."³⁰ Commonly, if not usually, when rate of return on investment standards are used, the rent setting body has adjusted the original investment by inflation.

However, in other instances California courts have upheld the use of a standard under which investment was calculated in a manner virtually opposite to adjusting the original investment by inflation. Instead they have upheld "...taking the price paid for the property and deducting accumulated depreciation to arrive at a net historic value" See e.g. *Palomar Mobilehome Park Assn. v. Mobile Home Rent Review Com.* (1993), 16 Cal.App.4th 481, 487, the Court reasoned:

[The park owner] argues that "historic cost" approach effectively transfers to tenants the use of \$11 million in assets (the difference between the historic cost of the property and its current value) free of charge. It is true that in calculating a "fair" return, the City's proffered formula does not give park owners credit for any appreciation in the value of their property. Yet this is true any time a "fair return on investment" approach is used in lieu of a "fair return on value" formula. As we have explained ... both the United States and California Supreme Courts have approved the "investment" approach as constitutionally permissible. We are in no position to hold to the contrary by accepting Palomar's value-based test as a constitutional minimum. (*Id.* 16 Cal.App. 4th at 488)

³⁰ 148 Cal.App.3d. 280, 289 (1983)

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iv. Outcomes under Alternate Variations of the Rate of Return on Investment Standards

The table on the following page illustrates how the wide range of possible rate bases and fair rates can lead to vastly diverging results under a rate of return on investment formula.

(Table 5)

**Alternate Outcomes under Rate of Return on Investment Standard
(Investment x Fair Rate = Fair Net Operating Income)**

Investment (Rate Base)	Fair Rate	Fair Net Operating Income* (fair rate x investment)
\$2,000,000 original investment (e.g. 40 apartments x \$50,000 / apartment unit)	5% capitalization rate (prevailing noi/purchase price ratio purchases in 2016)	\$100,000
	7%	\$140,000
	9%	\$180,000
\$1,200,000 original investment minus depreciation of improvements	5%	\$60,000
	7%	\$84,000
	9%	\$108,000
\$4,000,000 original investment adjusted by CPI	5%	\$200,000
	7%	\$280,000
	9%	\$360,000

* Allowable rent = fair net operating income + operating expenses

Even if the original investment is inflation adjusted (adjusted by the percentage increase in the CPI since the purchase date), the outcome under a rate of return on investment standard depends heavily on whether an apartment owner purchased during an upward or downward cycle in real estate values. An owner who paid the same price for a property in 2010 (at the end of a flat cycle in apartment values) as an owner paid in 2000 (at the end of a surge in values) is permitted a much lower rent under standard, because the period of inflation used to adjust the purchase price is much shorter.

v. An MNOI Standard Provides a Fair Return on Investment by Providing the Net Operating income that the Property Yielded in the Base Year

The use of an MNOI fair return standard in the implementation of ordinances which contain the term “fair return on investment” has been standard.

While an MNOI standard does not incorporate the amount of an owner’s investment into a fair return calculation, it can be viewed as providing a fair return in the sense that it provides the return (net operating income) that the property yielded prior to rent regulation. As noted a California Court of Appeal held that the MNOI standard provides a fair return on investment.

E. A Standard Providing for Rent Adjustments Based on Increases in Operating Expenses over the Prior Year

A third methodology for setting allowable rents pursuant to individual rent adjustments provides for rent increases to cover operating cost increases since the prior year, which are not covered by the allowable annual rent increase. This type of standard is in effect under San Francisco and Oakland rent regulations. San Jose used this type of standard until it was replaced by an MNOI standard in 2017.

Under San Francisco’s standard, rent increases above the amount authorized by the annual increase, which are based on operating cost increases, are limited to seven percent.³¹ In the past four years, the number of petitions pursuant to this standard has ranged from 43 to 70.³²

A concern about this type of standard is that substantial variations in annual maintenance expenses can be typical. This type of standard enables apartment owners to obtain increases due to unusually high operating expenses in a particular year or may reward intentional bunching of maintenance expenses which do not recur annually into a particular year. In any case, as a result, this standard can provide for rent increases which cover a surge in operating expenses and allow for increases that are more than adequate in the following years when the operating expenses return to normal levels.

In contrast under the MNOI standard if claimed expenses for a particular year are unusually high, typically they will be adjusted or particular unusual expenses will be amortized.

³¹ S.F.Residential Rent Stabilization and Arbitration Board Rules and Regulations, Sec. 6.10

³² See Rent Board, Annual Report 2015-2016, p. 11. San Jose’s experience with this type of standard is not “instructive” because it allowed annual rent increases of 8% from the 1982 through 2015.

F. The Exclusion of Debt Service Costs in Fair Return Standards

The Richmond ordinance is silent on whether or not debt service costs should be considered.

Eight of the eleven apartment rent control ordinances in California (Los Angeles, San Jose, Oakland, Berkeley, Santa Monica, West Hollywood, East Palo Alto, and Mountain View) specifically **exclude** consideration of debt service in setting allowable rent levels, (except when the debt service is associated with capital improvements).

(Table 6)
**Treatment of Purchase Mortgage Interest Expenses
Under Apartment Rent Stabilization Ordinances**

<i>Jurisdiction</i>	<i>Consideration of Purchase Mortgage Interest Expenses</i>	<i>Limitations on Allowance of Debt Service Expenses</i>
Los Angeles	Excluded	
Oakland		Debt service pass-through repealed on April 1, 2014. Pre-repeal purchasers exempted from repeal.
Berkeley		
Santa Monica		
West Hollywood		
Mountain View		
East Palo Alto		
Beverly Hills		
San Jose		

Most of the MNOI standards in mobilehome park rent stabilization ordinances preclude consideration of debt service. Also, consideration of debt service is usually excluded under rate of return on investment standards- because fair return is measured by the return on the total investment, rather than just the cash portion of the investment. (Consistent with using this measure of return, the rate base for measuring the return is the total investment, and the calculation of the return is based on consideration of the whole return, rather than return net of mortgage interest payments.)

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Under the San Francisco, Los Gatos, and Hayward ordinances, increases in debt service may be passed through. However, under the San Francisco ordinance, increases based on debt service increases are limited to 7% and in buildings with six or more units are allowed only once every five years.

Rationale for Exclusion of Consideration of Debt Service

If debt service is considered, owners who make equal investments in terms of purchase price and have equal operating expenses, may be entitled to differing rents depending on differences in the size of their mortgages and/or the terms of their financing arrangements.

Passing through increases in debt service, apart from other allowable rent increases, sets the allowable rent at a level that both:

- 1) provides for reimbursement for the financed cost of purchasing a building, and
- 2) provides the allowable rent increases that would otherwise provide a fair return by providing for increases in net operating income which can be used to finance increasing debt service.

Judicial Precedent Regarding Consideration of Debt Service in Fair Return Cases

The legal precedent, expands on the rationale for the standard policy of excluding consideration of debt service in calculating fair return.

As indicated, Courts have held there is no rational basis for consideration of debt service in a rent setting process.³³ Once court explained:

“Assume two identical parks both purchased at the same time for \$1 million each. Park A is purchased for cash; Park B is heavily financed. Under Palomar's approach, calculating return based on total historic cost and treating interest payments as typical business expenses would mean that Park A would show a considerably higher operating income than Park B. Assuming a constant rate of return, the owners of Park B would be entitled to charge higher rents than the owners of Park A. We see no reason why this should be the case.”³⁴

³³ *Palomar Mobilehome Park Ass'n v. Mobile Home Rent Review Commission* [of San Marcos], 16 Cal.App. 4th 481, 488 (1993);

³⁴ *Id.*, at 489.

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The same Court of Appeal reaffirmed its conclusion regarding the treatment of debt service expenses. “We have previously rejected the notion that permissible rental rates based on a fair rate of return can vary depending solely on the fortuity of how the acquisition was financed.”³⁵ More recently, another Court of Appeal again affirmed the view that tying rents to individual owners’ financing arrangements has no rational basis.

Apart from the inequities that would result from permitting a party who financed its purchase of rent-controlled property to obtain higher rents than a party who paid all cash, there are additional reasons for disregarding debt service. ...debt service arrangements could easily be manipulated for the purpose of obtaining larger rent increases, by applying for an increase based on servicing a high interest loan and then refinancing at a lower interest rate or paying off the loan after the increase was granted. Alternatively, an owner might periodically tap the equity in a valuable piece of rental property, thus increasing the debt load. In any event, we discern no rational basis for tying rents to the vagaries of individual owners' financing arrangements.³⁶

However, in an earlier case, one Court of Appeal held that consideration of debt service costs was required when it held that mobilehome park owners have a vested right to have their debt service considered if debt service was specifically allowed as an expense under the fair return standard in effect under an ordinance at the time the property was purchased.³⁷ In that case, The Court concluded the guidelines in effect when the mobilehome park was purchased created vested rights. In 1991, the same court reaffirmed this conclusion.³⁸

III. RECOMMENDATION

As stated above, it is recommended that the Rent Board regulations that include a specific fair return standard. A fair return standard provides guidance not only to the hearing officer but also to the parties impacted by the Ordinance and provides an objective methodology for consistent decisions.

Furthermore, the adoption of a maintenance of net operating income (MNOI) standard is recommended. The standard guarantees a right to rent increases which cover

³⁵ *Westwinds Mobile Home Park v. Mobilehome Park Rental Review Bd.*, 30 Cal.App.4th 84, 94 (1994)

³⁶ *Colony Cove Properties v. City of Carson*, 220 Cal.App. 840,871 (2013). Courts in other states have reached similar conclusions. In 1978, when considering the constitutionality of an apartment rent control ordinance, the New Jersey Supreme concluded that: “Similarly circumstanced landlords ... must be treated alike. Discrimination based upon the age of mortgages serves no legitimate purpose.” *Helmsley v. Borough of Fort Lee*, 394 A.2d. 65, 80-81 (1978).

³⁷ *Palacio de Anza v. Palm Springs Rent Review Com.*, 209 Cal.App.3d. 116 (1989)

³⁸ *El Dorado Palm Springs, Ltd.v. Rent Review Com.*, 230 Cal.App.3d. 335 (1991)

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operating cost increases and provide for growth in net operating income over a base year. The standard has been approved in principle by the courts and in challenges to individual decisions applying the standard, its use has been consistently upheld.

In contrast, a rate of return standard would lead to a situation in which rent regulations could be overridden with investments which are not justified by the current rents. While the courts have not rejected a rate of return on investment standard in principle, courts have repeatedly qualified the scope of its use (e.g. for example, by holding that there is no right to a fair return on excessive investments.) In practice rate of return hearings require the application of a particular rate, when there is no single rate that is fair and the opinions of courts and experts about what rates of fair have widely diverged.



MEMORANDUM

TO: Chair Gray and Members of the Rent Board
FROM: Kenneth Baar, Consultant
DATE: February 21, 2018
SUBJECT: FAIR RETURN REGULATIONS

I. Introduction

A central purpose of allowing individual rent adjustments based on fair return standards is to ensure that landlords can obtain a return that meets **constitutional standards** in the event that the combination of annual general adjustments and allowable vacancy rent increases do not permit a fair return.

This memo contains a discussion of the specifics of a maintenance of net operating income (MNOI) fair return standard and a draft MNOI regulation.

Under Richmond's Fair Rent, Just Cause for Eviction and Homeowner Protection ordinance owners of regulated rental units have a right to a fair return. on investment.

The Richmond Fair Rent and Homeowner Protection Ordinance states that in reviewing individual fair return petitions the Board or hearing examiner shall consider "the purposes of this chapter and shall specifically consider all relevant factors, including (but not limited to)" the following list of enumerated factors. (Section 11.100.070.(g));:

- (1) Increases or decreases in property taxes;*
- (2) Unavoidable increases or any decreases in maintenance and operating expenses;*
- (3) The cost of planned or completed capital improvements to the rental unit (as distinguished from ordinary repair, replacement and maintenance) where such capital improvements are necessary to bring the property into compliance or maintain compliance with applicable local code requirements affecting health and safety, and where such capital improvement costs are properly amortized over the life of the improvement;*
- (4) Increases or decreases in the number of tenants occupying the rental unit, living space, furniture, furnishings; equipment, or other housing services provided, or occupancy rules;*
- (5) Substantial deterioration of the controlled rental unit other than as a result of normal wear and tear;*
- (6) Failure on the part of the Landlord to provide adequate housing services, or to comply substantially*

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with applicable state rental housing laws, local housing, health and safety codes, or the rental agreement;

(7) The pattern of recent rent increases or decreases;

While the ordinance lists the foregoing factors to be considered for evaluating petitions for fair return rent adjustments, it does not set forth a specific methodology (formula) for determining what rents will permit a fair return. Consideration of these factors is subject to the qualification that upward adjustments shall be allowed only when necessary to permit a fair return. The ordinance states:

It is the intent of this chapter that individual upward adjustments in the rent ceilings on units be made only when the Landlord demonstrates that such adjustments are necessary to provide the landlord with a fair return on investment. (Sec. 11.100.070.(g)(8))

The packet for the Rent Board meeting of December 20, 2017 included a lengthy memo on alternate fair return methodologies by this author, with a recommendation to adopt a Maintenance of Net Operating Income (MNOI) standard.

At that meeting, the Board directed staff to prepare a fair return regulation with an MNOI standard.

II. Description of the MNOI Standard

Under an MNOI standard apartment owners are entitled to increases in rents over the base period rent levels which are adequate to cover increases in operating costs since the base year and provide growth in net operating income over the base year level. Mortgage interest is not considered under an MNOI standard.

The following hypothetical illustrates the operation of the MNOI standard. The Maximum Allowable Rent must be adequate to cover the increases in operating expenses of \$30,000 since the base year and provide for growth in net operating income of \$30,000 based on the increase in the CPI since the base year.

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	CPI	Gross Income	Operating Expenses	Net Operating Income	Fair Return Allowable Rent Increase
Base Year	100	\$100,000	\$40,000	\$60,000	
Current Year	150	\$150,000	\$70,000	\$80,000	
Pct. Increase Base Year to Current Year	50%	50%	75%	33%	5%
Fair NOI (Base Year NOI Adjusted by the 50% (100% of the increase in CPI))				\$90,000	
Allowable Fair Return Rent Adjustment (= Fair NOI - Current NOI) (\$90,000 - \$80,000)					\$10,000

III. Experience under MNOI Standards

To place the role of fair return rent adjustments in perspective, it is noted that in cities that have had rent controls in place since California since the early 1980's, very few fair return petitions have been filed under MNOI standards. This outcome is probably due to the fact vacancy increases over an extended period have allowed rent increases and, therefore, increases in net operating income, which have exceeded the rate of increase in the Consumer Price Index (CPI). In the case of newly adopted ordinances with a recent base year, the impact of vacancy increases would be more limited, since the proportion of units that have had vacancies since the base year would be much lower

MNOI standards have been commonly used as a fair return standard under rent controls since the 1980's.

IV. Proposed MNOI Standard – Description and Discussion of Issues

The proposed standard is largely modeled on a composite of standards that have been in effect for decades. It includes:

- 1) A definition of fair return – base year net operating income (NOI) adjusted by a CPI factor,
- 2) A methodology for determining rental income,
- 3) A list of allowable and excluded operating expenses for the purposes of calculating net operating income,
- 4) A standard for including capital improvements and other non-recurring costs as amortized operating expenses,
- 5) An interest allowance for the amortized cost of capital improvements and other non-recurring expenses that are amortized.
- 6) Standards for the adjustment of the base year net operating income for the purposes of the MNOI analysis on the basis of exceptional situations. (A principal ground is disproportionately low rents in the base year.)

The ordinance sets forth a base date of July 21, 2015 for setting rents pursuant to the Annual General Adjustment Standard. (Section 11.100.070 (a).

A. Selection of a Base Year

Under an MNOI standard it is necessary to establish a base year for the purposes of calculating a base year net operating income. The Rent Board has discretion in setting the base year under the fair return standard.

There are alternate rationales for choosing 2014 or 2015 as a base year. 2014 could be considered as the last full year in which rents were set in the absence of regulation or the pending adoption of regulation. The use of 2015 as the base year would incorporate vacancy increases that were implemented prior to the actual effective date of rent control ordinance. If 2015 is set as the base year, rent levels would reflect the fact that some landlords may have known about an impending new rent control law and taken vacancy rent increases between July 21, 2015 and December 30, 2016.

In February 2015, the City Council directed staff to prepare a draft rent control ordinance. An ordinance was adopted in August 2015; however, the Council repealed the ordinance before it went into effect in response to petition compelling the Council to reconsider the enactment. Subsequently, an initiative measure was placed on the ballot. That measure was adopted in November 2016 and went into effect in December 2016.

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In the case of newly purchased properties, landlords may not have base period income and expense data. However, if new purchasers were able to use a base period that was later than the base period for other landlords because they did not have base year information, they would be able to incorporate vacancy increases into their base rent which occurred subsequent to the base year. In contrast pre-base year purchasers would not be able to incorporate these increases into their base rent.

In the case of properties purchased subsequent to the adoption of an MNOI standard, if the base year is later than the purchase, base year NOI could be inflated by minimizing operating expenses in the base year.

Purchasers subsequent to the adoption of an MNOI standard may be considered to be on notice that base year information would be required in order to make a fair return application.

A. Establishing Base Year Operating Expenses in the Absence of Data

MNOI standards usually provide for a method for projecting base year operating expenses in the event that the landlord does not have base year operating expense information. A reasonable presumption is that operating expenses increased by the percentage increase in the CPI since the base year. The proposed regulation includes this presumption and sets forth the principle that projections about increases for particular expenses may be modified based on evidence (e.g. information about increases in property taxes based on Proposition 13, information about utility costs based on rate trends, and/or changes in the level of services.)

B. Inflation Based Adjustment of Base Year Net Operating Income (“Indexing”) in Order to Provide a Fair Return

Fair return standards provide for varying rates of “indexing” net operating income in order to provide a fair return.

Under the Los Angeles, San Jose, and Oakland standards a fair net operating income is equal to the base year net operating income adjusted by 100% of the percentage increase in the CPI since the base year.¹ Santa Monica fair return regulations provide for indexing by 40% of the percentage increase in the CPI; West Hollywood provides for 60% indexing; and Berkeley provides for 65% indexing.²

The courts have held that freezing net operating income is confiscatory, but on three occasions have *specifically rejected* the view that 100% indexing is required and upheld standards which provided for indexing net operating income by 40% or 50% of the percentage increase in the

¹ Los Angeles Rent Stabilization, Just and Reasonable Guidelines, Sec. 242; Oakland, _____, San Jose Muni. Code, Sec. 17.23.810.

² Santa Monica Rent Control Board, Regulations; Sec. 4106; Berkeley Rent Stabilization Board Regulations Sec. 1264, West Hollywood Municipal Code Sec. 17.44.030 (h).

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CPI.³ In 2001, in *Galland v. Clovis*, the State Supreme Court held that the concept of “fair rate of return” is a legal term that refers to a “**constitutional minimum.**”⁴

While a limitation of indexing to less than 100% of the percentage increase in the CPI provides for growth in net operating income at less than the rate of increase in the CPI, under the typical circumstance, of an apartment purchase financed by a mortgage, cash flow will increase at a greater rate than the CPI. On the other hand, 100% indexing will still provide protection against unreasonable rent increases.

In the past three decades the differences between 100% indexing and for example 65% indexing have been in the range of one percent a year or less since the rate of increase in the CPI has usually been 3% or less. Differences in indexing rates have a greater impact over a longer period when the cumulative increases in the CPI between the base year and the current year are more substantial. **MNOI increases based on 100% indexing may be higher over a longer period, but over a longer period fewer landlords may qualify for MNOI increases due to vacancy rent increases.** *The following table demonstrates the differences in potential increases using 100%,75% and 50% indexing of CPI.*

³ See *Berger v. City of Escondido*, 127 Cal. App. 4th 14-15 (2005); *Stardust v. Ventura*, 147 Cal. App.4th 1170, 1181-82 (2007); *Colony Cove Properties v. City of Carson*, 220 Cal. App.4th 840, 876-877 (2013). These cases involved mobilehome park space rent regulations. However, the judicial doctrine regarding a constitutional fair return is the same for regulations of apartments and mobilehome park space rents. Typically an appellate court opinion on fair return issues will cite cases involving both types of regulations.

⁴ 24 Cal.4th 1004, 1026 (2001)

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Illustration of MNOI Standard Alternate "Indexing" Ratios

	CPI	Gross Income	Operating Expenses	Net Operating Income	
Base Year	100	\$100,000	\$40,000	\$60,000	
Current Year	150	\$150,000	\$70,000	\$80,000	
Pct. Increase Base Year to Current Year	50%	50%	75%	33%	
				Fair Net Operating Income	Fair Return Allowable Rent Increase
Base Year NOI Adjusted by 25% (50% of the 50% increase in CPI)				\$75,000	None
(Base Year NOI Adjusted by 37.5% (75% of the 50% increase in CPI)				82,500	\$2,500
(Base Year NOI Adjusted by 50% (100% of the 50% increase in CPI)				\$90,000	\$10,000

C. Allowance for Amortized Cost of Capital Improvements

The proposed MNOI standard for Richmond provides for the inclusion of the amortized costs of capital improvements as an operating expense. Rent Boards have usually adopted their own amortization schedules for capital improvements which have a detailed breakdown of types of capital improvements, with amortization periods ranging from 5 to 20 years. These schedules are in contrast to the IRS depreciation schedule which has a few broad categories and provides for a 27.5 year amortization period for structural improvements.

Attachment A of this memo includes the amortization schedule of the Santa Monica Rent Control Board amortization schedule and the IRS depreciation allowance schedule.

Interest Allowance for Amortized Costs

The proposed interest allowance for amortized costs is uniform for all fair return increase adjustments rather than being based on the actual financing arrangements of the landlord. The rationale is that the all landlords should be provided with the same size rent increases for the same costs and capital improvements regardless of differences in their financing arrangements and/or whether the landlord used cash rather than financing to cover the costs. In three cases, the Court of Appeal has held that differences in allowable rent increases based on an owner's individual financing arrangements has no rational basis.⁵

The amount of the proposed interest allowance is tied to a prime mortgage rate index plus two points at the time the application is filed. This index is recommended because it is most closely tied to the cost of borrowing capital for real estate investments. More commonly, under fair return regulations the allowable interest rate is tied to the prime interest rate for borrowing.

On the following page is a hypothetical amortization with varying capital improvement amortization periods and interest rates, with explanations about how these varying amortization periods and interest rates would actually impact monthly rent increases.

⁵ *Westwinds Mobile Home Park v. Mobilehome Park Rental Review Bd.*, 30 Cal.App.4th 84, 94 (1994); *Westwinds Mobile Home Park v. Mobilehome Park Rental Review Bd.*, 30 Cal.App.4th 84, 94 (1994); *Colony Cove Properties v. City of Carson*, 220 Cal.App. 840,871 (2013)

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Monthly Amortized Costs

Hypothetical Showing Impacts of Varying Amortization Periods and Interest Rates

The hypothetical below sets forth the monthly payments under alternate amortization standards with varying amortization periods and interest rates for a capital improvement that costs \$5,000 per unit.

To place the hypothetical in perspective, a few observations are noted:

1. Ten years after a fair return increase is permitted, only a small portion of units would be subject to the decision, and therefore, any rent allowances for capital improvements since they would become subject to vacancy decontrol during this period.
2. Improvements with longer amortization periods are more likely to have higher costs per unit.
3. The difference between the monthly allowances for 20 and 27.5 year amortization periods are not substantial.
4. The differences based on one or two percent differences in interest rates are not substantial.

AMORTIZED COST TABLE								
Units in Bldg	10							
Cost	Annual Interest Rate	Amortization Period Years	Amortization Period Months	Total Principal & Interest Life of Improvement	Total Interest Life of Improvement	Monthly Amortized Cost	Annual Amortized Cost	Monthly Cost Per Unit
Varying Amortization Periods - Same Interest Rate								
\$50,000.00	7.00%	5	60	\$59,403.60	\$9,403.60	\$990.06	11880.72	\$99.01
\$50,000.00	7.00%	7	84	\$63,389.26	\$13,389.26	\$754.63	9055.61	\$75.46
\$50,000.00	7.00%	10	120	\$69,665.09	\$19,665.09	\$580.54	6966.51	\$58.05
\$50,000.00	7.00%	15	180	\$80,894.54	\$30,894.54	\$449.41	5392.97	\$44.94
\$50,000.00	7.00%	20	240	\$93,035.87	\$43,035.87	\$387.65	4651.79	\$38.76
\$50,000.00	7.00%	25	300	\$106,016.88	\$56,016.88	\$353.39	4240.68	\$35.34
\$50,000.00	7.00%	28	330	\$112,796.57	\$62,796.57	\$341.81	4101.69	\$34.18
Same Amortization Period & Varying Interest Rates								
\$50,000.00	5.0%	15	180	\$71,171.43	\$21,171.43	\$395.40	4744.76	\$39.54
\$50,000.00	6.0%	15	180	\$75,947.11	\$25,947.11	\$421.93	5063.14	\$42.19
\$50,000.00	7.0%	15	180	\$80,894.54	\$30,894.54	\$449.41	5392.97	\$44.94
\$50,000.00	8.0%	15	180	\$86,008.69	\$36,008.69	\$477.83	5733.91	\$47.78
\$50,000.00	9.0%	15	180	\$91,283.99	\$41,283.99	\$507.13	6085.60	\$50.71
\$50,000.00	10.0%	15	180	\$96,714.46	\$46,714.46	\$537.30	6447.63	\$53.73

D. Adjustments of Exceptional Expense Levels

Commonly fair return petitions include one or more categories of exceptional operating expense levels for the current year.

If exceptional operating expense levels are incorporated into a fair return determination, they justify a rent level that will be higher than the level required to permit a fair return in future years when the level of operating expenses returns to its recurring level.

The proposed regulation authorizes adjustments of exceptional expense levels, based on prior year's expense levels, industry standards, and standards of reasonability.

E. Projections of Operating Expenses in the Absence of Actual Data

Under IRS regulations income property owners are required to maintain income and expense records for at least three years after a return is filed.⁶ The adoption of an MNOI standard provides notice that base year income and operating expenses data is required in order to submit a fair return petition.

MNOI standards commonly include provisions for making projections of base year operating expenses if an owner does not have records of actual expenses. Typically, they provide for presumptions about the percentage increase in operating expenses between the base year and the current year. The proposed regulation includes such provisions.

F. Ceilings on Amount of Rent Increases within a Year

Fair return regulations commonly place a ceiling on the amount of a rent increase that can be imposed in a single year in order to avoid rent shock for tenants. When a landlord is required to phase-in the rent increases required to provide a fair return, the landlord is also entitled to interest on the portion of the fair return increase that is delayed because the increase is phased-in.

Santa Monica places a limit of the greater of 12% or \$50 on the amount of an annual increase for units occupied by low-income tenants.⁷ Berkeley places a cap on the allowable increase equal which is adjusted each year by the percentage increase in the CPI. The ceiling on the cap is equal to the greater of \$94.22 or 15% of the rent up to a ceiling of \$141.33.⁸ It's ceiling on allowable increases within a single year *only applies to rent increases based on historically low rents.*⁹ West Hollywood limits the allowable increase based on fair return to 12% in the first year and 12% in the second year, with an interest allowance of 10% on the deferred

⁶ See IRS Publication 583, "Starting a Business and Keeping Records."

⁷ Santa Monica Reg. 4107.

⁸ Calculation provided by Berkeley Rent Stabilization Board staff.

⁹ Berkeley Regulations Sec. 1274.

portion of the increase.¹⁰

The proposed regulation is modeled after the West Hollywood regulation, except that it provides for an interest allowance tied to mortgage interest rates plus two percent, rather than a fixed rate of 10%, which is high by current standards.

G. Allowances for Legal Expenses and Costs of a Fair Return Petition

Under the proposed regulation, the reasonable costs of obtaining a fair return rent adjustment are considered as an allowable operating expense if they were necessary in order to obtain a fair return. If no increase is permitted the expense would not be considered and if the expense is not reasonable, only a reasonable portion would be allowed.

State law provides that such expenses are an allowable expense if vacancy decontrol is not in effect.¹¹ In *Galland v. Clovis*, the California Supreme Court held that “the reasonable expenses of seeking rent increases” must be allowable.¹²

The proposed regulation also provides for the amortization of legal expenses that are not annually recurring. This type of requirement is standard and is provided for in the state law that would be applicable if vacancy decontrol were not in effect. The standard amortization period is five years.

Policy Alternatives To Be Addressed in Subsequent Memos

V. Passthroughs of Amortized Costs of Capital Improvements without Fair Return Calculation

As indicated, the proposed regulation the amortized costs of capital improvements are included as operating expenses. Such an allowance is required in order to permit a fair return. At the same time, the inclusion of the allowance for capital improvement expenses under an MNOI standard does not exclude the adoption of regulations that permit rent adjustments for capital improvements without any consideration of overall income, operating expenses, and net operating income. The issues associated with a separate allowance for capital improvements and possible incentives for particular types of capital improvements will be discussed in a separate memo.

VI. Adjustments of Historically Low Rents

Some jurisdictions have authorized rent adjustments based on historically low rents without consideration of income, operating expenses, and net operating income. The issues associated with such an allowance will be discussed in a separate memo

¹⁰ West Hollywood Municipal Code Sec. 17.44.030 (h).

¹¹ Cal. Civil Code 1947.15

¹² 24 Cal.4th 1003, 1027-28 (2001)

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Chapter 9. Standards for Individual Maximum Allowable Rent Adjustments

Please note: Regulations 901-904 and 911-912 are not contained within this document.

Such regulations are accessible at the following

link: <http://www.ci.richmond.ca.us/DocumentCenter/View/45610>.

905. Maintenance of Net Operating Income (MNOI) Fair Return Standard

A. Fair Return Standard

1. Presumption of Fair Base Year Net Operating Income. It shall be presumed that the net operating income received by the Landlord in the base year provided a Fair Return.

2. Fair Return. A Landlord has the right to obtain a net operating income equal to the base year net operating income adjusted by ___-% of the percentage increase in the Consumer Price Index (CPI), since the base year. It shall be presumed this standard provides a Fair Return.

3. Base Year.

a. For the purposes of making Fair Return determinations pursuant to this section, the calendar year _____ is the base year. The base year CPI shall be _____, unless subsection (b) is applicable.

b. In the event that a determination of the allowable Rent is made pursuant to this section, if a subsequent petition is filed, the base year shall be the year that was considered as the "current year" in the prior petition.

4. Current Year

The "current year" shall be the calendar year preceding the application. The "current year CPI" shall be the annual CPI for the current year.

5. Adjustment of Base Year Net Operating Income.

Landlords or Tenants may present evidence to rebut the presumption that the base year net operating income provided a Fair Return. Grounds for rebuttal of the presumption shall be based on at least one of the following findings:

a. **Exceptional Expenses in the Base Year.** The Landlord's operating

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expenses in the base year were unusually high or low in comparison to other years. In such instances, adjustments may be made in calculating operating expenses in order that the base year operating expenses reflect average expenses for the property over a reasonable period of time. The following factors shall be considered in making such a finding:

- i. Extraordinary amounts were expended for necessary maintenance and repairs.
- ii. Maintenance and repair expenditures were exceptionally low so as to cause inadequate maintenance or significant deterioration in the quality of services provided.
- iii. Other expenses were unreasonably high or low notwithstanding the application of prudent business practices.

b. Exceptional Circumstances in the Base Year. The gross income during the base year was disproportionately low due to exceptional circumstances. In such instances, adjustments may be made in calculating base year gross rental income consistent with the purposes of this chapter. The following factors shall be considered in making such a finding:

- i. If the gross income during the base year was lower than it might have been because some residents were charged reduced rent.
- ii. If the gross income during the base year was significantly lower than normal because of the destruction of the premises and/or temporary eviction for construction or repairs.
- iii. The pattern of rent increases in the years prior to the base year and whether those increases reflected increases in the CPI.
- iv. Base period rents were disproportionately low in comparison to the base period rents of comparable apartments in the City.
- v. Other exceptional circumstances.

6. Calculation of Net Operating Income. Net operating income shall be calculated by subtracting operating expenses from gross rental income.

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DRAFT Rent Adjustment Regulations: *Chapter 9 (Standards for Individual Maximum Allowable Rent Adjustments) Regulation 905 (Maintenance of Net Operating Income (MNOI) Fair Return Standard*

a. **Gross Rental Income.**

i. Gross rental income shall include:

Gross rents calculated as gross scheduled rental income at one hundred percent occupancy and all other income or consideration received or receivable in connection with the use or occupancy of the Rental Unit, except as provided in Subparagraph (B) of this section.

If there are vacant units at the time a petition is filed the rent shall be calculated on the basis of average rents for comparable units in the property which have had vacancy increases within the past two years. If there are no comparable units in the property rental income for the vacant units shall be calculated on the basis of rents for recently established initial rents for comparable units in the City.

ii. Gross rental income shall not include:

Utility Charges for sub-metered gas, electricity or water;

Charges for refuse disposal, sewer service, and, or other services which are either provided solely on a cost pass-through basis and/or are regulated by state or local law;

Charges for laundry services; and

Storage charges.

b. **Operating Expenses.** Operating expenses shall include the following:

i. **Reasonable costs of operation and maintenance of the Rental Unit (including property insurance).**

ii. **Management expenses.** It shall be presumed that management expenses have increased between the base year and the current year by the percentage increase in rents or the CPI, whichever is greater, unless the level of management services has either increased or decreased significantly between the base year and the current year. This presumption shall also be applied in the event that management expenses changed from owner managed to managed by a third party or vice versa

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- iii. **Utility costs** except a utility where the consideration of the income associated with the provision of the utility service is regulated by state law and consideration of the costs associated with the provision of the utility service is preempted by state law or the income associated with the provision of the utility is not considered because it is recouped from the Tenants on a cost pass-through basis..
- iv. **Real property taxes**, subject to the limitation that property taxes attributable to an assessment in a year other than the base year or current year shall not be considered in calculating base year and/or current year operating expenses.
- v. **License, registration and other public fees** required by law to the extent these expenses are not otherwise paid or reimbursed by Tenants.
- vi. **Landlord-performed labor** compensated at reasonable hourly rates. However, no Landlord-performed labor shall be included as an operating expense unless the Landlord submits documentation showing the date, time, and nature of the work performed. There shall be a maximum allowed under this provision of five percent (5%) of gross income unless the Landlord shows greater services were performed for the benefit of the residents. (HOURLY RATE PRESUMPTIONS TO BE INSERTED)
- vii. **Legal expenses.** Reasonable attorneys' fees and costs incurred in connection with successful good faith attempts to recover rents owing, successful good faith unlawful detainer actions not in derogation of applicable law, legal expenses necessarily incurred in dealings with respect to the normal operation of the Property, and reasonable costs incurred in obtaining a rent increase pursuant to Sections ___ ___ of the Ordinance.

To the extent allowable legal expenses are not annually reoccurring and are substantial they shall be amortized over a five-year period, unless the Rent Board concludes that a different period is more reasonable. At the end of the amortization period, the allowable monthly rent shall be decreased by any amount it was increased because of the application of this provision.

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- viii. **The Amortized Costs of Capital Replacements.** Operating expenses include the amortized costs of capital replacements plus an interest allowance to cover the amortization of those costs. For purposes of this section a capital improvement shall be any improvement to a unit or property which materially adds to the value of the property, appreciably prolongs its useful life or adapts it to new use and has a useful life of more than one year and a direct cost of \$250.00 or more per unit affected. Allowances for capital improvements shall be subject to the following conditions:

The costs are amortized over the period set forth in Section ___ of this regulation and in no event over a period of less than thirty-six months.

The costs do not include costs incurred to bring the Rental Unit into compliance with a provision of the Richmond Municipal Code or state law where the original installation of the improvement was not in compliance with code requirements.

At the end of the amortization period, the allowable monthly rent shall be decreased by any amount it has increased due to the application of this provision.

The amortization period shall be in conformance with the following schedule adopted by the Rent Board unless it is determined that an alternate period is justified based on the evidence presented in the hearing.

(continued on following page)

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AMORTIZED COST TABLE (EXAMPLE)

Units
in Bldg 10

Cost	Annual Interest Rate	Amortization Period Years	Amortization on Period Months	Total Principal & Interest Life of Improvement	Total Interest Life of Improvement	Monthly Amortized Cost	Annual Amortized Cost	Monthly Cost Per Unit
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Varying Amortization Periods - Same Interest Rate

\$50,000.00	7.00%	5	60	\$59,403.60	\$9,403.60	\$990.06	11880.72	\$99.01
\$50,000.00	7.00%	7	84	\$63,389.26	\$13,389.26	\$754.63	9055.61	\$75.46
\$50,000.00	7.00%	10	120	\$69,665.09	\$19,665.09	\$580.54	6966.51	\$58.05
\$50,000.00	7.00%	15	180	\$80,894.54	\$30,894.54	\$449.41	5392.97	\$44.94
\$50,000.00	7.00%	20	240	\$93,035.87	\$43,035.87	\$387.65	4651.79	\$38.76
\$50,000.00	7.00%	25	300	\$106,016.88	\$56,016.88	\$353.39	4240.68	\$35.34
\$50,000.00	7.00%	28	330	\$112,796.57	\$62,796.57	\$341.81	4101.69	\$34.18

Same Amortization Period & Varying Interest Rates

\$50,000.00	5.0%	15	180	\$71,171.43	\$21,171.43	\$395.40	4744.76	\$39.54
\$50,000.00	6.0%	15	180	\$75,947.11	\$25,947.11	\$421.93	5063.14	\$42.19
\$50,000.00	7.0%	15	180	\$80,894.54	\$30,894.54	\$449.41	5392.97	\$44.94
\$50,000.00	8.0%	15	180	\$86,008.69	\$36,008.69	\$477.83	5733.91	\$47.78
\$50,000.00	9.0%	15	180	\$91,283.99	\$41,283.99	\$507.13	6085.60	\$50.71
\$50,000.00	10.0%	15	180	\$96,714.46	\$46,714.46	\$537.30	6447.63	\$53.73

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ix. **Interest Allowance for Expenses that Are Amortized.** An interest allowance shall be allowed on the cost of amortized expenses. The allowance shall be the interest rate on the cost of the amortized expense equal to the "average rate" for thirty-year fixed rate on home mortgages plus two percent. 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. In the event that this rate is no longer published, the Rent Board shall designate by regulation an index which is most comparable to the PMMS index.

x. **Impact of Vacancy Decontrol on Rent Increases Based on Capital Improvements**

If a unit becomes vacant during the pendency of a schedule which provides for the expiration of increases for capital improvements and the unit qualifies for a vacancy increase pursuant to Civil Code section 1954.53, the capital improvements schedule shall terminate.

c. **Exclusions from Operating Expenses.** Operating expenses shall not include the following:

- i. Mortgage principal or interest payments or other debt service costs and costs of obtaining financing.
- ii. Any penalties, fees or interest assessed or awarded for violation of any provision of this chapter or of any other provision of law.
- iii. Land lease expenses.
- iv. Political contributions and payments to organizations or individuals which are substantially devoted to legislative lobbying purposes.
- v. Depreciation.
- vi. Any expenses for which the Landlord has been reimbursed by any utility rebate or discount, Security Deposit, insurance settlement, judgment for damages, settlement or any other method or device.
- vii. Unreasonable increases in expenses since the base year.

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- viii. Expenses associated with the provision of master-metered gas and electricity services.
 - ix. Expenses which are attributable to unreasonable delays in performing necessary maintenance or repair work or the failure to complete necessary replacements. (For example if a roof replacement is unreasonably delayed, the full cost of the roof replacement would be allowed; however, if interior water damage occurred as a result of the unreasonable delay
- d. **Adjustments to Operating Expenses.** Base year and/or current year operating expenses may be averaged with other expense levels for other years or amortized or adjusted by the CPI or to reflect levels that are normal for residential Rental Units or may otherwise be adjusted, in order to establish an expense amount for that item which most reasonably serves the objectives of obtaining a reasonable comparison of base year and current year expenses and providing a Fair Return. If the claimed operating expense levels are exceptionally high compared to prior expense levels and/or industry standards the Landlord shall have the burden of proof of demonstrating that they are reasonable and/or reflect recurring expense levels. Expenses which are exceptional and reasonable shall be amortized in order to achieve the objectives of this section.
- e. **Projections of Base Year Operating Expenses in the Absence of Actual Data**
- If the Landlord does not have base year operating expense data, it shall be presumed that operating expenses increased by the percentage increase in the CPI between the base year and the current year. This presumption is subject to the exception that specific operating expenses shall be adjusted by other amounts when alternate percentage adjustments are supported by a preponderance of evidence (such as data on changes in the rates of particular utilities or limitations on increases in property taxes.)

7. Allocation of Rent Increases

Rent increases authorized pursuant to this section shall be allocated as follows:

- a. Rent increases for unit-specific capital improvements shall be allocated to that unit;
- b. Rent increases for building-wide or common area capital improvements shall be allocated equally among all units;

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City of Richmond Rent Program

DRAFT Rent Adjustment Regulations: *Chapter 9 (Standards for Individual Maximum Allowable Rent Adjustments) Regulation 905 (Maintenance of Net Operating Income (MNOI) Fair Return Standard*

- c. Rent increases resulting from the Net Operating Income analysis shall be allocated equally among all units;
 - d. Notwithstanding the subsections above, the hearing examiner or the Board, in the interests of justice, shall have the discretion to apportion the rent increases in a manner and to the degree necessary to ensure fairness. Such circumstances include, but are not limited to, units that are vacant or owner occupied.
- 8. Conditional Rent Adjustments for Proposed Capital Improvements**
- a. In order to encourage necessary capital improvements, the Board allows a Landlord to petition for an upward rent adjustment based upon anticipated future expenses for capital improvements. The purpose of this procedure is to permit Landlords to seek advanced authorization for future rent adjustments based upon anticipated capital improvements. A petition under this Section should only be made for anticipated expenses that the Landlord intends to incur during the twelve month period following the date of final Board decision. This procedure should not be used for anticipated expenses for ordinary repairs and maintenance.
 - b. If the petition is granted in whole or in part, the rent increase shall be postponed until such time as the capital improvements are made and an Addendum authorizing the increases is issued.
 - c. No addendum shall be issued for such proposed capital improvements unless they are completed within twelve months from the date of final decision granting the conditional rent adjustment, unless the Landlord obtains an additional addenda authorizing an extension of the time period to complete the capital improvement. If supported by just cause such extensions shall be granted.
- 9.** Any unit which received a vacancy rent increase pursuant to Civil Code section 1954.53 within the two years prior to the Fair Return application shall be ineligible for a rent increase for the portion of any rent increased based on the cost of proposed capital improvements.

10. Relationship of Individual Rent Adjustment to Annual General Adjustment

Any Individual Increase Adjustment established pursuant to this Section shall take into account the extent of any Annual General Adjustments the Landlord may be implementing, or otherwise be entitled to, at and during the time for which the Individual Adjustment is

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sought regarding the petitioning year, and the Individual Adjustment may be limited or conditioned accordingly.

If it is determined that the Landlord is not entitled to an Individual Adjustment, the Landlord may implement the full upcoming General Adjustment.

11. Limits to Annual Rent Adjustments Based on Maintenance of Net Operating Income Standard

A. Purpose

The purpose of this subsection (A) is to protect Tenants from substantial rent increases which are not affordable, and which may force such Tenants to vacate their homes and result in consequences contrary to the stated purposes of the Ordinance, namely, to maintain the diversity of the Richmond community, to preserve the public peace, health and safety, and advance the housing policies of the City with regard to low and fixed income persons, minorities, students, handicapped and the aged.

B. Rent Increase Limit

Notwithstanding any other provision of this regulation, the implementation of a Maximum Allowable Rent increase shall be limited each year as follows:

_____ (e.g. 15%) of the Maximum Allowable Rent on the date the petition is filed, or _____ (e.g. \$150 per month), whichever is greater.

On January 1st of each year beginning in February 2018, the \$___and/or ___% limitation shall be adjusted upward by 100% of the percentage increase in the Consumer Price Index, All Urban Consumers, for the San Francisco-Oakland-San Jose metropolitan area, less its shelter component, for the twelve month period ending on the preceding June 30th, rounded to the nearest dollar.

If the amount of any rent increase granted under these regulations exceeds this limit, any portion in excess of the annual limit shall be deferred.

In subsequent years deferred amounts of the allowable rent increase may be implemented.

At the end of each year the deferred amount of the increase shall be calculated and an interest allowance shall be calculated based on the standard set forth in Section ___ of this regulation. One

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twelfth of the interest allowance shall be added on to full monthly increase authorized under the MNOI standard.

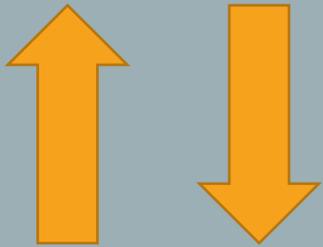
12. Constitutional Right to a Fair Return.

No provision of this regulation shall be applied so as to prohibit the Board from granting an individual rent adjustment that is demonstrated by the Landlord to be necessary to meet the requirements of this ordinance and/or constitutional Fair Return requirements.

DRAFT

City of Richmond Rent Program

SETTING STANDARDS FOR CHANGES IN THE MAXIMUM RENT



Community Workshops | December 2017



PURPOSE AND BACKGROUND



PURPOSE OF THIS WORKSHOP

- 1. Provide an overview of the reasons for filing petitions for an individual increase or decrease in the maximum rent**
- 2. Gather community feedback on specific policy options**
 - All comments and notes will be shared with subject matter experts drafting regulations**
 - The Rent Board will consider regulations governing the petition process in December 2017 and January and February 2018**

RENT REGULATION BASICS

- **The Richmond Rent Ordinance regulates the amount of rent that may be charged for a rental unit in two key ways:**
 1. **The Annual General Adjustment (Inflation, or Cost-of-Living Increase)**
 - **Equal to 100% of the change in the Consumer Price Index**
 - **2016: 3.0%**
 - **2017: 3.4%**
 2. **Individual increases or decreases in the maximum rent granted by the Rent Board Hearing Examiner during the petition process**

NOT ALL RENTAL UNITS ARE REGULATED

- The following types of properties are exempt from limits on the amount of rent that may be charged (RMC 11.100.070):
 - Single family homes (one dwelling unit on one parcel)
 - Condominiums
 - New construction (unit built after 2/1/1995)
 - Units regulated by another governmental agency (e.g. Section 8, Tax Credit units)
 - Permitted small second dwelling units
 - Tenancies where the Landlord lives and shares a kitchen or bathroom with the Tenant(s)

STANDARDS FOR MAXIMUM RENT INCREASES

INCREASE IN EXPENSES: “FAIR RETURN” BASICS

- **Owners covered by rent regulations have a constitutional right to a fair rate of return on their rental property investment.**
- **The Courts are the ultimate arbitrators of what constitutes a fair rate of return.**
- **The Courts have not required the adoption of a particular standard for determining whether or not a fair return is achieved.**
- **Since a fair return standard is not specified in the Ordinance, determining what a fair return means in the City of Richmond must be done legislatively, through regulations adopted by the Rent Board.**



INCREASE IN EXPENSES: “FAIR RETURN” BASICS ACCORDING TO THE COURTS

- In determining if a fair return has been achieved, Rent Boards must allow for growth in the Net Operating Income (NOI)

Net Operating Income = All Revenue – All Expenses (excluding debt service)

- The courts have determined that consideration of debt service has no rational basis. An owner’s individual financing scheme may not merit differences in the maximum rent that may be charged.

Philosophical question: Should a Landlord who obtained less optimal financing terms (e.g. a higher interest rate) be able to charge higher rents?

INCREASE IN EXPENSES: POSSIBLE “FAIR RETURN” STANDARDS

Fair Return Standard	Calculation	Example Cities
Maintenance of Net Operating Income (MNOI)	Fair Rent = Base Year NOI adjusted by CPI increase since base year + operating expenses	Berkeley, East Palo Alto, Santa Monica, Los Angeles, West Hollywood, Oakland*, San Jose, Beverly Hills, Mountain View
Return on Investment (ROI)	Fair Rent = Operating expenses + X% of investment	None - Board would need to determine reasonable rate of return on investment
Return on Value (ROV)	Fair Rent = Operating expenses + X% of value	Not used – Courts determined this is circular
Cost Pass-Through	Fair Rent = Prior year rent + increase in operating costs over prior year	Oakland, San Francisco



INCREASE IN EXPENSES: MNOI FAIR RETURN STANDARD

Definition of Maintenance of Net Operating Income (MNOI): The net operating income of the current year is compared to a base year, allowing for growth based on CPI and increases in operating expenses.

Example Calculation:

- A Landlord owns a four-plex. In 2015, the rent was \$1,200 in each unit.

Monthly revenue = \$1,200 x 4 units = \$4,800

Monthly expenses (30% of revenue) = \$1,440

Base Year (2015) monthly NOI = \$4,800 - \$1,440 = \$3,360



INCREASE IN EXPENSES: MNOI FAIR RETURN STANDARD (EXAMPLE CONTINUED)

- It is now the year 2020, and the Landlord's expenses have increased. The Landlord files a petition on the grounds that they are no longer able to receive a fair return since expenses have increased more than the rent pursuant to the Annual General Adjustment (*let's assume the combined AGA rent increases were 15% between 2015 and 2020.*)

New monthly revenue = \$1,380 x 4 units = \$5,520

Monthly expenses (40% of revenue) = \$2,208

Year 2020 monthly NOI = \$5,520 - \$2,208 = \$3,312

- The Hearing Examiner applies the change in the Consumer Price Index between 2015 and 2020 to the Net Operating Income and rents (*let's assume the combined change in the CPI was 15% between 2015 and 2020.*)

Permitted 2020 Net Operating Income based on 15% change in CPI = \$3,864

- The Hearing Examiner determines the rent in each unit may be increased to \$1,518, which allows the Landlord to maintain the same Net Operating Income as the Base Year, including the change in the Consumer Price Index.
- Examples: Berkeley, East Palo Alto, Santa Monica, Los Angeles, West Hollywood, San Jose, Beverly Hills, Mountain View



INCREASES IN EXPENSES: ALTERNATIVE FAIR RETURN STANDARDS USED IN RENT CONTROL CITIES

Modified MNOI: The MNOI standard is modified slightly, to allow for pass-through of cost increases over the prior year without consideration of a base year NOI

- **Examples: Oakland, San Francisco**

Some Rent Boards have not adopted one standard. Instead, they have a list of factors the Hearing Examiner can consider in making their determination.

- **Examples: Alameda, Los Gatos, Hayward**



Summary of Community Feedback from Community Workshops
12/4/2017 and 12/9/2017

Increases in Operating Expenses, Fair Return Standards

What do you think are the most important factors to consider in setting a fair return standard?

- One factor includes the high costs that Landlords must pay to improve their rental units and keep them up to code. [*Comment from one property owner: If landlords are not afforded a fair rate of return on their rental properties, in comparison to other investment areas, then inevitably Richmond will end up with more and more run-down housing stock. When the rent for an apartment is locked-in at a price much lower than the going market rent, landlords will have very little incentive to invest money in maintaining and improving their property. This causes landlords to do the bare-minimum in upkeep and spending money, which is a rational response to not receiving a fair return on investment. I would ask that you please take to heart this upspoken downside to rent control that often gets ignored.*]
- Units damaged by previous tenants are another financial burden a landlord has to face.
- Insurance costs to landlords are increasing due to the ability to not add addendum to the current lease (Tenant insurance).
- Considering mortgage payments is an important factor.
- Due to some of their rental units having large families, many Landlords have seen an increase in their utility bills.
- Property taxes have also seen a hike for many Landlords in the previous years.
- Consider the fees that Landlords must pay to conduct business in the City of Richmond (Business License, Fire Prevention, Rental Inspection, and Rental Housing fee).
- Depending on the number of units that a building has, there is a scheduled time as to when they must refinance the building.
- Consider the costs for legal services for issues with tenants.
- Landlords feel that the Annual NOI should stay above the AGI.

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2. What did you like or dislike about any of the fair return models presented?

- Landlords disliked that there was no transparent remedial courses of action regarding tenant and Landlord responsibilities for claims and actions.
- A couple of Landlords did not like the ROI model presented.
- Landlords thought the MNOI model was okay but had questions in regards to excluding the debt service and the rent rollback.
- The ROI model was also questioned and some Landlords wanted to know what exactly was the investment and if it included mortgage payments.

3. Please share any additional comments or questions in the space below:

- A question arose that if a Landlord were to create a rule requiring renter's insurance, would that be considered a "rent increase"?
- Many Landlords voiced their disapproval of the fact that tenants were allowed to add more tenants into their unit and the Landlord could not increase the rent automatically.
- The ROV model also had a few questions in regard to some of the wording used such as the meaning of "value."